The Subprime Crisis Shows That Government Intervenes Too Little in Financial Markets? It Just Ain't So!

BY LAWRENCE H. WHITE

Start with two assumptions. No. 1: Banking and financial markets are inherently unstable. No. 2: Government intervention into banking and financial markets can only stabilize (never destabilize). You'll find it easy to conclude that any period of market instability we experience, like the recent subprime-lending problem, is the market's fault and that it could have been avoided with more intervention.

Following the same logic, any lessening of instability that we are now experiencing can't be due to the market's self-correcting, but must be due to timely intervention by government.

Thus argues Paul Krugman in his *New York Times* op-ed column "Success Breeds Failure" (May 5). According to Krugman, the subprime troubles occurred only because "Wall Street did an end run around regulation." The "out-of-control financial system" didn't collapse completely only because our government central bank, like the fictional TV hero MacGyver, "has cobbled together makeshift arrangements to save the day." If we listen to "market-worshiping ideology" and fail to impose increased intervention—"fundamental financial reform," he calls it—Krugman expects that "the next crisis will probably be worse than this one."

Krugman's two initial assumptions, however, are false. If even one is false, the case for increased intervention no longer follows.

Over the broad sweep of history, banking systems with few legal restrictions have been more stable than systems with more intervention. Perhaps the most striking example is that Canada, which allowed nationwide branch banking (unlike the United States) and had fewer restrictions on banknote issue, had no bank failures during the Great Depression (while the United States had thousands). Krugman invokes the Great Depression, claiming that in the recent troubles "we were in a situation bearing a family resemblance to the great banking crisis of 1930–31," facing "a cascade of financial failures that would cripple the economy." But he fails to mention that Canada's less-restricted system had no "great banking crisis" in the Depression.

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Krugman notes that the New Deal imposed new banking regulations and claims that the "new system worked well for half a century." He chose the 50-year period advisedly. Fifty years after the New Deal banking reforms of 1935 lands us in 1985, just after the savings-and-loan industry collapsed, but before regulators had acknowledged and addressed the collapse. The S&L fiasco demonstrated the dangers of New Deal regulation, specifically deposit insurance. Federal regulations compelled S&Ls to hold portfolios consisting almost entirely of 30-year fixed-rate mortgages, which left them highly exposed to losses in the event of a sharp rise in interest rates.

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When inflation rose sharply in the 1970s (due to sharply expansionary Federal Reserve monetary policy), it drove interest rates sharply upward as well. The interest rates S&Ls had to pay for new deposits rose well above the fixed rates they were earning on old mortgages. The S&Ls quickly bled to death. They had been able to hold such a risky portfolio without depositors noticing or objecting because depositors were insulated by federal deposit insurance. This was the "moral hazard" problem: Recipients of subsidized deposit insurance, with 100 percent coverage and no deductibles, took no care to avoid risky institutions, and so the institutions had much less incentive to avoid taking on risk. When regulators failed to close the "dead" (insolvent) S&Ls promptly, they created a race of "zombie" institutions, the living dead, whose desperate-to-recover strategies made the red ink multiply. This was moral hazard on steroids. Ultimately taxpayers were left with a bill of about $260 billion in today's dollars.

Unprecedented Interventions

The Federal Reserve's interventions in the recent subprime-mortgage crisis have included—at its own initiative, without precedent, and without congressional oversight—the extension of credit lines to investment banks and the lending of Treasury bills to "primary" securities dealers. The traditional role of the central bank as a "lender of last resort" is to make loans only to commercial banks, because the traditional rationale is to protect the economy's payment system. The hope of the traditional last-resort lender is to avoid a collapse of the economy's money stock by injecting reserves into the commercial banking system when there is an extraordinary "internal drain" of reserves (namely bank runs).

In the recent crisis, by contrast, there has been absolutely no threat of a shrinking money stock. Investment banks do not issue checking deposits, are not subject to bank runs, and are not part of the payment system. Neither are securities dealers. The Fed's expansions of its own role therefore had nothing to do with protecting the payment system or stabilizing the money supply. The Fed's new moves were rather made in the hope of protecting investment banks and securities dealers from the consequences of holding portfolios overweighted with mortgage-backed securities, or exotic derivatives based on such securities, while keeping levels of capital inadequate for such portfolios. The reason that some financial institutions have been having trouble rolling over their debts is fundamentally the market's uncertainty about their solvency. It is not a liquidity problem.

By blunting the market penalty for financial imprudence, the Fed is breeding a new kind of moral hazard. If the next crisis is worse than this one, moral hazard —not failure to regulate—will be high on the list of suspects.

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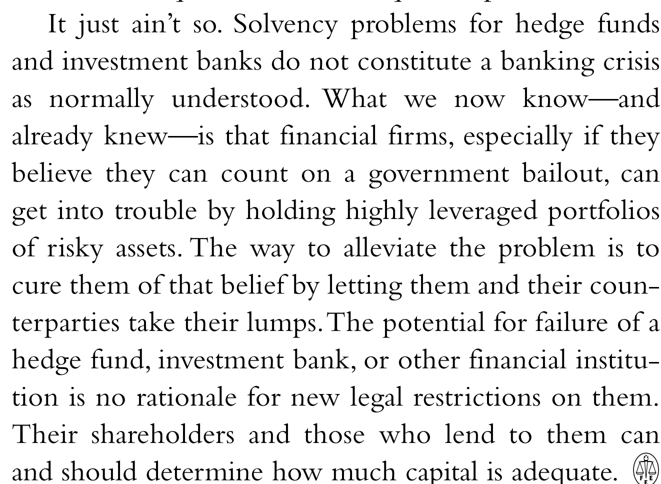
The Fed is currently lending hundreds of billions of Treasury securities from its portfolio and taking junk assets as collateral. In a few years we will be able to tabulate the losses to the American taxpayer.

Krugman declares: "We now know that things that aren't called banks can nonetheless generate banking crises, and that the Fed needs to carry out bank-type rescues on their behalf. It follows that hedge funds, special investment vehicles and so on need bank-type regulation. In particular, they need to be required to have adequate capital."



It just ain't so. Solvency problems for hedge funds and investment banks do not constitute a banking crisis as normally understood. What we now know—and already knew—is that financial firms, especially if they believe they can count on a government bailout, can get into trouble by holding highly leveraged portfolios of risky assets. The way to alleviate the problem is to cure them of that belief by letting them and their counterparties take their lumps. The potential for failure of a hedge fund, investment bank, or other financial institution is no rationale for new legal restrictions on them. Their shareholders and those who lend to them can and should determine how much capital is adequate.