Summary of the Commentary

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This book is based on presentations given at the joint conference on "The US Financial System—Five Years After the Crisis" of the Brookings Institution and the Hoover Institution on October 1, 2013. Questions and comments from members of the audience at both the Brookings Institution and the Hoover Institution followed the presentations. This chapter is a summary of the discussion, organized into sections that correspond to the four parts of this book.

Causes and Effects of the Financial Crisis

Commenting on Lawrence Summers's presentation (see chapter 2), **Peter Thiel** suggested that the decoupling of the real economy from the financial economy goes back further, starting with the recovery of the early nineties that was much slower than predicted by macroeconomic models. Even though the interest rate was very low for a long time back then, the transition mechanisms to the real economy were broken. In addition, Thiel pointed to the tech bubble in the late nineties as a predecessor to the bubble in the housing and financial markets in the 2000s.

Thiel further suggested heavy micro-regulation as an alternative to poor macroeconomic policies as a cause for the slow recovery. Even with low real interest rates, investors are not finding many good opportunities in the real economy, as evidenced by low capital expenditures. He noted that a lot of this micro-regulation comes under the header of environmental regulation, so that a debate on the cost of environmental regulation would be needed. As an example, he estimated that abandoning all zoning laws in the United States would lead to a rise in gross domestic product (GDP) growth in the following year by 6 percent.

Lawrence Summers pointed out that there were several years in the nineties with positive real interest rates, a robust economy, and no strong evidence of bubbles. Therefore, he doubted that the decoupling of the real and financial economies goes back twenty years. Summers agreed with the concerns about regulation. He pointed out that in 1903, before the bulldozer had been invented, the Harvard football stadium was conceived and built in just twenty-one months with a building time of just four and a half months. This would no longer be possible in today's regulatory environment, despite technological progress. However, he doubted that there was a discontinuity in regulatory policies between the years 1980 and 1989, given the political constellation in the United States. Hence, he did not fully agree with Thiel's theory that micro-regulations were causing slow recoveries but noted that regulatory issues can form a part of resolving slow growth. Summers also said that the burden of environmental regulation on investment is unlikely to be large enough to cause slow GDP growth. In addition, he noted that unprecedentedly punitive and burdensome regulation would be associated with low corporate profits as a share of corporate output, which is not supported by the data. However, Summers recognized the importance of the issue that Thiel was raising.

While **John Taylor** did not disagree with Thiel that increased micro-economic regulations were a factor in the slow recovery, he noted that Stanford had recently built its football stadium in only nine months, tearing down the old one after the end of the 2005 season and building a new one before fall 2006, notwithstanding modern environmental regulations. He further commented that the slow recovery from the deep downturn was very unusual in comparison with most of US history. In contrast, a mild recovery of the early 1990s was not unusual because it followed a mild recession. In his opinion, however, the causes for both the deep recession and the weak recovery were changes in policy that occurred more recently than the longer-term increases in environmental regulation.

Lee E. Ohanian brought up long-run supply-side policies. Indicators for many of the key drivers of economic growth—such as entrepreneurship, new business formation, job creation, and job reallocation (moving workers from less productive to more productive positions)—have deteriorated substantially since the 1990s. Traditional economics suggests a number of policies to address these issues. He said that there is broad consensus among economists about immigration reform to bring in high-skilled workers and entrepreneurs and a lot of discussion about corporate tax reform. Ohanian inquired whether these trends suggest significant, substantive problems with the underlying economy and what policies should be considered to alleviate them. He argued that these long-run problems were more important than the short-run demand issues highlighted by Summers.

Lawrence Summers agreed with economists' consensus on immigration reform, a general desire to have the economy function more efficiently, and a desire to remove tax barriers to investment. He noted that the economists at the Brookings Institution and the Hoover Institution might disagree on whether the economy is demand-constrained. If a market is constrained by a lack of demand and supply is increased, the level of output won't rise. He pointed to a recent study on training programs in different French localities.[1] The study found that in all localities, the people who got trained were more likely to get jobs than the people who did not receive training. In the localities that previously had full employment, more training led to more employment overall. However, in the localities with high unemployment previously, the training programs did not lead to an increase in the total level of employment, since those who received no training were less likely to find a job due to the stiff competition from people with training. This demonstrates that increasing supply does not matter when there is a constraint on demand. Summers argued that in the past several years and for several years in prospect, the US economy likely has been and will be substantially demand-constrained. Therefore, while he supports supply-side agendas, he did not think that they address the pressing near-term challenges. However, Summers also noted that focusing only on the near-term demand challenges would be a mistake, in particular since supply-side measures take years to implement. He also noted that the sense that successful long-run supply-side measures are being put in place contributes to confidence, which may lead to increased demand in the short run. Summers concluded that while supply-side policies are important, the current constraint on the economy stems from the side of demand.

Sheila Bair noted that one problematic aspect of loose monetary policy is that it papers over the underlying structural problems in the economy that can only be dealt with by elected officials. Therefore, it absolves political leaders of accountability to show leadership on these structural changes. Bair agreed that immigration reform is important. She also pointed to the importance of infrastructure improvements for the competitiveness of the US economy and emphasized that government

1. Bruno Crépon, Esther Duflo, Marc Gurgand, Roland Rathelot, and Philippe Zamora, "Do labor market policies have displacement effects? Evidence from a clustered randomized experiment," published as NBER Working Paper 18597, December 2012.

plays a necessary role in infrastructure repair. She added that the United States needs to become more competitive in the global economy so that there will be increased demand for its goods and services. However, competing on the basis of labor costs is difficult and undesirable. Bair instead pointed to a better-trained workforce, better infrastructure, and lower energy costs. She said these areas—in particular, infrastructure and job training—require the long-term commitment of elected officials, an effort that will pay off over time. In the shorter term, she noted that corporate tax reform is a low-hanging fruit, since there is a tremendous amount of inefficiency in the corporate code. By broadening the tax base, the top rate can be reduced. Bair pointed to very viable proposals for corporate tax reform put forward by very smart people and expressed her astonishment at the lack of progress in this area.

Bair said she wondered whether the political leadership can show the wherewithal to stand up to the special interests that benefit from various breaks in the corporate tax code. She argued in favor of closing loopholes and broadening the tax base, which would make the corporate tax rate more competitive. This would abolish a tremendous friction in the system and enable a substantial repatriation of foreign profits. There should be much more focus on corporate tax reform, she argued.

Paul Saltzman inquired whether more policymakers should have predicted the crisis and how the insights gained from the recent recession will affect our ability to predict future crises.

Kevin Warsh noted that the goal of the Dodd-Frank regulations and the burden assumed by the Federal Reserve is to make sure bad economic outcomes never happen again, using new power, authority, and macroprudential remit. He agreed that, coming out of the crisis, we have learned lessons about sources of instability in the economy. He expressed concern, however, that the Fed is over-promising and hence might under-deliver. Betting an institution's credibility on its ability to predict and prevent crises is risky, in particular for the Fed, whose institutional credibility is tested every day in financial markets.

Warsh also pointed to a second-order consequence of the current aggressive monetary policy: it removes a lot of volatility from financial markets. This might have benefits through wealth and confidence effects in the near term. However, he was concerned that markets are no longer able to point regulators and government officials to areas of the economy where problems are building up. Measures of volatility in equity markets, fixed income markets, and capital markets more broadly are low globally, but perceived risk from news reports is high. He concluded that risk is highest when measures of risk are lowest and that the aggressive central bank policy might therefore generate greater risks in the long run.

Finally, Warsh expressed great concern that the novelty and aggressiveness of the government's policy response in recent years may have fundamentally altered the behavior of businesses and households on the front lines of the economy. Hence, a reduction in our economy's dynamism would correspond to the weakness of the recovery to date.

John Taylor commented that financial crises are always very hard to predict. However, economic imbalances are what to look for, which was the case with Fed policy in the early 2000s. Taylor pointed to the yen/dollar exchange rate in 2012 as another example where economists were detecting imbalances. He cautioned that while it may be possible to detect imbalances, predicting the exact moment when markets will move to correct the imbalance is very hard.

Lawrence Summers argued that we can't expect to anticipate crises and forestall them with public policy. He gave two reasons. First, financial crises involve major movements in the price of some asset. Since vast fortunes can be made by reliably predicting major moves in asset prices, individuals who are smart enough to do that are likely to become investors and not regulatory officials. Thus, investors are likely to be better than regulators at predicting moves in asset prices. And if there were a consensus that a price was going to move in a major way, it would have already moved since the number of sellers exceeded the number of buyers. Summers concluded that the notion that public policy is able to predict crises is epistemologically problematic. Similarly, if there is an imbalance that predictably leads to a crisis, then noticing the imbalance is the basis for a sound trading strategy, which is more likely to be discovered by the private than by the public sector.

Second, Summers pointed out that the essence of a bubble is a widely shared and pervasive view that turns out to be wrong. In a democratic society, the government acts on prevailing and consensus beliefs. Asking the government to be a systematic opponent of prevailing consensus beliefs is not likely to be successful. Therefore, Summers argued that financial regulatory policy is unlikely to be able to anticipate and prevent crisis. Instead, we need to recognize that aspects of human nature such as greed, stupidity, herd behavior, fear, and revulsion will not change, and set up a regulatory system that is safe for a world with these features of human nature. This includes provisions for capital buffers and liquidity. Summers then drew an analogy to the late senator Daniel Patrick Moynihan's first major policy initiative, an essay on automobile safety. Before Moynihan's essay, the dominant paradigm for addressing automobile safety was drivers' education. Moynihan, however, realized that people have faults and they are going to drive too fast, get tired, or misuse the steering wheel. Even with excellent drivers' education, accidents are going to happen. Seatbelts, banked highway curves, guard rails, and crash-proof bumpers were a superior strategy. Since then, the fatality rate per vehicle mile has decreased by a factor of ten. Summers's vision of success for financial regulation was that a failsafe system is a system that's safe for failure, not one that can realistically aspire to avoid failure, accidents, and mistakes.

Sheila Bair commented that while it is not hard to see a crisis building, predicting the precise timing is hard. In the case of the recent crisis, it was not difficult to see a housing bubble and over-leveraged financial system. However, she argued that taking action before the crisis erupts is problematic since market participants are making a lot of money as long as the bubble is building, so regulators would have to fight popular sentiment.

Commenting on Summers's presentation, **Martin Baily** disagreed with the notion that the financial sector is fully restored, which would rule out problems in the financial sector as a cause for slow growth. Instead, he suggested that the financial sector is still focusing on fulfilling regulatory requirements, as opposed to evaluating the riskiness of loans and focusing on risk management. For that reason, the availability of funds from the financial sector has not yet been fully restored. In addition, Baily asked why the policies targeted at the lack of demand—both quantitative easing and fiscal stimulus—have not returned the economy to full employment. His reservation on this issue was that the United States has been running large trade deficits for a long time, and that people in the nineties and early 2000s have argued that there was too much consumption, suggesting excess demand, not excess supply. Even in the current environment, the US trade deficit is at 4 percent, which makes it hard for the US economy to get back to full employment. Baily suggested that this might be done by improving competitiveness, or by adjusting the dollar, or perhaps it would turn out not to be possible at all due to economic weakness in the rest of the world.

Lawrence Summers agreed with both points. He noted that there are regulatory headwinds that constrain lending by financial institutions. However, it can also be argued that these are necessary corrective regulations of pre-crisis excesses. He pointed out that if we returned to prudent behavior in the financial sector, similar issues on regulation would remain on the agenda. In commenting on the international aspect, Summers noted that he had urged the administration in early 2010 to set a goal of doubling exports over five years and to organize energy around that goal. He said that in comparison with the other countries in the industrialized world, the United States is a natural capital importer given its demographics and the capacity of the US economy to innovate. He also pointed out that there is a global aspect to the determination of the real interest rate. Summers said that the structure of the global economy and the US economy currently implies that full employment is only attained at real interest rates that are uncomfortably low from the point of view of financial stability. He suggested that the solution is to accept low interest rates, to promote various kinds of public investments, to reduce foreign surpluses, and to promote net exports. In addition, he suggested avoiding major fiscal contraction. However, he argued that the lesson from five years before and after the crisis is that business as usual does not necessarily produce a healthy, fully employed economy and that this lesson has not been drawn in the debate so far. He noted that policies involve trade-offs and expressed concern about a policy agenda solely pursuing financial stability, which seems to currently be congealing into conventional wisdom. The elements of this financial stability agenda are (1) that loose money needs to be avoided because it produces bubbles, (2) that more regulation is needed since insufficient regulation generates bubbles, and (3) that fiscal consolidation is required because long-term debts are a problem. Summers argued that this agenda does not add up to a growth strategy and that the economy has been demand-constrained for a long time. He stressed that the economy is not naturally fixing itself in the way one might have expected in an era of 4 percent inflation and 6 percent nominal rates that could freely be adjusted downward to accommodate demand constraints.

The Federal Reserve's Role

Following the presentations on the role of the Fed (chapters 5–8), **Donald Kohn** commented that although unconventional monetary policy might produce distortions in asset markets, it was also addressing a large distortion in the real economy—high unemployment and underutilized capital—and the costs of the asset distortions needed to be weighed against the problems in the real economy. From the presentations, he gathered that the prescription for monetary policy is to avoid using unconventional monetary policy. In the absence of unconventional monetary policy, interest rates would be higher. Kohn asked whether lowering the interest rate on excess reserves, as had been advocated in the presentations, and reducing uncertainty would be enough to offset the effects of the rise in the interest rate on economic activity that follows from withdrawing unconventional monetary policy in the face of current restrictive fiscal policy.

Peter Fisher pointed to the slope of the yield curve and expressed his objections to the Fed suppressing the term premium by buying long-term bonds and selling short-term bonds in Operation Twist. He noted that the Fed's model is that a reduction in interest rate will unequivocally lead to increased investment. However, this effect is lowered as the long end of the yield curve approaches zero because of portfolio investors' reasonable concerns about a future backup in rates. In addition, he expressed concern about the perverse effects of prolonged, low long-term rates on business investments.

Donald Kohn inquired whether Fisher wanted the yield curve to be more sloped and whether higher interest rates would be better for the economy. Fisher conceded that he thought somewhat higher and more predictable *long-term* interest rates would be better and argued that suppressing the term premium through extraordinary policies has discouraged business investment.

Alan Blinder disagreed and noted that, in his opinion, it was appropriate to decrease medium- and long-term interest rates, since these are the interest rates that matter for economic transactions—unlike the standard tool of monetary policy, the federal funds rate. He noted that the argument for reducing the interest on excess reserves (IOER) is that quantitative easing is a weak instrument. Since the Fed is rational, it picks the low-hanging fruit first and then moves to higher-hanging fruit. Now it is pretty high up in the tree, and the effects of additional quantitative easing are limited. So IOER is another potential tool for the Fed, though not a panacea. Blinder argued that the first-best solution would be to have additional room to decrease the federal funds rate but that this is not in the realm of choice, given the zero lower bound. So second- and third-best instruments need to be used, one of which is the IOER. He noted that using the IOER as a tool would also have the side benefit of calming critics who argue that the Fed's balance sheet is out of control, since the Fed could reduce its balance sheet as banks disgorge some of the reserves and still contribute positively to the economy. Blinder, however, cautioned that there is not much experience with these tools.

Allan Meltzer pointed out that he is not opposed to unconventional monetary policy and supports security purchases once the federal funds rate reaches the zero lower bound. He noted that buying longer-term securities has the same effects on the economy as conventional monetary policy via the federal funds rate, except in some long-run models. The Fed chooses not to do that, because it takes the first-round effects and then locks up the reserves as idle. Meltzer suggested the opposite: fewer increases in reserves and more increases in money growth. He referred to the case when Japan initiated quantitative easing: Japan's money supply growth increased and output rose more rapidly. In the United States, on the other hand, asset purchases only result in small output effects and large increases in stock prices and excess reserves; the monetary effects seen in Japan are absent. Meltzer agreed with Blinder on dropping the interest paid on excess reserves to zero. He argued that this had very good efficiency effects and pointed to the fact that half of the payments—$5 billion in interest and reserves—goes to foreign banks' branches in the United States. Blinder suggested that lowering the interest on excess reserves must be a non-controversial issue, given that both he and Meltzer agreed on it.

Michael Bordo agreed that keeping the interest rate on excess reserves high had been a mistake, citing the situation in the 1930s and the case of Japan as examples. With respect to interest rates, Bordo suggested that raising short-term rates to up to 2 percent could help normalize the situation in financial markets. The benefits of this normalization might outweigh the potential costs of a short-term slowing of the economy.

Paul Saltzman brought attention to the shadow banking system, pointing out that a significant portion of financial intermediation is provided by nonbanks. He inquired whether the notion that banks will continue to be the principal channel of monetary policy transmission is the working assumption of the presenters' opinions on monetary policy. He also asked how the growth of the shadow banking system might challenge this assumption.

Allan Meltzer said that the shadow banking system would not pose a problem if it were allowed to mark to market completely. The shadow banking system is a result of the Federal Reserve Board's regulation Q, which capped interest payments on checking and savings accounts. The government did not want to repeal or circumvent regulation Q, so it decided to allow mutual funds to create a separate banking system. Meltzer argued that this was a mistake that is still continuing today. Concerning the transmission of monetary policy, Meltzer argued that what mattered was the change in relative prices and the increase in money stock, not whether the transmission is done through commercial banks, savings and loan associations, or insurance companies.

Alan Blinder agreed that shadow banks are an important channel of monetary transmission. He deduced that the money supply, which is a product of banks, is less important than interest rates, since interest rates affect everybody. Therefore, moving interest rates affects the shadow banking system as well as the regular banking system, regardless of whether any particular definition of the money supply moves. Blinder added that since the shadow banking system is just as important, or more important, than the conventional banking system, a sensible regulatory regime for the shadow banking system is critical. Meltzer and Blinder both agreed that higher money growth would currently be preferable.

Kevin Harrington asked about ways to solve problems that would arise from ending quantitative easing. Blinder had asked why bond market participants believe that ending quantitative easing will steepen the yield curve. Harrington responded that one reason they expect this is that the Fed's quantitative easing policy is absorbing a lot of duration, thus performing a maturity transformation usually carried out by banks and bond investors in normal times. So ending the policy could be expected to steepen the yield curve, all other things equal, since other market agents need to be provided incentives to perform this maturity transformation function with the increased carry and roll-down that a steeper yield curve provides. Whether or not this proves to be the market-balancing mechanism, marginal buyers of some sort need to be found to absorb the bonds created by the large fiscal deficit. The banks probably won't be performing this function to the extent needed. Because banks are being regulated more aggressively and their capital requirements forced higher, their returns on equity will be much lower in the future, and so no new banks are being formed and existing banks cannot meaningfully expand their balance sheets. Thus the banking system's collective balance sheet is constrained.

So who will the marginal maturity transformers be when the Fed's balance sheet as well as the balance sheets of Fannie Mae and Freddie Mac are shrinking? Alternatively, sovereign reserve accumulators such as

China, Russia, the OPEC countries, and potentially Japan could absorb the excess supply of bonds. But taking this course will further increase the current account imbalance that had already been a major cause of the financial crisis in the first place. Harrington argued that if quantitative easing is ended, the problem of excessively easy monetary policy will just be transformed into the problem of substantial current account imbalances, setting up the United States for another big crisis in the future.

Alan Blinder noted that as the economy strengthens and people get richer, aggregate demand will increase and so will demand for bonds. This needs to be taken into account when determining the speed of the exit from quantitative easing. Blinder recommended not rushing into it as long as the economy stays weak.

Peter Fisher agreed with the concerns about current account imbalances. He argued that quantitative easing created both a stock and a flow effect and that the Fed had substantially underestimated the flow effect. Fisher said that he had no qualms about the expansion of the Fed balance sheet early on in the crisis in 2007–2008. However, the Fed's recent open-ended purchase program had an even larger flow effect, the unwinding of which risked washing out the effects that were previously obtained. He argued that the problem of having a significant flow effect is that the reversal of the flow effect cannot be avoided when it's time to exit.

Allan Meltzer argued that it will take years to unwind the balance sheet and that it has to be done slowly. The way to do it is to announce a path conditional on certain events and to subsequently stick to the path. Meltzer then challenged the current administration, inquiring why it does not seem to be aware of the fact that raising tax rates and regulating businesses, in the way that is currently done, burden the economy and slow the recovery. He noted that when Franklin Roosevelt was president, at the onset of World War II he swiftly abandoned populist policies, appointed two Republicans to his cabinet, and appointed the head of General Motors to be his production czar, even though he had previously called businessmen "economic royalists." Meltzer argued that this was a recognition that the president had abandoned populist policies, and concluded that we need a similar signal now.

Is "Too Big to Fail" Over? Are We Ready for the Next Crisis?

In the discussion following the presentations on "too big to fail" (chapters 9–12), a member of the audience inquired about demand deposits and time deposits, asking what kind of tool could be instituted to reduce the run for deposits.

John Cochrane answered that for demand deposits, a first-come, first-served system could be maintained. Money that is immediately available comes from a money market fund backed by short-term Treasuries. For a higher interest rate, one would have to opt for a different product, which would not allow the right to run. Cochrane noted that another standard tool for dealing with runs and crises, sometimes advocated for money market funds that hold illiquid assets, is to suspend convertibility. However, the problem with suspension of convertibility is that investors who anticipate an imminent suspension of convertibility withdraw their funds immediately. Cochrane pointed out that the suspension of convertibility, designed as the tool to stop the run, then creates the run in the first place.

Darrell Duffie added that the idea of having full reserve backing for deposits has been around for a long time, suggested by Milton Friedman (though he eventually recanted the idea). Duffie also noted that narrow banking is a closely related proposal.

Another member of the audience inquired about contingent convertible bonds (CoCos). **John Cochrane** questioned whether CoCos have any economic advantages. He noted that the reason to prefer CoCos over equity is that CoCos preserve the subsidy to debt implicit in their tax deductibility. Hence, CoCos would be a security that is really equity, but denominated as debt for reporting purposes at the IRS. Cochrane cautioned that similar window dressing was related to the financial crisis.

Sheila Bair noted that all four speakers were opposing the restrictions on the Fed's discretion under section 13(3) of the Federal Reserve Act. She explained that the Dodd-Frank Act was designed to allow the Fed to use 13(3) to generate lending programs that were generally available to a broad set of financial institutions in unusual circumstances. In the case of the idiosyncratic failure of a single institution, on the other hand, the institution would go into Title II or the bankruptcy process. She argued that this is the way in which Dodd-Frank bans bailouts and that many people believe that Title II is credible and provides a viable resolution strategy, with the potential of ending bailouts and the too-big-to-fail problem. Her concern was that reversing the ban on bailouts and giving the Fed wide discretion under 13(3) would lead to the market doubting that the government would use Title II, since a bailout by the Fed would be an easier approach. She asked the panelists how they would solve the too-big-to-fail problem if the ban on bailouts under 13(3) were abandoned and the Fed's unfettered discretion were restored. Bair also inquired about the panelists' comments regarding "flights to safety." Given the panelists' hypothesis that large banks now have huge capital cushions and are very safe, why would depositors run from a large bank to an institution that just entered a Title II resolution process?

Steve Strongin clarified that depositors would likely run to the systemically important financial institutions (SIFIs) in a period of stress, not to the specific SIFI in resolution but to other SIFIs because of their strong capital positions. However, the other SIFIs might well have to refuse those deposits so that they do not violate the new leverage restrictions—and this in turn could be systematically destabilizing in a new way.

Darrell Duffie asked Bair's opinion on whether providing liquidity to financial market infrastructure under emergency lending is a good or bad idea, and why. Bair responded that in her opinion, liquidity assistance to solvent institutions is a good idea. In a system-wide crisis, when healthy banks are under stress for reasons beyond their control, the Fed should be able to make assistance generally available. The restriction in the Dodd-Frank legislation bans one-off bailouts, such as the bailouts of mismanaged institutions like AIG, Bear Stearns, and Citigroup. The intention of the legislation was to keep the government, including the Fed, from doing these one-off bailouts. She argued that if this restriction is eliminated, the market is going to believe that the Fed is going to do bailouts. She asked how one would convince the market that "too big to fail" is over if the Fed has unfettered discretion to do bailouts.

Donald Kohn pointed out that the Fed was in favor of Title II and did not favor bailouts for individual institutions. **Martin Baily** added that the ability to provide liquidity to the system is desirable, but that this may mean providing liquidity to a particular institution. In this way, central banks provide liquidity to a bank that is suffering from a run but is not insolvent.

Steve Strongin pointed out that liquidity support in a single-point-of-entry (SPOE) resolution should be provided within the holding company at the point of recapitalization (for example to the new bridge holding company, see chapters 9–12) and not be limited to the bank's subsidiaries.

Sheila Bair pointed out that there is broad authority to provide liquidity assistance once an institution has entered a Title II resolution, with the shareholders and creditors responsible for any losses. She added that

13(3) restricts the Fed from providing one-off assistance to a troubled institution. She noted that according to her understanding, the panelists were all suggesting abandoning this restriction. She cautioned against that since it would hurt the progress made so far in limiting the problem of "too big to fail."

Donald Kohn added the following two points: first, the distinction between solvency and illiquidity is very difficult to make in the middle of a crisis. Making loans against good collateral is part of Bagehot's dictum, which prescribes that a central bank, in order to avert a panic, should act as the lender of last resort by lending freely at high rates to solvent firms with good collateral.[2] However, the collateral needs to be valued cautiously and at a haircut to normal market circumstances. Kohn noted that in a fire sale it is hard to know who is going to be solvent when the fire sale is over, exacerbating the distinction between solvency and illiquidity. Second, he expressed worry regarding the transparency of section 13(3). Every institution that borrows from the Federal Reserve will be identified to Congress and its name will be released to the public in no more than two years. From experience, it is known that there is a lot of stigma involved in borrowing from the Fed. He expressed concern that the ability of the Fed to play its Bagehot role of providing liquidity to prevent runs, or to intervene at the beginning of a run to prevent it from getting worse, will potentially be impaired by institutions' great reluctance to borrow from the Federal Reserve until they are in the process of failure. He added that, beyond the risk that the market finds out that the institution has borrowed from the Fed, thus reducing its liquidity, there is substantial political risk as well.

John Cochrane reminded the audience of the background of 13(3). In the crisis, the Fed took extraordinary measures by participating in the bailout of specific companies, which had political consequences. Therefore, Congress took away this power. Cochrane argued that with the Fed's macroprudential project, intense regulation of specific industries, allocation of credit flow, and popping bubbles, market participants will make and lose tens of billions of dollars. The ones who lose money will call their representatives in Congress. He noted that so far the Fed has had very limited power in return for great independence. He cautioned that as the Fed starts taking a lot of discretionary power that has strong effects

2. See *Lombard Street: A Description of the Money Market* (1873) by the English economist Walter Bagehot.

on people's bottom lines, it will lose this political independence. If the Fed is restricting credit to real estate in Palo Alto since it judges there to be a housing bubble, Congress is going to intervene as those who lose money from this policy will speak up. Cochrane said the loss of political independence as a response to the Fed taking discretionary power is a big danger in the pursuit of macroprudential policies.

Steve Strongin pointed toward the liquidity coverage ratio (LCR) as an implicit floor for the liquidity and the amount of stress that good collateral is under. If the regulator is only lending against collateral and against the LCR schedule, there are a lot of restrictions, so that government money is not at risk. The assets and haircuts are predetermined and sufficient for almost any circumstances. He noted that embedded in the LCR is hence the notion of what the liquidity floor could be without incurring significant government risk.

Sheila Bair agreed with these points, but stressed the question of why the Fed needs the ability to tailor an emergency measure to just one institution. She further asked why it would be insufficient in a severe liquidity situation to allow all solvent institutions that would otherwise be under stress to borrow against collateral under certain conditions.

J. W. Verret challenged the notion that the restrictions on 13(3) have actual restrictive content. He pointed out that Jeffrey M. Lacker, president of the Federal Reserve Bank of Richmond, had recently testified on this issue before a congressional committee. A simple rule from a legal standpoint, he said, is that a law that no one has the authority to sue under is not a law, but instead a mere aspiration, goal, or hope. The Fed still has a significant amount of discretion under the restrictions in section 13(3), given the gray area between insolvency and illiquidity. However, he pointed out that if the Fed chose to ignore the law and to lend to an individual institution, there would be political consequences but no legal consequences. He wondered whether the panel would consider the possibility of making restrictions self-executing, such as rights of action to seize the proceeds of support issued in violation of the restrictions or a mandatory minimum penalty for lending under 13(3). These would make the restrictions real from a legal standpoint.

Martin Baily said he considered it unlikely that the Fed would violate regulations which Congress has passed. He further expressed concern that the debate was focusing entirely on 13(3).

Russell Roberts challenged the panelists by noting that the debate so far had focused on financial regulation as an economics or engineering problem and had discussed progress achieved by tweaking a complex system. Roberts argued that instead of being an economics or engineering problem, the issue at hand is overwhelmingly a political problem. He pointed to the elephant in the room: the political power of the large banks in the United States. Due to this power, promises can't always be credible. Roberts noted that in the last twenty-five to thirty years of American discretionary policy, when push came to shove the large banks got their way. While this is not done in a transparent way, it seems that we make it easy for large financial institutions to use borrowed money rather than their own money. He argued that until this political problem disappears, we are living in a Kafkaesque world where the people who are not immersed in the debate on financial regulation see the charts and complexity that they don't understand, but know what is going to happen when the time comes. The people who have billions of dollars at stake are not going to stand for something else. He urged that this political problem be fixed before addressing the economic problems.

As a former banker, **Douglas Elliott** decided to comment on this point. He agreed with Roberts's concerns but argued that, notwithstanding the public focus on bailouts, the owners of the failed banks were wiped out. Those who had owned shares in Citigroup ended up with merely 5 percent of their initial value. Hence, Elliott pointed out that it is politically possible to do damage to the people who run the big banks. He did agree that in the United States, as in the rest of the world, rich people tend to have a lot of influence, so that it is reasonable to raise concerns about banks' political influence. He argued, however, that the fact that we have recently been through a financial crisis will lend political support to bankers' opponents. In addition, many restrictions will be embedded in the regulatory structures going forward. Elliott found it hard to envision that the equity holders of financial institutions would be rescued to any significant extent in some future financial crisis. He also pointed out that equity holders were not rescued in the recent financial crisis, but instead took very large hits.

Russell Roberts observed that equity holders are not the crucial decision-makers in the case of risk-taking. Instead, it is the creditors, since they have no upside and only the downside of bankruptcy. The equity holders have the upside. They also have downside risk but can diversify away. Hence, when taking away the downside risk to creditors, he argued that we are taking away the single most important watchdog in the financial system, because creditors overwhelmingly care about downside risk. Bailing out creditors without a haircut removes the crucial oversight creditors provide.

Martin Baily argued that one of the suggestions discussed in the presentations was to hit long-term debt with losses in the bankruptcy process, which is a change relative to the system prior to the crisis that would address Roberts's concern.

George Shultz agreed that big banks have a lot of power, but interpreted recent large fines to JPMorgan Chase and other financial institutions as a sign that this power is diminishing. JPMorgan now looks like a cash cow.

John Cochrane noted that, notwithstanding the large fines levied on large banks, in the end the government will not let them fail, which means really the government won't let them lose a lot of money. So it's a bit of a charade overall: levy big fines with one hand but subsidize and guarantee with the other.

Donald Kohn asked about Cochrane's proposal, under which there would be no deposits and debt would be taxed. He inquired whether this interpretation is correct and whether it would mean that there are indeed no deposits.

John Cochrane answered that there are demand deposits, but that these are guaranteed fully by short-term Treasuries. This allows for taxes on debt instead of capital requirements, since the latter leads to debates about how to risk-weight assets. As an economist, he preferred the use of a price rather than a quantity, so as to avoid the arguments about the exact quantity. An institution like Lehman Brothers with 30–1 leverage that is rolling over short-term funds every night will then pay a high tax for its capital structure and hence consider issuing more equity.

David Skeel noted that some of the speakers had criticized the leverage ratio as encouraging risk-taking. He therefore wondered whether the presenters would just get rid of it or whether the optimal solution would be to include both a risk-weighted measure of capital and a leverage ratio, as is done in Basel III, or to pair the leverage ratio with some other form of capital measurement.

Martin Baily argued that the leverage ratio is a useful backup measure but that it should be paired with other forms of capital. Purely using the leverage ratio leads to excessive risk-taking, so that employing risk weights adds an important dimension. However, he added that the leverage ratio should be a constraint that is not frequently binding.

Bankruptcy, Bailout, Resolution

Martin Baily took up the point mentioned by Michael Helfer on the advantage of cross-border agreements under Title II (chapter 16). He noted that Title II makes it easier to negotiate with foreign regulators. He then asked the members of the panel to comment on whether Title II needs to be available for global SIFIs, even if Chapter 14 is added to the bankruptcy code.

David Skeel answered by first noting that he agrees with Helfer in that he does not favor repealing Title II, but rather making it as unnecessary as possible by minimizing the likelihood that it needs to be used. He further noted that the notion that judges cannot coordinate as closely as regulators can is overstated. He mentioned projects on which judges in multiple countries work, including a project on cross-border principles in bankruptcy cases run by the American Law Institute. He cautioned, however, that mere handshake agreements like the one between the United States and the United Kingdom on whether single-point-of-entry measures will apply may not hold up in a financial crisis.

Ken Scott agreed with Skeel that substantial international cooperation in the court system does occur as well, pointing to a paper on dealing with cross-border issues by the American Law Institute.[3] He added that the situation in which a global SIFI fails and foreign governments engage in ring-fencing to protect subsidiaries and branches is only a subset of the issues that can arise with SIFIs that have global activities. Another example is a huge loss in a foreign subsidiary of a SIFI and the subsequent decisions that need to be made regarding whether the subsidiary should be kept in operation.

Randall Guynn added that Europeans are often confused about the meaning of the bankruptcy Chapter 14 alternative, which might pose a challenge in the case of a financial crisis. He argued that it is therefore easier for regulators to cooperate under Title II. Guynn agreed with Helfer in favoring an improved bankruptcy code. However, he argued that more work is needed to avoid confusion by foreign regulators about the two alternatives. One way to achieve this is by the process of drawing up living wills, in which regulators communicate with each other. In addition,

3. The American Law Institute and the International Insolvency Institute, "Transnational Insolvency: Global Principles for Cooperation in International Insolvency Cases," report to the American Law Institute, March 30, 2012.

under Chapter 14, regulators would have a role and the Chapter 14 proceedings could be used for cross-border cooperation.

Michael Helfer agreed with Guynn's assessment but argued in response to Scott that cross-border issues are not limited to situations in which a foreign subsidiary experiences a large loss. He said that many large institutions operate through branches outside the United States and argued that losses within the United States could lead to ring-fencing and similar actions by foreign regulators in the absence of clear understandings about how the branches would be kept open.

Kevin Harrington observed that significant mergers and acquisitions have the potential to move currencies substantially and that financial crises usually result in sizeable currency movements as well. He therefore inquired whether single-point-of-entry or Title II resolution mechanisms take account of the (possibly large) currency movements that would result from capital transfers between currency jurisdictions that are implicit in recapitalizing a foreign banking subsidiary. If such currency movements take place, then wouldn't such recapitalizations be a form of socializing banking losses in disguise, transferring them to trade-sensitive economic sectors via currency movements?

Randall Guynn answered that he could not immediately identify this problem, but cautioned that this may be due to its complexity. If a foreign subsidiary became undercapitalized, some debt or equity would need to be converted, or an asset from the holding company would need to be contributed to recapitalize the subsidiary. Even with the largest SIFIs, this transfer would amount to a couple of billion dollars or potentially a lot less. Therefore, it was not clear to him why a transfer of that size would move the currency. He was of the opinion that it would not pose an issue.

Finally, **David Skeel** noted a related concern pertaining to lengthy stays on derivatives: the continual currency movements and movements in the prices of other assets. This is an argument for keeping the stay short (one day in the Dodd-Frank Act and up to three days in the proposal for Chapter 14).

Discussion Commentators

Peter Thiel	Co-founder of PayPal, co-founder and chairman of Palantir Technologies, and managing partner of Founders Fund

Lee E. Ohanian	Professor of economics, University of California, Los Angeles, and senior fellow at the Hoover Institution
Donald Kohn	Senior fellow at the Brookings Institution and former vice chairman of the Board of Governors of the Federal Reserve
Kevin Harrington	Managing director, Thiel Macro LLC
J. W. Verrett	Assistant professor of law, George Mason University
Russell Roberts	John and Jean De Nault Research Fellow at the Hoover Institution