

## MEMORANDUM FOR THE RECORD

Event: John Cassidy, author of *How Markets Fail: The Logic of Economic Calamities* and staff writer for *The New Yorker*.

Type of Event: Interview

Date of Event: August 11, 2010 (3-4pm)

Team Leader: Matthew Cooper

Location: FCIC, Phone Interview. FCIC participants used the large conference room.

Participants – Non-Commission: John Cassidy

Participants – Commission: Matthew Cooper, Gary Cohen, and Adam Paul

MFR Prepared By: Adam Paul

Date of MFR:

Summary of the Interview:

**The following is a summary of the conversation. It should not be taken as a transcript.**

Key Points

- Incentives drove the crisis
- The Fed and the economics profession allowed a policy framework that encouraged speculative bubbles.

Cooper began the interview by asking Cassidy what he believed caused the crisis. “You are never going to have a mono-causal explanation,” said Cassidy of the events that take places across multiple continents.

Cassidy outlined three overall narratives that circulate about the crisis. The first, which he hears mostly from the man on the street, tells that “crockery and greed” caused the crisis. The second storyline stresses the role behavioral shortcomings such as disaster myopia. Economists, including George Akerlof, have been the strongest supporters of this view. The third narrative traces the crisis to bad incentives.

Cassidy views the first two narratives as symptoms rather than causes and favors incentives to explain the crisis.

“You have to look at what motivated people all along the mortgage chain,” said Cassidy. This includes short-sighted payment structures and the market environment. In Cassidy’s story people

are not irrational but they will react even to incorrect market signals. Cassidy spoke at length about the Federal Reserve's low interest rate policy in generating such signals.

"One big reason that people got bad signals is that the Fed let a speculative bubble develop," Cassidy said. Cassidy did give some credence to the argument, proffered by Greenspan and Bernanke, that a "Wall of money from abroad" blunted the Fed's policy tools but was skeptical of their overall mindset.

"Over ten to fifteen years, the Fed—not just Greenspan, not just conservative economists—let themselves get into an overall policy framework that was conducive to speculative bubbles." Cassidy called this framework "damaging" both to the institution and to markets. According to Cassidy, this framework, even if each individual Fed decision was justified by reasoned evidence, added to a type of "Greenspan Put": a belief that the Fed would intervene to provide liquidity, and support the prices of assets, in a crisis. This perception is associated with higher risk by financial firms.

Cooper then asked Cassidy what aspects of the crisis he would like to know more about and that FCIC should further investigate. Cassidy said that he remains "puzzled by the internal deliberations of big banks." He cited an internal report from UBS as a well-documented case study but said that American banks have been less forthcoming about their thinking.

"It's still a mystery why Citi got into mortgages so big, so late... A lot of smart bankers made very unwise decisions." Similar investigations into firms like Merrill Lynch and Goldman Sachs are also of interest. A second mystery was the role of Fannie and Freddie. Cassidy said that he understands that these firms were "joining rather than leading the herd" but would like to see the FCIC produce hard numbers on their role, especially in subprime.

Cooper also asked how to balance financial innovation and regulation. Cassidy used compensation as an example to pose that true innovation takes time to prove itself. "If something is a really innovation it should be producing profits for five or ten years not just five or ten quarters... {hard to tell} what's a real innovation and what designed to produce compensation until the guy moves *{across/off??}* The Street."

Cohen asked if anything could have been done about the moments of panic in late 2008. Cassidy responded that it was "rational to panic." As in a classic bank run, investors knew that "if they get to the front of the queue, they can get their money out."

Cooper followed this question by asking Cassidy's opinion of Bear and Lehman. "At the time I supported the bailout of Bear." While he wished the Fed and Treasury had acted earlier, he expressed doubts that the political will would have existed to do so.

Cassidy expressed that breaking up large banks, though something like a Volcker Rule may be one of the best policy options. Cassidy also said that changes in the backgrounds of policy

makers, especially the predominance of PhD holders at the Fed (Volcker was the last Fed Chairman with regulatory experience), has changed the government reactions. “Now all the Fed leaders are PhD economists. Regulators get relegated and realize that people at the top are not interested.”