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The Noneconomic Costs of Financial Crises

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A common theme in the literature on financial regulation is that the costs of crises must be weighed against the costs of onerous regulation.[1] (After all, if debt were outlawed, there would be no crises, but neither would there be much growth.) This conceptual approach is generally framed in purely economic terms.[2] There are, however, at least two types of costs generated by financial crises that are not well captured by economic variables and that argue in favor of placing a thumb on the scale in favor of crisis prevention.

First are the psychic costs borne by people directly affected by a crisis.[3] At first glance, this may not appear to add much to the economic analysis: after all, if there is a trade off between economic growth and crisis prevention,[4] then the psychic costs to one group of people from a crisis should be weighed against the psychic gains to others from higher growth.[5] Gains and losses do not, however, perfectly offset each other in this context: humans tend to weigh losses more heavily than equivalent

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1. *See, e.g.*, GARY B. GORTON, MISUNDERSTANDING FINANCIAL CRISES: WHY WE DON'T SEE THEM COMING 177 (2012) (arguing that "[w]e could design a financial system that avoids crises, for a period of time at least, but the design faces the problem of risking a crisis on the one hand or being financially repressive on the other").

2. *See, e.g.*, John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 960–63 (2015) (reviewing studies of financial crisis costs, all expressed in terms of percentage of gross domestic product); *but see* GORTON, *supra* note 1, at 171 (listing costs to social well-being among the potential costs of a crisis).

3. GORTON, *supra* note 1, at 171 (observing "the costs to social well-being" may include "stress or depression due to unemployment . . . and even suicides").

4. *Id.* at 177 (citing a study finding that "countries that have experienced occasional financial crises have tended to grow faster than countries that have not experienced crises").

5. *See, e.g.*, FRÉDÉRIC BASTIAT, *What Is Seen and What Is Not Seen*, *in* SELECTED ESSAYS ON POLITICAL ECONOMY 1, 1 (George B. de Huszar ed., Seymour Cain trans., Found. for Econ. Educ. 1995) (1848), http://www.econlib.org/library/Bastiat/basEss1.html [https://perma.cc/NAA7-9UFJ] (observing that "[t]here is only one difference between a bad economist and a good one: the bad economist confines himself to the *visible* effect; the good economist takes into account both the effect that can be seen and those effects that must be *foreseen*.").

gains.[6] Furthermore, ex post redistribution offers an imperfect solution: social insurance programs, as important as they are, can be ineffective in assuaging the blow to one's self-esteem and well-being that often accompanies the loss of a job or home. (I do not mean to suggest, of course, that job loss and foreclosures can be eliminated in a healthy economy; my focus here is on the narrow question of how we should weigh various costs in designing a financial regulatory system.)

The second cost that is not well captured by economic variables is the damage a crisis can wreak on public confidence in key societal institutions. Such damage likely correlates strongly with wreckage to the real economy; as Jonathan Rauch argued recently in *The Atlantic*, "[s]ome of what always looked like unconditional support for democracy [in Europe and North America] may actually have been conditioned on rising prosperity."[7] Of course, if economic prosperity is what matters, and if both crises and regulation meant to prevent crises can harm economic growth, then the political costs involved in striking the appropriate regulatory balance would seem to mirror the economic costs precisely. But the point made above about the asymmetry of the psychic impact of losses and gains[8] suggests that crises could undermine public faith in key institutions more than slower (but steady) growth coupled with fewer crises, even if total long-run economic output was equivalent in the two cases. In other words, higher psychic costs could generate higher civic costs.

Of course, regulators can limit the economic damage from a crisis, but this usually requires protecting financial firms or their

6. *See, e.g.*, DANIEL KAHNEMAN, THINKING, FAST AND SLOW 282 (2011) (describing the phenomenon of loss aversion).

7. Jonathan Rauch, *Containing Trump*, ATLANTIC, Mar. 2017, https://www.theatlantic.com/magazine/archive/2017/03/containing-trump/513854/ [https://perma.cc/4TD6-SESR]; *see also* Jon Hilsenrath & Bob Davis, *Election 2016 Is Propelled by the American Economy's Failed Promises*, WALL ST. J. (July 7, 2016, 12:39 PM), https://www.wsj.com/articles/election-2016-is-propelled-by-the-american-economys-failed-promises-1467909580 [https://perma.cc/RLF2-UAHQ] (arguing that the period since 2000 "has proved so turbulent and disappointing it has upended basic assumptions about modern economics and the political system"). The financial crisis was obviously not the only cause of economic woes over the past two decades, but its contribution should not be underestimated. *See, e.g.*, Martin Wolf, *The Long and Painful Journey to World Disorder*, FIN. TIMES (Jan. 5, 2017), https://www.ft.com/content/ef13e61a-ccec-11e6-b8ce-b9c03770f8b1 [https://perma.cc/L9JX-X3GM] (arguing that the financial crisis and subsequent Eurozone crisis "had devastating economic effects" and that the "economies of the advanced countries are roughly a sixth smaller today than they would have been if pre-crisis trends had continued").

8. *See supra* note 6 and accompanying text. The argument here ignores important distributional concerns, though my suspicion is that such concerns would bolster the case for crisis prevention (as would be true, for example, if financial crises hurt the less well-off more than lax regulation helps them).

creditors, which may exacerbate the public's anger.[9] Former Treasury Secretary Tim Geithner captures this problem in what he calls "the central paradox of financial crises": "What feels just and fair is often the opposite of what's required for a just and fair outcome. It's why policymakers generally tend to make crises worse, and why the politics of crisis management are always untenable."[10]

In any event, to the degree that economic losses create psychic harms and fuel discontent with liberal democracy in ways that foregone gains of a comparable dollar amount do not, it should lead us to place even greater emphasis on efforts to "panic proof" the system. Accepting this diagnosis does not, alas, yield immediately obvious or uncontroversial policy prescriptions. This is in part because the very tools regulators need to halt a financial panic, such as emergency lending and guarantee authorities, may also create moral hazard, thereby increasing the probability of a crisis. This tension led to a sort of schizophrenia in the Dodd-Frank Wall Street Reform and Consumer Protection Act as Congress gave regulators some new panic-prevention tools[11] while stripping them of others.[12]

Is there a way out of this dilemma? The answer, I believe, lies in trying to recapture the conditions that produced the panic-free, seventy-five-year stretch that Gary Gorton has dubbed the "Quiet Period."[13] Such an approach would require limiting the areas of the financial system in which vulnerable funding structures make panics possible, as well as recognizing that market discipline cannot, *by itself*, prevent crises. The first step[14] is to understand what a financial crisis is: it is not (merely) an asset bubble bursting, but rather the widespread withdrawal of short-term debt funding.[15] Step two is to recognize that short-term debt serves as the functional equivalent of bank deposits.[16]

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9. *See, e.g.*, Adam Nagourney, *Bracing for a Backlash Over Wall Street Bailouts*, N.Y. TIMES (Mar. 15, 2009), http://www.nytimes.com/2009/03/16/us/politics/16assess.html [https://perma.cc/ATG8-KSEG] (noting administration concern "about a populist backlash against banks and Wall Street, [and] worr[y] that anger at financial institutions could also end up being directed at Congress and the White House . . . .").

10. TIMOTHY F. GEITHNER, STRESS TEST: REFLECTIONS ON FINANCIAL CRISES 505 (2014).

11. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, tit. II, 124 Stat. 1376, 1442–1520 (2010) (codified as amended at 12 U.S.C. § 5384 (2012)) (providing regulators with the authority to wind down systemically important financial firms outside of bankruptcy).

12. *See, e.g.*, *id.* § 1106, 124 Stat. at 2125 (codified as amended at 12 U.S.C. § 5611 (2012)) (eliminating the Federal Deposit Insurance Corporation's free-standing authority to a widely available debt guarantee program).

13. *See* GORTON, *supra* note 1, at 4.

14. The "answer" adumbrated here is the one set forth in MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION (2016).

15. *Id.* at ch. 4.

16. *Id.* at ch. 2.

Step three is to enforce in *functional* terms the prohibition on nonbanks issuing deposits.[17] This means, in practical terms, stamping out "shadow banking." Step four is to bolster government backing of bank deposits.[18] Step five is to strengthen regulation to address heightened moral hazard problems—for example, by charging appropriate risk premiums to banks for deposit insurance.[19] The economic argument for this approach is persuasive; the political argument—helping maintain citizens' faith in central societal institutions—makes it compelling. An important goal of those thinking and writing about financial regulation in the coming years should be to shift the Overton window[20] to make these reforms politically tractable.

17. *Id.* at ch. 9.
18. *Id.*
19. *Id.*
20. The Overton window, or the "window of discourse, is the range of ideas the public will accept." *Overton Window*, WIKIPEDIA, https://en.wikipedia.org/wiki/Overton_window [https://perma.cc/5KC4-BLNK] (last updated June 9, 2017).