FINANCIAL CRISIS: New evidence of the long shadow of US bank deregulation

US financial liberalisation during the 1980s created the environment in which a global glut of savings from China and other emerging economies could drive up US house prices during the late 1990s and early 2000s – which ultimately resulted in the subprime collapse and the global financial crisis. That is the central message from research by Mathias Hoffman and Iryna Stewen, to be presented at the annual congress of the European Economic Association in Mannheim in August 2015.

The researchers note that commercial banking in the United States was historically segmented along state borders. Only during the 1980s did federal states begin to remove the legal barriers that impeded banks from other states to enter their local markets. The main result of the new study is that house prices in states that liberalised their banking markets earlier were more sensitive to the impact of the global savings glut. The authors conclude:

‘The subprime crisis was the result of policy changes and bad luck. But financial liberalisation during the 1980s cast a long shadow: it effectively increased the ability of the US financial system to produce assets that were perceived as safe by global investors when a huge demand for such assets – in the form of global imbalances – arose a decade later, with the emergence of China on the world economic stage.’

More...

What drove America’s housing boom and bust of the first decade of this century? Excessive financial liberalisation or a global glut of savings that lowered interest rates and drove up asset prices? Or was it all just due to lax monetary policy?

This paper argues that financial liberalisation during the 1980s created the environment in which a global glut of savings from China and other emerging economies could drive up US house prices during the late 1990s and early 2000s.

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The Figure shows aggregate capital inflows into the United States (the negative current account balance relative to GDP) and the average valuation of residential housing (here expressed as the price of a house normalised by income to account for income differences across states) for states that opened their banking markets early (before 1984) and those that liberalised late (after 1987).

In both groups, house valuations started to increase from the mid-1990s, together with US capital inflows and peaking in 2005 and 2006. Strikingly, however, the increase in valuations before the crisis and their fall during the crisis is considerably stronger in states that deregulated early.
The econometric results confirm the visual impression: for a hypothetical pair of states of which one liberalised in 1980 and the other in 1990, aggregate US capital inflows over the period 1995-2005 (which averaged 3.5% of GDP a year) would have accounted for a difference in housing valuations of 28% in 2005.

What can explain this pattern? The researchers show that by the mid-1990s, states that had opened their local markets earlier had a stronger presence of geographically diversified banks, that is, banks operating in several states. Earlier research has interpreted the global savings glut as reflecting a demand for safe assets that was driven by a lack of safe investment opportunities in emerging markets.

The authors of this study argue that this global demand for US safe assets was essentially a positive funding shock to geographically diversified US banks. Since it was considered inconceivable at the time that the aggregate US housing market could decline, lending to a bank whose balance sheet reflected a geographically diversified portfolio of US mortgages could be considered a safe investment.

This perception allowed geographically diversified US banks to refinance themselves at low rates while increasing leverage at the same time. Consistent with this interpretation, the study finds that aggregate capital inflows into the United States lead geographically diversified banks to increase their lending and to lower interest rates whereas there is virtually no impact on local banks.

So what? The subprime crisis was the result of policy changes that happened much earlier and of bad luck.

Financial liberalisation during the 1980s cast a long shadow: it effectively increased the ability of the US financial system to produce assets that were perceived as safe by global investors when a huge demand for such assets – in the form of global imbalances – arose a decade later, with the emergence of China on the world economic stage.

ENDS

Holes in the Dike: the global savings glut, US house prices and the long shadow of banking deregulation
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