In search of the root causes of the 2008 crisis: New York Fed to hear new theory on financial meltdown

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(PhysOrg.com) -- Anjan Thakor, finance professor at the Olin Business School, Washington University in St. Louis, will present a new theory on the causes of the financial crisis to a meeting of the New York Federal Reserve Bank on Tuesday, Dec. 8, 2009.

Thakor's research examines what happens when the leverage ratios of banks and borrowers move in unison, a phenomenon he calls "infectious leverage". This convergence of two cycles could be dangerous with the potential to expose the financial system to substantial risk.

"With this new theoretical model, we are trying to understand whether this correlation between consumer and bank leverage was just a random phenomenon or were there some systematic factors that would have led to consumer leverage and bank leverage being high at the same time," Thakor explains.

Thakor presented his preliminary research at the annual conference of the National Association of Business Economists held in St. Louis in October. He has also presented the paper at the National Bureau of Economic Research Summer Institute in Boston and at a financial crisis conference hosted by the Bundesbank in the fall. He will present it at the Federal Reserve Bank of New York Tuesday, Dec. 8, 2009.

Thakor says it is important to determine the root causes of the financial crisis in order to prevent it from happening again. "We had this double fragility in the financial system from high borrower and bank leverage. We want to understand what economic forces drove that and what we show is that it was not some random event. There were sound economic reasons that fueled it. In particular, the common underlying cause was high prices for the assets consumers purchased that were financed by bank loans and served as collateral for bank loans."

To get at root causes of the current crisis and prevent future meltdowns, Thakor offers these proposals:

- create an agency to gather information and monitor the interconnectedness of institutions, including the shadow banking system

- increase the minimum regulatory capital requirements for banks (a controversial, but necessary calibration according to Thakor)

- provide thoughtful research-based policy prescriptions that halt the tide of over-regulation

Blaming executive compensation or pumping more liquidity into the system is not going to fix the financial crisis, says Thakor. "I don't think the current regulatory dialogue that I see is getting at the root causes of the crisis. I think they are getting at politically appealing scapegoats…This crisis was the consequence of the interactions of monetary policy, housing prices, and credit policies, with politics affecting these interactions. So you have to attack all three, and understand the role of political influences."

Anjan Thakor is associate dean and John E. Simon professor of finance at the Olin Business School, Washington University in St. Louis.

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