Responding to Financial Crises: What Role for the Fed?

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I am delighted to return to Cato, an organization with which I feel a natural affinity, especially through Bill Niskanen with whom I served as a member of the Council of Economic Advisers a quarter century ago. That sounds like a long time ago, and I guess it was. However, when it comes to the subject of this panel, I do not think much has changed. The key issue then, as today, is time inconsistency. It seems to make sense in the middle of a financial crisis for someone to bail out a failing firm or firms. However, the inconsistency is that, however sensible a bailout seems in the heat of crisis, bailouts rarely make sense as a standard element of policy. The reason is simple: Firms, expecting aid if they end up in trouble, hold too little capital and take too many risks. As every economist understands, a policy of bailing out failing firms will increase the number of financial crises and the number of bailouts. Along the way, the policy also encourages inefficient risk-management decisions by firms.

In writing the previous paragraph, I at first began by saying, "Everyone knows that a policy of bailouts will increase their number." But here we are in Washington, and a cursory examination of federal policy proves that not everyone knows. Federal disaster relief policy is exhibit A, but every company, financial or otherwise, knows that if it gets into trouble it is at least worth a major effort to attempt to secure a bailout because there is always a significant probability of success. Given this state of affairs, in place for many decades despite economists' pleadings, I think the most important issue is not reflected in the title of this panel—what to do in the event of financial crisis—but instead how to avoid financial crisis in the first place.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments, especially Robert H. Rasche, senior vice president and director of Research and William R. Emmons, senior economist. However, I retain full responsibility for errors.

AVOIDING FINANCIAL CRISIS

Deposit insurance and a broader, fuzzy, safety net for financial firms creates an incentive for firms to take too much risk and hold too little capital. That is a fact of life. I believe that we should continue to seek reforms to the deposit insurance system. I am particularly fond of proposals that would establish a formal policy of "haircutting" the insurance coverage to, say, 90 percent of insured liabilities and/or requiring that insured financial institutions issue explicitly uninsured long-term subordinated debt. Such reforms would administer a healthy dose of market discipline to financial firms. But until such reforms are put in place, I do not see any other option than maintaining substantial supervisory oversight of large, systemically important financial institutions. The supervisors need to have the authority to require adequate capital and maintenance of robust risk-management policies in financial firms.

I believe that supervisory oversight is in pretty good shape, with one glaring exception. Government-sponsored enterprises are not adequately capitalized and the supervisory powers of the Office of Federal Housing Enterprise Oversight (OHFEO) are inadequate. I'll concentrate on the housing GSEs—Fannie Mae and Freddie Mac. This is a topic I've addressed several times in the past (Poole, 2003 and 2004) and I'll not repeat those arguments in any detail here. Although the GSEs are not formally insured by the federal government, the market clearly believes that they are effectively backstopped. As I've emphasized before, the Federal Reserve does not have the legal authority to bail out a troubled GSE. The Fed can provide liquidity support through its discount window, but only indirectly through collateralized loans to banks that would then bear the credit risk of making loans to a troubled firm. Under emergency conditions, the Fed does have the authority to make loans directly to a GSE, but the loans must be fully collateralized. The Fed is obviously disinclined to use its emergency powers to lend to firms other than banks; despite numerous financial upsets over the years, the Fed has not used this authority since the 1930s.

Given the obvious moral hazard facing the GSEs, the first best solution would be to turn the GSEs into fully private firms subject to normal market disciplines and with no special connection to the federal government. Absent that step, what supervisory policy actions could reduce the threat they pose to financial stability? The two items of highest priority are, first, that the GSEs' portfolios should be limited in both scope and scale to assets with a clear public purpose; and, second, capital at the GSEs should be higher—substantially higher. As I have argued before, the capital standards applied to the GSEs are simply inconsistent with the interest rate risks the firms have assumed. It does not make sense for public policy to permit GSEs to hold far less capital than required in large banks given that GSEs have substantially similar or even greater risks than large banks.

Finally, Congress should create a prompt corrective action (PCA) policy regime for the GSEs that truly mimics the one that was introduced into U.S. banking law 15 years ago.[1] The idea behind PCA is simple—if a regulated firm holds only a small buffer of capital to protect the firm's debt holders from loss, it is critically important that the firm face immediate and increasingly stringent restrictions on its activities as its capital dwindles. Otherwise, an undercapitalized firm experiences even stronger incentives to exploit its unpriced real or perceived guarantees.

The PCA regime is well established for banks but the situation for the housing GSEs is not so clear. Unfortunately, OFHEO did not publish a final rule implementing its version of PCA until 2002, and even now OFHEO lacks the legal authority to impose the ultimate PCA sanction on a critically undercapitalized GSE, namely, closure of the institution and appointment of a receiver. Thus, the promise of PCA for reducing risks to financial stability posed by the GSEs remains unfulfilled. New legislation should provide the GSEs' supervisor with clear and credible receivership authority. Carried out faithfully, a distressed GSE would be subject to a PCA regime of phased early intervention (including prompt closure, if warranted) and required recapitalization.[2]

The PCA regime has a major advantage for regulators in that they are instructed by law not to engage in regulatory forbearance, the source of some of the problems that eventually led to the collapse of numerous savings institutions in the 1980s and early 1990s. The only way to deal with time inconsistency is to make bailouts unlikely

[1] The statutory authority for prompt corrective action applied to depository institutions is found in the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) at 12 USC 18310; for the GSEs, it is in the 1992 Federal Housing Enterprises Financial Safety and Soundness Act (FHEFSSA) at 12 USC 4611 through 4623.

[2] For evidence that the PCA regime has been effective in minimizing the FDIC's losses at banks, see Aggarwal and Jacques (1998).

by tying the hands of regulators. Taking away the power to provide a bailout permits regulators to put more pressure on firms earlier. Moreover, in the absence of regulatory discretion, firms know that a bailout requires a successful approach directly to Congress, which might or might not be successful. Uncertainty over congressional action adds to market discipline.

The Fed's role in contributing to general financial stability through a policy of maintaining price stability is also important. Historically, periods of restrictive monetary policy designed to bring inflation down have often been accompanied by failures of many financial and other firms. The Fed also contributes to general financial stability by cushioning disturbances to employment and output. The Fed cannot make the economy recession-proof but it can reduce the severity of recessions.

Some have argued that the Fed's success in stabilizing inflation at a relatively low level and moderating recessions during the period since the early Volcker years has actually made the financial system less stable. The argument is that a more stable economy reduces risk and makes financial firms more willing to pursue risky strategies, just as flood-control projects actually increase flood losses by encouraging people to build on flood plains. Eventually, a large flood overwhelms the defenses, the floodplain is inundated and those who thought it safe to build on the flood plain suffer large losses.

I believe that there is an important difference between flood control experience and the effect of greater macroeconomic stability. Macroeconomic stability does not eliminate risk from microeconomic adjustments. In our vigorously competitive economy, one firm can take market share from another, creating risks and opportunities for both firms, without affecting aggregate economic activity. Diversification across firms can reduce portfolio risk for individual investors without affecting the incentives individual competitive firms have to manage their risks appropriately.

In fact, reducing macroeconomic risk, such as risk from currency instability through counterfeiting or generalized inflation, permits firms to concentrate on managing their own inherent business risks more effectively. In the flood control case, individuals and firms make mistakes because of poor estimates of flood risks and the expectation of compensation should there be a flood. Unlike that case, firms' responses to a more stable macroeconomic environment improve productivity because they concentrate on business risks they can affect rather than on macroeconomic risks beyond their control. I know of no convincing arguments that the Fed could improve productivity and growth by deliberately introducing random disturbances to the economy. If that point is accepted, then the converse must also be true—reducing macroeconomic instability improves economic efficiency. Of course, there is an important corollary: If the Fed fails to maintain price stability after achieving it and creating expectations of its permanence, then the disruption to the economy from renewed inflation will be considerable precisely because firms ceased to plan for such an event. Unlike the situation with natural variability of rainfall, however, inflation is controllable and not inevitable.

DEALING WITH FINANCIAL UPSETS

Now for the topic of the panel. What should the Fed do when financial instability strikes?

In most cases, nothing. The important principle here is support for the market mechanism rather than support for individual firms. The Fed has, appropriately, permitted many highly visible firms to fail without any attempt to provide support, or even any particular comment except to say that it does not intend to intervene.

Of course, the Fed has intervened from time to time. One important case was the provision of additional liquidity and moral support to the markets when the stock market crashed in 1987. The Fed also provided support to the market at the time of the near failure of Long Term Capital Management in 1998. In both cases the Fed cut the federal funds rate, which provided evidence to the markets that the Fed was on the job and prepared to provide extra liquidity as needed. I realize that the Fed's presence in the negotiations for additional financial support for LTCM from other firms is controversial; I would simply emphasize that the Fed itself did not provide any financial support and, in my opinion, would not have done so if the effort to encourage support from other firms had failed.

Some observers have viewed the large expansion of hedge funds as a rising danger to financial stability, requiring additional regulation and Fed readiness to intervene. I myself believe the dangers of systemic problems from hedge fund failures are vastly overrated. The hedge fund industry is indeed large but it is also highly diverse and competitive. Many and perhaps most of the large positions taken by individual firms have other hedge funds on the opposite side of the transactions. I trust normal market mechanisms to handle any problems that might arise.

The Fed has not had to face the issue of a potential large bank failure since enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991. I believe that the correct principle is that no bank is too large to fail, although a bank may certainly be too large to liquidate quickly. As already noted, the Fed can provide liquidity support but cannot provide capital to prop up a failing firm. Ultimately, the only source of capital from the federal government, absent new legislation, is from the Federal Deposit Insurance Corp.

A very interesting case arose with the terrorist attacks on 9/11. Thinking back to my academic years before coming to St. Louis, I recall no discussion or journal articles analyzing the possibility that the payments system might crash because of physical destruction. But that is what nearly happened, because the Bank of New York, a major clearing bank, was disabled when the twin towers came down. Moreover, trading closed in the U.S. Treasury and equity markets, and banks were unable to transfer funds because the Bank of New York was not functioning. With normal sources of liquidity shut down, many banks faced the prospect of being unable to meet their obligations. The Fed's provision of funds through the discount window and in other ways prevented a cascading of defaults around the world. No private entity would have been able to provide liquidity on such a massive scale.

I do not know what a totally unanticipated future systemic shock might be but am sure that the Fed needs to be ready to respond, and to some extent, invent the appropriate response on the fly to a currently unimaginable shock. That is surely what a central bank is for, among other things. At the same time, a great reluctance to intervene will serve the economy well in the long run.

CONCLUDING REMARKS

I can summarize my position very succinctly. The Fed has a responsibility above all to maintain price stability and general macroeconomic stability to reduce the likelihood of economic conditions that would be conducive to financial instability. Included in this responsibility is provision of advice to Congress on needed legislative action to deal with possible risks. The largest of these risks on my radar screen arises from the thin capital positions maintained by government-sponsored enterprises and the ambiguity of whether Congress would or would not act to bail out a troubled firm. The time to deal with potential financial instability caused by structural weaknesses of the GSEs and their regulatory regime is before instability strikes. The steps I outlined earlier would go a long way to improve prospects for sustained financial stability in coming years.

Although prevention is the most important of the Fed's responsibilities, without question the Fed needs to be prepared to provide liquidity support should markets be in danger of ceasing to function. We know a lot about this subject and have in place deep contingency arrangements to assure that the Fed itself will remain operational at all times. I do not see any way that these functions could be privatized; I believe the markets do have confidence that the Fed has necessary legal authority and the internal strength to act as necessary. That said, the Fed's reluctance to act is also an important element of strength.

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