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Free Enterprise: Stress test results relieve some anxiety

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Finally, some of the trepidation and uncertainty that hobbled the credit markets has been reduced, if not laid to rest. With the results from the "Supervisory Capital Assessment Program" - the "stress tests" - the government has at last acknowledged that some banks are better prepared than others to weather any additional economic calamities.

That is in stark contrast to last year, when regulators not only provided funds to weakened banks but also badgered others to accept unwanted government assistance. This was done to not tarnish the financial institutions under duress.

Although stress tests of banks are not something new in the course of regulatory oversight, having the 19 largest financial institutions simultaneously undergo a comparable in-depth risk-analysis was a new application of this concept. The problem is that it took the intervention by regulators to impose a level of contingency planning that should be customary for large financial institutions in the course of prudent decision making.

As Richard Posner, one of the most prolific and well-known federal appeals court judges, recently pointed out in an essay: "Rational risk-taking behavior by profit-maximizing firms does not, usually, have to account for possible dangers to the overall economic system. Those systemic risks represent what is described in economics as a negative externality."

This refers to costs one imposes on other market participants without having to actually pay for them.

How to force "too big to fail" institutions to not ignore such spillover effects in the future, without taking away their ability to provide credit and earn profits in the process, will be one of the great policy challenges.

For the time being, the stress test seems to have worked its psychological magic by giving professional investors and the general public something positive to hang their hats on.

There is, not surprisingly, room for criticism of the assessment.

Making Citibank look better by focusing on a \$5.5 billion capital shortfall rather than on much bigger

exchanges of preferred securities (owned by the government) to common stock paints a rosier picture, which obviously serves the government's purpose.

Also, assuming a worst-case average unemployment rate for 2009 of 10.3 percent might be more than just optimistic, it may be misleading.

Nevertheless, whatever one thinks about the robustness of the government's tests or even the numbers reported, giving banks and investors a more tangible basis for their dealings with other banks is a plus for the economy.

The real stress test, the one imposed on the really stressed out, however, is still ongoing. Friday's unemployment numbers, although coming in at lower than the predicted additional 600,000 jobs lost, are a measure of distressed households.

Counting unemployed as well as underemployed and "discouraged" workers, those who would like to work but who have given up looking, the unemployment rate is 15.8 percent rather than the reported 8.9 percent.

To paraphrase a well-known quote: "Reality is the leading cause of stress amongst those who have to navigate the recession without an anchor."

The financial system has managed to find a kind of safe harbor with the stress test results. That is amply demonstrated by the willingness of private equity sources to entertain providing some of the \$75 billion needed to recapitalize a few of the banks.

Now, the hope is that the economic waters surrounding this financial meltdown get less choppy too.

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