Economic Recovery And The Coming Financial Crisis

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Is The Crisis Over?

• Yes: in the sense that confidence back to financial markets, headline growth improves
  – But full cost, in terms of higher unemployment, lost growth, lower incomes, still to be felt

• No: long-standing, underlying problems from “super-sized finance” have actually worsened
  – Far from being addressed by US anti-crisis strategy, we now face greater dangers
  – Real reform eventually likely, but immediate opportunity to act already missed: vast costs
Two Views Of The Crisis

• Official (US government, G20): an unfortunate global financial accident occurred
  – Rare: once per century in global finance core
  – Need counteract with massive policy response
    • Increase US debt/GDP from 41% to around 80%
  – Small changes to regulatory structure will suffice

• Alternative: political and economic structure in the United States changed since 1980s, creating global vulnerability
  – The destabilizing power of financial sector, repeating historical patterns in US and elsewhere
What Is U.S. Official Strategy Exactly?

• Support existing “financial intermediation”
  – Directly: administration + Congress
    • Cash: TARP, Fed. Reserve, FDIC debt-guarantees, + more
    • Accounting: forbearance via stress tests, FASB changes
  – Indirect: fiscal stimulus, housing support (small)

• If put large, unconditional, and potentially unlimited subsidies into the banking system, it will “recover” (i.e., show large profits)
  – Lower probability of bank runs/bankruptcy
  – Job security for insiders
  – Helps stock investors (for a while?)
What Could Go Wrong?

• Long historical view, US not exceptional
  – Tendency of powerful groups to rise
    • particularly dangerous when in and around finance
  – “Modernize” not necessarily imply democratize

• Leading examples: challenge executive power
  – Second Bank of United States, 1830s: A. Jackson
  – Trusts, 1900s: Teddy Roosevelt, Pujo, Brandeis
  – Wall Street, 1930s: Pecora Hearings, FDR

• Reinterpretation: Highly regulated banks of 1940s-70s, followed by deregulation, as episodes in repeated historical cycle
Contrast With End 19th Century

• Then: railroad/banking Trusts sought monopoly power and ability to raise prices
  – Legal foundations to oppose this were not enough; needed an explicitly political decision
  – Amassed considerable political power (Senate)
  – Financial sector was small, as % of GDP

• Now: large banks have extraordinary political influence in the U.S. and elsewhere
  – “false” financial innovation: consumers overpaying
  – PLUS: Able extract rents directly from the state when needed: access to large fiscal capacity
More Bluntly

• This is not standard US “regulatory capture”

• Instead, a kind of “state capture” seen (or recognized) more usually elsewhere

• What it’s not:
  – Corruption as Indonesia under Suharto, or US in 19th century
  – Political connections as in Malaysia under Mahathir, or the US in some historical periods

• US now: advanced “oligarchy”; cultural capital
  – Campaign contributions; Congress + executive
  – Intellectual capture: the genius of finance
What Happened?

• Rising economic power of major finance players, from 1980s: from deregulation

• Put this money back into politics and into buying intellectual influence
  – Bank bandwagon was alluring for many
  – Arguments for further deregulation, easy money

• Helped by new “technologies”
  – Emerging markets open to capital flows (lower communication and airfare costs)
  – Derivatives (falling cost computing power)

• Result: more economic power for big banks
Profits in US Financial Sector

Financial Profits (ex-Federal Reserve) as Share of Domestic Profits
U.S. Financial Sector Compensation

Financial industry compensation / all private industries compensation
Employment in US Financial Sector

Percentage Share Of Employment in (Finance + Insurance) in Total Employment


Share of (Finance + Insurance) Employment, By Sub-Sectors

- Federal Reserve banks, credit intermediation, and related activities
- Securities, commodity contracts, and investments
- Insurance carriers and related activities
- Funds, trusts, and other financial vehicles
What Caused The Crisis?

• Same causes as typical in emerging markets
  – Or in the United States, historically (e.g., 1800s)
• Oligarchs: political influence based on economic power; drive boom
  – Invest for growth; state as backstop
  – Take risks, with borrowed money
  – Global investors think they can’t lose
  – Overexpansion creates vulnerability to shocks
    • Typically: currency crisis, banking crisis, fiscal crisis in some combination
Some Deregulatory Policies

• Insistence on free flows of capital across borders (Bhagwati)
  – Handling “global imbalances”
• Repeal of Depression-era regulations separating commercial and investment banking;
• Congressional ban on the regulation of credit default swaps;
• Major increases in the amount of leverage allowed to investment banks;
• Light (invisible?) hand at the Securities and Exchange Commission in its regulatory enforcement;
• International agreement to allow banks to measure their own riskiness (Basel II);
• General failure to keep regulatory pace with the tremendous pace of financial innovation.
The Long Bull Market for Wall Street Pay

The rise of deregulation helped fuel financial-industry pay, which rose faster than overall wages.

Ratio of financial-sector wages to nonfarm private-sector wages, through 2006

Source: WSJ

Source: Ariell Reshef of the University of Virginia and Thomas Philippon of New York University
What Breaks This Kind Of Crisis?

• Experience from emerging markets
  – Some oligarchs fail or lose businesses
    • Not enough bailout resources for everyone
    • Messy process of deciding who gets saved
  – The IMF gets involved: effects depend on G7 agenda
    • political struggle by oligarchs for survival

• But the United States is different
  – Reserve currency: enormous fiscal capacity; borrower of first resort
  – There is enough to bail out most of big finance, to an extraordinary degree (as Japan in the 1990s)
So Have The Bankers Won?

• Short-term: yes, undoubtedly
  – Recovery coming: “move along, nothing to see”
  – Crisis strengthens oligarchs who survive; Jamie Dimon: “probably our best year ever”
    • Top 3 US banks: 30% of deposits, up from ~20%

• Longer-term: no, sooner or later
  – Overgrazing: “tragedy of the bankers’ commons”
  – Increasing public scrutiny of excess, errors
  – Growth unlikely to prove sustainable, volatile

• Other powerful groups unhappy, worried
  – Power of ideas, over time
Who Opposes Big Finance?

• Official view: Just the populists
  – “pitchforks” vs. the bankers

• Actually, within finance:
  – Small finance: they are allowed to fail (FDIC)
    • CIT Group experience instructive (e.g., ABA vs. FSR)
  – Venture capital: start-up process disrupted
  – Private equity: could change sides

• Outside of finance
  – Entrepreneurs: their taxes go up
  – Broader reactions to *The Quiet Coup*: right and left
Why Can’t Reflated Finance Be The Basis For Sustainable Growth?

• Limits to “innovation” that harms consumers
  – Most financial innovation since the 1970s not like nonfinancial innovation
  – Some consumer protection is coming (new agency: nudge vs. sharp elbows)

• Moral hazard affects banker behavior
  – Banks and others “too big to fail”, but no action to break them up: government blinked
    • Incentive to seek rents, take unreasonable risks
    • Compete for access to further government subsidies, privileges, forbearance
But Mostly Because...

• Finance already very large in the US
  – Seen in share of corporate profits
  – This is a bubble that is hard to reflate

• And compensation high relative to the rest of the economy
  – Greater regulation usually brings down relative pay
    • Even this administration/Congress will tighten rules to some extent, even though not deal with real problems

• High talent share already in finance: Goldin/Katz
  – Harvard grads in finance: 5% (1970) to 15% (1990)
Innovative Sectors: Rising Finance, Falling Agriculture

Finance Plus Insurance vs. Agriculture, as Share of US GDP, 1947-2008

Source: BEA
Banking Value Added, 1839-1899
(share of service sector and entire economy)
Meanwhile, Over In Europe

• US: biggest banks “too big to fail,” in the view of public policy

• Western Europe: most banks not just “too big to fail,” but also “too big to rescue”
  – So banking problems immediately became fiscal issues (limiting space for countercyclical stimulus)
  – Western Europe starting with weaker balance sheets (higher levels of debt)

• Europe less captured by finance (except UK, Switzerland) but consequences still severe
OECD/BIS “Comparable” Data

Graph 3*

Share of the financial sector in GDP (in per cent)

* The financial sector comprises financial intermediation, real estate, renting and business activities.

Source: OECD.
“Excess Credit Level” (OECD)

Deviation of domestic bank lending to the private non-financial sector as a share of GDP from long-term trend.

3-month moving average

Source: OECD, May 2009
European Bank Assets, 1980-2007

Total Bank Assets/GDP

Worldscope data

- CHE
- GBR
- ISL
- IRL
- ESP
- PRT
- USA
- ITA
- GRC
European Bank Assets, 1999-2007

Total Bank Assets/GDP
Orbis data

SWITZERLAND
UK
ICELAND
IRELAND
SPAIN
PORTUGAL
USA
ITALY
GREECE
...provided they are credible

Assets of some banks are too large to guarantee

Total bank assets to 2007 GDP
*In percentage and billions of Euros*

- **Iceland GDP €8.5**
  - Kaupthing 623%
  - Landsbanki 374%
  - Straumur 73%
  - Spron 29%

- **Ireland GDP €180**
  - B.of Ireland 102%
  - Anglo Irish 54%
  - Allied Irish 99%

- **France GDP €1624**
  - BNP Paribas 104%
  - Credit Agricole 87%
  - Socgen 66%

- **Portugal GDP €132**
  - Millen.BCP 67%
  - BPI 31%
  - BES 52%

- **Spain GDP €692**
  - Santander 132%
  - BBVA 73%

- **Britain GDP €1644**
  - RBS 126%
  - HSBC 98%
  - Barclays 94%
  - HBOS 51%

- **Holland GDP €473**
  - ING 290%
  - Rabobank 121%

- **Belgium GDP €349**
  - Fortis 254%
  - Dexia 173%

- **Germany GDP €2237**
  - Deutsche Bank 86%
  - Commertzbank 28%
  - Hypo Real Estate 18%

- **Switzerland GDP €294**
  - UBS 484%
  - Credit Suisse 290%

- **Italy GDP €1284**
  - Unicredit 180%
  - Sanpaolo 47%

- **Greece GDP €183**
  - NBG 49%
  - EFG Euro. 37%

Source: FT
The UK Since The Mid-1990s

Source: The Economist
Recap: Global Crisis and Institutions
Who Dunnit?

• The Usual Suspects:
  – Was it housing? (incentives, regulation, globalization)
  – Or overexpansion of credit? (capital flows)
  – Or excessive risk taking by financial institutions?

• Deeper causes: metabubble/new oligarchs
    • Share of profits, compensation relative to average
  – Undermining institutions around the world
Does The Weakening Of Institutions Matter?

• Institutions: the laws, rules and norms that govern how we behave, politically and economically. Includes
  • Security of property rights, strength of investor protection
  • Expropriation by powerful elites, state failure, corruption
• Institutions have a major impact on:
  – Sustained economic growth rates, over long periods
• Weak institutions do not prevent booms
  – longer time horizons, more certainty, better behavior
• But weak institutions mean
  – More frequent crises
  – More severe crises, with grabs for power and property
  – Derailment of growth: the Argentine experience
This Is The United States

• At the center of the world’s financial system
  – Who has hedged their economy sufficiently to handle the ensuing instability?
• This will dominate all other considerations of economic development, poverty reduction, etc
• Goodbye, Great Moderation; Hello, Great Instability?
  – Costs likely larger outside the US
The Great Escape (For Finance)?

• The official failsafe?
  – Protests to the contrary duly noted

• Go for global inflation: reduce real value of debts
  – Credit can’t easily be withdrawn by the Fed
  – Perhaps helped by structure of the oil market and failure of U.S. energy policy
  – Dollar may depreciate against the euro; but default risk haunts Europe
Is that in New Dollars or Old Dollars?

• What’s your model of inflation?
  – Output gap view: no inflation for foreseeable future
    • But Fed is credit provider of first resort; how can they cut this off when the economy recovers?
    • Bernanke: not repeat 1930s mistakes
  – And there is the budget deficit (Bernanke, November 21, 2002)
    • Global inflation, move into commodities as store of value
    • Interest rates rise
    • Monetize the deficit (remember Sargent and Wallace?)

• It couldn’t happen here...
  – Recession and inflation: more emerging market characteristics in the heart of the global economy
    • Spring 2008 as foreshadowing: rising commodity prices with declining growth prospects?
The Pushback (1)

It wasn’t a new form of financial oligarchy, as in *The Quiet Coup*, because...

- Finance-led growth was accidently excessive
  - Just go back to mid-1990s (Summers, Surowiecki)
- Banks are stupid, not super smart (Brooks)
  - Smarter regulation can prevent future mistakes
- Is that the real policy implication?
  - Banks too big to fail, financially
  - Bank management systems/leadership failed
  - Political and cultural capture works fine, as in ‘90s
The Pushback (2)

• We need the “experts” who built the system to help us solve the problems (NEC/Treasury)
  – And they all come from or are closely connected with a small set of financial firms

• But their schemes are complicated and nontransparent ways to prop up a bloated sector
  • This is hard to sustain under any circumstances
  • Expect another fiscal stimulus...

• Consumer protection agency could help, a bit
The Pushback (3)

• Obama administration is not captured by this oligarchy and can implement reform
  – There are no serious conflicts of interest for the rich (curious cases of Friedman and Liddy)
  – What big players want is what we all want (Gross)

• Unusual arguments
  – You mustn’t talk about or attempt to measure political connections in the United States: “nothing good will come of it”
  – Technocrats must stick together, and with finance
    • Ignore current dissonance within finance?
Alternatively, Think Of It This Way

• US has strong (non-financial) innovative sectors, broadly defined
  – Financial sector of 1950s/1960s supported plenty of capital-intensive breakthroughs

• Major risk to innovation and growth always from rent-seeking sector
  – In the US, this is now big finance

• Either break it up, preferably sooner
  – Or face the consequences:
    • Slower growth, inflation, higher interest rates, taxes
    • International disruption and costs
Reform Proposals

• Increase bank capital, substantially
  – But how much would be enough?
• Federal Reserve operating mandate leads to bailout/bubble/bust/bailout cycle, unless tight regulation
  – Greenspan “put” has become a much larger and open-ended Bernanke put
• Revolving door, Wall Street-Washington, is a big part of the problem
Equity As Percent Of Assets, US Commercial Banks, 1840-1995

Fig. 1. Equity as a percent of assets, 1840–1993 for U.S. commercial banks. (Ratio of aggregate dollar value of bank book equity to aggregate dollar value of bank book assets.)

Fed Funds Rate After Every Crisis, 1980-2009

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One Page Summary

• Political rise of finance capitalism in the United States, since 1980
  – Repeating a historical pattern seen in US booms, and also familiar from emerging markets
  – Parallels in other industrial countries, e.g., Western Europe
• Crisis solves nothing: surviving oligarchs stronger
• Will the 21st century turn out to be a great deal like the end of the 19th century? Who won last time?
  – The Big Argument is only just starting
• Recovery likely around the corner, depending on balance sheets, confidence
  – But then so is the next crisis?
    • Which will cost another 40% of GDP, or more, for the US
    • And potentially destabilize the world