

## Put out the fire before fixing the sprinkler

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Last week, President Barack Obama asked Congress to move swiftly to create a new financial regulatory system for the US. The system is clearly broken, and fixing it should be a high priority. However, moving swiftly to put in place a new regulatory system now would be a serious mistake.

There are several reasons not to rush regulatory reform. We are in the midst of a financial crisis that is crushing the economy. Recovery of the financial system has to be the first priority and is a complex task. Without the ability to allocate capital to productive uses, so that businesses and households start spending, the economy will continue to contract.

Focusing on reforming the financial regulatory system will divert attention from the more crucial task of promoting economic recovery.

Complicating matters, key senior positions in the Treasury are yet to be filled. Regulatory reform requires considerable technical expertise. This is a case where the details matter and where the decisions made now are likely to last for decades. We need the administration to have its top experts engaged in these deliberations. Decisions about reform need to be carefully considered and not made in haste.

How the crisis plays out will inform us about how to proceed. The government is engaged in financial rescues of a number of large companies, including [Citigroup](#) and [AIG](#). It is also possible that the stress tests will reveal other seriously under-capitalised institutions that will require massive government support. The experience gained from seeing how these interventions work will inform us about what financial reforms are desirable. This experience might also make the government more sensitive to the costs of overhauling institutions and the challenges of re-orienting large institutions.

In addition, the configuration of what the financial industry will look like once the crisis is contained is unclear. There will be substantial benefits to seeing where the industry settles before deciding which direction regulatory reform should take.

Finally, one of Mr Obama's principles for regulatory reform is that we face global challenges. Following from this principle is that fixing regulation will require global co-ordination. A go-it-alone reform effort will be ineffective as it will be possible for companies to evade many of our rules by relocating business activities to other countries. It is much more costly to close loopholes and strengthen the system than it would be to get regulations right and harmonised at the outset.

Unfortunately, the regulatory system in Europe is even more fractured than ours. Reaching consensus will take time, even if we knew what the post-crisis landscape would look like.

We are not advocating that we do nothing about regulatory reform. There is a good historical model for what should be done. The US savings and loan crisis from the late 1980s bears some resemblances to the current situation, although that crisis was less severe. We had the 1988 presidential election in the midst of the crisis, and there was little discussion during the campaign about how to resolve it. The policy response after the election, however, was sequenced.

The first priority was to resolve the crisis and this was done in the early days of the George H.W. Bush administration with the Financial Institutions Reform, Recovery and Enforcement Act of 1989. This act had a provision that the Treasury was required to produce a comprehensive study and plan for reform of the federal deposit insurance system to make a re-occurrence of banking crises less likely. Congress then went on to pass the Federal Deposit Insurance Corporation Improvement Act in 1991, which raised capital requirements and led to a stronger banking system.

The policy process that was successful in that period was first to stabilise the financial system and then implement major regulatory reform. This is still the right blueprint.

When a house is on fire, you put all your initial effort into putting it out. Only after the fire is squelched, do you redesign the sprinkler system.

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