

THE US CONGRESS INQUIRY ON THE FINANCIAL AND ECONOMIC CRISIS*

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The recent financial crisis seems destined to remain an event without causes. Despite the increased attention given over the last decades to the role that credit and finance play in a modern capitalist economy, the outbreak of the crisis was totally unexpected. And in the aftermath, attempts to provide an explanation of events rarely went beyond a simple description of how the financial mess spread. In the light of this state of things, the release of a US government report on the sources of the current economic and financial disorders is an important fact, offering an opportunity to discuss the main lines of interpretation that have emerged a year and a half after the most acute phase of the financial turmoil. This review will first provide a summary of the reconstruction of events by the Financial Crisis Inquiry Commission. The report's explanations of the crisis are then discussed. It is argued that the main limitation of these explanations lies in a conception of the crisis as an entirely monetary and financial event. The following sections discuss some not strictly financial factors that caused the crisis. We will focus, in particular, on changes in income distribution, arguing that the recognition of the role they played in fostering the crisis establishes the needed connection between the financial crisis proper and the economic crisis in a wider sense.

JEL Classification: E25; E58; G01

I. INTRODUCTION

In the spring of 2009, the Fraud Enforcement and Recovery Act (FERA) was passed by the US Senate and House of Representatives with large majorities. In addition to amending some aspects of the security fraud legislation and providing additional funds to a range of Federal agencies in order to prevent financial frauds, the FERA instituted the Financial Crisis Inquiry Commission (FCIC) to investigate ‘the causes, domestic and global, of the current financial and economic crisis in the USA’. On 27 January 2011, the 10-member bipartisan panel (6 appointed by the Democrats and 4 appointed by the Republicans) delivered a 600 page report which

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recaps one year and a half of work during which more than 700 witnesses were interviewed in public hearings.¹

Bravely conceived by his Democrat chairman Phil Angelides as the new ‘Pecora Commission’² (the famous investigative panel established by the US Government after the 1929 crash, which gave political impetus to the legislation which transformed the financial market in the thirties), the FCIC submitted its findings to Congress in a political climate very different from the consensus against the Wall Street abuses that had characterized the start of its work. Instead of acting as a driving force for radical reforms, the release of the report has aroused a controversy so bitter that the Commission has been charged of overspending and partisanship.³

The hostile reception of the report was largely predictable. In December 2010, the four Republican commissioners had published a ‘primer’,⁴ anticipating their dissent from the majority of the Commission, stating their own views on the causes of the crisis. The four dissenters did not sign the Commission report. Three of them (including the Republican vice-chairman Bill Thomas) added a minority report of about 30 pages (pp. 411–440), while the fourth dissenter (Peter J. Wallison) presented a personal statement of 100 pages (pp. 441–538)—about one quarter the length of the majority report (pp. 3–410). That the committee would split became clear by July 2010, when President Obama signed a lightweight financial reform, which was declared by both Republicans and Democrats as final. The dissenting member of the Commission Peter J. Wallison wrote:

The question I have been most frequently asked about the Financial Crisis Inquiry Commission... is why Congress bothered to authorize it at all. Without waiting for the Commission’s insights into the causes of the financial crisis, Congress passed and the President signed the Dodd-Frank Act (DFA), far reaching and highly consequential regulatory legislation. Congress and the President acted without seeking to understand the true causes of the wrenching events of 2008 (p. 443).

Indeed, after the enactment of the DFA, commissioners found themselves in the unpleasant position of having to conclude a ‘preliminary work’ for a financial reform bill that the Congress had already passed.⁵ At that point they had no choice but to stay the course.

Many peculiarities of this report can be understood in the light of a tendency towards the normalization of the US financial and economic scene in 2010. A

¹ All the transcriptions of the hearings, as well as the material submitted, are available at: <http://fcic.law.stanford.edu>. The list of hearings and witnesses can be found in Appendix B to the report at pp. 545–552.

² FCIC (2009, p. 2.)

³ The FCIC had fallen under scrutiny since July 2010, when Darrell Issa, a Representative who chaired the House Oversight and Government Reform Committee, raised questions about the panel’s request for \$1.8 million in addition to its \$8 million budget (cf. Schmidt & Mattingly, 2011). Lehman’s bankruptcy examiner (the private firm Jenner & Block) had a \$42 million budget (cf. Weil, 2011).

⁴ Republican Commissioners on the FCIC (2010).

⁵ It is worth noticing that the FERA did not invest the Commission with the task of making Recommendations.

memorandum of dissent that appears as a sort of parallel report next to that of the majority, in fact, is not the only oddity that strikes the reader. The report's conclusions are at the beginning, after the preface, in 14 introductory pages (pp. xv–xxviii). This part is not simply introductory, since the 400 pages of the majority report are mainly historical and descriptive. The report lacks an extensive conclusive section on the causes of the financial crisis. A reconstruction cannot of course be purely historical and descriptive, and in fact the majority distilled their 'hard facts' to support a precise idea of the source of the financial mess. Yet, the effort to spell out clear indications of the causes of the crisis is very limited, a weakness which the dissenters have taken advantage of. What the Commission provides is a very detailed account of events. This account is persuasive, and can be easily grasped by an educated public. In a sense this is fortunate, the legislator being no longer the recipient of the results of the inquiry. The FCIC has the merit of offering a great deal of information about how the US financial industry works, including its abuses and frauds, and argues that the need to radically reshape the sector is still there.

A brief summary of the FCIC report is offered in Section 2. Section 3 tries to make explicit that the FCIC revolves around the conception of the crisis as a purely monetary and financial phenomenon. Sections 4 and 5 seek instead to link the financial degeneration described by the Commission to imbalances in the real economy, identifying the changes in income distribution as the fundamental imbalance. Section 6 concludes, summarizing the current debate on this controversial hypothesis.

II. THE RECONSTRUCTION OF EVENTS

The mainstay of the majority report is in parts II–IV. These parts are divided in 19 chapters (2–20) structured along the lines of the Minsky–Kinolleberger description of the credit cycle: the displacement — i.e. the trigger event (Chapters 2–5); the stages of boom and euphoria up to the tipping point (Chapters 6–11); the phases of profit taking and panic (Chapters 12–20).

2.a The displacement

Part II is addressed to the "origins of risks as they developed in the financial system over recent decades" (p. 27). The report narrows the investigation to purely financial issues, focusing on four features of the US financial system: (i) the astonishing growth of the so-called shadow banking system; (ii) the financial deregulation; (iii) the substantial changes that occurred in the mortgage industry; (iv) the role of securitization, structured finance and derivatives.

The growth of the shadow banking system — or, more properly, the parallel banking system — and the concomitant easing of financial regulation are in essence two sides of same coin. Until the late 1970s, commercial banks and thrifts operated in the financial environment regulated by the Glass-Steagall Act of 1933. Banks and thrifts could borrow from the Federal Reserve, while their deposits were insured by

the Federal Deposit Insurance Corporation (FDIC). To prevent the destabilizing effects of unfettered competition among institutions covered by the protective umbrella of the lender of last resort, the range of their activities was restricted, and the Federal Reserve capped the interest rates they could pay to depositors (Regulation Q). The size of the banks was relatively small, financial institutions being mostly forced to borrow and lend within a single state. This system

was stable as long as interest rates remained relatively steady, which they did during the first two decades after World War II. Beginning in the late-1960s, however, inflation started to increase, pushing up interest rates. For example, the rates that banks paid other banks for overnight loans had rarely exceeded 6% in the decades before 1980, when it reached 20%. However, thanks to Regulation Q, banks and thrifts were stuck offering roughly less than 6% on most deposits. Clearly, this was an untenable bind for the depository institutions, which could not compete on the most basic level of the interest rate offered on a deposit. Compete with whom? In the 1970s, Merrill Lynch, Fidelity, Vanguard, and others persuaded consumers and businesses to abandon banks and thrifts for higher returns. These firms — eager to find new businesses, particularly after the Securities and Exchange Commission (SEC) abolished fixed commissions on stock trades in 1975 — created money market mutual funds that invested these depositors' money in short-term, safe securities such as Treasury bonds and highly rated corporate debt, and the funds paid higher interest rates than banks and thrifts were allowed to pay. The funds functioned like bank accounts, although with a different mechanism: customers bought shares redeemable daily at a stable value (pp. 29–30).

These shares redeemable daily at a stable value became a surrogate of the Government's deposit insurance. The commercial paper and repo markets enlarged, gradually becoming the main source of finance for the US credit system. Starting from the beginning of the 1980s, the unregulated segment of the market expanded more and more at the expense of the regulated segment:

Commercial banks were at a disadvantage and in danger of losing their dominant position. Their bind was labeled 'disintermediation,' and many critics of the financial regulatory system concluded that policy makers, all the way back to the Depression, had trapped depository institutions in this unprofitable straitjacket not only by capping the interest rates they could pay depositors and imposing capital requirements but also by preventing the institutions from competing against the investment banks (and their money market mutual funds). Moreover, critics argued, the regulatory constraints on industries across the entire economy discouraged competition and restricted innovation, and the financial sector was a prime example of such a hampered industry (pp. 33–34).

The savings and loan crisis of the 1980s precipitated events. The unregulated sector took the lead, establishing the free-market framework for the financial sector as a whole. On the one hand, the traditional banking system was allowed to undertake activities previously not allowed. On the other hand, the regulative barriers that had prevented mergers in the banking industry were repealed, letting banks grow and integrate with securities and insurance firms.

Once the compartmentalization of the sector implemented by the Glass-Steagall Act had been dismantled, the regulated and unregulated sectors became integrated through securitization. The traditional banking system lent to corporations and — increasingly — to consumers. This branch of the system funded its activities by

securitizing the loans, selling the bonds to the parallel banking system. The intermediaries in this second branch of the business (investment banks mainly) were, in turn, funded by investors (investment managers, pension funds, insurance companies, security lenders) who were interested in a variety of maturities and risks, including a substantial demand for checking accounts. Their holdings were very concentrated, thus well above the limit insured by the FDIC; the need for safe money was satisfied 'rolling over' safe assets in the commercial paper and repo markets. This process of securitization offered to the purchasers of these safe assets a return higher than the return on Treasury notes. But how was it possible to achieve efficiency gains large enough to improve the position of borrowers, lenders and intermediaries?

Private securitizations, or structured finance securities, had two key benefits to investors: *pooling* and *tranching*. If many loans were pooled into one security, a few defaults would have minimal impact. Structured finance securities could also be sliced up and sold in portions — known as tranches — which let buyers customize their payments. Risk-averse investors would buy tranches that paid off first in the event of default, but had lower yields. Return-oriented investors bought riskier tranches with higher yields (p. 43).

Thanks to securitization, commercial banks were freed from the need to borrow short and lend long-term, acting as the originators of the raw material needed to create new financial products. Investment banks *structured* these products, profiting from the fees obtained by pooling and tranching loans. Investors and borrowers benefited from a better distribution of the risks and the rewards thereby obtained. Credit rating agencies gave their stamp of approval. As a result

By 1999, when the market was 16 years old, about \$900 billion worth of securitizations, beyond those done by Fannie, Freddie, and Ginnie, were outstanding . . . That included \$114 billion of automobile loans and over \$250 billion of credit card debt; nearly \$150 billion worth of securities were mortgages ineligible for securitization by Fannie and Freddie. Many were subprime (p. 44).

The crisis will show that many deals in this trillion-dollar business were priced incorrectly according to unfounded expectations about default rates, and that the complexity of many products was such that even the best equipped credit rating agencies were not able to assess the risks. A simple point, however, should have been clear from the outset: as Lindsey, the former Fed governor reportedly said, securitization "was diversifying the risk . . . But it wasn't reducing the risk . . . You as an individual can diversify your risk. The system as a whole, though, cannot reduce the risk. And that's where the confusion lies" (p. 45).

Securitization is intimately connected with subprime lending, the fourth development of the US financial market that, according to the FCIC, led the system to collapse. The role of subprime lending is central to any analysis of the financial crisis for two reasons: first, the widespread insolvency of subprime borrowers was the discernible trigger event of the crisis (a circumstance that has prompted an identification between the proximate and the ultimate causes of the financial disorder);

second, subprime lending is closely connected to the socially valuable goal of increasing the number of homeowners — a political ambition endorsed by both Democrat and Republican administrations — which seems to suggest that the government is the culprit. The growth of subprime mortgage debt (together with the expansion of structured finance and derivative contracts) is the most significant event that occurred in the US credit market in recent decades. Starting from the beginning of the 1990s, banks, mortgage firms and investment banks began to securitize ‘non-agency mortgages’, i.e. mortgages which did not conform to the Government Sponsored Enterprises (GSEs) standards. The business received a strong push by the savings and loan crisis: burdened by billion dollars loans from failed thrifts and banks, the government established the Resolution Trust Corporation in 1989 to offload mortgages onto it. Some uncollectable loans were sold to Fannie and Freddie; others did not conform to Fannie’s and Freddie’s standards and were sold to the market.

2.b Boom and bust

At the end of the 1990s, after the Russian debt crisis and the Long-Term Capital Management collapse, the business recorded a stop and the rate of subprime mortgage securitization dropped from 55.1% in 1998 to 37.4% in 1999. This, however, was only momentary. Although in the mid-1990s a new legislation instructed the Federal Reserve to monitor the development of subprime lending practices,⁶ the Federal Reserve did not exercise its new powers. It instead directed all its actions (first of all a policy of extraordinarily cheap money) towards strengthening the interaction between the increase in house prices and rising mortgage debt:

The effect was unprecedented debt: between 2001 and 2007, mortgage debt nationally nearly doubled. Household debt rose from 80% of disposable personal income in 1993 to almost 130% by mid-2006. More than three-quarters of this increase was mortgage debt. Part of the increase was from new home purchases, part from new debt on older homes (pp. 83–84).

Since an increasing number of mortgages was granted irrespective of the credit-worthiness of borrowers, lending standards collapsed. The FCIC carefully documents that it was common knowledge that the financial position of many debtors was becoming untenable. But despite complaints from regulators directly involved in the business of household lending and consumer groups, the Federal Reserve calmed the market, resolutely opposing the enforcement of more prudent lending standards and failing to act against predatory lending. As a result,

By 2005 and 2006, Wall Street was securitizing one-third more loans than Fannie and Freddie. In just two years, private-label mortgage-backed securities had grown more than 30%, reaching \$1.15 trillion in 2006; 71% were subprime or Alt-A (p.102).

⁶ “The 1994 legislation that gave the Fed new responsibilities was the Home Ownership and Equity Protection Act (HOEPA), passed by Congress and signed by President Clinton to address growing concerns about abusive and predatory mortgage lending practices that especially affected low-income borrowers” (p. 76).

Over the 2000s, mortgage lending became a no-documentation business, i.e. a business where money could be lent without any guarantee.⁷ This business could continue only through a reiteration of the device of the subprime-mortgage securitization process. While there is always plenty of irresponsible borrowers, in fact, irresponsible lenders are not so easy to find:

Wall Street came up with a solution: in the words of one banker, they ‘created the investor.’ That is, they built new securities that would buy the tranches that had become harder to sell. Bankers would take those low investment-grade tranches, largely rated BBB or A, from many mortgage-backed securities and repackage them into the new securities — CDOs. Approximately 80% of these CDO tranches would be rated triple-A despite the fact that they generally comprised the lower-rated tranches of mortgage-backed securities. CDO securities would be sold with their own waterfalls, with the risk-averse investors, again, paid first and the risk-seeking investors paid last. As they did in the case of mortgage-backed securities, the rating agencies gave their highest, triple-A ratings to the securities at the top (p. 127).

Thus, in order to run what the report calls the ‘mortgage machine’, a ‘CDO machine’ was also needed. Here is the mechanism by which the financial system gets rid of the risk: highly risky subprime loans were structured into tranches; safer tranches were sold to risk averse investors who mostly preferred to stay short in the repo and commercial paper markets; riskier tranches, instead, were retained by the system, and partly ‘insured’ buying protection through derivatives from AIG. The break up between the safer and the riskier tranches was not clearly defined, since, through a recursive use of structured finance (squared CDOs), most of the dangerous tranches could be further ‘transformed’ in safe assets. The bit of magic in this process of disappearance of risk was undoubtedly provided by credit rating agencies, as extensively documented by the paragraph on ‘Moody’s alchemy’ (pp. 146–150). Totally disregarding the riskiness of this endless *production of financial products by means of financial products*, leading rating agencies largely ignored the correlation of default among loans, classifying as super safe even slices taken from the pool of the riskiest tranches of mortgage backed securities and CDOs.

In the spring of 2006, the housing market touched the tipping point. The ‘raw material’ which fuelled the financial pipeline started to deteriorate:

Mortgages in serious delinquency, defined as those 90 or more days past due or in foreclosure, had hovered around 1% during the early part of the decade, jumped in 2006, and kept climbing. By the end of 2009, 9.7% of mortgage loans were seriously delinquent. By comparison, serious delinquencies peaked at 2.4% in 2002 following the previous recession... Serious delinquency... varied by type of loan... Subprime adjustable-rate mortgages began to show increases in serious delinquency in early 2006, even as house prices were peaking; the rate rose rapidly to 20% in 2007. By late 2009, the delinquency rate for subprime ARMs was 40%. Prime ARMs did not weaken until 2007, at about the same time as subprime fixed-rate mortgages. Prime fixed-rate mortgages, which have historically been the least risky, showed a

⁷ “[F]rom 2000 to 2007, low- and no-doc loans skyrocketed from 2% to roughly 9% of all outstanding loans. Among Alt-A securitizations, 80% of loans issued in 2006 had limited or no documentation” (p. 110).

slow increase in serious delinquency that coincided with the increasing severity of the recession and of unemployment in 2008 (pp. 215–216).

Serious delinquencies spread in all areas of the country and affected unforeseen numbers of subprime and *prime* mortgages: the essential hypothesis on which the structured finance technique was based — uncorrelation among defaults — proved incorrect. The financial superstructure stood up groundless, a house of cards built on investors' gullibility.

2.c Profit taking and panic

Derivatives have had a determining role in the financial crisis, having been intensively used to relieve traditional and investment banks from the risk of holding the most unsafe tranches of mortgage-backed securities and CDOs. Thus, by writing billions of dollars of protection for Goldman Sachs, Merrill Lynch, Société Générale, etc., AIG cleaned up the toxic waste of the structured finance process, acting as risk-bearer of last resort. In 2006, AIG began to reduce its commitment in the lucrative business of insuring subprime CDOs. But Wall Street continued to expand the scale of its activities:

The CDO machine had become self-fueling. Senior executives — particularly at three of the leading promoters of CDOs, Citigroup, Merrill Lynch, and UBS — apparently did not accept or perhaps even understand the risks inherent in the products they were creating. More and more, the senior tranches were retained by the arranging securities firms, the mezzanine tranches were bought by other CDOs, and the equity tranches were bought by hedge funds that were often engaged in complex trading strategies: they made money when the CDOs performed, but could also make money if the market crashed. These factors helped keep the mortgage market going long after house prices had begun to fall and created massive exposures on the books of large financial institutions — exposures that would ultimately bring many of them to the brink of failure (p.188).

With the containment of the involvement of AIG, the system, trying to download risk through the sale of credit default swaps (CDSs) and synthetic CDOs, ended up swallowing its own bait. Supported only by its own momentum, the CDO machine dragged the US financial institutions into chaos.

It is normally argued that the role of derivatives in the crisis was to contain investors' irrational exuberance, re-introducing the market discipline of the law of supply and demand. CDSs and synthetic CDOs, in fact, are pure bets that can only happen if, in addition to the long investors who make money from the swap if the reference securities perform, there are also 'short' investors, who buy CDSs on the reference securities, making money if the securities fail. The booming CDS market was just a sign that a bearish sentiment was spreading, joining and contrasting the bullish sentiment. Through CDSs, in other words, the market signalled that an increasing number of investors was moving against the housing boom and the securities on which it rested. In January 2006, the ABX.HE index was introduced. Acting as a sort of Dow Jones for the prices of CDSs on mortgage-backed securities — the higher the protection bought by the investors,

the lower the index — the ABX.HE started to monitor the mortgage market: “the declines in the ABX index in late 2006 would be one of the first harbingers of market turmoil. ‘Once [pessimists] can, in effect, sell short via the CDS, prices must reflect their views and not just the views of the leveraged optimists’, John Geanakoplos, a Yale economics professor and a partner in the hedge fund Ellington Capital Management, which both invested in and managed CDOs, told the FCIC” (p. 195). This is certainly true, but the real problem was that, in many transactions, investment banks which engineered and sold mortgage-backed securities and CDOs were simultaneously shorting them:

In the following months, Goldman reduced its own mortgage risk while continuing to create and sell mortgage-related products to its clients. From December 2006 through August 2007, it created and sold approximately \$25.4 billion of CDOs — including 17.6 billion of synthetic CDOs. The firm used the cash CDOs to unload much of its own remaining inventory of other CDO securities and mortgage-backed securities. Goldman has been criticized — and sued — for selling its subprime mortgage securities to clients while simultaneously betting against those securities. Sylvain Raynes, a structured finance expert at R&R Consulting in New York, reportedly called Goldman’s practice ‘the most cynical use of credit information that I have ever seen,’ and compared it to ‘buying fire insurance on someone else’s house and then committing arson’ (p. 236).

So great was the ability of financial markets to price transactions correctly, that the leading US financial house was able to engineer and sell a ‘product’ only worth betting against.⁸ Of course, Goldman must have had a clear idea of the fair price of these securities, as it profited twice. But who put the money in? The FCIC brings out a captivating case study on this issue. IKB Deutsche Industriebank was a bank founded in 1924 in Dusseldorf, which used to lend to mid-sized German businesses. In 2002, it created an offshore and off balance-sheet vehicle — Rhineland — to profit from structured finance securities backed by car loans, mortgages, and credit card receivables. By 2007, IKB had built a \$19 billion portfolio of asset backed securities (mainly CDOs). Assisted by Goldman, Rhineland funded itself by issuing short-term commercial paper held by American investors. These investors, though investing in US highly risky loans, were in fact taking minimal risk because IKB had stood in, making ‘risk transformation’:

In early 2007, when Goldman was looking for buyers for Abacus 2007-AC1... it looked to IKB. An employee of Paulson & Co., the hedge fund that was taking the short side of the deal, bluntly said that ‘real money’ investors such as IKB were outgunned. ‘The market is not

⁸ “During a FCIC hearing, Goldman’s CEO Lloyd Blankfein was asked if he believed it was a proper, legal, or ethical practice for Goldman to sell clients mortgage securities that Goldman believed would default, while simultaneously shorting them. Blankfein responded, ‘I do think that the behavior is improper and we regret the result — the consequence [is] that people have lost money’. The next day, Goldman issued a press release declaring Blankfein did not state that Goldman’s ‘practices with respect to the sale of mortgage-related securities were improper... Blankfein was responding to a lengthy series of statements followed by a question that was predicated on the assumption that a firm was selling a product that it thought was going to default. Mr Blankfein agreed that, if such an assumption was true, the practice would be improper. Mr Blankfein does not believe, nor did he say, that Goldman Sachs had behaved improperly in any way’” (p. 236).

pricing the subprime [residential mortgage-backed securities] wipeout scenario,' the Paulson employee wrote in an email. 'In my opinion this situation is due to the fact that rating agencies, CDO managers and underwriters have all the incentives to keep the game going, while 'real money' investors have neither the analytical tools nor the institutional framework to take action before the losses that one could anticipate based [on] the 'news' available everywhere are actually realized.' IKB subsequently purchased \$150 million of the A1 and A2 tranches of the Abacus CDO and placed them in Rhineland. It would lose 100% of that investment (p. 247).

On July 10, 2007 rating agencies downgraded a variety of mortgage-backed securities and the 'news available everywhere' began to spread. "On July 20, IKB reassured its investors that rating downgrades of mortgage-backed securities would have only a limited impact on its business. However, within days, Goldman Sachs . . . told IKB that it would not sell any more Rhineland paper to its clients" (p. 247). Deprived by the short money needed to run its business, IKB became insolvent, and IKB's largest shareholder, KfW Bankengruppe, bailed out IKB.

The IKB episode occurred in the same month as the bankruptcies of two Bear Stearns' hedge funds; this started a year of unprecedented financial turmoil, during which the mortgage market collapse pounded the US financial market at its weak points — high leverage, short term funding and risky loans. Difficulties in the commercial paper and repo markets, however, were only the first symptom of a more profound problem of solvency:

While a handful of banks were bailing out their money market funds and commercial paper programs in the fall of 2007, the financial sector faced a larger problem: billions of dollars in mortgage-related losses on loans, securities, and derivatives, with no end in sight. Among U.S. firms, Citigroup and Merrill Lynch reported the most spectacular losses, largely because of their extensive collateralized debt obligation (CDO) businesses, writing down a total of \$23.8 billion and \$24.7 billion, respectively, by the end of the year. Billions more in losses were reported by large financial institutions such as Bank of America (\$9.7 billion), Morgan Stanley (\$10.3 billion), JP Morgan (\$5.3 billion), and Bear Stearns (\$2.6 billion). Insurance companies, hedge funds, and other financial institutions collectively had taken additional mortgage-related losses of about \$100 billion (p. 256).

After the assisted failures of several investment banks, and large commercial banks and thrifts, in September 2008 the crisis became systemic: first, following the government's failed attempt to support the collapsing mortgage market by increasing the GSEs activities, the takeover of Fannie Mae and Freddie Mac; then the bankruptcy of Lehman; afterwards the bailout of AIG.

Repo and commercial paper investors called increased margins on loans which were backed by collateral potentially involved in the mortgage market. Borrowers that had put mortgage-backed securities as collateral were required to put more, to compensate for the depressed value of the collateral. To meet these margin calls, they were forced to sell, further depressing the value of collateral. The process of deleveraging went on inexorably, bringing down prices in exactly the same way leverage had pushed them to the tipping point. It was panic in the repo, commercial

paper and interbank markets. To stop the run, the Federal Reserve stepped in, directly purchasing commercial paper — a wholly new development.

III. THE SEARCH FOR CAUSES

3.a *The majority report*

The majority report states that the financial crisis resulted from failures of financial regulation and supervision, which added to failures of corporate governance and risk management at many systemically important financial institutions. It could have been avoided. The government rather added uncertainty and panic. The deterioration of mortgage lending standards and the ensuing collapse of mortgage securitization is held responsible for having ignited the crisis. Over the counter derivatives and credit rating agencies are considered primary determinants of the process of financial destruction.

Despite the attempt to present the section on the causes of the crisis with a biting wit, the 14 introductory pages dealing with them are disappointing. The report rightly sees risky mortgages as the proximate cause of the crisis. However, this does not tell us much about its more remote causes. The identification of the growing household debt as a critical event is just a premise: the basic question to be addressed revolves around the reasons for such massive systematic accumulation of risky loans. According to the majority, the Federal Reserve's failures in supervision let the financial environment deteriorate, allowing the mortgage machine and the CDO machine to run too fast for too long. But putting the blame on Greenspan and on a systemic breakdown of accountability and ethics evades the question. Why did the Federal Reserve neglect these developments? The majority explicitly addresses this fundamental issue in a couple of pages (pp. xxv–xxvii) when comparing its explanation of the crisis with those prevailing today. The Commission chooses to discuss three of them: excess liquidity, the role of GSEs and government housing policy.

The 'excess liquidity' view conflates the two mainstream explanations of the crisis: the cheap money thesis and the saving glut thesis. The majority report rejects both:

Those conditions created increased risks, which should have been recognized by market participants, policy makers, and regulators. However, it is the Commission's conclusion that excess liquidity did not need to cause a crisis (p. xxvi).

Low interests rates and the availability of foreign capital are simply regarded as pre-requisites of the credit bubble; it was rather the inability of the system to address these financial flows to their productive uses that caused the financial mess. The Commission thereby avoids entering the cheap money *versus* saving glut debate. These two explanations of the crisis are incompatible, but have in common the idea that the excess of liquidity has triggered the crisis. The gist of the debate concerns the origins of the flood of liquidity — whether it should be conceived as the upshot of a badly conducted monetary policy or as the unavoidable result of a huge inflow

of global saving.⁹ The difference between these two explanations is crucial because, according to the latter, the Federal Reserve does not bear any responsibility. The Commission circumvents the issue following a completely different line of reasoning: the excess liquidity would have affected the economy positively, providing that the financial system had prevented the occurrence of abuses and frauds in the mortgage markets. In this way, the majority report identifies a source of the financial crisis which is independent of low interest rates; yet the determinants of the crisis are still seen as purely monetary and financial.

GSE mortgage securities are not considered a primary cause of the crisis:

GSE mortgage securities essentially maintained their value throughout the crisis and did not contribute to the significant financial firm losses that were central to the financial crisis. The GSEs participated in the expansion of subprime and other risky mortgages, but they followed rather than led Wall Street and other lenders in the rush for fool's gold (p. xxvi).

Finally, the government housing policy is dismissed as irrelevant:

The Commission concludes the CRA was not a significant factor in subprime lending or the crisis. Many subprime lenders were not subject to the CRA. Research indicates only 6% of high-cost loans — a proxy for subprime loans — had any connection to the law (pp. xxvii).

The Commission's analysis of the role of GSEs and government housing policy is developed in line with its vision of the crisis as the result of an unregulated allocation of financial flows. On the one hand, the report stresses the differences between a sustainable housing policy and irresponsible predatory lending;¹⁰ on the other hand, it aims at highlighting the relatively small role of GSEs in the process of growth of subprime lending. The latter argument shows some inconsistencies. The Commission, in fact, notes that GSEs "added helium to the housing balloon" (p. xxvi). Even if GSEs' purchases "never represented the majority of the market" (p. xxvi), it can hardly be denied that private-label securitization prospered also thanks to the widespread awareness that the government and semi-governmental agencies would have provided assistance to the private sector. In more general terms, the Commission's effort to downplay the government's involvement in the securitization process seems to lose weight in the light of the fact that the majority report insists on the Fed's role in nurturing the credit bubble. The US central bank does not act independently of political power. The involvement of the government simply follows from the involvement of the Federal Reserve. And the Federal Reserve's policy of 'benign neglect' can only have been a political choice widely shared by American élites, certainly not due to the irresponsible behaviour of a Fed governor blinded by his ultra *laissez-faire* beliefs. Since the Commission restricted its field of investigation to the issues of regulatory mistakes and abuses of financial

⁹ On this see Barba & Pivetti (2011, pp.81–85).

¹⁰ "In describing the GSEs' affordable housing loans, Andrew Cuomo ... told the FCIC, 'Affordability means many things. There were moderate income loans. These were teachers, these were firefighters, these were municipal employees, these were people with jobs who paid mortgages. These were not subprime, predatory loans at all'" (p. 41).

institutions, the report ends with denying any rationale to the *policy* of growing household debt. Doing this, it leaves the causes of the financial crisis largely unexplored.

3.b *The dissenters*

This limitation is well exploited by the Thomas minority report:

Not everything that went wrong during the financial crisis caused the crisis, and while some causes were essential, others had only a minor impact. Not every regulatory change related to housing or the financial system prior to the crisis was a cause. The majority's almost 550-page report is more an account of bad events than a focused explanation of what happened and why. When everything is important, nothing is (p. 414).

According to the dissenters, the majority is too focused on regulation failures. Also, ignoring international comparisons, it would have failed to distinguish between causes and effects. International comparisons are considered important in view of the fact that the US was only one of the many countries to experience an impressive growth in housing prices. Since many countries with housing bubbles had not undergone a process of substantial financial deregulation, the failure of the US regulatory and supervisory system cannot be considered as the sole cause of the financial disorder. This line of argument is rather confused. The housing bubble is not, in itself, what caused the crisis. It connects to the crisis only to the extent that the growth in house prices has allowed the growth in household debt up to intolerable levels. Many countries with ballooning house prices did not experience the massive increase in household insolvencies which spurred the crisis. They experienced difficulties because the balance-sheets of their financial institutions were contaminated with the toxic assets of the mortgage-securitization process. The epicenter of the crisis was undoubtedly in the USA. International comparisons might help to disentangle the causes of the crisis in a different sense: other countries might have followed in promoting the unsustainable growth of household debt (and indeed in some countries this actually happened, though on a smaller scale).

The minority concentrates, rather inconsistently, on a description of the stages of the crisis which is basically a short summary of the work of the majority. As a result, the three dissenters come close to the central issue of explaining 'what happened and why' only when they consider the main explanations of the credit bubble currently in vogue. First, they deal with the role of global saving flows and of a process of re-pricing of risk;¹¹ then they focus on the role of cheap money. The position of John Taylor (the father of the celebrated Taylor rule and the main critic of the Fed's policy of low interest rates) is compared to that of Greenspan and Bernanke. After rightly noticing that the academic debate is far unresolved, the dissenters reject the idea that the Federal Reserve fuelled the housing bubble by wrongly keeping interest rates too low for too long: "global capital flows and risk repricing caused the credit

¹¹ Investors had adopted a speculative mentality that drove them to purchase risky assets at prices higher and higher in the belief that they could always pocket the capital gains.

bubble, and we consider them essential to explaining the crisis. U.S. monetary policy may have been an amplifying factor, but it did not by itself cause the credit bubble, nor was it essential to causing the crisis” (p. 421). This is nothing but an act of faith in Greenspan, since the dissenters provide no argument to support their position: they merely blame the majority for failing to focus “more time and energy on exploring these questions about global capital flows, risk repricing, and monetary policy” (p. 421).

While the first minority report is rather a pointless ‘reservation’ than a real ‘dissent’, Wallison’s statement is a drastic rebuttal of the majority report, a rejection of its methods and conclusions. Wallison, an influential member of the conservative American Economic Institute, takes seriously the idea that ‘when everything is important, nothing is’. Instead of opening his memorandum of dissent with the usual observation that single-cause explanations are too simplistic, he starts with the assertion that “the *sine qua non* of the financial crisis was U.S. government housing policy” (p. 444). Wallison identifies the primary determinant of the financial crisis in the unprecedented number of defaults in risky mortgages.¹² This would be the peculiarity of the 2007–10 financial disorder, since in the past, with the outbreak of the housing bubbles, the number of defaults on mortgage loans was contained and confined to local areas:

Claims that various policies or phenomena — such as low interest rates in the early 2000s or financial flows from abroad — were responsible for the growth of the housing bubble, do not adequately explain either the bubble or the destruction that occurred when the bubble deflated. The U.S. has had housing bubbles in the past — most recently in the late 1970s and late 1980s — but when these bubbles deflated they did not cause a financial crisis. Similarly, other developed countries experienced housing bubbles in the 2000s, some even larger than the U.S. bubble, but when their bubbles deflated the housing losses were small. Only in the U.S. did the deflation of the most recent housing bubble cause a financial meltdown and a serious financial crisis. The reason for this is that only in the U.S. did subprime and other risky loans constitute half of all outstanding mortgages when the bubble deflated. It wasn’t the size of the bubble that was the key; it was its content. The 1997–2007 U.S. housing bubble was in a class by itself (p. 445).

To stress the role of subprime mortgages, Wallison starts from an appraisal of the statistical records to which the Commission refers. Mortgage loans are recorded as ‘subprime’ only if they are classified as such by the originators or by Fannie and Freddie. Instead, Wallison considers a mortgage as subprime when the debtor has a FICO score lower than 660,¹³ regardless of the denomination that was given to the loan in the origination process. “Fannie and Freddie, for many years prior to the financial crisis, were buying loans that should have been classified as subprime

¹² Wallison’s statement gives evidence on this mainly relying on the ‘Pinto memorandum’, a work that another fellow of the AEI (who served at Fannie Mae) submitted to the Commission staff, which, according to Wallison, the FCIC had deliberately overlooked.

¹³ The credit score created by FICO (the most widely used credit score in the USA) ranges 300–850. The higher the score, the better the merit of credit. Although there is not a single ‘cut off score’ used by all lenders, a score above 660 is considered acceptable by many loan programs.

because of the borrowers' credit scores and not simply because they were originated by subprime lenders. Fannie and Freddie did not do this until after they were taken over by the federal government" (p. 451). According to Wallison, "the key question for the FCIC was to determine why, beginning in the early 1990s, mortgage underwriting standards began to deteriorate so significantly that it was possible to create 27 million subprime and Alt-A mortgages [out of the 55 million total]. The Commission never made a serious study of this question, although understanding why and how this happened must be viewed as one of the central questions of the financial crisis" (p. 452). In reality, the majority answers this question arguing that the practice of predatory lending was responsible for the growth of mortgages in danger of delinquency. Wallison offers an alternative answer: in the early 1990s, the merit of credit began to degrade because of the Housing and Urban Development (HUD) program. HUD overextended the goal of providing affordable housing to the point that more than half of all loans purchased by the GSEs were made to borrowers with incomes below the median income of the area where they lived. Wall Street securitization followed. The GSEs did not engage the unsafe business of subprime lending to regain market shares and profit margins. They started the business, according to Wallison.

IV. THE TRUE DIVIDE

Wallison's statement set the tone of the debate which followed the release of the FCIC report. The discussion on the causes of the financial and economic crisis in the US quickly evolved into a squabble on the amount of government intrusion that a market economy necessitates — or tolerates — with the majority report and Wallison's dissent as the polar extremes, and in between the three dissenters who "reject as too simplistic the hypothesis that too little regulation caused the crisis, as well as its opposite, that too much regulation caused the crisis" (p. 414).

It is a pity that the discussion took this turn. The central issue, in fact, does not concern the government's role in fostering the crisis. Anyone familiar with monetary and financial issues knows that such a breakdown of underwriting standards would not have happened if the government had not provided the explicit — or implicit — support on which any process of irresponsible lending thrives. The central issue concerns the function that the overstretching of household debt was due to perform, a function so essential that frauds and malpractices, as well as the consequences of a soft landing, could be perceived as 'side effects'. In other words, the main point is not so much the right size of the government's role in the growth of subprime lending, but the objectives that the government was trying to accomplish by letting things take their course. Malpractices could have been checked and the effects of the credit bubble bust may have been greatly underestimated. But the fact remains that if the government acted with benign neglect, this choice might have been due to reasons other than the influence of financial lobbies or the attractiveness of politically convenient but unsustainable social policies.

The idea that the government could have legitimate reasons to support subprime lending (other than to offer a social palliative) is hard to swallow, being completely at odds with the widespread notion that household debt can exert a positive influence on economic activity only by differently allocating consumption flows. Hence, the view of a one-way avenue from financial instability to real instability — i.e. that the ultimate sources of the financial disorder cannot be traced back to the real economy. The Commission, in search for some guidance, began its hearings with two panel discussions and a forum where economists were asked to report academic explanations of the crisis on the horizon. Gorton, a leading financial economist, began his testimony¹⁴ with a quote from Seligman which describes the crucial factor that could determine the success or failure of the investigation:

The current explanations can be divided into two categories. Of these the first includes what might be called the superficial theories. Thus it is commonly stated that the outbreak of a crisis is due to a lack of confidence, — as if the lack of confidence was not itself the very thing which needs to be explained. Of still slighter value is the attempt to associate a crisis with some particular governmental policy, or with some action of a country's executive. Such puerile interpretations have commonly been confined to countries like the United States where the political passions of a democracy had the fullest sway . . . Opposed to these popular, but wholly unfounded, interpretations is the second class of explanations, which seek to burrow beneath the surface and to discover the more occult and fundamental causes of the periodicity of crises (Seligman, 1908, p. xi).

Unfortunately, explanations of the first kind dominated the FCIC discussion, and the efforts to 'burrow beneath the surface' never prevailed over the attempts to link the ultimate causes of the crisis to wrong government policies. The academics, in other words, did not help the Commission realize that "[w]hile the non-monetary causes which have contributed to the present distress, strictly speaking, fall outside the scope of . . . inquiry, [it is] impossible to avoid some discussion of them, for it is only by estimating their effect that we can arrive at some delimitation of the sphere of action of monetary causes properly so-called" (Committee on Finance & Industry, 1931, p. 9).

V. THE MISSING LINK

Notwithstanding the purely financial perspective of the majority report, its assessment of 'hard facts' reveals a number of openings through which the Commission could have a glimpse of the non-monetary causes that contributed to the financial mess. Starting with the introductory chapter, in fact, the majority notices that

When the Federal Reserve cut interest rates early in the new century and mortgage rates fell, home refinancing surged, climbing from \$460 billion in 2000 to \$2.8 trillion in 2003, allowing people to withdraw equity built up over previous decades and to consume more, despite stagnant wages (p.5).

Here and there in the report the Commission unconsciously flirts with the connection between mortgage equity withdrawal and stagnant wages. The part on boom

¹⁴ Cf. Gorton (2010).

and bust, for example, opens with a paragraph on ‘housing as a powerful stabilizing force’. After reminding the reader that “[b]etween 2002 and 2005, weekly private nonfarm, nonsupervisory wages actually fell by 1% after adjusting for inflation” (p. 85), the Commissioners added that

A Congressional Budget Office paper from 2007 reported on the recent history: ‘As housing prices surged in the late 1990s and early 2000s, consumers boosted their spending faster than their income rose. That was reflected in a sharp drop in the personal savings rate.’ Between 1998 and 2005, increased consumer spending accounted for between 67% and 168% of GDP growth in any year — rising above 100% in years when spending growth offset declines elsewhere in the economy. Meanwhile, the personal saving rate dropped from 5.2% to 1.4%. Some components of spending grew remarkably fast: home furnishings and other household durables, recreational goods and vehicles, spending at restaurants, and health care. Overall consumer spending grew faster than the economy, and in some years it grew faster than real disposable income (p. 87).

Here is the main limitation of the work of the FCIC. What the FCIC fails to see is that the growth in real disposable income could have hardly been accomplished without some components of consumer spending growing so fast. The substantial deterioration in income distribution has been prevented from lowering consumption — thus output and employment — by the increased household debt, which has made the household saving rate fall rather than rise.

The decrease in the share of disposable income allotted to the poorest 80% of the population is a long-term phenomenon that began in the early 1980s. The growth in credit assisted consumption is also a long-standing event. These two tendencies exacerbated towards the end of the last century. After the collapse of the dotcom bubble, non-residential investment ceased to offer a growing source of aggregate demand, leaving residential investment and consumer spending as the only source of growth. Given the change in distribution, the more household consumption was needed to sustain aggregate demand, the more household debt had to rise.

VI. WHAT ROLE FOR CHANGES IN INCOME DISTRIBUTION?

The link between rising income inequalities, growing household debt and the US financial crisis was first identified by some authors before the outbreak of the crisis,¹⁵ taken up by some others in the aftermath of the most acute financial turmoil,¹⁶ then discussed by the mainstream. The interest in this controversial hypothesis has been recently stimulated by the book *Fault Lines*, by Raghurian Rajan. According to Rajan, the growth of subprime lending has to be seen as the political response to growing fears of a middle class threatened by the polarization of employment opportunities:

¹⁵ Palley (2005), Cynamon & Fazzari (2008), Magdoff & Foster (2009), and Barba & Pivetti (2009) offer different but largely complementary perspectives on this.

¹⁶ See, for example, Fitoussi & Saraceno (2010).

the political response to rising inequality — whether carefully planned or an unpremeditated reaction to constituent demands — was to expand lending to households, especially low income ones. The benefits — growing consumption and more jobs — were immediate, whereas paying the inevitable bill could be postponed into the future. Cynical as it may seem, easy credit has been used as a palliative throughout history by governments that are unable to address the deeper anxieties of the middle class directly. Politicians, however, want to couch the objective in more uplifting and persuasive terms than that of crassly increasing consumption. In the United States, the expansion of home ownership — a key element of the American dream — to low- and middle-income households was the defensible linchpin for the broader aims of expanding credit and consumption. But when easy money pushed by a deep-pocketed government comes into contact with the profit motive of a sophisticated, competitive, and amoral financial sector, a deep fault line develops (Rajan, 2010, p. 9).

Rajan's reasoning has been strongly challenged during the meeting of the American Economic Association in Denver in January 2011.¹⁷ First, it was noted that the position of the poorest Americans — namely those below the 10th percentile — has improved in the 1990s. The 50th–10th percentile ratio, in fact, increased in the 1980s, but dropped in the 1990s. Second, it was alleged that Congress is extremely sensitive to high-income voters, is mildly responsive towards middle-income voters, and does not respond at all to the poor. Why should Congress have acted to improve the status of a segment of the population that had already regained some lost ground and is, in any case, apparently unable to influence the political process? This critique attempts to overthrow the logic of Rajan's hypothesis: the change in income inequality did not favour the policy response that has led to the crisis; rather, the interaction of irresponsible political decisions and the lobbying activities of the financial industry has on the one hand led to the crisis and to rising income inequality on the other. According to this argument, causality works in reverse: the increase in income inequality results from the exceptionally high rewards that the financial sector was able to deliver.

As Rajan has pointed out in his reply,¹⁸ however, the belief that an increasing number of 'superstars' is the only determinant of the change in the US income distribution is debatable. He stresses that "since the 1980s, the wages of workers at the 90th percentile of the wage distribution in the United States — such as office managers — have grown much faster than the wage of the 50th percentile worker (the median worker) — typically factory workers and office assistants" (Rajan, 2010, p. 8). While in the 1990s the 50th–10th ratio was shrinking, the 90th–50th ratio was rising. The process covers at least three decades, and does not depend on the growing number of financial superstars. Whatever the factors responsible for this, the fact remains that the change affected a vast portion of the American society. The poor's lack of political relevance is hardly a truth that can shake Rajan's argument.

¹⁷ For a review of the panel discussion on 'Income inequality and financial crisis?' among R. G. Rajan, D. Acemoglu and E. Glaeser at the AEA meeting of 6–9 January 2011, see *The Economist* (2011) and Johnson (2011). See also Acemoglu (2011) and Rajan (2011).

¹⁸ See Rajan (2011).

The point that Rajan's book does not seem able to develop fully, instead, is that the widespread process of substitution of loans for wages, although unsustainable in the long run, has had significant effects on growth. This growth process was clearly unbalanced, and in fact it ended in tears. But what if, given the changes in income distribution, consumer credit had not reduced the saving rate? Since nothing would have ensured an automatic restart of non-residential investment, the choice would have not been between unbalanced and balanced growth, but between unbalanced growth and stagnation. The notion of a rate of accumulation only determined by the supply side hides this point. Without any role for the principle of effective demand in determining the output level, in the short run as well as in the long, the policy of easy credit cannot be rationalized, if not as a social palliative deployed by a government that is 'unable to address the deeper anxieties of the middle class directly', which presumably means not being able to act directly upon the supply side.

The idea that easy credit has been used as a 'palliative throughout history by governments', that it sustained 'crassly increasingly consumption', is a restatement of the money neutrality principle. In a longer term perspective, this increase in consumption is considered to be excessive because, if the Federal Reserve keeps interest rates low, it only has inflationary consequences. So we find the same arguments about the inflationary effects of public spending, this time referred to a private circuit of overspending. This standpoint comes out clearly when Rajan discusses the issue of the external imbalance. In fact, "[t]here are usually limits to debt-fueled consumption", according to Rajan, "especially in a large country like the United States. The strong demand for consumer goods and services tends to push up prices and inflation. A worried central bank then raises interest rates, curbing both households' ability to borrow and their desire to consume" (p. 9). Therefore, the fact that a certain increase in the US demand was satisfied from abroad (Germany, Japan and China in particular), is seen as a permissive factor in that it has prevented a resumption of inflation, and allowed the Central Bank to continue with the cheap money policy. This is an interesting line of reasoning, very far from the saving glut thesis. Also the saving glut hypothesis seems to point to the external imbalances as the ultimate source of the financial disorder. However, the saving glut can only very indirectly be linked to subprime lending. The US had no need for global financial flows to increase domestic credit. Inflows of funds have only allowed a stable exchange rate despite the persistent and rising trade deficit. Unless one is willing to accept the implausible idea that the Federal Reserve has lost control of long-term interest rates, the credit easiness was not caused by the external deficit, rather the contrary.¹⁹ Rajan's idea is that, without the cooperation of export led growth countries easy credit would have only impacted on inflation.

¹⁹ Indeed, in some passages, Rajan seems also to embrace the saving glut thesis: "The flood of money lapping at the doors of borrowers originated, in part, from investors far away who had earned it by exporting to the United States and feeding the national consumption habit" (Rajan, 2010, p. 6).

Rajan's conclusion inevitably echoes Wallison's dissent. Sure, there is much more in *Fault Lines*, since the distribution of income comes into play and the Housing Urban Development program is not a factor of great importance. Yet, the debate on Rajan's book has come to focus on whether the crisis is an unintended result of the government's efforts to bridge the gap in home ownership, sharing the fate of the debate on the FCIC report.²⁰ This is determined largely by the fact that while a financial reform is no longer on the agenda, the US government is currently drawing up the draft of the GSEs reform. The discussion, in other words, is no longer on the constraints to be placed on financial institutions, whose business is actually going on basically unrestricted, but on whether the government's role in supporting the mortgage system should be restricted or enlarged. It is worth noticing in this regard that there is no incompatibility between the idea that the government has 'purposely' assisted the financial industry to feed the credit bubble, and the fact that the loans directed to enlarge home ownership of the most disadvantaged segment of the US population accounted for a negligible share of delinquencies. The FCIC extensively deals with the issues raised by Wallison and clearly shows "that in 2008 and 2009, GSE loans performed significantly better than privately securitized, or non-GSE, subprime and Alt-A loans... For example, among loans to borrowers with FICO scores below 660, a privately securitized mortgage was more than four times as likely to be seriously delinquent as a GSE" (p. 218). Nevertheless, it seems true that private bankers have extended credit to insolvent borrowers in the conviction that the government would come to the rescue when needed, as it had done several times over the past decades.

Of course, a totally deregulated financial market has given rise to speculative madness that no conception of 'benign neglect' can justify. To show the abuses of financial operators and the oversight of regulators (with the same people who often have played both roles) is undoubtedly the main result of the Angelides' Commission. But this tells us nothing about the crisis: one cannot presume that an effective regulatory framework would have prevented the financial industry from perturbing an otherwise balanced course of affairs. It could have prevented such long lasting consumption growth supported by unsustainable household debt. But this is a different matter. Precisely because of the incapability to assess the role of the financial system and its lending practices in connection with economic conditions generally (i.e. to the non-monetary causes of the crisis), the Commission has been unable to focus its reconstruction of events on the constraints the government was trying to overcome by monetary means. This was, in some way, an inevitable mistake. The economic debate before the outbreak of the crisis was so taken by the idea that capitalism had finally entered a phase of stable growth that a systemic crisis like that which occurred in 2007–08 was unthinkable. This attitude was so strong

²⁰ For example, Krugman's review of *Fault Lines* ignores the issues related to income distribution and external imbalances, and reiterates the belief that Fannie and Freddie have nothing to do with the crisis (Krugman, 2010).

that it has survived the crisis. Many still see it as an highly unlikely catastrophic event (the black swan), an occurrence that can certainly happen without challenging the conventional vision that must hold most of the time.²¹

For these economists the crisis being basically an accident, it hardly called for an explanation. In this state of affairs, a detailed chronicle in the style of Galbraith's *The Great Crash* (1954) was the best result one could reasonably expect from the FCIC. Despite the limited time and resources, this result has been achieved.

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²¹ Cf. Taleb (2007).

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