It`s the government`s fault

In the beginning of February, when the government of the US presented to the world the guidelines of its new stabilization plan for the financial sector, the secretary of treasury, Timothy Geithner, concluded his speech with a troubling sentence: “We will have to adapt the program if circumstances change. We will have to try things we have never done before. We will make mistakes. We will undergo periods when things will get worse and progress will be uneven and discontinuous”.

Said and done. A month has passed and the plan in which Geithner promises to clean banks` balance sheets and help them recapitalize is yet to be delivered. Two institutions in peril, Citigroup and AIG, had extra help from the government. A plan to renegotiate the debt in the real estate sector was received with skepticism. Details about the operation of a credit line created to reanimate loans to businesses and consumers were defined only a few days ago.

Nobody ignores the difficulties the authorities have to deal with to try to contain a crisis of this proportion. But a growing view, backed up by a bad mood from investors and some economists with conservative inclinations, states that the American government is directly responsible for the problems in the financial sector. Professor Taylor, a former undersecretary of treasury who teaches at Stanford University, presents this thesis in a concise and merciless manner in his new book, "Getting off Track" (Hoover Institution Press, US$ 14,95), still with no date to come out in Brazil.

“Government actions were the main cause of the crisis we are going through and have contributed to extend it dramatically”, said Taylor in an interview for Valor. Many people believe that the crisis happened because of the greed of a group of bankers that dealt the cards on wall street for too long, but these people will find no comfort in Taylor`s book.”There is no doubt that, a lot of mistakes were made by the private sector, but they generally were amplified by many mistakes of the government”.

The worsening of the crisis has generated calls for the financial system to be more strictly monitored and, in many countries, the renewed faith in capacity that governments would have to repair the damage caused by deregulation of markets. But Taylor believes that the lesson of the crisis is another. "The authorities should abandon the idea that large interventions government is the best response to current problems and realize that can often make things worse by doing so, "says the economist

Taylor blames the Federal Reserve, the U.S. central bank, for having too lax a monetary policy at the beginning of the decade and, with that, having blown the balloon that inflated the prices of buildings in the United States. After the bubble burst, he says, the Fed and Treasury failed to promptly realize that there were more serious problems in the balance sheets of the banks. When it finally tackled the issue, they did so in a confusing manner, increasing investors´ uncertainty.

Taylor owes his celebrity in academia to the Taylor rule, mathematical formula he proposed in 1992 with the purpose of calculating the interest rate that would be ideal to keep prices under control and the U.S. economy growing in a sustainable way. The formula is an important reference in any discussion of monetary policy and the current Fed chairman, Ben Bernanke, is a member of his fan-club.

Taylor believes the former president of the Fed Alan Greenspan went too far in lowering interest rates at the beginning of the decade. Greenspan wanted to revive the U.S. economy after the end of the Internet bubble and the terrorist attacks of September 2001, and was concerned about the risk of deflation that could further cool the activity. Based on his formula, Taylor believes the Fed would have achieved these goals even if they had maintained the interest rate higher.

"The low interest rates accelerated the speculation in the real estate market in several ways, reducing the fees charged by mortgage companies and encouraging market participants to take excessive risks," says the economist. Many excesses committed by bankers and investors would not have occurred if the interest were not so low and they were not all in search of higher yields. Governments can`t help that people have outbreaks of euphoria as we had before the crisis. It is human nature. But governments can avoid feeding the euphoria, adopting policies that are more clear and predictable. "

The calculations that Taylor presents in his book, based on a mathematical model that seeks to estimate the effect of interest rates on housing construction, suggests that the expansion of American real estate market in the first half of the decade would have been more moderate if the Fed had practiced higher interest rates between 2002 and 2004, following the policy that was recommended by the application of the Taylor rule.

"It is impossible to rewrite history," he acknowledges. "But what I'm saying is that they could have done different things with the information available at that time. There was clear evidence that interest rates were too low and could foresee that this would create problems. It is important to understand that, to ensure that others do not repeat the same mistake in future."

The bubble in the property market began to wither in the second half of 2006, when the price of property fell in several parts of the country and people who had debt in previous years began to have trouble keeping up to date payment of their mortgages. Banks and investors who had bought securities linked to mortgages and made other riskier bets began to suffer losses, and the supply of credit started to fall.

The financial crisis has become acute in August 2007, when interest rates charged by banks in the interbank market jumped dramatically. It was then that the U.S. authorities made another major mistake in the evaluation of Taylor, diagnosing the affliction of markets as a problem of lack of liquidity and not as an indication that the health of the largest institutions in the country was more fragile than their reports would suggest.

Taylor investigated the matter in depth in the heat of the moment. Along with a director of the regional branch of the Fed in San Francisco, Calif., John Williams, Taylor interviewed market traders and studied the behavior of investors. "It was clear to us that there was no lack of liquidity, but a major uncertainty facing the lack of information on the extent of problems in banks," says Taylor. "But many traders think differently and the government accepted the wrong diagnosis, which helped to prolong the crisis."

Instead of directly attacking the disease, the government has launched various programs in the months following to increase liquidity in the markets, injecting hundreds of billions of dollars in the market and facilitating the access of banks and other financial institutions to the coffers of the Fed. Interbank interest rates fell quickly well after the first steps were taken, but shot back up a few weeks later, indicating that the problem was different.

The panic took over the market in September, when investment bank Lehman Brothers went under without the authorities helping its shareholders. "Many people think that what has set off panic was the failure of Lehman Brothers, but I think the most important factor was the government's muddled response," says Taylor. "When Bear Sterns was rescued and broke months before it was clear that they needed to prepare for the next time that something happened. When Lehman Brothers broke up, everyone saw that they did not have a strategy to deal with the crisis. "

Since the swearing in of President Barack Obama in January, the new government has made efforts to develop a more effective strategy. But the lack of detail on some initiatives announced by Geithner continues to feed the insecurity of investors. "There is much concern about the signals that they do not have a well thought plan," says Taylor. "There is a serious problem of communication between government and markets, similar to what we saw last year."

Taylor has been on the other side of the counter and knows that it is difficult to govern. As Treasury undersecretary for international affairs from 2001 to 2005, the first term of former President George W. Bush, he helped to extinguishing fires in Argentina, Iraq and Afghanistan. "I'm not saying that the government should not do anything," says Taylor, who was in the election campaign last year working for Republican Senator John McCain. "However, the authorities need to recognize their limits and the risk to make things worse with his interference."

He views with suspicion the proposed nationalization of banks such as Citigroup and Bank of America, who lost the confidence of investors and can`t raise the volume of capital they need to stay afloat. "I think the idea very confusing and even frightening," says Taylor. "Would the government really be able to adequately manage banks of that size? The government has enough experience with the process of resolution of smaller banks, but not with such complex institutions."

Many economists believe that the transfer to government control of banks that are undercapitalized would be the best for purging the financial system of the excesses committed in recent years, passing over the resistance of the current shareholders and quickly eliminating the sources of uncertainty that still obstruct markets´ credit. But the risks of such an undertaking would be enormous and the government has also made clear that it does not want that path.

The Treasury already spent more than $ 270 billion to strengthen banks' capital, but they remain on the edge of the abyss. His plan now is to create a fund with money from the Treasury, the Fed and the private sector to buy securities linked to mortgages and other problematic assets that corrode the bowels of the financial system. This would help to clear the balance sheets of banks and enable them again to raise funds in the market. Details on the operation of the new fund are still under discussion in government.

Taylor is concerned about the effects that this and other programs launched by the Treasury and the Fed will have to tackle the crisis in the long term. In a recent debate with other economists, he said the U.S. central bank left aside monetary policy of the text-books to dedicate a new "monindustrial policy" where the Fed prints money to finance operations of government in several areas, not just to regulate the money supply in the economy.

Since September, the Fed loaned more than $ 2 trillion to banks and other financial institutions. Many of these loans are long-term operations that the Fed can`t undo easily, which undermines their ability to manage the economy when it has to worry about inflation again. Along with the economic stimulus plan proposed by Obama, programs to stabilize the financial system have increased the debt of the government, making the U.S. more vulnerable in the face of new external shocks.

"The fact that our debt is so attractive to so many people today is providential, for it allows us to obtain the resources necessary to fund these programs at a reasonable cost," says Taylor. "But this is not automatic and need to prepare, to avoid problems if one day foreign investors look at our debt with more suspicion than today. If the policies adopted by the Government continue to derail for a long time, there will be reasons for concern with the debt later. "