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The Causes and Cures of the Financial Crisis

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WHY ARE WE IN A FINANCIAL CRISIS AND HOW DO WE GET OUT OF IT?

The "why" can be simply explained: there is little confidence in balance sheet valuations because too many assets are overstated, too many liabilities are understated, and too much information is hidden. The crisis has spread due to a systematic failure of the regulatory system. Over the last 20 years regulations that fostered market stability were eliminated, and new financial instruments were allowed to propagate without any real oversight.

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The history of markets is one of booms and busts. The volatility of the cycles is magnified by leverage and tempered by transparency. The development of new financial instruments set the stage for this crisis because they were effective at pumping up the amount of leverage and masking the magnitude of risk in the system. A telling symptom of the crisis is that leaders of many institutions claim to be surprised at the amount of risk their firms were exposed to: they did not know they were placing large bets in the financial casino.

It is important to disentangle the initiatives that have been made and to understand which have worked and which have not. First consider the bailouts. These have been proffered to a select group of financial institutions whose collapse was feared to imperil the overall workings of the world financial system. The cost of bailouts has been enormous and threatens to grow even larger. The arbitrary way bailouts have been implemented in the financial sector presages a possible expansion of bailouts to many sectors of the economy, with political pull and not financial efficacy being the ultimate determinant of who gets bailed out and who does not. Despite tremendous cost, the program of arbitrary bailouts of financial firms has not been effective. While it has forestalled immediate crises and saved some firms from imminent collapse, it has not pulled the economy out of the larger crisis.

What have been successful are efforts central bankers have made to stop runs on the banks. By extending insurance for bank deposits before a general panic could commence, government bankers have instilled enough confidence in the system that people have, by and large, not felt the need to withdraw their funds and hide their savings under mattresses.

Central banks have made efforts to ensure liquidity, and they have applied doses of monetary stimulus. They have reduced interest rates and pumped money into the system. However, these stimuli have not yet proved effective at reversing the downturn. Why not? The problem is twofold. On the one hand, even with money readily available at low rates, bankers are hesitant to lend to questionable borrowers, and more and more borrowers are becoming questionable each day. On the other hand, overextended consumers are not clamoring to borrow money. They are frightened as their 401ks plummet and the equity in their homes shrinks toward zero. The financial crisis has sparked a general recession in the larger economy. Until demand recovers, firms in many sectors have little need to borrow to finance expansion of plant and equipment. To summarize, monetary stimuli alone are insufficient to revive demand.

How do we get out of this crisis? If our diagnosis of "why" is correct, and if our assessment of measures undertaken to date is accurate, then it becomes clear that a solution to our economic woes must be focused on two major objectives. First, all reasonable measures must be taken to stabilize and restore demand. Fiscal stimulus ought to be applied vigorously to do this. The federal government should send money to state and local governments in order to keep police, firefighters, schoolteachers and librarians in their jobs. It should increase the size of the armed forces. It should provide seed money to finance an accelerated schedule of highway and bridge construction, port improvements and alternative energy investments. It should loan money to auto manufacturers and other industrial firms that employ large numbers of people. Unemployment insurance should be extended even further. Anything that has a multiplier effect that will foster demand and keep unemployment down should be considered.

The second major objective is force an accurate, if not conservative, revaluation of all balance sheets and to impose

strong capital requirements on financial institutions. To do this will likely cause many large firms to fail. But that is what is needed. Credit will begin to flow once all players are sure of the net worth of others in the market.

The federal government should stop bailing out financial firms. That is throwing good money after bad. It should definitely not be taking an equity stake in them. This confuses the market about the net worth of the firms: are they implicitly backed by the government? It also undermines the value of other financial firms that do not have government backing.

Part of the process of ensuring adequate valuations is to impose stringent regulations and capital requirements on whole classes of new financial instruments. Any recent financial mechanism that appears to mask risk or increase leverage should be subject to such treatment. In effect, all the leverage and hidden risk needs to be unwound, before we can reach the floor and start the way back up on a sound and sustainable basis.

The philosophy inherent in the regulation of property and casualty insurance companies provides an interesting paradigm for how a wholesale revaluation could be accomplished without mortally wounding the whole economy. When an insurance company has inadequate capital, it is subject to seizure by state regulators even though it is technically not bankrupt. The state authority stops the company from writing any more business and then proceeds to liquidate it. This stops the company from trying to raise cash by writing a boatload of underpriced business. Meanwhile the claimants are not left with worthless paper; instead they are partly compensated by guaranty funds. These funds are partially replenished by recoveries from the liquidation. A variant of this idea is when the existing company is split into a New Company that writes new business and an Old Company that is liquidated.

The liquidation and guaranty fund approach provides a way out of the crisis. The government should seize weak financial companies and liquidate them. It should act as a partial guarantor of some of their financial instrument obligations, paying them off at 50 percent or some other set rate. The choice of which instruments should be partially honored needs to be thought through. Overall, instead of

investing in AIG, lending money to AIG, and paying off its credit default swaps at 100 percent, the government should put padlocks on its doors, liquidate it, pay off regular insurance contracts according to existing state guaranty fund rules, and guarantee to make good on 50 percent of its financial insurance obligations. This could be coordinated with foreign governments so policyholders and counterparties the world over would be treated to the same degree of painful but not fatal fallout.

For another example, Fannie Mae and Freddie Mac should be split into old and new companies. The old ones should be liquidated, and the new ones should be forced to operate under stringent lending rules. The same approaches can be used all the way through the nested chains of tranches and derivative instruments that wind through the economy. It will be very costly, but, in the end, it will cost far less than trying to revive a select few of the comatose and pay off 100 percent of their ill-considered financial obligations.

In conclusion, what is being called for here is not more of the same. Instead of bailing out weak financial firms, we should be liquidating them. All doubtful assets need to be written-downs; the sooner the better. We need accurate and transparent accounting. Government can help in this effort to clean up our accounting system. But it needs to stop being an investor propping up those that should be in the morgue. It needs to conservatively regulate all financial instruments. It should foster liquidity and stoke demand. That is what needs to be done to get out of this crisis. ✦

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