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Are We Safe Yet?

How to Manage Financial Crises

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The 2008 financial crisis [2] was the most damaging economic event since the Great Depression, for both the United States and much of the global economy [3]. Although the U.S. economy emerged from it more quickly and in better shape than many other economies did, the crisis imposed tragically high costs and left deep economic and political scars. To help prevent another crisis, Congress passed the Dodd-Frank [4] Wall Street Reform and Consumer Protection Act in 2010. These and other reforms have added a considerable margin of safety to the U.S. financial system [5].

But how safe is that system today? The answer is important, because although the United States may not face a major crisis anytime soon, it is certain to at some point. The choices policymakers make in advance of that event and in the moment will have a major impact in determining the magnitude of the economic damage. Indeed, the U.S. financial system's vulnerability to a crisis depends not only on the strength of the regulation designed to prevent one but also on how much freedom policymakers have to respond when prevention fails. It's just as in medicine, where the public's health depends not just on immunizations, nutrition, and checkups but also on hospitals, surgery, and emergency care.

Determining whether the system is now safer requires looking at three different dimensions of the question. The first involves trying to assess the underlying fragility of the system today. How much dry tinder, so to speak, is there in terms of short-term liabilities, and how much privately owned capital is available to absorb losses in an economic downturn? The second involves the ability to limit the intensity of a crisis. How much fiscal capacity does the government have to cushion a fall in private demand, and how much monetary scope does the Federal Reserve have to lower interest rates? The third dimension has to do with the other powers necessary to prevent a financial crisis from spiraling out of control. What emergency firefighting tools can policymakers use in the midst of a crisis?

Taken together, these three dimensions of safety offer reason to worry. Although regulations have reined in banks' risk-taking behavior, they can go only so far. Fiscal and monetary policy are more constrained than they have been for decades. And the government enjoys even less emergency authority than it did before the crisis. The result is that the U.S. economy is less vulnerable to a modest crisis but more vulnerable to an extreme one.

INHERENTLY FRAGILE

It's important to understand why financial systems are so vulnerable to crises. First, and most important, they are inherently prone to panics and runs. This results from a core function of banks called "maturity transformation," in which they accept deposits and lend those deposits out for long periods of time to finance homes and businesses. Maturity transformation is a valuable feature of the financial system, but it's also what makes it vulnerable to runs.

The danger is particularly acute in periods that see both large increases in wealth and optimistic beliefs about the economy—that the economy is safe, that risky assets will rise in value, that liquidity is freely available, and so on. This dynamic fuels demand for money-like short-term liabilities, such as bank deposits, and lowers the perceived risk of financing long-dated illiquid assets, such as bank loans. These short-term liabilities are dangerous because they are runnable, meaning that creditors can demand their money back at a moment's notice. And they account for trillions of dollars in modern economies. Runs present a sadly familiar set of perils when they happen to regulated and protected banks. They create more complicated perils when they happen to other types of financial institutions that are less regulated, as was the case in the United States before the 2008 crisis.

The second thing to understand is that systemic financial shocks, ones involving panics and runs, are fundamentally more dangerous than other types of financial shocks, such as the one-off failure of a single large bank, a stock market crash that is not accompanied by a broader fall in the value of risky assets, or the financial losses that stem from a modest recession. Panics and runs are dangerous not so much because of the damage they do to individual financial institutions but because of their capacity to lead to a vicious spiral of fire sales and a contraction in credit that threatens the stability of the entire financial system and can push the economy into recession. The policies required to break panics and runs are fundamentally different from the ones that are appropriate in response to a typical idiosyncratic financial shock or a modest recession.

Panics, although scary and dangerous, don't inevitably end in economic crashes. Much of what determines the severity of the outcome is the quality of the policy choices made in the moment. When expected losses to the value of assets appear very large, there will be uncertainty about which party will bear those losses. This uncertainty can lead to a general reduction in funding for a broad range of financial institutions. That, in turn, can force those institutions to liquidate assets at fire-sale prices, which, if used to measure the riskiness of assets across the system, will make large parts of the financial system appear to be insolvent. This dynamic is not self-correcting. Left unchecked, it will simply accelerate.

Nor are the dynamics of contagion fully knowable in advance. To paraphrase Ernest Hemingway, runs happen gradually, then suddenly. Their characteristics and severity depend on how things evolve in the event and on what policymakers do in response. What matters most are not the first-round effects of direct losses from the defaults of the weakest firms or even the linkages among those firms. Rather, what drives contagion is an increase in the perceived risk that a large number of firms could fail. Although the degree of exposure varies across financial institutions, all are exposed to the risk of runs and to the perils of losses in a deep recession. This is why fiscal and monetary policy, and actions by the government to provide or guarantee funding, are so important. Once a run starts and the risk of financial collapse grows, the challenge is to break the panic by reducing the incentives for individuals to run from financial institutions and for financial institutions to run from one another. Otherwise, a broader collapse in the financial system becomes almost inevitable.

The third thing worth knowing about crises is that there is no way to protect the economy from a failing financial system without deploying public resources—in other words, without temporarily substituting sovereign credit for private credit. No financial institution can insure itself against the equivalent of a 100-year flood: the collapse of the financial system or a great depression. When the system is in the midst of a panic, no private source of funding can match the cost or the scale of what the state can provide.

Policymakers can choose to let the panic play out, the financial system collapse, and the economy fall into depression. But if they want to avoid that outcome, they must recognize that only the government has the ability to offset the drop in private demand and preserve the functioning of the credit system necessary for economic recovery. Policymakers can wish this were not so. They can reduce the probability that a rescue is ultimately necessary. But they cannot eliminate the inherent fragility of the financial system, and they cannot escape the reality that its survival requires extraordinary intervention on the part of the state.

The inevitability of government intervention, of course, creates a moral hazard, whereby firms may take excessive risks, knowing that the government will bail them out if anything goes wrong. That's why regulations exist to constrain risk. And it's why it is so hard to find a balance between establishing a credible backstop in case of emergency and avoiding the expectation that investors will be fully protected against loss.

The inherent fragility of the system does not mean that it cannot be made safer. A lot can be done, has been done, and can still be done. But in designing reforms, it's important to choose the objective carefully. The goal should not be to eliminate the risk of the failure of individual banks or large institutions. Failure has its merits. It's important for creating the right incentives, spurring innovation, and promoting efficiency. Rather, policymakers should strive to enhance the resilience of the broader financial system. Even when the system is under extreme stress, it needs to remain able to perform its basic functions of providing payment, clearing, and settlement services; offering credit; and transferring risk.

In other words, policymakers should try to build a system in which an idiosyncratic event does not turn into a systemic crisis. This means seeking not only to reduce the probability of financial distress but also to increase the probability that the real economy remains insulated from it. Against that standard, how resilient is the U.S. financial system today?

THE DRY TINDER

There is no way to accurately measure the fragility of the financial system at any given time, but the history of financial crises suggests that the risks are greatest after long periods of optimism in which credit has grown rapidly relative to income and banks have taken on more risk. Given the role of manias in sowing the seeds of crises, it is worth starting with the reality that today, the memory of the global financial crisis still looms large. In a way, this should be reassuring. A world worried about the approaching abyss is safer than a more sanguine one, such as in 2006.

A combination of scars from the crisis and new regulation has diminished the threat of runnable liabilities, reducing the amount of dry tinder in the U.S. financial system. These days, a greater share of banks' assets is funded by deposits, which the federal government insures, thus reassuring people that they won't lose their savings if their bank collapses, and a smaller share is funded by unsecured debt: deposits now represent 86 percent of U.S. banks' total liabilities, up from 72 percent in 2008, and the Federal Reserve estimates that runnable liabilities in the United States have fallen by roughly 20 percent of GDP since 2008.

Moreover, the duration of the liabilities that banks hold is longer. When it comes to repurchase agreements, or repos—whereby dealers sell government securities to investors and agree to buy them back after a short time—the size of the market is smaller, the collateral much safer, and the amount financed overnight much smaller. Whole classes of risky funding vehicles were washed out in the crisis and have not reemerged.

Further reducing the risk of catastrophe, the postcrisis reforms have produced much stricter requirements for how much capital banks must have on hand and more conservative approaches to measuring the risk of a bank's assets. Capital requirements in the United States have risen to five to ten times their amount before the crisis. The quality of the capital that banks hold, now predominantly common stock, has improved greatly in terms of its ability to absorb losses. Under a new Federal Reserve rule, the major global banks face additional capital requirements, in effect forcing them to themselves take on more of the greater risk they pose to the rest of the system in the event of their failure. As a result of such requirements, U.S. banks have raised roughly $500 billion in common stock since the end of 2008, bringing the total amount of equity capital in the banking system to about $1.7 trillion. Today, the major U.S. banks could probably sustain losses greater than those experienced in the Great Depression and still have enough capital to operate.

Perhaps as important as the fact that capital requirements have grown in size is that they now apply more widely. Before the crisis, limits on leverage applied only to banks and, somewhat less effectively, their affiliates, which together accounted for about 40 percent of credit to the household and corporate sectors. No effective limits on leverage applied to the rest of the financial system, including investment banks; government-sponsored entities, such as Fannie Mae and Freddie Mac; money-market funds; and other financial institutions, such as the insurance corporation AIG.

Today, the largest investment banks are regulated as bank holding companies, subjecting entire institutions to higher capital requirements. Fewer financial firms fall outside that regulatory framework. The government now fully backstops the government-sponsored entities. Money-market funds are subject to more exacting regulatory requirements. And major insurance companies that sold protection to the financial system as a whole and required bailouts in the crisis are smaller now and subject to some form of supervision.

Finally, the government enjoys new powers that can help it contain sources of systemic risk that arise outside of banks. These include the authority to extend regulation to nonbank financial institutions by designating them as systemically important, to regulate additional classes of financial activities that might give rise to systemic risk, and to impose requirements that reduce risk in derivatives, repos, and securities lending. Together, these stronger shock absorbers have enhanced the ability of major financial institutions to absorb losses, thus reducing the risk of contagious runs.

THE LIMITS OF REGULATION

There are, however, less reassuring features of the financial world today. Although the new capital requirements seem large relative to the losses experienced in the 2008 crisis, those losses were limited by the scale of the fiscal and monetary response and by the government's success in breaking the panic relatively early. Had policymakers not had as much room to maneuver, the losses would have been much higher.

Over time, the new capital requirements and other limitations on banks have caused some financial transactions to shift away from banks and toward less regulated institutions. So far, this process is not that advanced in the United States. But it is inevitable that capital requirements, when they exceed what the market considers a prudent level, will push more risk outside the regulated financial system. Banks are dangerous, of course, but they are easier to stabilize in a crisis, so shrinking the market share of banks through regulation can leave the financial system more fragile in an extreme event. It's worth remembering how much financial activity migrated away from banks in the United States in the decades before the 2008 crisis, even with much lower capital requirements in place then. In periods of relative economic calm, even small differences between the amount of capital that regulations require and the amount that the market believes is necessary can incentivize financial service providers to move into less regulated sectors. Regulation can adapt, but it will always be behind the curve.

History also offers little reassurance about the value of capital requirements alone as protection against panics. In the five or so decades before the Great Depression, U.S. banks possessed much higher levels of capital, and yet the United States still experienced an appalling number of enormously damaging banking panics. These predated the modern Federal Reserve and deposit insurance, but they still serve as a reminder that creditors to banks can run, even when capital cushions seem large.

One final note of caution: there is no reason to be more confident about policymakers' ability to defuse financial booms or head off financial shocks preemptively. Central banks and international financial institutions have made huge investments in producing sophisticated charts aimed at identifying early warning indicators of systemic risks. But financial crises cannot be forecast. They happen because of inevitable failures of imagination and memory. Financial reforms cannot protect against every conceivable bad event. So it is important to recognize that the overall safety of the financial system—and the health of the broader economy—hinges on more than just the strength of financial regulation.

THE SHRINKING SPACE FOR POLICY

A country's ability to limit the intensity of a financial crisis also depends on how much room for maneuver its fiscal- and monetary-policy makers enjoy. Today, that room has shrunk in most of the major developed economies. Public debt as a share of GDP has soared. The overnight rates at which central banks lend money have fallen close to zero, and in some countries, they have dipped into the negative. The costs of long-term government borrowing have also fallen to record lows. And credit spreads—the difference between government and corporate borrowing costs—have narrowed. In terms of their ability to raise spending and lower interest rates, governments have less ammunition.

As far as monetary policy goes, the experience with negative rates so far is not that promising. Many central banks fear that negative rates have hurt rather than helped the economy, and even those that believe they have helped worry that rates cannot fall much further before they start to backfire. On the fiscal side, almost all the major economies have less room for stimulus than before the crisis. And where there is still room, the political constraints on using it may prove hard to overcome. The only remaining untried tactic is the more coordinated deployment of expansionary fiscal and monetary policy. Perhaps that will prove possible, and if so, perhaps the impact will be powerful. But it's hard to say.

The Federal Reserve, for its part, still has more room for maneuver in terms of monetary policy than other major central banks do. It could push long-term interest rates lower in a crisis. But even in mild recessions, the Fed has typically had to lower borrowing rates by three to five percentage points, and it does not have that room today.

The United States also has less fiscal capacity than it did before the crisis. From 2007 to the end of 2009, the debt-to-GDP ratio increased from roughly 35 percent to 75 percent, where it remains today. Most of this increase owed to lower tax revenues caused by the recession and to the jump in spending that occurred as automatic fiscal stabilizers, such as unemployment benefits, took effect. These costs would have soared even higher in the absence of the stimulus package and the financial rescue. In fact, rather than costing the five to ten percent of GDP that many expected, the rescue earned a modest positive financial return for the public. The stimulus was designed to be temporary and was quickly wound down. The federal deficit fell from its peak of ten percent of GDP in 2009 to around three percent, where it has stayed since 2014. Still, the debt-to-GDP ratio remains close to its postcrisis peak, and absent changes in policy, it will rise in the coming years.

The bottom line is that even though policymakers still have some remaining room to maneuver, they have much less than they did on the eve of previous economic downturns. There is no reassuring precedent for the present diminished state of the U.S. fiscal and monetary arsenal. The Fed has no experience navigating through a substantial shock to private demand without the ability to lower interest rates substantially and quickly. Most of the burden in responding to a crisis would therefore fall on fiscal policy, where the political constraints on action still seem daunting. The same story has played out in most advanced economies, and the implications are troubling. A shock could cause greater damage, last longer, and spread wider.

IN CASE OF EMERGENCY

During the 2008 crisis, governments undertook innovative emergency measures to prevent the collapse of their financial systems and protect their economies. In the United States, as in many other countries, the government acted well beyond the frontiers of historical precedent. The Fed expanded its role as the lender of last resort and provided huge currency swaps to foreign central banks. It purchased a broad range of mortgage-backed securities from government-sponsored entities. The government effectively guaranteed the liabilities of banks, bank holding companies, and government-sponsored entities, as well as the value of a large share of money-market funds. It helped boost the resources available to the International Monetary Fund and the multilateral development banks. The Federal Deposit Insurance Corporation (FDIC) closed hundreds of banks and helped restructure a number of large, complex financial institutions. The government provided a range of different types of capital and financial insurance to banks and other institutions.

A key lesson emerged: breaking the panic and preventing financial collapse ultimately required the government and the Fed not only to take on the role of lender of last resort but also to guarantee funding and inject capital into banks. The conventional arsenal, including the full use of the Fed's ability to lend against collateral and the FDIC's ability to wind down failing banks, was not enough.

To update the government's tool kit for the modern age, policymakers need broad powers. They need the ability to provide funding across the financial system, wherever there are runnable liabilities on a scale that matters. They need the ability to guarantee liabilities at the core of the financial system and to recapitalize that system if necessary. They need the ability to manage the failure of large, complex financial institutions. And they need the ability to provide dollars to the world's central banks and lend to foreign financial firms that have large dollar-denominated liabilities. With this mix of authorities in place, policymakers would have more freedom to allow bank failures without precipitating a panic, and they could recapitalize the core of the system before it was too late, at which point the only alternatives would be nationalization or financial collapse.

Recent reforms in the United States have substantially weakened policymakers' emergency authorities. Many of those that proved so critical in 2008 and 2009 Congress has let lapse, taken away, or subjected to new constraints. Dodd-Frank included reforms designed to limit the discretion available to the Fed, the FDIC, and the Treasury to act without congressional approval. In particular, Congress has restricted the government's ability to act as a lender of last resort, guarantee liabilities, and safely unwind failing firms. Together, these constraints threaten to leave the United States even less prepared to deal with a crisis than it was in 2007.

THE FED UNDER FIRE

The Fed has retained some of the instruments and authority that allow it to act as a lender of last resort, including the traditional discount window, where banks can borrow money from the Fed to cover temporary liquidity shortages. But because banks play a limited role in the U.S. financial system relative to other financial institutions, these conventional, bank-centric tools give the Fed less power compared with its counterparts in countries where banks play a larger role.

The result is that the U.S. financial system suffers from a large mismatch between the distribution of the risk of runnable liabilities and the reach of the accompanying safety net—deposit insurance, the discount window, and the Federal Home Loan Banks (a group of government-sponsored banks that provide lending facilities to banks similar to the discount window). The government's lender-of-last-resort facilities cover only banks, even though there are relatively important nonbank institutions that would need such help in a crisis.

Part of the problem is that although the Federal Reserve can lend freely to a solvent bank against essentially everything the bank has, it has very limited power to buy financial assets. It is allowed to purchase only U.S. Treasuries and securities issued by government-sponsored enterprises, whereas other central banks can typically buy a broader class of assets.

What's more, although the Federal Reserve has the authority to lend to nonbank financial institutions during a crisis, it can do so only when they are close to or past the point of no return. The Fed is required to find not only that the stability of the financial system is at risk but also that no alternative private source of funding is available. That requirement existed before the reforms, but new reforms restrict the Fed even further: the Fed is no longer allowed to lend to individual institutions and can instead lend only to a general class of institutions. The goal was to make it hard, if not impossible, for the Fed to take the types of actions it did when it rescued AIG and helped JPMorgan Chase acquire Bear Stearns.

In addition, the reforms require the Fed to report to Congress if any individual institution is borrowing from it. Because banks rightly fear that this information could leak out and thus exacerbate any funding problems they face, they will likely be dissuaded from taking advantage of the Fed’s lending facilities, at least in the early stages of a liquidity crisis. Although the stigma might diminish as a crisis intensifies and starts to affect a broad class of institutions, these disclosure requirements still limit the preemptive value of the Fed’s lending tools.

Finally, the Fed is now subject to new limits on how much risk it can assume in its lending operations. In general, the Fed is allowed to lend only to solvent institutions, not insolvent ones. The Fed’s emergency authority has long given it the power to judge which category an institution falls into, but new statutory language limits its discretion. Many within the Fed today believe that in a future crisis, these limits would deter, and perhaps prevent, the Fed from providing some of the most valuable lending facilities it offered in 2008 and 2009.

NO GUARANTEE

In addition to these limitations on the Federal Reserve’s authorities [6], the U.S. government faces other constraints on its ability to act in a crisis. Congress has left in place the expansions to deposit insurance (from $100,000 to $250,000) that were put in place in the fall of 2008, but it took away the FDIC’s power to guarantee the broader liabilities of banks and bank holding companies. During the crisis, this authority proved critical to limiting the run on the U.S. banking system that accelerated with the failures of Lehman Brothers, the Reserve Primary Fund, and Washington Mutual. At that point in the crisis, even the exceptionally aggressive use of the Fed’s discount window and other emergency authorities was not sufficient to arrest the run.

The problem was that when calculating the amount of collateral that borrowers had to put up to receive discount-window loans, the Fed, to protect itself against losses, had to apply so-called haircuts to the collateral, meaning that the value of the collateral had to exceed that of the loan. Creditors recognized that this lending ability was not the equivalent of a full guarantee on the part of the Fed and behaved accordingly. The fear of default was too great and collateral values too uncertain for them to continue lending to many banks.

The result was a dramatic intensification of the fire-sale dynamics in most asset markets, which pushed down the prices of financial assets and exacerbated concerns about the solvency of the entire system. In the case of Lehman Brothers and Washington Mutual, the losses experienced by their creditors caused the run to escalate dramatically in scope and intensity, ultimately requiring a much wider use of sovereign guarantees, a much larger fiscal stimulus, and a much more aggressive monetary policy.

The expanded guarantees amplified the power of the initial capital that the U.S. government injected into the financial system, which, although substantial, was not sufficient to fully address the fear of insolvency. Over the course of the fall of 2008 and into early 2009, the government provided more clarity about how it would treat various layers of the banks’ liabilities and what conditions would accompany future injections of public capital. This proved critical in attracting private capital back into the U.S. financial system.

Ultimately, the government induced a greater restructuring and a more aggressive recapitalization of the financial system because it could make credible guarantees of the financial system’s liabilities. With a powerful mix of funding and guarantees in place, it was able to recapitalize the U.S. financial system with just a fraction of the trillion-plus dollars that many had estimated would be necessary.

UNWINDING FAILING FIRMS

At the same time as Congress imposed these limits on the government’s emergency powers, it also expanded the FDIC’s mandate to handle the failure of large, complex financial institutions. This so-called resolution authority used to apply only to banks, which is why in 2008 and 2009, the government had to adopt a messy patchwork of approaches for rescuing AIG and preventing the collapse of Citibank and Bank of America. But this power now extends beyond banks.

The FDIC has designed a framework for using this authority to wind down an individual major financial institution in an orderly manner. The approach is to impose losses on creditors (excluding depositors) up to a level that would be sufficient to cover a conservative estimate of the bank's potential losses, protect taxpayers from losses, and leave the entity with enough capital that it can be sold quickly.

This is a promising approach in the event that an individual firm faces a funding challenge for idiosyncratic reasons, such as massive fraud or an outsize exposure to a single risk. But it is not designed to deal with a systemic crisis. In fact, if used as intended, this authority could make the crisis worse, intensifying the run on both individual institutions and the system as a whole.

Why is this so? If the government imposes losses on a broad class of creditors, then it risks exacerbating a run on a broader range of institutions, as investors rationally act to protect themselves against the possibility of incurring losses at other weak institutions. The risk of such a spiral is low when a single institution is vulnerable for idiosyncratic reasons and the overall economy is strong. But when there is widespread concern, this approach to winding down troubled firms could heighten the panic.

If the FDIC's resolution authority were combined with a standing ability to extend broad guarantees to the core of the financial system, then using it would be less likely to cause a collapse. But that ability does not exist today. And even if it did, it would be better to build more discretion into the resolution process itself, so that a failing institution could be unwound more safely. As things stand now, a strategy designed to reduce taxpayers' exposure to losses and limit moral hazard could end up exacerbating both risks. Since few governments will ultimately choose to let the entire system collapse, a strategy of applying haircuts in conditions vulnerable to panic can end up causing greater economic damage and costing taxpayers more.

THE POLITICS OF BAILOUTS

The limits imposed on the government's emergency authorities reflect the tragic cycle of crisis intervention and political reaction. The cycle works like this: The crisis starts. Policymakers are initially slow to react. The crisis intensifies, exceeding the capacity of the existing arsenal. Legislatures grant greater authority to put out the fire. Policymakers use that authority for bailouts. The bailouts have unappealing direct beneficiaries, enraging the public, and it's hard for anyone to appreciate why the alternative would be worse. To make matters worse, the bailouts to the financial system tend to come well ahead of the trough in economic activity. Asset prices might recover as the systemic risk recedes, but the loss of wealth and the damage to confidence continue to hurt the real economy. As the economy appears to worsen despite the bailouts, the public's outrage at policymakers intensifies. Politicians then rescind the government and the central bank's discretion and promise never to grant it again. The cycle repeats.

Policymakers thus face a dilemma: if they use the authority they are given, it will likely be taken away, but if they don't use it, they will be justly blamed for the ensuing damage. In the United States, Congress granted broad powers to the government during the crisis. The government used these necessary tools, and then Congress not only revoked them but also weakened the government's power further.

Elected legislators have made themselves the arbiters of whether to deploy the measures necessary to arrest a panic. As a result, the emergency response is more likely to be late and badly designed, and it will impose greater fiscal and economic costs, since runs happen faster than legislatures can act. A better model is town councils, which control overall spending but don't oversee how first responders react in an emergency. They try to ensure that the fire department has enough trucks and hoses at all times, rather than require it to seek approval to buy equipment after a fire starts.

Those who contend that the financial system should operate with limited emergency authority on the part of the government make two arguments: that such limits reduce moral hazard and that they are necessary for democratic accountability. Both arguments have merit, but there are better ways of addressing them that don't leave the country so vulnerable.

On the moral hazard concern, a paradox of financial crisis management is that if the government does not act swiftly to break a panic, then it might end up having to take on more risk and guarantee more liabilities, moves that create an even greater moral hazard. It's hard to solve a moral hazard problem in the midst of a crisis without dramatically intensifying it.

A more practical approach to limiting moral hazard involves a mix of things. To begin with, regulators have to bear most of the burden. If given the authority, they can decide how much leverage to permit and thus how much to force the financial system to insure itself. Such regulation will never protect against every eventuality, but it can offset much of the adverse effect that the safety net has on incentives.

Moreover, the emergency arsenal can be designed to achieve the right mix of incentives and reassurance. Preserving some uncertainty about how fast a government will escalate its support in a crisis and how far that support will extend should leave investors in and creditors of financial institutions with a healthy sense of fear, at least up to the edge of the abyss. That, in turn, should lessen the harmful incentives that a strong backstop creates.

The interventions themselves can also be designed to limit moral hazard. In order to reduce the risk of prolonged dependence, the government can lend at rates that are below what prevails on the market in a panic but well above normal levels. It can limit this assistance to those institutions that fall within the scope of regulation and impose tougher conditions on access to emergency support for those on the outside. Politicians, for their part, can pass reforms after the crisis to widen the scope of regulation [7] and force the system to operate with more insurance against future risk.

These efforts would limit the moral hazard created by a strong arsenal of standing emergency authorities, but they have to be done in advance. In the midst of a crisis, there is no way to resolve the fundamental conflict between the imperative of mitigating immediate damage and that of improving future incentives, because actions that seem sensible in terms of the latter tend to exacerbate the former. The alternative approach of severely restricting emergency authorities —in effect, locking the doors of the fire station—is dangerous if the limits to those authorities are credibly inviolable. And since they usually are not, it leaves policymakers with the worst of both worlds. In short, governments can't kill the moral hazard inherent in trying to run a functioning financial system, but they can wound it.

Compared with moral hazard arguments for limiting discretion, those that invoke accountability are more compelling. Financial rescues raise complicated questions of fairness in determining how losses are allocated and which institutions get saved. With such questions at play, it is only natural that the legislature has a say. But that involvement should come ahead of a crisis, in designing the framework for how the government responds, not during a crisis, in choosing how to act. The revealed, and perhaps rational, preference of a legislator during a crisis is to vote against a rescue as long as possible, until his or her vote is essential for passage—and then to blame someone else for the choices made in the moment.

There are many ways to constrain the government's discretion in a crisis without compromising speed and flexibility. Many democracies have required that committees' decisions pass by supermajorities, that emergency actions gain separate approval from both the central bank and the finance ministry, that the government disclose the terms of its rescues, and that actions get reviewed after the fact. Many have passed laws that distinguish what is expected in normal conditions from what might be possible in extreme ones and that define broad goals policymakers must pursue. Central banks [8], for example, are mandated to pursue broad objectives on monetary policy yet can choose how best to achieve them.

The right regime should recognize that successful crisis management requires allowing the government and the central bank to take risks that the market will not take and absorb losses that the market cannot absorb. It should allow the government to act early, before a panic gains momentum. And it should establish an overarching goal of preserving the stability of the whole system and restoring its capacity to function—not avoiding the failure of individual firms.

The regime that exists in the United States today has an awkward asymmetry when it comes to discretion. The government enjoys more freedom in monetary policy than it does in fiscal policy, both in terms of the taxing and spending tools that remain in the hands of legislatures almost everywhere and in terms of emergency measures, such as guarantees and capital injections. The result is an excessive reliance on monetary policy. Policymakers may turn to fiscal policy later than is ideal and face greater constraints on the size and composition of a stimulus. Solvency problems become more likely to be treated as liquidity problems. The government delays action until the only remaining options are even less politically appealing. The United States can and should do better.

THE CRAFT OF CRISIS MANAGEMENT

Just as important as the design of the tools and the authority that governs their use is the state of knowledge about how they should be employed. As a walk through the graveyard of past financial crises reveals, the variation in choices and outcomes is appallingly high. Given the amount of experience available among practitioners across the world, and the diversity of mistakes they have all made, governments should make the effort to learn what works and what doesn't.

Yet policymakers tend to underinvest in this process. In finance, there is no body akin to the National Transportation Safety Board, which investigates airplane crashes. Nor is there a standardized approach to looking at mistakes, such as the morbidity and mortality reviews commonplace in medicine. And nor is there anything like the U.S. Army War College, where experts study how the military fought previous wars and make recommendations about how to fight future ones. In the field of financial stability, all the excitement surrounds prevention, driven by the idealistic impulse that policymakers can eliminate systemic risk. No one wants to be engaged in the business of planning for what could go wrong and how to clean up the mess. Some even fear that planning for disaster will make disaster more likely.

Policymakers accumulated a lot of valuable experience in the 2008 crisis [9]. Compared with the early stages of the Great Depression, the recent shock caused a greater initial loss of wealth and a higher rise in the risk of default, but because of the forceful policy response, the outcomes proved much better. Unemployment peaked at ten percent, not 25 percent, and the economy started growing again in six months, rather than the years and years it took during the Great Depression. The various elements of the financial rescue yielded a substantial positive direct financial return; in effect, the government forced the financial system to pay for its own protection. The emergency supports were removed quickly. The government allowed a healthy amount of failure: compared with other major economies, the United States saw a much smaller fraction of its financial institutions emerge from the crisis as independent entities. For those entities that survived, the government forced more restructuring, and it recapitalized the financial system rapidly and largely with private capital. The government's more aggressive fiscal and monetary policy reinforced the power of the financial rescue, making both that policy and the rescue more powerful than either would have been on its own.

In a crisis, policymakers tend to follow one of two paths: either the liquidation of failing firms, ending in the collapse of the entire financial system, or the partial nationalization of that system. The U.S. government chose a third way, allowing a substantial amount of failure while rapidly recapitalizing the core of the system. And as a result, the United States suffered much less acute economic and fiscal costs. Still, had policymakers been granted more flexibility in advance, those costs would have been even lower. Congress ultimately provided the authority for the government to do what only it can do in a crisis, but that authority came late.

Financial crises are inevitable, and although governments can reduce their frequency and intensity through tighter regulation, they cannot limit their damage without a powerful emergency arsenal. It is perhaps inevitable that governments and central banks will act late, partly because they will wish to inflict some pain and allow some adjustment. Sometimes, then, they will fall behind the curve of an evolving panic and end up having to act with greater force to prevent the whole system from collapsing. If legislation limits their capacity to escalate quickly, the risk of economic calamity will grow.

ARE WE SAFER?

The postcrisis reforms have produced a more resilient financial system. Banks hold more capital and can thus absorb far more loss. They hold a smaller share of short-term liabilities and are thus less prone to runs. This better-capitalized financial system means that a given dose of fiscal and monetary policy will prove more powerful.

But these achievements need to be considered in the context of a weaker fiscal and monetary arsenal and weaker emergency powers. The former means that future economic shocks will likely do more damage. Although the overall reduction in financial leverage since the crisis should make the U.S. economy less fragile, it still faces many potential adverse shocks. The limitations on fiscal and monetary policy [10] will likely make the economy less resilient to those shocks.

The new restrictions on emergency authorities make this challenge more acute. The reforms were designed for the wrong type of crisis—for idiosyncratic crises, rather than systemic ones. By limiting the ability of the government and the central bank to respond to panics, they leave the economy more vulnerable to the most dangerous type of crisis. And by forcing the government to impose losses on creditors when managing the failure of institutions, the new regime risks intensifying an ongoing crisis.

At some point, policymakers will have to revisit and refine the financial reforms. When they do, it will be important to restore room for discretion to the emergency tool kit, and keep that in reserve—not as a substitute for strong safeguards against risk but as a complement to them. Financial crises [11] carry tragic economic costs. There is all the reason in the world to make sure policymakers have the freedom they need to manage them.

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