Comment: Bernanke Paints Crisis as a ‘Classic Panic’

By Editor Test *Tue, Aug 25, 2009*

"Although a panic may be collectively irrational, it may be entirely rational at the individual level," said the Fed chairman.

In a speech last Friday in Jackson Hole, Wyoming, Federal Reserve chairman Ben S. Bernanke went out of his way to describe the financial crisis in terms that didn’t blame anyone in particular for causing it.

In telling attendees at the Fed’s Annual Economic Symposium that the crisis devolved into a “classic panic,” he didn’t suggest that sheer recklessness and a lack of fiduciary responsibility might have created the conditions for the panic.

Instead, Bernanke described the crisis in clinical central banking jargon, rather than telling the blunt truth: that Lehman Brothers and others failed in 2008 partly because they played a lucrative but dangerous game that involved not keeping a reasonable amount of cash on hand for emergencies. The Fed chairman used more formal language to describe, or perhaps to obscure, the situation.

“Many financial institutions,” he explained, “Notably including the independent investment banks, financed a portion of their assets through short-term repo agreements. In repo agreements, the asset being financed serves as collateral for the loan, and the maximum amount of the loan is the current assessed value of the collateral less a haircut. In a crisis, haircuts typically rise as short-term lenders attempt to protect themselves from possible declines in asset prices.

“But this individually rational behavior can set off a run-like dynamic: As high haircuts make financing portfolios more difficult, some borrowers may have no option but to sell assets into illiquid markets. These forced sales drive down asset prices, increase volatility, and weaken the financial positions of all holders of similar assets, which in turn increases the risks borne by repo lenders and thus the haircuts they demand,” he said.

“A panic is possible in any situation in which longer-term, illiquid assets are financed by short-term, liquid liabilities, and in which suppliers of short-term funding either lose confidence in the borrower or become worried that other short-term lenders may lose confidence,” he said, as though describing the progression of a tornado or an avalanche, instead of a wholly man-made disaster.

“Although, in a certain sense, a panic may be collectively irrational, it may be entirely rational at the individual level, as each market participant has a strong incentive to be among the first to the exit,” the chairman mused.

Bernanke suggested regulatory reforms. “In the future, a more system-wide or macro-prudential approach to regulation is needed,” he said, as opposed to the fragmented regulatory system in the U.S. that spends its energy detecting small-time fraud while allowing enormous but legal abuses of the spirit of the law.

“The Basel Committee on Banking Supervision and the U.S. bank regulatory agencies have recently issued guidelines for strengthening liquidity risk management at financial institutions," Bernanke said in reference to the banks' failure to hold enough cash or cash equivalents.

"Among other objectives, liquidity guidelines must take into account the risks that inadequate liquidity planning by major financial firms pose for the broader financial system, and they must ensure that these firms do not become excessively reliant on liquidity support from the central bank," he added.

More coordinated or "macro-prudential" regulation is also needed to prevent the failure of one or two big banks from pulling down all the others, Bernanke said.

"The hallmark of a macro-prudential approach is its emphasis on the interdependencies among firms and markets that have the potential to undermine the stability of the financial system, including the linkages that arise through short-term funding markets and other counterparty relationships, such as over-the-counter derivatives contracts. A comprehensive regulatory approach must examine those interdependencies as well as the financial conditions of individual firms in isolation," he said.

Bernanke's story had an exuberant ending. "The use of Fed liquidity facilities has declined sharply since the beginning of the year—a clear market signal that liquidity pressures are easing and market conditions are normalizing… After contracting sharply over the past year, economic activity appears to be leveling out, both in the United States and abroad, and the prospects for a return to growth in the near-term appear good."

But not irrationally exuberant. "Notwithstanding this noteworthy progress, critical challenges remain: Strains persist in many financial markets across the globe, financial institutions face significant additional losses, and many businesses and households continue to experience considerable difficulty gaining access to credit," he noted. "Because of these and other factors, the economic recovery is likely to be relatively slow at first, with unemployment declining only gradually from high levels."

Such is the art of "talking to the markets." It would have been refreshing to hear Bernanke say, as President Obama blurted out about the Cambridge police officer who arrested a famous professor in his own home, that leading bankers had acted "stupidly," and that such activities won't be tolerated in the future.

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