“Remarks on the Financial Crisis”

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Excerpts from “A Conversation about Key Conclusions,” in *Ending Government Bailouts As We Know Them*, Kenneth E. Scott, George P. Shultz, John B. Taylor (Eds.) Hoover Institution Press, 2009

GPS: *Remember that markets work.*

There is a narrative about the financial crisis that states the problem was a failure of the market system. That narrative is wrong. A long period of easy money led to excessive risk taking, and government pressure to make questionable loans triggered a housing bubble.

Yes, many financial institutions went wild, so let’s fix the problem of financial institutions and hope that government will behave better in the future. Government should set the rules of the game, implement them credibly, and then get out of the way. The rules should be clearly stated and stable over time so that people understand them and make decisions based on them. Then we can let markets work.

GPS: I am more convinced than ever that we have to define and measure systemic risk operationally if we are going to make any progress. Without an operational definition the bailout mentality will continue. I said this at the opening of the conference, and John Taylor’s essay and Monika Piazzesi’s discussion of it confirmed this. I heard no one disagree. It’s clear that we do not have a workable definition yet, despite much discussion and research over the past year. As Paul Volcker says, it is “a fuzzy concept.” There is even disagreement about whether systemic risk in the recent crisis was due to government or the private sector. Defining and measuring systemic risk is a very big project and will require a concentrated effort by economists, lawyers, and financial market participants using data on loans and counterparty relationships and experience. That should be the priority now.

GPS: I think the essays and the discussions [in this book] represent substantial progress on finding a credible alternative to bailouts. The hours of work and frequent Saturday meetings of Ken Scott’s Resolution Project have really paid off. Tom Jackson’s Chapter 11F bankruptcy proposal shows us how to deal with many of the criticisms that skeptics had made about the slowness of bankruptcy or about the lack of financial expertise in the bankruptcy courts. In addition, Darrell Duffie explained how new types of contingent convertible debt and mandatory rights offerings can be deployed without “relying on the backstop of a government bailout.” Peter Wallison and David Skeel were in agreement with Tom on bankruptcy, as were most who commented from the floor. So I say let’s write Chapter 11F into the law so that we have a credible alternative to bailouts in practice. We can then be ready to use a rules-based bankruptcy process to allow financial firms to fail without causing financial disruption.

GPS: Paul Volcker and Nick Brady argued strongly that we constrain financial institutions that have access to Federal Reserve loans and federal guarantees more than other financial service organizations. I agree. To be clear, we should not prevent innovative financial products, but neither should we allow financial structures to put taxpayer funds at risk because of such products. Separating proprietary trading from banking is one means of prevention, and this does not mean going back to Glass-Steagall and taking underwriting out of banks. Other financial institutions can establish separate “mutual funds” if they want to engage in such activity, and make clear that the funds are not guaranteed by the parent organization.