Comments to Swagel, “The Financial Crisis: An Inside View”

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The end of an administration is no time to have a financial crisis, and the end of the George W. Bush administration was an especially inopportune time. With its senior staff substantially reduced and the remaining political appointees potentially distracted by concerns about their next job, the most powerful Treasury in the world found itself in late 2007 and 2008 without the human capital needed to plan for and deal with the worst financial crisis in three generations. Worse still, by that time the administration had lost the trust of Congress over the alleged weapons of mass destruction in Iraq, and the unpopular president was all but missing from the scene. This paper by Phillip Swagel provides some 60 pages of detailed description of the events of this period, yet President Bush appears only once, thanking the Treasury’s cafeteria staff as well as the policy team for their efforts.

In this context, Swagel should be thrice commended. First, he should be commended for serving his country with passion and dedication until the end of his appointment. Although I disagree with many of the choices made, I have complete faith that Swagel worked with only with the interest of the country at heart. Second, he should be commended for consenting to serve as the public voice and face of an unpopular administration. Last but not least, he should be commended for the candor with which he has written this account of his extraordinary time at the Treasury. I think historians will long use his chronicle as the best description of what was going on at those critical moments.

It is precisely this candor that makes my role as a discussant easy, perhaps unfairly so. Although I write without the full benefit of hindsight—the crisis has yet to run its course, making it too early to draw final lessons—I certainly benefit from more information and more time to process it than Swagel and the other key players had at the time. Most important, criticizing other people’s choices is much easier than improving upon them.

With all these caveats, however, my role as discussant is to point out the contradictions and limitations in Swagel’s account. Only by reviewing and criticizing the decisions made in this crisis can the economic policy community train itself and prepare for the next one. Just as the analysis of the policy mistakes at the onset of the Great Depression proved useful in informing the decisions made at the onset of the current crisis, so, too, one may hope, analysis of the mistakes made at the onset of this crisis will help tomorrow’s policymakers cope with or even avoid the next one.

Let me first point out the elements of Swagel’s narrative most likely to suffer from the naturally “self-serving” bias he honestly admits to. The first regards the role played by the lack of legal authority, which, according to Swagel, prevented the Treasury from taking all the actions it deemed appropriate to deal with the crisis. Obviously, the United States is a country of law, and an administration cannot intervene in financial markets without legal authority. But this limitation is not so clear cut as Swagel makes it out to be. In March 2008 the Federal Reserve had dubious legal authority to lend to Bear Stearns, yet it found a mechanism (lending to JP Morgan to purchase Bear Stearns) by which to do so. It had no legal authority to buy toxic assets from Bear Stearns, yet, as Swagel describes, it found a trick to make it happen. The Treasury had
no authority to force the major banks to take TARP money, but by exercising moral suasion it was able to bring them on board. Indeed, so strong is the power of moral suasion wielded by U.S. bank regulators that bankers often joke that when the regulators tell them to jump, they can only ask, “How high?” When one considers these various capacities in their totality—the Fed’s control over whom to lend to, the FDIC’s authority to take over bank subsidiaries (but not bank holding companies) that pose a systemic risk, the Treasury’s ability to exercise moral suasion—it is clear there was some power to intervene, had there been the political will. For example, the Fed could have mandated a very large bank recapitalization, with the Treasury offering to provide the capital in case the market was unwilling to do so.

Thus, the real problem was the lack of political will, and the real question is why it was lacking. Was it because the Treasury experts really thought that buying toxic assets was the right solution, or because the lobbying pressure to do so was overwhelming? Unfortunately, it is here that Swagel’s account is uncharacteristically lacking in detail: the paper contains no mention of any lobbying pressure from the financial industry. Is it possible that an industry that in 2008 spent $422 million in lobbying expenses played no role in shaping a policy so crucial for its survival? Why is the paper silent about these pressures?

The second potentially self-serving bias in Swagel’s account is the emphasis on the limits imposed by Congress, which the paper amply blames as the source of all the administration’s woes. Much of the paper suggests or implies that if only Treasury officials could have made Congress do what they wanted, the world today would be a better place. To be sure, Congress has imposed and still imposes limits on what an administration can do. But this is not necessarily a bad thing; in fact, this country was founded on the premise that there should be no taxation without representation and that each branch of government should exercise a check over the others. Decisions that impose a fiscal burden on U.S. taxpayers are and should be subject to the approval of their elected representatives. Of course, Congress does not always perform this job perfectly, and often individual representatives in powerful positions pursue their own agendas rather than the interest of the American people. But that does not justify the implicit call, which percolates through Swagel’s account, for freeing the administration from congressional oversight. In fact, more useful than a blunt attack on Congress as a body would have been a detailed account of the self-serving constraints that individual members may have put on the path to a superior solution. Yet the only constraints that Swagel outlines in some detail appear to have been imposed not by self-serving minority interests, but by the lack of political (and popular) consensus on the proposed policies—which in a democracy should be a constraint.

Beyond that, Congress’ unwillingness to appear to be rewarding people who overextended themselves financially to buy a house was not only a legitimate democratic constraint, but also good economic policy. And with the right amount of ingenuity, the negative home equity problem could have been (and still could be) resolved without violating this constraint (see, for example, Zingales 2008a and Posner and Zingales 2009). Similarly, when Congress balked at the prospect of handing out billions of dollars to the banks through the TARP, that was not a manifestation of congressional myopia, but rather an indictment of a Treasury secretary more used to strong-arming corporate boards than to eliciting popular consensus. The September 29, 2008, House vote against the TARP, far from being the short-sighted response of a hopelessly politicized Congress, was in fact a high point of American
democracy. Undaunted by the dramatic headlines and the catastrophic forecasts issued by Secretary Paulson and Fed Chairman Bernanke, Congress realized the dangers involved in issuing a $700 billion blank check—and voted no. In fact, if there are grounds for criticizing Congress’s performance in this episode, it is for later reversing its vote under the enticement of a heavy dose of pork-barrel add-ons.

This view of Congress as an obstacle to the Treasury’s enlightened leadership, rather than as an equal player exercising proper constitutional balance, is what leads Swagel to congratulate the Treasury and the Fed for engaging in various financial engineering maneuvers aimed at imposing a fiscal burden on taxpayers without Congress’ approval. One example is the nonrecourse loans offered by the Fed to Bear Stearns. Another is the guarantees offered to Citigroup and Bank of America. It is sad to learn that Swagel regrets that the Paulson Treasury took too long to fully appreciate the power of these tricks, leaving to the Obama administration the rare privilege of actually implementing the most deceptive ones. Having written against the use of these interventions by Paulson’s successor, Tim Geithner (Veronesi and Zingales 2009), I believe I can criticize their creation by the Paulson team without fear of being accused of bias. It is precisely these types of tricks that feed the mistrust that Congress and the American people have toward the administration. As Swagel aptly describes, congressional mistrust toward the Treasury had very negative consequences during the crisis. But Swagel’s own account provides the justification for that mistrust.

We know from microeconomics that any choice can be represented as the optimal one, depending on how one characterizes the constraints that apply. Swagel’s description of the Bush Treasury’s political constraints seems calculated in exactly this manner, as a means of relieving the administration of any responsibility for making the wrong decision: if the chosen strategy was the only feasible one, it must also have been the optimal one. Ironically, Swagel persists in maintaining this fiction of an absence of alternatives even after the Treasury’s policy changed course dramatically in a matter of weeks. Whence the change in policy? The constraints had changed!

This Manichean view of an enlightened elite fighting against the neutering constraints imposed by Congress prevents Swagel from discussing the other feasible options in greater detail. Since the approval of the TARP, academics have produced detailed analyses of the costs and benefits of several such alternatives: from asset purchases to debt guarantees, from equity infusions to long-term put options to a spinoff of toxic assets into a “bad bank” (Philippon and Schnabl 2009, Caballero and Kurlat 2009, Landier and Ueda 2009, Veronesi and Zingales 2008, Zingales 2009). Similar discussions should have taken place inside the Treasury and the Fed before any decision was made. Yet Swagel’s account provides no evidence that the costs and benefits were seriously debated. As he correctly points out, the turning point was the Bear Stearns crisis. Up to that point the administration could cultivate the illusion that the crisis would remain contained; afterward there was no excuse. Indeed, as Swagel recounts, it was after Bear Stearns that the Treasury started thinking about what he calls the “break the glass” policy—what to do in the event of a systemwide collapse. From the Bear Stearns rescue to the Lehman collapse, six months went by. What was the Treasury able to produce in that time? By Swagel’s own admission, only the three pages of draft legislation that Paulson presented to Congress on September 20 and that led to the TARP. There is no mention of any intellectual discussion, no
mention of any internal disagreement, no mention of any assessment of costs and benefits. This
deafening silence in Swagel’s account does nothing to dispel the pervasive (and, one hopes,
wrong) view that the TARP was just a welfare plan for needy bankers pushed by Wall Street
upon their friends in the government.

Even if the TARP had been the right break-the-glass plan—which it was not, as I wrote at
the time (Zingales 2008b) and as Paulson himself later admitted—the fact that the plan required
two full months to become implementable (as Swagel clearly details) validates the accusation of
incompetence raised against the Paulson Treasury. What would one say about a hurricane
emergency plan that took two months after the calamity to start working? Why were the details
of a plan that had been conceived by at least March not fully worked out by September? If lack
of staff is the reason, then the Obama administration is right to make the creation of a more
permanent research department at the Treasury a priority.

Swagel’s account is extremely interesting not only for what it says, but also for what it
does not say. There is no mention of any economic principles guiding the Paulson Treasury. All
its actions seem to have been guided entirely by legal and political constraints, without any
overarching aim. Even if one accepts the idea that these constraints were rigidly binding,
a well-justified strategy would have been helpful not only in selling the plan to Congress and the
country, but also in avoiding confusion in the markets. After all, the government’s actions during
the course of the crisis were all over the map—from bailing out creditors but not shareholders in
Bear Stearns, Fannie Mae, and Freddie Mac, to wiping out both in Lehman Brothers and
Washington Mutual, to bailing out both in AIG, Citigroup, and since. In the words of the
legendary Yale endowment manager David Swensen, “they’ve [acted] with an extraordinary
degree of inconsistency. You almost have to be trying to do things in an incoherent and
inconsistent way to have ended up with the huge range of ways that they have come up with to
address these problems.”¹ Nor has this inconsistency escaped the notice of ordinary Americans.
In a representative survey of more than 1,000 American households conducted in December
2008, 80 percent declared that they felt less confident about investing in financial markets as a
result of the type of government intervention undertaken in the last three months of 2008
(Sapienza and Zingales 2009b). This outcome did not stem from an ideological bias against
government involvement; on the contrary, a majority of respondents expressed the belief that the
government must regulate financial markets. What they objected to was the specifics. It is hard
to estimate the real damage created by this inconsistency. What is known is that it had major
negative effects on the level of trust that Americans have in the stock market (Sapienza and
Zingales 2009a), leading them to shun investing in equities (Guiso, Sapienza, and Zingales
2008).

In his conclusion, Swagel nicely summarizes the four key dimensions along which a
rescue plan should be evaluated: shutting down the zombie banks, adequately recapitalizing the
solvent ones, eliminating uncertainty about the surviving institutions, and maintaining consensus
on all these actions. Swagel admits failure on the first and last counts—the Paulson Treasury was
unable to be selective in the allocation of TARP money and unable to maintain political
consensus—but he claims victory on the other two. A final judgment is certainly premature.

¹ FOXBusiness, “Yale’s Swensen: Pols Missing the Point,” January 6, 2009
(www.foxbusiness.com/search-results/m/21735678/yale-s-swensen-pols-missing-the-point.htm).
In 1998, after its first bank recapitalization, the Japanese government declared victory only to discover later that it would have to go through four more recapitalizations (Hoshi and Kashyap 2008). But even at this early date, Swagel’s claim of victory seems hollow. As the recent bank stress tests have shown, the capital injections under the CPP program were insufficient to make troubled institutions fully viable, but sufficient to allow insolvent ones to keep limping along. The very fact that additional interventions had to be undertaken to support Citigroup and Bank of America after the first CPP injection suggests that the second and third goals had not been reached. Although Swagel is right in pointing out that after the CPP program the tension in financial markets subsided, it is unclear whether most of the credit goes to the capital injection or to the FDIC debt guarantee. And even if the Treasury is given full credit for stopping the panic in October 2008, one cannot ignore the fact that the Treasury shares much of the blame for creating that panic to begin with.

REFERENCES FOR THE ZINGALES COMMENT


