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The Baseline Scenario

What happened to the global economy and what we can do about it

Economic Donkeys

Posted on September 13, 2009 by Simon Johnson | 138 Comments

Early in the First World War, British generals decided to attack German trenches with an initial light bombardment, followed by infantry walking in close order across No Man's Land. The result was tens of thousands killed in a series of military disasters, but the generals reacted with only small adjustments to their approach and essentially persisted in repeating the same mistakes for years. "The English soldiers fight like lions," one German general remarked. "True. But don't we know that they are lions led by donkeys?" was the reply.

Today, a year after global financial collapse and the ensuing tragedy for millions, our economic leaders are lining us up to suffer again (and again) through the same horrible experiences.

The collapse of Lehman Brothers in September 2008 demonstrated just how far our economic system in general and bank management in particular have gone awry. Lehman borrowed at low interest rates in global credit markets, and invested over half a trillion dollars of other people's money in assets which, today, are worth next-to-nothing: failed ski hills in Montana, now empty suburban housing in California, and crazy bets on derivatives (options to buy or sell securities, in various complex combinations).

Worries about these failed investments sparked a run on the bank. And, after a mad weekend of trying to save Lehman, the U.S. "authorities" – meaning Henry Paulson (Secretary of the Treasury), Ben Bernanke (chairman of the Federal Reserve Board), and Timothy Geithner (President of the New York Fed) – decided to let it go bankrupt. Creditors, realizing no major bank is safe if our leaders might now let them fail, pulled cash from major financial institutions and bought relatively safe US Treasuries and UK Gilts.

Today Lehman's senior debt trades at a mere 10 cents on the dollar, suggesting its $600 billion in assets were a mirage. This outcome is even more startling when compared to senior debt at Kazakhstan's defaulting large banks, where management is now accused of serious malfeasance, yet that debt trades at 20 cents on the dollar – twice the price of Lehman's debt.

At the G20 meeting of finance ministers last week, political leaders united behind two key steps which they claim will "prevent another Lehman": tighter controls on the pay of executives and more capital for banks. France and Germany blame the crisis on lax regulation in Anglo-Saxon markets and excessive pay packets that encourage irresponsible risk taking. The British and Americans counter that European banks have too much debt (i.e., in the jargon, are "overly leveraged"), and need to raise more capital. The final communiqué proposes to do both, and we will hear more of the same at the upcoming G20 heads of government summit in Pittsburgh. But, in reality, both sides want only minor adjustments that cannot solve the real problems posed by our financial system.

Tim Geithner, now US Treasury Secretary, is pushing for higher capital requirements for banks, i.e., they need to have more shareholder funds to protect against future losses. But he surely knows that two weeks prior to its bankruptcy, Lehman's management reported they were well-capitalized, with a tier one capital ratio of 11% — roughly twice what the United States currently considers is needed for a well-capitalized bank, and much higher than the American side is proposing in private conversations.

Christine Lagarde, France's Finance Minister, and Angela Merkel, President of Germany, helped convince the G20 that bank compensation policies need to be amended to encourage long term incentives. They want compensation packages to be limited and bonuses to be locked up, so we can be sure employees' incentives are consistent with the long term survival of their banks.

President Merkel and Minister Lagarde need to look no further than Lehman for a model of how to introduce a good policy to align incentives. The top management and many employees in the company were largely compensated in shares of the company which vested over many years, so when Lehman Brothers went down, it brought crashing down the lives and finances of its 20,000 employees. Dick Fuld, the highly compensated head of Lehman, lost many million dollars – and presumably a large part of his total wealth. Apart from criminal penalties (of the kind not seen for banking in a century), can we think of a better way of aligning incentives with the outcomes for a bank?

The real problem with our financial system is that our economic and political system work together to encourage excessive risk, and this risk in turn leads to cycles of prosperity and collapse. In 1998, a much smaller Lehman Brothers was placed in financial peril by the aftermath of the Asian financial crisis and failure of Long Term Capital Management, a major hedge fund. The Federal Reserve responded by lowering interest rates and other central banks followed suit. This reduced the cost of obtaining funds, effectively bailing out Lehman and other institutions in trouble.

As markets have grown to recognize how quick the Federal Reserve is to bail out institutions (and executives) in trouble, they naturally respond. In the 1990s, people talked about the "Greenspan Put" a term which derisively suggests that it is always safe to invest in risky assets, because the Federal Reserve is ready to bail out investors (a put is effectively a promise to buy an asset at a fixed price if you are unable to sell it to someone else at a higher price – this is a way to lock-in profits or limit losses on investments). However, in months following the collapse of Lehman, we learned that the "Bernanke Put" is even more valuable since Chairman Bernanke, alongside the Bank of England, the European Central Bank, and central banks in much of the rest of the world, is prepared to take drastic measures to prevent asset prices from falling when there are risks of global collapse.

This policy of responding to the aftermath of bubbles, rather than addressing them before they get going, through tighter regulation, has become the mantra of most central banks. It is usually combined with fiscal policy stimulus and other measures to support the economy. Each time banks fail, by bailing the system out again, we teach our finance sector a lesson: you can safely take too much risk because, when you lose, the taxpayer will pick up the bill. We also send a simple message to creditors: it is safe to lend to Goldman Sachs, or Barclays Bank, because taxpayers and our nations' savers are standing by to cover your losses. Rational bank executives and creditors respond as any person would: creditors lend to banks at low interest rates, and our banks gamble heavily hoping to make large profits. Such a system is destined to fail, but the party can run for a long time.

While Ben Bernanke has done a wonderful job of preventing financial meltdown, his calls in 2002-2003 for very low interest rates, without fixing our financial system, contributed to the credit expansion that led us into the current mess. In the United Kingdom, the Conservatives plan to transfer regulatory powers to the Bank of England, despite the fact that, like the Federal Reserve, the Bank of England has been a key component of our ever growing cycles of credit expansion and bust.

The "collapse or rescue" decision forced by Lehman's failure is a symptom of a much larger systemic problem. We need leaders, both in the financial world and in public service who recognize that our financial sector too often causes social harm. There is no doubt that it also provides valuable services that are vital to the well-being of our pensioners and savers, and help manage and mitigate risk for our corporations. Yet too often these activities cause losses, which, either directly or indirectly, become a burden on the rest of society.

The pre-crisis activities and portfolios of Barclays, Goldman Sachs, and other "survivors" of this crisis were only slightly different from Lehman Brothers or Bear Stearns, which failed. The "good" banks also securitized subprime assets, helped build the intricate web of IOUs between banks and insurance companies, and leveraged their balance sheets to enormous levels. The winners were not better, they were just smart enough to make sure someone else held the bad assets when the music stopped, and they were powerful enough to win generous bailout packages from their governments.

The danger we face is that, by bailing out these institutions and rewarding failed managers with new powerful positions, we have now created a much more dangerous financial system. The politically well-connected, knowing they will most likely do fine in the next crisis, is now highly incentivized to take even greater risk.

Once we admit this profound problem in our system, we can begin to think of the radical measures needed to solve it. There is no doubt these solutions will include much greater capital requirements, so that bank shareholders know that they face substantial losses if their ventures fail.

But, we also need to ensure that our regulators are not captured by the banks that they are meant to oversee. This means we need to put checks on financial donations to political parties, and we need to buttress our regulators with more intellectual firepower and financial resources, along with rules that ensure independence, in order to be sure they can act in the interests of the broader population.

We also need to close the revolving door, through which politicians and regulators leave office to earn their nest eggs in finance, and "financial experts" move directly from failing banks to designing bailout packages. The conflicts of interest are abundant and most dangerous.

Last week the UK's chief financial regulator, Adair Turner, faced heavy criticism from the City, Chancellor Darling, Boris Johnson, and editorials in the Financial Times and Wall Street Journal. His main offense was daring to raise the issue of whether parts of our financial system have become socially dysfunctional, in an interview with Prospect Magazine. He called for greater capital requirements at banks, and he pondered how it would be possible for regulators to preserve the valuable parts of our financial system, while ensuring that regulation limited the harmful parts. These are eminently sensible questions which anyone with a public spirit should understand are critical policy issues today.

Sadly, these public rebukes to Lord Turner are a further indication that very few of our leaders are prepared to even discuss the real problem, let alone seek a sufficient solution. Smart people and well-organized governments can, as in the past, behave like donkeys.

By Peter Boone and Simon Johnson

An edited and shorter version of this post appeared today in the Sunday Times (of London).

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138 RESPONSES TO "ECONOMIC DONKEYS"

Gregg Hill | September 13, 2009 at 8:11 am |

A small quibble, but Angela Merkel is not President of Germany but Chancellor (Prime Minister, head of government). The President of Germany is head of state and largely a ceremonial post.

Bond Girl | September 13, 2009 at 8:26 am |

This is an excellent post.

I think it is somewhat dangerous just to say that banks need "greater" capital requirements, as opposed to say, capital requirements that "actually reflect what they are holding."

It is not just that parts of our financial system have become socially dysfunctional. It is also our government. Although I'm not sure where one ends and the other begins.

andrew clayton | September 13, 2009 at 8:28 am |

It´s about "doing the right thing". It seems like we have forgotten what this is or what this means.

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