The New York Times

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April 2, 2010

OP-ED COLUMNIST

Financial Reform 101

By PAUL KRUGMAN

Let's face it: Financial reform is a hard issue to follow. It's not like health reform, which was fairly straightforward once you cut through the nonsense. Reasonable people can and do disagree about exactly what we should do to avert another banking crisis.

So here's a brief guide to the debate — and an explanation of my own position.

Leave on one side those who don't really want any reform at all, a group that includes most Republican members of Congress. Whatever such people may say, they will always find reasons to say no to any actual proposal to rein in runaway bankers.

Even among those who really do want reform, however, there's a major debate about what's really essential. One side — exemplified by Paul Volcker, the redoubtable former Federal Reserve chairman — sees limiting the size and scope of the biggest banks as the core issue in reform. The other side — a group that includes yours truly — disagrees, and argues that the important thing is to regulate what banks do, not how big they get.

It's easy to see where concerns about banks that are "too big to fail" come from. In the face of financial crisis, the U.S. government provided cash and guarantees to financial institutions whose failure, it feared, might bring down the whole system. And the rescue operation was mainly focused on a handful of big players: A.I.G., Citigroup, Bank of America, and so on.

This rescue was necessary, but it put taxpayers on the hook for potentially large losses. And it also established a dangerous precedent: big financial institutions, we now know, will be bailed out in times of crisis. And this, it's argued, will encourage even riskier behavior in the future, since executives at big banks will know that it's heads they win, tails taxpayers lose.

The solution, say people like Mr. Volcker, is to break big financial institutions into units that aren't too big to fail, making future bailouts unnecessary and restoring market discipline.

It's a convincing-sounding argument, but I'm one of those people who doesn't buy it.

Here's how I see it. Breaking up big banks wouldn't really solve our problems, because it's perfectly possible to have a financial crisis that mainly takes the form of a run on smaller institutions. In fact, that's precisely what happened in the 1930s, when most of the banks that collapsed were relatively small — small enough that the Federal Reserve believed that it was O.K. to let them fail. As it turned out, the Fed was dead wrong: the wave of small-bank failures was a catastrophe for the wider economy.

The same would be true today. Breaking up big financial institutions wouldn't prevent future crises, nor would it eliminate the need for bailouts when those crises happen. The next bailout wouldn't be concentrated on a few big companies — but it would be a bailout all the same. I don't have any love for financial giants, but I just don't believe that breaking them up solves the key problem.

So what's the alternative to breaking up big financial institutions? The answer, I'd argue, is to update and extend old-fashioned bank regulation.

After all, the U.S. banking system had a long period of stability after World War II, based on a combination of deposit insurance, which eliminated the threat of bank runs, and strict regulation of bank balance sheets, including both limits on risky lending and limits on leverage, the extent to which banks were allowed to finance investments with borrowed funds. And Canada — whose financial system is dominated by a handful of big banks, but which maintained effective regulation — has weathered the current crisis notably well.

What ended the era of U.S. stability was the rise of "shadow banking": institutions that carried out banking functions but operated without a safety net and with minimal regulation. In particular, many businesses began parking their cash, not in bank deposits, but in "repo" — overnight loans to the likes of Lehman Brothers. Unfortunately, repo wasn't protected and regulated like old-fashioned banking, so it was vulnerable to a pre-1930s-type crisis of confidence. And that, in a nutshell, is what went wrong in 2007-2008.

So why not update traditional regulation to encompass the shadow banks? We already have an implicit form of deposit insurance: It's clear that creditors of shadow banks will be bailed out in time of crisis. What we need now are two things: (a) regulators need the authority to seize failing shadow banks, the way the Federal Deposit Insurance Corporation already has the authority to seize failing conventional banks, and (b) there have to be prudential limits on shadow banks, above all limits on their leverage.

Does the reform legislation currently on the table do what's needed? Well, it's a step in the right direction — but it's not a big enough step. I'll explain why in a future column.

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