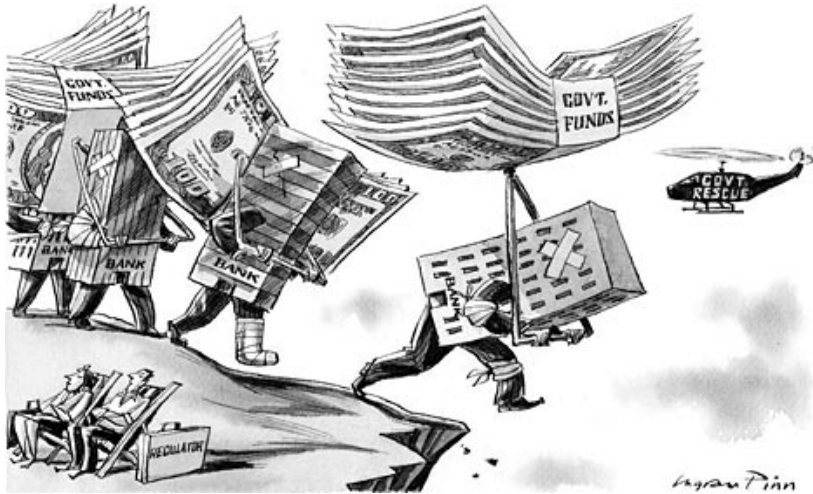


Why we need to regulate the banks sooner, not later

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By Kenneth Rogoff

Published: August 18 2009 20:11 | Last updated: August 18 2009 23:12



When in doubt, bail it out," is the policy mantra 11 months after the September 2008 collapse of Lehman Brothers. With the global economy tentatively emerging from recession, and investors salivating over the remaining banks' apparent return to profitability, some are beginning to ask: "Did we really need to suffer so much?"

Too many policymakers, investors and economists have concluded that US authorities could have engineered a smooth exit from the bubble economy if only Lehman had been bailed out. Too many now believe that any move towards greater financial regulation should be sharply circumscribed since it was the government that dropped the ball. Stifling financial innovation will only slow growth, with little benefit in terms of stemming future crises; it is the job of central banks to prevent bank runs by reacting forcefully in a potential systemic crisis; policymakers should not be obsessed with moral hazard and should forget trying to micromanage the innovative financial sector.

This relatively sanguine diagnosis is tempting, but dangerous. There are three basic problems with the view that the costs of greater bank regulation outweigh the benefits, and that the whole problem was the botched Lehman bail-out.

First, the US economy was not exactly cruising along at warp speed in the run-up to September 2008. The National Bureau of Economic Research has the US recession beginning at the end of 2007. Financial markets had begun to exhibit distress from the subprime problem by the summer of 2007. The epic housing bubble had begun to burst six months earlier. Given that the US consumer had been propelling the global economy for a quarter of a century, was it reasonable to think that the inevitable collapse of the US housing market would be a non-event? As Carmen Reinhart and I argue in our forthcoming book *This Time is Different: Eight centuries of financial folly*, by most quantitative measures, the US economy was heading towards a deep post-war financial crisis for several years before the subprime crisis. Indeed, in related papers, we argued the case long before Lehman hit.

Second, the view that reining in the financial sector jeopardises future growth needs to be nuanced. Certainly enhanced financial development is integral to achieving greater growth and stability. But economists have less empirical evidence than we might care to admit on which financial sector activities are the most helpful. In general, the links between growth and financial development are complex. Mortgage "innovation" in the US was supposed to be helpful by lowering interest rates to homebuyers. Yet, as the crisis revealed, innovation was also a mechanism for leveraging implicit taxpayer subsidies. More generally, financial innovation was supposed to bring diversification and stability. But in a system-wide breakdown, it also fuelled contagion.

Third, it is dangerous to point to the nascent restoration of profits in the financial sector as clear evidence of a corresponding benefit to the economy. There is an element of arbitrage, as banks borrow at low rates against the implicit guarantee of a government bail-out in the event of a crisis. Do people really believe, as some argue, that moral hazard is a non-issue? Why should large systemically critical financial institutions be allowed to heavily leverage themselves with short-term borrowing? What would be lost if regulators placed stricter capital requirements to discourage arbitrage activities that excessively expose too-big-to-fail banks to systemic risk? Certainly economists have models of why it can be efficient for lenders to keep borrowers on a short leash. Yet these models do not explain why the leash has to be wrapped around borrowers' necks three dozen times, as in

the case of a highly leveraged bank.

The fact is that banks, especially large systemically important ones, are currently able to obtain cash at a near zero interest rate and engage in risky arbitrage activities, knowing that the invisible wallet of the taxpayer stands behind them. In essence, while authorities are saying that they intend to raise capital requirements on banks later, in the short run they are looking the other way while banks gamble under the umbrella of taxpayer guarantees.

If the optimists are wrong, does this mean that the pre-Lehman financial system was one big Sodom and Gomorrah, inevitably condemned to doom? We will never know. Again appealing to my work with Ms Reinhart, theory and history both tell us that any economy that is excessively leveraged with short-term borrowing – be it government, banking, corporate or consumer – is highly vulnerable to crises of confidence. Accidents that are waiting to happen usually do, but when? Neither statistical analysis of history, nor economic theory offer tight limits on the timing of collapses, even to within a year or two.

Certainly the US and global economy were already severely stressed at the time of Lehman's fall, but better tactical operations by the Federal Reserve and Treasury, especially in backstopping Lehman's derivatives book, might have stemmed the panic. Indeed, with hindsight it is easy to say the authorities should have acted months earlier to force banks to raise more equity capital. The March 2008 collapse of the fifth-largest investment bank, Bear Stearns, should have been an indication that urgent action was needed. Fed and Treasury officials argue that before Lehman, stronger measures were politically impossible. There had to be blood on the streets to convince Congress. In any event, given the system's manifest vulnerabilities, and the impending tsunami of the housing price collapse, it is hard to know if deferring the crisis would have made things better or worse, particularly given the obvious paralysis of the political system.

Economists will conduct post-mortems of the crisis for decades. In the meantime, common sense dictates the need for stricter controls on short-term borrowing by systemically important institutions, as well as regularly monitored limits on oversized risk positions, taking into account that markets can be highly correlated in a downturn. Better macroprudential action is needed, particularly in reining in sustained, large current account deficits. While such deficits can sometimes be justified, prolonged imbalances fuel leverage and can give the illusion that high growth and asset prices are sustainable. There should also be more international co-ordination of financial supervision, to prevent countries using soft regulation to bid for business and to insulate regulators from political pressures.

It is good that the economy appears to be stabilising, albeit on the back of a vast array of non-transparent taxpayer subsidies to financial institutions. But this strategy must not be relied on indefinitely because it risks compromising the fiscal credibility of rich-country governments. The view that everything would be fine if Hank Paulson, then US Treasury secretary, had simply underwritten a \$50bn bail-out of Lehman is dangerously misguided. The financial system still needs fundamental reform, and not just starting in five years.

The writer is professor of economics at Harvard University

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