Why The Financial Crisis Might Happen Again

Luis Garicano tweeted as follows in late 2018 **(emphasis added)**:

Today 10 years ago the Queen asked me "Why did nobody saw the crisis coming?" On the occasion of her visit to LSE to inaugurate our new building, I was asked by the Palace to explain to the Queen the financial crisis. At the end of my explanation, she asked just THE one question. An excellent question that put me, and all economists on the spot. If we are so clever, and the financial system was in such poor health, why did no one say anything about it?

Some people did see it. I explained that every agent thought they were doing what they were supposed to do by relying on other agents, but the system failed. The answer, as the FT's @alanbeattie put it then, was half right

> The truth is that lots of people in lots of different countries simultaneously made the same mistake. The explanation you got from the man from the LSE was a pretty good summary. “At every stage,” Prof Garicano apparently replied, “someone was relying on somebody else and everyone thought they were doing the right thing.” That is at least half right.
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> House buyers took the view that as long as someone was prepared to lend them money, things would be OK. The mortgage lenders reckoned that as long as they could package up the mortgages as newfangled financial derivatives (it’s a long story, Ma’am) and sell them on, that would be fine. The financial institutions surmised that as long as the credit ratings agencies were giving the derivatives their seal of approval, everything would be dandy. The credit ratings agencies thought – actually, it is pretty hard to work out what in God’s name the credit ratings agencies were thinking, except that as long as their rivals were giving these assets the thumbs-up, they had better do so as well.
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> **As for the regulators, Ma’am, the point is that they didn’t really know and too many didn’t want to.** Warren Buffett, a somewhat well-known investor from one of your revolted colonies, called these exotic derivatives “weapons of mass destruction”.

The other half of the answer is that regulation failed. Banks, insurance companies (AIG-FP) etc. gamed regulations by reducing bank capital to ridiculous levels. Equity is expensive, debt too cheap. Banks gambled with house money: tails they win, heads taxpayers lose.

The whole system was built on regulating each institution in isolation. No-one was looking at "systemic" risk. "Given" AIG provides insurance, Citibank's CDOs are safe. Of course, this was not the case, since they could both collapse together (as they did).

Can the same problems be repeated? Yes. In spite of the world economy coming to an extremely deep crisis, not much has fundamentally changed. Banks have more capital to face any issue, but the basic problems that caused the crisis are still there. If anything, the vulnerability has been increased by the rescues and the lessons "learned" from Lehman's--that it was wrong to let it fail. In my view, as @MESandbu has argued, the liquidation should have been well managed, but letting it fail was right

> While the treatment of Lehman can be faulted on many grounds, not rescuing it in toto is not one of them. The system-critical parts could have been better segregated; the Fed could even have required more assets to be transferred to them from other parts of businesses. The need

> for a money market guarantee could have been anticipated. The consequences of Lehman's wind-down amount to a case for managing bank liquidations better, not for avoiding them altogether.

And systemic risk is always going to be unfathomable, the "unknown unknowns". How much off balance sheet debt is there today in the shadow banking system? And who is exposed to it?

For a while, regulators took action. **But now, particularly in the US, regulations are being rolled back.** Even though the financial crisis is at the root of the world political turmoil we are still facing, lessons are already forgotten. In Europe, there has been more progress. But recent bailouts in Italy confirm the key risk is political: when things get hairy again, politicians and regulators will want to bail banks out. Lenders know this, and banks continue taking too much risk.

I am afraid the Queen's question will be much tougher next time around: having seen what happened in 2008, how could these things happen again? No one will be able to claim ignorance then.