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Crisis Management and Global Markets

Morris Goldstein rates the performance of the US Treasury and the Federal Reserve as crisis managers and calls for broad changes in global financial regulations to curb the contagion and prevent future turmoil.

Steve Weisman: Welcome to Peterson Perspectives. This is Steve Weisman at the Peterson Institute for International Economics. Our guest today is Morris Goldstein, senior fellow at the Peterson Institute and renowned expert on international financial crises and a longtime official at the International Monetary Fund where he was Deputy Director of research for many years.

Morris, thanks for joining us today.

Morris Goldstein: I'm delighted.

Steve Weisman: We certainly meet at a time of great crisis. The whole world is holding its breath and watching the markets in turmoil. And we've seen some extraordinary actions by the United States Treasury and the Federal Reserve working with central banks and finance ministries around the world, just in the last few days. Let's start by asking you, how you would rate the performance of the Treasury and the Fed in the last couple of weeks.

Morris Goldstein: I guess I would give them mixed marks and let me elaborate. For the Merrill-Bank of America case, I would give them very high marks because in that case, we didn't put any public money at risk. Merrill's operations were taken over by Bank of America and things will move forward.

In the Lehman case, I would also give them high marks. They chose in the end to opt for Chapter 11 bankruptcy rather than bailing out Lehman. But in that case, the crisis is seen as coming for quite a while. Lehman had been having difficulties with capital and liquidity, and it's probably too early to tell what the ultimate impact of that will be but I think that was a better decision than putting a lot of public money in.

When we turn, on the other hand, to Fannie and Freddie and to AIG, I would say that I don't give them quite as high marks. In the Fannie and Freddie case, the regulator originally said, "Well, they have plenty of capital." But it turned out of course they didn't. When you actually looked at what was in, that capital wasn't sufficient. They reduced their capital requirement because they wanted to get more activity in the mortgage market. Secretary Paulson originally said, "Well, if we had this unlimited line, we wouldn't have to use it." Well, as it turned out, he did have to take the bazooka out of his pocket.

And then but I think by picking the conservatorship rather than the receivership, there's much more uncertainty. They did penalize the shareholder, which you want to do. But ultimately you want to get to a situation with Fannie and Freddie where they support the mortgage market but eventually privatize and sell them off to smaller pieces where we don't have 'too large to fail' as such a problem. And by kicking the can down the road, I think we didn't really advance the ball as much as we could have. We should have gone for the receivership.

Now on the large insurance case, I think also that wasn't as good. If we're going to have an insurance company of that size, like AIG, that can go outside these insurance activities, these were known for a long time. And if there were systemic importance, something more should have been done to rein those in at an earlier stage and we didn't do so. In my mind, it also raises the question of whether we ought to be having state regulation for insurance companies rather than a federal regulator.

In the end, they decided they had to intervene and provide the $85-billion loan. I'm not objecting to the conditions they put on that but certainly that was a case where the risk could have been seen earlier. And also, that was a case where, if they had moved ahead and established a clearing house for over-the-counter derivatives and if we had had a resolution regime for systemically important non-banks in place, as some have suggested, including yours truly in April, then I think maybe we wouldn't had to do that.

So, given where they were at the moment, not too bad, but I would've given them higher marks if they acted earlier.

Steve Weisman: Very interesting. Of course, you've just listed the major institutions that have been caught up in this and that were resolved one way or another. But the next question I think most people have is, will this contain the contagion or is it going to spread further.

Morris Goldstein: Well, I think you know we're probably only midway through this crisis. There are various ways you can look at it to see sort of where we are. One way is to look at previous banking crises in industrial countries and large emerging markets. And if you do that, what you see is once you have one of this crises, economic growth usually stays below potential for two or three years after the onset of the crisis.

So if you say that this crisis started last summer, let's say August 2007, then we're talking about it not being over until the middle of 2009 or maybe 2010. That's one indicator. A second one you can look at is, look at the scale of write-downs relative to your estimate of ultimate credit losses. We've had about 500 billion written down. And now, it looks like the ultimate credit losses, not just subprime but everything—consumer loans, commercial real estate, et cetera—is going to be perhaps a trillion or so.

So again, you're halfway, maybe halfway done. I don't think it'll be as intense as what we've seen hopefully in the last couple of days. But I think we've got ways to go and you know we've had these securities that are under stress purchased all around the world, and confidence is a problem.

Steve Weisman: Of course, the crisis will remain, as you just said, but will it affect more financial institutions. Are we seeing more failures, do you think?

Morris Goldstein: Well, I think we will see some continuing difficulties. I mean what you worry about is the fact that the financial difficulties—and particularly cutbacks and lending by banks and others—make the economy weaker. And in turn, the weaker economy makes the financial sector weaker because for example if .US. consumption weakens, then consumer loans start to perform a lot more poorly. Similarly, commercial real estate, which is a big item for banks and others, could get more difficult. Then when you have difficulties at some banks, it affects other institutions and we've seen difficulties not just at banks but at investment houses and many, many other kinds of institutions. So I'm afraid I think we will continue to see some difficulties.

Steve Weisman: Now, you've rated the performance of Treasury and the Fed. Do you see them as cooperating effectively with central banks and finance ministries around the world in this crisis?

Morris Goldstein: I think the level of cooperation has been pretty good. I don't think that's the main problem with the crisis. I mean, they all seem to be on the same page. We've seen a lot of coordination on liquidity support. So I think unlike in some earlier episodes, I don't think this is really something we have to worry about too much. Trying to get a common answer on what to do about regulatory reform, which is the longer-term issue, I think is going to be more troublesome.

Steve Weisman: It's not always easy to chart a course into the future of what regulatory reform should be while the crisis is still unfolding. What should that new structure look like and who should write it?

Morris Goldstein: Well, I've been thinking a lot about what the regulatory structure ought to be. In view of the fact that while this crisis has many origins, I think it does represent a major regulatory failure. So certainly the US authorities ought to be at the center since this started as a US crisis, and this is really the main focus of the crisis, ought to be at the lead I think rewriting regulation. But in cooperation with other countries who are interested.

And the things that I think ought to be at the top of the list, I'll just go through them quickly.

Steve Weisman: Sure.

Morris Goldstein: One is we need an international quantitative standard for liquidity for banks and investment houses. Liquidity has been in decline. If you think of own liquidity, we have lots of principles. We don't have a quantitative minimum requirement and we need one. Also, we need the private sector firms, financial firms, to cooperate and to form these private liquidity pools. We just saw that a couple of days ago. I had suggested that in April and we finally got the 10 of the large banks to do that to the tune of about $75 billion. But you need to do that, otherwise you're going to have some firms hording liquidity. They need to share much.

We have the IMF Fund on the sovereign side where one country has a balance of payments problems, it shares finances. It can borrow, it can overdraft. We need the same type of things. We need something on liquidity. We need an orderly workout scheme for systemically important non-banks, investment banks, and large insurance companies. If you don't have that, then you're in the terrible choice of either pushing the failing firm into Chapter 11 or providing a big bailout—you don't have the time to think. We've got to have that; we've got to push that legislation.

Steve Weisman: What do you mean by a workout scheme?

Morris Goldstein: Well for banks, we have a plan under the Federal Deposit Insurance Corporation Improvement Act, so-called FDICIA, where once a bank's capital gets to two percent and the regulators decide to close it, you can put its assets in what's called the bridge bank. And then, the government can continue operations just as if the bank was still there so you don't get lock-ups in markets. You have continuity, and at the same time you wipe out the shareholders, you change the management and you can guarantee some of the obligations but at expected recovery cost. So you combine the two things you want, which are continuity and good moral hazard properties. And that's what we need.

Steve Weisman: And for non-banks?

Morris Goldstein: Yes, for non-banks. We have it for banks, for US banks. We don't have it for important non-banks. And as the Bear Stearns case shows, as the Lehman case shows, as the AIG case shows, we've got to have it. So that's another thing, we need to overhaul the ball to capital regime for banks. We need to make it countercyclical, not pro-cyclical. We need to raise capital requirements; that's very important. We need to improve the incentives in the securitization model. We can't have it so that mortgage originators basically get paid on the number of mortgages they hand out rather than the quality of those. The covered-bonds idea is a good idea for the mortgage market. We've got to change Wall Street compensation.

As I mentioned earlier, we got to have a clearing house for our OTC derivatives. If we don't, it's a mess.
So we got to get going with that as quickly as possible because a couple of those regimes will actually be useful in fighting the present crisis.

Steve Weisman: You've advocated many of these things for some time. Do you think the climate has changed and the world will now be more receptive to a more vigorous set of regimes along the lines you've proposed?

Morris Goldstein: Well, I think the more serious the crisis, the better the prospects for reform. And I think, by this time, almost everybody is saying, "Never again. We've got to have something different. And we've got to change the regulatory structure."

Steve Weisman: And it has to be on an international scale, does it not?

Morris Goldstein: Well, it does, because you're inevitably going to have level-playing-field issues. So it's important that we get something that countries can agree together and implement.

Steve Weisman: Since the crisis started with the United States, how is it going to be possible for the United States to show leadership on this when so much of the problem originated in the United States?

Morris Goldstein: Well, I think the fact that the crisis originated here—and we've seen already some of the consequences of it—it means that the US reputation has been tarnished some. After all, we've had risk management failures at what are reported to be our best financial institutions. We've had clearly failures in regulation and supervision.

But we'll come out of it better if we also take the lead in trying to fix it. You know, one of the good things is that that is starting to move. We're addressing some of those things. So I think the United States has to be at the center of those and has to start making very specific suggestions as to what the new financial regulatory landscape is going to be like.

Steve Weisman: Morris Goldstein, I can promise you one thing. As this unfolds in coming weeks and months, we'll have you back to talk about it and give us your scorecard. Thank you very much for joining us today on Peterson Perspectives.

Morris Goldstein: I'd like that.