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The Recession Is Over — for Now

By PETER BOONE and SIMON JOHNSON SEPT. 19, 2009

SPEAKING at the Brookings Institution last week, the chairman of the Federal Reserve, Ben Bernanke, remarked that the recession in the United States is "very likely over." He's surely right that a recovery is under way; in fact, the short-term bounce back may actually turn out to be faster than he thinks — rapid growth is not uncommon right after a severe financial crisis.

Mr. Bernanke commands great respect because of his impressive efforts to head off financial collapse, but his speech was deeply worrisome on the bigger questions: what caused the financial crisis, and how can we prevent another such calamity?

Mr. Bernanke still refuses to acknowledge the Fed's role in creating financial boom-bust cycles, and therefore his diagnosis and solutions sound overly technocratic and somewhat hollow. He has called for requiring banks to hold more liquid assets and increase their equity cushions, and passing legislation that would permit the Fed to effectively close large financial institutions when they are failing. He also wants the Fed to be responsible for regulation of such large banks.

But none of this is enough. Why should we believe that the Federal Reserve could regulate banks and avert financial bubbles when that agency has repeatedly failed to do so over the past 30 years? The greatest failure of all time happened from 2002 to 2007, and for most of that time Mr. Bernanke was on the Fed's board of governors. To make financial regulation workable again, the chairman needs to admit the institution's recent failures and call for deeper reforms in the operation of the Fed to make financial regulation workable again. Otherwise, the United States and the rest of the world are being set up to face another — much larger — financial crisis.

As someone who came to government from academia rather than banking, Mr. Bernanke is not beholden to business, and that puts him in a good position to make the kind of basic changes to the culture of regulation that are most needed — in particular, changes that would stop so many regulators from moving back and forth into the finance industry. He is also a student of the history of the Fed and knows how, after 1934, his predecessor Marriner Eccles helped lead a redesign of the financial system that served America well for 50 years. So he should also realize that if he truly wishes to end our cycles of boom and bust, he needs to fight for a stronger regulatory system and against the powerful financial interests that encourage policy makers to avoid real reform.

In successive financial boom-busts over the past 30 years, the Fed undertook smaller versions of what Ben Bernanke did over the past 12 months. In the Latin American debt crisis of 1982, the savings-and-loan crisis of the late 1980s, the Asian financial crisis and the collapse of Long-Term Capital Management in 1998 and during the bursting of the dot-com bubble in 2001, you saw the same pattern: First, of course, the financial system grew rapidly, bank profits were large and a bubble emerged. At a certain point, we reached the market peak and stared down the mountain. Bankers frantically called the Fed, and it dutifully stepped in to prevent an economic collapse — by lowering interest rates and providing credit to "maintain liquidity."

In his speech last week, Mr. Bernanke indicated that interest rates are now likely to stay low for a long time. That means that if you are running a major bank, you have good reason now to take on more "leverage" (debt). If collapse threatens again, bank executives know the Fed will support them. And lenders know that it is a far better risk to make loans to banks supported by the Fed than to firms that can go bankrupt, like automakers or high-technology companies.

All of this facilitates a short-term recovery, of course, and is the cornerstone of Mr. Bernanke's strategy. But it also feeds a new financial frenzy — making it harder to sustain real growth, and also making it less likely that a broad cross section of society will benefit.

There is nothing wrong with having the Federal Reserve in place to deal with financial shocks. This was the original idea that emerged from the 1907 financial crisis, and from the subsequent National Monetary Commission reports — that the United States needed a central bank to manage downturns. At that time, Democrats were rightly suspicious that the commission, led by Senator Nelson Aldrich, Republican of Rhode Island, was looking for a way to give private banking interests influence over federal money.

When it was created in 1913, the Federal Reserve was meant to be a compromise — a way for private bankers to have a say in the operation of the national bank but also a way for the government to keep private bankers in check. And that is how it worked from 1935 to 1980, when the Fed and other agencies ensured that banks' activities did not put the public purse at risk.

Both before 1935 and again after 1980, however, the Fed's financial regulation was and has been weak. At the heart of this weakness are the large profits that can be earned by taking advantage of lax regulation in the financial sector. The phenomenal growth of the derivatives market over the past 30 years, for example, has made all our big banks far more interconnected, and hence systemically risky; if one bank falls the others fall with it. Yet our regulators, many of whom remain in office today, watched as this time bomb grew and then exploded with the collapse of the American International Group.

Since our top regulators are political appointees, it should be no surprise that, in the face of heavy lobbying by the financial sector, they often turn out to be regulatory doves. We've permitted our mid- and high-level regulators to revolve between jobs in finance and officialdom. To name just two examples, during the Clinton administration, Robert Rubin left Goldman Sachs to become secretary of the Treasury, then returned to the industry to take an oversight role at Citigroup, while Henry Paulson, the secretary of the Treasury during the last years of the George W. Bush administration, came straight to government from Goldman Sachs.

A high-level position at the Federal Reserve, the Treasury, the White House National Economic Council or at a Congressional committee overseeing banking can be a ticket to riches when public service is done. The result is that our main regulatory bodies, including the Fed, are deeply compromised. Rather than act as the tough overseers of the public purse that we need — and that we had before 1980 — they have become cheerleaders for the financial sector.

These cheerleaders, in turn, generate financial cycles by letting our financial system grow too fast, with far too little capital for the risks it takes. When the Federal Reserve inevitably bails banks out, it receives great applause (particularly from the financial sector). Yet with each cycle of failure and bailout, the financial system grows ever larger and more dangerous.

Not all of this, of course, is under Ben Bernanke's control. Like Alan Greenspan before him, when he provides bailouts and facilitates recovery, Mr. Bernanke can say he is only doing his job. But the true and original responsibility of the Fed is much broader that that. The central bank is supposed to prevent crises that threaten to bankrupt the country.

In today's nascent global recovery, we are already seeing bubble-like rises in the prices of real estate and assets, from Hong Kong and Singapore to Brazil. And many more emerging markets will likewise soon boom. The details of who makes which crazy loans to whom will no doubt be different from what they were from 2002 to 2007, but the basic structure of incentives in the system is unchanged. The same people are running the American banks, and the same regulators are regulating them, so you can easily get the same outcome here as we have just seen.

We should prohibit companies and senior managers in regulated financial industries from making donations to political campaigns. We should also restrict public employees involved in regulatory policy from working in those industries for five years after they leave office. And we should prohibit people who move to government from the finance sector from making policy decisions on bailout and regulatory-related matters for a minimum of five years.

Our regulators need to be smart people who understand finance, but they don't need to be drawn from the upper echelons of the financial industry. There are many proven, dedicated professionals in our regulatory agencies today, and we should support the development of an even stronger cadre of career regulators. It should be up to the financial sector to make its practices clear and simple enough for these professionals to understand, and any that are too complex should not be approved.

Finally, we should significantly raise capital requirements for the financial sector — and the bigger the bank, the more capital you should need. (Of course, this would discourage banks from growing too large.) The Obama administration should at least triple the current requirements.

Our financial system provides valuable services to the public, but it also poses serious risks. If we can't re-regulate more strongly to better protect public funds, the next crisis could be worse than the last one.

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