Disarm our doomsday machine

A crisis-prone system calls for measures to minimise the damage in the event of the inevitable

Are financial crises an inevitable feature of capitalism? Must the government rescue the system when huge crises occur? In his book *Stress Test*, Timothy Geithner, president of the Federal Reserve Bank of New York and US Treasury secretary during the 2007-09 crisis, answers “yes” to both questions. Yet these answers also harm the legitimacy of a market economy. It is bad enough if capitalism is crisis-prone. It is worse still if the state feels obliged to rescue those whose folly or criminality caused the damage, to protect the innocent.

Mr Geithner argues not only that crises are sure to recur but that governments must react with overwhelming force. The only way to stop a crisis is to remove the circumstances making it rational to panic. That means the government must borrow more, spend more and expose taxpayers to more short-term risk – “even if it seems to reward incompetence and venality, even if it fuels perceptions of an out-of-control, money-spewing, bailout-crazed big government”. This is a bald statement of an unpopular view.

Sheila Bair, head of the Federal Deposit Insurance Corporation during the crisis, has given an opposing view, arguing that if Wall Street believes the government will always pick up the tab for disastrous bets, instability will be the inevitable result. Mr Geithner’s justification of the bailouts only makes sense, she says, once you accept a false dilemma: “That our only choices were either to do nothing or to pursue the over-the-top measures which we did.”

The view that capitalism is crisis-prone seems compelling. Stability destabilises. It is, Mr Geithner suggests, human to take on risk during a prolonged period of prosperity.

That happened in the leverage cycle which preceded the crisis (see chart). People did not take on leverage because they expected to be bailed out. They did so because they expected to gain.

Yet there also exists what I like to call “rational carelessness” – the fact that bailouts were likely if the worst came to the worst surely comforted creditors and so increased the risk of a destabilising credit bubble.

Once Lehman Brothers failed, a new depression seemed to be on the way. In response finance ministers and central bankers of the Group of Seven leading high-income countries promised in October 2008 to “take decisive action and use all available tools to support
systemically important financial institutions and prevent their failure”. They did, and it worked. Panic – as measured by the spread between rates on unsecured interbank lending and expectations of future official interest rates – diminished. In the US the economy started to stabilise after two quarters of contraction.

Mr Geithner’s view is that the correct response to such a crisis has three elements: massive monetary and fiscal support; guarantees for the liabilities of systemically important institutions; and harsh stress tests. If an institution fails to raise capital, the government must inject it.

The conditions of the time – above all, the limited legal authority of the US (and other) governments – made a more tailored approach almost impossible to adopt. The value of assets was so uncertain, capital buffers so tiny, the reliance on short-term borrowing from fickle sources so ubiquitous and the mechanisms for resolving complex financial institutions so inadequate that governments had no reasonable alternatives. They simply could not risk the economic results of a cascading financial collapse.

Similarly, the authorities had to use monetary and fiscal instruments freely, to limit the longer-term economic damage. Even so, the costs have been huge. In the first quarter of 2014, US gross domestic product was as much as 17 per cent below its 1950-2007 trend (see chart).

Capitalism is indeed crisis-prone and the US government was right to intervene during the crisis. These conclusions leave us in a desperate position, with our fates apparently attached to a doomsday machine. The response of many on the free market side seems to be that the government should not impose increased regulation of the financial system, but simply rule out a rescue next time. Such is the unpopularity of bailouts that this approach might even be tried. But the consequences are likely to be catastrophic.

A more attractive possibility is to make the system far less unstable and far easier to deal with in a crisis. The options here include: higher capital requirements for any institution likely to prove systemically important together with requirements for long-term debt that can absorb losses in a crisis; reduction of tax incentives to take on debt; safer bank deposits backed by far higher reserve requirements; enhanced regulatory oversight of the system; and far greater ability to resolve complex financial institutions when they become insolvent.

Such measures should bring the world closer to what Ms Bair desires. It is likely that mistakes were far more important than moral hazard in creating the crisis. Yet after the rescue moral hazard does indeed exist, above all among the creditors of the systemically important institutions.

Mr Geithner has pushed for tighter regulation. But he also offers a law of unintended consequences. The safer the visible financial system is made, he argues, the greater the danger that the fragility will emerge somewhere less visible, but possibly even more dangerous. This, he adds, is precisely what happened before the crisis, with the expansion of the “shadow banking system”. Thus tight regulation could ultimately prove self-defeating.

The warning is well taken. But there are answers. An interventionist one is full oversight of the evolving financial system, adding capital and other requirements as risk migrates. Another is to make sure that core financial institutions can survive an earthquake at the periphery. Yet another is greatly increased transparency requirements, thereby preventing such obvious absurdities as the build-up of huge off-balance sheet positions in vital institutions.

Where does this leave us? We have to try far harder to reduce the crisis-prone nature of our financial system. We have to be able to intervene in a crisis without the comprehensive rescues needed last time. As Mr Geithner warns, these efforts might fail. Yet I can see no alternatives.

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