

Trying to Tame the Unknowable

By N. GREGORY MANKIWI

THE economy is recovering, in baby steps, from the financial crisis and deep recession of 2008 and 2009. A big question still looms on the horizon: What can policy makers do to prevent this kind of thing from happening again?

Perhaps the best place to start is to acknowledge what we cannot do. If recent events have taught economists and policy makers anything, it is the need for humility.

One thing we cannot do very well is forecast the economy. The recent crisis and recession caught most economists flat-footed. This is nothing new. We have never been good at foretelling the future, but when the news is favorable, others forgive our lack of prescience.

Some critics say the Federal Reserve should have foreseen the bursting of the housing bubble and its financial aftershocks. A few of them, having made the correct call themselves, are enjoying newfound celebrity.

Yet at any time, there are many forecasters with a large range of views. After the fact, a few will turn out to be right, and many wrong. Policy makers at the Fed don't know in advance who will be the lucky few. Their best course is to rely on the consensus forecast and to be ready for the inevitable surprises.

Another thing we cannot do very well is regulate financial institutions.

When I was chairman of President George W. Bush's Council of Economic Advisers from 2003 to 2005, I spoke openly about the need to reform regulation of Fannie Mae and Freddie Mac. I did not know when or how these government-sponsored enterprises would come crashing down, but I thought they posed undue risks for the economy and for taxpayers.

I was not alone in that judgment. While working on the issue, I consulted privately with an economist who had held a high-ranking

position in the Clinton administration. He shared precisely my concerns, as did Alan Greenspan, who was then the Fed chairman.

Why was nothing done? Many members of Congress were worried less about financial fragility than about expanding access to homeownership. Moreover, lobbyists from these companies assured Congress that there was no real problem, while the sheer complexity of these institutions made it hard for legislators to appreciate the enormity of the risks.

I recount this story not because Fannie Mae and Freddie Mac were the main cause of the recent financial crisis — they were only one element — but because it shows the kind of problem we'll encounter on a larger scale as we reform oversight of the financial system.

We should certainly aim for better financial regulation, especially for institutions with government-insured deposits. More transparency and more accurate assessment of risks are admirable goals. Higher capital requirements would be a step in the right direction.

There has been much talk about restricting the use of financial derivatives. Unfortunately, writing good rules is not easy. Derivatives, like fire, can lead to disaster if not handled with care, but they can also be used to good effect.

Whatever we do, let's not be overoptimistic about how successful improved oversight will be. The financial system is diverse and vastly complicated. Government regulators will always be outnumbered and underpaid compared with those whose interest it is to circumvent the regulations. Legislators will often be distracted by other priorities. To believe that the government will ever become a reliable watchdog would be a tragic mistake.

So where does this leave us? We should plan for future financial crises, to occur at some unknown date for some unknown reason, and arm ourselves with better tools to clean up the mess.

Much focus in Washington has been on expanding the government's authority to step in when a financial institution is near bankruptcy, and to fix the problem before the institution creates a systemic risk.

That makes some sense, but creates risks of its own. If federal authorities are responsible for troubled institutions, creditors may view those institutions as safer than they really are. When problems arise, regulators may find it hard to avoid using taxpayer money. The entire financial system might well become, in essence, a group of government-sponsored enterprises.

Another idea is to require financial firms to write their own “living wills,” describing how they would wind down in the event of an adverse shock to their balance sheets. It is hard to say whether this would work. Like real wills, the next of kin may well contest the terms when the time comes. That would slow the process and defeat much of the purpose.

MY favorite proposal is to require banks, and perhaps a broad class of financial institutions, to sell contingent debt that can be converted to equity when a regulator deems that these institutions have insufficient capital. This debt would be a form of preplanned recapitalization in the event of a financial crisis, and the infusion of capital would be with private, rather than taxpayer, funds. Think of it as crisis insurance.

Bankers may balk at this proposal, because it would raise the cost of doing business. The buyers of these bonds would need to be compensated for providing this insurance.

But this contingent debt would also give bankers an incentive to limit risk by, say, reducing leverage. The safer these financial institutions are, the less likely the contingency would be triggered and the less they would need to pay for this debt.

A few years ago, some people thought that major financial crises were a thing of the past. We know that was wrong. Despite our best efforts, more financial crises are likely to occur. As we recover from the last one, we should prepare for the next.