July 24, 2009 – 1:30pm
Policy Seminar with Russell Roberts
George Shultz Conference Room

PARTICIPANTS

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ISSUES DISCUSSED

- **Origins of the financial crisis:** Roberts started the meeting with a discussion of the state of the debate regarding the origins of the current financial crisis. He suggested that most suggested causes essentially boiled down to two distinct, but not mutually exclusive, views of the crisis: The crisis could be broadly considered either as a failure of markets (with greed and bad incentives playing a major role), or as a failure of government and government policy. Those wanting to defend the role of markets would have to address two primary questions (1) Why did the price of housing rise by so much and for so long, particularly from 1995-2003 in advance of the explosion in subprime lending? (2) Why did firms put their existence at risk by taking on such large leverage? The group then proceeded to discuss those two questions in more detail.

- **Cause of House Price Increase:** Roberts suggested that there are four possible answers to the first question of why prices rose for such a long time, and by such large amounts:

  1. **Irrational Exuberance and Social Contagion**: Robert Shiller is the most prominent advocate of this explanation. Roberts argued it was not a very appealing argument for what started the price increases.

  2. **Monetary Policy:** From 2001 onwards, monetary policy was harmful (that is, interest rates were held too low for too long). Roberts pointed to Taylor's work on this explanation.

  3. **1997 Tax-Payer Relief Act**: This act changed the rules on capital gains taxation of housing, and created a positive feedback loop once prices started to increase.

  4. **Federal Housing Policy**: Roberts claimed that federal housing policy, in particular housing policy with respect to Fannie and Freddie, was potentially an important driver of the crisis. Roberts argued that for Fannie and Freddie, their ability to borrow at lower rates than they pay out means that increasing their lending volume directly increases their profits. Officially, the two GSEs can only guarantee 'conforming loans,' as specified by government regulation. However, Roberts argued that federal housing policy led to a continuous weakening of those standards over time.

  One reason why lending standards weakened is related to the **affordable housing standards** that HUD put on Fannie and Freddie. As a result, the proportion of business that was steered towards lower income households increased from 40% to 50% of loans between 1995 and 2001. Roberts suggested that it was unlikely that a lot of this business would have been financed by other market participants and that the volume of loans involved would be likely to have an effect on prices.

These federal housing policies allowed lenders such as Countrywide to approve loans they may otherwise not have made, knowing that they could sell them to Fannie and Freddie afterwards, which were in need to fulfill their HUD requirements. Roberts then described a number of programs Fannie and Freddie created, aimed at expanding lending to low-income groups, including the Flexible-97, and Fannie Mae's My Community mortgages.

The second aspect of federal housing policy addressed by Roberts was the **Community Reinvestment Act,** which was originally set up in 1977, and was designed to encourage banks to meet the needs of borrowers in all segments of their communities, including low- and moderate-income neighborhoods. The enforcement behind the CRA increased in 1995. Roberts argued that Fannie and Freddie's practice of insuring CRA-mortgages led to an increasing number of loans being made to individuals who would previously not have qualified for a mortgage.

Roberts then discussed how you might evaluate the credibility of these claims—while the direction is right, are the magnitudes sufficient to explain the rise in prices? This led to a discussion of what micro-level evidence might be useful for confirming or rejecting the argument that easing of credit was a decisive determinant of rising housing prices.

- **Why was leverage so high?** Roberts also touched briefly on his second question of why companies put themselves in position where a 3-4% drop in asset value would destroy the firm. He traced this to a combination of private and public errors, and mentioned in particular the problem with institutions being considered "too big to fail." He argued that if the government consistently bails out creditors and counterparties, it takes away the incentives of those parties to adequately supervise risk-taking by firms.

- **Too big to fail:** The group also considered the problems inherent with bailing out banks considered "too big to fail." In particular, a recent op-ed in the FT by John Kay was discussed. In the op-ed, Kay made an analogy between the economy and complex systems in engineering, which are designed to not break-down completely if one of the components fails. The question posed by the op-ed was whether there was a similar approach to avoiding the problem of firms becoming "too big to fail", both within and between big organizations. Participants suggested that there were essentially two broad ways to deal with the issue of having companies that are "too big to fail." One is to ensure that each entity is sufficiently capitalized to make risk of failing negligible. The other is to make sure that failure can take place without significant impact on other entities, that is, to ensure that in case of a failure the knock-on effects are limited.