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No More Creampuffs

The Government Is Willing to Let Wall Street Firms Fail. That's Good.

By Kenneth Rogoff
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This past weekend, the U.S. Treasury and the Federal Reserve finally made it abundantly clear that they won't bail out every significant financial firm in America. Certainly this came as a rude shock to many financiers. In allowing the nation's fourth-largest investment bank, Lehman Brothers, to file for bankruptcy, and by forcefully indicating that they are prepared to see even more bankruptcies, our financial regulators showed Wall Street that they are not such creampuffs after all.

The question now: What's next? Assuming the financial sector continues to melt down over the next couple of months, at what point, if any, should the government get back into the game? It would be a mistake to do so before a great deal more consolidation takes place. During the epic boom of the past 20 years, the financial services sector became badly bloated. At its peak, it accounted for over one-third of corporate profits in the United States, not to mention the staggering billions of dollars in bonuses that Goldman Sachs ($12.1 billion in 2007) and others paid their employees. Now, in the wake of the subprime mortgage debacle, investment banks are seeing some of their most profitable lines of business evaporate. Profits from complex mortgage products are not coming back anytime soon; nor are profits in many other areas that rely on huge borrowing.

Instead, "deleveraging" is the buzzword throughout the financial system, as firms prune their borrowing and their positions. As profits come down to more earthly levels, the U.S. financial system is going to shrink. In all likelihood, at least 15 percent of financial employees -- including at the high end -- are going to lose their jobs. In principle, this shrinkage could take place through all firms and banks trimming their operations proportionately. But that is not how a capitalist economy operates. Whether it is the auto, airline or tech industries, the strong devour the weak. That is why it was inevitable that some banks would either fail or submit to distress mergers, including even some of the largest. That is why it has been quite clear for some months that the trauma to the U.S. financial system was not over.

Letting a big investment bank go, as the Fed and Treasury did this weekend, was a calculated risk in a difficult situation. And the risks are very real. With the immense interconnectivity of the financial system, there really is no telling where the unprecedented failure of a big investment bank might lead. On the other hand, ponying up tens of billions in tax money, as the Federal Reserve did in March when another investment bank, Bear Stearns, collapsed, is no answer, either. With the housing market still weakening, with U.S. exports likely to suffer as the global economy falters and with unemployment rising, it is clear that simply bailing out Lehman Brothers would not stop the rot in the financial system.

In March, the Federal Reserve took on $29 billion in risky Bear Stearns assets. Bailing out Lehman probably would have involved at least as large a commitment. If such a maneuver could have put an end to the crisis, it might have been justified, but that is hardly the case with many other giants teetering. This is not to mention the trillions of dollars in liabilities the Treasury took on 10 days ago in bailing out the mortgage giants Fannie Mae and Freddie Mac. These alone will probably end up costing taxpayers $100 billion to $200 billion, assuming inflation-adjusted housing prices fall another 10 to 12 percent.

Will taxpayers now escape without further damage? Probably not. More likely, the stress will continue for some time, radiating out into corporate debt, hitting big automakers, many debt-strapped cities and others. At some point, the federal government will blink again, and taxpayers will probably end up paying at least another couple hundred billion dollars before this extraordinary mess ends. But by placing some of the burden on the shareholders and bondholders of the big financial institutions, financial regulators have at least forced some discipline onto the system, making bankers and investors think twice before they once again head off to the races. By allowing firms that took excessive risks to fail, regulators also reduce the political pressure to overregulate the system in the aftermath of the crisis. Let's hope they hang tough for at least a little while longer.

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