

Veículo: *Economist.com*

Data: 22/08/2008

The credit crisis

Ben Bernanke wants regulators to be in charge of crisis prevention

A year after the credit crisis exploded, policymakers are scrabbling for ideas on how to prevent another one. Ben Bernanke, the Federal Reserve chairman, unveiled an ambitious proposal on Friday August 22nd: he wants to expand regulators' mandate from safeguarding institutions to preventing financial crises. His proposal, still on the drawing board, faces numerous technical and political obstacles. Yet the public and politicians may be ready for radical measures, as this crisis shows no sign of ending.

In his speech to the Kansas City Fed's annual economic symposium in Jackson Hole, Wyoming, Mr. Bernanke noted that bank regulators in America, like the Fed generally, "focus on the financial conditions of individual institutions in isolation". He wants them also to consider "potential systemic risks and weaknesses."

How would such supervision differ from current practice? He notes that, at the moment, a policy that reduces risk for a single institution could increase it for the system as a whole. During an economic slowdown, a supervisor worried about a particular firm's soundness "will tend to push for very conservative lending policies." In contrast, the "macroprudential supervisor" would recognise that if it applied such policies to everyone, it could cause a recession. Similarly, in the upswing, "risk concentrations that might be acceptable at a single institution...could be dangerous" if a lot of institutions had them.

Mr. Bernanke's proposal is designed in part to address demands that the Fed, having now presided over separate bubbles in stocks and houses in the past decade, take responsibility for preventing them in the future.

The Fed still thinks interest rates are too blunt a tool for the job. Its chairman is suggesting

that regulatory policy might be a more surgical approach. But regulators face many of the same problems as monetary policymakers. How would they identify a bubble in advance? Would the tools work or would the reckless lending simply migrate to less regulated institutions? The worst subprime loans were made not by banks but by barely regulated finance companies such as New Century. Most important, would the uncertain benefit of averting a future asset crash outweigh the certain cost of barring economic activity today that could make society better off? Even if the Fed thinks the trade-off is worth making, the firms, and their political allies, would be likely to fight back.

Mr. Bernanke has thought of some of these things. “In warning against excessive concentrations or common exposures across the banking system, regulators need not make a judgment about whether a particular asset class is mispriced”, he says. A new supervisory approach, he says, would have to encompass all financial firms, given that risky activities “have a way of migrating to other financial firms or markets.” He acknowledges that this could be costly and technically demanding, and that in the end it may still not prevent crises: “the expectations of the public...would have to be managed carefully.”

And he leaves an important question unanswered: who would do this job? America’s current patchwork of supervisors is poorly suited to the task: it encompasses five federal bank regulators, 50 state regulators, separate securities and futures regulators and now a new supervisor for quasi-private mortgage companies, Fannie Mae and Freddie Mac. Almost certainly, Mr. Bernanke would like it to be the Fed. By contrast, Henry Paulson, the Treasury secretary, has proposed largely stripping the Fed of such powers and giving them to a consolidated prudential regulator, while leaving the Fed broadly responsible for financial stability.

Mr. Bernanke also leaves unaddressed the risk that such an expansion of its powers could make it a larger political target and distract it from monetary policy, and damage its reputation if it were to fail.

In a separate but related proposal, Mr. Bernanke acknowledges that the Fed may not be the best agency suited to bailing out firms such as Bear Stearns, as it did in March. Others, such as the former chairman of the Fed, Alan Greenspan, have argued that such

bailouts compromise the Fed's balance sheet and monetary policy. Without acknowledging that risk, Mr. Bernanke proposes, as Mr. Greenspan did, that Congress give someone – “the Treasury seems an appropriate choice” – the authority to intervene when imminent “default by a major nonbank financial institution is judged to carry significant systemic risks.”

In his speech on Friday, Mr. Bernanke began with dovish remarks on the inflation outlook. He noted that the Fed has kept interest rates low despite high inflation on the view that once commodity prices flattened or fell, the downward pressure on wages and prices from a weak economy would push inflation back down. “In this regard, the recent decline in commodity prices, as well as the increased stability of the dollar, has been encouraging. If not reversed, these developments, together with a pace of growth that is likely to fall short of potential for a time, should lead inflation to moderate later this year and next year.”

At the same time he suggested that the worst “second-round” effects of the financial crisis are about to be felt: “the financial storm that reached gale force some weeks before our last meeting here in Jackson Hole has not yet subsided, and its effects on the broader economy are becoming apparent in the form of softening economic activity and rising unemployment.” Together, his remarks suggest that the Fed is not about to raise interest rates before the end of this year.

URL: http://www.economist.com/finance/displayStory.cfm?story_id=11990589