Introduction

Martin Neil Baily and John B. Taylor

The financial crisis of 2008 and the resulting recession devastated the American economy and caused US policymakers to rethink their approaches to major financial crises. Six years have passed since the collapse of Lehman Brothers, but questions persist about the best ways to avoid future financial crises and respond to those that occur anyway.

On October 1, 2013, the Brookings Institution and the Hoover Institution jointly hosted a conference addressing these issues. Twenty-four economic and legal scholars discussed the crisis, its effect on the US economy, and the way ahead. The conference took place simultaneously in Washington, D.C., and Stanford, California, with simulcasting between the locations for maximum interaction among panelists and audience members. A diverse group of panelists made for a day of lively discussion and interesting debate. As participants worked to identify the way forward, they highlighted the need for policies that can adequately help us avoid or deal with future crises. While there was a diversity of views presented, there were some important areas of agreement and the experts agreed on the need for further discussions to expand the range of consensus.

This volume is titled *Across the Great Divide: New Perspectives on the Financial Crisis.* The title is symbolic, first of all, of the range of different groups and opinions brought together, including, for example, those who have been harshly critical of the Federal Reserve Board and those who give high marks to the Fed's rescue efforts and unusual policy measures. In addition, while both Brookings and Hoover are proud of the range of scholars within each institution who embrace different politics and economic philosophies, Brookings is often seen as center left while Hoover is center right. So it was an important step to undertake this joint conference as a way of expanding the dialogue around monetary and regulatory policy. The goal is to maximize agreement in these important policy areas, both of which need continuity in order to give certainty to market participants and citizens that the rules of the game will not change with each swing in the White House or Congress.

This volume focuses on the 2008 financial crisis, the US response, and the lessons learned for future regulatory policy. It contains papers written by the conference panelists and serves to broaden the discussion about potential reforms. After this introductory chapter, Part I of the book explains the causes and effects of the financial crisis. Part II focuses on the role played by the Federal Reserve before, during, and after the 2008 panic. Part III addresses the concept of "too big to fail" (TBTF), and Part IV considers bankruptcy, bailout, and resolution. The volume closes with remarks on the key issues facing financial reforms and thoughts on the key findings of the conference and the way ahead for economic policy.

Causes and Effects of the Financial Crisis

The volume begins with an assessment by Sheila Bair and Ricardo Delfin of the Pew Charitable Trusts on the ways in which corrective regulatory policy often gives rise to new problems and risks in the financial system. They note that new policies which take lessons learned from previous crises into account often develop into blind spots that fuel future crises. They begin by examining five key drivers of the 2008 crisis: highly accommodative monetary policy, the housing bubble, the rise of securitization, the self-regulating markets myth, and the idea of "too big to fail." Bair and Delfin argue that the accommodative monetary policy seen in recent years has biased the financial system toward risk-taking and against risk-aversion. They remind the reader of the positive feedback loop created in the housing market in the years leading up to the 2008 crisis and suggest that financial asset prices and recent Fed actions raise serious questions about the stability of the market as a whole and the possibility of future bubbles. The authors point to the role securitization played in the housing bubble and note that the securitization model was a response to the 1980s savings and loan crisis. They go on to describe the regulatory policy changes that were borne of the failed self-correcting approach to markets, enforcement, and oversight. But they point out that the new command-and-control strategy is also concerning because it risks becoming overly dependent on micromanagement and regulatory discretion. Implicit government support for large financial institutions and government-sponsored enterprises, Bair and Delfin say, hampered discipline within the market and promoted a dangerous level of risk-taking. The paper concludes with suggested practices that temper lesson-learning with responsibility. The authors encourage regulatory policymakers to trust no one, including themselves; to remember what government and markets do well and what they do poorly; and to focus on strong, simple rules. By all means, they say, solve the underlying problem. But we must remain alert to unexpected consequences of our solutions and prepare ourselves to quickly and appropriately address new risks to the financial system.

Lawrence Summers of Harvard University explores whether the US economy is currently in a state of secular stagnation, unable to achieve satisfactory growth and full employment under stable financial conditions as the zero lower bound on nominal interest rates dampens demand below equilibrium levels. Summers supports this hypothesis by noting that the economy merely grew moderately in the five years leading up to the Great Recession, notwithstanding low interest rates and bubbles in financial markets, and failed to pick up even after the recession was over and the financial system repaired. He points to structural changes in the economy which have increased the propensity to save and reduced the propensity to spend and invest, both leading to lower equilibrium real interest rates, and to evidence for negative real interest rates from capital markets and economic research. Based on this analysis of current economic conditions, Summers cautions against both political passivity and unconventional monetary policies aimed at reducing real interest rates. There is little evidence that a passive political stance or pure focus on long-run policies will lead to satisfactory economic growth when the economy is in a liquidity trap. While unconventional monetary policy measures can increase demand by lowering economically important interest rates, they come with undesirable side effects such as boosting unattractive investments, creating uncertainty, and encouraging excessive risk-taking. Instead, Summers recommends raising demand at every possible level of the interest rate by raising government spending, improving inefficient regulations that currently hold back demand, and strengthening long-run supply-side fundamentals to increase consumer and business confidence. Such measures will quickly put the economy back to work and can even reduce future debt burdens.

John Taylor of the Hoover Institution suggests that assessments of the 2008 crisis that look to a narrow stretch of time—usually September through November of 2008—miss the bigger picture. A wider window, from 2003 through 2013, is more useful and reveals that government policy (namely monetary policy, regulatory policy, and an ad hoc bailout policy) played the largest contributing role in the crisis. He takes issue with the deviation from tried-and-true policies and says that these deviations created a boom-and-bust cycle and fueled both the crisis itself and the poor recovery. Specifically, he points to the Fed's low interest rate policy in 2003–2005, unenforced financial regulations, complex Dodd-Frank regulations, "exploding" federal debt, and discretionary monetary policy. Taylor concludes with a ray of hope: if we accept that policy is the problem, we also know that policy, not some other element of the economic system, needs to be fixed. Although he admits that today's policy strategy can't be identical to that of decades past, he nonetheless implores us to return to practices that successfully kept the economy working.

Kevin Warsh, also of Hoover, presents a perspective that complements the others in this section of the volume. He writes that while the US government's policy response to the 2008 crisis remains controversial, we must also take into account the systemic effects of the changes in policy on economic agents. To do so, we need a robust understanding of the behavioral responses to new policies. He thereby explores the role that modeling plays on policy, writing that "getting the model right appears to be a predominant factor in getting policy right." Warsh then focuses on what he calls the new stability agenda of economic policy which has emerged from the financial crisis. He is concerned that this well-intentioned approach to policy will too readily accept "statism" as a means to resist even the more benign turbulence in the economy or in sectors of the economy. Some turbulence, he argues, is not unhealthy for the economy, and indeed it is key to strong, sustainable economic growth and prosperity.

The Federal Reserve Role

The second panel of the conference focused on the role played by the Federal Reserve before, during, and after the 2008 crisis. Alan Blinder of Princeton University opened the dialogue, noting that while the Fed's actions before and during the collapse of Lehman Brothers on September 15, 2008, were generally unsatisfactory, it deserves excellent grades for its subsequent performance. Although not alone in the blame for the events leading up the 2008 crisis, the Fed nonetheless bears a significant portion of the blame because it had unique systemic responsibilities; was and is the *primus inter pares* among financial regulators; and had special consumer protection and mortgage-related responsibilities. In the early 2000s, the Fed ignored the early warning signs of impending economic struggles and ultimately failed to use its legal authority to mitigate the situation. However, it lacked the power to completely fix the problems that created and fueled the 2008 crisis, and the behavior of the Securities and Exchange Commission (SEC) and other regulatory bodies certainly did not help matters. Blinder goes on to describe the Fed's 2002–2004 monetary policy as too loose but ultimately as a minor mistake that caused relatively little harm to the economy. The Fed's biggest mistake, he writes, was allowing Lehman Brothers to fail spectacularly instead of intervening and loaning the necessary funds. After Lehman Brothers failed, however, the Fed addressed the new market circumstances quickly and deftly. Blinder lauds the Fed's use of controversial unconventional monetary policies, but reminds the reader that such policies will eventually have to be wound down.

Michael Bordo, of Rutgers University and the Hoover Institution, presents an examination of the Fed's role in the crisis that is rich in historical analysis. He notes that despite the popularity of comparisons between the Great Depression and the 2008 recession, the crises aren't exactly analogous and "in some respects, basing policy on the lessons of the Great Depression may have exacerbated the recent economic stress and have caused serious problems that could contribute to the next crisis." In the crisis of the 1930s the money supply and the deposit-to-currency-ratio collapsed; in the recent crisis both rose. The 2008 crisis saw none of the commercial bank runs that marked the Great Depression era, and was ultimately an insolvency issue rather than a liquidity issue. The Fed attempted to solve the 2008 crisis using lessons learned from the Great Depression, and in many ways the results were lackluster. Bordo describes the Fed's recent liquidity policy, credit policy, bailouts, and quantitative easing as seriously flawed and damaging to the Fed's reputation.

Peter Fisher of Blackrock joins the conversation with thoughts on how the lessons learned about the Fed from 2008 to 2013 can help guide future policy. He identifies three major lessons from the crisis. First, either the Fed should utilize supervision and regulation to manage excessive leverage or it should "lean against the wind." He stresses the importance of using supervisory tools to promote financial stability. Second, moral hazard is best addressed before, not during, a major economic crisis. He sees the Financial Stability Oversight Council that designates systemically important financial institutions as an important improvement in regulation. And third, the Fed must avoid crafting policies that are short-sighted and must bear in mind potentially perverse consequences. He argues that there is a long list of potentially adverse consequences of the Fed's extraordinary policies. Fisher ultimately recommends that we take this post-crisis opportunity to review the Fed's mandate: we can use lessons learned from the recession to update the Fed's objectives and constraints.

Allan Meltzer of the Hoover Institution devotes his paper to explaining the low inflation and slow growth that have plagued the recovery from the 2008 crisis. He indicates that the flat response to the recent growth of reserves is due to four key problems. First, the Fed mistakenly saw the 2008 crisis as a principally monetary problem and acted accordingly, even though current economic issues are mostly real. Second, the Fed has not announced or adopted a strategy that increases confidence. Third, increased bank reserves are mostly excess reserves; when banks are paid interest on excess reserves they are discouraged from lending. And fourth, credit allocation is not a useful tool to generate expansion. However, Meltzer notes that mistakes made during the 2008 crisis were not all made by the Fed. The administration also made several critical errors on fiscal policy: (1) Congress was given primary responsibility for the American Recovery and Reinvestment Act (ARRA) of 2009; (2) productivity was neglected; (3) individual and corporate taxes were not permanently reduced; and (4) expectation of future tax increases was not addressed. He says that the Fed can't have a long-term impact on real causes of sluggish growth; and the administration's failure to mitigate the public's uncertainty worsened the poor recovery. He concludes by pointing out that the only other slow recovery in US history (1937–1938) was marked by policies similar to those used in the 2008 crisis.

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

Martin Baily and Douglas Elliott of the Brookings Institution open the conversation on "too big to fail," noting that because we can't anticipate the exact nature of the next economic crisis, the financial system must be insulated and stable enough to absorb shocks. Some progress has already been made on this front, particularly through increases in capital ratios and new liquidity requirements. But there is still work to be done. The authors call for policymakers to raise capital and liquidity levels still further for the most systemically important financial institutions. This, they write, widens safety margins, minimizes potential taxpayer and societal losses, and incentivizes voluntary reduction of systemic importance when economically feasible. They also recommend that the legal frameworks for resolution be reformed so that firms (even systemically important firms) can fail without throwing the financial system into disarray. Finally, they suggest we create mechanisms to provide macroprudential oversight to the financial system in order to better manage systemic risks. They reiterate that the financial system is already more resilient to the next shock and conclude by noting that more work is needed, particularly in the areas of public perception, rule implementation, transparency, and quantitative analysis.

John Cochrane of the University of Chicago says that TBTF isn't over, and we're not prepared for the next crisis. Even if we were in a position to address a repeat of the 2008 crisis, history tells us that the next economic crisis will be different from the last one and will require a completely different response. We can, however, reframe our perspective of the 2008 crisis and think of it as a run. It's not institutions that present risk to the financial system, but run-prone assets. While many people resist banning run-prone assets, saying that borrowing will become more expensive and banks unable to transform liquidity and maturity, Cochrane says that this is an outdated notion. He suggests a tax on debt, especially short-term runnable debt, with the goals of decreasing arguments about risk weights and capital ratios, reducing the need for bank asset regulation, and minimizing the current mess of cronyism and politicization that plagues the current regulatory process. The result will be a well-insulated financial system that absorbs booms and busts rather than reliance on regulators to manufacture a world free from market ups and downs.

Darrell Duffie of Stanford University examines the impacts of a possible failure of firms that provide significant financial market infrastructure (FMI). In the United States, FMI firms clear over-the-counter derivatives or tri-party repurchase agreements (repos). Duffie argues that such a failure would have severe adverse effects on the entire financial system. However, existing failure resolution approaches or proposed reforms—whether through administrative procedures under Title II of the Dodd-Frank Act or through bankruptcy law—are not able to resolve these firms in a way that would prevent these effects. For example, the single-point-of-entry approach to resolution would not apply in such cases. Duffie gives the example of two large, complex banks: J.P. Morgan Chase and Bank of New York Mellon. Together they provide about $1.5 trillion of tri-party repo clearing per day in the United States, and they are both engaged in other lines of business that entail risk-taking. A failure of one of these banks would cut off access to tri-party repo financing, which could result in fire sales of securities.

Steve Strongin of Goldman Sachs and his coauthors present an optimistic argument that focuses on the newly strengthened or newly created lines of defense against failure, rather than on the remaining resolution hurdles. Analysis of these three lines of defense—more and better capital, capital incentives for banks to recapitalize early in a stressed situation, and the debt shield—show that the US financial system is far safer today that it was in the past. Although more work needs to be done on reforming resolution processes, these needed improvements should be placed in economic perspective and not used to demonstrate an overall lack of stability in the financial system. He closes by noting that because resolution is needed only in truly extraordinary circumstances, policymakers must conduct thorough cost-benefit analyses of costly proposed solutions.

Bankruptcy, Bailout, Resolution

Randall Guynn of Davis Polk & Wardwell opens the fourth panel with further discussion of the TBTF problem and suggestions for a solution. He describes the TBTF issue as a Hobson's choice between taxpayer-funded bailouts and a potential collapse of the financial system, and notes that the public usually chooses bailout. Guynn suggests a third option, however: a high-speed recapitalization of a financial group that imposes losses on shareholders and other creditors but avoids unnecessary values destruction and preserves the group's going-concern value. After discussing the implications of the Orderly Liquidation Authority (OLA) and the single-point-of-entry recapitalization method, he ultimately suggests a security liquidity provision in Chapter 14 of the Bankruptcy Code. Chapter 14 could more effectively limit the need for OLA if the Federal Reserve were authorized to provide secured liquidity to a bridge financial company if three conditions were met: (1) the bridge financial company is well-capitalized, (2) the liquidity is fully secured, and (3) the liquidity is provided at penalty rates. In cases without sufficient secured liquidity, the bridge financial company would be forced to sell its illiquid assets at fire sale prices. Such fire sales are likely to spread throughout the financial system and put it in serious jeopardy, requiring either OLA or bailouts. Anticipating economic and political arguments against his proposal, Guynn closes by noting that neither the Fed's discount window nor an expanded discount window are bailouts and that no material risk is posed to the Fed by his suggestion.

Ken Scott of Stanford delves further into the need for better bankruptcy resolution and suggestions for improved policy. In an OLA receivership, he says, the receiver uses a "single point of entry" to take over a failed institution and transfer its business to a new bridge company. However, he takes issue with the extent and use of discretionary powers vested in the receiver as part of the OLA process. In particular, he is concerned by the receiver's discretion over which liabilities go to the bridge company and which stay in the debtor's estate; the valuation of assets transferred to the bridge company; and the allocation of losses at both the parent holding company level and the subsidiary level. Scott also addresses major concerns regarding judicial oversight and procedural fairness in the discretionary environment. He concludes that the *ex ante* procedure, which requires the secretary of the treasury to file a petition in US district court in Washington, D.C., and for a judge to determine whether certain statutory conditions are met, is an "empty formality." The *ex post* procedure is also flawed: although there is an appeal process, stays are prohibited, and even if one ultimately received a ruling in one's favor, it may be too late at that point to remedy the situation. He goes on to note that Chapter 14 protocols are far less discretionary and, given their treatment of creditors, are well-equipped to promote disciplined risk-taking and exist in accordance with constitutional standards. However, any transfer of a floundering business to a bridge company gives rise to some problems, whether the transfer happens in Title II or in Chapter 14. Revisions to the bankruptcy code can address some of these issues, but other problems will have to be remedied outside of the bankruptcy code. Scott calls for policymakers to block runs by short-term creditors, assure the bridge company has adequate capital, and clarify liquidity requirements in a way that instills confidence.

David Skeel of the University of Pennsylvania addresses the single-point-of-entry resolution strategy in which bank regulators place a financial institution's holding company into resolution; transfer its assets, short-term liabilities, and secured obligations to a bridge company; and leave its stock and long-term debt behind. Such a transfer would create a well-capitalized new institution. Heralded by some as a regulatory silver bullet, the single-point-of-entry strategy imposes fewer demands on regulators, minimizes the risk to foreign subsidiaries, provides a clear set of rules, and should reduce the risk of runs. Nonetheless, the single-point-of-entry strategy does have several critical vulnerabilities. First, because it provides an option for narrowly targeted intervention, it may increase regulators' willingness to intervene; however, it may discourage regulators from intervening in more complex situations, such as a messy crisis at a major subsidiary. Attempts to resolve such a problem through single-point-of-entry processes might be unsuccessful, or could leave the troubled institution in government hands for years. Regulators are also unlikely to attempt single-point-of-entry resolution on two or more systemically important institutions simultaneously, making this an imperfect tool for handling a major economic crisis. Finally, the single-point-of-entry system dis-incentivizes derivatives monitoring and incentivizes the use of derivatives and other short-term financing options, adding instability to the financial system. Skeel closes by noting that the single-point-of-entry approach shows significant promise as a resolution tool but it does have limitations that make other corrective policies necessary.

Michael Helfer of Citigroup argues that the United States needs both Title II and Chapter 14, saying that "the country needs to have more tools in the toolbox when a large financial institution fails, not fewer." An effective resolution process must feature assurances that liquidity is available, guidelines for qualified financial contracts like derivatives, a responsible authority with the necessary expertise and resources, provisions for continuity of critical services for consumers, and imposition of losses on stockholders, creditors, and responsible management, not taxpayers. Title II addresses these items, and so does Chapter 14, but they are different tools that may not always be used interchangeably. Some crises may respond best to the Title II procedures; others may see best results from Chapter 14. It would be a mistake, Helfer says, to unnecessarily limit regulators' options.

Remarks on Key Issues Facing Financial Reforms

Paul Saltzman of The Clearing House addresses the major problems facing the financial system, highlighting his organization's role in the banking industry, the industry position on key macroprudential rules, and recommendations and observations on how to improve the pace and quality of Dodd-Frank rulemaking. As a recently designated systemically important financial market utility (SIFMU), The Clearing House Association and its membership of eighteen large and diverse commercial banks are directly affected by the topics discussed in this volume and are in a unique position to speak to the ramifications of proposed reforms on the banking industry.

Saltzman expresses concern about macroprudential policy, noting that mistakes made in the macroprudential realm are likely to be correspondingly larger than those made in the microprudential arena, involving macroeconomic consequences that may place the entire economy at risk. Similarly, there is concern within the banking industry that macroprudential regulation could be transformed into a policy that favors certain markets, businesses, or products. Finally, macroprudential regulation is by nature a one-size-fits-all regulatory methodology, and it is challenging at best to apply hard-and-fast rules to varied and distinctive organizations. “Fitting square pegs into round holes is never an easy task,” he says.

Saltzman discusses the position of The Clearing House on the topics of capital, long-term debt, the leverage ratio, liquidity, and single counterparty limits. He echoes Helfer by saying that while his organization supports Title II, it also supports legislative and regulatory improvements to the Title I process. He closes with observations and suggestions to enhance the rulemaking process: (1) Dodd-Frank notwithstanding, the pace of rule implementation has already accelerated in the marketplace; (2) when perfect policy simply takes too long to formulate and implement, good and manageable reform starts to look better than perfect; (3) staged implementation is needed because it allows for short-term (if modest) improvements and recognizes that reform work remains unfinished; and (4) more transparent empirical analysis is needed to ensure that reforms work as intended and are in the best interest of the economy.

Concluding Remarks

In his concluding remarks, George Shultz emphasizes that “there was more agreement here than people may have expected at the beginning of the meeting,” suggesting therefore that perhaps the conference helped to narrow the great divide.

He began by noting that many at the conference agreed that the Fed should go back to paying zero interest on reserves, and that there was general agreement that a failure of the regulatory system was a significant factor in the financial crisis. Though disagreement remained on why this happened and what should be done about it, in his view, regulatory capture was a big problem, much as George Stigler warned years ago. Reform therefore should focus on simple—easy to understand and monitor—regulatory rules, such as clearly stated capital and liquidity requirements.

Another area of agreement he emphasized was the importance of long-term, strategic thinking. Without clarity in procedures, it's easy to get off track, he said. And he expressed concern about the "legitimate questions [that] were raised about what the Fed has done in an institutional way," noting that the Fed faced the problem of mission creep and that it no longer appeared to be the limited purpose organization it once was.

He agreed with many at the conference that the damage to the financial system had largely been repaired, but worried that the real economy was still growing slowly, despite the huge stimulus from monetary and fiscal policy. The lesson is to concentrate on the real economy—reduce policy uncertainty, get a sound regulatory system in place, and reform the personal and corporate income tax system: "They're the kinds of things that would get the real economy going."

He noted that people at the conference instinctively realized that bailouts change people's behavior in a very undesirable way. Thus we need to look for ways that encourage people in leadership positions to resist bailout and, more generally, have the courage to implement good policy. As he put it: "What I'm saying here is that in order for all of the fascinating and important issues you have been talking about in this conference to work, there have to be some people at the top with guts who are willing to look at these things and see them through. It isn't easy."