Aaron Brown

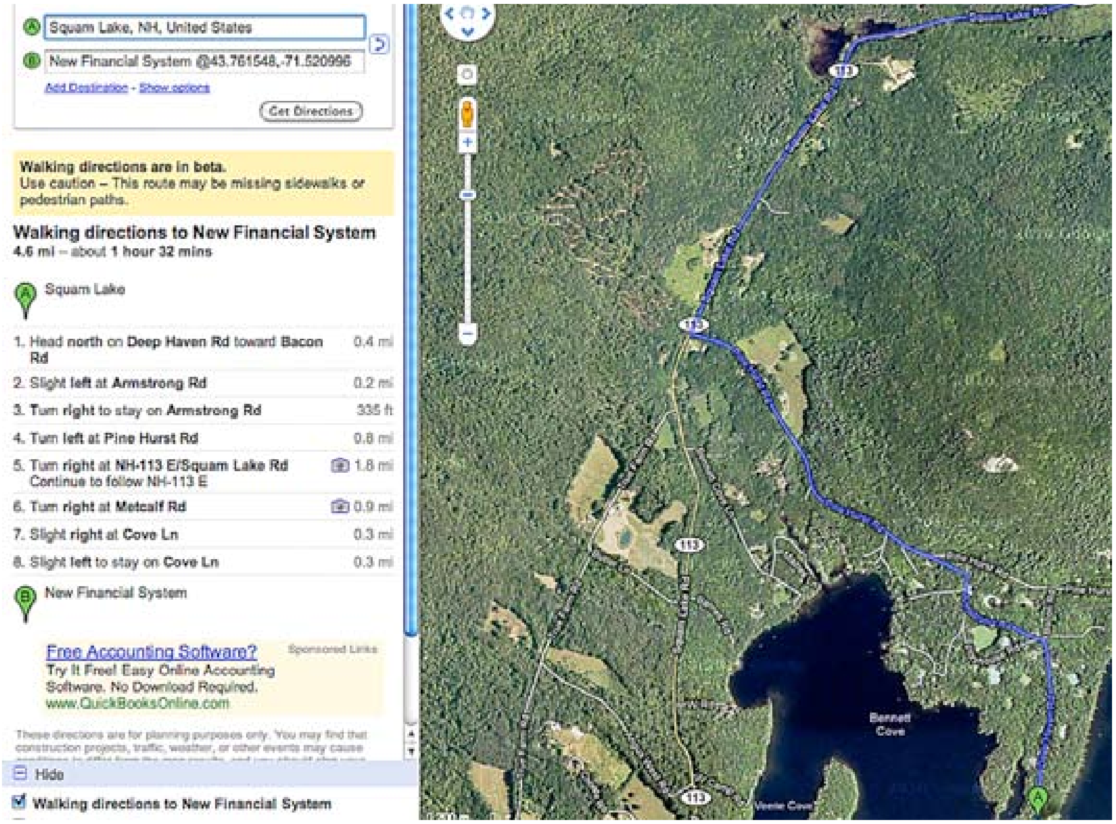
South of Bretton Woods

What fifteen of the finest economic minds came up with …

For a small and inoffensive place, New Hampshire resolves more than its share of world conflicts. Along with Iowa, it hosts a key primary for winnowing the American presidential candidates. The Russo–Japanese war was concluded by the Treaty of Portsmouth, New Hampshire. Bretton Woods, New Hampshire, was where the Allies met in 1944 to design the postwar financial system.

In 2008, Kenneth French decided to add to this tradition by assembling 15 leading financial economists at Squam Lake, New Hampshire, about 100 miles south of Bretton Woods. He invited Martin Baily, John Campbell, John Cochrane, Doug Diamond, Darrell Duffie, Anil Kashyap, Frederic Mishkin, Raghuram Rajan, David Scharfstein, Bob Shiller, Hyun Song Shin, Matthew Slaughter, Jeremy Stein, and René Stulz. That's a bunch of smart people, loaded with academic credentials and top-level policy connections. They span most of the range of views among people who basically like financial markets.

It took this group a year and a half of discussions to come up with consensus recommendations, which they published in a book, *The Squam Lake Report: Fixing the Financial System*. I just got back from the unveiling conference, which included an audience of academics, regulators, and practitioners; plus an address by Ben Bernanke, who gamely, but futilely, insisted that the current financial reform bill being developed in Congress conformed to the report (I was impressed, however, that he didn't leave the room until he had answered every question from everyone who wanted to come up to him).



"Let me Google it"

I wanted to like the report. The authors are extremely knowledgeable about finance and have the reputational heft to be taken seriously by people in power, especially when they speak in one voice. Unfortunately, I think it fails on two counts. It didn't get to the heart of the issue, and its recommendations are likely to be ignored, except where they coincide with what people wanted anyway.

The first line of chapter one is, "The financial system promotes our economic welfare by helping borrowers obtain funding from savers and by transferring risks." True enough, but that explains none of what actually happens in the high-risk, high-competition, high-stakes practice of finance. It doesn't explain why subprime mortgage defaults trigger a global meltdown in the real economy, or why so many people watch CNBC every day, or why practitioners make such gigantic amounts of money. It's like someone trying to broker a Middle East peace agreement starting out with, "Religion promotes social welfare by teaching morality and organizing communal activities."

If we took that first sentence seriously, we wouldn't bother fixing the financial system.

We'd build a better one from scratch, probably modeling it on eBay. We don't need to spend one-third of GDP to "help borrowers" and "transfer risks." I would be personally willing to contract to provide both services to everyone for a mere one-fourth of GDP, and I'd throw in free T-shirts.

This is a serious objection. The authors wisely avoid discussing the causes of the financial crisis. Everything is a cause, in the sense that if it had been different, things would have worked out differently. There's no chance of finding even two people, much less 15, who agree on specific causes that can be corrected. It's far more productive to examine the lessons of recent experience and come up with a list of things that will help in the future, regardless of what caused the problem in the first place. But I think the authors err by not setting out clearly the purpose of the fixed financial system. Do we judge the result by the effect on the real economy? Or by the returns to investors? Or by the productivity of capital? Or just by avoiding sudden changes that disrupt things? Or all of the above?

Perhaps I shouldn't complain that the authors don't define the purpose of the financial system, because they don't even define "financial system." It's obvious from the context that they consider it to extend beyond traditional regulated institutions to include the shadow banking system. But what about nontraditional ways to supply financial services? I think the market has voted clearly that large, regulated financial institutions should die, and that people should find new ways of doing financial business. Does "fixing" the financial system mean propping up existing institutions regardless of market opinion? Or does it mean encouraging creative destruction? Is the regulators' brief to be to stop the traditional system from causing harm, or to make it do good, or to make sure something does good? Does regulatory authority extend to cover any new idea?

This last question is the biggest dilemma. If regulation is limited to existing types of business, innovation will flourish outside the regulatory umbrella, making the regulation increasingly irrelevant. Consider, for example, the history of hedge funds. In 1940, Congress passed an Investment Act laying down strict rules for public commingled investment. Nine years later (and undoubtedly the delay was due to the war), the hedge fund was invented to avoid those rules. Over the next 50 years, hedge funds pioneered all kinds of innovative investment ideas, while the only big new ideas in mutual funds were index funds and money market funds (and money market funds were created to get around regulations on bank accounts). Since 1998, hedge funds have been subjected to increasingly strict regulation, which just means that a new type of investment vehicle will be invented to do the things that the regulators prohibit in hedge funds.

On the other hand, if the regulators can expand their powers to cover any new idea, there will be little innovation. Solutions will have to be found within the existing regulatory framework, by people with entrenched positions and specialized skills to protect. Every insider, whether practitioner or regulator or in the revolving door in between, will have an interest in keeping life easy and lucrative by shutting out competition and change.

I would have started the report by setting out some services that the government should protect. People should have access to clearing services to deposit moderate-sized paychecks and pay bills without significant risk or undue expense. There should be inexpensive, transparent, easy-to-use investment vehicles for long-term savings, like low-cost index mutual funds. Short-term credit for inventory and receivables should be available to all viable businesses on fair terms. Beyond that, I'd leave it to the market to decide what services to deliver and how to price them. You might have a longer or shorter list than me, but it's unreasonable to task the government with ensuring delivery, and dictating terms, of every financial service anyone offers. Most important, these are positive goals. We want certain services delivered, not other services prohibited. The only responsibility of a regulator with respect to contracts between consenting adults should be to ensure that they don't threaten the protected services, except through competition.

Once you decide what to protect, you should set out criteria for performance. Fees and error rates in checking accounts, fees and Sharpe ratio of long-term investments, fees and availability of short-term business credit, for example. Now you've got a clear goal and can get to work fixing.

The political reality is much uglier. There is a political necessity for elected officials to punish unpopular groups who either lost too much or made too much money. Regulators and lobbyists on behalf of business are working to expand power and profits. The consequence will be extensive complex legislation that leaves enormous discretion in the hands of regulators, which will lead, in turn, to the formation of a Treasury–financial complex to stifle innovation and entrench profits.

I don't mean this cynicism to apply to individuals. I know lots of smart and principled regulators working for the interests of society. I don't know many politicians but I'm sure some of them are thinking of the long-term public good rather than today's political posturing. Mostly, I know people in finance who want to make a lot of money and do a good, worthwhile job, with differing emphases on the former versus the latter. But, as Isaac Asimov and John Campbell taught us, speaking through Hari Seldon in the *Foundation* series, while individuals are unpredictable, the mass behavior of large groups can be forecast with precision. W

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