David Brooks

The world after Lehman

A few years ago, real estate was all the rage. Earlier this year, the business magazines were telling us to invest in Lehman Brothers and Merrill Lynch, because those stocks were bound to zoom. Now another herd is on the march.

We're in a paradigm shift, its members say. The current financial turmoil marks the end of the era of wide-open global capitalism. Today's gigantic government acquisitions signal a new political era, with more federal activism and tighter regulations.

This observation is then followed by a string of ethereal gottas and shoulds. We Americans gotta have smart regulation that offers security but doesn't stifle innovation. We gotta have rules that inhibit reckless gambling without squelching sensible risk-taking. We should limit excesses during booms and head off liquidations when things go bad.

It all sounds great (like buying a house with no money down), but do you mind if I do a little due diligence?

In the first place, the idea that America's problems stem from light regulation and could be solved by more regulation doesn't fit all the facts. The current financial crisis is centered around highly regulated investment banks, while lightly regulated hedge funds are not doing so badly. Two of the biggest miscreants were Fannie Mae and Freddie Mac, which, in theory, "were probably the world's most heavily supervised financial institutions," according to Jonathan Kay of The Financial Times.

Moreover, there is a lot of lamentation about Clinton-era reforms that loosened restrictions on banks. But it's hard, as Megan McArdle of The Atlantic notes, to see what these reforms had to do with rising house prices, the flood of foreign investment that fed the credit bubble and the global creation of complex new financial instruments for pricing and distributing risk.

In other words, maybe there is something more going on here than just a bunch of laissez-faire regulators asleep at the wheel. But even if it is true that America needs more federal activism, I'm a little curious about what we're going to need to make the system work.

The herd might just be wrong once again.

Surely, we're going to need lawmakers who understand what caused the current meltdown and who can design rules to make sure it doesn't happen again. And yet there's no consensus about what caused this bubble.

Some people blame the Fed's monetary policies, but some say the Fed had only a marginal effect. Some argue a flood of foreign investment allowed us to live beyond our means, while others say bad accounting regulations after Enron created a chain reaction of losses.

We don't even have a clear explanation about the past, yet we're also going to need regulators who understand the present and can diagnose the future.

We're going to need regulators who can anticipate what the next Wall Street business model is going to look like, and how the next crisis will be different than the current one. We're going to need squads of low-paid regulators who can stay ahead of the highly paid bankers, auditors and analysts who pace this industry (and who themselves failed to anticipate this turmoil).

We're apparently going to need an all-powerful Super-Fed than can manage inflation, unemployment, bubbles and maybe hurricanes — all at the same time! We're going to need regulators who write regulations that control risky behavior rather than just channeling it off into dark corners, and who understand what's happening in bank trading rooms even if the CEOs themselves are oblivious.

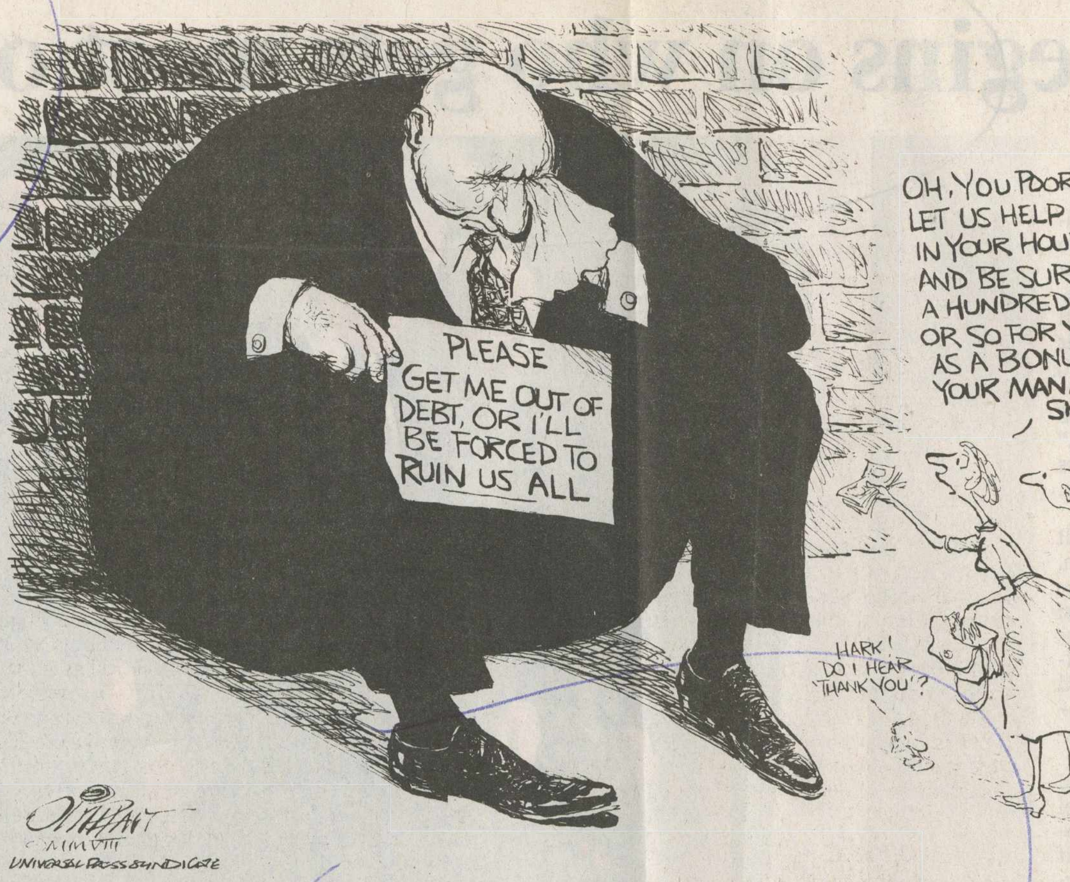
We're also going to need regulators who can overcome politics and human nature. As McArdle notes, cracking down on subprime loans just when they were getting frothy would have meant issuing an edict that effectively said: "Don't lend money to poor people." Good luck with that.

We'd need regulators who could spot a bubble and squelch a boom just when things seem to be going good, who can scare away foreign investment and who could over-rule popularity-mongering presidents. (The statements by the two candidates this week have been moronic.)

To sum it all up, this supposed new era of federal activism is going to confront some old problems: the lack of information available to government planners, the inability to keep up with or control complex economic systems, the fact that political considerations invariably distort the best laid plans.

This doesn't mean there's nothing to be done. Martin Wolf suggests countercyclical capital requirements. Everybody seems to be for some updated version of the Resolution Trust Corp., though disposing of complex debt securities has got to be more difficult than disposing of commercial real estate.

It's just that there's a big difference between dreaming of some ideal regulatory regime and actually putting one into practice. Everybody says we're about to enter a new political era, rich in global financial regulation. The herd might just be wrong once again.



Paul Krugman

Crisis endgame

PRINCETON, New Jersey

On Sunday, U.S. Treasury Secretary Henry Paulson tried to draw a line in the sand against further bailouts of failing financial institutions; four days later, faced with a crisis spinning out of control, much of Washington appears to have decided that government isn't the problem, it's the solution. The unthinkable — a government buyout of much of the private sector's bad debt — has become the inevitable.

The story so far: The real shock after the feds failed to bail out Lehman Brothers wasn't the plunge in the Dow, it was the reaction of the credit markets. Basically, lenders went on strike: U.S. government debt, which is still perceived as the safest of all investments — if the government goes bust, what is anything else worth? — was snapped up even though it paid essentially nothing, while would-be private borrowers were frozen out.

Government takeovers may be the only way to get the financial system working again.

Thus, banks are normally able to borrow from each other at rates just slightly above the interest rate on U.S. Treasury bills. But Thursday morning, the average interest rate on three-month interbank borrowing was 3.2 percent, while the interest rate on the corresponding Treasuries was 0.05 percent. No, that's not a misprint.

This flight to safety has cut off credit to many businesses, including major players in the financial industry — and that, in turn, is setting us up for more big failures and further panic. It's also depressing business spending, a bad thing as signs gather that the economic slump is deepening.

And the Federal Reserve, which normally takes the lead in fighting recessions, can't do much this time, because the standard tools of monetary policy have lost their grip. Usually the Fed responds to economic weakness by buying up Treasury bills, in order to drive interest rates down. But the interest rate on Treasuries is already zero, for all practical purposes; what more can the Fed do?

Well, it can lend money to the private sector — and it's been doing that on an awesome scale. But this lending hasn't kept the situation from deteriorating.

There's only one bright spot in the picture: interest rates on mortgages have come down sharply since the federal government took over Fannie Mae and Freddie Mac, and guaranteed their debt. And there's a lesson there for those ready to hear it: Government takeovers may be the only way to get the financial system working again.

Some people have been making that argument for some time. Most recently, former Fed Chairman Paul Volcker and two other veterans of past financial crises published an op-ed in The Wall Street Journal declaring that the only way to avoid "the mother of all credit contractions" is to create a new government agency to "buy up the troubled paper" — that is, to have taxpayers take over the bad assets created by the bursting of the housing and credit bubbles. Coming from Volcker, that proposal has serious credibility.

Influential members of Congress, including Senator Hillary Clinton and Representative Barney Frank, the chairman of the House Financial Services Committee, have been making similar arguments. And on Thursday, Senator Charles Schumer, the chairman of the Senate Finance Committee (and an advocate of creating a new agency to resolve the financial crisis) told reporters that "the Federal Reserve and the Treasury are realizing that we need a more comprehensive solution."

Sure enough, Federal Reserve Chairman Ben Bernanke and Paulson met on Thursday night with congressional leaders to discuss a "comprehensive approach" to the problem.

We don't know yet what that "comprehensive approach" will look like. There have been hopeful comparisons to the financial rescue the Swedish government carried out in the early 1990s, a rescue that involved a temporary public takeover of a large part of the country's financial system. It's not clear, however, whether policymakers in Washington are prepared to exert a comparable degree of control.

And if they aren't, this could turn into the wrong kind of rescue — a bailout of stockholders as well as the market, in effect rescuing the financial industry from the consequences of its own greed.

Furthermore, even a well-designed rescue would cost a lot of money.

The Swedish government laid out 4 percent of gross domestic product, which in America's case would be a cool $600 billion — although the final burden to Swedish taxpayers was much less, because the government was eventually able to sell off the assets it had acquired, in some cases at a handsome profit.

But it's no use whining (sorry, Senator Gramm) about the prospect of a financial rescue plan. Today's U.S. political system isn't going to follow Andrew Mellon's infamous advice to Herbert Hoover: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate."

The big buyout is coming; the only question is whether it will be done right.