Stabilization Policy, Part III

Author : James Annable

Date : Jan 5, 2018

This post continues examining the stabilization policy that emerged in the aftermath of the Great Recession. It provides more detail on some of the mistakes made in pursuit of a flawed strategy.

First pillar mistake. Dodd-Frank's prohibition of injections of public funds into large financial institutions is a fundamental mistake. It damages, not strengthens, stabilization authorities' capacity to prevent future episodes of extreme instability. Taxpayer losses from 2008-09 TARP lending to large banks is no more than a frequently repeated lie. Rejecting that falsehood sets the stage for the replacement message. If mark-to-market bank insolvency results from collapsing aggregate demand and asset prices, capital injections must be understood as a critical part of successfully halting and reversing contractions of total spending.

GEM feedback dynamics described last week demonstrates how prohibiting capital transfers to financial institutions exposes taxpayers to, not protects them from, huge losses. During the next episode of collapsing demand, the Dodd-Frank ban on temporary capital injections will surely be repudiated. The malfeasance in doing otherwise would become too obvious. The crucial question is whether the repudiation, now requiring legislative action, will come in time to effectively contribute to stabilization authorities' effort to reverse free-falling demand and prevent the immense costs of depression. History suggests skepticism about placing a massive bet on the capacity of Congress to act with foresight and speed in real-time macro emergencies.

Second pillar mistake. The second pillar of the stabilization consensus, i.e. breaking up the largest U.S. banks, was a harmful mistake that has apparently been quietly abandoned by regulators. It had been aggressively pursued in a multi-pronged campaign of ever-higher capital requirements on targeted institutions. The effort sought to transform scale, typically a source of productive synergy, into a cost-prohibitive burden. The most overt action here was the Federal Reserve's announced intention to impose substantial (albeit unspecified) capital surcharges on the largest banks. The new capital requirements piled onto the U.S. implementation of Basel III capital requirements (while the rest of the world largely ignored the agreement), imposition of substantial size-sensitive belt-and-suspender leverage ratios, and tighter definitions of capital that can be used to meet government requirements. Most ominously, U.S. regulators broadly hinted at ever higher required capital with no real-time indication of how much is enough, beyond background hints endorsing whatever it takes to force the largest banks to substantially shrink.

That campaign of increasing capital requirements until big banks break up was pursued absent any demonstration of how size causes instability or any careful assessment of the damage to economic efficiency and growth, international competitiveness, the capacity to manage future episodes of extreme instability, U.S. international power that results from the nation's globally dominant banking system, and fundamental property rights. There was little concern that a large number of huge foreign banks, deeply interconnected with the global financial system, would continue to exist, poised to fill the vacuum. Moreover, it is instructive that the post-crisis stabilization-policy effort simply avoided taking on the difficult task of effectively regulating the risk-seeking shadow banking system. Regulators admit, usually quietly, that the next financial instability crisis will most likely originate in nonbank institutions or outside the United States.

Third pillar mistake. The third pillar, returning demand-intervention powers that Congress believes have been usurped by stabilization agencies (especially the Fed), has been variously pursued. The collective effort is a huge mistake. In 2008-09, the Fed quickly and aggressively interpreted Section 13(3) of the Federal Reserve Act to enable massive lending outside the federally-regulated commercial banking system. That is where market failures causing the greatest damage to total spending were concentrated. The rationale for that policy response, especially the need for speed and scale, is inexplicably ignored by Congress.

A closer look at the 2008 money-market-mutual-fund (MMMF) emergency usefully illustrates the need for speed and scale in circumstances of brewing acute instability. As noted above, asset markets immediately tanked in response to the bankruptcy filing by Lehman Brothers on Monday, September 15, 2008. On Tuesday, the Reserve Primary Fund, a respected $67 billion money-market mutual fund hit by a tsunami of withdrawal requests had to "break the buck", shocking those who withdrew cash with a capital loss. The Fed staff estimated that withdrawals, if unchecked, would by the end of the week result in the collapse of the entire $3.8 trillion MMMF industry, with the forced sale of assets into already free-falling markets generating huge depositor losses. The best bet was that, by the following week, the adverse consequences on total spending could well become irreversible by stabilization authorities. The likelihood of the immense welfare losses of a 21st-century depression were unacceptably high.

Instead, three days after Reserve broke the buck, the Fed announced the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) that lent to cooperating big banks so that they could purchase securities being sold by money-market mutual funds, which were then pledged back to the central bank. The Fed became the buyer of last resort for the multi-trillion-dollar nonbank MMMF industry. Some $24 billion was lent the first day of AMLF operations, $217 billion for the run of the program. The existence of the backstop calmed depositors and prevented the MMMF industry failure. Dire feedback consequences for total spending were avoided. The crucial lesson here is the need, in circumstances of a brewing collapse in total demand, for speed and size in the design of effective stabilization policies. During the other perilous asset-market failures that quickly came, Bernanke’s mantra inside the Fed was: No program is too big; no program too quick.

Today, the central bank’s power to lend to nonbanks under 13(3) requires consent of the Treasury Secretary, introducing greater political pressure that almost always slows the response process. The central bank’s lending to nonbanks must now be organized as a broad program, prohibiting targeting of a single institution (e.g. AIG); and nonbank institutions must put up significantly increased collateral (during a period in which the mark-to-market value of collateral is collapsing). Those changes particularly hinder the ability of the Fed to intervene quickly and in size to halt and reverse a nonstationary contraction in total spending. Today, the U.S. central bank’s power to act as a lender of last resort is weaker than the European Central Bank, the Bank of England, or the Bank of Japan.

There is more. In 2008-09, the Treasury extended temporary guarantees to the MMMFs, while the FDIC expanded the scope and level of deposit insurance which most supportive of smaller banks. Prior Congressional approval is now required for the Treasury or FDIC to expand guarantees, destroying their ability to act quickly in a crisis of collapsing demand.

The GEM Project, which uniquely microfounds the centrality of contracting aggregate demand in extreme instability, is not alone in its indictment of the policy mistakes made in the aftermath of the 2008-09 crisis. Space limitations allow mention of one additional critic. Hal Scott is today’s preeminent economist in the specialized field of financial regulation in the circumstances of acute instability. His assessment of current public-policy actions to prevent future Great Recessions is succinct: “The losses and the impact on our economy and country in September 2008 would have been much worse but for the response of our government to halting the contagion [i.e. spreading panic among investors/lenders] that broke loose following the bankruptcy of Lehman Brothers. However, since then the Congress has dramatically weakened the Federal Reserve, FDIC, and Treasury’s ability to respond to contagion, leaving our financial system sharply exposed to another contagion.”

Blog Type: Policy/Topical Saint Joseph, Michigan