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Learning the Right Lessons From the Financial Crisis

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What caused the financial crisis of 2008? Are policymakers ready to handle the next one?

These are key questions for anyone interested in economic history and policy. In the past decade, a conventional wisdom has developed about the answers. Yet a new book questions that orthodoxy, offering a more disturbing perspective on the past and a less sanguine prognosis for the future.

In a nutshell, the conventional wisdom goes like this:

In the mid-2000s, the nation experienced a housing bubble. A combination of stupidity, negligence and malfeasance led a bunch of Wall Street firms to make excessively risky bets that the bubble would go on forever. Through mortgage-backed securities and related instruments, they extended credit to home buyers of dubious credit quality.

For a while, this credit expansion fueled the bubble. But when the bubble burst, these new homeowners defaulted in record numbers, and the Wall Street firms headed toward insolvency. The whole financial system teetered on the edge of collapse, leading to a deep recession.

Fortunately, policymakers came to the rescue. Henry M. Paulson Jr., the secretary of the Treasury, persuaded Congress to pass the Troubled Asset Relief Program, which he and his successor, Timothy F. Geithner, used to recapitalize the banks. Ben S. Bernanke, the chairman of the Federal Reserve, expanded the tools of monetary policy to support the financial system and the economy more broadly. Their bold steps saved us from another Great Depression.

In this conventional narrative, Wall Street financiers are the villains and Washington policymakers are the heroes. Certainly, the policymakers have promoted this view. Mr. Bernanke even titled his memoir “The Courage to Act.”

Yet a new book, “The Fed and Lehman Brothers,” by Laurence M. Ball, an economist at Johns Hopkins, casts doubt on this narrative. Mr. Ball (who is a friend of mine) does not excuse the financiers from starting the trouble. But he draws attention to the policymakers who, in his view, failed to do their jobs at a crucial moment.

Central banks like the Fed have two tasks. The first is to adjust the money supply and interest rates as economic conditions change. The second is to help ensure the safety and soundness of the financial system. As part of this second task, central banks sometimes need to act as a lender of last resort.

Remember the bank-run scene in the movie "It's a Wonderful Life"? Jimmy Stewart as George Bailey, head of the local building and loan association, explains the fragility of banking as an enterprise. Even if a bank is solvent (meaning that its assets exceed its liabilities), it cannot immediately satisfy all its depositors if they become fearful and try to withdraw their money all at once.

A central bank can solve this liquidity problem by lending to a financial institution experiencing a run. That is why the Federal Reserve Act calls for an "elastic currency." The central bank should be there so George Bailey does not need to rely on the despicable banker Henry F. Potter — or even his own generous friends — for the temporary cash injection needed to keep the building and loan afloat.

Here, according to Mr. Ball, is where policymakers failed us in 2008. When mortgage defaults started rising, many financial institutions experienced a run on their short-term liabilities. These liabilities were not traditional bank deposits but rather repurchase agreements, called repos. But the forces at work were much the same.

In September 2008, the financial giant Lehman Brothers found itself facing a liquidity crisis. Yet the Fed, rather than acting as a lender of last resort, pushed Lehman into bankruptcy. In the weeks and months that followed, all hell broke loose.

Why did the Fed not avert the crisis by lending to Lehman? The conventional narrative, promoted by Mr. Bernanke, is that Lehman did not have sufficient collateral, and that this barred the Fed from lending to it. Much of Mr. Ball's book — which expands on his work in an earlier paper — is aimed at rebutting that claim.

Mr. Ball argues that a careful look at Lehman's finances shows that it did have enough collateral. In addition, he examines the historical record and finds no evidence that Fed officials at the time were concerned about the insufficiency of collateral.

The claim of inadequate collateral arose weeks later when the full impact of the Lehman bankruptcy became clear. It was, Mr. Ball suggests, an attempt to cover up a policy blunder.

One fascinating element of the story is the dynamic between Mr. Paulson and Mr. Bernanke. The decision whether to lend to Lehman was legally up to the Fed. But it seems that Mr. Paulson was calling the shots.

He took a hard line because, after the rescue of Bear Stearns earlier in the year, he wanted to avoid the political fallout from being labeled "Mr. Bailout." Mr. Bernanke deferred to the Treasury secretary, partly because of the mistaken judgment that the markets would take the Lehman bankruptcy in stride.

Looking ahead, Mr. Ball is worried about the next financial crisis. One reason is that the Dodd-Frank Act has increased restrictions on Fed lending, making it harder for the Fed to act as lender of last resort.

Another is that we have not learned the right lessons from history. Mr. Ball wants to make sure that the next time a major financial institution faces a shortfall of liquidity, the Fed really will have the courage to act.