Fuel for the Financial Fire

It's time to ask whether the government's partial rescue of Wall Street added gasoline to the flames.

By John B. Taylor

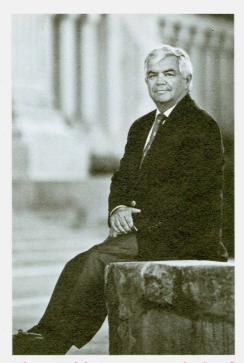
CONVENTIONAL QUESTION: DID THE government's quick intervention on Wall Street last year save us from another Great Depression? Alternative question, one that I prefer: Did government intervention make matters worse? As facts about the crisis roll in, more people are beginning to answer the second question in the affirmative.

First, consider the once controversial view that the crisis was largely caused by the Fed's holding interest rates too low for too long after the 2001 recession. This view is now so widely held that the editorial pages of both the New York Times and the Wall Street Journal agree on its validity. The low interest rates fueled the housing boom, encouraging adjustable-rate mortgages and other risk-taking searches for yield, which ultimately ended with the bust, defaults and toxic assets on banks' balance sheets. This government intervention, in which the Fed deviated from a policy that had worked well for most of the 1980s and 1990s, turned out to be very harmful.

Next, consider the view that the crisis was prolonged by a misdiagnosis that led to more interventions. When the crisis first

flared up, government officials argued that high interest rates in the money markets were due to a shortage of liquidity rather than to risk on the banks' balance sheets. That this was a misdiagnosis is now obvious; the weakness of banks' balance sheets is apparent to everyone. Yet the misdiagnosis led to several harmful interventions, including a sharp increase in Fed liquidity and a sudden cut in interest rates, which depreciated the dollar and led to sky-high gasoline prices and a drop in purchases of automobiles and other durables in the summer of 2008.

Now, with the recent one-year anniversary of the Lehman bank-ruptcy, people are discussing why the financial crisis worsened so much in the panic last fall. Many still say that the big government mistake was not stopping the failure of Lehman. I do not think the evidence supports that view. Of course the losses for Lehman's creditors and the run on certain money market funds were a jolt to the market. But far worse was the chaotic intervention by the government in the following weeks, including the Treasury Department's not very credible description of how it would remove toxic assets



The problem was not lack of intervention so much as the unpredictable, unprincipled pattern of intervention.

from banks' balance sheets, the huge amount of money it asked for with only two and a half pages of legislation and the scare stories it let loose about another Great Depression if the legislation was not passed. That the financial Armageddon stories were told to members of Congress behind closed doors and then leaked out gradually added to the fears, uncertainty and panic.

The S&P 500 was at 1252 on Sept. 12, the Friday before the Lehman bankruptcy. It initially fell with the bankruptcy news, but at the Sept. 19 close it had recovered to 1255. It was not until the following week and the frightening rollout of the toxic assets rescue plan that stock prices began to tank. They continued to sink until Oct. 10, when the S&P 500 hit 899 and the government finally clarified what the bailout money would be used for (equity injections). The same patterns are found in stock markets in Europe, Asia and Latin America.

The government interventions during this time of panic were part of a pattern of ad hoc responses starting with the Bear Stearns bailout. No guidance was given following Bear Stearns about the circum-

stances under which another firm, such as Lehman, would be rescued. Indeed, Timothy Geithner, who led the initial bailout as president of the New York Fed, suggested that more bailouts should be expected. So when the decision was made—without a good legal or economic reason—not to save Lehman, no one was prepared. But the problem was not the lack of intervention so much as the unpredictable, unprincipled pattern of intervention that had been followed for months, a pattern the toxic asset rescue plan revealed for the whole world to see.

This view of how government intervention led to the panic of 2008 is still controversial. Time will tell whether it will be as widely held as the previously controversial view that government interventions caused and prolonged the crisis. But as I see the facts, they are leading in that direction.

John B. Taylor, a senior fellow at the Hoover Institution and professor of economics at Stanford University, is the author of *Getting Off Track:* How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis (Hoover Press, 2009).