

The Liquidation Trap

The U.S. financial system is caught in a destructive liquidation trap that has falling asset prices cause financial distress, in turn compelling further asset sales and price declines. If unaddressed, it risks sending the economy into deep recession – or even depression.

Current conditions are the result of bursting of the house price bubble and the end of two decades of financial exuberance. That exuberance was fostered by a cocktail of forces.

First, economic policy replaced wages and productive investment as the engines of growth with debt and asset inflation. Second, greed and free market ideology combined to promote excessive risk-taking and restrain regulators. This was encouraged by audacious claims that mathematical economic models mapped reality and priced uncertainty, making old-fashioned precautions redundant.

Recognition of the scale of financial folly has created a rush for liquidity. This is causing huge losses, triggering margin calls and downgrades that cause more selling, damage confidence, and further squeeze credit. That is the paradox of deleveraging. One firm can, but the system as a whole cannot.

Having failed to prevent the bubble, regulatory policy is now amplifying its deflation. One reason is mark-to-market accounting rules that force companies to take losses as prices fall. A second reason is rigid capital standards.

Application of mark-to-market rules in an environment of asset price volatility can create a vicious cycle of accounting losses that drive further price declines and losses. Meanwhile, capital standards require firms to raise more capital when they suffer losses. That compels them to raise money in the midst of a liquidity squeeze, resulting in fresh equity sales that cause further asset price declines.

Bad debts will have to be written down, but it is better to write them down in orderly fashion rather than through panicked deleveraging that pulls down good assets too.

This suggests regulators should explore ways to relax capital standards and mark-to-market rules. One possibility is permitting temporary discretionary relaxations akin to stock market circuit breakers.

Later, regulators must tackle the underlying problem of price bubbles. Currently, central banks are only able to control bubbles by torpedoing the economy with higher interest rates. New flexible measures of control are needed. One proposal is asset based reserve requirements, which systematically applies adjustable margin requirements to the assets of financial firms.

The Fed must also lower interest rates, and not just for standard reasons of stimulating spending. Lower short term rates are needed to make longer term assets (including houses) relatively more attractive, thereby shifting demand to them and putting a bottom to asset price destruction.

Fears about a price – wage inflation spiral remain misplaced. Instead, the threat is deep recession triggered by the liquidation trap. If inflation is a wild card, now is the time to use the credibility the Fed has earned. Emergency rate reductions can be reversed when the situation stabilizes.

The great irony is central banks can produce liquidity costlessly. Usually the problem is restraining over-production: today, it is overcoming political concerns about “bail-outs”. Those concerns are legitimate, but they also risk inappropriately restricting liquidity provision and unintentionally imposing huge costs of deep recession.

At the moment the Fed is protecting banks and the treasury dealer network but leaving the rest of the system in the cold. That is perverse given how the Fed went along with expansion of the non-bank financial system. Instead, the Fed should consider an auction facility that makes longer duration loans available to qualified insurance and finance companies too.

The facility’s guiding principle should be an expanded version of the Bagehot rule. Accordingly, the Fed would auction funds at punitive rates, with loans being fully collateralized. The goal should be to facilitate repair of distressed financial companies with minimum market disruption and at no taxpayer expense. By creating an up-front facility, the Fed can get ahead of the curve and reduce need for crisis interventions that are always more costly and disruptive.

Among financial conservatives there is a view that financial markets deserve punishment for their “sins” and only that will cleanse them. This view is often presented in terms of need to restore market discipline and stay moral hazard.

The view from the left is strangely similar, arguing Wall Street “fat cats” need to be punished. Asset prices should fall, banks must eat their losses, and all but the most essential financial firms should be allowed to fail.

Both views have a moralistic dimension, and both risk unnecessary economic suffering. The mistakes of the past cannot be undone. All that can be done is to minimize their costs and then truly reform the system so that they are not repeated.

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