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THE FINANCIAL EXPRESS

Print Story

Be responsive, not reactionary

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Posted online: Wednesday, March 19, 2008 at 0031 hrs

Sceptics of financial liberalisation and innovation have been emboldened by the crisis in the world's credit markets that erupted in mid-2007, when problems with subprime mortgages first appeared in the US. Are these sceptics right? Should we halt financial liberalisation and innovation to prevent such crises from recurring?

The subprime market is largely a decade-old innovation built on such things as option adjustable-rate mortgages (option-ARMs), new kinds of collateralised debt obligations, and structured investment vehicles. Previously, private investors did not lend to mortgage seekers whose credit history was below prime. But, while it does sometimes appear that the current crisis is due, at least in part, to financial innovation, liberalisation has been shown to be a good thing overall.

A study published in 2005 by economists Geert Bekaert, Campbell Harvey, and Christian Lundblad found that when countries liberalise their stockmarkets, allowing them to operate freely without government intervention, economic growth rises by an average of one percentage point annually. This tends to be associated with an investment boom, which in turn seems to be propelled by the lower cost of capital for firms.

While complex financial arrangements allow growth, they also can create hazards. Think of the scaffolding around construction sites. Sometimes a piece of scaffolding falls, with disastrous consequences. But, with every setback, we learn. Governments and insurers implement better safety requirements. The same is true of financial disasters.

The US is one of the world's most financially liberal countries. Its financial markets' high quality must be a reason for its relatively strong economic growth. Indeed, given a very low savings rate and high fiscal deficit over the past few decades, the US might otherwise have faced economic disaster.

The reason is simple. Individual firms might have splendid investment opportunities but might be deterred by cash shortages or perceived macroeconomic risks. Effective financial markets enable them to pursue such opportunities despite these constraints by enlisting investors to provide the capital.

There has been a longstanding discussion about whether new derivative markets, which provide such financial hedging, tend to increase preexisting financial markets' volatility. The consensus is that they do not. In 2000, Stewart Mayhew, a Sec economist, surveyed the extensive literature on this topic. Mayhew concluded that it is difficult to tell whether derivative markets worsen financial-market volatility, because their creation tends to come when existing financial markets already are more volatile. Moreover, he found that there is no evidence that derivative markets create volatility in underlying cash markets; in fact, they may even reduce it.

The effect on underlying financial markets' volatility may not even be the right question to consider. The right question is whether these products are conducive to economic success and growth. Here, Mayhew concludes that new derivative markets clearly increase the liquidity and quality of information in financial markets —which propels economic growth.

The subprime crisis has exposed serious problems that we must address. We need stronger consumer protection for retail financial products, stricter disclosure requirements for new securities, and better-designed vehicles for hedging risks. Some of the innovations associated with the subprime crisis—notably option-ARMs—seem to have little redeeming value. But others help spread risks better around the world.

So, we should not slow down financial innovation in general. On the contrary, some of the fixes that result from the subprime crisis will probably take the form of still more innovation.

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