Lessons from the Crisis

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Summary

What caused the crisis? Contrary to conventional wisdom that it was due to bad incentives in the mortgage industry, it is argued here that the main problem was the bubble in house prices in the US. The main factor contributing to this bubble was the fact that interest rates were kept too low for too long by the US Federal Reserve. Lesson 1 is that central banks need to think carefully about the effects of monetary policy on asset prices, particularly property prices, going forward.

Although the bubble was the basic cause of the crisis, the severity of the situation was considerably exacerbated by the collapse in the price of AAA-rated tranches of securitized mortgages. Rather than being due to bad incentives in the mortgage industry, it is argued that this collapse was caused by a break between prices and fundamentals that limits to arbitrage prevented from being corrected. Lesson 2 is that careful research is needed to distinguish the relative importance of the Bad Incentives View and the Mispricing View.

Why didn’t regulation prevent the crisis? It is argued that the reason is that banking regulation is different from other types of regulation in that there is no wide agreement on the market failures it is designed to correct. It is argued that the most important market failures are inefficient liquidity provision, mispricing due to limits to arbitrage, and contagion. Lesson 3 is that banking regulation needs to be designed to solve market failures rather than imposed as a piecemeal as a reaction to crises.

One of the most worrying aspects of the current crisis is the possibility for contagion across borders. This is the “too big to save problem”. Lesson 4 is that it is necessary for the international community to put in place a system of burden sharing so that crisis management can be effective in case a large multinational bank is faced with bankruptcy.

What’s going to happen next. It is suggested that Japan’s experience in the 1990’s and 2000’s provides the best precedent. Japan’s bubble was much bigger than the bubble in the US. However, Japan may be more stable than the US because its firms are reluctant to fire workers. Lesson 5 is that it is important to understand the experience of Japan in the 1990’s and the determinants of feedback effects such as corporate governance.