

To the Fed: Don't *Overreact* to Financial Crises

William A. Niskanen

The Federal Reserve System has two instruments to avoid or counter financial crises: Bank regulation may reduce the frequency and magnitude of financial crises. And open market policy may be used to counter a financial crisis once underway. My judgment is that the Federal Reserve has *overreacted* to prospective financial crises in the design of regulations and the use of open market policy to counter specific crises.

Regulation

Government-sponsored deposit insurance and our complex system of bank regulation are both defended as necessary to reduce the frequency and magnitude of financial crises. Deposit insurance is defended as necessary to reduce the frequency of bank runs, but it creates two moral hazards: The incentives of depositors to monitor banks is reduced, and the incentives of bank managers to make risky loans is increased. And bank regulation, in turn, is defended as necessary to offset the moral hazards caused by deposit insurance. This combination, although usually successful in reducing bank failures, increases the interest rates on bank loans. And when it is not successful, the taxpayers are liable for the losses on the insured deposits.

William A. Niskanen is the chairman of the Cato Institute

There are several problems, however, with this public interest rationale for deposit insurance and bank regulation. First, the underlying *political* rationale for both deposit insurance and some regulations has been to protect small banks against money center banks or the banks of a given country from foreign banks. The former U.S. restrictions on branch banking and interstate banking are examples of the use of regulation to protect small banks against the money center banks; these restrictions, by limiting competition and the opportunity for regionally-diverse loan portfolios, led thousands of U.S. banks to fail during the Great Depression, whereas not one Canadian bank failed during this period. The Basel I restrictions on bank loan portfolios seem to have been designed primarily to reduce the penetration of Japanese banks in the United States and Europe, and they had this effect, but these restrictions also led to no growth of commercial and industrial loans by U.S. banks from 1989 through 1994 – probably contributing to the 1991 recession and the slow subsequent recovery of employment.

Second, the combination of deposit insurance and bank regulation has not always been effective, sometimes at great expense to the taxpayers. We are now fortunate that the authors of a major recent book -- *Rethinking Bank Regulation: Till Angels Govern* (Barth, Caprio, and Levine 2006) -- have surveyed and analyzed the bank regulation and supervision in over 100 countries. As summarized by a reviewer of this book (Anderson 2006)

The book concludes that increasing the powers of official bank supervisors does not reduce the likelihood of banking crises nor does it compensate for the reduced private-sector monitoring caused by deposit insurance.

About two-thirds of low- and medium-income countries have

had major banking crises over the last 30 years. They have cost their governments up to 40 percent of GDP to compensate the depositors. Surprisingly, almost the same proportion of high-income countries

have also had large-scale bank failures. We have only to look at the savings and loan fiasco in the United States in which roughly 3,000 banks failed, costing taxpayers \$180 billion.

Their research “raise[s] a cautionary flag regarding reliance on direct official oversight of banks, government ownership of banks, generous deposit insurance, and regulations that restrict bank activities and impede the entry of new domestic and foreign banks.” The authors conclude that countries should instead “focus on improving and empowering the private market’s ability to monitor and discipline banks.”

Similarly, a recent review of academic studies of bank capital regulation (VanHoose 2006) concludes that “ ... the intellectual foundation for bank capital regulation in general and for the proposed Basel II system specifically is not particularly strong. Instead of expanding the scope and complexity of the current system of capital regulation, it may be time to contemplate alternative approaches to bolstering the safety and soundness of the banking system.”

What is one to make of these findings? At a minimum, this record should lead monetary specialists in both the academy and government to question whether the problems of deposit insurance and conventional bank regulation are best reduced by adding even more complex regulations such as Basel II. Second, at least until these issues are sorted out, we should stop promoting conventional bank regulation as a condition for receiving governmental aid or World Bank and IMF loans. And third, we should seriously consider replacing deposit insurance and conventional bank regulation by regulating bank deposits like other financial securities are regulated, as New Zealand has already done.

As on so many economic issues, those engaged in this process of rethinking bank regulation may best start with the observations of Adam Smith (1776) that

The statesman, who should attempt to direct people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be as dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.

Open Market Policy

On the outbreak of a financial crisis, the Federal Reserve faces two questions: Whether to respond to the crisis? And by how much? My observation is that the Federal Reserve responds too often to financial crises by open market policy that increases the variance of nominal demand in the United States

First, it is important for the Fed to leave some uncertainty about whether it would respond to a financial crisis by open market policy in order to encourage better risk-management by other institutions. The primary criterion for an open market response to a financial crisis, I suggest, should be whether it is likely to create a systemic risk to the U.S. banking system that reduces the growth of nominal domestic demand. Despite the increasing public concern about the magnitude of the risk of hedge funds, for example, I suggest that the Fed has responded appropriately to the collapse of two large hedge funds. Following the collapse of Long Term Capital Management, the Fed's response was limited to organizing the restructuring of this fund. And with no apparent Fed response to the recent collapse of Amaranth, the markets reacted calmly. Not responding to what others may regard as a financial crisis provides important information to the market.

Several times in the past twenty years, however, the Federal Reserve has responded to a financial crisis with vigorous open market policy. At the risk of boring some of you, my discussion of this issue is based on the same graph that I presented at this conference last fall with the addition of data from the most recent four quarters.¹ The graph shows the percent *difference* from the trend rate of increase of demand from the third quarter of 1987 through the third quarter of 2006. My measure of demand is the nominal final sales to domestic purchasers. Domestic demand increased at a 5.4 percent annual rate during this period, consistent with an increase of real GDP at a 3 percent annual rate and an average inflation rate of 2.2 percent. Although the standard deviation around the demand trend was only 1.4 percent, this variation had significant effects on asset prices and the real economy, and most of this variation was a consequence of the Fed's response to financial crises.

The Fed's characteristic response to a financial crisis during this period was to put a lot of money in the market quickly and then slowly take it out. The first unusually large increase in demand was clearly a consequence of the Fed's response to the large decline in U.S. equity prices in October 1987, only two months after the confirmation of Alan Greenspan. This response led to higher real economic growth in 1988 and 1989 than most experts had forecast. In turn, Fed tightening to deflate this demand bubble contributed to the shallow recession of 1991.

The second unusually large increase in demand was clearly a consequence of the Fed's response to a series of foreign and domestic financial crises beginning with the

1. Much of this discussion is the same as in my 2006 article on "An Unconventional Perspective on the Greenspan Record."

Asian crisis of 1997, sustained by the collapse of Long Term Capital Management and the Russian default in 1998, and ending with the Brazilian devaluation and the anticipated Y2K crisis in 1999. The Fed's easy money policy led to a bubble in aggregate demand that was roughly synchronous with the equity bubble, and Fed tightening to deflate the demand bubble contributed to the sharp reduction in equity prices and the shallow recession of 2001.

It is less clear what triggered the third large increase in demand. Some have suggested that the events of September 11, 2001 led to this increase, but this is not clear because demand did not begin to increase rapidly until the beginning of the Iraq war 18 months later. In any case, the most recent increase in demand now seems to have peaked, and the lower growth in demand has been reflected in a sharp decline in the residential housing market and a lower growth of real GDP. Ben Bernanke's next major challenge will be to avoid the recession that may be a consequence of deflating the demand bubble that he inherited from Alan Greenspan.

The major lesson from this graph is that most of the variation in demand during this period was triggered by the Fed's response to financial crises. A second lesson is that the Fed seems to overreact. A reasonable standard by which to judge the Fed's response to a financial crisis would be to avoid a *decline* in the growth of demand relative to the target path, but, in each case, the Fed's policy led demand to increase relative to the target path. A third lesson from this record is that the deflation of the demand bubbles caused by overreacting to financial crises led to the sharp reduction in equity prices in 2000 and 2001, the sharp decline in of the residential housing market in 2006, the two

shallow recessions during the Greenspan years – and, maybe, another shallow recession in 2007.

Conclusion

The conventional perspective on this issue is that the Fed faces a tradeoff between the potential near-term contagion effects of a financial crisis and the longer-term problem of moral hazard, and that the Fed is biased in favor of reducing the near-term contagion effects. The record of the past 20 years suggests that there is another potential long-term cost of responding to a financial crisis by open market policy – the increased probability of a recession following the deflation of the demand bubble caused by the Fed's overreaction to a crisis.

I do not mean to imply that the Fed should never respond to a financial crisis. My objective is to induce more analysis about how to minimize the combined effects of a financial crisis and the Fed's response to it on the Fed's primary mission – to maintain a steady increase in nominal demand consistent with a low target rate of inflation.

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