INTERVIEW

George Kaufman

Editor's Note: *This is an abbreviated version of RF's conversation with George Kaufman. For the full interview, go to our Web site: www.richmondfed.org/publications.*

It will be many years before economists have a comprehensive understanding of what caused the financial crisis. But policymakers need to act in real time to help resolve such crises and to take steps that will improve the overall stability of the financial system.

George Kaufman has spent his professional career, now ranging over five decades, studying the financial industry. His work has spanned both "theory" and "practice" — or, perhaps more precisely, has connected the two. He has brought academic rigor to bear on important policy questions. Like all economists who endeavor to influence policy, some of his research findings have been heeded while others have not. Indeed, Kaufman has long maintained that the financial system would benefit from greater market discipline. But the lack of such discipline arguably was one of the major factors contributing to the onset and severity of the crisis — and remains an issue that policymakers must confront in the wake of the safety net protection that was recently extended to numerous institutions.

Kaufman worked as an economist at the Federal Reserve Bank of Chicago from 1959 to 1970. He then spent the following decade at the University of Oregon, before returning to Chicago in 1981 to teach at Loyola University and to direct its Center for Financial and Policy Studies. Kaufman is the founding editor of the *Journal of Financial Stability*, serves as co-chair of the Shadow Financial Regulatory Committee, and is a consultant at the Chicago Fed.

Aaron Steelman interviewed Kaufman in December 2009.

PHOTOGRAPHY: MARK BEANE, LOYOLA UNIVERSITY CHICAGO

RF: There are signs that the economy may have turned the corner. Looking back at the financial crisis from our current vantage point, what are the major lessons that policymakers should take from it?

Kaufman: There are a number of important lessons. First, capital matters for banks. It is not everything, but with too little, banks are likely to freeze up and fail, and contagion is likely if losses at one bank wipe out capital at other banks in chainlike fashion. Capital should be the primary concern for any prudential regulatory system.

Second, asset price bubbles are dangerous to the economy and the longer they last, the more dangerous they become. More attention needs to be devoted to them, including whether to include asset prices in the measure of prices targeted by policymakers and how to protect financial institutions against their bursting. In addition, the implications of low interest rates on asset prices as well as on goods and services prices and employment need to be carefully studied.

Third, planning and preparation for tail events, such as financial crises and insolvency of large financial institutions, are very important. These plans should be made public so everyone understands the ground rules. Part of the reason for the inconsistency in public policies attacking the current crisis was the lack of advance planning for the measures that were announced publicly. The inconsistency in policy increased uncertainty in the market and intensified the turmoil. Strategies adopted should be consistent through time so that participants can make plans. Inconsistent actions lead to inconsistent and unpredictable responses.

Four, simplicity trumps complexity.

RF: In March of 2008, you remarked, "Everybody knows Santayana's saying that those who fail to study history are condemned to repeat it. Those who study financial history are condemned to first agonize over the patterns they recognize and then repeat it anyway." Do you think that will be true this time as well?

Kaufman: Yes, very much so. Many of the policy actions taken were the same or similar to the actions in past crises — say, in the S&L crisis of the 1980s — but even larger in scale. They focused on bailouts and forbearance. In part, this reflects a combination of being caught by surprise, lack of preparation, need to act quickly (frequently over a weekend) with no grand plans, extreme risk aversion, and political pressure. Thus, moral hazard is likely to be stronger coming out of the crisis than going in.

RF: That leads me to a broader issue, one that you may have not directly addressed, but I imagine you have considered: Why is there often such a large gap between the recommendations of academic economists and the actions of the policymakers they seek to influence or may even directly advise? And in which areas do you think economists have been most successful in bridging that gap?

Kaufman: There is a gap because policymakers are in the hot seat and under pressure from various constituencies, many of whom focus on the short run, while academic economists focus primarily on long-run efficient solutions. The academic economists would act more like the policymakers and vice versa if there was a role reversal. Policymakers are likely to respond more favorably to advice from academics and other outsiders when the leading constituencies are out of favor or discredited. For example, the prompt corrective action and least-cost resolution provisions of the Federal Deposit Insurance Corporation Improvement Act, which were designed with the help of academics, were enacted in 1991 over the objection of most bankers and bank regulators, whose credibility had been tarnished by the S&L crisis. In contrast, in the current financial crisis, while bankers may have had their credibility tarnished again, regulators appear to have maintained theirs better and academic proposals have not advanced as far. But, as Keynes concluded:

> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.

RF: Given the expansion — both implicit and explicit — of the federal financial safety net during the crisis, what practical steps could policymakers take to restore meaningful market discipline?

Kaufman: Very few in the short run. Based on the experience of the last two years, most market participants believe that by exerting sufficient pressure on the government and regulators they can receive a wide range of guarantees on their deposits and other creditor securities. Only actual losses through time will dissuade them. But losses, if any, are likely to be permitted by regulators only in noncrisis periods. To build their credibility, regulators must be willing to let market discipline operate and permit losses on all de-jure uninsured deposits and other liabilities over a number of years. In a crisis atmosphere, such as recently, market discipline is again likely to be an early casualty. Thus, the long-run cost of recent bailout programs in terms of weakening market discipline through time is very high.

RF: In a perfect world, to what extent would you limit the safety net? For instance, is there good reason to do more than simply guarantee small depositors at commercial banks?

Kaufman: No.

RF: Many in the public — and a nontrivial number of economists — believe that the financial system is inherently fragile and requires significant regulation to reduce systemic risk. How would you respond?

Kaufman: There is a difference between fragility and breakage. For example, fine wine glasses are more fragile than ordinary drinking glasses, yet, at least in my household, the ordinary drinking glasses break more frequently. That is because they are handled more carelessly. The same is true with banking. Before the introduction of the Fed, banks operated with lower capital ratios than nonbanks, as they do now, yet their failure rate was no higher on average. However, banks did fail more in clusters, as their high leverage makes them more sensitive to tail shocks that affect them in common. But, in the absence of a government safety net, bankers are likely to handle their banks with care, taking only as much ex-ante risk as is consistent with their capital. Of course, ex-post risk may exceed ex-ante risk, particularly in a crisis. Then the central bank needs to provide liquidity, but not to protect creditors of insolvent banks. Such a strategy is only self-defeating. The greater the protection provided, the greater the risks bankers take, and the greater the number and cost of failures.

RF: Some blame the financial crisis on financial innovations that went astray. What are your thoughts?

Kaufman: I believe that innovation both in methodology and application have been and continue to be an integral part of finance and that, on the whole, both finance and the macroeconomy have benefited from it. Numerous empirical studies have shown convincingly that political jurisdictions which have deeper and more sophisticated financial sectors have experienced faster economic growth. But there are costs as well as benefits to having large financial sectors. When things go right in the financial sectors, the economy benefits. But when things go wrong, they have adverse consequences for the economy — and the larger the financial sector, the more serious the damage.

The rapid growth in financial institutions and markets in the United States in recent years has in part been driven by innovation. Because finance basically involves information collection, storage, processing, and distribution, innovations in computer and telecommunication technology have shortened the time necessary to perform these functions and reduced their costs. This has encouraged innovations that permit financial products to be tailored more to the unique needs of existing or potential participants in financial markets.

Innovations of any kind are risky and their lasting value should be judged on the basis of their benefits relative to costs. Some may not work as advertised and possibly do considerable damage at high cost. Others may work but require a long learning curve, during which time the costs exceed the benefits but are then reversed. And some may generate benefits immediately.

Many of the world's greatest innovations required lengthy learning curves to gain the full benefit. Early application of the steam engine to railroads and ships resulted in numerous explosions that killed or maimed users. And the bigger the engine, the more deadly the accidents. Likewise, early flying machines, including those that proceeded or immediately followed the Wright Brothers, had a poor safety record and the higher the flight, the greater the severity of injury. Those that did not fly high did not produce many injuries but they achieved little.

The great advances in computer technology and telecommunications in recent years have encouraged the development of increasingly complex financial instruments. Some of the innovations were so complex that they outran the ability of both users and regulators to understand them quickly. Thus, they had the potential for misuse with resulting serious damage. And the potential was realized.

An example is subprime residential mortgages. They were designed to increase the flow of mortgage credit to households that previously had not qualified for regular mortgages because their credit rating and income were too low. Thus, they were not eligible for homeownership. But, as we now know, these mortgages were often misused to provide credit to those who could not afford them or did not fully understand the conditions of the mortgage contract. So, the default rate was unexpectedly high and subprime mortgages have almost disappeared from the market. But undoubtedly some low-income or credit-challenged households are using them successfully to purchase homes that they otherwise would not have been able to. Nevertheless, it appears that, as of now, the costs have exceeded the benefits.

I believe that in the not-too-distant future subprime mortgages will reappear, but probably under a different name and with an improved design. I am reminded of the development of corporate junk bonds in the 1980s. They were the subprime mortgages of their day. Junk bonds were subprime corporate bonds that opened capital markets to risky, often younger, corporations. And like subprime mortgages, they were misused at first. Judging their risks required different analytics than for regular corporate bonds and they experienced high default rates. Indeed, they resulted in the bankruptcy of the investment banking firm Drexel Burnham Lambert, which was the largest underwriter of junk bonds, and in a prison term for the firm's Michael Milken, who was the primary champion of junk bonds. As Drexel was also the largest market maker for junk bonds, its demise almost shut down the junk bond market. But the need for bonds to service this underserved part of the corporate market remained, and investors learned in time to understand them and use them correctly. Junk, or more tactfully, high-yield, bonds made a comeback and now comprise some 20 percent of the corporate bond market and no longer raise eyebrows.

The feeling that financial innovation has gone too far is quite widespread. Recently, for instance, former Fed Chairman Paul Volcker expressed concern over the value added by such innovation. I admire and respect Paul Volcker greatly. He was one of the world's great central bankers and is now one of the truly wise men in finance. But here I believe he may overstate the negative. The innovated securities did not cause the crisis but magnified its impact. The basic cause was the bubble in home prices, which provided the base for many of these securities. Would we have been better off if we had banned the steam engine and the airplane because of the high casualty rate at their births? I don't think so. But one can come back and argue that the aggregate cost of the financial accident was much higher. And they may be right, but the cost of correcting the problem I believe is also far less. And this includes not only subprime mortgages but also the more complex securitized products like collateralized debt obligations and credit default swaps. If used correctly, they show great promise in adding to our future economic welfare by diversifying risk over a broader base of investors and thus increasing the flow of funds and investment. I believe that in time market participants will climb up the learning curve and at least partially resuscitate the less complex of these innovations and use them more safely. But it will take time.

RF: How would you define an asset price bubble? And when we believe that one is emerging or has emerged, what, if anything, should policymakers do in response?

Kaufman: Asset price bubbles are difficult to identify. One person's bubble is another person's fundamental value. As I noted in my answer to the first question, the best protection against damage from the bursting of a bubble is to fortify the financial system, which, as also noted above, is highly leveraged and fragile to tail shocks. Higher capital ratios would cushion and absorb the adverse impact and reduce systemic risk. Alternative policies of incorporating asset prices in the inflation target or leaning against the bubble are insufficiently researched to date.

RF: What do you think of the recent rules aimed at limiting executive compensation?

Kaufman: I understand the public backlash against the outlandish bonuses paid by some financial institutions, but trying to stop the practice is both costly and likely to be unsuccessful. In a competitive environment, limiting compensation in some firms or industries is likely to be costly to those firms or industries as their best talents are bid away. Ironically, this may hurt the government if the affected firms are those that the government aided and received ownership in. Moreover, compensation regulation is relatively easy to circumvent. For example, in response to a similar public outcry against high executive compensation in the mid-1990s, the government imposed a ceiling of $1 million on the deduction that corporations could take on cash compensation by their top executives. The response was an increase in compensation in stock options rather than cash, leading to an increase in risk-taking. One promising avenue, however, is increased emphasis on deferred payments.

RF: How important do you think independence from the political branches is for the conduct of sound monetary policy by the Fed? And if you think it is desirable, are you concerned that some of the proposals in Congress could compromise that independence or might they shed useful light on the Fed's actions?

Kaufman: I think Fed independence for monetary policy is very important. At times, to achieve favorable longer-term outcomes in employment and price stability, temporary short-run outcomes may be politically unpopular — say, high interest rates or high unemployment. If politics made it difficult to permit these short-run outcomes, the desired long-run results may be more difficult to achieve. Permitting the Government Accountability Office to audit the activities of the Federal Open Market Committee (FOMC) to increase transparency would lead to second-guessing of its actions and introduce an additional element of uncertainty. An interesting alternative proposal suggested recently by the Shadow Financial Regulatory Committee, which I co-chair, is to have the FOMC speed up the release of the transcripts of its meetings from the current five-year delay to three or four weeks, in line with the release of the summary minutes. This would achieve transparency without providing a platform for second-guessing by another government agency.

RF: Please tell our readers a little about the Shadow Financial Regulatory Committee. For instance, why was it founded, who serves as its members, and which issues has it been considering?

Kaufman: The Shadow Financial Regulatory Committee, which is now entering its 25th year, is a group of independent experts on the financial services industry and its regulatory structure. The purposes of the Committee are: (a) to identify and analyze developing trends and ongoing events that promise to affect the efficiency and safe operation of the financial services industry; (b) to explore the spectrum of short- and long-term implications of emerging problems and policy changes; (c) to help develop private, regulatory, and legislative responses to such problems that promote efficiency and safety and further the public interest; and (d) to assess and respond to proposed and actual public policy initiatives.

The results of the Committee's deliberations are intended to stir debate and to increase the awareness and sensitivity of members of the financial services industry, policymakers, the media, and the general public to the importance and implications of current events and policy initiatives affecting the efficiency and safety of the industry.

The longevity of the Committee attests to its success in achieving its objectives. Perhaps its most lasting contribution to date is its role in developing the prompt corrective action and least-cost (structured early intervention and resolution) provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991.

Members of the Committee are drawn from academic institutions and private organizations and reflect a wide range of views. The only common denominators of the members are their public recognition as experts on the industry and their preference for market solutions to problems and the minimum degree of government regulation consistent with efficiency and safety. **RF**

George Kaufman

➤ Present Position

John F. Smith Jr. Professor of Finance and Economics, and Director of the Center for Financial and Policy Studies, Loyola University of Chicago

➤ Previous Faculty Appointment

University of Oregon (1970-1980)

➤ Education

B.A. (1954), Oberlin College; M.A. (1955), University of Michigan; Ph.D. (1962), University of Iowa

➤ Selected Publications

Author of *The U.S. Financial System: Money, Markets, and Institutions*; editor or co-editor of more than 20 books on financial economics; author or co-author of numerous papers in such journals as the *American Economic Review*, *Journal of Political Economy*, *Journal of Monetary Economics*, and *Journal of Finance*