A Conversation with Harvey Rosenblum

The Dangers of Complacency About Risk

Dallas Fed Research Director Harvey Rosenblum discusses the stability of the U.S. economy’s Great Moderation and how it set the stage for the financial turmoil that has gripped the nation since August 2007.

Q. Would you explain the term Great Moderation?
A. Economists use it to describe the marked decline in the frequency of recessions over the past 25 years. A less volatile macroeconomic performance was accompanied by big reductions in inflation and inflation volatility. This environment changed expectations. Inflation and inflation expectations are the keys to economic stability because they’re the primary drivers of changes in interest rates over long periods.

One way this relationship affects the average American is through its impact on mortgage rates, which also rise and fall based on inflation and inflation expectations. As interest rate volatility nearly disappeared in recent times, home mortgage rates declined appreciably, making the American Dream of homeownership more affordable.

Q. So far, this sounds positive. How did we get from there to the irrational behavior we’ve heard about in the housing and mortgage markets?
A. We have to realize that some of the irrationality that characterized the years leading up to the credit crisis was a by-product of the economic tranquility being experienced. The Great Moderation induced a feeling of minimal risk, but the feeling did have an aura of rationality to it.

Indeed, it may have been quite rational to have faith in positive outcomes, to become a bit complacent, given the economy’s increased and prolonged stability. The real question is, how do you draw the line between rational complacency and misplaced confidence?

Q. How did this complacency manifest itself?
A. Through what I call the three corollaries of complacency—complexity, confidence and compensation. The first of these concepts gets at whether managers can figure out what’s going on within their own organizations.

Take the obvious example of a bank, which we have to remember is a regulated entity. Can the CEOs describe their organizations’ structure and investment risks to their 12-year-old grandchildren? Are objectives other than safety, soundness and shareholder value being pursued? Or is the complexity of the corporate structure a way to hide things from top management and shareholders? If so, there should be a rating penalty; every effort at obfuscation must be “taxed.” It’s fine to have a far-flung empire. It’s not fine for it to be subsidized by shareholders, investors or, perhaps eventually, by taxpayers.

Q. Does it bother regulators that they’re once again dealing with the repercussions of off-balance-sheet financing?
A. Not necessarily. A little background on the workings of commercial banks helps here. The sustainable competitive advantage commercial banks have over their nonbanking competitors is the safety net that encompasses the Fed’s discount window and federal deposit insurance. Commercial banks voluntarily “pay dues” to be among the financial
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In a relatively short time, the industry went from a platform of homogenous, plain vanilla mortgages that may not have met all borrowers’ needs to an amalgam of customized mortgages with adjustable rates, zero or low down payments, interest-only payments and looser standards for documentation of income.

Q. How does that tie into our recent troubles?

A. The Great Depression taught us mortgages could be risky products. House prices fell when unemployment rose. For many years after the Depression, national banks weren’t allowed to hold mortgages because they were viewed as too risky. Fifty years of home mortgages being much less risky changed all that, abetted by the Great Moderation.

Q. I doubt many people today would describe mortgages as “less risky.”

A. It doesn’t help that the housing industry has been hit by what has been described as the equivalent of a 100-year storm. But unlike an uncontrollable event in nature, I think the storm in the housing market might have been prevented.

Q. So how do we navigate, and presumably escape, this perfect storm’s path?

A. Until we have a sense that house prices have stopped falling, it’s hard to say how long the current turmoil will last. But let’s not lose sight of the fact that there will be a bottom to this market. And it’s probably not all that far away. The Fed is using every tool at its disposal and creating new ones to mitigate the damage this storm is inflicting on the economy. The Fed has been rewriting the textbook on economics and finance. The Fed is clear about its mission, and I believe we’re succeeding.