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: <u>vast costs</u>

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

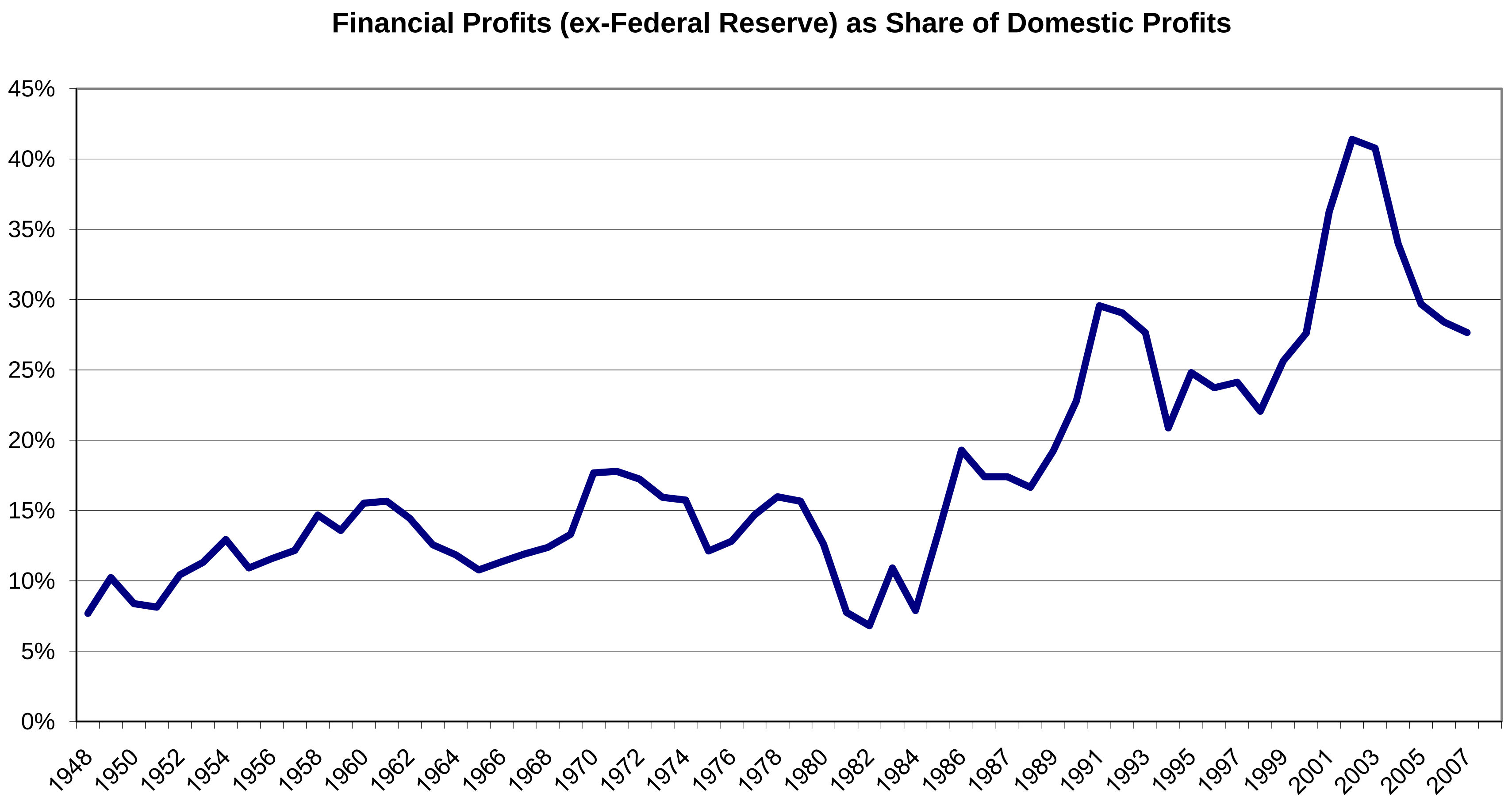
More Bluntly

- 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

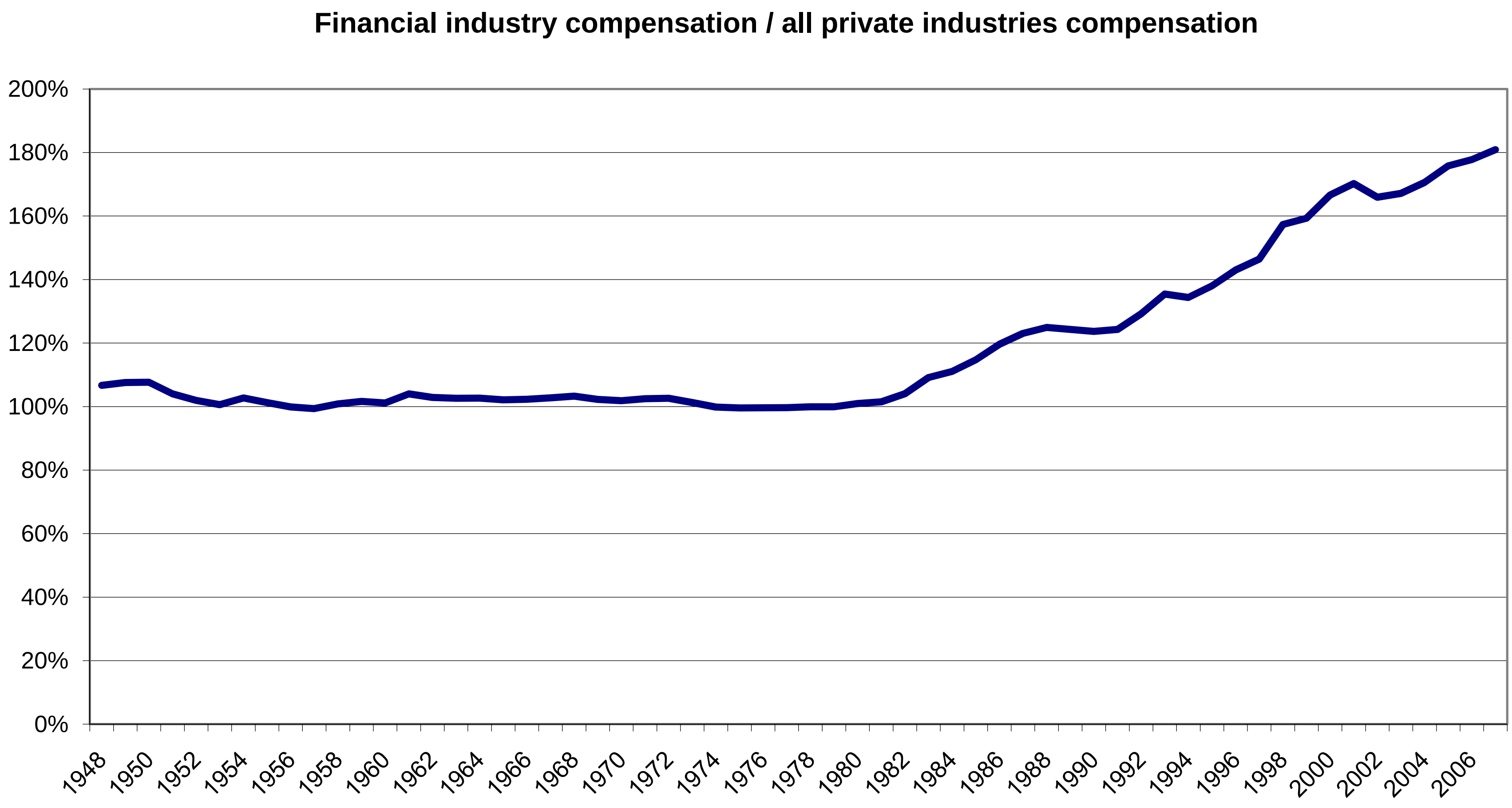
What Happened?

- 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

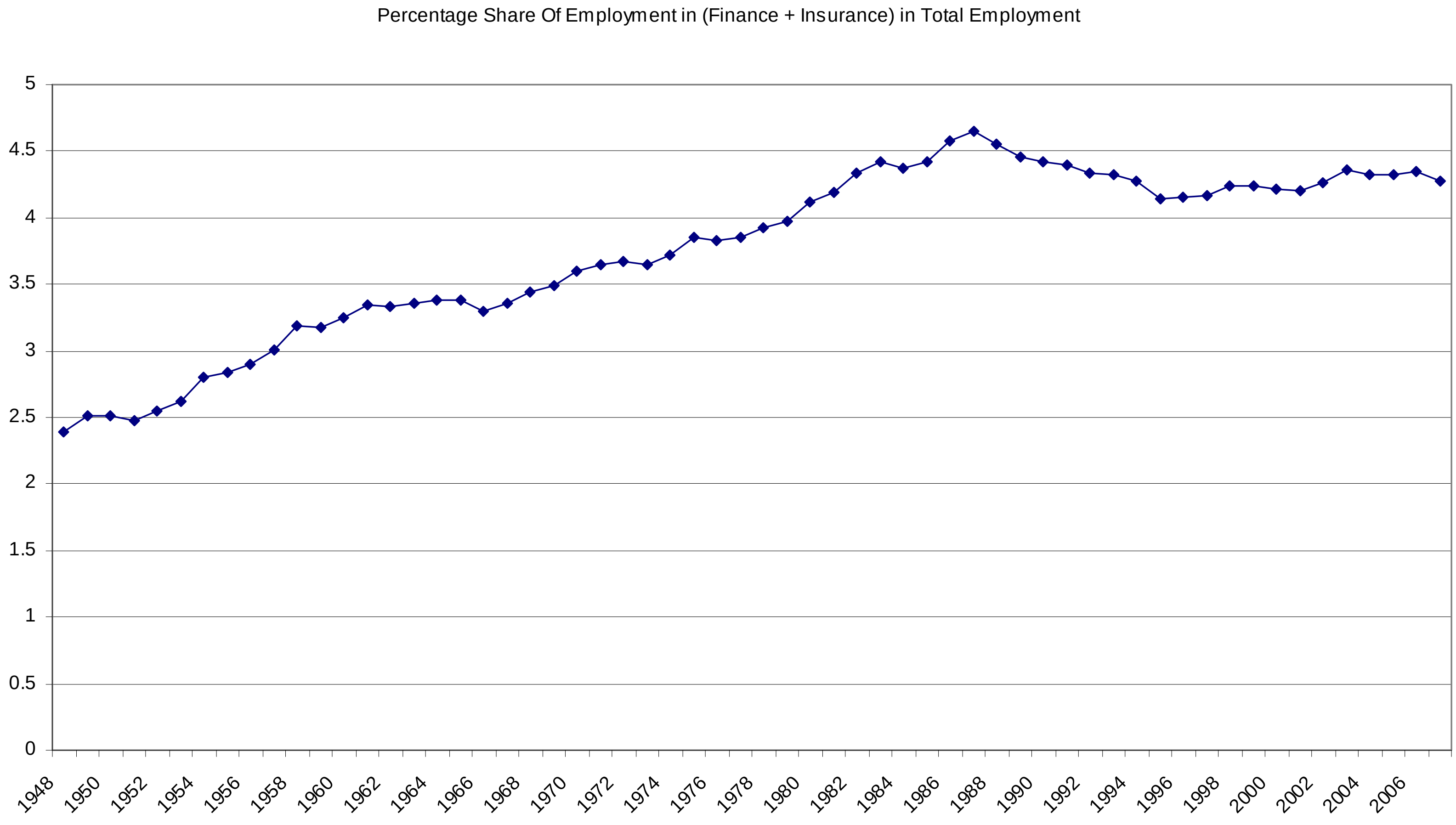
Profits in US Financial Sector



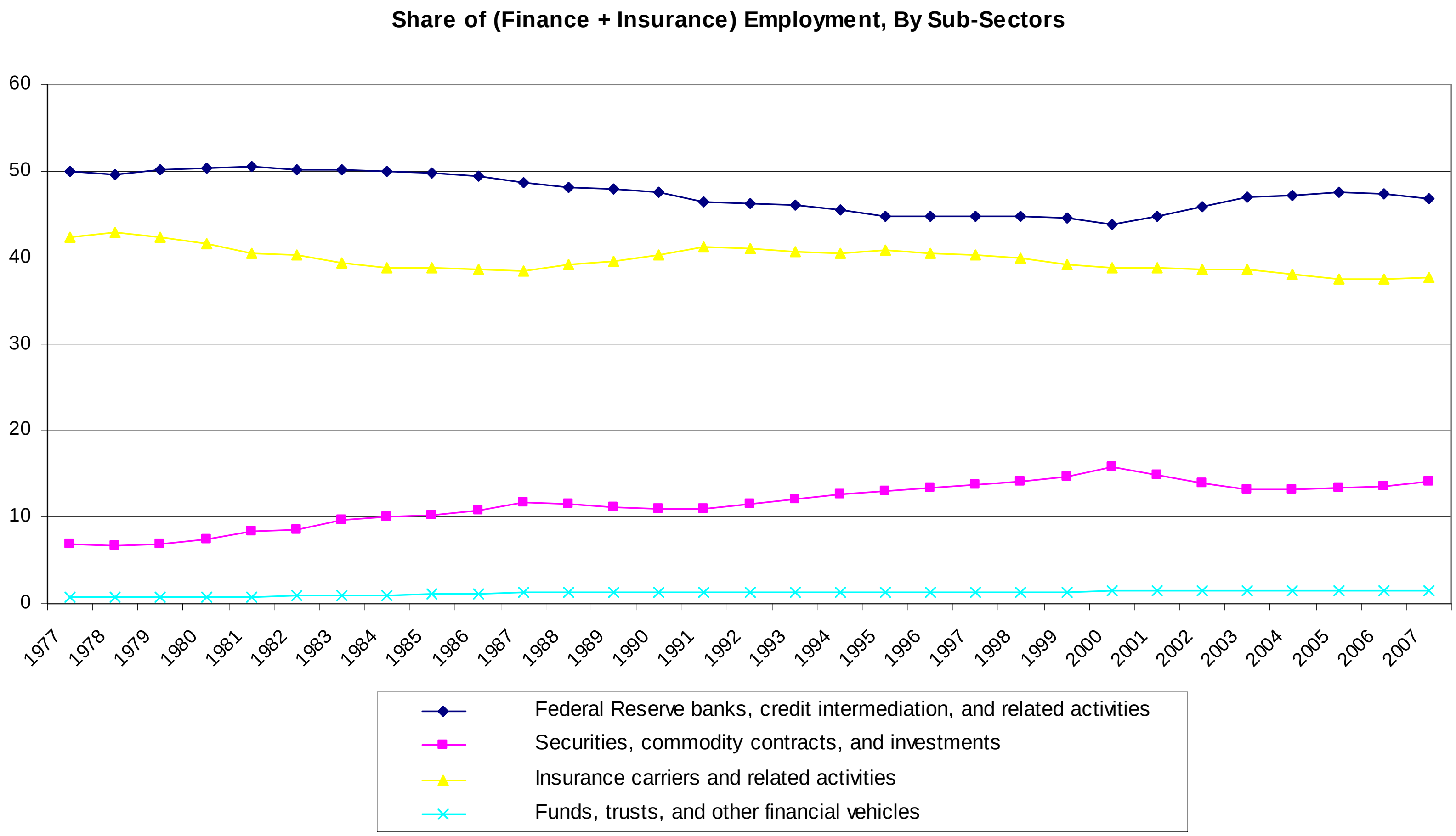
U.S. Financial Sector Compensation



Employment in US Financial Sector



Share of Financial Sector Employment, 1977-2007

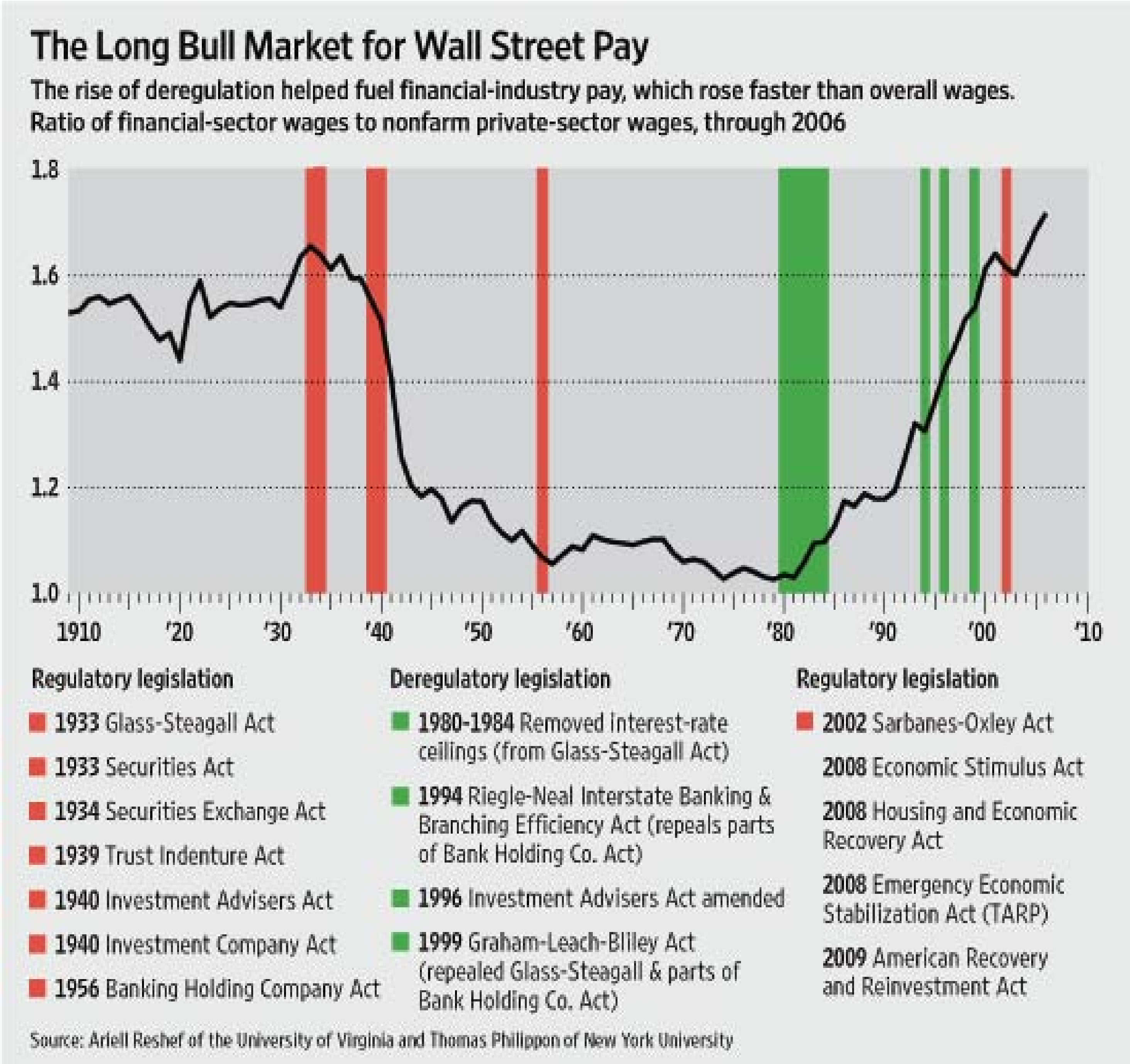


What Caused The Crisis?

- 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
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 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

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

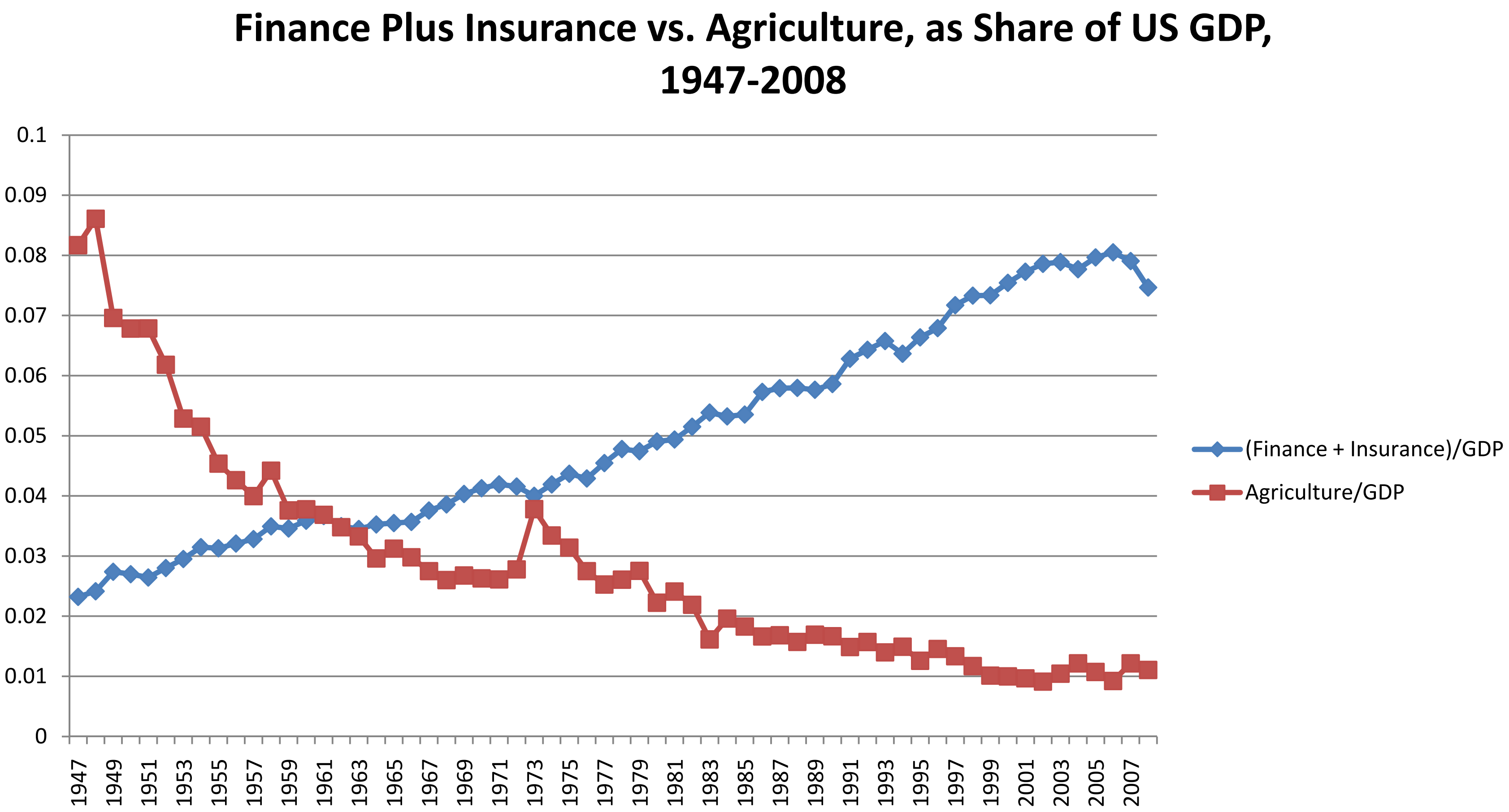
Why Can't Reflated Finance Be The Basis For Sustainable Growth?

- Limits to "innovation" that harms consumers
  - Most financial innovation since the 1970s <u>not</u> 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)

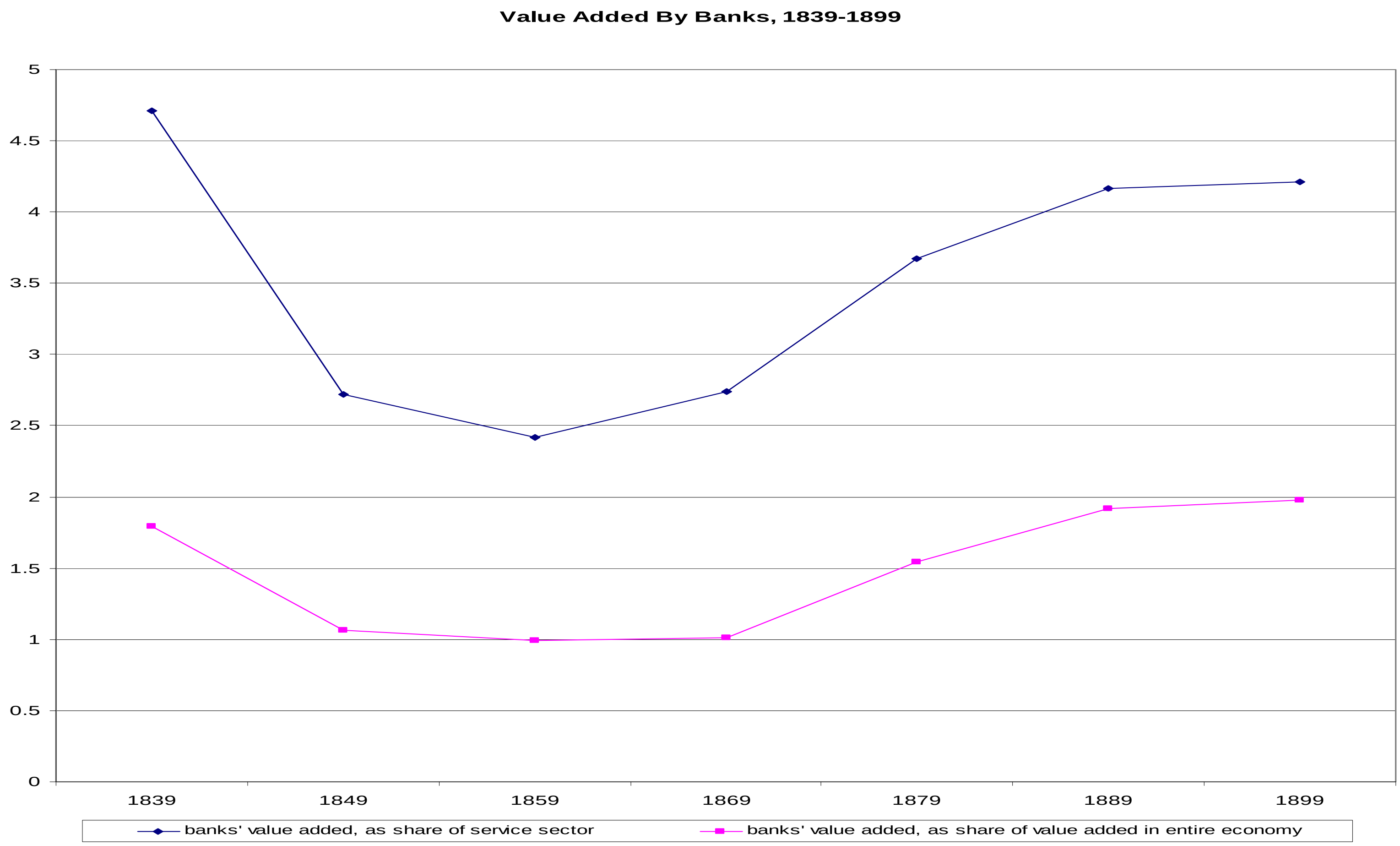
Innovative Sectors: Rising Finance, Falling Agriculture



Source: BEA

Banking Value Added, 1839-1899

(share of service sector and entire economy)



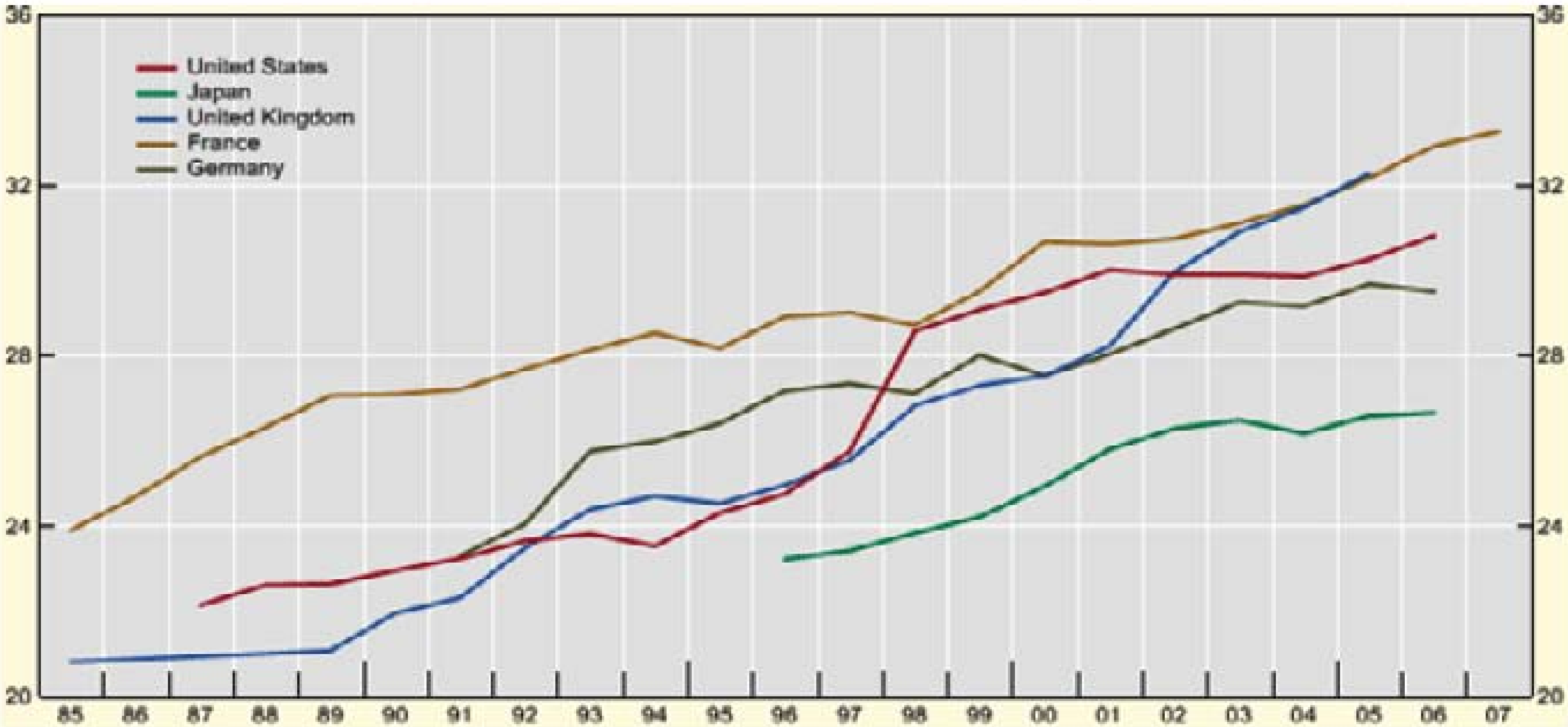
Meanwhile, Over In Europe

- 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)



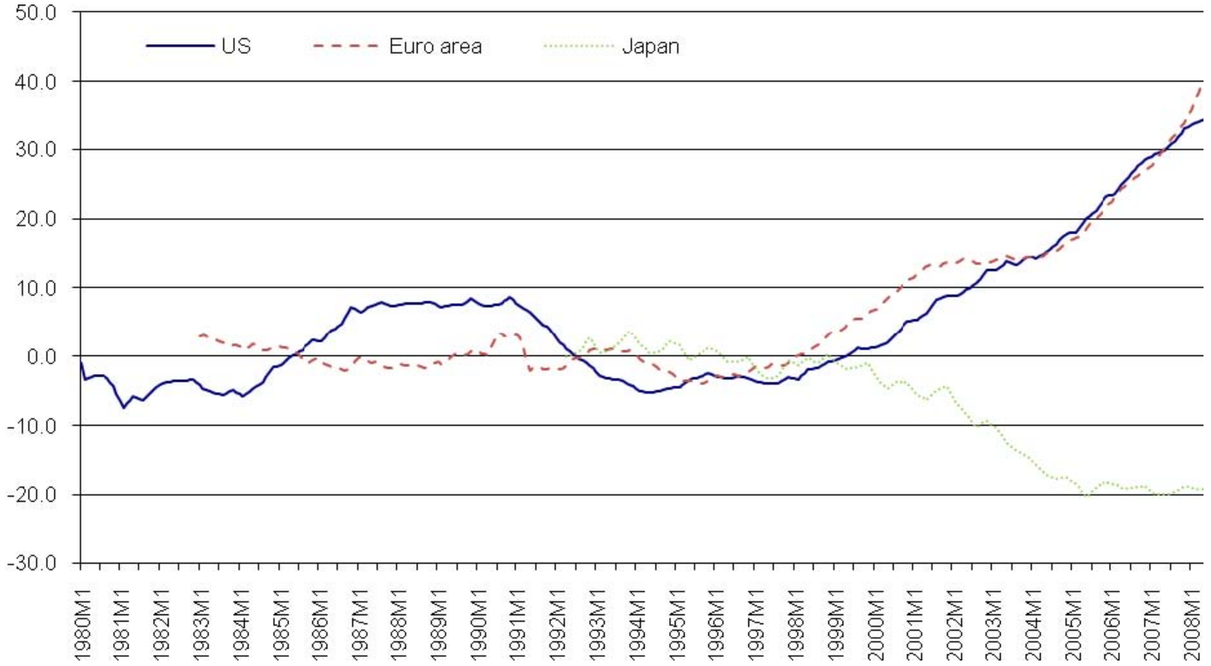
* The financial sector comprises financial intermediation, real estate, renting and business activities.

Source: OECD.

“Excess Credit Level”(OECD)

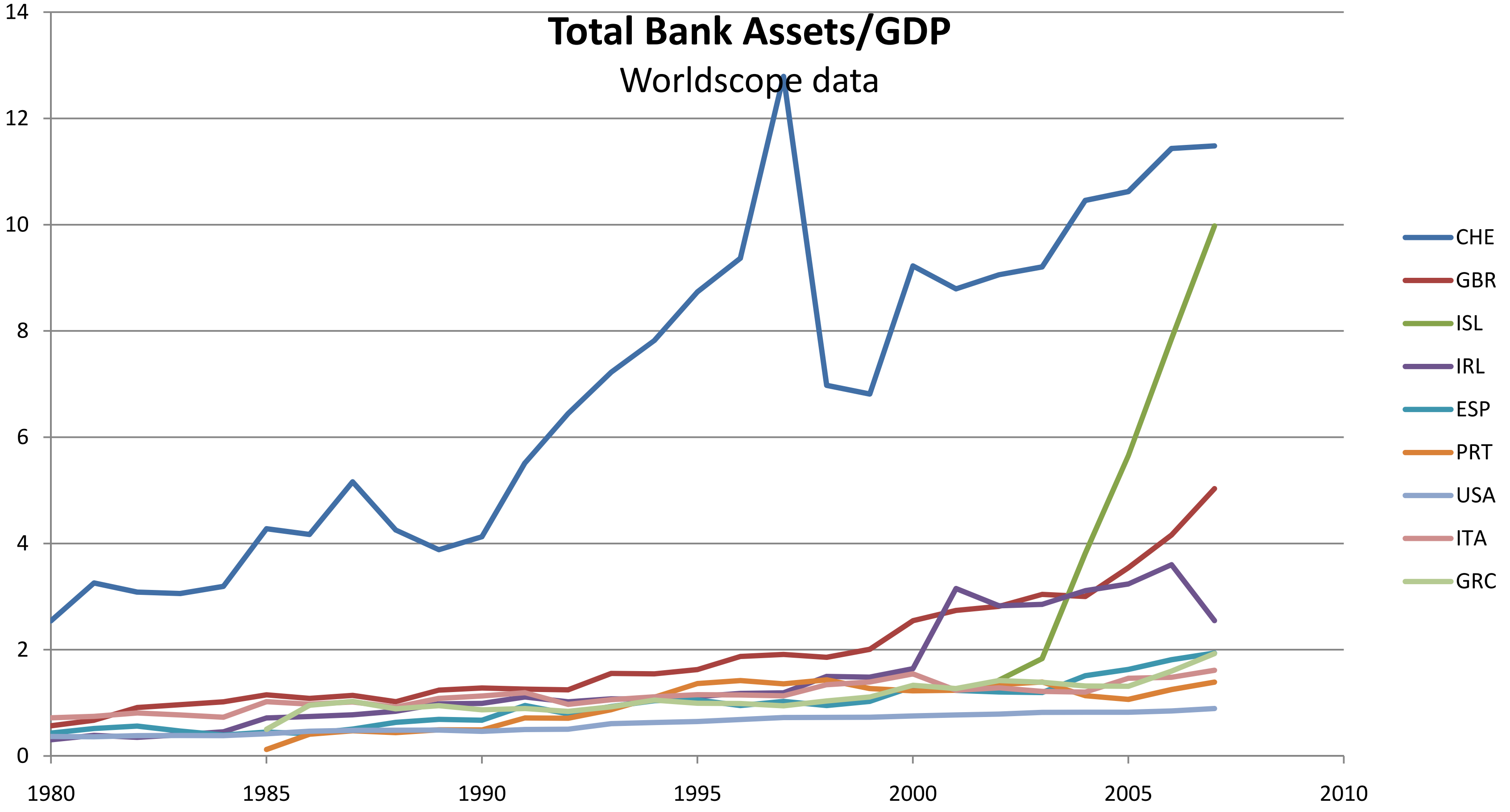
Deviation of domestic bank lending to the private non-financial sector as a share of GDP from long-term trend.

3-month moving average

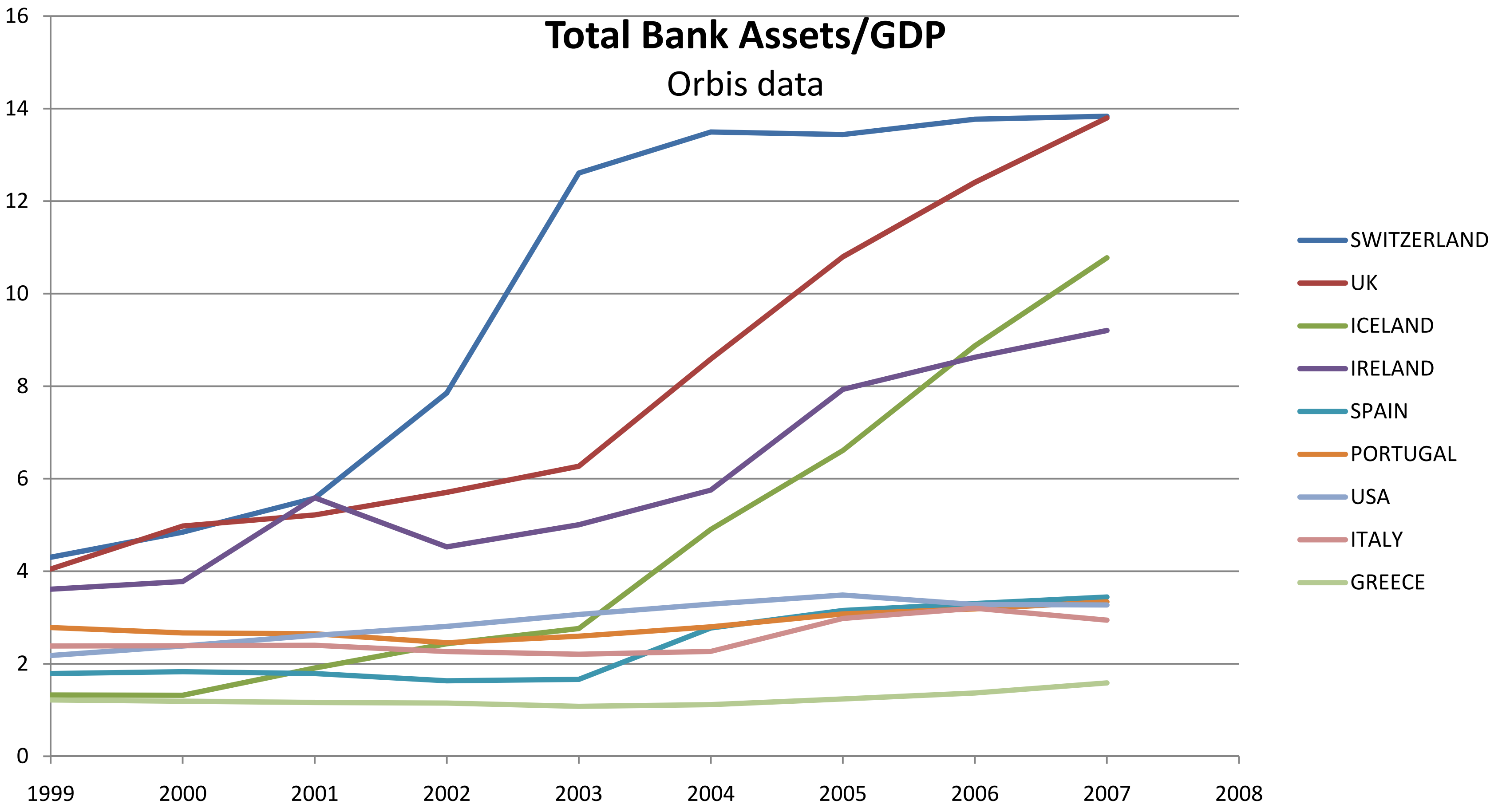


Source: OECD, May 2009

European Bank Assets, 1980-2007



European Bank Assets, 1999-2007

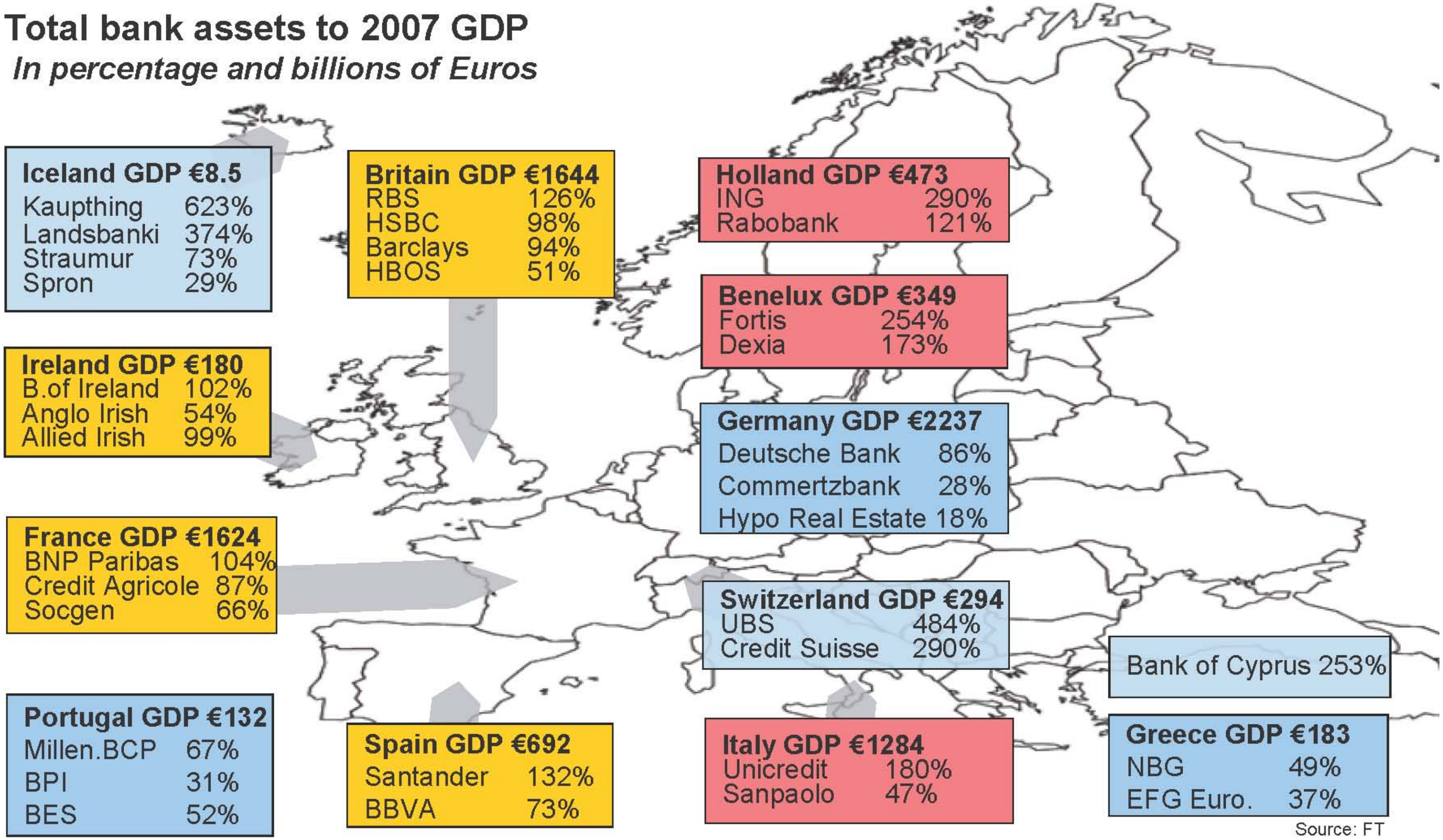


…provided they are credible

Assets of some banks are too large to guarantee

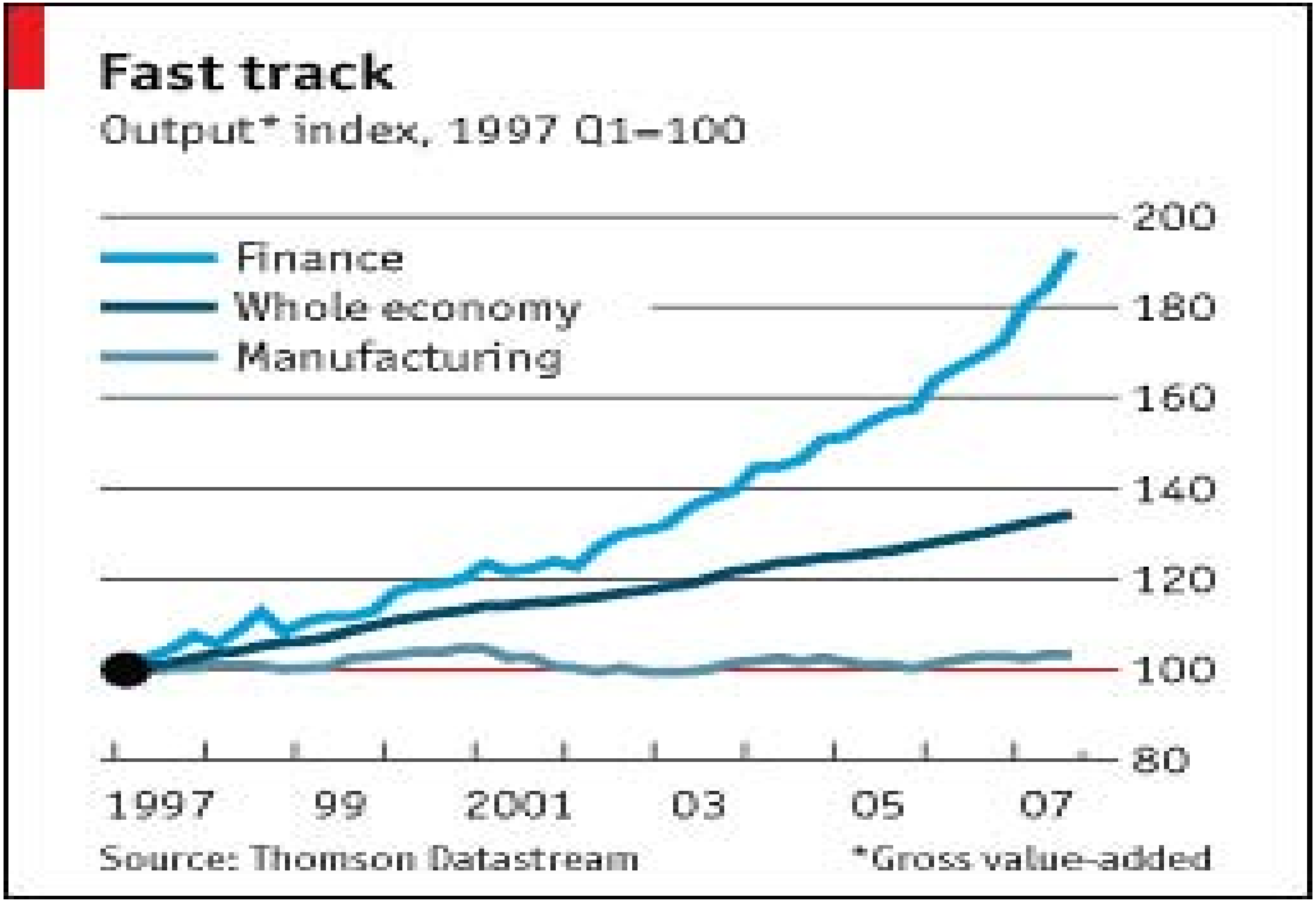
Total bank assets to 2007 GDP

In percentage and billions of Euros



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
  - Rise of the financial sector, US/Europe since ~1980
    - 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

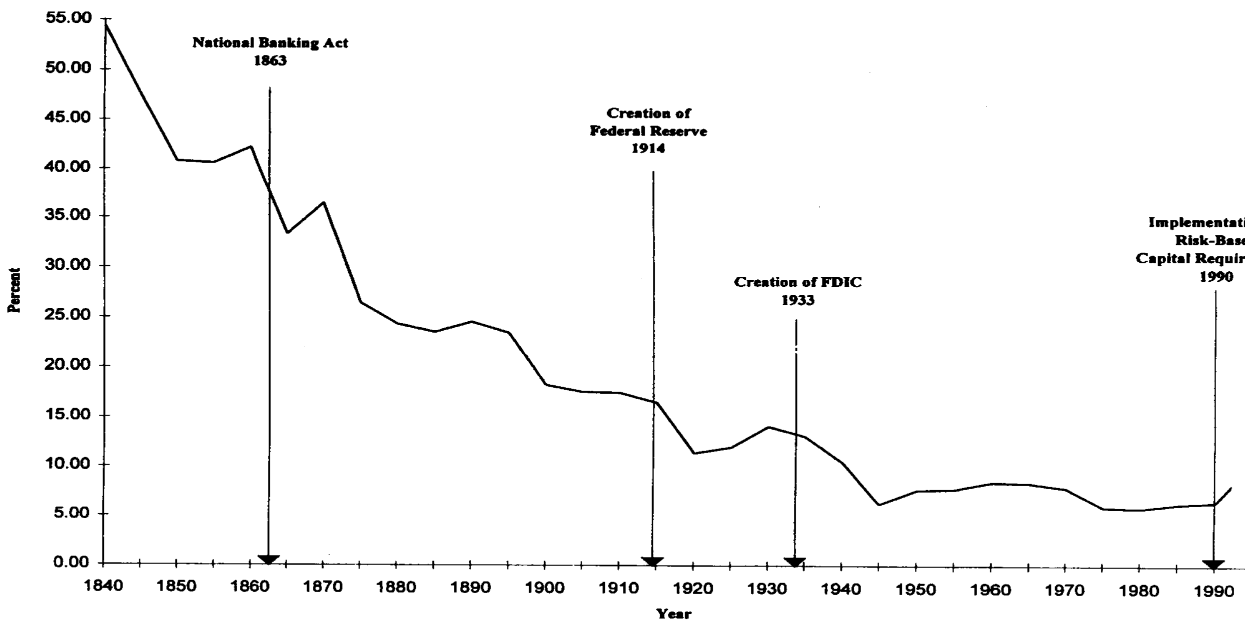


Fig. 1. Equity as a percent of assets, 1840–1993 for U.S. commercial banks. (Ratio of aggregate dollar value of bank book equity to aggregate dollar value of bank book assets.)
Source: Statistical Abstracts through 1970, Report of Condition and Income thereafter.

402 A.N. Berger et al. / Journal of Banking & Finance 19 (1995) 393–430

Fed Funds Rate After Every Crisis, 1980-2009

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