When the music is over*

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Alan S. Blinder
After the music stopped: The Financial Crisis, the Response and the Work Ahead

New York: Penguin Press HC, 2013, p. 496

ISBN: 978-1594205309

In his book, *Alan S. Blinder* discusses the financial and economic crisis which erupted in 2007, describing the antecedents, lessons and consequences of the meltdown. The author reveals the journey that led to this momentous series of events by seeking an answer to three main questions: *(i)* How did we get ourselves into such a predicament? What mistakes were made, who/what was responsible for triggering the crisis and how can we avoid repeating the same mistakes in future? *(ii)* What have we done to remedy the problems and mitigate the magnitude of the damage? Were the economic policy responses adequate, coherent, meticulously planned and sufficiently prepared? Did policy facilitate or impede implementation of the required economic policy measures? *(iii)* Did we draw the correct conclusions from the 2007–2009 crisis? Did the prudential rules adopted in 2010 steer the operation of the financial system in the right direction? What are the potential future threats and do we have adequate defence mechanisms in place to handle them?

In answering the first question, the author presents the road that led to the crisis. There is no simple answer to the question about how we got ourselves into this predicament. It was due to the unfortunate constellation of several factors, the most conspicuous of which was the bursting of the housing bubble in an extremely low interest rate environment. This, however, should not necessarily have led to such an enormous problem in its own right.

In his book, the author identifies seven "culprits". Number one is the housing and bond bubble, which reinforced the continuous growth of each another. While prices in the US real estate market increased by 0.1 per cent on average between 1890 and 1997, they

* The views expressed in this paper are those of the author(s) and do not necessarily reflect the offical view of the Magyar Nemzeti Bank.

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rose by a stunning total of 85 per cent between 1997 and 2006. Against this background, a home seemed like a terrific investment. The collateral value of real property increased, encouraging borrowers to take out more loans and creditors to extend more credit. The sharp upward drift in real property prices lead to the accumulation of leverage. This trend was further fuelled by the record low interest rate environment observed in the US after 2000.

The second culprit was the excessive leverage accumulating in the system. In pre-crisis years, the mortgage products offered to households allowed clients to purchase homes with a downpayment of as little as 5 per cent, which translates into twenty-fold leverage. This means that in case of a 5 per cent depreciation of the property, the client will have lost the entire amount of the downpayment. In practice, however, even the downpayment was often paid from loans.

Household lending was characterised by banks' irresponsible lending policy. The market of unregulated securities and derivatives, haphazard credit ratings, conflicts of interests with credit rating agencies and excessively high compensation packages led to unrealistically high profit expectations and hence, irresponsible risk-taking by financial institutions.

Blinder proceeds to present the course of the crisis including, in particular, the reactions of the government and the Fed, both of which are sharply criticised by the author. The USD 3,000 billion balance sheet of the Fed poses excessive risks, as does the practice of bailing out poorly functioning and thus distressed financial institutions. The current situation is absurd: those responsible (bankers) continue to lead a lavish lifestyle, while the victims hit most by the crisis (households) have suffered substantial and thus far irreparable damages.

Blinder also calls attention to several problems to be addressed in future. One of the most pressing issues is how the Fed will manage to phase out its unconventional monetary instruments (quantitative easing, forward guidance, key policy rate held near zero) without triggering unwanted financial turbulence. The other important question is how to reduce the US budget deficit and public debt without impeding the post-crisis recovery.

The author finds there are ten main conclusions to be drawn for the crisis that are worth considering over the long run. *(i)* We should always remember that people forget: in good times they tend to believe that the good times will last forever, which leads to the inevitable development of bubbles and unforeseen risks. *(ii)* Self-regulation is unreliable; markets and people need regulation. The notion of "market discipline" is an oxymoron. *(iii)* The interests of shareholders should be protected at all times; boards of directors must do a better job in protecting shareholders' interests. Accordingly, the leaders of corporations must be made accountable. *(iv)* The importance of risk management should not be underestimated – decision-makers should improve their risk management departments and heed their advice. *(v)* Leverage should be cut back. The activities of financial engineers in pursuit of impossibly high profits should be restricted. *(vi)* Simplicity is an important aspect – complex financial instruments conceal unforeseeable risks. *(vii)* Derivative products should be standardised and traded at regulated stock exchanges. Efficiently managed and regulated derivative products can be useful tools in risk management, but they can become financial weapons of mass destruction when misused. *(viii)* Everything should be kept in the balance sheet – off-balance sheet items reduce transparency. *(ix)* Compensation schemes need to be reformed. Executives must examine the extent to which their corporate remuneration system encourages risk-taking and penalises the accumulation of losses. *(x)* More attention should be paid to consumers – exposing clients to non-transparent and misleading lending practices is a threat to the health of the national economy.

As useful as they may seem, it is yet to be seen how these recommendations can be put into practice. Some claim that it is crisis management itself that lays the groundwork for the next crisis. The scope of regulations fails to provide a comprehensive cover, allowing for loopholes which facilitate the accumulation of heretofore unknown or long-forgotten risks. The author notes that crises, along with excessive leverage and lax risk management practices, tend to return, but regulatory expectations are expected to ease. Institutional changes are needed primarily to mitigate the damages from a future crisis. As long as we keep the conclusions of the current crisis in mind and make decisions based on the lessons drawn, the risks of a devastating future crisis may be reduced.