

Learning from the Nobels

The Nobel Laureate Meetings in Lindau, Germany offer a unique opportunity for young researchers from universities and other institutions to meet with their peers and with leading figures in their field. In August 2008, eight young IMF economists traveled to the third meeting in economic sciences, where 15 Nobel laureates included Robert Solow, Joseph Stiglitz, George Akerlof, Robert Mundell, Myron Scholes, and Peace Prize laureate Muhammad Yunus, creator of the Grameen Bank.¹ The laureates discussed a range of topics, but the focus was inevitably on the current financial and economic crisis. In this article, participant Chris Crowe provides a brief account of his impressions.

The global credit crunch took center stage both in the formal program of the economic sciences meeting and in informal discussions. The meetings were held August 20–23, five months after JP Morgan Chase swallowed up Bear Stearns and two to three weeks before the rescue of Fannie Mae, Freddie Mac, and AIG by the U.S. government. The first day commenced with a wide-ranging panel discussion of systemic risks in financial markets, moderated by David Wessel of the *Wall Street Journal* and taking in comments from Stiglitz, Scholes, and Yunus, as well as Daniel McFadden. Stiglitz in particular was highly critical of both the behavior of financial market participants and the government response, arguing that much of the blame for the crisis could be assigned to inadequate regulation and an “anything goes” culture on Wall Street. Scholes offered some defense of the laissez-faire status quo, although he too had some criticisms at the margins. Both elaborated further on their arguments at their individual speaker sessions later in the program.

For Stiglitz, the current crisis—the worst faced by the United States since the Great Depression—is an example of microeconomic failures translating into macroeconomic ones. He argued that financial sector firms, despite record profits in recent years, failed in their core roles of allocating and managing risk, an example of market failure more generally.

Information asymmetries were at the center of his account. For instance, securitization, while creating opportunities for efficient risk dispersal, also exacerbated agency problems. Mortgage originators, who made loans to borrowers with inadequate assets and incomes that they

quickly repackaged and sold on as apparently safe securities, provide the most obvious example, but these kinds of information and agency problems were widespread throughout the system. The difficulty in valuing many of these opaque securities and related contracts, which has been hampering efforts to clean up banks’ balance sheets, further illustrates Stiglitz’s point.

Other market failures have come to the fore. For instance, Scholes emphasized how externalities in financial markets have been heightened by the increased leverage of market participants. Leveraged financial firms that are forced to dump assets in an effort to strengthen their own balance sheet create externalities for others holding the assets, who see the price slump and may be forced into fire sales of their own. This downward spiral is exacerbated by mark-to-market accounting rules.

In Stiglitz’s assessment, the market failures highlighted by the current crisis have lessons for policy and theory. On the policy side, he argued that regulation should be strengthened, and indeed that the whole philosophy of regulation should be changed, as many of the current problems stem from the appointment of regulators who do not believe in regulation. For theorists, he argued that the current crisis should mark the death knell for models based on rational, representative agents.

Scholes focused more on the detail of the financial sector’s woes. For instance, highly leveraged financial firms (with a high debt-to-equity ratio) face what he calls an “inflexibility trap.” When debt levels are high, debt becomes more risky, taking on more equity-like characteristics. A financial firm that has to rebuild its capital base can then face particular difficulties. Efforts to issue new equity transfer value from equity holders to debt holders, because the risks to the latter fall as the equity cushion expands. This slashes the value of existing equity to such an extent that issuing new equity might worsen the debt/equity position.

More generally, the crisis has highlighted the costs of the inflexibility associated with leveraged capital structures and specialization in profitable but risky core activities. Flexibility can be increased, Scholes argued, by taking on a more diverse set of activities, having a less debt-heavy capital structure, or creating more “optionality”—that is, insuring against big downside risks but surrendering some of the upside as a result. Subsequent events proved Scholes’ point: the model of specialized, highly leveraged financial firms relying on wholesale markets for funding has been

¹The IMF participants were Rabah Arezki (FAD), Bergljot Barkbu (SPR), Chris Crowe (RES), Rishi Goyal (SPR), Roberto Perrelli (FIN), Martin Sommer (APD), Sven Jari Stehn (FAD), and Geneviève Verdier (INS). Some of the presentations are available online at <http://www.lindau-nobel.de>.



IMF staff with Nobel Laureate Professor Robert Mundell in Lindau, Germany. From left to right, top row: Rabah Arezki, Geneviève Verdier, Mundell, Chris Crowe, and Roberto Perelli. Bottom row: Rishi Goyal, Bergljot Barkbu, and Sven Jari Stehn.

the most prominent casualty of the current crisis, with one of the “big five” investment banks driven to bankruptcy, two merging with commercial bank groups, and two set to covert themselves into regular bank holding companies. On the other hand, the bailout of AIG—which took on too much of the downside risk by issuing debt insurance contracts to other financial institutions—illustrates the difficulties in achieving “optionality” in practice, particularly when downside risks represent aggregate shocks.

A second panel discussion focused on globalization and income inequality across and within countries. A diverse panel, including Akerlof and Solow as well as Finn Kydland and Robert Fogel, and moderated by the *Financial Times*’ Martin Wolf, offered a range of insights. Underlying all the discussions was unease at the rising inequality in countries such as the United States, where median incomes have flat-lined in recent years as incomes of the richest 1 percent or above have increased dramatically. Stiglitz—not the only commentator to pick up on this aspect of the U.S. mortgage crisis—linked the stagnation of median U.S. incomes to the subprime debacle. When incomes are stagnant or falling, house purchases have to be “paid for” by projected capital gains as house prices increase. However, an asset whose price is only supported by expected price increases and not by fundamentals is by definition experiencing a speculative bubble—which usually ends badly for all concerned, as the current crisis has shown.

Three days of discussions were brought to a close with a boat trip on the lake of Konstanz. Here some of the IMF economists were treated to a wide-ranging informal discussion with Martin Wolf, who had his own perspective on the

international dimensions of the crisis and the role of the IMF. However, amid the focus on high finance and trillion-dollar economies, perhaps the highlight of the conference was Muhammad Yunus’ account of the creation of the Grameen Bank, a microcredit institution in Bangladesh that lends almost exclusively to poor rural women.

Returning to his home country in the mid-1970s with a PhD from the United States, Yunus became interested in the problems affecting the poor in a village close to the university campus where he was teaching. Denied access to regular credit channels, many of the poor were indebted to loan sharks: Yunus discovered 42 people in the village who were in debt to these exploitative lenders. The total value of the loans was \$27. In the face of skepticism from the financial establishment, Yunus created the Grameen (“village”) bank as a means of mobilizing the poor’s savings and providing them with credit to start small businesses and help educate their children. The bank now has more than seven million customers, 97 percent of whom are women. Despite lending to “sub-sub-sub-prime” borrowers, it has a repayment rate that would be the envy of any U.S. mortgage lender.

Access to credit has transformed lives beyond recognition. The children of the indigent have been able to attend school and university and achieve professional success. Amid the crisis in global financial markets and the pain caused by mortgage mis-selling in the U.S. subprime market, Yunus provided a reminder of the positive, transformative role that credit can play in people’s lives. As we seek to reform the global financial system in the wake of the current crisis we would do well to keep it in mind.