

Simon Johnson on Why This Crisis Wasn't the Last

By Robert Huebscher

October 12, 2010

Is the last financial crisis over?

Not yet, according to Simon Johnson, a former chief economist at the IMF who is now a professor of finance at MIT. "Some very important repercussions" will upset economies over the next six months, according to Johnson, particularly in Europe but also in the US.



Simon Johnson

Did we at least fix the problems that *caused* the crisis?

Again, Johnson's answer is a resounding "no." The key problem – which is the focus of Johnson's new book, *13 Bankers* – is the phenomenon of "too big to fail." Our big financial institutions are here to stay, and we have to learn to live with them.

But is that the worst of our problems?

Unfortunately, the answer is once more "no," according to Johnson. Problems inherent in large banks will, at some point in time, bring them to the brink of failure. The public cost of saving them, Johnson said, will only make matters worse and we lack the political will to effectively deal with the underlying issues.



Answering those three questions was the focus of a talk Johnson gave to the Boston chapter of the CFA society on October 4. He explained why measures such as the Dodd-Frank legislation are insufficient to prevent another financial crisis and what regulatory steps the government should take to reduce systemic risk.

The ongoing problem

Too big to fail is the wrong way to characterize the problem, according to Johnson. The real problem facing policy makers is that many institutions have become too big to save, he said. When viewed in the context of the public good and wise use of taxpayer funds, the cost of rescuing the largest banks is simply too great.

Johnson pointed to Ireland's troubles as the latest example to illustrate that the financial crisis is not over. The assets of Ireland's three largest banks were approximately 200% of the nation's GDP when they failed. The exact losses those banks will incur depends on



their mostly domestic real estate portfolios, but Johnson expects Ireland's debt-to-GDP to rise by up to 100% as the cost of rescuing those institutions.

Johnson said Ireland will dominate discussions at the upcoming G20 meetings, although he doesn't expect it or other European countries to default. "I personally think they will do whatever it takes to avoid that," he said. "But whatever it takes is going to involve a lot of money and a lot of stagnation in that part of the world's economy."

In Washington, Johnson said there are two alternative views of what caused the crisis. One, which prevails among policy makers, is that a perfect storm was at fault, the result of the housing bubble, imperfect lending standards, and proliferating incentives to buy houses. Recent reforms and legislation largely fixed those problems, he said, as has market self-correction.

The second view, to which Johnson ascribes, traces the problems to policy makers allowing the financial sector, particularly the big banks, to gain too much power. From that view, the problem has not been fixed or even acknowledged by Washington.

Indeed, he said, he wrote his book to confront the conventionally accepted hypothesis of the perfect storm.

The book gets its name from a meeting between the CEOs of the 13 largest financial institutions and President Obama that took place in March 2009, following near-collapse of the markets and the effective bankruptcy of many of the companies represented at the meeting. The bankers all received their needed bailouts, but remarkably, from Johnson's perspective, not a single one lost his job, his pension, or his bonus, and not one had his Board of Directors upturned. "It was quite extraordinary and quite underreported actually," Johnson said.

Johnson was told privately by administration officials that, "if we had disturbed one hair on the head of a single Citigroup director, that would have deepened the crisis."

He doesn't believe it, and that's part of the reason for the book.

For starters, he points to government's *de facto* firing of GM's CEO, Rick Wagoner, in the wake of that company's bailout, despite lacking any legal authority to carry out the ouster. When you provide a bailout, Johnson said, it is typically "best practice" to make some changes and at least consider the removal of those who were largely responsible for creating the problem.

"To do otherwise would be crazy," he said. "This is the heart of too big to fail."

The failure of Fannie Mae and Freddie Mac, according to Johnson, arose from the same problem – they were backed unconditionally by the government, and that distorted their



incentives, causing them to take excessive and ill-fated risks. Today, as a result, large portions of the financial sector remain backed by the “full faith and credit of the US government,” and the too big to fail problem persists.

Some institutions have been allowed to fail, supporting Johnson’s thesis that the government does not need to coddle banks to protect the economy. He noted the failure of CIT Group, after which very little disruption to lending to small- and medium-sized business resulted. “Letting them fail was a good decision in retrospect,” Johnson said.

Johnson doubts, however, that an institution as large as Goldman Sachs, which now has a balance sheet of roughly \$800 billion, should be allowed to fail. That said, Goldman’s unsecured creditors should not be made whole in the event of financial distress, Johnson argues, as was the case with bailouts such as AIG’s.

Attempts to regulate banks through capital requirements, while well-intentioned, are not likely to succeed in the long run, Johnson said. Tier-1 capital requirements under Basel III are approximately 10%, roughly the level that Lehman had when it failed. Moreover, firms such as Goldman Sachs have fought off such restrictions very effectively.

A key concern for Johnson is the lack of a “resolution authority” for global banks – an institution with cross-border jurisdiction that could orchestrate the orderly unwinding of a failed bank. The complexity of such an undertaking is simply too great right now. Citigroup, he said, operates in over 100 countries, and Goldman Sachs does business in at least 50 or 60. Although the FDIC has authority in the US, Europe has no comparable authority, despite its efforts to create one over the last 15 years. “Countries will not agree to tie their hands,” he said.

“There is no limit to the size of an individual bank in an economy,” Johnson said. “Not when you globalize finance.” He noted that the six biggest US banks now have assets of nearly 64% of our GDP, up from 58% prior to the crisis and from the mid-teens in the early 1990s. Similar situations exist in the UK, where the top three banks have assets-to-GDP of 200%, and in Scotland, where a single bank has assets one-and-a-half times GDP. Even supposedly fiscally conservative Switzerland has two banks whose assets are eight times its GDP.

Out of control political power

“The political power these big players have is out of control,” Johnson said, and that is not good for business, society or the world.

That political power has been costly to taxpayers. The cost of the bailout should not be viewed merely as the funds spent on TARP and similar measures, Johnson argues; it must also include the eight million jobs that have been lost and the rise in our debt-to-GDP ratio from 42% before to the crisis to over 80% after. “They just blew 40% of GDP on this



exercise,” he said. Most of that increase came from automatic stabilizers, such as unemployment insurance, that kicked in during the recession.

Power concentration in the financial sector has had global political consequences too. When Fannie Mae and Freddie Mac were failing, Johnson said, the Chinese called Treasury Secretary Paulson, asking, “Where’s our guarantee?” “What Treasury Secretary is going to call that bluff?” Johnson asked.

Johnson stressed that his message of the danger of concentrated power does not make him “anti-business.” He cited Teddy Roosevelt, a Republican, who confronted a similar challenge in 1902 when he took on monopolies. His foe, at the time, was J.P. Morgan, who reportedly came to the White House and said, effectively, “If we are doing anything wrong, send your man to see my man and we will fix it up.”

Roosevelt said no, he did not want to fix it; he wanted to stop it, and what followed was the Sherman anti-trust legislation. Ten years later, when the government went to break up Standard Oil, the biggest and most powerful company in the US at the time, it wasn’t particularly controversial, Johnson said. The mainstream consensus had shifted in favor of effective limits on large companies.

While Johnson was articulate and forthright in his elucidation of the too big to fail problem and its consequences, he was also candid in his admission that he could not offer a comprehensive solution. He advised considering a variety of alternatives, including a system in which there are fail-safes ensure that, even if regulators fail, the entire financial system will not crumble. He said he would have forced failing institutions, such as Citigroup, to break up in March of 2009, but he did not say whether he would have protected their unsecured creditors. He agrees that banks should be allowed to compete globally, although he does favor the Volcker Rule, which would separate commercial and investment banking.

In criticizing the government’s failure to address the root causes of the crisis, Johnson spared neither party. Johnson said that President Obama should have taken a different approach to addressing the crisis, and he similarly faulted Republicans for their lack of leadership on certain issues. Virtually nobody at the national level has a grasp of the issues, he added.

The issue of too big to fail “is just power, concentrated economic and political power,” Johnson said. “It is not consistent with democracy. It is not healthy. And it will not lead to economic prosperity.”

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>