The Problem With Our Financial System and a response to Jeremy Grantham

Jeremy Grantham of GMO in a recent letter writes about a number of interesting points:

1. Bernanke missing the housing bubble and its bursting, the potentially disastrous implications interactions between lower house prices and new financial instruments (MBS, CDOs), and international distribution of the associated risk.
2. Other Teflon Men: Larry Summers, encouraging deregulation and lighter regulation and not sounding warning signals to the 2006 – 2007 bubble years. Tim Geithner, et al, for various failings relating to regulation and policy.
3. Misguided and reckless mortgage borrowers and the efforts to bail them out while prudent borrowers and home buyers receive no help.
4. Reckless homebuilders for overbuilding and subsidizing reckless homebuyers.
5. Over spenders and under savers.
6. Banks too big to fail, and a policy of making them bigger in the rescue attempt.
7. Over bonused finance types. Goldman Sachs is singled out.
8. Overpaid CEOs.
9. Investors in overleveraged and wounded corporations.
10. The auto industry.
11. The world’s most over-vehicled country.
12. Stock options. An old gripe about the asymmetric payoffs and the adverse selection created in management (agent) behaviour.
13. Greenspan. For promoting deregulation, for keeping rates

too low for too long.

And 6 months ago, Grantham predicted a sharp liquidity driven, fundamentals confounding rally. The logic is quite compelling.

Then he moves to prescriptions for redesigning the US financial system.

1. Regulators were too cosy with financial enterprise.
2. The overly large and overly complex financial system, well beyond the control and understanding of regulators.
3. Separate bank principal and agency businesses. Grantham points to the conflict of interest between representing clients and trading against them; Goldman is cited as an example. Some proprietary activities should be allowed, in particular genuine hedging of the main activities. Imposing leverage limits is suggested.
4. Prevent banks from getting or staying too big to fail. Break up the large banks into more manageable size.
5. Better public oversight and leadership.

He summarizes:

1. Yes, this was a profound failure of our financial system.
2. The public leadership was inadequate, especially in dealing with unexpected events that often, like the housing bubble breaking, should have been expected.
3. Of course, we should make a more determined effort to do a more effective job of leadership selection. But excellence in leadership will often be elusive.
4. Equally obvious, we could make a hundred improvements to the lifeboats. Most would be modest beneficial improvements, but in the long run they would be almost completely irrelevant and, worse, they might kid us into thinking we were doing something useful!
5. But all of the above points fail to recognize the main problem: the system has become too big and complicated

for even much-improved leaders to handle. Why should we be confident that we will find such improved leaders? For, even in an administration directed to "change," Obama and his advisors fell back on the same cast of characters who allowed, even facilitated, the development of the current crisis. Reappointing Bernanke! What a wasted opportunity to get a "son of Volker" type. (Or should that be "grandson of Volker?")

6. The size of the financial system continues to grow and shows every sign of being out of control. As it grows, it becomes a bigger drain on the rest of the economy and slows it down.
7. The only long-term hope of avoiding major recurrent crises is to make our financial system simpler, the units small enough that they can be allowed to fail, and, above all, to remove the intrinsically conflicted and dangerously risk-seeking hedge fund heart from the banking system. The rest is window dressing and wishful thinking.
8. The concept of rational expectations – the belief in the natural efficiency of capitalism – is wrong, and is the root cause of our problems. Hyman Minsky, on the other hand, was right; he argued that the natural outcome of ordinary people interacting is to make occasional financial crises "well nigh inevitable." Crises are desperately hard to avoid. We must give ourselves a chance by making the job of dealing with them much, much easier.
9. All in all we are likely to have learned little, or rather to act, through lack of character, as if we have learned nothing. In doing so we are probably condemning ourselves to another serious financial crisis in the not too- distant future.

Grantham has tremendous insight. His diagnosis of the evolution of the bubble and the precipitation of the credit crisis is accurate. The solutions for avoiding or mitigating further disasters, however, is a matter of opinion, and quite frankly of taste. There are many ways to skin a cat, pluck a black swan.

Grantham’s solution would work, but it would leave moral hazard unaddressed. The approach I favour is further deregulation, with a difference. Reregulation is a better word.

1. Education. In school, we are taught apart from maths, science, language and arts, the basic necessary functions of cooking, sewing, metal work, woodwork. Has anyone thought to educate people in basic management of household finances? Balance sheet management, cash flow management are basic elements of survival. More people know how to ride a bicycle than manage their own finances. The decision to be reckless or prudent should be a decision, not a non-decision based in ignorance. I do not advocate prudence, only that the individual is provided with the tools of their own success and demise.
2. The role of government and regulation should be pared down. A government should only provide goods and services that the free market is unable or unwilling to provide. It should also encourage the functioning of an efficient free market as far as possible. Where there is no market and government has to intervene, government should work to its own obsolescence.
3. Central banks and governments need to stop providing a safety net. Central banks need to stop providing a signal to the market about inflation expectations and interest rate policy. Reflating the economy post a bubble creates disastrous moral hazard. The removal of safety nets deals with the reckless mortgage borrowers, mortgage lenders, reckless bank prop desks, reckless credit providers, overpaid bankers and CEOs, overgrown banks, overgrown banking system, overcomplex financial systems. The only way to get economic agents to think

carefully, act prudently, is to simply remove the safety net. No more bailouts, no signal on inflation expectations, no leader on interest rates, no lender of last resort. How careful will we be in all our financial decisions.

4. Promote standards of public disclosure and transparency for financial institutions in lieu of restrictive regulation. Provide the market with the information to self regulate. Even here, don't force it. Full disclosure about compliance to standards is sufficient.

And that's it: a new world order where we are each and every one of us responsible for our own financial well being. Lets see if this answers the issues Grantham raises:

1. Central banker myopic: Central banker rendered less relevant.
2. Teflon Men and the de-regulation bandwagon: Get what they wish. Light on regulation, heavy on disclosure.
3. Reckless borrowers: Would be properly educated. Would lose their homes if reckless, just the same as before. Would blame everyone around them, just as before. But this will change in 1 generation since the lack of protection would constitute a true shift in paradigm.
4. Overspenders and Undersavers: What is the definition of over spending and under saving? Education about financial management should address this. A household has the right to be reckless as long as they know they are being reckless and decide to be so intentionally, knowing there is no safety net.
5. Reckless homebuilders: Will fall in line with the new credit underwriting standards in a world with no lender of last resort.
6. Without a safety net, a lender of last resort, banks would shrink to fit. Investors and creditors and depositors would self regulate the size and complexity.
7. Overpaid bankers: An educated investor base will self

regulate.

8. Overpaid CEOs: Ditto.
9. Investors in crap: Ditto.
10. The auto industry: Investors in crap. Ditto.
11. Over vehicled Country: Can’t help you there. China is getting there.
12. Stock options: Market ex lender of last resort will police.
13. Greenspan Put: He was the lender of last resort.