The rescue of Bear Stearns marks liberalisation's limit

By Martin Wolf
Published: March 25 2008 19:06 | Last updated: March 25 2008 19:06

Remember Friday March 14 2008: it was the day the dream of global free- market capitalism died. For three decades we have moved towards market-driven financial systems. By its decision to rescue Bear Stearns, the Federal Reserve, the institution responsible for monetary policy in the US, chief protagonist of free-market capitalism, declared this era over. It showed in deeds its agreement with the remark by Josef Ackermann, chief executive of Deutsche Bank, that "I no longer believe in the market's self-healing power". Deregulation has reached its limits.

Mine is not a judgment on whether the Fed was right to rescue Bear Stearns from bankruptcy. I do not know whether the risks justified the decisions not only to act as lender of last resort to an investment bank but to take credit risk on the Fed's books. But the officials involved are serious people. They must have had reasons for their decisions. They can surely point to the dangers of the times – a crisis that Alan Greenspan, former chairman of the Federal Reserve, calls "the most wrenching since the end of the second world war" – and the role of **Bear Stearns** in these fragile markets.

Mine is more a judgment on the implications of the Fed's decision. Put simply, Bear Stearns was deemed too systemically important to fail. This view was, it is true, reached in haste, at a time of crisis. But times of crisis are when new functions emerge, notably the practices associated with the lender-of-last-resort function of central banks, in the 19th century.

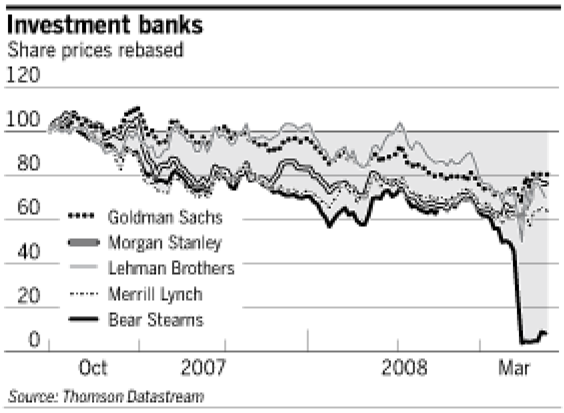
The implications of this decision are evident: there will have to be far greater regulation of such institutions. The Fed has provided a valuable form of insurance to the investment banks. Indeed, that is already evident from what has happened in the stock market since the rescue: the other big investment banks have enjoyed sizeable jumps in their share prices (see chart below). This is moral hazard made visible. The Fed decided that a money market "strike" against investment banks is the equivalent of a run on deposits in a commercial bank. It concluded that it must, for this reason, open the monetary spigots in favour of such institutions. Greater regulation must be on the way.

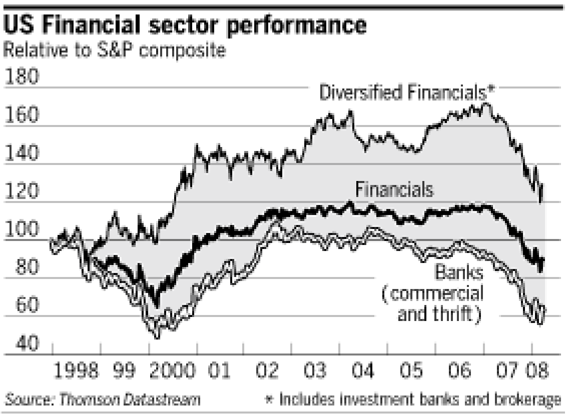
The lobbies of Wall Street will, it is true, resist onerous regulation of capital requirements or liquidity, after this crisis is over. They may succeed. But, intellectually, their position is now untenable. Systemically important institutions must pay for any official protection they receive. Their ability to enjoy the upside on the risks they run, while shifting parts of the downside on to society at large, must be restricted. This is not just a matter of simple justice (although it is that, too). It is also a matter of efficiency. An unregulated, but subsidised, casino will not allocate resources well. Moreover, that subsidisation does not now apply only to shareholders, but to all creditors. Its effect is to make the costs of funds unreasonably cheap. These grossly misaligned incentives must be tackled.

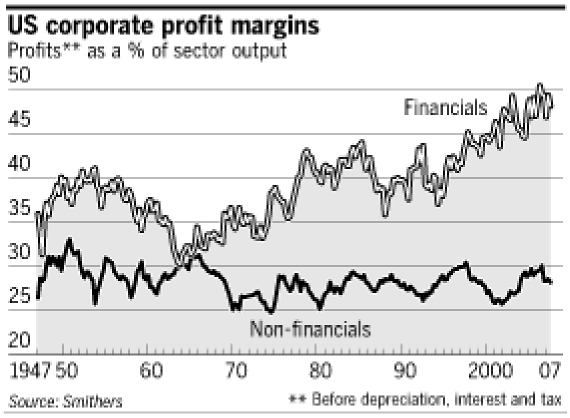
I greatly regret the fact that the Fed thought it necessary to take this step. Once upon a time, I had hoped that securitisation would shift a substantial part of the risk-bearing outside the regulated banking system, where governments would no longer need to intervene. That has proved a delusion. A vast amount of risky, if not downright fraudulent, lending, promoted by equally risky finance, has made securitised markets highly risky. This has damaged institutions, notably Bear Stearns, that operated intensively in these markets.

Yet the extension of the Fed's safety net to investment banks is not the only reason this crisis must mark a turning-point in attitudes to financial liberalisation. So, too, is the mess in the US (and perhaps quite soon several other developed countries') housing markets. Ben Bernanke, Fed chairman, famously understated, described much of the subprime mortgage lending of recent years as "neither responsible nor prudent" in a speech whose details make one's hair stand on end.* This is Fed-speak for "criminal and crazy". Again, this must not happen again, particularly since the losses imposed on the financial system by such lending could yet prove enormous. The collapse in house prices, rising defaults and foreclosures will affect millions of voters. Politicians will not ignore their plight, even if the result is a costly bail-out of the imprudent. But the aftermath will surely be much more regulation than today's.

If the US itself has passed the high water mark of financial deregulation, this will have wide global implications. Until recently, it was possible to tell the Chinese, the Indians or those who suffered significant financial crises in the past two decades that there existed a financial system both free and robust. That is the case no longer. It will be hard, indeed, to persuade such countries that the market failures revealed in the US and other high-income countries are not a dire warning. If the US, with its vast experience and resources, was unable to avoid these traps, why, they will ask, should we expect to do better?







These longer-term implications for attitudes to deregulated financial markets are far from the only reason the present turmoil is so significant. We still have to get through the immediate crisis. A collapse in financial profits (so significant in the US economy), a house-price crash and a big rise in commodity prices are a combination likely to generate a long and deep recession. To tackle this danger the Fed has already slashed short-term rates to 2.25 per cent. Meanwhile, the Fed also clearly risks a global flight from dollar- denominated liabilities and a resurgence in inflation. It is hard to see a reason for yields on long-term Treasuries being so low, other than a desire to hold the liabilities of the US Treasury, safest issuer of dollar-denominated securities.

"Some say the world will end in fire, Some say in ice." Harvard's Kenneth Rogoff recently quoted Robert Frost's words in describing the dangers of financial ruin (fire) and inflation (ice) confronting us.** These are perilous times. They are also historic times. The US is showing the limits of deregulation. Managing this unavoidable shift, without throwing away what has been gained in the past three decades, is a huge challenge. So is getting through the deleveraging ahead in anything like one piece. But we must start in the right place, by recognising that even the recent past is a foreign country.

*Fostering Sustainable Homeownership, March 14 2008, www.federalreserve.gov; **Globalization and Monetary Policy, March 7 2008, conference on globalization, inflation and monetary Policy, www.banque-france.fr*