COMMENTARY

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

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The story of the recent financial crisis that Taka Ito tells in his paper is one that I mostly agree with and so my role as a discussant will be to add some nuances to the story he tells. There are two issues I would like to address. First is whether Taka puts too much emphasis on the Lehman Brothers collapse in his discussion of the evolution of the financial crisis. Second is his assessment of the policy response.

The Role of the Lehman Brothers Bankruptcy in the Financial Meltdown

Taka emphasizes the Lehman Brothers bankruptcy on September 15, 2008, as the key event that tipped the financial system into a deep crisis when it completely seized up, with devastating effects on the economy. His is the common view, but I think it leaves out two other key elements that are extremely important to understanding the resulting severity of the financial crisis: the AIG collapse and the initial reaction of the U.S. government to obtaining bailout funds to deal with the crisis.

The first element is the AIG collapse on September 16, which was indeed triggered by the Lehman bankruptcy. The collapse of AIG revealed that the rot in the financial system was far deeper than the problems created by delinquencies in the subprime mortgage market. Up until the AIG collapse, the view in the markets was that the problems in the financial system were primarily due to lax lending standards in the subprime mortgage market that were leading to large losses on securities that were backed by subprime mortgages as these mortgages defaulted. Because the subprime market was only a small percentage of total capital markets, it looked like the problems in the subprime market, although serious, could be contained.

After the Bear Stearns bailout, it was common knowledge that Lehman was very exposed to losses on subprime mortgage securities and that there was a distinct possibility that Lehman might go bankrupt. As a result, the market was more prepared for a possible Lehman bankruptcy. AIG was, in contrast, a much bigger surprise to the market. It was not until September of 2008 that there was any inkling that AIG had made such big bets in the credit default swap (CDS) market. When Lehman failed and AIG required a massive rescue by both the Federal Reserve and the U.S. Treasury, it became clear that huge carry trades were the norm, not the exception, in the financial system. That is, financial firms were booking huge profits (in AIG's case premiums on the CDSs) as long as financial markets remained healthy, but if tail risks materialized, the losses would be astronomical. The collapse of AIG therefore revealed how risky the financial system had become and that any further systemic shocks to the financial system could result in a complete breakdown.

The initial attempt to obtain government bailout funds to deal with the crisis was another element of the crisis that deserves more attention. When thinking about the costs of a financial crisis, it is important to recognize that the loss of confidence is a key driving force of financial panics. In the wake of Lehman and AIG, when the Treasury first went to Congress to ask for $700 billion for the Troubled Asset Relief Program (TARP), it presented them with an extraordinary three-page proposal with many elements that were clearly unacceptable. Not only was it ridiculously brief, suggesting that the Treasury was insufficiently prepared to cope with the increased virulence of the financial crisis, but it had provisions that the Treasury's disbursement of funds would not be subject to any Congressional oversight, nor could the Treasury's actions be subject to court review and lawsuits. This proposal was rightfully considered to be inconsistent with democratic principles, and it severely eroded confidence in the Treasury's ability to cope with the crisis. Then when the TARP bill came up for a vote in Congress, it was voted down on September 29 and, most shockingly, it was President Bush's own party, the Republicans, that opposed the Administration's TARP bill. This vote indicated the weakness of the lame-duck Administration's ability to deal with the crisis. Then when the bill was passed, four days later on October 3, it was laden with special interest "Christmas presents," with one of the most outrageous examples being an excise tax exemption for producers and exporters of certain wooden arrows for children.

To say the least, all these shenanigans did not inspire confidence in the U.S. government's ability to cope with the crisis. The lack of confidence and outright fear in the financial markets was then manifest in the week following the passage of the TARP bill with the week beginning on October 6 showing the worst weekly decline in U.S. history. Credit spreads went through the roof over the next three weeks, with the Treasury bill to Eurodollar (TED) spread going to over 500 basis points, the highest value in its history to that time. Because fear is what drives financial crises, the collapse of AIG and the U.S. government response to the crisis in late September and early October should be seen as events that are every bit as important as the Lehman Brothers collapse.

Why is adding these elements to the story important? Because it bears on whether it was a mistake for the U.S. government to let Lehman slide into bankruptcy. Although I agree with Taka that, in hindsight, letting Lehman go into bankruptcy was a serious mistake because the aftermath was a full-scale financial crisis. However, ex ante, it is not as clear. It is not obvious that a Lehman bankruptcy would have had such disastrous effects on the financial system if AIG had not engaged in its risky activities in the CDS market or if the U.S. government had shown that it was up to the task of containing the crisis. In that case, letting Lehman go bankrupt may have made sense because the alternative of a Lehman bailout would increase future moral hazard risk-taking in the financial markets.

The situation did not get better later in the fall of 2008 and the spring of 2009. The way the Treasury administered the TARP funds was, to put it mildly, highly problematic. The Treasury rightfully concluded quickly that buying troubled assets would not contain the crisis and so moved to using the TARP funds to inject capital into the banking system. However, the disbursement of these funds was grossly mismanaged. Because Treasury Secretary Paulson insisted that healthy as well as unhealthy banks should be encouraged (sometimes coerced) to take TARP funds, the funds were disbursed with very few restrictions on their use. This led to recipients of TARP funds paying out a substantial percentage to the stakeholders in the recipient firms. Something on the order of half of the funds was paid out in dividends to shareholders, while employees continued to receive large bonuses. Particularly egregious is that financial firms with huge debt overhangs were allowed to reduce their capital base by paying out dividends. This is, of course, exactly what the management should do if it is acting in the interest of the shareholders, and indeed this is what we teach our MBA students is part of managers' fiduciary responsibility to maximize shareholder value. However, these payouts were clearly not in the public interest because the whole point of the TARP funds was to beef up banks' capital so that they would be less likely to go under and so they would continue to make loans. Having half the money go out the door to shareholders and not into higher capital was a misuse of these funds and indicated that the government response to the crisis was misguided.

The other problem with the administration of the TARP funds was that it poisoned the well for the allocation of additional funds to get the financial system on a sounder footing, or to prevent an even worse crisis if more Lehman

Brothers and AIGs came out of the closet. The public was hopping mad about how the TARP funds were used to bail out "Wall Street" and provide payments to shareholders and bonuses to fat-cat bankers. Not surprisingly, when the new Obama Administration came in, it became abundantly clear that the Administration was not going to ask for additional funds to shore up the financial system, nor would it have been able to get those funds if needed.

By March of 2009, the situation got downright terrifying and the credit spreads hit their peaks. The fear was not unjustified. If another Lehman Brothers had occurred at that time, the financial system would have imploded further and it is likely that a depression would have ensued. Luckily this did not happen, and the stress tests proposed by the U.S. Treasury revealed that the banks were not in as bad shape as some thought, and so the financial system began to recover.

A conclusion that I draw from this episode is that the lack of the U.S. government's ability to cope effectively with the crisis was a key reason why the crisis ended up being so severe. I would also add—although I am biased because I was a Federal Reserve insider who actively supported aggressive action by the Fed to contain the crisis—that the brave actions by Chairman Bernanke helped save the day and prevented a much more dire outcome. As Paul Volcker put it, the Federal Reserve went to the "very edge of its legal authority" to contain the crisis. I never viewed this as a criticism of the Fed because Volcker was just stating a fact. I believe that the Fed's actions were successful in promoting the recovery in the financial system that we see today. This does not mean that they are not controversial. There will be serious consequences from these actions because they will increase moral hazard incentives to take on additional risk in the future unless these perverse incentives are restricted by appropriate regulation and supervision of the financial system. In addition, these actions have spurred criticisms of the Fed that are leading to the most serious attacks on the Federal Reserve's independence in its history. Nonetheless, these actions helped avert a depression, and given the tradeoffs, I strongly believe that the Fed did the right thing.

Assessment of the Policy Response

I agree with Taka on his characterization of the difference between quantitative easing (QE) and credit easing (CE). Quantitative easing, which is what the Bank of Japan pursued in the late 1990s and early 2000s, involves an expansion of the liabilities side of bank balance sheets. Credit easing, on the other hand, which is what the Federal Reserve has been engaging in during this crisis, involves expanding the asset side of bank balance sheets.

I would put a slightly different slant on this distinction. Quantitative easing is a monetary action to expand bank balance sheets that has traditional expansionary effects by increasing money supply growth and raising expectations of future money supply growth along the lines that Auerbach and Obstfeld (2005) have articulated. In contrast, credit easing is focused on repairing credit markets so they can function normally again. Credit easing does involve an expansion of liquidity, but in contrast to quantitative easing, it is not focused on expanding the money supply, but rather on lowering credit spreads and making credit more readily available to jump-start the economy.

I also agree with Taka that the measures taken by the Federal Reserve were necessary and have helped stabilize financial markets and the economy. On the other hand, I think that Taka needs to address critics of the Federal Reserve actions, such as John Taylor (2009) to bolster his case.

Taka also discusses the role of inflation targeting in dealing with a financial crisis. He discusses the Bank of England's difficulties in meeting its inflation target. In the November 2008 and February 2009 *Inflation Reports*, the Bank of England indicated that it would not achieve its 2 percent inflation target even over the coming three years. Taka then asks whether the Bank of England was abandoning inflation targeting or was incompetent at achieving its target?

I believe that the answers to the two questions are no. The shock from the financial crisis was so large and unforeseen that missing the inflation target would have been the result even if monetary policy had been optimal on an ex ante basis. However, Taka's questions raise several issues about the conduct of inflation targeting when an economy is hit by a massive financial shock of the type we have recently experienced.

Some critics of inflation targeting have argued that this recent episode casts doubts on the effectiveness of inflation targeting as a monetary policy strategy. I strongly disagree. The lesson that should be learned from the recent crisis is that inflation targeting needs to be very flexible. A criticism of the conduct of some inflation targeting regimes that I brought up in the past (Mishkin 2005) is that some regimes, particularly the Bank of England, have given the impression that they were always trying to hit an inflation target at a set horizon, two years in the case of the Bank of England. However, optimal monetary policy would never set a fixed horizon for achieving an inflation target because, as Svensson (1997) has shown, when there is a concern about output fluctuations, as there should be, and the inflation rate is shocked sufficiently away from its long-run target, the path for the medium-term inflation target horizon needs to be modified. The recent financial crisis was exactly such a shock and it was sufficiently large that the horizon for hitting the inflation target would need to be lengthened substantially. In my discussion of the possibility that the horizon would have to be modified in Mishkin (2005), I discussed the case of an inflation overshoot as occurred in Brazil in 2002 and 2003 and how the Brazilian central bank handled this well by lengthening the horizon for its inflation target. This argument is just as valid for an undershoot of the inflation target that comes from a contractionary shock like the one we have experienced recently. The possibility of negative shocks to the financial system support increased flexibility for inflation targeting regimes.

But can inflation targeting help a central bank deal with a financial crisis? The answer is yes. Financial crises are contractionary and so actions to stabilize inflation are also ones that help stabilize economic activity. Furthermore the expectation that action will be taken to keep inflation from falling during a financial crisis makes monetary policy more effective in coping with the crisis. By preventing inflation expectations from falling, inflation targeting helps keep real interest rates from rising, which helps stabilize both financial markets and economic activity.

In addition, as I have argued in Mishkin (2008), preemptive actions when a financial disruption occurs are crucial to preventing more serious negative outcomes as a result of financial shocks. However, these preemptive actions would be counterproductive if they caused an increase in inflation expectations and the underlying rate of inflation; in other words, the flexibility to act preemptively against a financial disruption presumes that inflation expectations are well anchored and unlikely to rise during a period of temporary monetary easing. Inflation targeting can be extremely helpful in anchoring inflation expectations and therefore can be very helpful in enabling the central bank to effectively deal with a financial crisis.

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