If the panic of the second week of October 2008 worsens, governments need to be prepared to stop it using auditing, recapitalisation, and liquidation. A stopgap stabilisation plan would be to guarantee all banks’ short-term liabilities, audit their assets, and then clean up the mess.

We are in a midst of a banking panic caused by concern over the quality of bank assets and the adequacy of bank capital. Interbank lending has stopped and lending to non-banks is grinding to a halt. We need intermediaries to begin functioning again to avoid a deep recession.

The historical recipe for stopping a panic is an automatic stay (or suspension of convertibility) that freezes the ability of creditors to withdraw their money. This buys time so that authorities can audit the banks, decide who is solvent, wind down or recapitalise the shakiest banks, and stop the panic. Today, however, short of failing a bank, such a stay on short-term debt or deposits is impossible.

Perhaps the various guarantees made over the last couple of days will end the panic. But we must prepare for the alternative. If the panic continues, it can be stopped with the traditional tools of auditing, certification, recapitalisation, or asset liquidation. The challenge is to be ready with a plan to accomplish this within the law and without increased incentives for short-term creditors to run.

Our plan is for regulators to buy time by guaranteeing all banks’ short-term liabilities for a brief period. This would amount to saying that all securities maturing in the next three months would be federally guaranteed and could be rolled over up to five months. To prevent gaming, asset growth would need to be limited to normal lending growth. Dividend payments would be stopped.

The timeout would be used to verify asset quality and establish capital adequacy. This would start with rapid audits of bank assets, marking to market using common pricing assumptions across banks (above fire-sale values), with the goal of establishing the relative net worth of the banks. Banks would be invited to raise additional capital, with the understanding that any capital raised would be senior to existing capital (except perhaps recently raised capital). If the banks subsequently needed to be liquidated or required government capital infusion, these new investors need the assurance they will be protected (their seniority respected) - otherwise they will not participate. The banks that emerge with higher capital could use the funds to buy weaker banks. The weakest banks, which no one wants to buy, would be wound down. If it turns out that a number of banks are insolvent, even though their core capabilities such as local knowledge have value, they could be failed and recapitalised by the government (without imposing any losses on the short-term creditors).

This plan should be viewed as a stopgap measure. It is possible that the asset purchases under the Troubled Asset Relief Program will eventually help, both to allow
banks to sell without depressing prices and to allow the market and regulators to value banks. Likewise, schemes aimed at stabilising home prices, if done on a massive scale, could influence the value of bank assets. But these types of solutions are infeasible in the short term and helpful only if investors believe that they will stop the bank run and make banks solvent. With the number of at-risk institutions growing every day, stabilising the banking system must be the first priority.

About the Authors

**Douglas W. Diamond** is professor at University of Chicago's Graduate School of Business having previously taught at Yale and the Hong Kong University of Science and Technology. He specializes in the study of financial intermediaries, financial crises, and liquidity, and worked for the Board of Governors of the Federal Reserve System as a graduate student. He is a visiting scholar at the Federal Reserve Bank of Richmond, a position. He is a former president of the American Finance Association and the Western Finance Association, a fellow of the Econometric Society, the American Academy of Arts and Sciences, and the American Finance Association.

**Anil K Kashyap** is professor at University of Chicago's Graduate School of Business, consultant for the Federal Reserve Bank of Chicago, and advisor to the Cabinet Office of the Japanese Government's research project "Japan's Bubble, Deflation and Long-term Stagnation". He studies banking, business cycles, corporate finance, and monetary policy. He spent three years as an economist for the Board of Governors for the Federal Reserve System and is an academic members of the Bellagio Group (whose non-academic members consist of the Deputy Central Bank Governors and Vice Ministers of Finance of the G7 countries). He cofounder of the US Monetary Policy Forum.

**Raghuram G. Rajan** professor at University of Chicago's Graduate School of Business, having served as Chief Economist at the International Monetary Fund (2003-2006). He has taught at Northwestern University, MIT, and the Stockholm School of Economics. He has been a consultant for the Indian Finance Ministry, World Bank, Federal Reserve Board, Swedish Parliamentary Commission, and various financial institutions. Along with Luigi Zingales, of the book, Saving Capitalism from the Capitalists. He received the inaugural Fischer Black Prize in 2003.