It Doesn't Take Nostradamus

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Was the present crisis predictable and avoidable? Naysayers, most notably those who pushed the deregulatory policies that created this mess, have argued that today's critics are looking at the world with 20/20 hindsight.

To be sure, economists are better at predicting the past than the future. For this reason, defenders of the status quo argue that the next crisis will be unpredictable and different than the present one so that regulation is at best futile and at worst counterproductive.

The anti-regulatory crowd takes their point too far.

Rereading some of my papers in preparing for the publication of the second volume of my Selected Works (to be published by Oxford University Press), I came across a paper, written almost two decades ago, commenting on the move—just beginning then—towards securitization. I was struck by what I had written.

The paper sought to ascertain whether the switch was an efficiency enhancing innovation or was in fact motivated by problems in corporate governance, in which case untoward results could be expected.

Two paragraphs in particular seem particularly on point:

> The evidence of the incompetency of banks is, by now, bountiful: a series of disasters—real estate loans…loans to Third world countries, oil and gas loans—provide a convincing case of incompetence. This string of failures could, of course, simply be bad luck, but that seems an unlikely explanation. Some of this may be related to the peculiar incentives associated with high leveraged firms operating in an environment in which deposits are guaranteed. Yet the pervasiveness of the problems…suggests that there is more to it than that. At the very least, the banks have demonstrated an ignorance of two very basic aspects of risk: (a) the importance of correlation…(b) The possibility of price declines.

I went on to suggest that "it is hard to believe in the 'rationality' of a market which seems,

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on the basis of no sound evidence, to discount the possibility of a major recession…"

And all of this was written before the string of bad lending associated with Mexico, East Asia, Russia, Brazil, and Argentina.

I went on to explain how securitization can give rise to perverse incentives:

> …when banks retained the mortgages which they issued, they had greater incentives to screen loan applicants. The brokers who write the mortgages often receive commissions on the loans they write, with little or no accountability on their efficiency in screening. Their incentives are thus only to ensure that the loans meet (on paper) the requirements of the loan…[T]he broker has an incentive to find an appraiser who will appraise the property accordingly. The question is, has the growth in securitization been a result of more efficient transactions technologies, or an unfounded reduction in concern about the importance of screening loan applicants? It is, perhaps, too early to tell, but we should at least entertain the possibility that it is the latter rather than the former.

We now know the answer.

I went on to argue that "the switch may actually lead to less efficient utilization of capital resources," and increased cyclical fluctuations.

Often, we see the world through a cloudy crystal ball, sensing unease about certain ways our society or economy seems to be evolving. But this crisis was totally avoidable. I warned roughly two decades ago of the need for greater government regulation of mortgage securitization. I don't think my prediction showed any astounding brilliance. Others no doubt felt similarly. Economic theory—and historical experience—made the risks apparent.

Unfortunately, the call for the regulation of mortgage securitization reached deaf ears at that time. Let's hope that this time is different.

The next crisis may well be different than the present one, but I'd like to see appropriate regulations that make sure of it.

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REFERENCES AND FURTHER READING

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