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### FCIC memo of staff interview with Institute for International Economics (IIE)

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## MEMORANDUM FOR THE RECORD – MFR

EVENT: Interview with Institute for International Economics (IIE) -- Interviewed to gather notable economists' take on global financial crisis.

TYPE OF EVENT: Group interview

DATE OF EVENT: March 16, 2010

TEAM LEADER(s): Greg Feldberg

LOCATION: FCIC large conference room, Washington, District of Columbia

### **PARTICIPANTS/ NON-FCIC:**

C. Fred Bergsten (FB), Director, IIE

William R. Cline (WC), Senior Fellow, IIE

Morris Goldstein (MG), Senior Fellow, IIE

Gary Clyde Hufbauer (GH), Reginald Jones Senior Fellow, IIE

Simon Johnson (SJ), Senior Fellow, IIE

Steven R. Weisman (SW), Editorial Director and Public Policy Fellow, IIE

John Williamson (JW), Senior Fellow, IIE

### **PARTICIPANTS / FCIC:**

Ron Borzekowski

Wendy Edelberg (WE)

Greg Feldberg

Tom Stanton (TS)

### **PARTICIPANTS / Unidentified:**

Mike

MFR PREPARED BY: Greg Feldberg / Rich Cheng

DATE OF MFR: November 29, 2010

### **SUMMARY OF INTERVIEW & SHORT BIO OF INTERVIEWEE :**

**Note: This is a summary of the interview, not a complete transcript. Direct quotations appear inside quote marks. Please consult the FCIC audio file of the interview, if necessary.**

### **WE - Themes**

- (1) Define the crisis -- Does it include victims? Are smaller markets victims?
- (2) Shock vs. Propagation
- (3) What did we not see in 2005-2006?
  - Know: Low rates, capital flows, asset bubble

### **FB**

- Transmission of capital flows into lower underwriting standards not necessarily known.

### **SJ**

- Thirteen Bankers -- role of deregulation

### **WC**

- Currently writing book -- Financial Globalization
  - (1) They all did it.
  - (2) Banking panic:
    - Why? -- underlying assumption that housing prices could be flat for 10 years accompanied by inflation.
    - Financial system depended on prices never failing.
    - Lack of transparency in MBS -- only when ABX showed decline was there transparency.

### **WC**

- Sympathetic to soft \$; J. Taylor.
- Current account was financed @ 1/3 and not the main factor.
- You need to look at net flows.

## MG - Define Crisis

- (1) Currency -- No. Although it was for some emerging market.
- (2) Debt -- Based on credit rating agency (CRA) sovereign ratings. No.
- (3) Banking -- Fiscal cost of rescuing institutions.
  - Total will be much lower on financial institutions (FIs).
  - Higher if you include writedowns.
- (4) Economic -- substantial movement in GDP.
  - You need to ask why did real GDP fall so far.
  - Worldwide (w/w) spread. Unemployment.
- Causes -- Agree on supervision, housing goals, etc.
- Remedies -- opportunity to bring back old ideas.
  - E.g., Prop trading -- not a cause

## March 30, Paul Volcker at IIE

- **Mike:**
  - Why did unemployment go up so far based on usual relationship w/ GDP, etc.
  - **JW:** German unemployment rates up less than expected.
- **Mike:**
  - U.S. GDP was smallest in G-7, but really large increase in unemployment.
  - Series of events. Not ignoring what happened in the row.
  - 2003-2007 -- Build-up. Global business cycle boom. Early 2007 -- had stopped tightening mid-2006; residential stopped growing late 2005.
  - Summer 2007 -- More turbulence. Federal Reserve eases.
  - August 2007 -- Bear Stearns (BSC). Calming -- VIX (Volatility Index). Spread calmed down again.
  - (NBER) dates peak end-2007.
    - World economy boom continued through 1Q08.
    - Very inflationary in 2008. ECB last tightening measure in mid-2008.
  - LEH. VIX, TED spreads shoot up.
  - Global economy turned negative summer 2008.
    - Dives in 2H08 - including China.
    - Last 2Q larger decline G-20 nations since WWII.
  - Wasn't TBTF -- the financial system was TBTF. We liquefy (provide liquidity) everyone.
  - Recovery since mid-2009. Intense financial disruption has eased.
  - It's not all the financial sector.

- Following inflation of 2008, a slowdown was inevitable.
- Auction Rate Securities (ARS) -- part of phenomenon -- making \$ by creating liquidity. Liabilities that are more liquid than the underlying assets.
- Depended on buyers. Liquidity dries up immediately.
- Asset-backed commercial instruments: same principle.
  - Massive creation of pseudo-liquidity.
- Essence of banking is creating wealth by creating liquidity. One has to be careful how you let FIs engage in that activity.

## SW

- You have 2 roles:
  - (1) Narrative
  - (2) Investigative -- “had we known, outcome might have been different.”
- **WC:** (1) CRAs just insiders knew it was a scam.
  - **JW:** Did they really?
  - (2) AIG exposure -- even TFG (Geithner) didn’t know.

## GH

- Complete & utter regulatory capture -- way more than ICC.
- (1) BASEL was so captured by banks.
  - Tarullo book.
  - IRS can’t deal w/ big international firms.
    - Regulators aren’t paid -- compared to Singapore.
- (2) Only 100 institutions count. Fed should have D/B (databases) on all. Fed shouldn’t have missed huge pile of securities.
  - Also Hedge Funds (HFs) > MMFs.
  - Legislation will cover that.
  - AIG -- Hank Greenberg.
  - They knew what they were doing.
- (3) Government can’t stop massive asset loss.
  - Next crisis won’t be housing.
  - Suppose Fidelity / Vanguard / Trowe Price went bankrupt:
    - Look at populations they serve.

**WE:** BB (Ben Bernanke) was looking at subprime & bubble. Why was he wrong?

- (1) More bad stuff.

- (2) Didn't understand where it was.
- **GH:** Thought it would be like previous bubbles -- inflation would take care of it.
- **JW:** Leverage -- spread shock.
- **WC:** Gary Gorton -- concern about counterparties, after LEH.
- **MG:** Who will be protected after LEH.
- **WC:** David Wessel -- why BSC & not LEH.
  - Argentina factor. Nothing happens when A fails.
- **Mike:** Case-Schiller had made case for bubble.
  - Stupidity.
  - Existence of risk underestimated by government & private sector. 1981, 1975, 1991 -- banks would have been insolvent under mark-to-market (MTM).
    - Capital was too little then.
- **WE:** If we had really run a 20% housing price drop, we would have caught GSEs, LEH .
- ..
- **MG:** Economic fads -- securitization will remove risk. Raghuram Rajan speech at Jackson Hole -- Kohn said don't worry.
  - AG (Alan Greenspan): Hype -- risk hadn't been spread.
- **GH:** Gave false sense that leverage could go to 40%.

### **Australia & Canada banks did not go AIG**

- **TS:** AG (Alan Greenspan) said shocked banks don't follow self-interest.
- **GH:** Risk managers should have status/power/tenure.
  - Risk managers should have to sign off.
    - Like CEOs under Sarbanes-Oxley (S-Ox).
- **MG:** AG (Alan Greenspan) belief in self-regulation.
- **Mike:**
  - Collateral damage from failure.
  - You want owner to hold the risk.
  - People assumed they could unload risk.
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