The Future of Finance

"The Future of Finance"
Lawrence H. Summers
Financial Times View from the Top Conference
October 7, 2010

Introduction

I am glad to be here and glad to have a chance to talk about the future of finance. There was a time when, I suppose only 2 years ago, people were wondering whether finance had a future. I think it's instructive to begin by looking back to the turn the year from 2008-2009.

The economy was losing three quarters of a million jobs a month. Global trade was declining more rapidly than it had in the first year of the Depression. Panic in the largest financial institutions was actually greater than at the beginning of the Depression. And the stock market fell more in the 6 months between October 2008 and March 2009 than it did in the 6 months after Black Tuesday in 1929.

President Obama, when he took office, had two priorities with respect to the financial system, two priorities that he continues to have today:

- The first was the return of stability, confidence, and the flow of credit to support strong recovery.
- The second was reform of the financial system and its relationship with the larger economy to avoid recurrences of what took place between 2007 and 2009.
  He regarded these two priorities as closely linked, because only with a sense of reform that would reduce the risk of recurrence was a durable resumption of confidence likely. I want to talk today about where we stand with respect to these two priorities.

The diagnosis with which the president confronted the financial crisis was that it reflected multiple re-enforcing vicious cycles. Declining asset prices led to deleveraging, which led to selling, causing further decline in asset prices, perpetuating the cycle. Lower asset prices meant less capital for financial institutions, that meant less lending, that meant less support for asset prices and lower asset prices.

Most fundamentally, a weakened financial system meant less borrowing and spending, which led to a weakened economy, which led a weakened financial system. And at the most critical moments fear was contagious, leading to panic.

The priority for policy at such a juncture had to be confronting those vicious cycles in any way one could, at any crucial point of interaction, in the hope the vicious cycle would give way to virtuous circle.

That just as a vicious cycle of a weakened financial system could lead to a weakened economy, so forth a virtuous circle could be created in which improved financial conditions supported improved economic conditions, which in turn led to further improvements in financial conditions.

Re-Assessing TARP

The president's program had multiple aspects, one that will not be the focus of my remarks today, but was of fundamental importance was the Recovery Act and the associated infusion of substantial spending power into the economy both through public sector spending and through tax reductions that encouraged private savings, leading to a slowing and eventually stopping in the declines in employment and personal income and supporting the resumption of spending.

But no amount of direct support for spending in the economy would have been sufficient without an effective response to the financial crisis, which profoundly affected almost every financial intermediary and through its affect on the financial system almost every participant in the American economy and a very large fraction of the participants in the global economy.

Of central importance was, of course, the little mourned TARP program. If journalism is the rough draft of history then surely the postmortems of outgoing policymakers are no more than the second draft of history. But permit me several observations.

First, the cumulative taxpayer born cost of resolving the U.S. financial crisis now appears to be remarkably low, given the scale and pervasiveness of the crisis. While the systemic banking crisis around the world has often been associated with taxpayer bills - it came to 10% or more of GDP, the cost of the TARP is now likely to be below 1/3 of 1% of U.S. GDP.

Now there are many ways of doing the accounting, as some of you will be thinking the TARP bill, as it is conventionally calculated, leaves out the cost of support to the government-sponsored enterprises, Fannie and Freddie. It also leaves out the extraordinary senior profits earned by the Federal Reserve System as it expanded its balance sheet profits, which are in the normal course rebated to the Treasury.

There are multiple ways of doing the accounting, but no reasonable one would get to a figure as large as 2% of GDP. That this financial crisis could be resolved in its financial dimension at a price tag relative to the size of the economy, likely to come in below the far less sweeping S&L crisis of the late 1980s, was an event anticipated by almost no one in the fall 2008.

In order to think about that success, it is important, I believe, to think of the TARP as coming in two phases. The first phase came in the fall of 2008 following the Lehman, AIG panic weekend, and had as its objective the prevention of systemic breakdown. A judgment was made that support for the financial system and the largest components of the financial system had to be pervasive and across the board to avoid stigmatizing and putting at risk the most troubled firms.

A consequence of the judgment - that support was to be pervasive - was that it had to be made acceptable to all firms even those that were healthy. That meant quite attractive pricing and quite light conditionality. The effort was successful; it prevented the breakdown that many feared in those darkest weeks.

But it left in its wake major problems. Major problems of political legitimacy, given that the broad gauged support meant attractive pricing and relatively light conditionality. Problems of supporting lending capital, which performs two functions in financial institutions - it supports balance sheet expansion and it provides assurance to creditors. The fundamental idea of capital is that it is permanent and so it supports both these objectives.

Given how painful financial institutions found it to be partners with the government as TARP capital made them, they felt enormous pressure to repay TARP capital as rapidly as practical.

This meant that it was effective in providing reassurance to creditors, but that it was not effective in supporting balance sheet expansion, given that paying back as rapidly as possible was a preferable alternative to using it as a basis for balance sheet expansion.

The TARP, as originally implemented, focused on support for the financial institutions that were, in the shortest run, the immediate point of risk, but not on assuring the supply of credit to key sectors of the economy except indirectly through support for financial institutions.

There was as 2008 came to a close, a sense that the problem was pervasive and that in all likelihood it would prove necessary to seek additional support for the financial system beyond the $700 billion that the TARP represented.

The incoming Obama administration grateful for the success that had been achieved in avoiding systemic breakdown, none-the-less, recognized that it was necessary to move to a second phase in assuring financial recovery. Our strategy had 4 elements:

First, hope for the best while planning for the worst, and move early, not late to respond to problems. Even before the president took office he expended substantial political capital working with Congress to generate the required permission to enable the second $350 billion of TARP funds to be spent promptly.

Cognizant of the political difficulty of expanded TARP support, the president none-the-less signaled his commitment to do what was necessary, by providing a budget message to Congress for the prospect that it would be necessary to seek increased funds for support for the financial system and vowing to do what was necessary to maintain confidence.

Second was to force transparency and reliance on private markets. The famous stress tests, which generated considerable cynicism when first suggested, proved to be enormously successful.

Transparency removed the fear of the unknown that acted as a specter over the financial system. Transparency provided a basis for estimating capital needs which made it possible for firms to go to the private markets to raise capital. Tough conditions on TARP repayment encouraged the rapid substitution of private capital for public capital in the financial system.

Third, because we were in a second phase where the objective was not to avoid stigmatizing the most troubled institutions; rigorous conditions were exacted for extraordinary support. Those institutions, those few institutions, that received additional financial support, direct or indirect, beyond the first phase of the TARP, were subject to rigorous conditions on their balance sheet and in some cases on their management.

Careful review of continuing TARP recipients problematic compensation practices, was instituted. Appropriate stakeholder sacrifices were sought notably in the case of the automobile bankruptcies and the rigorous restructuring of AIG that is now likely to result in a substantial profit for taxpayers.

And finally, a crucial component of the Obama administration's efforts was emphasis on the flow of credit. The provision of post-bankruptcy support to the automobile companies in recognition of the fact that credit conditions in the spring of 2009 made a normally functioning debtor in possession finance market impossible.

Substantially enhanced in the Recovery Act: support for small business, a commitment to the housing market, to support for the GSEs, and to the mortgage market. One of the less remarkable changes that took place between January and July of 2009 was the increase of nearly 20% in futures market indicators in expectation for housing prices. That is expected housing prices at the end 2010 increased by nearly 20% from their levels in the winter of 2009, supporting a whole range of financial intermediaries and financial activity.

We are not out of the woods, but with the TARP cost likely to be small, with the four largest financial institutions in the country now having market capitalizations of equity well above 100 billion dollars, even as original shareholders have been very badly diluted, we are in far stronger shape than could have been imagined 2 years ago.

Maintaining Demand

Indeed it is fair to suggest that the dominant problems in the flow of credit in the winter of 2009 lay on the supply side, lay on the capacity of financial intermediaries to lend and in the capacity of securitization markets to function.

Today a far larger fraction of those problems lie on the demand side. One sees that in the magnitude of cash on corporate balance sheets: the magnitude of excess reserves on banks' balance sheets, the magnitude of undrawn credit lines, which are at unusually high levels today.

The financial challenges that interfere with the economy lie in the desire of borrowers to reduce indebtedness rather than in the desire of creditors to reduce exposures. And that reality must and does shape our economic strategy going forward. It shapes a recognition that increases in spending power, increases in demand, will be the dominant determinate of the pace of recovery.

Sectors in which increased demand normally drives recovery cannot be relied on in the conventional way at this time. Large overhangs still exist in the housing sector. Similar qualitative overhangs exist in respect to other consumer durable goods, notably automobiles. Capacity utilization remains low in most sectors of production.

Where then can we look for the increased demand that is necessary to drive recovery?

Three areas stand out: first exports.

This is right as a matter of recovery strategy and it is right as a matter of long term adjustment. That is why the president has set as a goal doubling the level of net exports in the American economy over the next 5 years. Much of this has to do with macroeconomic strategy and the encouragement of growth abroad.

But there are other key steps as well. We have substantial progress on the largest overhaul of U.S. export controls in decades. That removes a self-inflicted barrier to increased exports. The President has committed to take all steps possible to move forward on our trade agreement with Korea and more generally to move forward the Doha round.

We have substantially increased export import bank financing to promote levels of US exports. New initiatives with respect to service sector exports are underway. Increasing exports has to be a first component of any growth strategy.

Second, spurring productive investment:

Investments take two forms. Investments take the form of expansion in capacity and they also take the form of replacement investment or augmentation investment where qualitative improvement is possible.

My purchase of an iPad did not reflect the obsolescence of my computer or my lack of desire to own a computer. It reflected a new opportunity that was open to me. And similarly if one looks at the composition of investment, an increasing fraction of the sectors in which investment is largest reflect qualitative improvement.

Of particular importance for public policy here is support for investments in renewable energy and investments in energy efficiency, which are desirable independent of current degrees of capacity utilization. And so government has emerged as a major supporter of investment in these areas over the last several years.

Similar, in representing a qualitative improvement, is the president's commitment to health information technology investment. It simply cannot make any sense that the average Seven-Eleven in the United States is far more reliant on information technology than the average doctor's office, at a time when information technology can literally make the difference between life and death in reducing medical errors.

The third key source of demand is necessary public support for investment. Anyone who compares the quality of American's airports and train stations and roads with the quality of its malls and resorts cannot doubt the scope and desirability of increased public infrastructure investment.

Can there be a better time to expand infrastructure investment, than a time when the government is able to borrow for 30 years well below 4%? A time when construction unemployment approaches one-fifth? A time when building costs are 20% below normal, because of excess capacity?

It is both a long term imperative and a short-term macroeconomic imperative to increase infrastructure investing; to provide the necessary uses of funds through public borrowing, not for public consumption, for public investment, at a time when private borrowing for investment is lagging.

Financial system repair support for demand to push the economy forward in key sectors, an attempt to engage the mechanisms of a virtuous circle and strengthened incomes and strengthened finance reinforce each other this is the first component of our financial strategy.

Implementing Financial Reform

The second area about which I will speak much more briefly is financial reform and reform of the financial system. Start with this, if one looks over the last generation we have seen, and people in this rooms have lived through, the 1987 financial crisis, 1987 stock market crash, the Latin American debt crisis, the Real Estate woes of the early 90s, the S&L crisis, the Mexican financial crisis, the Asian financial crisis, Russia and LTCM, the tech bubble, Enron, and now this.

If you work it out roughly once every 3 years, for a generation, a financial system whose function is to spread and allocate and diversify risk has in fact proven to be a source of risk that has led to the unemployment of hundreds of thousands, if not millions, of people who have no other major contact with the financial system.

It probably should have been clear before this latest crisis that major reform was necessary. It was certainly clear after this latest crisis that major reform was necessary. I believe that the Dodd-Frank legislation passed by the Congress, with strong Administration support, and signed into law by the President, offers a framework for substantially reducing the risk of a future financial crisis.

If one thinks about important contributors to the most recent financial crisis, consider this: strengthened consumer protection would not have left an unregulated subprime mortgage market to prey on people and set off a housing bubble. Increased capital requirements and comprehensive regulation of all systemic institutions would have meant less borrowing and less leverage in the financial system.

Clearinghouses would have brought a transparency to the derivatives market of a kind that was singularly lacking at AIG and in other places. And resolution authority would have enabled a framework for handling institutions that like Lehman that were going down.

Now these reforms are anything but self-actualizing. The passage of the law was the first step, not the last step. Judgments made by regulators in implementing these laws, the quality of cooperation globally, the responsibility of those who lead financial institutions and those who bare responsibility for the management of their risk, will be essential going forward. But a framework that offers the prospect for substantial improvement is in place.

Political Economy

A final thought, this has been a period I think it is fair to say, both of unusual difficulty and of unusual acrimony, in the relationship between the public sector and the financial sector. That is perhaps inevitable, given the degree of the difficulty that we have been through.

There are issues that will need to be carefully considered in the years ahead on both sides. Surely it is important for those of us in the public sector to recognize the central role that a healthy competitive and innovative financial system plays in supporting a sound economy. Surely it is important for those of us in the public sector to recognize that success in the financial system can, and is likely to, be a crucial contributor to success of our broader national economic project.

At the same time, I would suggest that those in the financial system need to recognize that as responsible citizens, and as beneficiaries of a broad umbrella of regulation and support, that they to have obligations to support the system. Obligations that require effort to make views known clearly vividly and strongly, but to support a healthy decision making system.

When I read that the financial industry spent $1 million dollars per member of Congress lobbying the most recent regulatory bill, I come to more sympathy with some of those who have been critical of the sector. When I learned that there four registered lobbyists working the bill for each member of Congress, not each member of the banking committee, not each member of the Senate, each member of Congress, the nature of concerns about our democracy becomes clearer.

When I consider the range of those who financed the ads attempting to convince people that they wouldn't be able to keep a tab at their florist if financial regulation was passed, I wonder further about the quality of our debate.

And I when I observe that some institutions have been willing to pledge that they will not use corporate funds to anonymously support large scale efforts to influence elections but that most institutions have today been unwilling to take such a pledge, I wonder about whether we fully have the kind of democratic system for making these decisions that can assure legitimacy in the future.

Because ultimately, the success of our financial system depends upon the broader success of our national project and in the other way round.

Conclusion

I would just conclude with this thought - when people asked me in January of 2009 how I would know whether we had succeeded here is how I responded: I said my daughter had just completed an Advanced Placement course in U.S. history and it had been interesting to me to see what they had learned about and what they hadn't learned about.

All kinds of things that seem very important to me: the 1982 recession, the stock market crash, the 1907 financial panic, were not mentioned in their course. On the other hand they had spent 6 weeks studying the events of the 1930s. And it was then clear to me what my criterion of success would be. If this period, and its financial dimensions, was not the subject of history books in 2040 then we would have fundamentally succeeded.

I believe that things are moving in that direction. And I believe that with continued efforts, but this is by no means assured, that those history books in 2040 can record that this was a period like some others in American history when we undertook reforms that strengthened both our economy and our democracy. And the financial sector will be an important object of those reforms in the years ahead.

Thank you very much.