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by Valerio Carnovale

STRESS TEST

REFLECTIONS ON FINANCIAL CRISES

TIMOTHY F. GEITHNER

Geithner T. Stress Test

Geithner wrote an emotional, clear and detailed history of his experience at the Fed and as the U.S. Treasury Secretary in the worst economic times and describes how the U.S. have managed the crisis to overcome it. It's a practical manual of central banking.

The central paradox of financial crises is that what we feel reasonable, just and fair (punish the perpetrators, impose losses on their creditors, limiting taxpayers exposure) is often the opposite of what's required (exploding government budget deficit when the families and businesses have to tighten their belts) for the just and fair outcome. If natural instinct infect strategy, it will cause a lot of damage; if government measures discourage risk-taking, they further depress confidence. Austerity intensify the problem. It's why policymaker tend to make crises worse. It looks profligate and immoral preventing messy collapse of systemic firms, assuring creditors of financial institutions but is the only way to stop a financial panic.

Manias are inherently unpredictable. There's no way to be sure when a bubble will pop, no certain way to prevent mania from becoming panic. But there is a lot that can be done in advance to make crises less damaging: safeguards (shock absorbers) that help to reduce the likelihood and severity of crises; emergency authorities that help policymakers limit the damage when crises erupt. Strict capital requirements that restrict leverage and ensure that institutions can absorb losses in a downturn; liquidity requirement, deposit insurance, discount window access for depository institutions, margin requirements for derivatives, mortgage down-payment requirements are the principal safeguards. But when the fire starts it needs adequate firefighting tools. Fiscal stimulus and monetary stimulus are the ordinary authority powers when the government has a strong fiscal position and the central bank has a strong record of maintaining low inflation. But government and central bank need emergency authority (extend the lender-of-last-resort authority to provide liquidity, resolution authority to allow the orderly wind-down of failing firms, broad deposit insurance, guarantee on other financial liabilities) that must be deployed quickly on a massive scale when a crisis hit.

In the early stage of the financial fire there is no way to be sure if it's systemic. Increases in private credit, financial leverage, short-term financing can indicate a system's vulnerability to a severe crisis. Letting the fire burn can help determine the severity of the crisis and can also wipe out the weakest firms and the riskiest financial mechanisms. But to let the fire burn too long can gain them enough force to create a general panic. The line is not always easy to discern. In an emergency, you need to lean against the panic, to restore confidence, to reduce uncertainty, to make the system investible again. The financial rescue protocol is complex because you have to conduct a form of triage that distinguishes between the insolvent and the merely illiquid, between firms that will never be viable and firms that just need protection from being caught in the stampede. You have to decide where to set the boundaries, the line of defense. There is no automatic formula and only a few basic guidelines. The complexity and unpredictability of the market and of the human behavior require flexible and discretional authority.

A lender of last resort should make short-term loans backed by safe collateral available to the banking system longer and broader. They should be lent freely at a penalty rate to make the loan expensive so that the banks will replace them with private funds when the panic recedes, but not so expensive to put stigma on the borrower. If the financial system relies heavily on nonbank financing, you might need to backstop those markets and institutions as well. In a severe crisis governments might have the need to guarantee a broader range of financial liabilities. But crisis management should also insist on forcing capital into the financial system quickly, to make sure it can eventually stand on its own, support an economic recovery and absorb losses in the future. To stabilize and restructure the financial system, insolvent firms should be allowed to fail, but not to tear down the entire system in the process. Viable firms should be protected from the hysteria of the moment and required to thicken their capital buffers. This kind of triage would be simple if policymaker had a perfect way to distinguish merely illiquid banks from insolvent ones during a crisis and if they could use unlimited resources. We designed the stress test to solve these problems, letting the private sector conduct our triage while committing government resources. By disclosing the losses the firms could face, we forced them to raise capital to survive that horrible scenario, we let the market to decide which ones could survive with private capital and how much government help the others would need. We maximized the likelihood the private investors would recapitalize the system and minimized the eventual burden to the taxpayers, ensuring the worst dilution of the worst capitalized banks. We limited the government's long-term involvement in the financial system and accelerated its restructuration. It worked.