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Lessons Learned: Edwin (Ted) Truman

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As an experienced financial diplomat, Mr. Truman was appointed as special counselor to the Secretary at the U.S. Treasury in the run up to the Group of 20 (G20) summit in London. He was the architect behind the $250 billion special drawing right (SDR)[1] proposal, which was passed at the London summit and implemented in August 2009. Truman is currently a nonresident senior fellow at the Peterson Institute for International Economics and has been a visiting economics lecturer at Amherst College and a visiting economics professor at Williams College. Previously, he had served as assistant secretary of the U.S. Treasury for International Affairs and had directed the Division of International Finance of the Board of Governors of the Federal Reserve System. He was one of three economists on the staff of the Federal Open Market Committee between the years 1983 and 1998. This "Lessons Learned" is based on an interview with Mr. Truman.

Crises do not happen all at once. They slowly develop and evolve. This provides an opportunity to engage them sooner rather than later.

Even before BNP Paribas's announcement, the system had already gotten to a point where it was likely to go into a global financial crisis. The major failure was that, prior to the crisis, there was a lot of examination of the subprime mortgages because it was clear that they were going sour and that they had tenuous financial structures built on top of them, however, there was inadequate information. People understood that these artificial structures were somehow vulnerable. However, it was not clear where the vulnerabilities were, how far financial institutions had built on top of these structures, or all that was going on in the markets, including in the subprime market. The general view, though, was that we would somehow get through this.

There was also denial and failure to recognize what was going on with the buildup of the gross financial flows. There were fewer net savings pouring into the U.S. than there was participation of European financial institutions in the U.S. financial system. There was also a failure to recognize that things could go wrong.

There were three phases of the crisis.

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[1] "The SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves. So far SDR 204.2 billion (equivalent to about US$291 billion) have been allocated to members, including SDR 182.6 billion allocated in 2009 in the wake of the global financial crisis. The value of the SDR is based on a basket of five currencies—the U.S. dollar, the euro, the Chinese renminbi, the Japanese yen, and the British pound sterling."
https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/14/51/Special-Drawing-Right-SDR

The first was the denial phase. In the second, other countries pointed to the U.S. as the source of the crisis, and only in the third phase, after Lehman Brothers' collapse, did international cooperation really begin.

There was a certain amount of finger-pointing at the U.S. because it was the epicenter of the crisis. To the extent that their financial institutions participated in the rush to invest in these assets, which were of lower quality than was advertised, supervisors abroad were as guilty as the U.S. The U.S. cannot be responsible for what foreign banks buy.

When Lehman Brothers collapsed in September 2008, it served as a wake-up call for everyone and made them realize the seriousness of the crisis. It made all parties more willing to cooperate and work together.

The U.S. was late but still quicker than other countries in understanding the extent of ramifications of the crisis.

There were two reasons for the U.S.'s quicker response. The first was the fact that the U.S. was the epicenter of the crisis. Secondly, other countries tended to underestimate the consequences, thinking it was a U.S. problem and that it would not affect them. This was due to the fact that there was little understanding of the extent to which non-U.S. financial institutions and their creditors were involved in this merry-go-round.

If we had acted proactively in 2007, the crisis might have been less severe. More aggressive use of the [U.S. Dollar] swaps earlier might have been a good idea. More pressure on the investment banks to improve their capital positions would have been better, especially in the wake of the Bear Stearns takeover. However, the authorities, especially in the U.S., did not have the tools to do that.

There were many reasons behind the failure to realize the risks earlier.

What was not understood by most analysts, observers, and the financial institutions themselves, was how far they had collectively built up these structures. There was a general impression, in the face of warning signs, that we would somehow get through this.

In financial markets there is always a tension between fear and greed. This was part of the problem: greed was overwhelming, and it took time for fear to set in. If fear or caution had set in earlier, the crisis would not have gotten as far as it did, and we could have been better prepared.

Policy instruments, such as the ability to put direct pressure on investment banks to curtail their activities, were not available in the U.S. at that time. In principle these financial institutions [investment banks] were being supervised by the Securities and Exchange Commission (SEC,) but the SEC's supervisory focus was historically from the perspective of investor protection. As a result, these institutions, which did not have the capital that banks did, were acting like banks but were not supervised. Then there was the problem of mortgage originators, many of which were not supervised at all. These mortgage originators were subject only to state regulations, and these state regulations differed from state to state.

Some financial officials saw the risks and understood what was going on. However, they were not active enough in drawing attention to the issue.

If a similar situation happens again, we will likely go through the same phase of denial. However, being particularly diligent and questioning as a crisis develops can help policymakers better assess risks and calibrate when to respond.

Denial and hoping that things will turn out just fine are natural responses. Policymakers should be gradual in their response when there is uncertainty. However, this view is undercut when dealing with a major crisis. There is a reluctance to take big steps necessary to prevent a serious crisis from going out of control. This is probably inevitable.

It is human nature to be optimistic, which is a useful aspect. However, we also need people that are not so optimistic, people who know from past experience that things can get out of hand and who can appreciate the potential for things getting worse before they get better. The role of policymakers and advisors is to strike a balance between these two.

In fact, the time spent in denial can be dealt with through better education about the lessons of previous crises. It is important to appreciate the importance of identifying and recognizing the potential for crises sooner rather than later.

In a crisis, policymakers must be open to using a wide variety of tools, even some that are less familiar.

[In 2009, I was] at the Peterson Institute for International Economics and I had, as a lot of us had, been watching developments in the fall of 2008 as the crisis developed. I was old enough to know what special drawing rights (SDRs) are, which is not true of most people. I thought that it would be a good idea to have a special issue of SDR. Although my name was associated with this proposal, there was a lot of encouragement from other people on the outside.

I had already written a paper mentioning this proposal that had come out at the end of 2008. I, and others, had mentioned the proposal when we were meeting as think-tank people with the British before the London summit and we knew it was somehow on the agenda of the G20 staff and officials who were preparing the summit. So, I decided to write this longer piece for *The Financial Times* proposing a substantial issue of SDR of $250 billion, which was roughly the most that could be done and approved by the Treasury Secretary without an act of Congress.

When Tim Geithner called me, and I happened to be in London when he called me, and asked me to come back to the Treasury, he knew I had made this proposal. My piece [in *The Financial Times*] had just come out. He said, "Well, I have an open mind on the subject of SDRs," even though some of the career staff at the Treasury were against the idea and the International Monetary Fund (IMF) staff itself was against the idea.

[Truman's SDR proposal was approved at the summit and the allocation became effective on August 28, 2009, earlier than most other proposals adopted at the London summit.]

The roles of international financial institutions such as the IMF and the World Bank have changed to some degree.

Both the IMF and the World Bank's response were very effective during the crisis. They have both evolved and now have new procedures and new instruments to deal with problems. One such example is the IMF's Flexible Credit Line.

On the other hand, their role as the central organizers of the international financial system has diminished over the past decades. This is due to the fact that their resources have not been augmented as much as they should have been. Also, although the world is now tied together more closely than it was 10 years ago, its leaders do not act on the fact that their countries, and, therefore their prospects, are tied together. The answer to this is to have better educated leaders, advisors, and commentators. The hope is that people have taken lessons from the past.

Because of how interconnected the financial system is, it is important to consider who will provide the safety net for the international financial system in the next crisis.

The swap network used during the crisis has been rolled back, but it still exists. However, the question is, in the next crisis, will the Federal Reserve be able to again respond as it did, by providing $600 billion to the world's markets, or will the political environment prohibit this? It will depend on the circumstances. If the Federal Reserve had responded so aggressively in 2007, it probably would have had real political problems. Though in principle, the Fed should have done more sooner.

There is tension about whether the Federal Reserve will be there for the international financial system the next time around. That brings us back to the question of whether there are alternative mechanisms that could fill this role. This raises the question of the resources of the IMF and the "global financial safety net" in general.

There is a recognition in the economics profession that the U.S. now has more scope to use fiscal policy to stimulate the economy than it did in the last crisis. During the Global Financial Crisis (GFC), a fiscal stimulus was done in 2008 and a second one in 2009. The second one, although believed by some to be too big, was in fact too small and was taken away too soon. However, most Europeans thought the U.S. had used too much fiscal policy.

The philosophical differences, and maybe even strategic differences occurred during the crisis and remain, if anything, they have been intensified.

Many countries used fiscal stimuli during the crisis. It is the case that probably a few countries overdid it in terms of their debt positions. However, even when the proposal to have a joint stimulus was made to ensure that everyone was working together, some technical differences arose. These were centered on what is considered a fiscal stimulus, whether automatic stabilizers were considered stimuli, or whether only discretionary actions could be included, and how to measure a stimulus.

Many Europeans, especially Germans, considered using fiscal stimulus beyond economic stabilizers to be inappropriate. That view still holds today.

In order to be prepared for a future crisis, we need to study what was done to combat the GFC, memorialize and engage these lessons so that these tools and experiences are readily available for the next time.

It is highly unlikely that a crisis on this scale will happen again in the next five to ten years because this was the worst global crisis since the Great Depression. However, we should try to remember and understand the lessons from this and previous crises. We should not follow exactly what was done, but rather use these tools as a basis, so we do not need to reinvent the wheel.

During the GFC, it was fortunate that there were still so many people that remembered the swap network that was dismantled at the end of the 1990s but which was resurrected and used in the wake of the 9/11 terrorists attacks. That meant that, when, at the end of 2007, the Federal Reserve thought it would be useful to transform this network and use it to provide liquidity to foreign commercial banks there were enough people around who knew swaps and how to work them.

This was unlike the situation with the SDR. One of the problems was that the last time SDRs were issued was in the early 1980s, for which the decision to allocate was taken in the late 1970s. There was a proposal for special adjustment of SDR holdings that was agreed upon at the end of the 20th century, but it had never been implemented, and most people in positions of authority in 2009 had never heard of the SDR. The earlier proposal could have been used as an opportunity to do more to promote the SDR.

We should know the history, read what experts have written, appreciate and think about what was done in the past so we can be better prepared for future crises. Everything that was done in 2008-09 might not be done in 2032-33, but we will at least have a better basis on which to think about alternatives than we would without such information.

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