The Global Crisis: Is It Over Yet?

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Quick Answers

• Yes: in the sense that confidence comes back to financial markets
  – 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) & complex causes
  – 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?

• Support “financial intermediation” above all
  – 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”
  – Lower probability of bank runs/bankruptcy
  – Job security for insiders
  – Helps stock investors (for a while?)
What’s Wrong With That?

• Another view of US (with no exceptionalism)
  – Tendency of powerful groups to rise, particularly in and around finance
• Leading examples: challenge executive power
  – Second Bank of United States, 1830s: A. Jackson
  – Trusts (railroads + banks), 1890s: T. Roosevelt
  – Wall Street, 1920s: Pecora Hearings, FDR
• Highly regulated banks of 1940s-70s, then deregulation were 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
• Now: large banks have extraordinary political influence in the U.S. and elsewhere
  – “false” financial innovation: consumers overpaying
  – PLUS: Ability to extract rents directly from the state and force government to massive increase in public debt
More Bluntly

• This is not standard US “regulatory capture”

• It is the 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
  – Intellectual capture: the genius of finance
What Happened?

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

• 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
  – Derivatives (falling cost computing power)

• Result: more economic power for big banks
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
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.
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; diagnosis focus on oligarchs

• 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)
  – 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?)

• 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
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)
Profits in US Financial Sector

Financial Profits (ex-Federal Reserve) as Share of Domestic Profits

![Graph showing financial profits in the US financial sector as a share of domestic profits from 1948 to 2007. The graph shows a trend of increasing profits from the 1960s, peaking in the early 2000s, and then declining.]
U.S. Financial Sector Compensation

Financial industry compensation / all private industries compensation
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

1.8
1.6
1.4
1.2
1.0

1910 20 30 40 50 60 70 80 90 00 10

Regulatory legislation
- 1933 Glass-Steagall Act
- 1933 Securities Act
- 1934 Securities Exchange Act
- 1939 Trust Indenture Act
- 1940 Investment Advisers Act
- 1940 Investment Company Act
- 1956 Banking Holding Company Act

Deregulatory legislation
- 1980-1984 Removed interest-rate ceilings (from Glass-Steagall Act)
- 1994 Riegle-Neal Interstate Banking & Branching Efficiency Act (repeals parts of Bank Holding Co. Act)
- 1996 Investment Advisers Act amended
- 1999 Graham-Leach-Bliley Act (repealed Glass-Steagall & parts of Bank Holding Co. Act)

Regulatory legislation
- 2002 Sarbanes-Oxley Act
- 2008 Economic Stimulus Act
- 2008 Economic Recovery Act
- 2008 Housing and Economic Recovery Act
- 2008 Emergency Economic Stabilization Act (TARP)
- 2009 American Recovery and Reinvestment Act

Source: Ariell Reshef of the University of Virginia and Thomas Philippon of New York University

Source: WSJ
Innovative Sectors: Rising Finance, Falling Agriculture

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

Source: BEA
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
...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

<table>
<thead>
<tr>
<th>Country GDP (€ billions)</th>
<th>Bank</th>
<th>% of GDP</th>
<th>Country GDP (€ billions)</th>
<th>Bank</th>
<th>% of GDP</th>
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</thead>
<tbody>
<tr>
<td>Iceland €8.5</td>
<td>Kaupthing</td>
<td>623%</td>
<td>Holland €473</td>
<td>ING</td>
<td>290%</td>
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<td>Landsbanki</td>
<td>374%</td>
<td>Rabobank</td>
<td>121%</td>
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<td>Straumur</td>
<td>73%</td>
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<td>Spron</td>
<td>29%</td>
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<td>Ireland €180</td>
<td>B.of Ireland</td>
<td>102%</td>
<td>Benelux €349</td>
<td>Fortis</td>
<td>254%</td>
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<td>Anglo Irish</td>
<td>54%</td>
<td>Dexia</td>
<td>173%</td>
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<td>Allied Irish</td>
<td>99%</td>
<td>Germany €2237</td>
<td>Deutsche Bank</td>
<td>86%</td>
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<td>Commertzbank</td>
<td>28%</td>
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<td>Hypo Real Estate</td>
<td>18%</td>
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<td>France €1624</td>
<td>BNP Paribas</td>
<td>104%</td>
<td>Switzerland €294</td>
<td>UBS</td>
<td>484%</td>
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<td>Credit Agricole</td>
<td>87%</td>
<td>Credit Suisse</td>
<td>290%</td>
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<td>Socgen</td>
<td>66%</td>
<td>Spain €692</td>
<td>Santander</td>
<td>132%</td>
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<td>Portugal €132</td>
<td>Millen.BCP</td>
<td>67%</td>
<td>Italy €1284</td>
<td>UniCredit</td>
<td>180%</td>
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<td>BPI</td>
<td>31%</td>
<td>Sanpaolo</td>
<td>47%</td>
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<td>BES</td>
<td>52%</td>
<td>EFG Euro.</td>
<td>37%</td>
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<tr>
<td>Spain €692</td>
<td>Santander</td>
<td>132%</td>
<td>Greek GDP €183</td>
<td>NBG</td>
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<td>BBVA</td>
<td>73%</td>
<td>Source: FT</td>
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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
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 UK Since The Mid-1990s

Source: The Economist
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)

• Extraordinary 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
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
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 21\textsuperscript{st} century turn out to be a great deal like the end of the 19\textsuperscript{th} century?
  – 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