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The Journal of Financial Crises

Volume 3 | Issue 4

2021

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Recommended Citation
Esmen, Yasemin (2021) "Lessons Learned: Lewis "Lee" Sachs," *The Journal of Financial Crises*: Vol. 3 : Iss. 4, 41-44.
Available at: https://elischolar.library.yale.edu/journal-of-financial-crises/vol3/iss4/7

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Yale Program on Financial Stability
Lessons Learned

Lewis “Lee” Sachs

By Yasemin Esmen

Lewis “Lee” Sachs was counselor to Treasury Secretary Timothy F. Geithner and head of the Obama administration’s Financial Crisis Response Team in the US Department of the Treasury. Mr. Sachs led the development and coordination of the Obama administration’s Financial Stability Plan to stabilize the financial system during the Global Financial Crisis of 2007–09 (GFC). He was tasked with continued coordination with the outgoing Bush administration, as well as putting together a team to develop further restructuring plans and oversee their execution. This “Lessons Learned” is based on an interview with Mr. Sachs.

There are three major steps to a financial stability plan: developing an architecture for the plan, establishing coordination, and putting a team together.

The crisis coincided with the presidential transition period. The first step of the new administration’s crisis response, according to Sachs, was to develop an architecture for the Financial Stability Plan. Afterward, they started coordinating with the Federal Reserve, other regulators, and the outgoing administration. Third, they put a team together to develop and execute their plans, which according to Sachs proved challenging. Specific expertise was needed yet:

> Treasury is not set up like the Defense Department where you have standing armies who are prepared to fight wars and defend the country when necessary. The Treasury Department is not set up to do that. We did not have standing armies of people with expertise in fighting financial crises.

The aim of any stability plan should be to rebuild confidence in the markets and the financial system as a whole. When there is a change of administration, coordination is very important to ensure that confidence.

Sachs said of the situation facing his team that the real urgency was the country’s economy and how it was affecting people’s lives. He explained,

> So, everything we did, every plan we put together, every step we took, was designed to break that negative feedback loop, with all those things negatively impacting the others. We had to develop detailed plans and start to rebuild confidence in the markets, the financial system, et cetera, very quickly.

Sachs stressed that it was vital that the Obama administration coordinate with the outgoing administration, and this was established very well. Continuity in policies was also very important, as well as coordinating with other agencies such as the Federal Reserve, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. Sachs said,

> You never want to have a financial crisis; you certainly do not want to have one during transition between administrations. However, if you are going to have to have one, and you are going to have to have one during a transition, it is much better to have it when the outgoing administration is as skilled, open, easy to work with [as the Paulson Treasury in the Bush administration], and I think they deserve a lot of credit for that.
>
> That was largely a pretty smooth process. Each organization, of course, had their own issues that they had to think about, but also, more importantly, recognized that the only way we were going to be able to break the fever of the crisis was for each of the organizations to work together.

Confidence is the cheapest form of stimulus.

Without confidence in the financial system, stressed Sachs, credit cannot flow, markets cannot function, and businesses become weak. "So, everything we were doing was designed to rebuild confidence in the system, institutions, markets, and the economy as a whole. Nothing succeeds without confidence."

This confidence was attained through a combination of programs. These programs were designed to work together with others to rebuild that confidence. One such example Sachs offered involved the efforts to prevent opacity at financial institutions. He noted,

> What we did was put together several programs, the most prominent of which were the stress tests that were designed to show the world what was in these banks and what they would look like in the most severe economic scenarios.

This was coupled with a capital backstop. If a bank needed to raise capital but could not at the end of six months, the government would step in and buy what was necessary. This way, the government was ensuring that the banks would not fail and that there would not be runs from the banks. Sachs explained further:

> We felt quite strongly that the system as a whole is better off when banks are held in private hands as opposed to government hands. However, we set a backstop because we did not know how much capital would be necessary, and we did not know if the markets would be prepared to provide that capital.

Acting swiftly has many benefits. However, this may be difficult to do, and many of the steps that need to be taken may be very unpopular.

Sachs shared that it is best to act soon and with great force to fight a crisis. However, he noted, it is also difficult to do so. "No one likes to see the government taking steps to 'bail out a bank.'" He notes that the administration did not think they were bailing out banks, but he admits that is how it was perceived.

According to Sachs, many of the steps that have to be taken early to be effective are unpopular but necessary to "put out the fire." Waiting to take those difficult steps only

exacerbates the crisis as it gets deeper and becomes more expensive to overcome as more people lose their jobs and homes, and more businesses lay off workers or close their doors.

> The problem is, because the steps you have to take are so unpopular, it is harder to take them until the pain has gotten so bad that the world says, "You have to do something to stop this. It is just too painful." The longer these crises go on, the louder that gets, and then, frankly, the easier it is to do the things that are necessary.

Although they have been, to this day, criticized for "saving the Wall Street," saving the institutions that make up the financial system was the only way to save the system as a whole, insisted Sachs:

> Everything we did was viewed through the lens of how to stop losing 800,000 jobs a month, how to stop the economy from declining at an 8, or 9, or 10 percent annual rate. This was the most effective, cheapest way to do it. To this day I have not seen any ideas or proposals, even with the benefit of time and 20/20 hindsight, that would have allowed us to achieve those goals, without reestablishing confidence in the system and the institutions that make it up at the time. If we could have, we would have.

Measures taken to save the patient should also help ensure its well-being going forward.

All the steps around the Financial Stability Plan were designed to first save the economy and the financial system from collapsing. However, by ensuring that these institutions were well capitalized, these measures also made sure that they were in a good position to lend going forward.

> In fact, if you look at what did happen subsequently and compare it to the experience in other countries, which were not necessarily as aggressive [as the US], our institutions and the flow of credit, and our recovery, happened much more quickly than elsewhere.

Opacity, shortages in capital and liquidity, and anything that can lead to panic can cause weaknesses in the system.

By creating uncertainty, opacity reduces confidence, which creates weaker markets, less credit, and less business activity. In short, opacity in financial systems or institutions decreases confidence in these same institutions and the system as a whole, stressed Sachs.

He continued that, other than opacity, there are numerous other things we should be watching out for when it comes to looking for weaknesses in the system or possible triggers for panic. A lack or shortage of capital and liquidity in large financial institutions is one of these, he noted; so are threats from the cyber realm and "anything that can lead to volatility in the markets and in the economy."

Dated: December 2021

YPFS Lessons Learned No: 2019-63