Lessons Learned: Phillip Swagel

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In every situation, we need to consider what our options are in the worst-case scenario so that we can be ready if things do get to that point.

In the case of a financial/economic crisis, it is difficult to estimate how bad things can get, but it helps to have a plan just in case things get really bad. That planning was what Mr. Swagel and his colleagues did in early 2008. They gathered some options they had, such as buying bad assets, injecting capital, and refinancing mortgages, etc., and wrote a glossary of their options in case the crisis turned very sour. They came up with ways for the government to intervene, knowing full well that these steps would not be taken unless there was a real emergency. Swagel recalls,

Then, of course, later in the year, as the situation with financial markets worsened, it was natural to come back to some of these ideas and [look at] what kinds of interventions would be necessary to stabilize the economy.

Acting early to prevent the crisis from getting bigger would have produced better outcomes, says Swagel. However, it is challenging as emergency interventions are difficult to take unless there is a real emergency that warrants them:

The idea that the government is going to take a massive intervention, unprecedented perhaps, to invest public money in private financial firms (this was eventually done with the TARP), it was just very difficult to do that until the moment when it was actually needed.

One key way to avoid a financial crisis, both in the U.S. and in other countries, is to make sure that financial institutions are adequately capitalized. We also need strong regulation and supervision to ensure this.

The Global Financial Crisis of 2008-09 revealed that many financial institutions, both in the U.S. and abroad did not have enough capital as a backstop in the case of a major financial crisis. This was something that the U.S. has remedied since the crisis. Swagel comments favorably on this,

That is something that the post-crisis financial regulatory regime focused in on. There is much more capital at U.S. financial institutions, which means they have a greater
ability to absorb losses. It makes sense that getting regulation right both helps avoid the crisis in the first place and also makes the impact of the crisis less bad.

We also need transparency to avoid a crisis.

One reason for the Global Financial Crisis, Swagel pointed out, was the opaqueness surrounding an investment instrument, in this case the mortgage-backed securities (MBS). There was not enough knowledge about them, he says: “...if regulators and supervisors had better visibility into those bad practices, the crisis might not have happened, or it would have been less bad.” Therefore, he advises, another key way to prevent a future crisis is to ensure transparency of investment instruments in general.

Keeping government intervention broad during a crisis signals confidence to the markets.

Swagel says that during the GFC, “[s]tabilizing the financial system was essential to ensuring that the broad economy did not plunge into another [Great] depression.” This was one reason, he explains, for TARP to be positioned broadly, not singling out a bank or a group of companies. This communicated to the market that the whole of the financial system would remain solvent and restored confidence in the system as a whole. This confidence in turn, stabilized the financial system in its totality, as well as the institutions in it.

It was not just the TARP, Swagel believes, but a number of other programs as well, that collectively helped provide confidence to the markets, stabilize the economy, and stave off another depression. These included the Capital Purchase Program, the Temporary Loan Guarantee Program, and the Government-Sponsored Enterprises (GSE) intervention.

We need to strike a balance between regulation and economic vitality.

We want to ensure that the government’s interventions that might detract from economic activity come with added security, that there are no costs without clear benefits, says Swagel. However, he also believes that this is a delicate balance:

So, what is the right tradeoff between more safety and economic cost? That is the harder [question] and I think it requires analysis. I would reject the idea that the cost of the financial crisis is so big and so negative that any intervention is therefore justified. I think it is important to do the analysis and see what will be beneficial.

Swagel stresses that getting the right tradeoff is the main challenge in the decision-making process.

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