Economists known as the "liquidity movement" predicted the financial crisis. Now they say we strangle securitizations at our own peril.

BEFORE THE CREDIT MARKETS seized up, before AIG nearly collapsed and before the economy went into a tailspin, a little-known group of economists was sending up pointed warnings.

This small group, made up of economists from top universities and officials of the New York Federal Reserve, identified in mid-decade some powerful forces that could damage liquidity, the free flow of money throughout the economic system. One conclusion: Highly leveraged financial institutions could send the world's financial markets into a virtual free fall.

"It seems reality caught up with our research," says Markus Brunnermeier, a Princeton economics professor and an early member of the liquidity movement, as the group is known.

While the crisis is receding, the liquidity economists aren't resting on their laurels. Some are especially worried about the near-standstill in Wall Street's once-booming business of securitization. This "shadow banking system" helped finance everything from auto loans to mortgages for skyscrapers. Yet now, issuance of some key types of securities is off nearly 90% from the pre-crisis peak, leaving traditional banks to pick up the slack. And the banks are still hobbled by their own capital crunch.

Liquidity expert Gary Gorton of Yale University puts it bluntly: "If we don't resuscitate securitization, I predict we won't be able to resuscitate the economy." He has an ominous forecast for stocks if nothing is done: a flat Dow for 10 years.

THE LIQUIDITY MOVEMENT has bold ambitions. It aims to create a new way to look at the aggregate economy, one that gives special weight to financial institutions and
their effects. The focus is on potential "frictions" -- especially, lack of liquidity and credit -- that can keep the economy from working efficiently.

"Economics used to ignore liquidity risk, like Newton's laws ignore friction in physics," says Lasse Pedersen of New York University. "However, now people are realizing similar frictions are central to what is going on in the economy."

Brunnermeier and Pedersen co-wrote one of the field's seminal works in 2004, referred to Liq-Liq. It highlighted the possibility of "liquidity spirals" arising as leveraged financial institutions ran short of capital and started selling assets at fire-sale prices. The resulting price declines and increases in volatility would, in turn, lead to tighter funding. All assets would move in tandem, rendering diversification all but useless.

Why weren't the warnings heeded? Officials at the Federal Reserve Bank of New York did begin paying attention to the research a few years before the crisis. Treasury Secretary Timothy Geithner, then president of the New York Fed, hosted a liquidity conference featuring many liquidity economists as early as 2005. But Liq-Liq failed to gain real traction, because, Brunnermeier says, its predictions were viewed as too extreme.

That changed when the crisis hit in 2008; liquidity-movement members were suddenly in demand at the highest reaches of policymaking. Members began meeting regularly in the New York Fed's august boardroom, in an economics variant of the Manhattan Project.

Organized by Tobias Adrian, who heads capital-markets research at New York's Fed, and Bengt Holmstrom, a Massachusetts Institute of Technology economist, the meetings included Brunnermeier, Gorton, Pederson, John Geanakoplos of Yale, Mark Gertler of NYU and Hyun Shin of Princeton University. Martin Oehmke of Columbia University has also worked with the group.

At last, the group's prescience was being recognized. "Illiquidity and leverage were the two central ingredients of the crisis" says Olivier Blanchard, director of research for the International Monetary Fund. "My thinking, and, dare I say, the thinking of the IMF, on these issues, was built very much on the work of these economists."

The liquidity economists have moved on to different topics, like better ways to measure and address systemic risk. But the biggest worry for some remains the drying-up of securitization. While the topic is getting scant attention in Washington, the liquidity economists make a strong case that rebuilding the securitization market should be part of any financial-reform package.

In its simplest form, securitization involves bundling assets like home mortgages to create securities, which spread risk and create credit. Until the crisis, securitization had funded lending for 59% of mortgages, 50% to 60% of credit-card debt, and 90% of auto loans.
Now, this form of financing is all but dead: New securitization issuances, except those sponsored by the government, have largely come to a halt. Issuance of new securities backed by credit cards, student loans and auto loans is down from a high of $95 billion in September 2006 to $11 billion this November, reports the newsletter Asset-Backed Alert.

"The securitization market is still on its knees. In fact, it is barely able to get up off the floor," says liquidity economist Darrell Duffie of Stanford University's Graduate School of Business.

As credit-card companies lose a ready outlet for new cards, they're cutting back sharply on lending. Richard Herring, a finance professor at the University of Pennsylvania's Wharton School, points out that solicitations for new credit cards are down 70% from two years ago.

Banks, too, can no longer offload new loans via securitization, and many aren't willing to keep large amounts of consumer loans on their own balance sheets. The banks are strapped for capital, and the recession is steadily raising delinquency rates on consumer loans.

Liquidity warriors, from left: Markus Brunnermeier of Princeton, Lasse Pedersen of NYU, Columbia's Martin Oehmke, NYU's Mark Gertler. Matthew Furman for Barron's

The way forward, liquidity economists believe, is to improve confidence in securitization -- not easy, given the huge losses investors suffered on mortgage securities and other asset-backed paper.
The thrust of most ideas is to bring securitization out of the shadows and into the daylight of banking regulation. For example, key buyers of complex securities were SIVs, short for "structured investment vehicles," lightly regulated entities that issued short-term debt to buy longer-term securitized assets. As the subprime-mortgage mess spread, many SIVs imploded.

Since SIVs looked and acted like banks, they should be regulated as "narrow banks," Gorton says. SIVs would have capital requirements, be examined and have access to the Federal Reserve's discount window for cheap loans. With SIVs buying again, more lenders would be able to sell off loans and make new ones.

Making securities more transparent also would be a big help, the liquidity camp says. Take collateralized-debt obligations, essentially securitizations of securitizations. Says Duffie, "CDOs have been very difficult for investors to analyze. As a result, many investors have unduly relied on the credit rating, rather than doing their own due diligence."

He favors giving investors clear data about the underlying loans and borrowers, in a uniform manner and with standard analysis software available for anyone who wants it.

The cost of providing adequate transparency on certain types of products may be high, but if overly so, the market will respond by avoiding them. A simpler, more transparent and arguably safer set of securities will result.

These ideas could give a real lift to lending. Says Gorton: "Right now the economy is muddling along. The stimulus program maybe did its thing. Maybe we will need another stimulus, or extension of the liquidity programs. And why would that be? Because we haven't fixed securitization."

Not everyone thinks the liquidity economists have all the answers to the recent crisis. University of Chicago economist Luigi Zingales thinks the central issue was the solvency of institutions, not systemwide liquidity. Calling it a liquidity crisis simply makes it easier to justify government intervention, he says. He agrees, however, that the revival of securitization is an essential step.

The liquidity economists hope to eventually develop a whole new type of economics. The field of "macroeconomics will change," says Princeton's Brunnermeier. "Its models ignored the main components of the crisis. What will happen is that macro will merge with the field of financial frictions, giving rise to a new economics."

Given their prescience in recent years, the liquidity economists may be well worth watching -- and listening to -- as they press ahead.

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