Commentary: The "Surprising" Origin and Nature of Financial Crises: A Macroeconomic Policy Proposal

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This is an interesting paper that takes a "contrarian" view, at least from the perspective of the academic and policy community if not necessarily from the perspective of the financial community. The basic thesis of the paper—at the risk of oversimplification—is that whereas bubbles and poor regulation may have set off the financial crisis, the real failure of the system was the absence of a hyperfast sweeping bailout mechanism. Catastrophic crisis insurance during a systemic event, it is argued, is cheap and should be provided with far less angst than during a more localized event. In a systemic panic episode, individual investors almost always far overestimate the risk of catastrophe, leaving room for government intervention. The authors appeal to Knightian uncertainty—uncertainty about the uncertainties—to make their case. Moreover, because we live in a world of constant financial innovation, investors are always going to be dealing with their fear of the unknown and unknowable. Governments know they will always have resources and can afford to take a far more balanced view, leaving scope for panic arbitrage.

The authors acknowledge moral hazard concerns but argue that they are of little relevance during a systemic panic. Thus there is little reason not to cast a far wider and more generous net of guarantee over the financial system than is currently the case, at least when it

comes to major catastrophes. The authors then offer a specific remedy based on this diagnosis, which is to have government issue tradable insurance credits.

Cabellero and Kurlat advance their diagnosis and prescription because they are concerned that the "conventional" view of the financial crisis is going to lead to an overreaction that will throw the baby out with the bathwater. They are concerned that excessive capital requirements and overly stringent regulation will cause a long-lasting deflation of leverage that will stunt growth for years to come. In contrast to the conventional view, which views excessive leverage as perhaps the central problem that needs to be addressed, the authors argue that high leverage of the bubble years may have had more to do with the economy's growth and dynamism than is commonly acknowledged. Thus the authorities should not cavalierly aim for a less leveraged system.

I am not going to go into any detail on the highly stylized model of the paper, or the highly stylized models of the background papers. I agree with the authors that there is a great limit to what any one model can capture on this issue, because it is quite difficult to analyze more than one or two aspects at a time. Nor will I go into any details on the authors' tradable insurance credits. For one thing, as will become apparent, I disgree with the diagnosis, and view excess leverage in the pre-crisis economy as a huge problem, particularly short-term borrowing. If one did agree with the authors' emphasis, I would still be reluctant to endorse this approach, however clever. Experience has long shown that perhaps the greatest problem governments face is deciding whom not to bail out. In a crisis, would the government really shut down financial firms that did not take out enough insurance, or even those firms that did not take any insurance at all? There is also the problem that there is in fact a wide variety of assets and risks in the economy, and the government might need to produce a wide spectrum of tradeable insurance credits, not just one. I do applaud the idea of trying to make bailouts more systematic, and also to find some way to make financial firms pay more for the essentially free insurance they now get.

Although the tradeable insurance credit is interesting and will no doubt stimulate further discussion, in these remarks I will mainly

focus on the basic premise of the paper. That is, do we need a more generous and proactive policy of bailouts during systemwide crises, rather than less, as some have concluded?

Let's start with the premise that the huge degree of leverage of the system was a good thing, and policies aimed at deflating the leverage could be very unwise. Others, of course, would argue that excessive leverage creates too much risk in the system. The truth is that the empirical academic literature does not yet give any decisive answers on this point, though certainly the history of international financial crises—of all types—suggests that excessive leverage, somewhere in the system, is almost always a culprit.[1] The literature certainly does not demonstrate that raising the leverage in an economy necessarily creates sustainable quality growth. U.S. policy in the run-up to the crisis involved gigantic subsidies to homeowners, with lax regulation in the mortgage market arguably being another form of subsidy. The authors of the paper talk about the "loss" of financial wealth the crisis caused, suggesting it was unnecessary. But was all the gain in financial wealth in the run-up to the crisis necessarily all real? As Robert Shiller has pointed at in a past contribution to this conference, the period 2000-2005 witnessed an unprecedented explosion of home prices, fueled in part by low interest rates and easy credit. But this "increase" in wealth facilitated by financial "innovation," although partly reflecting lower transactions costs in financial markets, also constituted an intergenerational transfer, with the older generation of homeowners being the winners, and potential homebuyers in the young generation being the losers. Even more importantly, some part of the financial innovation was simply a mechanism to maximize taxpayer subsidies.

The authors take as given that Knightian uncertainty makes investors too risk averse, especially in a panic. My Harvard colleague Robert Barro has argued in a series of papers, that, in fact, people are legitimately concerned about small probabilities of tail events, and that these legitimate concerns can explain many pricing anomalies such as the equity premium puzzle. Barro's explanation is quantitative as well as qualitative, using standard models without appeal to exotic uncertainty arguments, although I accept Knightian uncertainty as a legitimate

issue. (Another of my colleagues, Marty Weitzman, uses a Bayesian framework, where agents' behavior depends critically on beliefs about tail events, to reach similar conclusions.) The point is there are many models of how small events affect expectations and markets, and they do not necessarily lead to the same policy conclusions.

Then there is the matter of huge returns earned by the financial sector, which ballooned from 4% of GDP in 1970 to over 8% in the 2000s. By some measures, the financial sector reaped close to a third of corporate profits during the run-up to the crisis. Was this all a return to innovation, or was some significant share a return to the huge implicit subsidy built into monetary policy?

Let us return to the argument here that "insurance is cheap." Perhaps. But Carmen Reinhart and I have argued that to properly understand financial crises and their costs, one needs to look at far longer and broader data sets than in standard analysis. Our work calls into question the view that big countries get off lightly in financial crises and should not worry about them so much.

Indeed, one cannot view the U.S. taxpayer as an infinite well, as this paper implicitly seems to. A key job of the central bank, or the financial regulator, is to try to balance risks to private sector credit with risks to the financial integrity of the government itself. Yes, financial regulation should not "throw out the baby with the bathwater." But nor should it take excessive chances with the fundamental fiscal credibility of the government, thereby "killing the goose that layed the golden egg." Particularly as the financial sector has ballooned, and taken on greater and greater complexity, it becomes riskier and riskier for the government to take on open-ended guarantees that it, too, cannot possibly understand.

It must also be recognized that there are enormous political economy biases to tilt regulatory and financial sectors towards implicit taxpayer subsidies to the financial sector. During the bubble period in which leverage is building up, the financial sector invariably becomes politically more powerful and can push for softer regulation. This too is not in the present model, but a potent force, as many in the audience are no doubt well aware.

Given uncertainties and huge potential bias towards subsidizing the financial sector, it seems quite reasonable separating equilibrium where governments do not always react immediately at the first sign of a crisis, but instead use overwhelming force only when the evidence is very clear that it is necessary. A policy of "when in doubt, bail it out" is dangerous.

Let me conclude by noting that as Maurice Obstfeld and I pointed out in a series of papers in the 2000s (beginning with a paper presented here nine years ago), the United States was following a dangerous borrowing path in the years prior to crisis. Sustained U.S. current account trade deficits clearly posed a long-term risk even though altogether too many policymakers and academics dismissed these as a natural expression of U.S. financial superiority. The U.S. regulatory and financial system may have been excellent, but it was not bulletproof, as events demonstrated. Financial globalization will continue to be a net positive force for growth in coming years, but common sense still suggests that a reining-in of leverage, particularly short-term leverage, would be a very sensible response to the heart attack the economy has just experienced. This is not the time to be considering policies to reflate leverage even beyond its earlier level, especially when there is not clear empirical evidence that this necessarily leads to significantly greater growth or stability. Cabellero and Kurlat give some reasonable cautions on over-regulation and offer some rather different solutions. But in the end, the conventional, common sense response to financial crises—better regulation, rein in leverage, increase transparency, etc.—is not such a bad one.

Endnote

[1]See Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009.

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