Miahceal Barone, "Ad Hoc Fed, Treasury Acts Caused the Financial Crisis, Not Deregulation, Tax Cuts" – Wall Street Journal, March 10, 2009

If you want to read a very short book on how we got into the financial crisis, I don't think you could do better than John B. Taylor's Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis. Taylor argues persuasively that the Federal Reserve kept interest rates too low for too long in 2002-05 and that "government programs designed to promote home ownership, a worthwhile goal but overdone in retrospect," together with the credit that was plentiful because of unduly low interest rates created the housing bubble.

"The rapidly rising housing prices and the resulting low delinquency rates likely threw the underwriting programs off track and misled many people." The ratings agencies also bear some responsibility for creating the toxic assets that clog the banks and other financial institutions. "The ratings agencies underestimated the risk of these [mortgage-backed] securities because of a lack of competition, poor accountability, or, most likely, an inherent difficulty in assessing risk due to complexity." He also mentions, rather fleetingly, the role of Fannie Mae and Freddie Mac in flooding the marketplace with mortgage-backed securities; his account can usefully be augmented by the works of my American Enterprise Institute colleague Peter Wallison.

Taylor writes that the financial crisis first became evident in August 9 and 10, 2007, when the spread between Libor interest rates and the three-month overnight index swap widened hugely. "This was not a scenario like the Great Depression, where just printing money or providing liquidity was the solution; rather the situation was due to fundamental problems in the financial sector relating to risk." In his view Federal Reserve Chairman Ben Bernanke, perhaps the world's greatest expert on the Great Depression of the 1930s, misdiagnosed the problem, seeing it as one of liquidity (which was the case in the 1930s) and not of counterparty risk. "By late 2008, after the crisis was more than a year old, most researchers were in agreement that the counterparty risk was the primary driving factor. . . . If that diagnosis had been accepted a year earlier, the actions to remove bad assets or inject equity into the banks could have been done much earlier."

Bernanke here, and his predecessor Alan Greenspan on interest rates in 2002-05, were, I think, acting as deflation hawks, trying desperately to prevent us from getting into a downward deflationary spiral like that of the United States in the 1930s or Japan in the 1990s. That's something we definitely want to avoid. But perhaps they overshot, or perhaps they overrated the risk of deflation—at least, those are thoughts that Taylor's book provokes.

Taylor argues that the Fed's and Congress's actions—the Term Auction Facility (December 2007), the bipartisan stimulus package (February 2008) and interest rate cuts (August 2007-April 2008) didn't help because they were directed at the wrong problem. And he says that the interest rate cuts had the ancillary negative effect of producing the sharp rise in oil prices in spring 2008. He notes that after the Fed and the Treasury allowed Lehman Brothers to fail on September 15, 2008, and after Bernanke's and Paulson's testimony to Congress in favor of the $700 billion financial package on September 23, the Libor-OIS spread widened, only to narrow somewhat after the TARP equity plan was announced October 13. My sense is that at each of the crisis points—the August 2007 Libor-OIS spread, the March 2008 Bear Stearns package, the September 18 decision to seek rescue funds—Fed and Treasury leaders were acting in the belief that once they solved that problem the crisis would be over. That obviously has not proved to be the case. Taylor argues that they should have done what the IMF did in 2003, when it established its Exceptional Access Framework, in which it laid out the circumstances in which it would break its usual rules and take exceptional action to address systemic risk. Specific targets and standard rules enable players in the financial markets to know what the rules are and therefore to measure risk more accurately. The ad hoc response at various crisis points, Taylor argues, has left players in the financial markets full of uncertainty and fear. Which is, I fear, where they still are.

Taylor's book is a useful antidote to the mantra, spread by some Democrats including Barack Obama, that the crisis is the proximate result of Reagan- and Bush-style deregulation or the Bush tax cuts and other macroeconomic policies. When you get past this rhetoric, it is very hard to find a plausible chain of causation from either deregulation or the Bush tax cuts to the financial crisis. I think Taylor is clearly right that "government policies caused, prolonged and worsened the crisis"—but the governmental policies he identifies, not deregulation or the Bush tax cuts. As Treasury and the Federal Reserve struggle to come up with ways to solve the financial crisis, it's important for those of us who are bystanders to establish the correct narrative, and Taylor's short book is an invaluable asset in this enterprise.