The Financial Problem of September 2008

1. The effective repeal of the Glass-Steagall Act of 1933 with the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 opened the gates for commercial banks to operate and underwrite in sophisticated securities instruments, such as mortgage-backed securities, collateralized debt obligations and other derivatives. In practice, it meant that the traditional spread yielding borrowing and lending old practices of commercial banks were substituted by a complex net of financial derivatives; thus enabling commercial banks to engage in much higher leveraging. The ultimate exposure to housing collateral has led to the imbalance between assets and liabilities and the 'plunge to the abyss' of insolvency. The US has one of the most, if not the most well institutionalized framework for the frictionless operation of financial markets. However, in the last 25 years, enforcers, legislators and policy-makers alike have lost track of the regulatory arrangements that must embed the institutional framework. In lay terms, it is almost like relaxing the rules of a game to the point of no rule enforced. Here we are!

2. The US Treasury is seen now as the 'owner' of the last resort, in a word play of the lender of the last resort. The problem is moral hazard: The Treasury may insulate the guilty party from the ultimate cost of the dangerous risk taking behavior. I believe the US Treasury should not take it all; the market should be able to sort out some of the dangerous risks and the bearer should take responsibility. Easier said than done.

3. Many are relating the current crisis to the one that followed the stock market crash of 1929. I think not so. Real estate in general and housing in particular is an asset class that moves very slowly relative to other assets in the system, i.e. it takes time to buy and/or sell a real estate. The US situation is very much like the real estate bubble that plagued Japan in the late 1980s and burst in 1990. The point is that, as the Japanese experience has shown us, it takes more than a decade to only partially recover from a real estate bubble burst. Hang on because the ride isn't over!

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