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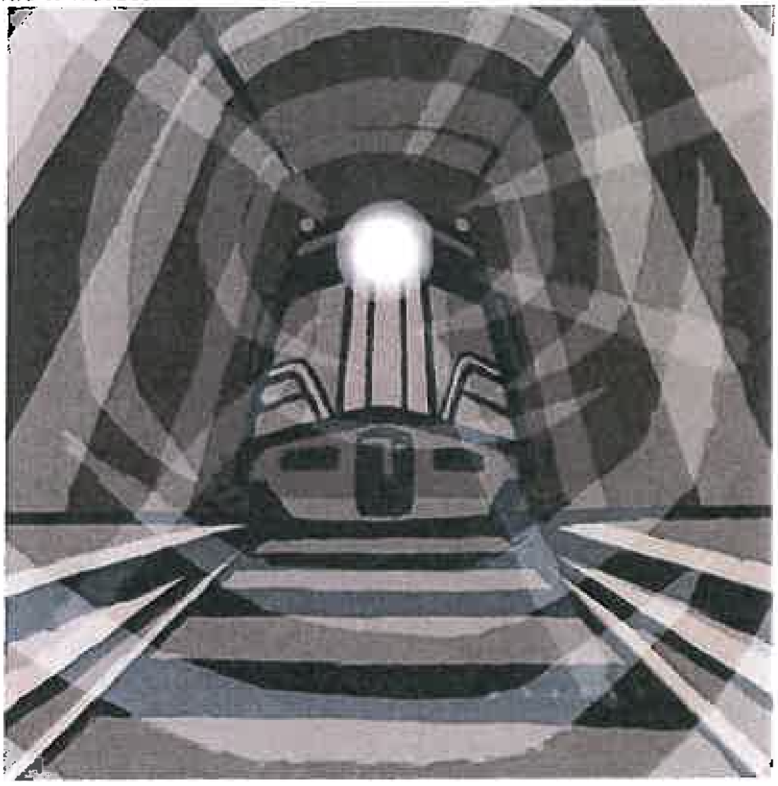
The Next Financial Crisis

BY PETER BOONE AND SIMON JOHNSON | **September 8, 2009**

It's coming—and we just made it worse.



To many observers, the Federal Reserve has never looked more heroic than it does right now. This past winter, America's financial system faced the prospect of utter ruin. And, while the economy has suffered plenty in 2009, the worst did not come to pass. The banking system that lends to our employers, thereby allowing our economy to function, never did collapse. Now, many of the accolades for averting catastrophe are going to the Fed. President Obama himself ratified this analysis last week when he renominated Fed chairman Ben Bernanke for a second term. Bernanke, the president told reporters, had marshaled "his background, his temperament, his courage, and his creativity" to help prevent a second Great Depression.

What these words of presidential praise obscured was that the Fed may well have mitigated our current crisis by sowing the seeds for the next one. All modern economies need a financial system that can connect people who want to save with those who have good investment projects. This is essentially what banks do. But, unfortunately, this process often goes wrong. And that is precisely what is happening now. Our banks have gotten into the habit of needing to be rescued through repeated bailouts. During this crisis, Bernanke--while saving the financial system in the short term--has done nothing to break this long-term pattern; worse, he exacerbated it. As a result, unless real reform happens soon, we face the prospect of another bubble-bust-bailout cycle that will be even more dangerous than the one we've just been through.

If you've studied U.S. economic history, none of this will come as a surprise. We have seen this spectacle--the Fed saving us from one crisis only to instigate another--many times before. And, over the past few decades, the problem has become significantly more dire. The fault, to be sure, doesn't lie entirely with the Fed. Bernanke is a prisoner of a financial system with serious built-in flaws. The decisions he made during the recent crisis weren't necessarily the wrong decisions; indeed, they were, in many respects, the decisions he *had* to make. But these decisions, however necessary in the moment, are almost guaranteed to hurt our economy in the long run--which, in turn, means that more necessary but harmful measures will be needed in the future. It is a debilitating, vicious cycle. And at the center of this cycle is the Fed.

Banking was once a dangerous profession. In Britain, for instance, bankers faced "unlimited liability"--that is, if you ran a bank, and the bank couldn't repay depositors or other creditors, those people had the right to confiscate all your personal assets and income until you repaid. It wasn't until the second half of the nineteenth century that Britain established limited liability for bank owners. From that point on, British bankers no longer assumed much financial risk themselves.

In the United States, there was great experimentation with banking during the 1800s, but those involved in the enterprise typically made a substantial commitment of their own capital. For example, there was a well-established tradition of "double liability," in which stockholders were responsible for twice the original value of their shares in a bank. This encouraged stockholders to carefully monitor bank executives and employees. And, in turn, it placed a lot of pressure on those who managed banks. If they fared poorly, they typically faced personal and professional ruin. The idea that a bank executive would retain wealth and social status in the event of a self-induced calamity would have struck everyone--including bank executives themselves--as ludicrous.

Enter, in the early part of the twentieth century, the Federal Reserve. The Fed was founded in 1913, but discussion about whether to create a central bank had swirled for years. "No one can carefully study the experience of the other great commercial nations," argued Republican Senator Nelson Aldrich in an influential 1909 speech, "without being convinced that disastrous results of recurring financial crises have been successfully prevented by a proper organization of capital and by the adoption of wise methods of banking and of currency"--in other words, a central bank. In November 1910, Aldrich and a small group of top financiers met on an isolated island off the coast of Georgia. There, they hammered out a draft plan to create a strong central bank that would be owned by banks themselves. What these bankers essentially wanted was a bailout mechanism for the aftermath of speculative crashes--something more durable than J.P. Morgan, who saved the day in the Panic of 1907 but couldn't be counted on to live forever. While they sought informal government backing and substantial government financial support for their new venture, the bankers also wanted it to remain free of government interference, oversight, or control.

The initial idea was politically controversial: It looked like a trick to get taxpayers to effectively finance banks and their various speculations. The eventual compromise, brokered by Woodrow Wilson, diluted the Fed's proposed powers and gave the government a stronger hand. But, while those who hatched the Fed didn't get everything they wanted, they did get the most important thing: an institution that could help cushion the blow when banking crises occurred.

In the years to come, the Fed would repeatedly provide lifelines to banks in need of help. This support has taken two broad forms: liquidity loans, whereby the Fed gives a bank a short-term loan that can be rolled over many times; and lower interest rates, which increase banks' profits by reducing the cost of most of their funding. These efforts would often help to mitigate individual disasters. But, by insulating banks from the terrible consequences of their own blunders, these measures would also encourage them to keep taking unwise risks, and thereby lay the groundwork for future crises.

In 2002, Ben Bernanke issued an apology on behalf of the Fed--but not for anything *he* had done. Bernanke was apologizing for the Fed's role in causing the Great Depression. He was referring to the fact that the Fed's monetary policy had been too tight from 1929 to 1933, allowing too many banks to fail. But this is only half the story. During the heady days of summer 1927, the Fed had done something else that would contribute to the Great Depression: It *lowered* interest rates. Markets responded to the rate cuts with a strong rally in the second half of 1927, and the Fed then decided to raise rates from 3.5 percent to 5 percent in 1928. But it stopped there. A higher rate would have choked off farmers who needed capital and were facing falling commodity prices throughout the decade. Moreover, it would have ended the bonanza of stock price gains that was benefiting the financial sector. To reduce risk, the Fed could have used its powers to convince banks to stop providing loans for stock purchases and to increase their capital, but this too would have ended the bonanza. It was a classic Fed dilemma: Should it raise rates and take other actions to curtail financial speculation involving excessive risk-taking, but possibly slow down the rest of the (real, not financial) economy in the process--and bear the resulting political damage? The Fed decided to stand aside. And so, history's most damaging economic bubble was created.

After 1929, the government considerably tightened the rules controlling banks, securities transactions, and risk-taking more generally. For a while, the system worked reasonably well. But, eventually, banks would learn how to play the new game. They would spend serious money lobbying to keep regulations lax, hiring lawyers and accountants to find methods to minimize or avoid regulations, and incentivizing employees to hide risk from regulators. While the banking sector became more risky, creditors to banks (such as depositors and lenders) knew they could count on the Fed to engineer bailouts via lower interest rates and access to credit if times got tough--so banks had no trouble raising funding from creditors, and our financial system grew rapidly.

The Fed did not create this atmosphere of elevated risk, but it ended up playing a central role in perpetuating it. Since the 1970s, successive financial crises have required ever more dramatic reactions from the Fed. Every time there is a potential financial meltdown, the Federal Open Market Committee quickly cuts short-term interest rates. These cuts have become larger and larger over time, now essentially taking interest rates to zero. Each round of interest-rate cuts has made sense when a given crisis breaks. But these cuts--which effectively function as bailouts for banks that have gotten into trouble--often helped bring about the next financial crisis. And the crises are getting larger, not smaller, over time.

Every crisis of the past few decades has had its distinctive features, of course, but the broad pattern is the same. Paul Volcker cut interest rates after the Latin American debt crisis broke in the early 1980s; this lowered the cost of funding speculative real-estate deals and--combined with regulatory breakdown--helped pave the way for the S&L crisis. Ironically, Volcker--seen as the very model of a traditional anti-inflation central banker--presided over the first major modern instance of using interest policy to help banks get back on their feet. Next, Alan Greenspan cut interest rates following the stock-market crash of 1987 and the development of commercial real-estate problems in the late 1980s and early '90s. The resulting credit boom helped push (unregulated) financial exuberance into emerging markets. One by one, there would be crises in those emerging markets: Mexico, Thailand, Indonesia, Malaysia, Korea, Russia, and Brazil all experienced economic calamity between 1995 and 1998.

In September 1998, we saw the failure of a single lightly regulated U.S. hedge fund, Long-Term Capital Management. This threatened our financial system, and the Fed cut rates preemptively--making popular the term "Greenspan put." (A put is a contract that gives the owner the right to sell assets at a fixed price, and it is often used to lock in profits or limit losses. So, if your assets fell in value, Greenspan would effectively buy them or--literally--put a floor under their value. Stocks, for example, are underpinned by future expected company earnings; the value today of those future flows goes up when interest rates are lower--so any cut by the Fed is welcomed by stock-market investors.) In a bright shining moment, markets realized that the Fed was prepared, through interest rate cuts and loose credit, to do whatever it took to bail out financiers facing large losses. Risk-taking without fear for the consequences became the name of the game, at least for our largest financial players: They get the upside if things go well, and the Fed will limit their downside when the speculative frenzy of the day finally runs out of steam.

This environment helped feed the technology bubble--and bust. And this led to further rate cuts--championed by Bernanke, then working under Greenspan. Those 2001 rate cuts--and subsequent decisions to hold interest rates low--encouraged our housing bubble. The phrase "Bernanke put" is now catching hold, meaning an explosive burst of bailouts, liquidity provision, and supportive fiscal stimulus far larger than anything implemented under Greenspan. But Bernanke's mega-put is just one further step along a path that was established long ago, back in 1913 when the Federal Reserve was founded.

Over the past century, we have moved away from a system where bank shareholders and senior executives paid dearly for bad management--and toward a system where fired bank bosses make off with fortunes or launch brilliant political careers. No one is on the financial hook, other than the taxpayer. Consider the case of Citigroup, a seriously troubled bank. Chuck Prince, the CEO who fell flat on his face, walked away with close to $100 million. Win Bischoff, former chairman and interim CEO of Citigroup during the debacle, has just been appointed chairman of Lloyds Banking Group in the United Kingdom--reflecting the high esteem in which he is apparently still held. And Robert Rubin, Treasury secretary under Clinton, made over $100 million as board member and chair of Citigroup. In an interview late in 2008, he brushed off any responsibility for the mismanagement of anything. And so, our recurring financial crises are not isolated random events; they emerge from a pattern of private and public sector behavior. Enabled by the Fed, our system's tolerance for risk is out of control. This is an increasingly dangerous system. It is only a matter of time until it collapses again.

What will that collapse look like? The bubbles this time will likely appear abroad. Parts of Asia and Latin America, a tiny fraction of the size of the U.S. economy, are experiencing large capital inflows, low interest rates, and the beginnings of a major boom. Countries with intact banking systems and access to global capital markets will lead the next speculative wave. The United States will be pulled in--probably soon enough that we will all be surprised by a supposedly robust recovery, fed by continued low interest rates and loose credit. We all know these episodes end in tears, but they can be spectacular while they last.

Just like in the late 1920s, most central banks--the Fed among them--will undoubtedly wait a long time to raise interest rates. Inflation remains low, and bankers will surely argue that financial-sector fragility means we should be cautious. It would take a tremendous political battle to stop the next bubble; who wants to take away the punch bowl in the midst of a perceived boom? By the time the Fed and other central banks get around to tightening monetary policy, it will already be too late.

Based on what we have seen over the past two decades, the cost of the next collapse will invariably be steep. Since the early 1980s, the Fed has gone back to its origins as the bailout machine for the financial sector. The only difference is that this sector has become much larger since 1907 or 1913. Back then, it accounted for around one percent of GDP. Now it is closer to 8 percent. The cost of bailouts--the current one and those to come--has skyrocketed as a result.

In June 2009, Treasury Secretary Timothy Geithner unveiled the administration's plans for reforming our financial sector and preventing a major crisis from happening again. The cornerstone of the proposal is to (slightly) reduce the number of agencies carrying out regulation, and to give new powers to the Fed.

Unfortunately, these changes are unlikely to work. They do not alter the enormous incentive our banks have to take excessive risks. They don't address the fact that strong financial groups can lobby our lawmakers and beat down regulators until they are largely ineffective. And they don't affect our propagation mechanism: The printing presses at the Fed remain open and available for when the next crash comes, and that makes creditors confident that they can lend without risk to our heavily leveraged financial sector. As long as this combination remains in place, today's financial executives fully understand that the party goes on.

Consider the lessons learned in the past twelve months by our major banks. If they again get into serious financial trouble, the Fed can be counted on to lend them essentially unlimited amounts at effectively zero interest rates. What would you do with free money? You'd pay off all your old debts, then you'd find something to invest in that would yield a decent return. But then you'd reckon--why not take more risk? After all, if things go badly, you'll get more free money.

We don't need to repeat history and make bank owners subject to "unlimited liability"--but we do need to make their financial outcomes more closely linked to the risks they take. First, we should sharply raise capital requirements at banks so that the shareholders have more at stake. Shareholders need to feel that when a bank takes gambles, their money is truly at risk. Under our current regulations, a bank like Goldman Sachs puts up only $1 billion of equity for every $13 billion of assets. Who is taking this risk? It is us--as taxpayers.

How much capital is enough? This is a hard question, with no definite answer. One answer, offered by Nobel Prize winner Robert Merton in 1995, is: not much. Merton reasoned that modern risk management and the availability of sophisticated hedging strategies meant that more and more of what banks do is essentially riskless and, therefore, does not need capital. Of course, Merton was deeply involved in the failure of Long-Term Capital Management in 1998, as well as the broader ideological development that underpinned the highly leveraged strategies built around housing during the early 2000s. His view remains theoretically elegant but completely ignores the reality that our financial system--because we bail it out every time things go wrong--provides strong incentives to take bad gambles.

The idea that banks should carry an "equity cushion" (to absorb losses before anyone has to turn to the government) worth around only 6 or 8 percent of their assets is a quite modern idea. (As recently as the mid-nineteenth century, banks financed significantly more of their assets with equity.) Perhaps a low equity cushion made sense when banks were tightly regulated and limited in the risks they could take, say from 1935 to around 1980. But leading students of central banking today, such as Charles Goodhart, argue strongly that, with the collapse of effective regulation over the past two decades, thin equity layers at many leading banks (in combination with limited liability of shareholders) are completely inappropriate for maintaining a stable financial system.

Second, the managers and boards of directors of financial institutions should be personally liable up to a reasonable sum when their companies fail. They should lose a portion of past salaries and bonuses, while also seeing their bank-provided pensions reduced substantially. Richard Parsons, the chair of Citigroup since February 2009, is estimated to be worth more than $100 million. Yet he reports that he owns only around $750,000 of Citi stock. Such negligible personal downside risk for the board of directors is the norm in high finance today. We should let bank executives be paid well when they are successful--but they should truly lose if they take risks that lead to taxpayer bailouts. It can take up to a decade before the success or failure of past business decisions really becomes evident in banking, so reductions in pensions, and clawback of bonuses, should take this into account.

Third, we need to set rules so that our regulators and public servants, who have the role of protecting taxpayers, are not financially conflicted. Today, the revolving door from government leads directly into the lobbies of our major banks. We need a rule that all employees of the Fed, the U.S. Treasury, and other regulatory bodies are not permitted to work in finance for at least five years after they leave office. If government employees have joined a regulatory authority from the financial sector, they should have a "cooling off" period within which they are prohibited from any official role in the design or implementation of regulation or bailouts.

Finally, we need more assertive leadership at the Fed regarding broader system issues. The Fed, of course, will protest, "This is not our job." It will say that Treasury is responsible for the administration's approach and that authority ultimately rests with Congress.

This is true, strictly speaking. The Fed did not create our current atmosphere of deregulated risk-taking. But neither is the Fed blameless. The Fed is partly a prisoner of the current system--but it is also partly a jailer. In the moments when the Fed is presented with a rescue-the-banks-or-the-economy-will-collapse scenario, it is a prisoner. But the Fed, and especially the chairman of the Fed's board, has plenty of power to shape the environment that produces this choice. And it has taken on the challenge of shaping the financial climate before.

During the 1930s, Fed chair Marriner Eccles was an advocate for change across the financial system. Now, Bernanke needs to play the same role. He needs to advocate for rules and regulations that ensure financial leaders will bear serious costs when there is a future failure due to excessive risk-taking. Otherwise, the Fed will continue to be a handmaiden to repeated bailouts. And, with each bailout laying the groundwork for the next one, the peril facing our financial system will only grow worse.

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