Only feds' cash can unclog the Wall Street traffic jam

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BY BOB CHIRINKO

The financial crisis has brought with it a vocabulary all its own. Terms like credit default swaps, subprime mortgages, tranches, collateralized debt obligations, and more leave all but the specialist in a fog. Perhaps two parables concerning Chicagoland expressways can help shed light on how we got into this situation, and the direction out.

Consider the Dan Ryan Expy. during a Friday rush hour. Traffic is heavy but still flowing. Then, suddenly, a "paralyzing fear" takes hold of one-third of the drivers. Traffic virtually grinds to a halt. Nothing "fundamental" has happened -- no accidents, no rainstorms, no blizzards. A loss of confidence by drivers (financial market participants) has led to a clogged and dysfunctional highway (financial system).

The situation recently confronting Citigroup is a classic example of a "loss of confidence." In part because of the first injection of government funds, its large base of deposits, and its diverse businesses, Citigroup's fundamentals were reasonably sound. Nonetheless, a paralyzing fear took hold, the stock price plunged, and Citigroup's survival was threatened.

Underlying the "paralyzing fear," however, is a "fundamental fear." Experience suggests that risky and reckless behavior by a few drivers can lead to deadly outcomes for prudent drivers. Excessively cautious behavior can be very reasonable, which takes us from the Dan Ryan to the Kennedy for a second parable.

On a Friday afternoon, Frank and a few of his friends from work repair to the local watering hole. Frank has had too much to drink. His colleagues suggest that he leave his car and take a cab home, but in the end, they lack the power (regulatory authority) to prevent him from getting behind the wheel (risky behavior).

Driving home on the Kennedy Expy., Frank hits a guardrail. Fortunately, no one is injured, and Frank walks away. However, his car blocks two lanes.

How is this problem solved? Under a free market solution, motorists would recognize their shared self-interest and team up to move Frank's car. Two difficulties confound this scenario -- such collective action is unlikely to emerge, and even if it did, moving the damaged car may require specialized equipment. In the end, the free market solution fails.

Few would disagree that the person causing the problem should be responsible for resolving it. The legal system can impose appropriate penalties, but while Frank's case worked its way through the courts, traffic would remain snarled. The legal solution may be fair but is surely much too slow.

The way to break the impasse is clear. The government needs to bring out a tow truck. Spending the government's money to clean-up someone else's mess is far from fair, but it is efficient. It is the solution (the huge injection of funds into the financial system) that needs to be undertaken as aggressively as possible so that thousands of motorists (prudent businesses and investors) are not tied up in traffic jams. The government failed to bring out the tow truck for Lehman Brothers, and that episode with its associated disruptions worldwide, is a stark reminder that letting things alone to work themselves out is not much of an option.

There are several lessons to be drawn from these parables. The financial system is incredibly fragile. A loss of confidence can have very negative consequences. Currently, many prudent businesses (and consumers) are hampered by very congested credit markets because of a massive loss of confidence. This loss was initiated by the actions of a reckless few. Such risky behavior needs to be controlled -- though not strangled -- by tight regulations.

Even with the most carefully constructed and executed regulations, however, accidents will occur. In such a case, strong and swift government action is required. Aggressive and innovative policies -- like those taken by Ben Bernanke and Henry Paulson -- are the correct policy responses.

It will take some time for the government policies aimed at the financial sector to work and, given the circumstances facing the economy, not all will be effective. Nonetheless, these policies will ultimately restore confidence and unclog the financial system so vital to the proper functioning of the U.S. and world economies.

Bob Chirinko, professor of finance, is a research fellow at CESifo (Munich) and a visiting scholar at the Federal Reserve Bank of San Francisco.