It is time to dance to a new long-term tune

By Glenn Hubbard

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“As long as the music is playing, you’ve got to get up and dance. We’re still dancing.” Chuck Prince, then chief executive of Citigroup, July 2007

This was a defining quote of the final days of the period before the fall of Lehman Brothers. On September 15, 2008, the music stopped when US officials allowed it to fail. On the heels of its bankruptcy came the colossally expensive rescue of insurance giant AIG, the worst credit-market crisis in 70 years and many questions. Should Lehman have been rescued? How should the Federal Reserve and government have responded as the downturn worsened? Who or what was to blame?

Economists and policymakers are vigorously exploring the first question. It is likely that Lehman could have been rescued. But it is far from clear that a rescue would have eliminated the possibility of a financial panic, as pressures in the system were too large to ease gradually.

But it is the second and particularly the last question that should now interest us most. Lehman’s demise is not just a focal point of the crisis – it was a watershed, highlighting long-ignored structural problems in the both the US and the global economy.

But will policymakers lift their gaze from the short term? The initial verdict is not promising. The banking reforms agreed in Basel on Sunday are too focused on capital buffers and not enough on the long-term stresses that precipitated the crisis. While slow to recognise the crisis, the Fed’s unconventional interventions did blunt the potential spillover in credit spreads and a collapse in liquidity following Lehman’s demise. By contrast, the government’s early missteps with banks’ troubled assets increased investor uncertainty. In 2009, a poorly targeted stimulus in the US yielded little, while a campaign to raise taxes on saving, sabre-rattling on trade and increases in hiring costs from healthcare mandates have left a trail of uncertainty. The responses emphasised short-term problems in the economy, ignoring structural factors in Lehman’s fall – and our wake-up call.

How did the pressures build before the blow-up? Imbalances in global saving coupled with investment growing for more than a decade led to low real interest rates around the world for many years, putting pressure on prices of assets and reducing risk premiums in financial markets. In addition, in countries that pursued accommodative monetary policies after the 2001 recession, the housing bubble was greater. Finally, regulatory gaps and incentives in securitisation that used
credit-ratings to mask poorly understood risks left the burgeoning holdings of mortgage-backed securities on the balance sheets of many financial institutions priced for perfection.

But pressures were building – for the economy as well as for Lehman – in the years before its fall. Wages for many Americans had been stagnating, influenced by shifts in skill premiums in labour markets, but also by rising employer healthcare costs, which drained labour’s gains in compensation from higher productivity. Against this backdrop of a need for enhancing skills and containing healthcare costs, policymakers focused more on near-term consumption. Under both Democrat and Republican governments, temporary tax cuts and easier credit especially for housing was the rule.

The short-term focus increased pressures in financial imbalances, ultimately destroying Lehman – by failing to appreciate links between emerging imbalances and liquidity – and deepening the financial crisis, by failing to appreciate the costs of inconsistent policy responses in influencing investor expectations. We have made further unpleasant trade-offs in fiscal policy with higher levels of debt. We have passed a new healthcare law that will raise employer healthcare costs, further increasing stresses on wages and employment. We have also increased entitlement debt burdens by raising benefits and delaying reforms, implying higher future taxes on employment.

We do have lessons to learn. Leverage was at the root of the crisis and a workable resolution mechanism would help to separate a “good bank” and a “bad bank” – and reduce unwelcome spillovers to the financial system. However on these points the Dodd-Frank Act, largely took a pass.

Our collective over-emphasis on policy for the short term over long term in the era before Lehman’s fall has returned to haunt us. Lehman’s foundations were cracked by emerging shoots from seeds of destruction in the US economy and economic policy. For the economy as a whole, however, there are seeds of prosperity in reforms of financial regulation, tax and budget policy, trade and healthcare that will keep the economy’s music alive with a rich sound. It is to this score that we should turn our attention.

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