Introduction

AEI Conference on Addressing Systemic Risk

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This conference is long overdue. The idea that the government should regulate and supervise all financial firms that might pose a systemic risk to the financial economy has been widely discussed in Washington at least since January of this year, when a report by a subcommittee of the prestigious Group of 30 supported the idea. The fact that the subcommittee was headed by Paul Volcker, an adviser to President Obama, gave the concept an aura of inevitability, and soon the press was reporting that a "consensus" had been reached in Washington that the Federal Reserve would be given authority, as the "systemic regulator," to designate and supervise all financial firms that were considered "systemically important."

Sure enough, in late March, the idea for a systemic regulator was advanced to Congress by Treasury Secretary Tim Geithner, along with a proposal for giving the FDIC the authority to take over and resolve failing financial firms in much the same way that it assumes control of failing banks. Notably, the administration's plan did not name the Fed as the systemic regulator, although conventional wisdom in Washington has assumed that the Fed would ultimately get this role.

It is hard to overstate the far-reaching effect of these proposals, and it is remarkable that there has been so little public debate outside Congress about their implications and feasibility. For the first time, firms that are not backed explicitly or implicitly by the federal government—securities firms, insurance companies, hedge funds and finance companies—would be subjected to controls on their capital and leverage. Market discipline would be discarded in favor of government discipline.

The administration's companion proposal—to authorize the FDIC to take over and resolve financial institutions other than banks—also has enormous implications. It would remove failing financial firms from the bankruptcy system, and place the federal government in a position to decide which firms survive and which do not. Ironically, we can get a glimpse of how this might work by watching the ongoing Chrysler and GM workouts—where the government's preferences have superseded those of the creditors. This may be good or bad, depending on your point of view, but we can all agree that it's very different.

All of these changes are proposed so that we can avoid a systemic breakdown, but no one has yet come forward with a definition of what a systemic breakdown actually is. In theory, we can say that systemic risk describes the possibility that the failure of a large firm causes major losses to ripple or cascade through the economy, causing the failure of many other firms. But how large does such a systemically important firm have to be? The failure of any firm, of any size, causes some disruption in the economy. When does mere disruption become a systemic breakdown?

This is not merely playing with words. In order to determine whether a firm is systemically important—that is, liable to cause a systemic event if it fails—we have to have some idea what a systemic event is. If we don't, where does the systemic regulator draw the line between those firms that are specially regulated because they are systemically important and those that are not because their failure will not cause a systemic breakdown?

GM is an interesting example. It's not a financial firm, but its bankruptcy it will cause substantial disruption in the economy. Lenders, suppliers, customers, and their employees will all suffer major losses. This would be about as close to a systemic event as might be imagined, yet no one is suggesting that we need a government agency to resolve large nonfinancial firms like GM.

What is it about the failure of a large financial firm that raises the specter of systemic risk, when GM's bankruptcy does not? Or to turn the question around, why should we have a special government resolution system for financial institutions and not for the large operating companies that can also cause severe economic disruption if they fail? What will be the effect on competition in the financial sector of designating some firms as, in effect, too big to fail?

These are some of the questions that will be raised in this afternoon's conference, which will be made up of two panels—the first on the designation of systemically significant firms, and the second on the idea of resolving these companies through use of a government agency rather than through the bankruptcy system.

But before we get to that we have the distinct privilege to hear from our keynote speaker today, Alan Greenspan--as everyone knows, the former chairman of the Federal Reserve Board and one of greatest public servants or his or any other generation.

Alan Greenspan is a particular hero of mine, not only because of his long and distinguished service to this country, but also because it was only when he took up the issue of Fannie Mae and Freddie Mac in 2003 that anyone other than a few lonely academics—the ones not in the pay of Fannie or Freddie—took any interest in the risks to our economy that these companies were creating. In congressional testimony and elsewhere, Alan kept these risks front and center, enabling the rest of us to borrow a little bit of his credibility when we addressed the same subject. We are now reaping the whirlwind of congressional inaction on this question, but Alan—who has the most right to say it—has not been saying I told you so.

Alan served for19 eventful years as Fed chairman, appointed by Ronald Reagan in 1987 and leaving office under George W. Bush in 2006. He is famous for his data-based analytical methods, and he seemed to read everything that came to his desk. During his tenure, the United States had two long and inflation-free periods of economic growth—one of 92 months and another of 120 months, with only two relatively mild recessions of eight months each. These are the longest periods of sustained growth in U.S history, and the fact that both were achieved without significant inflation is testimony to the skill with which the Fed was managed during the Greenspan chairmanship.

There were enormous challenges during these 19 years: the 1987 stock market crash, the Thai Baht collapse, the Russian bond default, the unknowns associated with the turn of the millennium, 9/11, the collapse of the dot-com bubble, and the Enron episode. All were overcome with minimal disruption of the U.S. economy.

After the dot-com collapse, there was genuine fear of deflation. Most of the commentators who now talk sagely about the adverse effect of the low interest rates that prevailed in the early part of this decade have conveniently forgotten this fact. The experience of Japan shows clearly what can happen if the central bank raises interest rates before deflation is fully defeated. Anyone who has been in government knows that decisions have to be made, and may be criticized in hindsight. If you worry about that, you won't be doing your job. Alan has certainly been subject to more than his share of hindsight risk, but we can only guess how history would have been different if the Fed had tightened too quickly after the Dot-Com bubble collapsed.

So whenever I hear criticism of Alan Greenspan I think of Teddy Roosevelt's remarks about the man in the arena:

> "It is not the critic who counts," said Roosevelt; "not the man who points out how the strong man stumbles, or where the doer of deeds could have done them better. The credit belongs to the man who is actually in the arena… his place shall never be with those cold and timid souls who neither know victory nor defeat.

Please join me in giving a warm welcome to Alan Greenspan.