GENERAL DISCUSSION

Fire, Flood, and Lifeboats: Policy Responses to the Global Crisis of 2007–09

Chair: Kevin M. Warsh

Mr. Warsh: We talked a lot about the centrality of Lehman Brothers to the financial panic and ensuing weakness in the economy. I think Rick had a broader view, that it was more than Lehman, and talked about the role of other entities like AIG. I wonder if each of you could speak to the centrality of the failures of Fannie Mae and Freddie Mac, which preceded Lehman Brothers and give us your own sense as to how important that weakness was. Parenthetically, there was about $5 trillion of outstanding Fannie and Freddie debt, and the government tried to assure holders that those holdings were in effect backed by the government.

Mr. Hale: Taka, I just want to make a suggestion to you that in interpreting the Lehman failure, it is important to look at the politics of the U.S. Congress on the issue of rescuing banks. The equity capital of the U.S. banking industry 18 months ago was $1.3 trillion. As we discussed yesterday, the total write-offs over the last year and a half amounted to $1.1 trillion, almost 90 percent of bank capital. In the first half of 2008, banks did raise $400 billion with equity sales. This includes banks that failed; Wachovia, City National, Lehman, Fannie Mae, and Washington Mutual together raised $50 billion dollars just in May and June of 2008. But the capital raised was too little to compensate for the losses that occurred. If we hadn't had the Lehman failure and the panic that followed, it's unlikely Congress would have approved the Troubled Asset Relief Program (TARP). The fact is we had to have Lehman fail in order to get Congress to approve the TARP money. In the absence of Lehman's failure, the problem might have taken a different form and taken longer but could have been even more serious and more shocking.

Mr. Frenkel: Several quick comments. First, I think it is fair to say, and only people in the Fed can confirm this, that there was insufficient knowledge about the degree of interconnectedness of markets and about the damage that would occur. If there wasn't that lack of knowledge, I suggest the crisis probably would have been much less severe.

I also want to address the question of the role of government, which I think is a very central issue as we look forward. The fact that congressional anger potentially may constrain monetary policy is a serious danger. The anger of Congress should not be ignored, but the independence of the Fed should make it invulnerable to that anger. And one way to go about it is to make sure that there is a very sharp distinction between the fiscal policies that have to do with public money and the Federal Reserve, which really should not engage in things that have consequences for taxpayers.

One last remark, which has to do with governance. At the present time, the government and the Fed find themselves owning private companies. Very little has been discussed, in the public at least, about how the conduct of corporate board meetings and the like is being implemented. I can tell you it's a very challenging matter when the owners, the lawyers, and creditors meet, even in normal times. Here the Israeli experience of the 1980s is insightful. We had a bank-share crisis in Israel and the government, in a sense, found itself owning the entire banking system. Since then it has been reprivatized, but on the day the government took over the banks, a law was passed that forbade the government from intervening, having a board member, or interfering in any way with management of the banks. Thus there was a sharp distinction between ownership and management. This is a very key point that we need to worry about now because the government will not exit from corporate ownership very quickly.

Mr. Warsh: Let's gather two more questions and then give Rick and Taka a chance to respond.

Mr. Feldman: I have a two-part question. First, could the panelists comment on the Balkanized regulatory structure in the United States and what should be done about it? One of the things Japan got very right was unifying the regulatory structure under a single entity. It would be nice if perhaps Sato-san could also comment on this issue. Second, following up on the issue of congressional behavior, what sort of redesign of the incentive structure for Congress would be beneficial in bringing about the things that Jacob just mentioned? This is something that Japan also did right, though it is not well understood. In the early or mid-1990s there was a restructuring of the district voting system that actually did have, in my view, quite a strong impact on bringing more accountability for both fiscal and other structural reform. So, what kind of incentive structure changes are necessary in the legislative process, and are there any other lessons from Asia to help us redesign it here in the United States?

Mr. Obstfeld: I think Taka is absolutely right about the need for a resolution structure and that it would have helped in the crisis. One would hope that the existence of such a credible structure with the right features would act as a deterrent to bad behavior by financial institutions, though it's doubtful that it would be enough. And so, one wonders going forward about instituting other means of persuasion that might avoid getting to the point where a resolution process is needed because once you get to that point damage has already been done. In that connection, I think the Lehman experience after Bear Stearns is quite instructive. Everybody knew Lehman was weak, and apparently the Fed communicated to Lehman the need to raise more capital, but Lehman failed to do so. One tool the Fed had available was its lending facilities and, apparently, in an example of the law of unintended consequences, Lehman was able to get around that by drawing on dollar facilities that the Fed had extended to Europe for some of its liquidity needs. And so, unintentionally the Fed set up a way for Lehman to actually continue its bad behavior, which led to the crisis. So, this comes back to Rob Feldman's point about the fragmented nature of information in the U.S. regulatory structure. This is why AIG came as such a shock, and it was also apparent in the way that lender of last resort facilities were put together in a sort of ad hoc way during the crisis. These facilities solved some problems but led to others.

Mr. Warsh: Taka, perhaps you go first, and then Rick.

Mr. Ito: Regarding Fannie and Freddie, it was known and recognized that their debts had implicit guarantees, as was evident in interest rate spreads. Much of the debt was bought by foreign governments, held as foreign reserves, and even as late as March 2008, Congress told Fannie and Freddie to lower capital so that they could lend more. This is more than forbearance. Congress is telling them to lend, which means that they have a guarantee from Congress. So I think it was just natural that those implicit guarantees were turned into explicit guarantees. And it was a good thing, because if Fannie and Freddie were allowed to fail, most likely the dollar would have crashed because the Asian countries and Middle East countries held a lot of agency debt. It was not in the headlines, but there were a lot of negotiations between these countries and the U.S. Treasury concerning those agency bonds. So, the crash of the dollar was avoided because Fannie and Freddie were saved.

David Hale implied that Lehman's failure was necessary to get a new tool, TARP money, to fight the bigger fire. Japan, intentionally or unintentionally, did the same thing; they allowed the Hokkaido Takushoku Bank to fail in 1997. In a sense, that shock made it possible to acquire more funds to rescue the rest of the banking system. I originally thought that it was a good thing to have allowed Hokkaido Takushoku Bank to fail, but I have revised my view. I think the government and the central bank have to avoid ex ante what they think will generate only a minicrisis. You need to communicate and persuade the public of the necessity of injecting a lot of money to save the system, to maintain systemic stability.

I think I will defer Jacob's question to Rick. Robbie Feldman mentioned the regulatory framework and that Japan got it right in 1998 when they removed the defunct supervisory function from the Ministry of Finance and created an independent supervisory agency, the integrated Financial Services Agency (FSA). It has worked, I think, over the years. In this crisis, the Japanese financial system has coped much better with the crisis than it did before, probably thanks to the FSA. Mr. Sato may tell us more about it later today.

I think that Maury's question is also in line with my thinking, and I think it's very important to think about the resolution mechanism. I think that Barry (Eichengreen) will have a much more concrete proposal in the next session.

Mr. Mishkin: Let me first deal with Kevin's issue about Fannie and Freddie. Fannie and Freddie was clearly an accident waiting to happen, as was well known among economists. I don't know how many editions of my textbook mentioned this. It had a box saying, "It's going to blow up, it's going to cost the taxpayer a lot of money." It wasn't that I was especially savvy; every other textbook in my field would say something like this. So this was not a surprise. Of course, it got even worse when Congress in the early 1990s allowed Fannie and Freddie to expand their portfolios. As an aside, the *Wall Street Journal* view that this crisis was caused by Fannie and Freddie is, to me, just off-base. It was not the driving force behind the crisis. It has cost the taxpayers a lot of money and it is a big deal. But this episode is a classic financial crisis where you have financial innovation, unfortunately at a bad time. You had a financial innovation where they didn't get the business model right, and this has happened over and over again throughout financial history. Also unfortunately it occurred at a bad time because there was all this liquidity sloshing around. This is what Maury talked about—all these global imbalances actually helped add fuel to the fire—although I don't think it was the primary cause. It was something that just made this much worse. That's really what caused this crisis, and thinking that it's all because of Fannie and Freddie is just not correct.

Jacob talked about the issue of knowledge of interconnectedness. I think he is absolutely right. In fact, that was the point I was making about AIG, that there was not a full understanding of exactly how serious this problem was going to be, and how deep the rot was in the financial system. And that's the nature of doing supervision. You don't always have enough information. You're not prescient. You don't have a crystal ball. The other thing that Jacob pointed out, which I think is absolutely right, but I think we need to be a little careful about, is that it is very dangerous for central banks to be involved in fiscal actions because it very much compromises their independence. However, in the midst of a crisis there is a blur between what's a fiscal action and what's monetary policy action. And so, I have been very supportive of what the Fed has been doing, both when I was inside the Fed and afterwards, in terms of some of the extraordinary actions the Fed has taken. But what worries me is that the Fed has to get out of this kind of activity in the long run, and I have not yet heard discussion of how that would be achieved. I'm particularly concerned about mortgage-backed securities; to have the Fed permanently involved in housing finance, which is thoroughly politicized, is very dangerous. So, this is a big challenge in terms of the exit strategy for the Federal Reserve. It was appropriate to get into the markets to deal with this crisis, but you don't want to stay in on a permanent basis. That's one of the most important challenges.

Regarding the regulatory structure, I've actually stated my views very strongly that there needs to be a single systemic regulator. Doing it by committee is not a great idea. Anybody who has worked in Washington, other capitols, or even the IMF knows that there's always bureaucratic infighting, and you have to have somebody in charge. That doesn't mean that a committee of regulators wouldn't be helpful to provide some oversight: somebody's got to be there to do the job. But as I've expressed in op-eds, the central bank is the institution best suited to be in charge.

And finally, on the issue of resolution authority, I couldn't agree with Maury and Taka more on this. It is an absolute crime that we are sitting now, a year after Lehman, and we don't have a resolution authority in place. It is staggering to me. It is an indication of the problems we have with Congress, because the Administration has proposed this. And what, to me, is remarkable about this is that a lot of Congress is saying, we hate the bankers. They've been bad. They're getting paid too much money and so forth. Having a resolution authority is the key thing that you need in order to get good behavior. Think about what went on here. After Lehman Brothers went under, if the government says to a systemically important institution that it should do something to get more capital, the institution could say, you know what, you've got a choice: You can send me into bankruptcy and get another Lehman Brothers. Think about what that's going to be like. Or you give me the money, or let me do whatever crazy things I want to do. So, it's not just an issue of being more efficient when the crisis occurs and when the institution goes under. It's actually critical in terms of having the stick to enforce good behavior. That's an extremely important point, and I think it's implicit in what Taka said.

Mr. Warsh: Thanks Rick. Taka is going to make a quick final remark.

Mr. Ito: Just a side remark about Fannie and Freddie who provided implicit guarantees for their debt. Ten years ago, in the midst of the Asian crisis, the Thais, Indonesians, Koreans, and Japanese were told that implicit guarantees were the worst form of financial regulation. We were told this 10 years ago by Americans. So why did the U.S. provide these guarantees in its system?

Mr. Mishkin: Well, one response is that economists said this is outrageous. We weren't listened to. That's democracy.