Are We Safer? The Case for Strengthening the Bagehot Arsenal
Per Jacobsson Lecture

Timothy F. Geithner
October 8, 2016
The Anatomy of a Financial Crisis
Kindleberger’s *Manias, Panics, and Crashes*
If you want peace, prepare for war.

Attributed to Sun Tzu, and Plato, and others
Some Lessons From This Crisis

Starting with the deep forces that produced the boom
The Quiet Period
Commercial Bank Two-Year Loan Loss Rate

70 years of calm
“The Great Moderation”
Quarterly Real GDP growth

Low Volatility
The Long Decline in the Risk Free Rate

10-Year Treasury Constant Maturity Rate
The Housing Boom
Nominal Home Prices
The “Mount Fuji” Chart
Household debt as a percent of GDP
The Rise of “Shadow Banking”
Liabilities as a percent of GDP

- **Banks**
  - Depository Institutions

- Holding Companies and Broker/Dealers

- “Shadow Banks”
Short Term, Deposit-like Liabilities
Net Repo Funding to Broker/Dealers

$ Trillions

Financial Crises Damage the Economy: The Vicious Spiral

1. Economic growth slows, fear of losses to banks
2. Funding pressure increases on financial institutions
3. Financial institutions reduce lending and sell assets
4. Asset prices decline further
5. People spend less and businesses invest less
6. More financial institutions look weak
Some Lessons From This Crisis

The dangers in long booms

Hard to get more capital into the system at the peak of the boom

Crisis defense requires full arsenal of tools, well beyond Bagehot

Very costly to fall behind the curve of panic

Dangerous to leave the central bank out there all alone too long

Capital alone is not enough in a panic

Hair cuts accelerate runs

Need more of the burden to fall on fiscal policy
## Beyond Bagehot

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How Should We Define “Safe”?

What level of “safety” should we be trying to manage to?

Objective should not be to prevent financial failure. Failure has its merits.

The overriding objective should be to reduce the risk of a classic run on the financial system and to limit the attendant damage to the economy.

Make the system “safe for failure.”
01 Level of ex ante vulnerability
02 The Keynesian Macroeconomic Policy Arsenal
03 Emergency Financial Authorities: Beyond Bagehot
04 Policy choices in crises
| Level of ex ante vulnerability | The Keynesian Macroeconomic Policy Arsenal | Emergency Financial Authorities: Beyond Bagehot | Policy choices in crises |
Capital Buffers Are Higher

Capital Requirements under Basel III

Percent of risk-weighted assets

- Basel I
- Basel III
- Basel III Adjusted

Legend:
- Additional Tier 1 Capital
- Additional Common Capital Surcharge for Systemically Important Banks
- Tier 1 Common

The diagram illustrates the capital requirements under Basel I, Basel III, and Basel III Adjusted, showing the percent of risk-weighted assets for each category.
Short-term, Deposit-like Liabilities
Net Repo Funding to Broker/Dealers

$ Trillions
1.6
1.4
1.2
1.0
0.8
0.6
0.4
0.2
0.0

The less reassuring facts

Economic growth rates are lower, with a smaller margin between expansion and recession.

New capital levels high relative to loss in crisis, but those losses were limited by recourse to the now diminished Keynesian policy arsenal.

There is no reason for confidence in our ability to preempt “shocks.”

The migration of maturity transformation away from banks is still limited, but over time risk will move outside the financial system. Moving market-making capacity and credit provision outside of banks leaves it in weaker hands in a crisis.
The Rise of “Shadow Banking”

Liabilities as a percent of GDP

- Banks
- Depository Institutions
- Holding Companies and Broker/Dealers
- “Shadow Banks”
Stronger Shock Absorbers, but . . .

The less reassuring facts

History is not that reassuring about the value of higher capital ratios alone as protection against panic.
Book Equity to Assets of U.S. Banks Since 1840

Are We Safer?

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Long Decline in G-10 Policy Rates

Target Policy Rate, Percent

Source: Bloomberg.
Public Debt to GDP Since 1800

Public sector debt burdens are much higher as a share of GDP.

Policy rates are close to, or below, zero.

The long end of sovereign yield curve is close to, or below, zero.

High grade credit spreads are low.

There is no recent precedent for this.
Implications

The incremental room available for policymakers in “advanced” economies to respond to a crisis is dramatically more limited than in 2008.

The impact of a shock will cause more damage, last longer, and spread wider.

There is much less room for error in management of panics.
Are We Safer?

01  Level of ex ante vulnerability
02  The Keynesian Macroeconomic Policy Arsenal
03  Emergency Financial Authorities: Beyond Bagehot
04  Policy choices in crises
Fed Liquidity Facilities

Source: Federal Reserve.
### Beyond Bagehot

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Key Support for Markets and Institutions

- **Insured Deposits Under $100k**: $4.5 Trillion
- **Expanded Deposit Insurance**: $1.2 Trillion
- **TAG & $250K Deposit Insurance**: $7.8 Trillion
- **Expanded Implicit Backstop of Non-Insured IDI and BHC Liabilities**: $2.9 Trillion
- **PDCF & TSLF**: $0.8 Trillion
- **AMLF & CPFF**: $1.0 Trillion
- **CPFF**: $4.3 Trillion
- **PPIP & TALF**: $3.3 Trillion
- **AMLF and MMF Guarantee**: $6.7 Trillion

**Sources:**
- TLGP, TARP, & TAF
- PDCF & TSLF
- AMLF & CPFF
- CPFF
- PPIP & TALF
- HERA
- AMLF and MMF Guarantee

**Institutions:**
- Broker/Dealers
- ABCP
- Corporate CP
- ABS
- MMF
- GSEs

**Guarantees:**
- HERA
- AMLF and MMF Guarantee
### Authorities Used in the Crisis

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Post Crisis Erosion in the Policy Arsenal for Financial Crises

Keynesian Policy Room

Stronger

Weaker

Weaker

Bagehot Arsenal

Stronger

US 08
EA 08
PRC 08
Post Crisis Erosion in the Policy Arsenal for Financial Crises

Keynesian Policy Room

Stronger

Weaker

Bagehot Arsenal

US 08
PRC 08
EuroArea 08

US 16

PRC 16

EuroArea 16

Stronger

Weaker
Are We Safer?

01 Level of ex ante vulnerability

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Beliefs, Loss of Memory, Lack of Experience, Politics . . .
All Distort Policy Choices in Crisis

More fear of the political costs of bailout rather than of the economic costs of uncontrolled panic.

Confusion about the role of brakes and the accelerator; the appropriate sign of fiscal policy

Confusion about how best to limit loss to taxpayer

Moral hazard fundamentalism

The lack of knowledge of what to do increases the power of these beliefs

Fear of the political costs of bailouts rather than the economic costs of uncontrolled panic
Countercyclical monetary policy

Idiosyncratic Shock

- Haircut creditors of failing banks
- Liquidate failing institutions
- Allow markets to adjust
- Resist pressure to intervene
- Resolution authority

Systemic Financial Shock

- Automatic fiscal stabilizers
- Liquidity provision to solvent firms
- Countercyclical monetary policy
- Large fiscal stimulus relative to decline in demand
- Inject capital into banks
- Guarantee (rather than haircut) creditors to break run
- Liquidate failing institutions
- Allow markets to adjust
- Resist pressure to intervene
- Resolution authority
Moral Hazard and its Perils

It’s hard to solve a moral hazard problem in the midst of the crisis, without dramatically intensifying the crisis.

One of the many paradoxes in financial crisis management is that if you do not act swiftly and effectively to break a panic, then you might end up having to socialize more risk and guarantee more liabilities, with complicated and potentially worse moral hazard implications.
More Practical Ways to Limit Moral Hazard

Prudential regulation has to bear most of the burden of limiting the moral hazard risk.

Preserving flexibility and uncertainty about the pace of escalation and perimeter of support in crisis should leave investors and creditors of financial institutions with healthy sense of fear, until you need to act to stop a panic.

Impose tougher conditions on access to emergency support in the event you have to extend that support to institutions that are “systemic.” Provide liquidity and guarantees at a price, below the levels prevailing in a panic, but well above normal conditions, to limit the risk of prolonged use or abuse.
The Challenge for Democracies

The consequences of limiting discretion, and the asymmetry of discretion across policy tools
Democracies have evolved a mix of checks and balances for circumstances where it makes sense to provide discretion for action in emergencies.

Need to introduce more discretion and power in the financial arsenal.

The financial crisis framework should recognize that success requires allowing the government and central bank to take risks the market will not take and losses the market cannot absorb.

And needs flexibility for speed and ability to adapt.
Are we safer?
Living with the current mix of constraints is dangerous for the United States.

And it is irresponsible, given the importance of the U.S. financial system and the dollar to the world economy.

We should try to rebuild the arsenal of emergency authorities and invest more in learning how best to deploy those authorities in crises.
Wars vs Financial Crises

Battle Deaths per million of world population

Financial Crises, share of world GDP
We Can Do Better.