“This time is different,” a phrase so often used before a crisis that two prominent economists set out to reject it in their book. Things change, but structure abides. Today, some economists are warning about the next financial crisis. They point to the corporate debt market as a harbinger for the next crisis. The run up of debt by large corporations introduces the prospect of massive defaults if credit is extended too freely. “And these more venturesome CEOs will be right most of time,” comments Warren Buffet, an acute observer of the market. But he warns that “at rare and unpredictable intervals, however, credit vanishes and debt becomes financially fatal.” We might want to listen to him. While observers speculate and posture, taking a look at the history of panics and crises is warranted and might give us insight into what will happen next. First, the desire for credit and speculation is central to markets. Second, when authorities regulate a form of credit to dampen euphoria, substitutes to money always arise. The creation of money substitutes poses a dilemma for policymakers trying to prevent the next crisis. Won’t risk just shift somewhere else?

Former Treasury Secretary Tim Geithner calls the financial system a “dark mirror” on society. In an interview with Andrew Ross Sorkin, Geithner claims that the desire to want more than one can reasonably have is a dangerous thing. Similarly, a tendency for credit to expand is a hallmark of speculative manias. People expect prices to increase and they pour money into markets that diverge drastically from any notion of fundamental value. This occurred in the last housing bubble a decade ago and the Dutch tulip bubble four hundred years ago. It’s natural to ask why can’t policymakers put an end to these manias? By the definition of a bubble, it’s difficult to know about a bubble until it bursts. As long as prices are increasing, it may be rational to keep buying, a point two Boston Fed economists make in a paper examining the housing market. Charles Kindleberger, a renown financial historian, provides an interesting answer. He writes, “The stylized historical fact is that every time the monetary authorities stabilize or control some quantity of money…more money and near money substitutes will be produced in periods of euphoria.” If authorities impose greater capital requirements and insure that institutions don’t otherwise take more risk, human nature or just dumb luck will drive humans to financial products or markets that have hire returns and more risk. This poses a central challenge for Treasury and Federal Reserve officials. If you regulate the risk out of something, it may just go elsewhere.

So why is this important? Government officials need to be vigilant of where risk is heading and have the authority to dampen unrealistic expectations. The subtle point I’m trying to make is that policymakers cannot be content with existing regulations. In 2004, NY Fed officials were looking at the hedge fund leverage ratios, thinking (in the wake of LTCM’s collapse) the next crisis was going to arise from hedge funds. Instead, the crisis popped up in the housing market. For those looking forward, the best to time to look for vulnerabilities is when the ship is sailing smoothly, not in the middle of a storm.

As economists and commentators point to the next source of risk we should be asking whether we have the right tools to fight the next financial fire. The repeal of certain sections of Dodd-
Frank and the restrictions on Treasury authority, may inhibit a timely response. If we can’t completely stop the next devastating fire before the fact, we better make sure that we have the best tools to combat it when the time comes.