

● Prevention isn't enough. Regulators will need more tools when disaster inevitably strikes

● By Peter Coy

Ten years after the fall of Lehman Brothers, trouble is brewing again, though this time the U.S. hasn't slid into a recession. In fact, growth is so strong in America that the Federal Reserve is trying to preempt inflation by raising interest rates, and that's attracting speculative investors from the rest of the world to the U.S.—to the detriment of emerging markets. Argentina and Turkey are most under pressure, followed by Brazil, India, Indonesia, Pakistan, Russia, South Africa, and others. “We are having a confidence crisis in emerging markets, with some level of contagion being present,” says Pablo Goldberg, a portfolio manager at BlackRock Inc. in New York.

Regardless of the source of trouble, the question is whether the world is better equipped than it was a decade ago to cope with another financial crisis, whenever it arrives. Banks in most countries are more prepared for a downturn. But when a crisis does inevitably break out despite new layers of safety measures, central bankers and finance ministers will be no readier to battle the flames. In some respects, they're even less ready—their hands have been tied by new laws and opposition from the Left and the Right to bailouts.

Ray Dalio is worried about the world's preparedness to fight the next global conflagration—though he doesn't see one arriving anytime soon. “There's a cycle here,” says Dalio, founder and co-chief investment officer of Bridgewater Associates LP, the world's biggest hedge fund firm. “What they did was to write regulations that reduced the chance of a financial crisis but significantly limited the flexibility in dealing with it.”

Emerging-market economies, as opposed to American subprime mortgages, are the current area of concern (page 31). The Institute of International Finance says emerging-market economies had more than \$8 trillion in debt in foreign currencies such as the U.S. dollar and the euro at the end of 2017, up from less than \$5 trillion a decade ago. Raghuram Rajan, the former head of the Reserve Bank of India who foretold the last crisis in 2005, says, “the traditional ingredients have been put in place” for another meltdown. “The betting would be, yes, we will see accidents,” says Rajan, an economist at the University of Chicago Booth School of Business. “How bad will it get? No one knows.”

Turkey's troubles could spill over to France, Italy, and Spain, whose banks lent heavily to Turkish companies, warns Carmen Reinhart, a Harvard economist who co-wrote the authoritative book on debt crises in 2009, *This Time Is Different: Eight Centuries of Financial Folly*. She adds: “I am not convinced in the least that the 2008-09 crisis is over either for Italy or Greece.”

One reason financial crises keep surprising us is that people aren't as rational as intro econ textbooks say we are. Investors tend to overextrapolate in good and bad times alike, Andrei Shleifer, an economics professor at Harvard, and Nicola Gennaioli, a finance professor at Bocconi University in Milan, write in a new book, *A Crisis of Beliefs: Investor Psychology and Financial Fragility*. They say regulators should survey investors for evidence of overoptimism. They lean toward the camp that says regulators should tighten financial conditions when markets are frothy. In a jacket blurb, former Fed Chair Janet Yellen calls their approach “a powerful new tool to prevent future financial crises.”

One thing lawmakers and regulators got right over the past decade was insisting that banks have thicker safety cushions, with assets exceeding liabilities by a larger margin than before the crisis. If banks lose money on bad loans, the losses are more likely to be borne entirely by their shareholders without exposing taxpayers to risk. Banks are also more liquid, meaning they can raise more cash in a hurry.

Is what's been done enough, though? The Federal Reserve Bank of Minneapolis calculates there's still a two-thirds probability of another major financial crisis in the next century (granted, a long time horizon), down from an 84 percent likelihood before the new measures. The Minneapolis Fed estimates that its proposal, which includes even bigger equity cushions for banks, as well as a tax on borrowing by the “shadow banking” sector of firms such as hedge funds and money-market funds that provide banklike functions, would reduce that risk to 9 percent, more than paying for itself by decreasing the chance of a long period of mass unemployment and lost output. Other Fed officials have dismissed the proposal as overkill.

Many foreign banks got in trouble before the last crisis by borrowing too much in dollars. In its rescue, the Fed lent to them directly and supplied dollars in exchange for the currencies of their national central banks. The banks seem to have forgotten their near-death experience, though. In a June post on the International Monetary Fund's blog, the Fund's experts warned that non-U.S. banks are again relying on sources of dollars that “could dry up quickly in times of financial-market stress.”

One thing that hasn't been forgotten in the past decade is the sting of bailing out the 1 Percent. Rescues of financial companies are always going to be unpopular, but governments made them even more exasperating by falling down on the essential job of punishing the bad guys while ordinary people lost their homes. No high-level U.S. financial executive went to jail over the crisis. There were large fines on banks, but they were paid by shareholders, not by the individual wrongdoers. Some executives even collected bonuses after the bust. Then the government stinted on fiscal stimulus that would have shortened the recession. Says Anat Admati, a professor of finance and economics at the Stanford Graduate School of Business: “The public's anger was allowed to fester, and then it got diverted. It didn't get focused on the right things.”

The widespread feeling that Wall Street screwed Main ▶

◀ Street has had lasting consequences. Ordinary taxpayers are determined not to be played for suckers again. While understandable, that's a dangerous attitude given the near certainty that someday, somewhere, bailouts will be needed to keep a small crisis from sliding into a big one. After all, the fire department still puts out fires, even for people who smoke in bed. "Our ability to come together and spend money to bail out the sinners and the saints, there's less of that," says Glenn Kelman, CEO of real estate brokerage Redfin Corp.

With bipartisan support in Congress, the Dodd-Frank Act of 2010 deprived the Federal Reserve of some of its freedom to respond to crises. It narrowed a key provision called Section 13(3) that allowed the central bank to lend to a broad set of nonbank borrowers "in unusual and exigent circumstances." It was Section 13(3) that the Fed used to provide as much as \$85 billion in credit to rescue American International Group Inc. one day after the bankruptcy filing of Lehman Brothers. Dodd-Frank requires any offer of credit to have "broad-based eligibility," which means that if another AIG were failing today, the Fed couldn't single it out for help. It might have to wait until a whole category of financial companies got into trouble before it could justify launching a rescue.

The populist backlash against bailouts has shorn regulators of two other vital rescue tools. Under Dodd-Frank, the Federal Deposit Insurance Corp. is now prohibited in an emergency from giving a blanket guarantee to banks' uninsured depositors and other creditors—even though that was a key element in arresting bank runs in 2008. And under the Emergency Economic Stabilization Act of 2008, the Department of the Treasury is no longer allowed to use its Exchange Stabilization Fund to guarantee U.S. money-market mutual funds, as it did effectively in 2008.

That's a lot of ammunition to forfeit. Dodd-Frank did set up a procedure for the FDIC to close bank holding companies and other complex financial institutions that are failing, which is supposed to end "too big to fail." But whether this so-called orderly liquidation authority would work when lots of banks are failing all at once, as in 2008, is questionable.

The Fed's broad 13(3) powers in particular were "very cool and very consequential and very important," Tim Geithner, who was president of the Federal Reserve Bank of New York and President Obama's Treasury secretary during the crisis, said at a Brookings Institution conference on Sept. 11. Under the new law, he said, "things have to be pretty far past the point of no return before you can act."

The Brookings conference was also attended by Ben Bernanke, the Fed chairman during the crisis, and Henry Paulson, who was President George W. Bush's Treasury secretary. Paulson, who wore a necktie decorated with dollar signs and snorting bulls, said in an interview that he shares Geithner's concerns that regulators will be hamstrung in the next crisis. "A lot of it is going to come down to who is sitting in the seats and how much political heat they're willing to take," he said.

Readiness for a crisis that crosses national borders is even

sketchier, wrote the Group of Thirty, an advisory body of senior policymakers and academics, in a Sept. 6 report. In 2008, German Finance Minister Peer Steinbrück flatly declared the crisis to be "an American problem," apparently unaware that German banks were also teetering. Small countries with big banking sectors were swamped. Ireland put the health of its government finances on the line by abruptly guaranteeing all the liabilities of its banks. Iceland, in contrast, was so overwhelmed that British and Dutch insurance funds initially had to cover losses suffered by citizens of those countries who had deposits in a troubled Icelandic bank.

There's still no clarity about how nations would share the rescue of, say, a European or Asian bank with extensive operations in London and New York. It's easy to imagine a free-for-all, with multiple national regulators making a grab for the same assets. "We're very likely to go into the next crisis without a resolution framework," says Bloomberg Intelligence policy analyst Benjamin Elliott.

What makes the lack of agreement on rescue plans worrisome is that a financial crisis is no time for finger-pointing or trying to withhold aid from the undeserving. "At such times, above all else, the most important thing is to provide life-blood (i.e., stimulants) to keep the systemically important parts of the system alive," Bridgewater Associates wrote in an August 2007 warning to clients about overheated markets called, presciently, "This is the Big One." Dalio, Bridgewater's chief, cites the note in a new book, *A Template for Understanding Big Debt Crises*.

The scariest day of 2008 wasn't the day Lehman failed. It was two weeks later, when the House of Representatives voted down a \$700 billion bailout package despite President George W. Bush's warning that "our country could experience a long and painful recession" without it. Most members of his own party abandoned him. "This is a huge cow patty with a piece of marshmallow stuck in the middle of it, and I am not going to eat that cow patty," said Representative Paul Broun, a Georgia Republican. The S&P 500 fell almost 9 percent on the day of the vote, its worst performance of the crisis.

Shocked by the market's reaction, Congress eventually did pass a version of the measure. Today it would probably be even harder to get a bailout bill through Congress given the degree of bitterness and division in the country. Likewise, international cooperation on a rescue would be harder to obtain given the damage caused by President Trump's fights with America's traditional allies. And with interest rates already low, there's less room for central banks to cut them to stimulate growth. "The only way out of this dilemma is effective regulation so we never get into this situation again," says Columbia University historian Adam Tooze, author of the book *Crashed: How a Decade of Financial Crises Changed the World* (page 70). "Unfortunately, under this president, there's every prospect of going in precisely the opposite direction."

Pay attention to the stresses in Ankara, Buenos Aires, and elsewhere. Because when the next global financial crisis breaks out, it will be hard to stop. **B** —With Ben Bartenstein