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Cochrane: Diagnosing the Financial Crisis

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Professor John Cochrane offers his take on the financial crisis of 2008 in the current issue of the Cato Institute's *Regulation*.

His basic argument: "the signature event of this financial crisis was the 'run,' 'panic,' 'flight to quality,' or whatever you choose to call it, that started in late September of 2008 and receded over the winter. Short-term credit dried up, including the normally straightforward repurchase agreement, inter-bank lending, and commercial papermarkets. If that panic had not occurred, it is likely that any economic contraction following the housing bust would have been no worse than the mild 2001 recession that followed the dot-com bust."

Was that really the source of the crisis? Maybe, although no one really knows. This is economics, after all. Certainly there's no shortage of competing notions of what happened. But even if you don't agree with Cocgrane 100%, he makes a number of salient points that, at the very least, demand consideration in the months and years ahead as the powers in Washington attempt to "fix" the system.

With that in mind, here are a few points in Cochrane's article that are worth debating...

> Why was there a financial panic? There were two obvious precipitating events: the failure of Lehman Brothers investment bank in the context of the Bear Stearns, Fannie Mae (FNM), Freddie Mac (FRE) and aig bailouts; and the chaotic days in Washington surrounding the passage of legislation establishing the Troubled Asset Relief Program (TARP). Why would Lehman's failure cause a panic?
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> Why, after seeing Lehman go to bankruptcy court, would people stop lending to, say, Citigroup (C), and demand much higher prices for its credit default swaps (insurance against Citi failure? Nothing technical in the Lehman bankruptcy caused a panic. The usual "systemic" bankruptcy stories did not happen: We did not see a secondary wave of creditors forced into bankruptcy by Lehman losses. Most of Lehman's operations were up and running in days under new owners. Lehman credit default swaps (CDSS) paid off. Sure, there was some mess — repos in the United Kingdom got stuck in bankruptcy court, some money market funds "broke the buck" and had to borrow from the Fed — but those issues are easy to fix and they do not explain why Lehman's failure would cause a widespread panic. What is more, Lehman's failure did not carry any news about asset values; it was obvious already that those assets were not worth much and illiquid anyway.
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> We are left with only one plausible explanation for why Lehman's failure could have had such wide-ranging effect: After the Bear Stearns bailout earlier in the year, markets came to the conclusion that investment banks and bank holding companies were "too big to fail" and would be bailed out. But when the government did not bail out Lehman, and in fact said it lacked the legal authority to do so, everyone reassessed that expectation. "Maybe the government will not, or cannot, bail out Citigroup?" Suddenly, it made perfect sense to run like mad.

The critical issue, Cochrane writes, is that...

> Bank deposits, subject to runs, pose an externality.We all understand that markets can fail when there are externalities. If we need to allow bank deposits,we need a guarantee or priority in bankruptcy, which leads tomoral hazard and puts taxpayer at risk. Some regulation and a forced separation of these "systemic" contracts from arbitrary risk-taking are necessary. But this is a very minimal level of regulation compared to the too-big-to-fail guarantee and extensive discretionary supervision and regulation now being applied to the entire financial system.

The stakes, as a result, are clear, he asserts:

> We are in an ever-increasing cycle of risk-taking and too-big-to-fail bailouts, going back decades. Now we know that bank holding companies, insurance companies and investment banks are too big to fail in the government's eyes and their activities are not going to be fundamentally restricted in size and scope. This crisis strained the

fiscal limits of the United States to make good on bailout expectations. The next one will be bigger. Where will it come from? State and local government defaults? Defined benefit pension funds? Commercial real estate? A new "Asian bubble?" Default by Greece, Italy, or Ireland? Who knows? We do know this: when the government no longer has the fiscal resources to bail out its financial institutions, the crisis will be much, much worse. Iceland can happen in the United States if we do not get this right.