



Economist.com

FINANCE & ECONOMICS
ECONOMICS FOCUS**Economics focus****History lesson**

Mar 19th 2008

From The Economist print edition

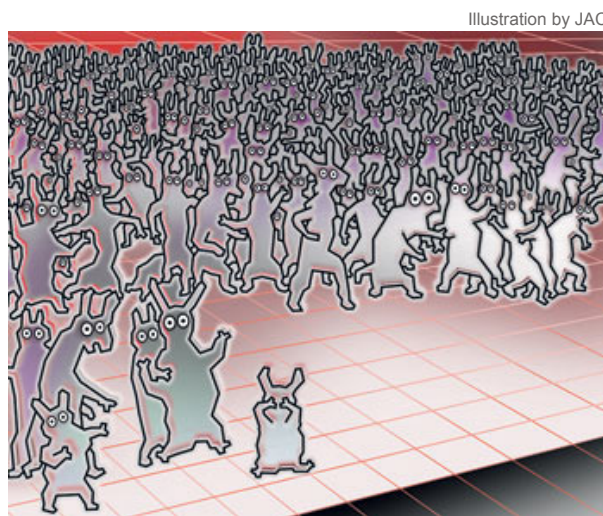


Illustration by JAC

How to deal with banking crises[Correction to this article](#)

THE decline and fall of Bear Stearns illustrates both an old truth and a new one. The old truth is that when cash is scarce, he who has deep pockets is king. Bear Stearns is still standing only because JPMorgan Chase was solid enough to prop it up. The new truth lies in the Federal Reserve's role as matchmaker of last resort, smoothing the deal with a temporary loan of \$30 billion. This shows just how far a financial supervisor's purview now extends. Even though Bear is not a fully regulated institution, the investment bank was deemed too central to the complex web of America's financial system to be allowed to fail.

Private-sector solutions to banking crises, in which strong institutions buy the weak, demand well-heeled banks. Just now, these are in short supply. Few institutions have been left unscathed by bad mortgage debts; JPMorgan Chase is a rare exception. When banks are threatened with insolvency, it is often the government—with the deepest pockets of all—that has to make good their losses. But how much might the state have to stump up? And how should it go about it? As today's credit crisis widens, commentators are turning to history as a guide.

One lesson is that trouble is all too common. Most members of the IMF have undergone at least some distress since the late 1970s. Crises in poorer countries tend to be deeper and more costly, often because they are twinned with collapsing currencies. According to a 1996 survey of insolvencies by economists at the World Bank, the bail-out of Argentina's banking system in the early 1980s cost a stunning 55% of GDP to fix.

The rich world's banking troubles have not been cheap either. The bill for bolstering Finland's banks in the early 1990s came to 8% of GDP; Sweden's bail-out was scarcely less dear. America spent more than 3% of GDP cleaning up the savings-and-loan crisis, its priciest to date. That suggests that the possible cost of today's troubles, though alarming, is not off the charts. The best, though still highly uncertain, estimate of prospective lending losses is around \$1.1 trillion, less than half of which would be borne in America by banks, investors and in forgone taxes: \$460 billion is equivalent to about 3% of last year's GDP.

Ideally, fiscal support for banks should be targeted, if it is needed at all. Bail-outs are often limited to just one

institution. Continental Illinois in America and Johnson Matthey Bankers in Britain were rescued in 1984, because regulators judged that the banks were large enough to rock the whole system should they go bust. When Barings, another British bank, was wiped out by trading losses 11 years later, regulators let it fail, judging that the risk of wider damage was low.

These episodes occurred in times of relative financial calm, so have few lessons for today. The parallels with the Nordic crises of the early 1990s look more useful. Then as now, the banking bust followed economic and asset-price booms fired by the deregulation of credit, low interest rates and lax supervision. Norway's three biggest lenders were nationalised, but research by its central bank puts the fiscal cost at far less than in Finland or Sweden. Once banks were taken into public ownership, shareholders were universally wiped out. And though the cost of working out bad debts was around 2% of GDP, all that and more was recouped when the banks were privatised. In other words, the state made a profit from the crisis. Denmark, meanwhile, avoided the storms altogether because of stricter capital rules—prevention is better than cure.

The Nordic crises were not so long ago, yet they seem a world away. Norway probably avoided a worse fate by acting swiftly once it was clear that its biggest banks were insolvent. The obvious contrast is with Japan, where bad debts were left to fester. But today it is much harder for regulators to tell which banks, if any, are insolvent. That is because bad debt is hidden within complex securities, and the value of those securities is almost impossible to measure when markets have dried up. These days, the trouble lies as much in the financial markets as with the banks that trade in them.

1998 and all that

The growing complexity of links between banks is the reason why Bear Stearns, an investment bank that may not have worried regulators had it failed 15 years ago, could not be left to collapse today. The manner of its rescue recalled the efforts to shore up Long-Term Capital Management, a hedge fund tied intricately into the financial system, in 1998. Bear's demise also shows how the boundary between illiquidity and insolvency is fast dissolving. The bank was sold for a fraction of its book value after it was shut out of lending markets. Yet it is not clear whether it was insolvent in the sense that its assets were worth less than it owed.

By throwing open its discount window to investment banks, the Fed has tacitly admitted that the old rules no longer apply. It was a bold step, but not necessarily a sufficient one. There is still a stigma attached to discount-window borrowing, which means banks may be unwilling to avail themselves of it until it is too late, even when they are truly desperate.

In today's unholy tangle of short-term funding and long-term derivatives contracts, more banks may well fall into the liquidity traps that snared Bear and Britain's Northern Rock. If so, central banks may find they have to go further than ever and provide a floor for asset prices in illiquid markets. Since banks are unwilling to trade in mortgage assets, because they do not have the capital or cannot risk marking losses to market, there may be an opportunity for governments to buy assets at big discounts. Judicious intervention could in principle improve liquidity, bolster confidence and may in the end even make money for taxpayers if asset prices recover. But supporting badly run investment banks should also come with strings attached: regulatory control to reduce the chance that public support will be needed again.

Correction: We wrongly stated that the best estimate of prospective banking losses is around \$1.1 billion. We meant \$1.1 trillion. This error was corrected on March 21st 2008.