

## Turmoil in the Markets: How Big a Danger

*Adam S. Posen explains and assesses the actions by the Federal Reserve and the US Treasury to rescue AIG and suggests how the United States can lead in creating a new regulatory system for global financial institutions and markets.*

© Peterson Institute for International Economics, 2008.

Steve Weisman: Welcome to Peterson Perspectives at the Peterson Institute for International Economics. This is Steve Weisman. Today, our guest is Adam Posen, Deputy Director of the Peterson Institute. Mr. Posen has been a consultant to central banks worldwide, and in the 1990s served as an economist at the Federal Reserve Bank in the United States.

Thanks for coming.

Adam S. Posen: Thanks for having me.

Steve Weisman: The news this week is that after many weeks of turmoil, the United States government, the Federal Reserve, has offered a lifeline to the insurance giant, AIG. How exactly is that lifeline going to be working?

Adam S. Posen: The Fed is offering a very high interest rate loan to AIG and the collateral is actual stock, ownership control of AIG. So the Fed has offered this 80 billion. AIG is going to be charged an annual interest rate of something like 11.3 percent, and the Fed controls now 80 percent of AIG stock. AIG has every incentive to get itself into shape or to sell off good assets so that it can find cheaper financing or pay off the loan early. And if not, then the Fed gets, meaning the taxpayers get, the remaining assets.

Steve Weisman: What is the risk for the taxpayers?

Adam S. Posen: The risk is probably not much. AIG has a huge number of component insurance businesses, including some leading franchises worldwide particularly in Asia—and those are assets that are not impaired at the moment. It's the holding company of all those different companies that is the one with the problem because they invested in a lot of what are called CDS or debt swaps to insure bad investments. Once that gets worked through, there's plenty of value at AIG.

Steve Weisman: Isn't this an unprecedented action for the Federal Reserve?

Adam S. Posen: Absolutely, this takes us into completely new territory. The Fed was only able to do this by invoking essentially the Emergency Powers Act. After the Great Depression, the Fed was given an emergency clause in its governing law that lets it lend money and get involved with any institution that's significantly affects financial stability. That has never been invoked. This time, it was because otherwise there's no reason for the Fed to be involved with an insurance company, not its normal day-to-day work.

More importantly, it's unprecedented in that the Fed is saying, "Well, this place really is too big to fail even though all the insurance components are regulated at the state level and there are guarantees for the insurance policyholders." So, it is an even more extreme version of what happened with Bear Stearns, where they're saying the issue is all the counterparties in the banking system whose contracts with AIG are at risk. That makes them nervous, not AIG's actual role in the financial system.

Steve Weisman: The Fed obviously consulted with the Treasury Department, and I'm sure with central banks around the world. What do you think their reaction was worldwide to the Fed doing this?

Adam S. Posen: The usual reaction to this kind of bailout, although there's never been one on this scale, is initial relief and long-term worry. Everyone's initially relieved because this buys time to unwind the positions of AIG so assets don't get dumped on the market, further cutting off credit and value for everybody else. And there's no question that the Federal Reserve and the Treasury have enough money to make it work in the short term.

But over the long term, people get worried because then this tends to erode the Fed's credibility, that they're focused on price stability, that they're willing to let the market take its slumps, that the U.S. balance sheet— meaning the taxpayer obligations won't keep expanding without limit— and frankly, that the Fed and the Treasury were not ahead of the game in knowing where the problems were.

So short term, everyone breathes a sigh of relief. Long term, everyone worries a little more.

Steve Weisman: How would you rate the performance of the Fed and Treasury as crisis managers, addressing the other actions they've taken in the last few months?

Adam S. Posen: I think, in general, they've done a much better job of crisis management than they did of regulating and supervising before the crisis came. The proof in the pudding is they have managed to keep real impact on the economy as a whole rather limited. It sounds cheap, but we only had a couple short periods in

March and this past week where there was real panic in financial markets. The crisis may have been on for a year, but things have been largely functioning.

That said, one would like to think that they would take the fact they did all these ad hoc, very large scale, aggressive buyouts and bailouts as a reason to think, “Wow, our system and our principles really were wrong. We have to rethink.” I think all of us in mainstream economics have to admit we were a little too cocky and have to rethink this.

Steve Weisman: What are the prospects for creating a new set of global standards governing financial institutions that might avert this kind of crisis in the future?

Adam S. Posen: There is a double impetus to doing this at a global level.

First, that in today’s world, investors have money all over the place, and that’s why investors in China and Brazil were breathing a sigh of relief regarding Fannie and Freddie or AIG just as we breathed a sigh of relief when Japan got out of its mess 10 years ago.

The second global impetus is if you have very differing rules across countries, financial systems essentially arbitrated. They go running around to wherever it’s easiest and cheapest, and rules are loosest. Think of it like ships who you know all get chartered in Panama rather than the U.S. because the inspection standards are lower.

And so, for those two reasons there’s compelling argument to largely, not perfectly, but largely standardize things globally. The trick’s going to be that the U.S. standing to set that agenda and play a really big role in that process has taken a huge hit, especially after so many years of the U.S. lecturing other countries during their crises—the Asian crisis in the ‘90s, the Japanese crisis, the Mexican crisis, before that the Argentinean crisis— and then, seeming to apply very different principles when it came home to roost in our house.

So yes, there will be a global agenda. It’s not clear how well it will go forward without U.S. input but the U.S. is going to be, even under a new administration, somewhat shame-faced about being too aggressive on this. And so, that may leave us the worst of both worlds that we don’t get to ride out coming from the regulatory process and without that, the U.S. continues to stand out as a problem.

Steve Weisman: So with the U.S. leadership damaged in the eyes of the world, what are the chances of the next president really being able to take the lead on this?

Adam S. Posen: I think they have to. I think either an Obama or McCain administration now is facing this as perhaps not the number one item on their agenda but within the top three. I think with a new Congress and new mandate, there will be a real

reopening of the regulatory issues. But I think we shouldn't underestimate the intellectual spade-work of what is the right response isn't self-evident. We can all say deregulation went too far, and in some ways, that's true. But partly it's because our regulators who had rules on the books didn't properly enforce them, and these include the Fed, particularly under Greenspan.

They didn't implement the rules that were there to protect consumers about mortgages. They didn't implement the rules that were there about provisioning. If AIG had gotten into trouble, it wasn't from the insurance activities; it was from these activities of its holding company. Well, why was an insurance holding company allowed to be so speculative? We have to ask questions about that.

So, there is an agenda to be done. There is real force for doing something that requires tighter regulation. But it's not self-evident what those steps should be.

Steve Weisman: Well, we'll see if the United States can engage in both soul-searching and leadership. Let me ask you one more question. What do you think right now is the most likely impact of these recent events in the financial markets on the global economic outlook?

Adam S. Posen: I think, again, people will be pleasantly surprised that the real economic impact is less than people fear. That's a general principle about financial crises and that is a result of the reasonably decent crisis management that the Fed and Treasury have engaged in. So, obviously, I'd expect the next half a year to be less good than it would otherwise have been and that may mean a small contraction in the U.S.

But I think the ability of the U.S. economy to continue to export, which has been the main source of our growth for the last two years, the ability of non-financial businesses, good exporting companies and manufacturing companies and services outside the financial sector, will not be that impaired in terms of their ability to get capital.

So, we're not looking at an eternal disaster here, even if for the people in New York on Wall Street, it certainly looks that way.

Steve Weisman: Well, on that reasonably hopeful note, Adam Posen, thank you very much for joining us today on Peterson Perspectives.

Adam S. Posen: Thank you.

*[End of Transcript]*

