Differing perspectives on the Credit Crisis from Harvard's Top Minds

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In an extraordinary response to events unfolding on Wall Street and Capitol Hill, Harvard University convened a panel of six of its most respected faculty to discuss the credit crisis. The September 25 discussion revealed a lack of unanimity regarding the government's planned response, but a strong consensus regarding the gravity of the situation.

Much of the discussion recounted the causes of the crisis and the events leading up to it, which we omit — our readers are, no doubt, all too familiar with them. The more interesting dialogue surrounded the planned response and longer term future for the markets, which we provide below. A full-length video of the panel is available here.

There six panelists were:

- Jay Light, the George F. Baker Professor of Administration and Dean of the Faculty of the Harvard Business School. He previously served as chair of its finance department. He is a director of the Harvard Management Company, the Blackstone Group, and other organizations.
- Robert S. Kaplan, the Baker Foundation professor of management at HBS and former interim CEO of the Harvard Management Corporation. He previously was vice chairman of Goldman Sachs.
- Elizabeth Warren, the Leo Gottleib professor of law at Harvard Law School and an expert in bankruptcy and commercial law, and the author of numerous books on a wide variety of legal topics.
- Gregory Mankiw, professor of economics and former chair of the President's Council of Economic Advisors under George W. Bush. He previously served as an economic advisor to Mitt Romney during his Presidential candidacy.
- Kenneth Rogoff, the Thomas D. Cabot Professor of Public Policy and Professor of Economics He previously was chief economist at the IMF, and currently serves as an economic advisor to John McCain. He is also a grandmaster in chess, but no longer plays competitively.
- Robert Merton, the John and Natty McArthur University Professor at the Harvard Business School and winner of the 1997 Nobel Prize in economics.

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Jay Light

Light described the last one-and-a-half years as a "slow-motion train wreck" that, as of the last two weeks, is no longer in slow motion. He described an "unexpectedly fragile" market structure created by the collision of a housing bubble with new and untested financial systems that had yet to weather a full boom-and bust credit cycle.

Light argued that three factors made the market so fragile:

- the excessive leverage of homeowners, the GREs, and Wall Street firms,
- a lack of transparency in collateralized securities, and
- illiquidity in the markets.

Evaluating potential solutions, Light advocated a medical-style triage approach to the financial trauma: stabilize the patient, fix the problem, and follow through with a rehabilitation and recovery process.

The characterization of the $700 billion program as a "bailout," in Light's eyes, is a misnomer. He calls it an auction, with the goal of rectifying both liquidity and transparency shortages in the current market – part of the stabilization phase of the triage process. "It can't be done in the usual ways," Light said. "We don't know the market value of these securities." But the government is designing an auction process that, if properly designed, will allow for price discovery, he added.

In the long run, Light expects to see a new regulatory structure, but cautioned that any such overhaul will take years to achieve. The ultimate package of solutions will include parts that will be implemented in the coming weeks, months, and years, as the triage process unfolds.

Robert Kaplan

Kaplan argues the financial crisis is symptomatic of a much deeper issue: The middle class has been severely weakened. "Over the last 8-10 years real wage growth has been stagnant due to globalization, outsourcing of labor, and other factors," he said. At the same time, he noted, the costs faced by the middle class (food, energy, education, and health care) have risen.

"Facing this squeeze, the middle class have used their

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homes to provide financing," said Kaplan. That, along with the fact that corporate profits and margins are at record highs, has masked a financial deterioration in their ability to pay for services through wages.

Kaplan described a massive consumer de-leveraging process that started 12-15 months ago. This is a "downward cycle" that he says is threatening our economic health.

Kaplan said the bailout program is necessary, but not sufficient without a second step designed to rebuild the "engine of the economy" — the middle class. It would need to address tax-related issues, energy, health care reform, infrastructure improvements, and also provide incentives to improve the rate of consumer savings.

Elizabeth Warren

Warren focused on the unfair practices of mortgage-lending institutions. "The problem is unaffordable mortgages that could not be sensibly compared by consumers," she said. She characterizes the government program as a "bailout," but says that it addresses the "wrong end" of the issue. "It does not address the trauma of foreclosure at the family level," she said. Whole loans (mortgages that have not been securitized) comprise only 10% of the capital to be addressed by the bailout, and the other 90% of mortgages have been spread across "thousands" of new owners, giving homeowners no clear path for renegotiating the terms of their loans.

Warren would like to see steps to keep families in their houses where appropriate. She advocated modifying the bankruptcy process to provide more flexibility in refinancing mortgages. On a regulatory front, she advocated a consumer protection scheme to prevent unfair lending practices. She likened subprime loans to "selling toasters that have a one-in-five chance of going up in flames," then saying to consumers, "Here's the wiring diagram in case something goes wrong." She noted that 60% of subprime loans were made with no Federal regulation and said new regulation is needed to prevent such abuses in the future.

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Gregory Mankiw

Mankiw discussed the criticism of the government's program within the academic community and said it falls into two basic categories. First, there is a fear of overpayment. Ironically, he said this criticism is coming from both the right, who claim it is a violation of the free markets, and the left, who claim it is a bailout of the rich. The Treasury's response is that this is an auction, not a bailout. The second criticism is that the program does not do enough to recapitalize banks. The Treasury's response is that they are creating liquidity in the market, which will make the securities on banks' balance sheets more valuable.

He outlined three types of alternative programs that have been proposed by academics. The first is to "let the market take care of it." Private equity investment is available to banks, he noted, but the issue will be whether such investment will be too expensive.

Second, academics have suggested that government should make direct equity investments in banks, similar to what Warren Buffet did with Goldman Sachs. The question is whether this should be mandatory or voluntary, and whether the costs of such investments will be too high.

Lastly, he noted that some University of Chicago professors have said that banks should be forced to get more capital, but he said the Treasury does not have the tools to implement such a solution.

Mankiw discussed the responses of both presidential candidates. He said Obama traces the causes of the crisis to "markets that ran wild, due to unfettered capitalism," which created a "ticking time bomb." Mankiw said the problem with this argument is that the GSEs were heavily regulated by government. Obama's fellow Democrat Chris Dodd, chairman of the Senate banking committee, was the number one recipient of Freddie Mac and Fannie Mae donations over the last 20 years. Mankiw also cited a 2003 statement by Barney Frank, the chairman of the house financial services committee, that the GSEs were not facing any solvency issues. Mankiw said "dealing with the ticking time bomb was not something the political process was at all ready to handle."

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Mankiw said McCain traces the cause of the crisis to “greed and corruption on Wall Street.” But Mankiw said corruption is really not a major part of the story, and we should not expect to find criminal actions similar to what happened with Enron uncovered. He said there is no doubt that greed contributed to the problem, but does not expect greed to disappear from Wall Street as a result of any proposed remedy. He also criticized McCain’s suggestion that Christopher Cox should be replaced by NY Attorney General Andrew Cuomo as chairman of the SEC. Mankiw says Cuomo was one of the most outspoken advocates to increasing home lending to poor families, a contributing factor to the crisis.

Kenneth Rogoff

Rogoff said the financial sector is too “bloated.” The financial sector represents 4% of the GDP – 7% if you include insurance companies — but it represents 30% of corporate profits and 10% of wages. The financial sector, in his view, needs to shrink “a lot,” something almost inevitable given its size. The financial sector claims to offer efficiency in the creation of financial products, he said, but its size belies this efficiency.

Rogoff says the problem with the government’s proposed reverse auction is the difficulty of evaluating the securities in question. The government has proposed employing now-unemployed investment bankers for this process. “But this amounts to hiring the bankers who couldn’t figure out the value in the first place, when they were working for investment banks, having them now work for you and me, using the money to recapitalize banks, so that they could then get their old jobs back,” he said. This drew some of the most appreciative applause of the afternoon.

Rogoff also spoke of the problem’s international dimension. “The US has been running a spectacular deficit for about 15 years,” he said, adding that it is debatable whether this is good or bad. But our deficit has been financed through foreign lending, he said, and as we run into problems we increase our borrowings. He cautioned that foreign governments may become reluctant to lend to us and our economy will no longer be able to “run up a tab” without feeling pain as a result.

Over-regulation also worries Rogoff. Securitization was a good idea, and the financial sector “for all its flaws was a flagship sector of the US economy,” he said. “We need to have it come back.” We fostered the recovery of the technology sector after the dot-com era, he said, and his greatest fear is “regulation that would cause the financial sector to take too long to come back.”

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Robert Merton

Merton chose to highlight four aspects of the credit crisis. First, he emphasized that "real wealth has been destroyed," unlike situations where one person's gains have been offset by someone else's losses. He said that from June of 2007 to June of 2008 housing prices declined by approximately 16-18% and, given the $20-23 trillion US housing market, this equates to between $3.5 and $4 trillion in wealth destruction. The value destroyed represents real losses with real effects, he said. It translates to decreased borrowing power for homeowners and affects retirement plans that were based on home values.

Second, Merton stressed how leverage propagates risk. He criticized models that relegated such crises to "black swan" events with one-in-a-billion probabilities – in fact they seem to occur "every five or ten years," he said. "We need to understand the structure of increasing risk due to leverage," he said.

Third, he said there is an important feedback loop at work. Banks have been allowed to classify Fannie Mae and Freddie Mac preferred stock as Tier 1 capital, the least risky type. But this preferred stock has declined in value by 90% as a result of the GSE conservatorship, which will force many banks to raise more capital.

Lastly, Merton lamented the lack of infrastructure support for the "newfangled innovations" of structured finance. He said it is not possible to build such support in an environment where new innovations are rapidly developed and brought to market. "We must balance intelligent regulation to go with these innovations," he said.

"There is no question we will see regulatory changes," Merton concluded, but he is concerned about unintended consequences. He noted that banking and insurance are two of the most highly regulated institutions, along with health care. "Regulation is not a panacea, and should not be done to meet a political clock or to make people feel better," he said.

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