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Moral Hazard: The Long-Lasting Legacy of Bailouts

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In a *Wall Street Journal* interview (WSJ March 30, 2009, p. R3), several weeks ago, Treasury Secretary Timothy Geithner stated:

... People across the country are angry and frustrated, as they should be, that this economy, the United States of America, got itself in the position where enormous damage has been done as a consequence of a long period of excess risk-taking without meaningful adult supervision.

...

And the consequences of that are tragic because they're basically fundamentally unfair; because people who were careful and responsible, conservative in their decisions, are suffering a lot from the consequences of mistakes they were not a part of.

I'll use somewhat stronger language than Secretary Geithner: The bailout regime in which we find ourselves is an affront to the market and an affront to democracy. I, too, am angry, frustrated and worried. These affronts are affecting policy, making many companies skittish and thereby damaging the recovery process. It is imperative that Washington devise an exit strategy from our current environment in which many large firms are too big to fail.

Outrage over bonuses and corporate perks is unfortunate—Washington is not the place to make decisions on details of how to run financial businesses, whether or not they are receiving federal support. The outrage, though, is fully justified at a deeper level. What is

incomprehensible a full year after the Bear Stearns bailout is that there is still no satisfactory plan for the future. Now, all large banks are backstopped by the federal government, and it seems likely that should any other large financial firm run into trouble it too would receive federal support.

Everyone agrees that the bailout regime cannot be allowed to persist. But I differ profoundly with Secretary Geithner when he implies that what is needed is more regulation—“meaningful adult supervision” as he puts it. Regulation itself cannot be the solution because if regulators make mistakes, as they have in the past and will in the future, the government is likely to again bail out banks deemed too big to fail.

Recent proposals to establish new regulatory authority to control systemic financial risk and to provide resolution powers to close down nonbank financial firms deemed too big to fail are likely to spread the too-big-to-fail protection to many financial firms beyond banks and increase financial risks over the long run. The intention, of course, is to reduce systemic risk but the effect will be to change market incentives and add to systemic risk over time. Because regulators are no more omniscient than the rest of us, they will miss some systemic risks and elsewhere intervene unnecessarily.

We need to look at the situation a different way, by focusing on the incentives firms face so that market forces will lead them, or force them, to pursue less risky strategies. I'll outline a reform proposal that changes incentives in fundamental ways. You may not like my reform proposal; I present it as an illustration to encourage a different way of thinking about fixing our financial services industry. Considering various reform options will help to assess whatever proposals are eventually put on the table.

The bailout problem is not confined to the United States; nor in the United States is it confined to financial firms. It is unclear the extent to which the federal government will support auto firms and their suppliers in the weeks ahead. In general, over the past few decades most countries have moved away from support of specific firms and industries. Experience with state management of enterprise has been almost uniformly costly and unsatisfactory. I predict that current U.S. involvement with management and direction of financial firms and auto companies will come to be viewed the same way.

My purpose is not to provide a broad overview of world experience with bailouts but rather to concentrate on today's pressing issue—what to do with weak financial firms and how to exit from the situation. Before discussing reform ideas, however, the place to start is to understand why reform is so very necessary.

An Affront to the Market

Our current bailout regime is an affront to the market and inconsistent with it. A fundamental feature of market allocation of capital is that the allocation depends on assessments of risks and returns. Market assessments, as we know, can be dramatically wrong. The current financial crisis is a consequence of a serious under-pricing of risk of subprime mortgages and securities of various sorts issued against that paper. This experience is hardly unique in monetary history; although we did not know it at the time, ten years ago we were in the late stages of the dot-com boom, which shortly thereafter turned into a bust.

The booms led to excessive allocation of capital to the dot-com companies and to housing. There was physical waste of resources, in thousands of miles of excess fiber-optic cable and thousands of houses and condominiums that should never have been built. These capital

investments had a much lower rate of return than anticipated, which meant that financial instruments issued to finance them fell far below their par value. The mortgage boom not only left us with too much housing but also with insolvent households that had extracted equity from their properties and used the funds for consumption.

Investment manias have occurred for hundreds of years. But we must not forget that they are called manias only when they collapse. We have also experienced hundreds of years of investment booms that turned out well overall, though with many failures along the way; examples are railroads in the 19th Century and automobiles in the 1920s. Even the dot-com boom turned out well in some respects, such as the widespread use of the Internet for transactions of all sorts today and firms such as Amazon and eBay that have survived and prospered.

Market processes, above all in the United States, serve to allocate additional capital to the successes and withdraw capital from the failures. Markets make mistakes, but also correct their mistakes. Economies organized on non-market principles also make mistakes, but have a much weaker record of correcting mistakes. Soviet-style economies failed in part because they would not shut down failed enterprises.

Bailouts are an affront to the market because they keep failed firms afloat and because they distort market risk assessments. Worse yet, firms deemed too big to fail attract even more capital, simply because they are protected. Today, creditors' risk assessment for any large bank is based entirely on whether the federal government will, in extremis, bail it out. Creditors of big banks—who, after all, provide roughly 90 percent of a bank's capital—have reason to believe, though not with absolute certainty, that their claims are safe. The efficiency of a big bank is essentially irrelevant to those who provide debt capital.

Providers of equity capital, on the other hand, are at considerable risk. The government might decide at any time to take over a bank and wipe out equity. Or the government might force a bank to raise new equity at a cheap price, substantially diluting existing shareholders. The risk assessment is not primarily about a bank's quality of management and soundness of its assets but about government policy. There is heightened market concern right now as the government prepares to release results of stress tests. Clearly, current government policy is grossly distorting capital market decisions.

Moral hazard is a serious and widely discussed issue today. The hazard is that management of firms too big to fail will take excessive risk or fail to correct known problems because of expected government protection. Consequently, the market will allocate too much capital to these firms. Banks below the top 10 or 20 are at a disadvantage, relative to the big banks, in raising debt capital. Should a smaller bank fail, creditors not protected under current programs may lose some fraction of their claims. Even in today's risk-averse climate some banks may be taking excessive risk as they are pressured by the federal government to expand lending to help us get out of the recession.

We cannot live with this situation. After the recovery begins, questions about the health of large banks will be with us for many years, perhaps decades, unless the government acts decisively to change the situation. Market participants will be asking questions such as these: Just how large must a bank be to be too big to fail? What happens if a bank almost large enough, but not quite, is allowed to fail? Will concern spread to other almost large enough banks? And what about the politics of the situation—given that the government bailed out Citigroup and AIG, is it *fair* to let other firms, including nonfinancial ones such as auto companies and their suppliers, fail?

An Affront to Democracy

Our current bailout world is an affront to democracy. There is much anger in our society. People who were responsible in their use of debt, many of whom are struggling to stay current on their obligations, will eventually be taxed to cover losses incurred by irresponsible borrowers and lenders. We know that many executives of financial firms, despite huge losses, have larger fortunes remaining than most of us can ever dream of enjoying. Taxpayers, in general, will pay for losses incurred by the insolvent, or nearly insolvent, firms these executives left behind. These bitter attitudes in our society today tend to be dismissed as “populist.” That is a mischaracterization; no one, whatever his political persuasion, should be willing to accept without complaint wealth transfers of the sort now taking place.

In the United States, most people understand that economic success should be rewarded. What people cannot understand is how we can allow a system to persist in which success is rewarded and losses are socialized. The federal government may spend several trillion dollars bailing out financial firms and households. Each trillion is more than \$3,000 per capita. Our government is not treating us fairly.

We are told that we must pay, because the economic consequences of not paying would be even worse. And I think we do have to pay—we cannot at this time just let the big banks go down. Nevertheless, we have a right to expect of our leadership a plan that will guarantee that we will never be stuck in this situation again. The regulatory approaches now being discussed in Washington will not be effective.

Given today’s anger, we will face a truly hazardous situation if and when another large firm gets into trouble. The political fallout from saving another large firm could be extreme. The

issue will be how such a situation could have been permitted to develop after the enormous costs to taxpayers of the current bailouts. Politicians may not want to risk another bailout. Yet, if a firm is truly a systemic risk, its failure may create another financial crisis. Can strengthened regulation control the situation?

A Skeptical View of Regulation

Must the current financial crisis be viewed as a regulatory failure? In one sense, the answer has to be “Yes.” We have regulators and yet we fell into the worst financial crisis since the Great Depression. Regulators were not alone in failing to understand the risks of a financial crisis. Many of the most sophisticated financial firms in the world, here and abroad, bought billions of dollars worth of subprime mortgage paper. Some smaller firms completely avoided the paper, and a few profited greatly by betting against the paper. But all the big commercial and investment banks became involved to some extent, as did many other financial firms.

This is not the first financial crisis missed by regulators and market alike. In the 1970s, many money-center banks loaded up on Latin American debt. Defaults on that debt, starting with Mexico in 1982, almost caused a financial crisis. The riskiness of Latin American loans was simply not understood by regulators and large banks alike. We cannot count on regulators to be omniscient.

The issue is whether regulators can enforce constraints on financial firms that are robust with respect to surprise events. For a number of reasons, I think not.

One issue is that in a democracy it is inevitable that Congress will affect the regulatory process. Today, some members of Congress are agitating for substantial modification of fair-value, or mark-to-market, accounting. I happen to be a fan of the principle of fair-value

accounting, although I am sure that improvements in present practice are possible. That, however, is not the point. Regulation will not be left to technocrats, nor should it be. Regulators sometimes abuse their power or act in ways that do not reflect market realities. Congress ought to intervene to control regulatory abuses. What is an abuse and what is not is ultimately a political issue.

We can certainly expect that companies will lobby to affect regulatory rules and outcomes, as they have in the past. As early as the late 1960s, economists understood risks to the savings and loan industry, but the industry, homebuilders, mortgage finance companies and congressional advocates of expanded home ownership prevailed to maintain weak regulation in the 1970s and to weaken it further in the early 1980s. In this episode, which ultimately cost taxpayers about \$150 billion, economists and regulators did not miss the boat but were unable to prevail.

For another example, long before the huge increase in subprime mortgage issuance, Alan Greenspan warned repeatedly of dangers in the structure and regulation of Fannie Mae and Freddie Mac. I gave a number of speeches on the same theme, starting in 2002. Vigorous lobbying and large campaign contributions by these firms and their executives and a failure in Congress to understand the risks prevented reform. Now these two companies have been taken over by the federal government and taxpayer costs will be measured in the hundreds of billions. Anyone who believes that we can escape similar situations in the future does not understand how democracy works.

A second issue is that the financial world is intensely competitive. If regulations put particular types of firms at a competitive disadvantage, other firms that are able to sidestep regulation will offer financial services and take the business from regulated firms. A visible

example of this phenomenon is the credit union, which has tax and other advantages over commercial banks. Credit unions have taken business over time from banks and have been able to expand their reach. The Internet today is expanding opportunities for firms to transact business of all sorts, including provision of financial services.

We live in an intensely competitive international environment. Some firms operating in U.S. markets have charters from countries abroad, and it may not be possible for countries to agree on international regulatory standards. Aggressive financial firms will use their national governments to further their commercial interests. And even if our current financial crisis leads to agreed international regulatory standards, the innovative environment in which we live will soon make the standards obsolete in certain respects.

As we all know, there is an active legal practice in regulatory compliance and in the closely related field of regulatory avoidance. It is a pipe dream to expect that these practices will disappear or can be so controlled by Congress that lawyers and accountants will never again find or create regulatory loopholes. In time, the current financial crisis will fade into history. Whatever restraint we may observe over the next few years will disappear and we will be back to business as usual.

The only new idea on the regulatory front is that a federal agency—either a new one or an existing one—be granted power to close down a systemically significant nonbank financial firm before it fails. The proposal stems from experience in dealing with AIG. Beyond this proposal, I have heard of no new regulatory ideas with any substance.

We have long had a bankruptcy procedure for dealing with firms that cannot meet their obligations. This process is market driven, based on bankruptcy law. Creditors negotiate with a

company in trouble and when the negotiation fails, the company is forced into bankruptcy. It is the company and not the government that initiates a bankruptcy filing.

A different resolution procedure applies to banks. One reason is that the federal government, through the Federal Deposit Insurance Corporation, has a major financial interest in banks. The FDIC has the authority to close an insolvent bank and is supposed to do so before the bank's capital is exhausted. The FDIC attempts to resolve the failed bank in whatever way minimizes taxpayer cost.

We have this procedure for banks because a purely market driven procedure does not work well. Most bank liabilities have short maturities—demand and savings deposits are payable on demand and most other bank liabilities are due within one year. When depositors run a bank, the bank ordinarily cannot raise funds rapidly enough through asset sales or borrowing to satisfy depositors. The bank must suspend payments. Fear of suspension can create more bank runs. To maintain an orderly financial system, the FDIC and other regulators monitor the condition of our banks and close them in an orderly way when necessary.

Bankruptcy works well as the method for society to resolve insolvency for the typical nonfinancial corporation. Owners of company liabilities cannot run because most liabilities are long-term, as with long-maturity bonds, or equity. When a company cannot honor its obligations as they come due there may be a crisis for the firm and its creditors but not for society as a whole.

The current discussion about establishing a new resolution process for systemically important firms will produce more problems than it will solve because it will expand the reach of too big to fail. Advocates of this approach underestimate the difficulty of beginning a resolution process for any large firm. Doing so will create investor concerns about other, similarly large

firms. Bailing out AIG created investor concerns about other insurance companies, which was unavoidable when the decision to bail out AIG was made over just a few hours. Regulators will not lightly begin a resolution in the future for fear of spreading concern in the market. If a firm subject to the new systemic regulator nevertheless fails, regulators will come under heightened political pressure.

When a firm is at the edge of insolvency, it is often unclear whether bankruptcy or infusion of more capital is the best option. We should not lightly substitute a process in which the government makes the decision rather than the market. We need to isolate AIG as an exception to the normal bankruptcy process rather than treat it as a precedent for how the government will resolve large nonbank financial firms in the future. If we treat AIG as a precedent, then we will face an endless number of decisions as to which firms must be bailed out, or seized by the government, because they are too big to fail. There are no satisfactory criteria to determine which firms are too big to fail and which are too small to matter. Moreover, we will spread federal regulatory authority across the landscape, because if taxpayers are expected to bail out large firms they will rightly demand a say in how these firms are operated. We will simply add costs and inefficiencies and, in the end, future regulation will be no more effective than past regulation.

In current Washington debate, the assumption seems to be that more effective regulation can adequately control risk-taking by large financial institutions. But suppose a particular large financial firm, or large financial firms in general, are simply too large to manage effectively and are inherently inefficient. In economic theory, a basic idea is that there can be an optimum firm size in any given industry; economies and diseconomies of scale have been studied extensively at an empirical level.

I am troubled by the lack of specifics behind the proposal for a systemic risk regulator. Lawyers and economists agree that legal rules should be as clear as possible with regard to their reach because elementary considerations of fairness and predictability require that a firm have a reasonable expectation of what rules will apply to its behavior. It is unacceptable that the rules be subject to a regulator's discretion and whim, made up on the fly as time goes on. Economists and lawyers also understand the importance of reasonable certainty about legal rules for making business decisions. The efficiency of business decisions requires predictable rules. It is impossible to define "systemically significant" with any degree of precision and for this reason the reach of new regulatory power will remain undefined.

Creating new regulatory authority over large financial firms such as AIG simply does not address the main problem. The present regulatory authority over banks did not avoid the crisis or lead to the closure of any of the large banks. Lehman, a large investment bank, was allowed to fail but no large commercial banks have yet failed. They have all been bailed out despite the regulators having all the authority they need to close a big bank. I understand the decisions to keep big banks afloat, but recognizing the need to do so under present conditions does nothing to avoid similar decisions in the future.

A Reform Plan

Instead of more regulators with more power, we need to change the incentives under which firms operate. Our financial firms got into trouble because they had too much leverage and too much of their debt was short term. They were subject to too little market discipline. Finally, we need a market-based method for forcing large firms to scale back their operations in an

orderly way when they get into trouble. These issues can be addressed by changing the incentives under which firms operate.

Four problems must be addressed. First, many financial firms have too little capital relative to the risks they run. Unfortunately, capital inadequacy is often revealed only after the fact. We need arrangements that force banks to hold more capital than might seem necessary. Second, banks need long-maturity capital that cannot run. Third, we need to rely more on market discipline to deny funds to banks deemed risky. Fourth, when a bank needs to be restructured, it would be best for the bank rather than the federal government to manage the restructuring.

A straightforward fix to address excessive leverage is through the tax system. Firms borrow in part because they believe that debt capital is cheaper than equity capital. That is certainly the case under the U.S. corporate tax system, because interest is a deductible business expense in calculating income subject to tax, whereas dividends are not deductible. A useful reform would be to eliminate the deductibility of interest on business and personal tax returns. A quick look at 2005 data, the latest available in the IRS Statistics of Income, indicates that, for the corporate sector as a whole, eliminating the deductibility of interest would roughly double corporate income subject to tax. Cutting the corporate tax rate in half would leave revenues from the corporate tax system roughly unchanged. Given the current and prospective economic situation, the corporate profits tax would have to be cut further for revenue neutrality, perhaps to 10 percent.

We should not, however, try to force the adjustment all at once. Instead, we could phase out the deductibility of interest on all tax returns over the next ten years. Next year, 90 percent of interest would be deductible; the following year 80 percent would be deductible and so forth

until interest is no longer deductible at all. The same reform would apply to all business entities; partnerships, for example, should not be able to deduct interest when corporations cannot.

With this simple change, the federal government would encourage businesses and households to become less leveraged. We have learned that leverage not only makes individual firms more vulnerable to failure but also makes the economy less stable. We use the tax law all the time to promote socially desirable behavior; eliminating the deductibility of interest would reduce the risk of failure of large firms—especially large financial firms—and thereby promises to reduce the collateral damage inflicted by such failures.

A lesson of our current financial crisis—not a new lesson but an old one—is that financial firms can collapse suddenly, in part because too much of their debt has very short maturities. An idea favored by economists for many years is to require that banks maintain a substantial block of subordinated, long-term debt in their capital structure.

Here is a specific proposal to illustrate the idea. Every bank, including savings institutions and investment banks, must issue subordinated debt equal to 10 percent of its total liabilities. The debt would consist of 10-year notes, uncollateralized, and subordinated to all other debt obligations of the bank. With 10-year notes equal to 10 percent of the bank's total liabilities, the bank would have to refinance one-tenth of its sub debt every year, equal to 1 percent of its total liabilities. The subordinated debt would be in addition to existing requirements for equity capital.

The subordinated debt proposal has several important advantages. We have seen that banks do not have an adequate cushion against losses under current capital requirements. If taxpayers are to be expected to stand behind our giant banks, taxpayers deserve a larger cushion against bank mistakes. More importantly, because banks would have to go to the market every

year to sell new sub debt, banks would have to convince the market that they are safe. A bank that found it too expensive to sell new sub debt would have to shrink by 10 percent.

Restructuring a bank at a rate of 10 percent per year is perfectly feasible, and the restructuring would be managed by the bank and not by the government.

A subordinated debt requirement has a significant advantage over a higher equity capital requirement, which is one of the regulatory changes being discussed. Sub debt entails much more market discipline, because a bank must go to the market every year to replace maturing debt, or shrink. If a bank's prospects appear poor to investors, its stock price will decline and it may be unable to sell more equity. But, it is not forced to shrink in these circumstances, nor will regulators necessarily force a bank to shrink. Market discipline through sub debt would be much more rigorous than regulators are likely to apply. Bankers will argue that market discipline from sub debt would be too rigorous and go too far in discouraging risk taking. However, does anyone defend the risks banks took that created the financial crisis? Wouldn't we now be much better off if bankers had believed that subprime mortgage paper was too risky for bank portfolios? The economy will work better if the banking sector becomes a smaller, but more stable, part of the economy.

It is important to keep in mind that in order to control moral hazard, it is essential that some creditors and not just equity owners be at risk. Among creditors, holders of subordinated debt are most at risk and they provide maximum market discipline. In the event of a bank insolvency, the FDIC would seize a bank and cover insured depositors. Other creditors would be protected by the fact that losses would go first to equity and then to subordinated debt. If those forms of capital were insufficient to cover the losses, then other non-insured creditors would take a hit.

To reiterate: to exit from too big to fail we must have a system that puts some creditors at risk. That is what the subordinated debt proposal accomplishes in a way that protects the stability of the banking system because the debt is long term and cannot run.

These two reforms—phasing out the deductibility of interest on business tax returns and requiring banks to maintain subordinated debt in their capital structure—would change the incentives under which firms operate. Firms would be more stable individually and the economy would be more stable.

These are not radical proposals. They rely on market incentives and avoid intrusive and ultimately ineffective government regulation. If we are unwilling to approach the issue of financial stability from the perspective of getting the incentives right, then we will not enjoy financial stability as a long-run matter.

A Bridge from Here to There

A vexing issue is how to get out from under the current bailout regime. Most recent discussion has focused on how to get the impaired assets out of banks. Whatever may be the merits of various approaches, taking the bad assets out of banks does nothing to get us out from under the moral hazard problem.

Back up for a moment and consider two simple premises. First, under current conditions the government cannot let a large bank fail. There are two reasons. First, there is so much doubt about bank solvency that if one big bank goes down—that is, is taken over by the FDIC—the market will immediately distrust certain other big banks, and will move funds away from them. At a minimum, equity values of other banks will decline, making it more difficult for them to raise additional capital in the market. Runs on multiple big banks today are a recipe for chaos.

The second reason is that banks are interconnected—if one bank goes down other banks with claims on the failed bank will suffer losses that might be enough to yield insolvency.

These considerations mean, like it or not, that taxpayers are on the hook for whatever gap may exist between the value of a big bank's assets and its liabilities. Creditors, covering all the claims on the liability side of the balance sheet except for common and preferred equity, will not be allowed to lose a nickel, at least not before the financial situation has clearly stabilized. Any effort to resolve an insolvent bank by having creditors share in the losses runs the risk of a run on other banks. Attempting to minimize taxpayer losses by such provisions as making the government's preferred stock senior to other claims is beside the point—the federal government is committed to paying all creditor claims at 100 cents on the dollar. This situation is just not viable in the long run. However, that is where we are today and we must face up to that fact in designing an approach to get us out of our financial mess.

If a bank is insolvent—and I have no idea whether any large bank is—then the issue is what to do. The government is rightly resisting the idea of taking over, or nationalizing, a large bank. These are huge, complicated enterprises. The federal government does not have the managerial resources to run a large bank. And once the government took over a large bank, all the incentives would be wrong. Management, constrained by limits on executive compensation and other rules, would have an incentive to flee to other firms. There would be no shareholder interests to protect and motivate sound management decisions.

To recap, the federal government is committed to supporting every large bank, so that no creditor will lose a nickel. And, it makes no sense for the government to take over a large bank and to restructure or dismantle it, because the government does not have the managerial resources to do so. It appears that we are well and securely stuck in a bad place.

To get out of this situation, the federal government should restructure its existing support for banks, and add new funds as necessary, to buy 10-year subordinated debt from the banks equal to 10 percent of each bank's total liabilities. The subordinated debt would have a ladder of 10 maturities. The first would mature in two years, the next in three years, and so forth out to the final block of sub debt maturing in 11 years. To the extent that a bank already has subordinated debt outstanding, the government would coordinate its maturities with those of the existing sub debt. The government's subordinated debt would be senior to the bank's existing sub debt.

Each bank would know that starting two years from now it would have to sell new sub debt every year to the market to pay down the maturing government-held debt. If the bank could not raise the funds, it would have to shrink by selling assets or letting assets mature to provide the funds to repay the maturing debt held by the government. Banks not currently receiving federal assistance would also have to sell sub debt, perhaps starting in five years. Under this proposal, the government would have a clear schedule for withdrawing special assistance and forcing banks to stand on their own. The markets need the certainty of when and how the government is going to end this sorry chapter in U.S. financial history. Vague plans for regulatory reform will not provide the clarity the markets need and taxpayers deserve.

You may object that the federal government cannot afford to put more funds into banks. But that decision has already been made—creditors will not be allowed to lose a nickel at this time. What is needed is for the government to structure its support in a way that has a clear end game.

This proposal provides a bridge to a future with a much more stable banking system. It leaves the banks with the incentive to perform or shrink if performance falls short. The proposal would end most of the uncertainty about the government's support for the financial system.

Some will object to this proposal because banks must increase their lending to get us out of the recession. My answer is that the banking system may need to expand its lending but not any particular bank or banks. The market needs the certainty of a sensible design to extract ourselves from the bailout world we are in, and a bridge to a stable financial system ahead.

Concluding Comments

Financial bailouts, in the form of infusion of government funds to keep firms afloat, are part of a more general phenomenon of special government support of particular firms or industries to blunt the normal forces of competition. I could name a dozen or more specific government actions designed to assist the savings and loan industry starting in the 1960s. The assistance blunted necessary adjustment, and most S&Ls ended up failing, at a taxpayer cost of roughly \$150 billion.

Over the years, a number of manufacturing industries have received assistance through restrictions on international trade. Firms obtain these favors, costly to consumers and taxpayers, through the political process. Sadly, for the presumably protected firms and their workers, what happens is that their confidence in protection leads them to delay adjustment. As the cost of protection and bailouts becomes politically untenable, the scale of assistance winds down and once-great firms decline and perhaps fail. This is the process playing out today for General Motors and Chrysler. Federal protection is inevitably accompanied by intrusive regulation and control. This protection, if long continued, will ruin our large banks as well.

In short, it is in the interest of taxpayers and the firms themselves that the federal government design and begin to implement an exit from the bailout regime in which we now

live. Without a plan for an orderly adjustment, even with all the pain that adjustment brings, we have only heartbreak ahead of us.

I have offered a plan to demonstrate that there is a way out of the financial mess we are in and a way to a more stable future. My primary purpose is not to advertize my plan—although that is certainly not absent from my mind—but rather to emphasize what an effective plan to deal with moral hazard might look like. If we do not see the federal government offering some sort of plan in the near future—a plan that relies on changing the incentives under which financial firms operate—then we cannot expect a more stable financial future. We may muddle along and things will look better once the recession hits bottom. Nevertheless, without fundamental reform that moves us decisively away from the risk of further bailouts, the financial system will not be stable. Whenever a solvency issue arises, so also will debate over a possible bailout. A bailout world is an unstable world.

It is often said that markets hate uncertainty, but that is not the right way to state the issue. Markets are superb, most of the time, in dealing with unavoidable uncertainty. Success, though, requires stable rules of the game. We face a situation now in which changes in federal policy, in some cases driven by politics and not sound policy considerations, interfere with market efforts to assess and manage risk. That is why it is essential that we quickly find a way out of the bailout regime we are now in.