FINANCIAL CRISES AND BANK CAPITAL

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ABSTRACT

Yogi Berra said, "If you don't know where you are going, you will end up someplace else." The initiatives toward more financial regulation since the global meltdown of 2008 have confused the symptoms of the crisis including the surge in bank loans to millions of sub-prime borrowers with the cause, which was the sharp increase the supply of credit in part because of the surge in cross border investment inflows to the United States and twenty other countries. The U.S. banks lent billions of dollars to sub-prime borrowers because the supply of credit was much larger than the demand from prime borrowers; the banks believed that they had a massive profit opportunity because their cost of funds was much less than the interest rates on their mortgage loans. The surge in cross border investment inflows to the United States and these other countries resulted from the large increase in the export earnings and the trade surpluses of China and of the oil exporting countries (hereafter OEC). China and the OEC could have achieved trade surpluses only if there was a comparable increase in the trade deficits of the United States and other industrial countries, which were responses to the dramatic increases in the prices of real estate and stocks and household wealth that led to the massive expansion of consumption spending and payments for imports.

Great Britain, Ireland, Iceland, and Spain also had banking crises in the Autumn of 2008, Greece and Portugal had sovereign debt crises

fifteen months later. Each of these countries previously had had an economic boom, which resulted from the domestic adjustments to the increase in its capital account surplus. Some of the borrowers in each of these countries had relied on money from new loans for the interest payments on their outstanding loans; when the increase in the supply of money from new loans slowed, some of these borrowers defaulted on their loans. Asset prices in some of these countries imploded. Banks incurred massive losses, many failed.

This paper includes a proposes that a new government credit agency be establisheThe d to provide funds to re-capitalize U.S. banks that have incurred large loan losses as a result of the decline in asset prices in systemic banking crises.

Introduction

The U.S. government's decision to allow Lehman Brothers to close on September 15, 2008 was the costlier mistake in American financial history, measured both by the sharp decline in U.S. GDP relative to the projected decline in August 2008, and by the surge in the indebtedness of the U.S. Treasury. The U.S. government sought a buyer for Lehman, but it was unwilling to commit taxpayer funds to facilitate the purchase by Barclays or by a consortium of U.S. banks, even though the Fed had made a massive commitment to induce JPMorgan Chase to buy Bear Stearns. The Paulson-Bernanke claim that the U.S. government did not have the authority to provide "taxpayer funds" so that Lehman could remain open was smoke; the Bush Administration had made a political decision that taxpayer money should not be used to enable Lehman to remain open. Richard Fuld the head of Lehman may have been the least popular banker on Wall Street and was not Paulson's best friend. The Bush Administration may have concluded that saving Lehman would lead to charges of nepotism. George Walker, President Bush's first cousin, ran Lehman's asset management decision. Richard Paulson the brother of the U.S. Secretary of the Treasury, sold mortgage backed securities for Lehman in Chicago. One analyst concluded that Lehman was solvent, and could have remained open without any permanent cost to the taxpayers. (Ball)

Lehman's closing led to a freeze in the international credit market and to a surge in the demand for money; spending declined sharply. Paulson-Bernanke had greatly underestimated the costs of Lehman's bankruptcy, which suggests that they did not understand the cause of the surge in property prices that had begun in 2003. The credit crunch revealed that the Fed and the Treasury had done little contingency planning to cope with the financial distress that would follow from the decline in property prices.

The 2008 U.S. financial meltdown was a systemic crisis. Between 2003 and 2006 the market value of U.S. residential real estate increased from $12,000 billion to $23,000 billion. Much of the increase was in sixteen states that accounted for fifty percent of U.S. GDP, so the percentage increase in prices in many local markets was much greater than one hundred percent.

The first section of this essay reviews the taxonomy of bank failure; a few small banks fail because of idiosyncratic firm specific factors. In contrast, when a large number of banks fail at the same time including some large ones that previously had been considered well-managed, the cause is a systemic shock that led to a large change in the relationship between the prices of two large asset classes. The second section provides an explanation of the surge in U.S. real estate prices and those in many other industrial countries between 2003 and 2006; six of these countries including Britain, Ireland and Iceland also had banking crises. The third section asserts that the regulatory initiatives that have been adopted to forestall a repetition of the 2008 crisis ignore the significance of the variability of cross border investment on the prices of different asset classes and hence are likely to be irrelevant in forestalling a crisis. The fourth section proposes that a new government agency modeled on the Reconstruction Finance Corporation be established de-politicize the re-capitalization of failing banks and to minimize the tendency toward the consolidation of banks when one fails. The new government agency—RFC II--would receive common stock, and preferred stock that would be convertible into common stock in exchange for its capital infusion. Hence the ownership interests of existing shareholders would be diluted as and the top managers would be scalped. Once the economic environment had been stabilized, the RFC II would sell its shares.

Why Banks Fail

One reason banks fail is idiosyncratic or firm-specific and may reflect self-dealing by the top managers or the deterioration of the local neighborhood; the monetary system is stable. The major reason that a large number of banks fail at the same time is a systemic shock that leads to a sharp change in the price relationship between two assets classes—stocks and bonds, bonds and real estate, domestic securities and foreign securities, and short term securities and long term securities. A systemic shock often occurs after an extended episode when many investors had relied on money from new loans for interest payments on their outstanding indebtedness.

Walter Bagehot, in his classic *Lombard Street*, advised that a central bank should provide unlimited credit to an illiquid but solvent bank; otherwise the bank would sell assets to enhance its liquidity, and the induced decline in asset prices might cause some otherwise solvent banks to become insolvent. Bagehot also wrote that a central bank should not assist an insolvent bank. This distinction is logically fallacious because the boundary between solvency and insolvency changes as asset prices fall. A bank often becomes illiquid because its peers are not one hundred percent confident that it is solvent—and will be solvent one month and three months from now. If a bank is not solvent, then the courts will require that its assets be sold to satisfy its creditors; the prices of these assets will decline, and the solvency of other institutions will be impaired.

Central banks were established to provide "unlimited" liquidity; Bagehot advised that the loans from the central bank be at a penalty rate. Deposit insurance was adopted first at the state level and then at the national level to reduce the likelihood that depositors would "run for their money."

The United States has experienced four systemic shocks since the Federal Reserve was established in 1914. Each of these shocks was associated with a sharp change in the price relationship between two classes of assets. The first episode was during 1920 when agricultural prices declined sharply; farm land values had increased dramatically in the previous several years as food prices soared. The second was the Great Depression of the early 1930s, which followed both the sequential devaluation of many currencies that began in the late 1920s as countries stopped pegging their currencies to gold; the decline in the export earnings in these countries because of the Smoot Hawley tariff of 1930 led countries to reduce the prices of their currencies that contributed to downward pressure on the prices of agricultural goods. These declines in the prices of currencies led some investors to buy gold, which caused the banks to become more cautious lenders. The systemic crisis in the early 1980s was triggered in response to the move to an extraordinarily contractive monetary policy at the end of 1979 that led to a sharp increase in interest rates on short term securities relative to those on long term securities. The failure of more 500 banks in 2008 and 2009 and the decimation of the U.S. investment banking industry followed from the sharp decline in real estate prices after four years when these prices had increased sharply.

The U.S. government took a benign neglect approach to the 1920 crisis; the Fed remained on the sidelines. The United States still was largely an agricultural country. Commodity prices declined by forty percent after rapid increases in the previous three years. Many hundred banks of closed; there was a brief sharp recession.

The Reconstruction Finance Corporation was established in 1932 to provide capital to banks that had experienced large loan losses. 1300banks had failed in the previous two years as a result of the decline in the price level and the increase in real interest rates. The U.S. banks were squeezed between the decline in U.S. prices of traded goods in response to the falls in the prices of foreign currencies and the increase in investor demand for gold. As U.S. banks failed, home owners with mortgage indebtedness found that they could not re-finance maturing loans – then primarily five-year terms – and they became distress sellers of real estate. President Roosevelt nationalized American holdings of gold soon after he took office, which reduced the banks' concerns about liquidity.

The systemic shock in the early 1980s followed the adoption of a sharply contractive monetary policy in late October 1979, the Fed's policy had been feckless in the previous several years and slighted investor concerns that the U.S. inflation rate would accelerate. U.S. short term interest rates surged relative to long term rates, and the interest rate yield curve became negative, with the result that the interest payments on the short term liabilities of thrift institutions climbed above the interest income on their long term mortgages. The capital of these firms was being depleted; the concern was whether the short term interest rates would decline significantly to reduce the bleeding before the firms failed. The U.S. Government eased some regulations in the effort that the firms might be able to earn their ways out of their holes, which led to financial shenanigans as investors gamed the deposit insurance arrangement.

The failure of more than 500 banks since 2007 reflects the sharp decline in home prices that began at the end of 2006, which lead to more than ten million foreclosures—nearly ten percent of the housing stock. The Greenspan Fed had adopted an expansive monetary policy in 2002, which contributed to the increase in real estate prices and the consumption spending boom financed with mortgage equity withdrawals. Prices peak toward the end of 2006. Various policies were adopted to dampen the impact of declining property prices, including the establishment of Maiden Lane One to facilitate JPMorgan Chase's purchase of Bear Stearns and the establishment of Maiden Lane Two to enable AIG to remain in business. Then in October the U.S. Congress approved the request for $700 billion – the Troubled Assets Relief Program or TARP – to enhance the capital of banks.

Once property prices start to decline, the banks become more cautions lenders. Some borrowers will not be able to refinance maturing debt and they will become distress sellers of real estate, which could cause the price decline to accelerate. Without government intervention, the prices might decline below long run equilibrium values. Home prices in Florida declined below reproduction costs, which suggests—incorrectly—that the land had negative value.

The imbalances that preceded the systemic crises of the early 1980s resulted from the feckless monetary policy of the late 1970s. The imbalances that preceded the 2008 crisis followed the sharp increase in investor demand for U.S. dollar securities and the expansive monetary policy that the Greenspan Fed adopted in 2002 to stimulate the economy after stock prices had started to decline sharply.

The Early 2000s Global Surge in Real Estate Prices

The U.S. banking crisis of 2008 was a country specific manifestation of a global event; four other countries—Great Britain, Iceland, Ireland, and Spain had crises at the same time. Greece and Portugal had sovereign debt crises about fifteen months later. Iceland's banking crisis was triggered by its currency crisis when its banks defaulted on their foreign loans; for the previous five years the banks had relied on money from new loans for the interest payments on their outstanding indebtedness denominated in foreign currencies. The crises in these countries followed booms that were associated with increases in their external indebtedness; nearly twenty countries experienced real estate booms. The features of these 2008 crises were similar to the currency and banking crises in Thailand and Indonesia and other countries in Asia in 1997 and to the Mexican crisis during its presidential transition at the end of 1994.

The likelihood that the 2008-2010 crises in seven countries were independent national events is trivially small. Moreover, the preludes to the sovereign debt crises in Greece and in Portugal were similar to those in the counties that had banking crises, the major difference was the identity of the borrowers.

Every country that has had a banking crisis since 1980 previously had a boom; not every boom has been followed by a crisis but every crisis was preceded by a boom, which was induced in response to the increase in its capital account surplus; the boom in Japan was associated with a decline in its capital account deficit. (The first difference of the change in the Japanese capital account deficit was the same as the first differences in the changes in the capital account surpluses of the United States, Great Britain, and these other countries). The capital account surplus in each of these countries could not increase unless there was a contemporary increase in its current account deficit. The increase in their capital account surpluses led to consumption booms as prices of securities and real estate and hence of household wealth moved up.

The external shock that led to the booms that preceded the 2008 global crisis was a sharp increase in the demand for international reserve assets, partly from the oil-exporting countries including Norway and Saudi Arabia and the United Arab Emirates, and partly from China. Soon after 2002, these countries experienced increases in their export earnings, about the time that China became a member of the WTO. They used part of the increase in their export earnings to buy off-the-shelf securities available in the United States and Great Britain and other industrial countries, which meant that the capital account surpluses of the United States and these other countries increased.

China and the oil exporting countries, and the United States and the other industrial countries were involved in a complex tango; the countries in the former group could achieve increases in their current account surpluses only if there were adjustments in the major industrial countries that would lead to counterpart increases in their current account deficits. The invisible hands were at work to motivate the increases in spending in the industrial countries; the principal factor was the surge in prices of real estate and of stocks that led to greater consumption spending. The increases in the prices of the currencies of these countries were associated with increases in their capital account surpluses.

During the expansive phase, some borrowers relied on money from new loans to pay all of the interest on their outstanding loans. The Government of Greece relied on money from new loans for the interest payments on its outstanding loans. Once the foreign banks slowed their purchases of the IOUs of the Greek Government, it lacked the money for the interest payments.

Iceland's capital account surplus increased from one percent of its GDP in 2003 to a peak of eighteen percent in 2008. Iceland had a massive boom, stock prices increased nearly tenfold and real estate prices doubled. The increase in asset prices was a response to the surge in the supply of credit from two sources—one was the sharp increase in cross border investment inflows and the other was the dramatic increase in the domestic loans of the three Icelandic banks. (An increase in the growth of domestic credit by itself would have led to the increase in asset prices and in total spending, and the price of the Icelandic krona would have declined because of the increase in spending on foreign goods). The autonomous increase in the investor demand for Icelandic securities led to higher prices for Icelandic stocks that enabled the Icelandic banks to rapidly increase their domestic loans. The capital of the three Icelandic banks increased by sixty to seventy percent a year. Some of the borrowers from the banks used the money to buy goods, some used the money to buy real estate and stocks.

The Icelandic banks took the initiative to sell more of the IOUs in foreign centers soon after they were privatized; they brought some of the foreign funds to Iceland which they converted to krona so they could increase their krona loans. They also lent some of the foreign funds to Icelandic households and business firms, who brought some of these funds to Iceland and also converted them to krona. Iceland could experience an autonomous increase in its capital account surplus only if there was a counterpart induced increase in its current account deficit. The principal factor contributed to this surge in consumption spending was the dramatic increase in household wealth, the secondary factor was the increase in the price of the Icelandic krona.

The capital of the Icelandic banks increased as stock prices increased, which enabled them to buy more domestic loans; their assets and liabilities also increased by a factor of nine. (Note there is no special stash of securities called bank capital.

The necessary condition for the banking crisis in Iceland was that the external liabilities of the Icelandic banks had increased by more than twenty percent a year for six years, which was much more rapid than the increase in its GDP; it was inevitable that at some stage, the lenders would become more cautious about buying Icelandic IOUs, and the price of the Icelandic krona would then decline. The sufficient condition was that the ratio of Iceland's gross external liabilities to its GDP was in the range of ninety to one hundred twenty percent. (The increase in the ratio of the Iceland's gross external liabilities to its GDP was substantially larger than the increase in its net international indebtedness; the difference was the increase in the net foreign assets of Icelandic firms and investors). When the foreign demand for Icelandic IOUs slowed, the price of the Icelandic krona would decline by at least thirty to forty percent, since Iceland would no longer be able to finance a trade deficit. The krona equivalent of the indebtedness denominated in a foreign currency of Icelandic households and business firms would increase. Some of the Icelandic borrowers with indebtedness denominated in a foreign currency then would sell domestic stocks and real estate to obtain the funds for their debt service payments and the prices of these assets would decline; other borrowers would default on their indebtedness. As the price of Icelandic stocks fell, the capital of the Icelandic banks would decline, and they would shrink their assets; they would sell stocks and they would not renew some maturing loans. The Icelandic banks then would reduce their loans to Icelandic borrowers, some of these borrowers would become distress sellers of assets and others would default.

The U.S. capital account surplus surged in the early years of each of the last four decades—the 1980s, the 1990ss, the 2000s, and the 2010s; this surplus declined in the last several years of the first three decades. The increase in the U.S. capital account surplus generally was associated with an increase in the price of the U.S. dollar, except during the 2000s decade.

The ratio of the U.S. capital account surplus to U.S. GDP increased by three percentage points from 2002 to 2006 as sovereign wealth funds and foreign central banks bought U.S. securities. The massive increase in U.S. real estate prices was induced by the increase in the U.S. capital account surplus to ensure that there was an induced increase in the U.S. current account deficit that more or less continually corresponded with the autonomous increase in the U.S. capital account surplus.

Japan experienced the “mother of all asset bubbles” in the second half of the 1980s. property prices and real estate prices increased by a factor of three. The background for the Japanese experience differed from those of most other countries, since Japan had a large but declining capital account deficit in the second half of the 1980s; during the first half of the decade, there was a surge in Japanese purchases of U.S. dollar securities. By 1985, the U.S. dollar had become overvalued; the incentives for Japanese investors to buy U.S. dollar securities had greatly diminished. Instead Americans began to buy Japanese securities, motivated in part by the increase in the price of the Japanese yen and in part by the increase in the price of Japanese stocks. Japan then had to adjust to a decline in its capital account deficit, which could have occurred only if there was a counterpart decline in its current account surplus. The principal factor that contributed to the reduction in the Japan's current account surplus was the sharp increase in the prices of real estate and stocks which led to a surge in consumption spending.

The transfer problem process was at work in Iceland, the United States, and Japan, and in each of the other countries that experienced an autonomous increase in its capital account surplus. When a country's currency is not anchored to a parity, the country cannot experience an increase in its capital account surplus unless there is a comparable increase in its current account deficit. Every country that has had a banking crisis previously had an asset price boom, and every one of these countries except Japan experienced an increase in its capital account surplus—which could have occurred only if there was a counterpart increase in its current account deficit. The intermediate argument was that asset prices increased by the amount necessary to ensure that consumption spending increased and the demand for imports increased to ensure that the increase in the country's payments increased to match the increase in its receipts.

The Irrelevance of Dodd Frank

Yogi Berra might have said, "If you don't know where you started, you can't get there from here." One of the fascinating questions is that despite the one hundred fifty years since the publication of Lombard Street, the financial regulators in many countries do not understand the fallacy of composition. Home mortgage loans are collateralized by the real property in the United States, Japan and numerous other countries. If real estate prices increase, the banks can increase the amounts they can lend against the higher market value. Bank profits will increase as a result of the increase in the volume of transactions. (This cycle of higher real estate prices and larger bank profits is the mirror of Irving Fisher's debt deflation cycle.) The regulators have not asked whether the market value of the real property was consistent with long term equilibrium based on household incomes and the rental rate of return.

Maureen Dowd in the New York Times wrote, "We (Americans) let the corrupt bankers who ravaged our economy roam free with bigger bonuses, more lavish Hamptons houses and fresh risky schemes." Some bankers profited greatly from the monetary ease of the2002-2005 period, in part from the fees associated with the production and trading of asset-backed securities and mortgage-backed securities. The volume of these securities surged because of the massive increase in the supply of credit, partly from investment inflows and partly from domestic credit creation.

The dominant view is that the 2008 crisis resulted from the shortcomings of regulation. The perimeter of regulation often is said to be too limited, with the implication is that too many lenders are not regulated; the term “shadow banking system’ is invoked. Banks had specialized investment vehicles that could under take transactions that the banks themselves could not undertake. Another criticism was that the scope of regulation was too limited; “derivatives” were not regulated. A third criticism is that the regulators were “asleep at the switch”, career regulators want a quiet life, like firemen in the desert.

A competing view implicit in the previous section is that regulation is irrelevant when there is a surge in the credit supply. The United States had to adjust to an increase in investor demand for U.S. securities; the U.S. capital account surplus could have increased only if there were a comparable increase in the current account deficits. The primary factor that led to the increases in their current account deficits was the increase in prices of securities and in household wealth; the U.S. consumption boom reflected that the inflow of foreign saving displaced domestic saving

The Wall Street Reform and Consumer Protection Act of 2010, more popularly Dodd-Frank (hereafter DF), is the most comprehensive attempt at financial regulation to avoid a crisis like the one in 2008. The theory of the cause of the crisis can be inferred from the set of measures adopted to reduce the likelihood of another meltdown like the one in 2008. The inference from increase in capital requirements and from limitations is that each bank failed because of idiosyncratic factors. Thus the implicit view is that the cause of the 2008 crisis was some sort for financial flu that hit more than 500 banks with the same symptoms at about the same time. DF ignores that bank failures are interdependent rather than independent events. DF provides that banks should be subject to stress tests; the practice is that Bank of America, Citibank, and Wells Fargo are subject to the stress test on successive days of the week Monday, Tuesday, and Wednesday. The regulators appear not to have asked whether Bank of America, Citibank, and Wells Fargo can pass the stress test on the same day.

The United States has no established procedures to deal with a systemic shock that leads to a large decline in capital for all banks as a group or even for a large bank like Continental Illinois Bank. When this bank was failing in 1984, the Federal Reserve ensured that the bank would continue to function. No effort was made to re-capitalize the bank in a formal way, but the support of the Fed was an implicit capital injection for a brief period.

DF does nothing to insulate the U.S. economy from an increase in investor demand for U.S. dollar securities and the temporary increase in U.S. asset prices that occur as an integral part of the adjustment program. Moreover DF does not recognize the costs of financial regulation. Regulations incur costs, someone pays. An increase in the bank capital requirement increases the costs of financial intermediation and leads to the expansion of non-regulated financial firms.

DF does not recognize that the U.S. banking crisis of 2008 resulted from the variability of the U.S. capital account surplus. The autonomous increase in this surplus induced a massive increase in the price of U.S. real estate as an integral part of the adjustment process to ensure that the U.S. current account deficit increased as the U.S. capital account surplus increased. If his legislation been adopted in 2000 and the flow of investor funds to the United States is taken as a given, the U.S. banks would have supplied less credit and some non-bank lenders would have supplied more credit. When the investor demand for U.S. dollar securities slackened, U.S. real estate prices would have declined. DF deals with a level problem, and the basic problem is that crisis in real estate resulted from the increase and the subsequent decrease in real estate values.

The Reconstruction of Finance Corporation

The U.S. Government regulation developed to prevent the failure of individual banks has been more extensive than the combination of regulations applied to firms in all other industries as a group. One motive is consumer protection, another is economic stability since failure of a bank can be devastating for a small community. A second motive is that the failure of a number of banks in a systemic crisis disrupts the national economy and leads to a much larger decline in GDP than in a traditional recession.

Each of the four waves of banking crises since the early 1920s has been a response to a systemic shock. Hundreds of U.S. banks failed in the early 1930s because of downward pressure on the U.S. prices of tradeable goods that followed from the declines in the prices of foreign currencies and the rush for gold by American households. More than a thousand banks and thrift institutions failed in the early 1980s in response to the surge in interest rates that resulted from the sharply contractive monetary policy that the Federal Reserve adopted in October 1979 to crush anticipations of accelerating inflation. More than five hundred U.S. banks failed after 2008 following the implosion of property prices, which had doubled at the national level in the four previous years. These dramatic increases could not have occurred unless there was as superabundance of credit.

The irony is that the banks have been blamed for the 2008 crisis, even though they were the victims. Some bankers were villains, they bought mortgage loans from those who could not afford the monthly payments. The Greenspan Fed was unknowing about the impacts of the increase in the U.S. capital account surplus on the prices of U.S. real estate and U.S. stocks.

The traditional U.S. approach has been to merge failing banks with healthier banks, a marriage that often is blessed by removing doggy assets. The ratio of the capital of the acquiring banks to its deposits inevitably declines. This approach leads to a consolidation of banking firms. There is not systematic approach to re-capitalizing failing or failed banks, so the process inevitably involves extensive political rather than administrative decisions. The failure to provide government capital so that Lehman Brothers could remain open was the costlier mistake by a U.S. administration in the last two hundred years. The clichés “too big to fail” and “bailing out the bankers” dominated decisions about government investments that would assisted in economic stabilization during the systemic crisis.

The U.S. Congress should establish the Reconstruction Finance Corporation II to provide the funds to recapitalize failing and insolvent banks. The RFC was established in 1932 provide capital to failing banks and firms in other industries (Jones). RFC II would buy newly-issued common shares in any bank deemed to have too little capital; the ownership interest of the existing shareholders would be diluted. If the capital requirement for each bank is five percent of assets and loan losses reduce the capital to four percent, RFCII would write a check to the bank for the dollar amount required to bring capital to the five percent minimum, and RFC II would receive newly issued common shares so that it would own twenty percent of the bank. If instead the capital had declined to three percent, RFC II would receive the number of newly issued shares so it would become the owner of forty percent of the common shares. If the decline in capital was larger, the RFC II would write a check so that it would own fifty percent of the common shares, and the bondholders would be required to participate in a debt for equity swap.

Once the RFC II had acquired common shares in a bank, it would become the controlling shareholder. The senior two or three officers would be removed, and the board of directors would resign. These RFC II banks would be managed as private enterprises on a care-taker basis; the thrust would be to prepare the banks to be privatized within three or four years.

The objective of the proposal is to stabilize the U.S. banking system in response to the impact of the variability of investor demand for U.S. dollar securities on household wealth. An increase in this demand leads to a boom, a decrease leads to a bust. The current arrangement requires that bank assets adjust to the level of bank capital, which often has been declining; instead the proposal provides a low cost way to adjust capital to the value of bank assets.

One advantage of this proposal is that it would sharply reduce the consolidation of banks that now occurs when the FDIC induces a strong bank to buy a failing bank. A second advantage of the proposal is that RFCII would be profitable; at least this is the inference from TARP, and Maiden Lane 1 and Maiden Lane II. . The RFCII would be a classic vulture investor, and it would profit because it would acquire failing banks when their values were greatly depressed because of cyclical crash.

A third advantage of the proposal is that it would de-politicize the extension of government support for failing banks, there would be well publicized procedures for providing government capital. The cliché about the “bailing out the banks” might be trashed, the banks would be saved while the top bankers would be furloughed. A fourth advantage of the proposal is that the effectiveness of monetary policy would be enhanced; the Federal Reserve would no longer be concerned about the impact of increases in interest rates on financial stability.

A fifth advantage of the proposal is that it would reduce the “tax” on banks from high capital requirements. These requirements have no advantage, they are irrelevant in preventing a systemic shock and in mitigating a shock.

One potential criticism of the RFC II proposal is “moral hazard”; that the bank managers would take on riskier assets because the provision of government capital would guarantee that the bank would not fail. The bankers would lose control if they required government capital to remain open.

Conclusion

The key idea of this essay is that U.S. macroeconomic stability would be enhanced if the U.S. Congress established a government agency to provide capital to failing and insolvent banks, which would stabilize the supply of capital to banks after a systemic crisis had led to large loan losses. The rationale is that if the supply of bank capital is not increased to compensate for loan losses, the debt deflation cycle described by Irving Fisher in the 1930 would apply, and bank liabilities would shrink to correspond with depleted capital.

A few banks have failed for idiosyncratic or firm-specific reasons; most banks have failed including some very large ones because of systemic shocks. Many of these banks that failed at the same time previously had been considered well-managed. These banks have failed because a systemic shock led to a sharp change in the relationship between two different asset classes. There have been four systemic crises since the Federal Reserve was established in 1914; three were associated with a sharp decline in the price of real estate and one was associated with a sharp increase in short term interest rates. Hundreds of banks and thrifts institutions failed in each crisis; the early 1930s crisis and the 2008 crisis led to sharp declines in nominal and real GDP.

The second section provided an explanation for the Global Financial Crisis of 2008, which reflected the surge in the export earnings and the trade surpluses of China and the oil-exporting countries; the increase in their demand for U.S. securities led to higher prices for U.S. real estate and stocks; similarly, the increase in their demand for securities in other countries led to higher prices for real estate and stocks in these countries. These increases in the prices of real estate and stocks were transient; these prices were likely to decline when the inflows fell. A crisis might develop if there were a sharp decline in real estate prices.

The third section focused on Dodd-Frank, which extended the types of regulatory initiatives appropriate for dealing with bank failure because of idiosyncratic factors to deal with failure because of systemic shocks. The implicit premise of Dodd Frank is that the crisis resulted from the decisions by U.S. banks to rapidly increase their purchases of risky securities rather than from a surge in the supply of credit from the combination of increases in the capital account surpluses of this group of countries and more expansive monetary policies. DF does nothing to dampen cyclical increases in investor demand for U.S. dollar securities. . Dodd Frank increases the cost of financial intermediation in the “good years” and reduces the perimeter of regulation while it does nothing to abate the severity of the systemic crisis.

The Reconstruction Finance Corporation established in 1932 is a model of a government institution that provided capital to failing and insolvent banks. The proposed RFCII would acquire common shares and preferred shares in failing and insolvent banks; the ownership interest of the private shareholders would be diluted. The objective is to save the banks as functioning institutions while the senior managers would be replaced and the board of directors would be dismissed. The new managers would prepare the banks to be privatized once the macro economy had stabilized.

One of the collateral benefits is that the banking system would be more competitive; the existing arrangement of merging failed banks with more robust competitors reduces the number of banks. This arrangement would be profitable; at least that is the inference from TARP and from the Federal Reserve’s investment in IG. Monetary policy would be enhanced, since it would no longer be constrained by the adverse impact on financial stability. The costs of bank intermediation in the good years would be reduced because bank capital requirement would be lower.

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