WSJ Lessons from the Great Recession

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The *Wall Street Journal* used the 10th anniversary of the Great Recession to instruct its readers on the lessons from the massive market failure: "It has been 10 years since the financial crisis. The *Wall Street Journal* is taking a look back at what happened and the lessons learned. Here are some of the highlights of the package." This post is an annotated version of the list. Spoiler alert: If you are looking for a guide on how to effectively prevent repetition of the huge cost of the 2008-09 extreme instability, the *WSJ* – hung up on the Sisyphusian task of preventing future banking crises – does not come close.

"The failure of Lehman Brothers exposed how cavalier the world had been towards risk."

The *WSJ* misunderstanding of the essential 2008-09 macrodynamics begins with their poor grasp of the keystone risk motivating the GR. Their reporters believe that the core problem was that low-income households stopped making payments on their subprime mortgages, many of which were fraudulently obtained by overstating income. They are wrong; there was no widespread subprime default. As documented in *The Financial Crisis Inquiry Report* (2011), for 2005 to 2007 tranches of mortgage-backed securities originally rated triple-A, despite the mass downgrades, only 4% of subprime securities had been 'materially impaired' – meaning that losses were imminent or had already been suffered – by the end of 2009. Instead, as modeled in the GEM Project, the damage was done by the increasing perception by investors/lenders that the near-term risk of depression had become non-trivial. They responded by becoming rationally inactive, waiting for credible bottoms to emerge in asset markets. Such inactivity is jet fuel for asset market collapse. (See Chapter 10 in the website's e-book.)

"Countless investors lost faith in financial markets—and never got it back."

That is mostly true. It is an understandable response that must not be ignored by stabilization policymakers, but not in the way the *WSJ* believes. It was the big, not small, investors that played the crucial role in the collapse of nonstationary demand that was organizing itself in the immediate aftermath of the Lehman bankruptcy. Despite that, authorities should pay close attention to who is most hurt by instability. In the first decade of the 21st century with its extraordinarily low "risk-free" bond rates, households had little choice but to invest their IRAs (holding most of their retirement funds) in equities. When stocks begin their collapse after the Lehman bankruptcy and the gathering inaction among buyers of financial assets, low-information households – that is, almost all households – were told by the brokers and other advisors to stand pat, wait out what was surely a temporary correction.

This class of investors were the last to sell, liquidating their holdings closer to the bottom of the 50% decline in the S&P 500 index. Promising themselves that they would never risk what was left of their retirements in equity markets, they missed the recovery in stock prices that rapidly occurred in 2009. The lesson here is that policymakers were irresponsibly satisfied with a stock-market recovery. They should be more protective of low-information people who retirements were hugely damaged by the macrodynamics of the Great Recession.

"Banks are no longer the power brokers on Wall Street. *Profits, assets and influence have moved from investment banks such as Goldman Sachs to money-management giants such as BlackRock and Vanguard. These firms were once sleepy clients of Wall Street. Today they direct huge flows of capital and capture the lion's share of the finance industry's fees".*

That's a bit overstated, but basically true. It is one of the numerous reasons why increased bank regulation can never be effective protection against another Great Recession. But the shift doesn't have much to do with preventing future episodes of extreme instability. The major stabilization message of the GEM Project is that assembling a powerful array of demand-management tools and the well-understood will to use them is the only effective protection available to policymakers.

"The financial crisis changed home buying forever. *It was easy—too easy—to buy a house during the boom years. Not today. Lenders have tightened their standards, and many banks now view mortgages as a side service to offer to a small group of wealthier customers rather than a big-volume revenue generator."*

O.K. Overzealous regulation has made underwriting and servicing residential mortgages significantly more expensive for commercial banks, pushing the business to less reputable firms. The biggest losers here, once again, are low-income households. Such shifts in the nature of home-mortgage financing, however, doesn't much matter in effective stabilization policymaking.

"The new mortgage kings are companies you've probably never heard of. *The home-lending business has shifted to specialized mortgage lenders that fall outside the banking sector. Such nonbanks now have 52% of U.S. mortgage originations, up from 9% in 2009. They symbolize both the healthy reinvention of the mortgage market—and how the growth in that market almost exclusively has been in its less-regulated corner."*

The WSJ fails to mention that virtually all of the tarnished underwriting of subprime loans in the years leading up to the Great Recession was done outside the federally-regulated banking system. Were the fly-by-night, typically state-regulated brokers that populated much of that low-level criminal activity the "healthy reinvention of the mortgage market" of pre-recession housing boom that the WSJ has in mind today? Once again, none of this matters in the debate over the design and execution of proper stabilization policy.

"People who started at Lehman the day it failed reflect on lessons they've learned."

Is the lesson here that it sells papers to let readers hear from victims of a train wreck?

"What will trigger the next crisis? *The person who predicts the next financial crisis, and there will be at least one, should get credit for luck rather than forecasting skill. A decade of extraordinarily low interest rates has created multiple distortions in the global economy and financial system. Any of those can unwind painfully but predicting what factors would trigger a global downturn is near impossible. Potential threats include bad loans, a euro exodus, China's debt levels and earthquakes."*

The correct answer, which the *WSJ* indicates before resorting to well-worn possibilities, is that we don't know. (I am most afraid of the looming U.S. credit crisis rooted in trillion-dollar federal deficits during periods of full employment. The eventual consequences of that out-of-your mind fiscal policy are really bad.) Perhaps fortunately, the nature of the next crisis is not a particularly constructive design-of-stabilization-policy question. What the *WSJ* should be asking is whether the Fed's toolkit for the management of aggregate demand is sufficiently powerful and its resolve is sufficiently robust to prevent the next unhappy macro surprise (whatever it may be) from morphing into another Great Recession or depression.

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