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What Should Be Done About the Financial Markets?

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The widening and accelerating turmoil in the world's financial markets is so severe that it threatens gridlock throughout the economy. That in turn threatens dislocation and enormous damage to the economy, resulting in a continuing torrent of bankruptcies and job losses in otherwise sound sectors.

As a general principle, the federal government should not intervene to stave off the consequences of unwise business decisions—even when those decisions are influenced by bad incentives or regulations emanating from the government. Bailing out firms that have miscalculated in the market shoulders taxpayers with costs that should be borne instead by those who made the mistakes. And any indication from government that it will save one group of investors encourages others to line up for help, and the prospect of ultimate protection induces many more to make riskier business decisions—a phenomenon that economists refer to as "moral hazard."

But there can be rare situations in which a wave of bad decisions in one sector has such dire consequences for the most basic operations of the economy that other sectors are threatened, jeopardizing the functioning of the entire economy. We are in such a situation. And in these rare cases another principle comes into play: Government institutions have a critical role in helping to assure the integrity of the market's infrastructure, from the sanctity of contracts to the liquidity of the financial markets. When government fails to carry out this role in critical times, such as its failure to maintain liquidity after the stock market crash of 1929, the results can be catastrophic. As economist Milton Friedman explained, the failure of the Federal Reserve to maintain liquidity and functioning credit markets helped trigger and deepen the Great Depression.

The challenge today is how to reconcile these two principles in light of the crisis that has been engulfing financial and equity markets. What is the appropriate role of government institutions such as the Federal Reserve Board, the Securities and Exchange Commission, and the Treasury? And how do we assure that actions taken to resolve the crisis do not reward investors who should suffer the consequences of their decisions, create incentives for other investors to speculate against the taxpayer, or needlessly widen the intrusive reach of the government?

Lawmakers have just been presented with the outline of an expansive and potentially costly package of proposals said to be needed to bring a permanent solution to the crisis. This follows a series of actions and legislation that sought, unsuccessfully, to halt the deterioration in financial and related markets. As they evaluate this package and other

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proposals, lawmakers should be guided by the following goals and strategies:

- *Do not prop up failed or failing institutions.* The goal should not be to keep troubled enterprises in business but to ensure that they are restructured or wound down in a way that does not cause undue disruption in the financial system as a whole. Thus, for instance, policymakers did not try to keep Bear Stearns in business even though its sudden collapse would have disrupted U.S. financial markets. Instead the government assured its orderly acquisition.
- *Do not try to support prices.* Policymakers should not attempt to keep stocks or housing prices from falling to their proper market-determined levels. The role of the federal government is not to ensure that prices do not drop. Market practices such as "short selling" that tend to lower prices generally should not be discouraged—they are part of the process by which the marketplace determines value. Limits on such practices, however, may be appropriate as very short-term, emergency measures to "cool off" spiraling markets. Thus, the Securities and Exchange Commission's actions to suspend all short selling on shares of specified financial services firms for up to 40 days will serve as a breather, but it should be lifted as soon as is prudent.
- *Do not allow the government to become the permanent "owner of last resort."* Any assets acquired should be disposed of as expeditiously as possible. The Resolution Trust Corporation, which in the early 1990s acquired assets from failed thrift institutions, is one such model. Those assets were held by equity partnerships with private investors, facilitating sales. Any approach instituted to deal with this crisis should not allow the government to take ownership stakes in the institutions themselves but simply acquire assets.
- *Strictly limit legislation to the immediate need to stabilize the financial situation.* Within hours of the Bush Administration's announcement of a financial rescue plan, there were media reports that congressional leaders were considering adding in provisions on a host of other issues, including unemployment benefits, food stamps, and infrastructure and Medicaid funding. Lawmakers should oppose any and all attempts to expand the legislation being proposed.
- *Avoid "moral hazard."* Policymakers must ensure that all concerned have financial "skin in the game," thereby providing incentives for them and others to act responsibly and discouraging others from seeking similar support. If a private firm is so integral to the financial operations of the economy that it requires assistance, the taxpayers' financial exposure should be minimized and the managers and stockholders should suffer consequences for their miscalculations. In the Administration's plan, moral hazard is not fully avoided. But if this plan or something like it is adopted, Congress must at least require financial institutions to receive a deeply discounted price for their assets, or pay a significant fee for assistance in liquidating their portfolio.
- *Carefully define the Fed's role.* The Federal Reserve should exercise its "lender of last resort" responsibilities to ensure liquidity but avoid the unwarranted mission creep of those responsibilities to new fields. The Fed's loan to provide funding for AIG, for example, was a measured extension of the classic "lender of last resort" function, which provided a way to get cash to illiquid but otherwise solvent enterprises. The action represented the first time, however, that such funding was provided by the Fed other than to a bank. Since AIG's activities were so intertwined with that of the banking system, however, that expansion may have been justified. But that authority should not be expanded to other industries, such as manufacturers or airlines.
- *Limit taxpayer exposure and keep actions temporary.* Any new mechanism or authority to halt the deterioration in the market should ensure that affected firms pay a cost and be strictly limited in time and scope to minimize taxpayer exposure.
- *Assure liquidity in markets but require full pricing of government insurance.* Money market funds, a critical element in the flow of capital,

have almost completely seized up in recent weeks. The Treasury's actions to offer insurance are intended to restore confidence and allow capital to flow smoothly again. However, the Treasury must ensure that the price of any insurance fully reflects the market risk.

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