

SHOULD POLICY ATTEMPT TO AVOID FINANCIAL CRISES?

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The 2008 financial crisis and the 2007–09 recession have predictably spurred interest in how policy can avoid financial crises. A prior question, however, is whether policy should avoid financial crises. The answer might seem obvious. But I argue here that if policymakers focus on avoiding crises, they will generate undesired side effects and typically fail to avoid crises in any case.

My argument has four steps. First, avoiding crises is not, in and of itself, the right goal for policy. Second, as a matter of theory, the costs of crises are not necessarily large. Third, as a matter of evidence, the costs of crises do not seem to be enormous. Fourth, whatever the costs of crises, anti-crisis policies might be worse than the disease.

What Is the Right Objective for Policy?

The single most important objective for economic policy is a high level of income per capita, or, taking a dynamic perspective, a high growth rate for income per capita. That is, the primary objective of policy should be maximizing the size of the economic pie, because this facilitates all other goals.

A second goal for policy might be reducing economic volatility, the variation in output growth around its average rate. This goal makes sense if economic agents are risk averse, but tradeoffs might exist between an economy's average growth rate and the variability of this

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growth rate. Changes in technology or other real shocks to the economy can improve growth over the long haul yet increase variability in the short term. The arrival of the Internet, for example, might have spurred reorganizations that initially slowed growth but ultimately enhanced it. Alternatively, oil price hikes might reduce growth and increase variability while leaving policy with few options to mediate either impact. Thus, the goal of reduced variability should be treated with caution.

The crucial issue is then whether financial crises play a causal role in lowering output growth or increasing volatility. If so, then avoiding crises might make sense as an intermediate target. But if crises have only a modest impact on growth and volatility, or if crises are mainly a symptom of poor economic performance rather than a cause, then targeting crises is a less obvious goal.

Are Crises Bad for the Economy? Theory

The next question is whether, as a matter of theory, financial crises are necessarily bad for the economy. Popular opinion, and much of the economics profession, now takes this conclusion as given, but it is not the only defensible view. Consider, in particular, banking crises like those the United States experienced before the founding of the Fed in December 1913, or during the Great Depression, or in the 2008 financial crisis.

Banking crises occur under the following conditions. One or more banks suffer losses on their loans, reducing bank net worth and impairing liquidity. If the losses are modest and the banks are small, the repercussions for broader financial markets are modest.

If the losses are larger, however, and concentrated at large institutions, then further impacts are likely. The banks that suffered initial losses may call in loans from other banks, who may then suffer fire-sale losses as they try to make good on counterparty claims.

What happens next? Because of the loan defaults, someone is poorer, and policy cannot change this fact. After the recent bursting of the housing bubble, for example, policy could not alter the fact that homeowners and mortgage lenders had lost considerable wealth. Policy can affect who bears the losses, via bankruptcy rules, too-big-to-fail (TBTF), and the like, but it cannot recreate the wealth that has disappeared. When reality falls short of expectations, someone takes a hit.

Other than this loss of wealth, however, nothing else about the economy's path need change. Any investment project that made sense before the defaults and failures should still make sense, setting aside the possibility that defaults on one kind of loan contain information about other kinds. The fact that housing was overvalued, for example, does not mean that pharmaceuticals, or fracking, or social media has become any less valuable.

Thus, someone in the economy should be willing to finance any good investment project, even though some loans have defaulted and some banks have failed. Neither the fact that the economy's wealth is lower, nor the fact that it has been reallocated between borrowers and lenders, necessarily changes what is available going forward, so bank failures should have no independent impact; they are merely reflections of losses that have already occurred. Wealth declines, but future investment should not.

To conclude that crises should be avoided, therefore, requires a different view on the nature of crises. This alternative story holds that bank failures not only redistribute wealth but also reduce investment and growth because of an externality. This view, attributed especially to Ben Bernanke (see, for example, Bernanke and Gertler 1987, Bernanke 1983, and Bernanke and James 1991), holds that asymmetric information between lenders and borrowers makes bank lending special: When a bank fails, this destroys "intermediation capital," which is the bank's ability to disentangle the information fog and make productive loans. This loss in intermediation capital means reduced lending, investment, and growth.

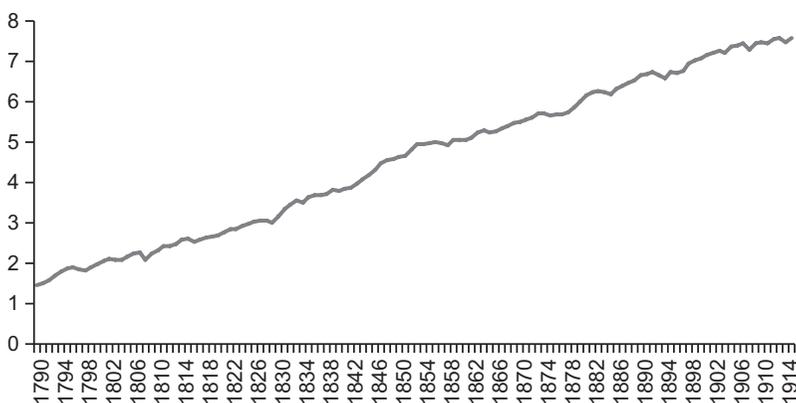
The externality view is not implausible; bank failures probably impede lending to some degree, for some period of time. But whether this impairment is large, and how sustained, are empirical questions.

Note also that when a substantial sector of the economy declines, generating substantial losses or defaults on the relevant lending, it might be because that sector was overbuilt. In this case, it is efficient for lending and investment in that sector to decline. If a housing construction boom and price bubble burst, for example, mortgage lending should decline and housing construction should contract, until depreciation and growth generate a better match between housing demand and supply. Thus, if investment declines after a financial crisis, that is potentially the desired outcome from the perspective of economic efficiency.

Are Crises Bad for the Economy? Evidence

Figure 1 presents annual data on industrial production for the period 1790–1915. This is the period before the founding of the Federal Reserve, and a period in which the United States experienced several financial crises.¹ These were widely decried as costly, and the desire to eliminate them was a key reason for creation of the Federal Reserve.

FIGURE 1
LOG OF INDUSTRIAL PRODUCTION, 1790–1915



SOURCE: Davis (2004).

The striking feature of the graph is the steady increase in industrial output over this period, with only minor indications of panics or recessions. Indeed, if one were not aware of the dates of so-called financial crises, one might have a hard time identifying them from the graph. Major panics occurred in the 1830s, 1857, 1873, 1893, and 1907 (Jalil 2012). Production does slow around those dates, but not severely or persistently. Joseph Davis (2004: 1177), who constructed these data, notes that “the index also demonstrates that the pernicious deflationary depressions that purportedly followed the financial panics in 1837 and 1873 were actually rather mild recessions when expressed in real output.” Thus, the pre-Fed data do not suggest a major impact of panics on the economy’s growth rate.

¹The exact number and timing depends on which accounting one accepts; see the discussions in Selgin, Lastrapes, and White (2012) and Jalil (2012).

Table 1 compares output growth across periods with panics (1869–1914) and (mainly) without panics (1947–2009). The table shows that growth was only modestly lower during the pre-Fed period, when a number of financial panics occurred, compared to the post-WWII period, when panics were absent until 2008. This fact makes it difficult to argue that panics played a *large* role in slowing economic growth. Similarly, Selgin, Lastrapes, and White (2012) show that although volatility declined between the pre-Fed and post-WWII periods, the magnitude of the decline was modest. Again, therefore, panics do not appear to have a *large* impact on output dynamics.

TABLE 1
ANNUAL GROWTH RATE OF GNP PER CAPITA,
PRE-FED AND POST-WWII

	GNP	GNP Romer	GNP BG
1869–1914	1.47	1.70	1.75
1947–2009	1.98	1.98	1.98

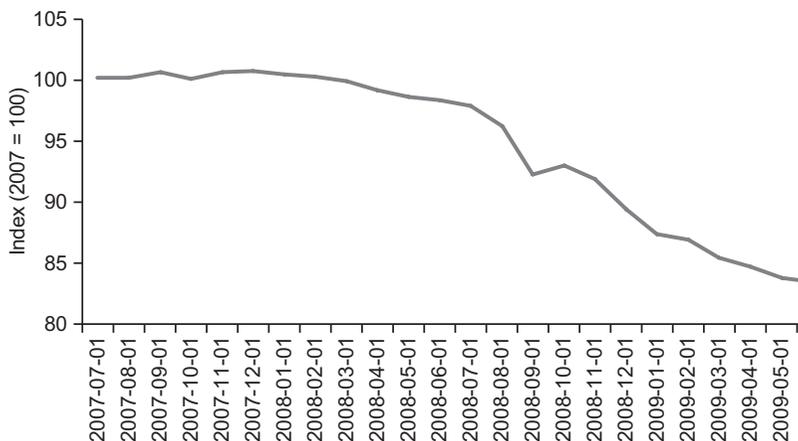
SOURCE: Miron (2012).

Advocates of the view that panics cause substantial output declines might still point to the Great Depression and the 2007–09 recession as empirical support. In each case a financial crisis or crises coincided with large output losses, which might seem to show that crises are harmful. Several caveats, however, are in order.

First, the Great Depression and the 2008 financial crisis are two episodes out of many. The broader accounting discussed above does not suggest as dramatic an impact of crises as these two episodes taken in isolation. In particular, many minor crises never became major crises, and many major crises were not associated with unusual output declines.

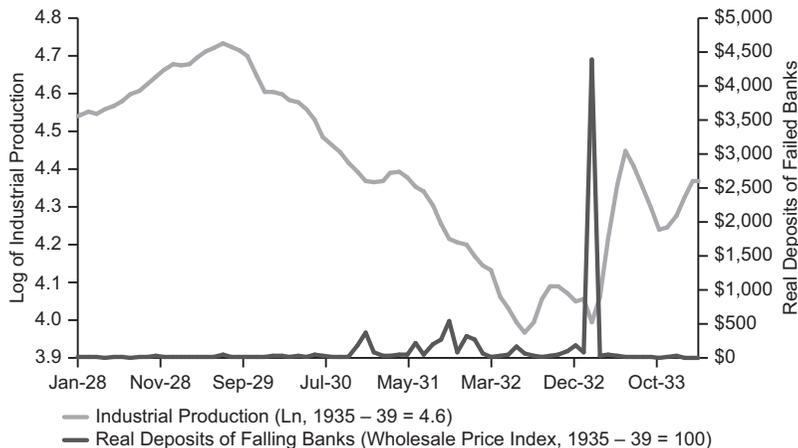
Second, in both cases, substantial output declines were under way before the panics kicked in. Figure 2 shows U.S. industrial production for the period July 2007–June 2009. A recession was under way, and nontrivially, long before Lehman’s collapse in September 2008; indeed, about half the reduction in industrial production had already occurred. Figure 3 shows a similar picture for the Great Depression,

FIGURE 2
INDUSTRIAL PRODUCTION INDEX, 2007–2009



SOURCE: Federal Reserve Bank of St. Louis Economic Research, “Industrial Production Index.”

FIGURE 3
INDUSTRIAL PRODUCTION AND REAL DEPOSITS OF FAILED BANKS, 1928–34



SOURCE: Federal Reserve Bank of St. Louis Economic Research, “Liabilities of Business Failures, All Commercial for United States”; Federal Deposit Insurance Corporation, “Deposits of Failed Banks, 1936–1941.”

along with Bernanke's (1983) chosen measure of panics, the liabilities (deposits) of failed banks. A major decline in production occurred before the first significant panic, and the rate of decline did not change after that panic.

Third, and perhaps most importantly, governments undertook a large range of problematic policies in response to the early stages of both contractions, and these may explain much of the extended declines. In the case of the Great Depression, monetary policy, trade policy, and fiscal policy were all problematic in the early years of the downturn. In the case of the 2008–09 recession, wasteful stimulus programs, costly financial regulation, the likelihood of increasingly redistributive taxation, the demonization of business success, the failure to address entitlement growth, and the adoption of Obamacare were all likely to depress the economy independent of the financial crisis.

On a related note, Reinhart and Rogoff (2010) emphasize that economic recoveries from financial crises tend to be slow, but the question is, why? One explanation is the structural imbalances that caused the crisis, such as the overbuilding of the housing stock, take time to reverse, so recovery is slow not because of the crisis but because of the factors that caused the crisis. Another explanation is that crises, more than regular recessions, generate new, wealth-destroying policies, which retard recoveries. Under either interpretation, financial panics may be associated with severe recessions, without themselves playing a causal role.

To summarize, crises may play a role in generating output declines, but they do not appear to be so deleterious that policy should be obsessed with avoiding them. Rather, policy toward crises must depend on both the potential benefits of avoiding them and on the potential costs of these policies.

Are Anti-Crisis Policies Good for the Economy?

The crucial aspect of anti-crisis policy is the too-big-to-fail doctrine, under which policy prevents the failure of large financial institutions via Treasury bailouts, central bank lending, low interest rates, targeted purchases of problematic assets, and the like. The standard justification, consistent with the foregoing discussion, is that failures will disrupt the economy's lending mechanism and thereby reduce investment and output. Relatedly, advocates of TBTF believe that

during crises, large financial institutions are illiquid rather than insolvent, so temporary assistance will not be costly over a longer horizon.

Whatever the merits of this view, TBTF has potentially serious costs. Most importantly, the risk insurance implied by TBTF is likely to generate excessive risk taking, which fosters overinvestment in risky activities. The excess buildup of the housing stock during the housing boom is a textbook example. It is not trivial to quantify the moral hazard caused by TBTF, but few economists would deny that if TBTF becomes ingrained in the market's psyche, it will have significant deleterious effects.

A different effect of TBTF is erosion of policy neutrality toward different sectors of the economy. For example, now that the housing, banking, and auto sectors have received bailouts, it is a smaller leap to believe that other sectors, such as municipal or student debt, might receive them as well. This expansion, and potential politicization, of the Fed's mission was less of a risk when the Fed only bought Treasury debt.

One response to the tradeoff between the costs of crises and the costs of TBTF might seem to be regulation. According to this view, legal restrictions on the risk taking behavior of banks and other financial institutions—such as those being developed under Dodd-Frank—can prevent banks from undertaking excessive risk, thus avoiding the need for TBTF.

Such a fortuitous outcome seems unlikely, however. If financial market participants believe that TBTF is operative, they face a strong incentive to find ways around the regulation. A good example is the run-up to the 2008 crisis. The Fed, the Treasury, the SEC, and other regulatory bodies had ample tools to have pushed back against the aggressive risk taking and the accounting gimmickry designed to cover it up, yet these regulatory bodies failed to act.

So regulation is unlikely to be a solution. Certain kinds of regulation might nudge outcomes in a beneficial direction for a while, but if TBTF is the prevailing policy stance, regulation will not work for long.

Conclusion

My point here is part of a larger concern. No one likes the economic volatility or disruptions that accompany financial crises, so it is tempting to believe that government policy can reduce or eliminate

them. Yet experience to date does not suggest that governments are good at eliminating volatility; indeed, in many instances, governments contribute to volatility. And, the policies that seek to reduce volatility have their own adverse consequences, chiefly the moral hazard created by implicit or explicit insurance.

But theory and evidence do suggest a simple way to improve an economy's average growth rate: reduce the size of government and let markets operate more freely. Thus, the more robust stance for policy is to emphasize growth and let the volatility chips fall where they may.

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