Scholar Questions 2008 Crisis Narrative

By Robert Feinberg
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The Cato Institute recently hosted a presentation by Vern McKinley, a research fellow at the Independent Institute, titled "Run, Run, Run: Was the Financial Crisis Panic Over Bank Runs Justified?" based on the recent policy analysis he did for Cato. Mark Calabria, director of financial regulation studies at Cato, moderated the panel, and Louise Bennetts, associate director of financial regulation studies at Cato, commented.

The introduction to the program mentions that the Financial Crisis Inquiry Commission found as many as 10 bank runs that were supposed to have affected policy during the 2008 episode of the ongoing financial crisis. McKinley's main thesis was that there was virtually no net movement of funds out of the banking system during this episode, so he has proceeded to ask more questions about why the various authorities acted as they did.

The best feature of this event was that McKinley has asked a lot of questions and made some Freedom of Information Act requests in an effort to learn more about what happened during that crucial fall of 2008 beyond the too-neat narrative that has been propagated by the administration and the financial lobbies.

It goes to the question this writer has raised regarding why the leaders of Congress and of the congressional banking committees were so easily stampeded at the meeting, recounted by former Sen. Christopher Dodd, D-Conn., and former Rep. Barney Frank, D-Mass., where Treasury Secretary Hank Paulson and Federal Reserve Chairman Ben Bernanke warned Congress that unless extraordinary action was taken immediately, the global banking system would soon collapse.

Readers will recall that Paulson just happened to be the former CEO of Goldman Sachs. Along with Morgan Stanley, Goldman Sachs undertook a shotgun conversion to a bank holding company so that it could participate in the bailout.

McKinley leveled sharp criticism against John Dugan, the Comptroller of the Currency during the crisis, for his contradictory message to the markets. On the one hand, the Office of the Comptroller of the Currency never lowered the ratings on the "too big to fail" banks from a strong 2 on a 1 to 5 scale, while on the other hand, Dugan "went on a rant" about the weakness of the financial system that had to be controlled somehow.

When contemplating the actions of the financial regulators, one is left asking the Trump question: Who hired these people; where did they come from?

McKinley referred to the standard of the legendary Walter Bagehot to define how a central bank should respond to a crisis: lend freely to solvent institutions at a penalty rate on good collateral.

Looking at banking crises of the 1920s, 1980s, and 1990s, Anna Schwartz, the legendary historian of the Federal Reserve, found that the Fed had violated the injunction against lending to insolvent institutions. McKinley concluded that by the 1970s, the authorities had fallen into the habit of propping up insolvent institutions when it would have been cheaper to shut them down.

Perhaps McKinley went too far when he credited Congress with trying to rein in the generosity and fecklessness of the regulators, first by enacting Prompt Corrective Action and Least Cost Resolution and more recently by repealing the authority to prop up institutions when in "exigent circumstances." By now the markets expect the authorities to nullify any such laws, and the regulators who do this expect to be praised for this; in fact, they write the books themselves.