

**Comment on Vincent Reinhart: “The Origin, Propagation,
and Magnification of the Financial Crisis”**

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- Reinhart: Surveys the factors that produced, spread and intensified crisis
- Identifies shortcoming of most research so far: “narrow and focused inward to the United States”
- “The initiating economic shock.. Appeared small and localized compared to the havoc wreaked on global markets”
- This implicitly de-emphasizes domestic explanations
- Strong evidence of global explanation
- U.S.,U.K. best illustrate global trend: large current account deficits, foreign capital inflows, housing bubbles, deep recessions: neatly follow the C. Reinhart/Rogoff recipe for a crisis
- But the exceptions are as interesting as the rules

Mystery #1: Why did some countries have housing bubbles but not banking crises?

	<i>Housing bubble</i>	<i>Banking Crisis</i>
Australia	Yes	No
Canada	Yes	No
Germany	No	Yes
Japan	No	No
Spain	Yes	No
Switzerland	No	Yes
United Kingdom	Yes	Yes
United States	Yes	Yes

Mystery #2: Why did some countries with current account deficits not have crises?

	<i>Current account</i>	<i>Banking Crisis</i>
Australia	Deficit	No
Canada	Balance	No
Germany	Surplus	Yes
Japan	Surplus	No
Spain	Deficit	No
Switzerland	Surplus	Yes
United Kingdom	Deficit	Yes
United States	Deficit	Yes

Mystery #3: Why did some countries avoid crises but not recessions?

	<i>Banking Crisis</i>	<i>Recession</i>
Australia	No	No
Canada	No	Yes
Germany	Yes	Yes
Japan	No	Yes
Spain	No	Yes
Switzerland	Yes	Yes
United Kingdom	Yes	Yes
United States	Yes	Yes

Mystery #3 solved

- Reinhart: “Linkages have turned out to be very important.”
- Japan’s export dependency resulted in recession
- Spain’s enormous dependence on residential investment resulted in recession
- More generally: financial contagion: animal spirits with or without CDOs

What about U.S. monetary policy?

- Reinhart exonerates Fed
- Global saving glut broke link between U.S. short and long term rates
- But all major central banks maintained low rates: with hindsight, a synchronized policy error?
- Either story would explain global housing bubble, reduce Fed culpability

What about U.S. regulatory policy?

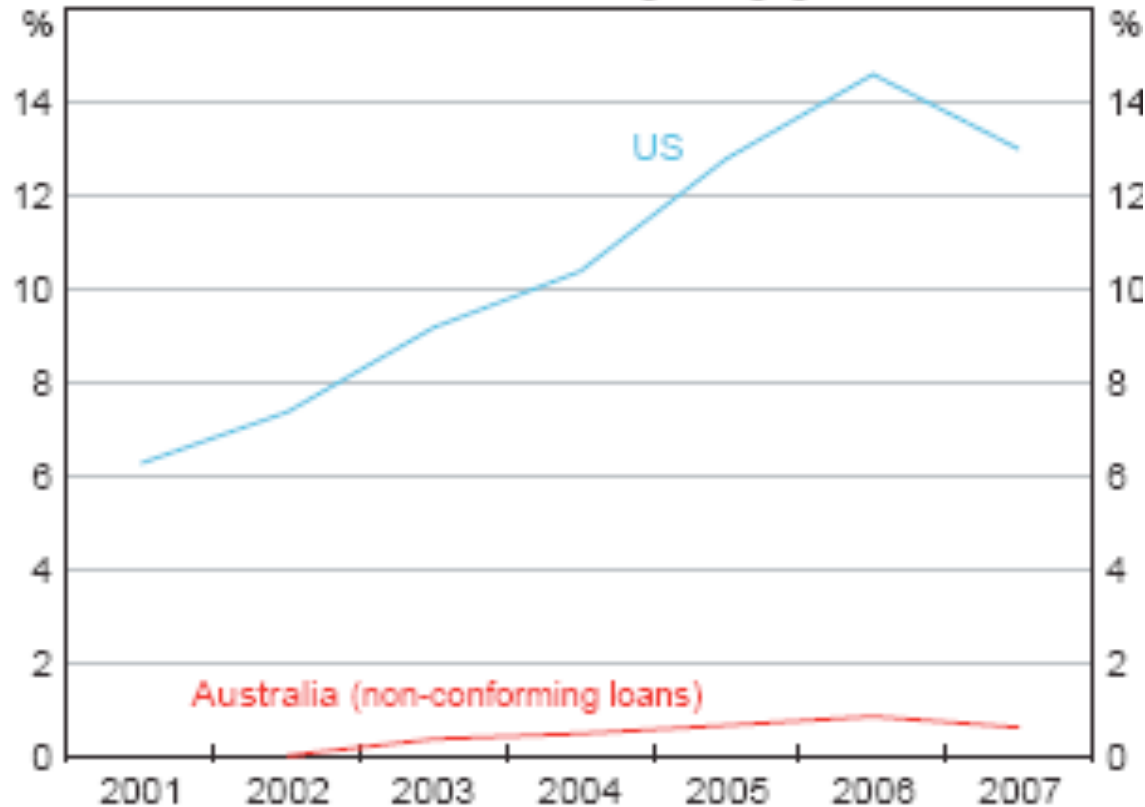
- Reinhart: during crisis, Treasury & Fed intervention impaired private resolution
- Before crisis, policy encouraged excessive investment in homes: Community Reinvestment Act, GSEs
- Unconvincing: CRA only covered banks but loans originated by banks performed better than loans originated by mortgage brokers (Jiang)
- GSEs did increase subprime exposure but to meet public mandates or recapture market?

The real regulatory failures

- The structure of the domestic financial system, including regulation, helps explain mysteries #1 and #2
- Reinhart: U.S. “exported some of its innovations in housing finance”
- German banks purchased CDOs,
- UK banks offered 125% down loans, relied on wholesale funding
- But Australia, Canada had well developed MBS markets but no crisis

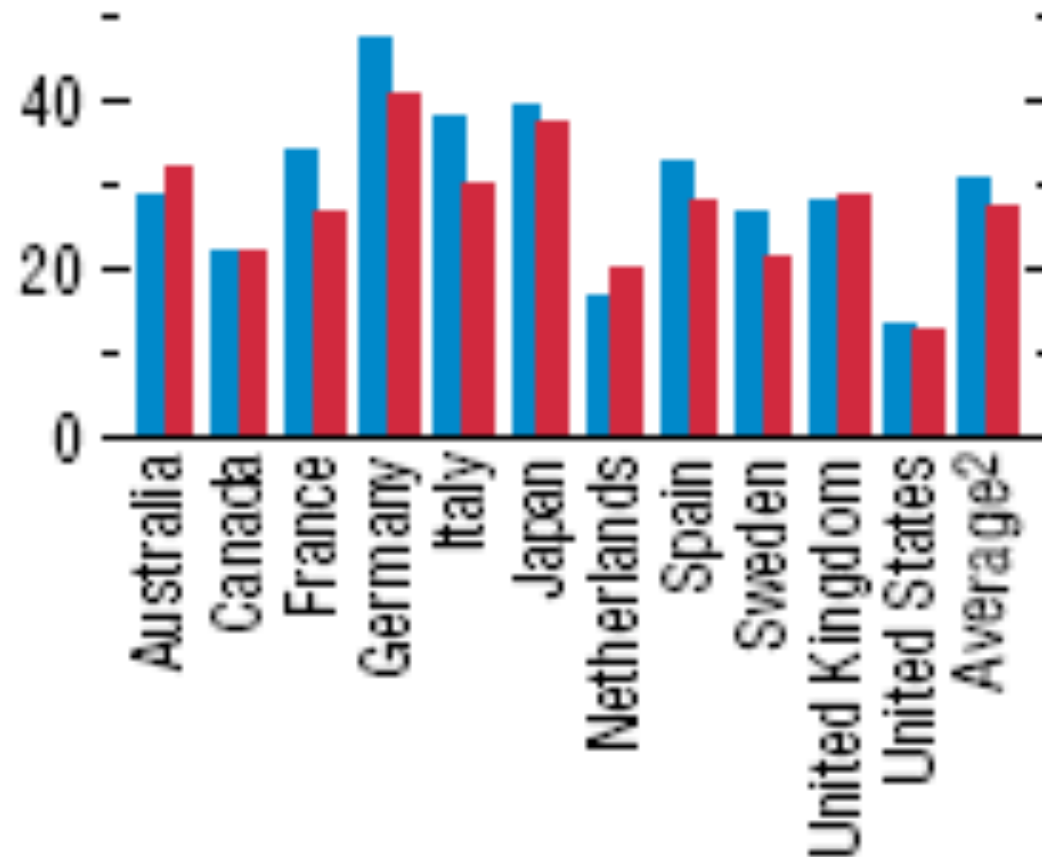
US subprime mortgage market unusually large

Size of Sub-prime Housing Markets
Share of outstanding mortgages



Source: Guy DeBelle, RBA, May 16, 2008

US has largest shadow banking system (banks' share of credit, %)



Source: IMF WEO, Sept. 2006 Ch. 4 p. 4

Shadow banking

- Pluses: innovative products (ARMs), increased credit availability, higher home ownership, reduced dependence on taxpayer (ex-ante!) via deposit insurance
- Minus: more leveraged financial system, vulnerable to crisis
- Minus: banks sought to level the playing field by circumventing capital, regulation (with implicit support of Fed & other regulators), purchasing nonbank loan originators

Not at first a banking crisis

- Sequence of distress/failure inversely correlated with capital, regulation
- First : standalone finance companies (HSBC/Household, New Century, 2007)
- Second: investment banks, GSEs (Bear Stearns, March 2008, GSEs, July 2008)
- Third: banks/bank holding companies (Washington Mutual, Wachovia, Citigroup, Bank of America – Sept-Dec 2008)

Policy implications

- No obvious solution to global savings glut and recurrence of bubbles (The next time will not be different)
- Increased bank capital requirements could revive shadow banking, regulatory arbitrage
- Geithner plan: Give Fed oversight of biggest shadow banks (“Tier 1 FHCs i.e. GE Capital); will it miss new entrants to shadow banking system?
- It doesn’t sufficiently address absence of effective state-level regulation
- Is the Fed the right agency to carry out this job?