Heading Off The Next Credit Crisis

Forbes
From Knowledge@Wharton
July 12, 2010

In an economic downturn, dealing with macroeconomic pressures is bad enough. But financial institutions add to their woes, experts say, by refusing to provide capital to worthy businesses because they fear other lenders will also cut back. In the end banks create a credit shortage that extends the crisis and delays recovery.

This sort of self-fulfilling credit crunch is the focus of Wharton research that explores alternative ways to prevent inefficient credit tightening from causing further damage to an already wounded economy. In a paper titled, "Self-Fulfilling Credit Market Freezes," Wharton finance professor Itay Goldstein and Lucian A. Bebchuk of Harvard Law School examine different approaches to halt an overreaching credit crunch.

Goldstein says the credit freeze that bedeviled companies during the 2008–09 financial crisis prompted the analysis. "One of the most interesting phenomena of the crisis was the credit freeze. There was an extended period of time when the banks were just not lending."

After examining numerous policy responses to the problem, the authors suggest that governments should put up capital to be distributed to nonfinancial companies. However, they say the public sector should rely on private entities that are putting some of their own capital at risk to evaluate proposals and disperse the funds. That way, the money will not get caught in a bank-created credit squeeze and instead will be directed toward viable businesses. This solution to self-driven financial crises is similar to the U.S. government's Term Asset-Backed Securities Loan Facility, which helped free up credit during the height of the 2008–09 financial crisis, the authors conclude.

Goldstein notes that banks, companies and individual consumers are all economically interdependent on many levels. If a company runs into trouble, it may lay off employees or cut back on purchases of supplies. The belt-tightening hurts the prospects of profitability for the company's suppliers and for the consumer products companies that sell to the employees. In turn, those businesses may begin cutting personnel and reducing orders to their own suppliers--creating a multiplier effect that works its way into all sectors of the economy. When banks detect that firms may have trouble repaying loans, it is easy for them to extrapolate that other lenders will also withhold credit. As a result, banks choke off the sources of funds necessary to finance ongoing and future business ventures likely to generate profits that companies could use to pay back loans and continue the cycle of borrowing that keeps financial institutions afloat. The authors consider the banks' reaction to be rational, but also a "coordination failure" that leads to inefficient credit decisions.

"In such a world, you can imagine how you can get into a credit freeze," Goldstein points out. "If all of us think that the others are not going to produce profits, and if the banks think that other banks won't lend the whole thing becomes a self-fulfilling crisis." Considerable anecdotal

evidence exists showing that in the most recent financial meltdown an overly cautious credit environment made the overall situation even worse, he argues.

Finding the Right Solution

When times are good, banks do not need government help. Likewise, when companies or industries are deeply affected by poor macroeconomic fundamentals, there may be little impact from government involvement in credit markets. However, the authors suggest there is an "intermediate range" of economic distress that requires a more sophisticated approach to keep credit flowing as businesses pass through a rough patch. Using a theoretical model that tests a series of potential policy actions, the paper reveals the strengths and weaknesses of each response, as well as the conditions in which one policy might work better than another.

Typically, interest rate reductions are a first-line response to a weak economy. In 2008 the U.S. Federal Reserve Board cut rates from 4.24% in January to 1% in October. According to Goldstein and Bebchuk, an interest rate reduction can reverse a faulty credit freeze, but not always. Even if interest rates drop to zero, the researchers' model indicates that banks may prefer to accept that return rather than take the risk of lending if officials believe that other institutions are also likely to pull back on financing. The authors liken this finding to the liquidity trap in monetary economics.

Another government policy enacted in times of crisis is capital infusion into the banking system. This, too, is an effective way to hold off an inefficient credit crisis, the authors suggest. However, its effectiveness is also limited. During the 2008–09 financial crisis, governments around the world helped shore up banks facing mounting losses from real estate mortgages and other bad investments. In the U.S., the Troubled Asset Relief Program provided about $250 billion to banks. In the U.K., the government invested $90 billion in several large banks. Providing additional capital can make banks more willing to continue to lend to businesses, the researchers note. But this policy also has its limits: While there may be additional breathing room, banks can still hoard cash, anticipating that other institutions will not provide funds to businesses--which again would lead to a credit crunch.

To get around this problem, governments facing an unwarranted credit freeze in their economies can lend directly to firms. "This approach could be viewed as extending the government's role as a lender of last resort from the financial sector to the nonfinancial sector," the authors write. Indeed, during the 2008–09 crisis, the U.S. government took the unprecedented step of buying commercial paper and held as much as 22% of the market in January 2009. This solution gets around the problem of banks hoarding cash, but it presents another complication: Governments typically do not have the same expertise as banks and other financial firms to determine which companies have viable projects. As a result, they could wind up lending to firms that do not have good prospects for success. "Direct lending to operating firms, without screening ... by intermediating banks, can waste resources by channeling capital to some firms with bad projects," the paper states.

Closing Loopholes and Preventing Risk

The researchers then set out to compare whether direct lending to businesses or the infusion of capital into financial institutions is a better response to a credit crunch. The model indicates that

"lending directly to operating firms more effectively increases the returns to banks from lending and encourages banks to lend, and thus is more likely to bring the economy to a credit thaw."

With that finding in place, the authors go on to question whether the downside of government direct lending--lack of expertise in determining winners and losers--could be overcome if government funds were managed by private firms in the business of evaluating companies. Goldstein and Bebchuk investigate a system in which the government puts capital into the hands of banks or other financial firms that are paid a proportion of any profits they generate. Like hedge fund managers, however, they would not lose if the investments they select fail. This system does present the risk that the lure of government incentives would drive fund managers to make loans to companies that did not deserve the financing.

To solve that problem, the researchers also look into how government guarantees might be used to keep lending going when banks might otherwise pull back. Under this plan, the government provides banks with guarantees in case the loans they make fail. The U.S. government used guarantees during the 2008–09 financial crisis to help Citigroup and other banking companies limit loan losses. When it comes to lending for new projects, the authors contend that guarantees lower the threshold below which a crisis is likely to occur by making it more attractive for banks to lend. The government may not even have to pay anything out to get the desired effect of keeping credit flowing to worthwhile businesses. However, this method is relatively weak in breaking up the coordination failure leading to a credit freeze and is more likely to be successful when there is little public information being disseminated about the strength of the economy.

Finally, the authors describe the best option according to their model, which combines many elements of other policy approaches. In this scenario, government funds would be managed by private firms that are also exposed to risk. The level of downside risk should remain small, the model suggests, in order to make private financial firms interested in lending. "The bottom line is that a combination of forces, a more sophisticated mechanism, is needed to achieve the best of both worlds," says Goldstein. "If you just give money to the bank, or give it to a firm, you will suffer from one kind of inefficiency."

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Goldstein acknowledges that faulty bank coordination can work two ways. It can act to freeze credit in bad times and to extend excessive credit in boom times. However, he says he is more concerned about the downside because economic systems naturally have more brakes on the upside, as institutions recognize when they have created overcapacity that will result in declining profitability and pare back.

On the downside, however, a large, external force needs to step in and take the lead in order to break through banks' faulty strategy of clamping down on lending in unison. Goldstein notes that widespread market disruptions that could have arisen from the collapse of the hedge fund Long-Term Capital Management were avoided after the Fed brought leading banks together to take over the company. The authors point out that coordination failures could be avoided by having fewer and larger financial institutions--just the type of bank that some policymakers have criticized as "too big to fail" with an implicit guarantee that the government will bail them out.

The authors liken their work to research into bank runs--or when a large number of customers withdraws their deposits because they believe a bank is insolvent--although they point out their emphasis is on a run by financial institutions that affects companies in nonfinancial sectors of the economy. "In a sense, banks lose faith in the economy," Goldstein concludes. "In this problem, the traditional lender of last resort isn't going to be good enough. ... We need something else a bit more creative."