

Transcript:

Regulating for financial innovation

I think the government has to take an attitude that it is the sponsor of innovation, both of scientific innovation and of financial innovation. The government learned that years ago, just after World War II, when they created the National Science Foundation—and the government aggressively supports scientific innovation. We have to have the same attitude toward financial innovation.

And, unfortunately, the problem is financial innovation is difficult to measure, and to evaluate, because a lot of the outcomes that are promised by financial innovations are outcomes that take place years in the future. And it's possible to be misled and deceived by some supposed financial innovations. And the government finds it difficult to regulate them. But, unfortunately, it's necessary.

I think the US government is actually a world leader in financial regulation, even though people say this financial crisis started in the United States. I think good financial regulation also started in the United States; and the Securities and Exchange Commission has had a long history of regulation that has been basically supportive of financial innovation, but we have to carry that further now. And I think that the kind of new regulation that we need is, as [former US Treasury Secretary Henry Paulson] called it, objectives-based regulation—we have to be thinking more expansively about where we're going and how we can encourage financial innovation that gets us there. And we have to think less bureaucratically.

I don't want to see us killing off innovation, and this is what may get lost—and I hope it doesn't get lost—in the current crisis. Ultimately, let's not forget that we've learned lessons that a capitalist economy is an economy that promotes entrepreneurship, and entrepreneurship is not the province for government bureaucrats.

The business has to be that we have a sort of creative destruction. We have people trying things. And what does an entrepreneur do? You go to a number of different investment banks or venture capital firms, present your idea. And most people can't recognize an important, new idea, but some can. And that process, which is a free-market process, is really an important source of economic growth, and it can't be taken over by the government. And I think we will remember that. We are in a crisis situation, and these claims that we're at the end of capitalism are misplaced. I don't think that anything like that is going to happen.

Reducing trust in models

The 1970s, I think that was the heyday of the so-called efficient-markets hypothesis. It became thought of as one of the established facts, that markets are efficient. What does "efficient markets" mean? It means that markets fully incorporate all publicly available information, and they do it optimally.

I think the problem with it is that the very volatility of the market can't be explained in those terms. It moves too much. Often a price move for an individual company represents some news about that company. But there is rarely such news about the aggregate stock market. It's much more ambiguous about how to forecast the

market. So, I think it's really psychology that drives the stock market—and, increasingly, the market for homes as well.

The problem is that it's always a combination of psychology and reality. So right now, many entrepreneurs are holding off. They're not taking risky measures to start a business, because you can't. You can't get a loan. Now, that's reality. But that reality is the product of yet more fundamental decisions that people are making that brought us to this situation.

So, often you will find yourself, as a manager, making decisions that are similar. I mean, you have no choice, right? But there is a certain latitude of choice that one does have, and I think it's very important for managers to think about really what's driving this. And it helps them to understand how to do a somewhat contrarian policy and investment policy. And that means you have to understand that not only is there this reality that's crimping your effort to do business, but there's also a component of your own feelings that are being brought along by our natural herd instincts and our natural tendency to pay attention to what everyone else is paying attention to now.

I just have the general feeling that managers have to be Renaissance people in some sense. They have to read widely and try to put events into the context of history. Now, I think that financial modeling has made tremendous progress, even during this efficient-markets period, when I think we had too much faith in the existing models. You have to be a quantitative person if you're managing a company. The quantitative details really matter.

And so you're going to have to be looking at models, but I think that part of what brought us into this crisis—I said it was complacency, initially—it's also a kind of a blind acceptance of others' authority that, in terms of variance at risk or econometric models, or in terms of the counterparties we were dealing with, we tended to think of as bigger than life. And so, people were taking too much for granted.

Redesigning institutions

I'm hopeful that we'll democratize our financial institutions so that they work better for the people. Of course, we have health insurance—but it omits, you know, over 40 million Americans now. Health insurance is a basic risk-management institution, but it isn't working well enough. And so one thing would be to expand the scope of that.

Another thing is risk management with regard to housing, for example. We have a huge mess-up here, because people have been urged by experts and by national leaders to invest all of their life savings in a single risky investment, a home in a city, in a leveraged way. They would borrow 80 percent, 90 percent, or even more of the money to buy the home. And so they're putting their life savings on the line in a crazy way. So this shouldn't be the new normal; but we have to then redesign our mortgage institutions.

We have over 12 million people who are underwater—that is, they have negative net worth in their homes. And, typically, these people have nothing else, so they're wiped out. How can it be that we were anywhere close to the right system? There are some people who doubted it would ever happen. I've talked to these people, and

it seems to be often based on the assumption, one way or the other, that home prices would only go up. Well, we've just learned that they don't just only go up.

We didn't have the right system. It was normal. We thought that the conventional mortgages that were being issued represented some kind of enlightenment, but that was a group thing. That was taking for granted that what we have now is right, and it's not right. So it has to be fixed. So I'm hopeful that this event that we're going through now will trigger a lot of institutional rethinking that will make our economy work better.

Another thing I might mention is that economic inequality has been getting worse and worse over the last couple of decades. And that is an alarming trend that I'm hopeful this crisis might start to give us the mandate to work on.

I think fixing our mortgage institutions is one way of partially dealing with that crisis. Anything that reduces the exposure to individual risks—like health insurance risks or housing risks or any other risk that impacts on people—anything that we do to reduce those risks will also reduce inequality. And if it's really good risk management, it's not going to reduce incentives to hard work or entrepreneurship. So I think we have to get on with making fundamental redesigns in our financial system.

Time line for turnaround

I think there's a tendency, when we're watching the day-to-day fluctuations, to think that we're going to find some news story that's going to mark the turnaround and overreact to that. And I think that overreaction generates the high short-term volatility that we have now. More recently, we've been back up to Depression levels of volatility, and that reflects the heavy focusing of attention on the market now. So I don't know what to say about finding a bottom, except that this is a process that's going to evolve over years. And the confidence loss that we have is a serious problem.

I don't want to say that I don't think there will be a turnaround soon, but I think that many of us are too much expecting that it might come tomorrow or the day after. And this volatility is evidence of that. So I think it is quite possible that the stock market and the housing market, five years from now, will be close to where they are now.

This is not a forecast; but it wouldn't surprise me in the least if we were right where we are now. And so maybe we shouldn't be so trigger-happy and so worried about timing the market. I guess the basic investment advice that I would say is, maybe not so much focusing on that, but focusing on getting your risk profile right, getting the exposures so that you're not overexposed to any one risk—you're properly diversified, you're hedged against specific risks that phase you.