

The doomsday cycle

Simon Johnson, Peter Boone 22 February 2010

Over the last 30 years, the US financial system has grown to proportions threatening the global economic order. This column suggests a 'doomsday cycle' has infiltrated the economic system and could lead to disaster after the next financial crisis. It says the best route to creating a safer system is to have very large and robust capital requirements, which are legislated and difficult to circumvent or revise.



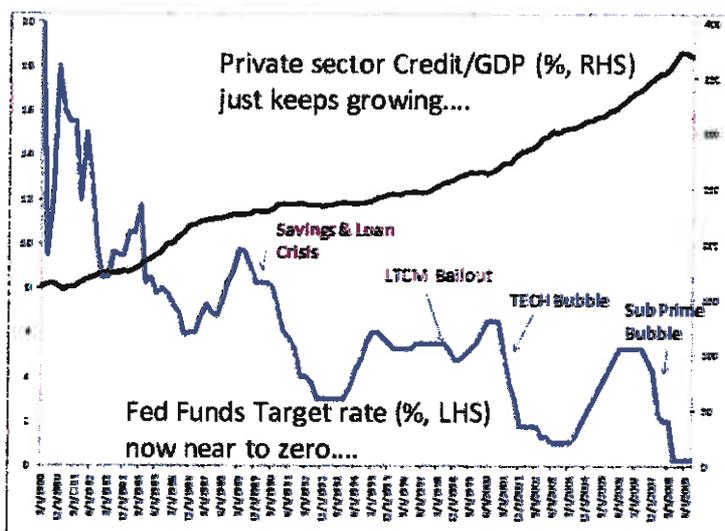
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Over the last three decades, the US financial system has tripled in size, as measured by total credit relative to GDP (see Figure 1). Each time the system runs into problems, the Federal Reserve quickly lowers interest rates to revive it. These crises appear to be getting worse and worse – and their impact is increasingly global. Not only are interest rates near zero around the world, but many countries are on fiscal trajectories that require major changes to avoid eventual financial collapse.

Figure 1.



Source: Bloomberg, Department of Commerce USA

What will happen when the next shock hits? We believe we may be nearing the stage where the answer will be – just as it was in the Great Depression – a calamitous global collapse. The root problem is that we have let a 'doomsday cycle' infiltrate our economic system (see Figure 2 and Haldane and Alessandri 2009).

Figure 2.



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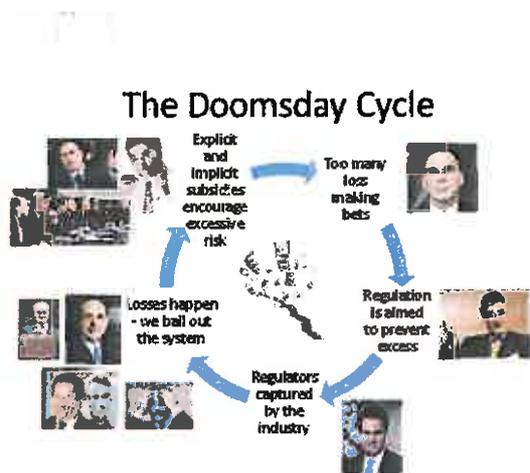
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The doomsday cycle has several simple stages. At the start, creditors and depositors provide banks with cheap funding in the expectation that if things go very wrong, our central banks and fiscal authorities will bail them out. Banks such as Lehman Brothers – and many others in this past cycle – use the funds to take large risks, with the aim of providing dividends and bonuses to shareholders and management.

Through direct subsidies (such as deposit insurance) and indirect support (such as central bank bailouts), we encourage our banking system to ignore large, socially harmful 'tail risks' – those risks where there is a small chance of calamitous collapse. As far as banks are concerned, they can walk away and let the state clean it up. Some bankers and policymakers even do well during the collapse that they helped to create.

Regulators are supposed to prevent this dangerous risk taking. Adair Turner, chairman of the Financial Services Authority, is calling for more radical change than most regulators. But banks wield substantial political and financial power, and the system has become remarkably complex, so eventually regulators become compromised.

The extent of regulatory failure ahead of the current crisis was mind boggling. Many banks, including Northern Rock, convinced regulators that they could hold just 2% of capital against large and risky asset portfolios. The whole banking system built up many trillions of dollars in exposures to derivatives. This meant that when one large bank failed, it could bring down the whole system.

Given the inability of our political and social systems to handle the hardship that would follow economic collapse, we rely on our central banks to cut interest rates and direct credits to bail out the loss-makers. While the faces tend to change, each central bank and government operates similarly. This time, it was Mervyn King, Gordon Brown, Tim Geithner and Ben Bernanke who oversaw policy as the bubble was inflating – and are now designing our rescue.

When the bailout is done, we start all over again. This has been the pattern in many developed countries since the mid-1970s – a date that coincides with significant macroeconomic and regulatory change, including the end of the Bretton Woods fixed exchange rate systems, reduced capital controls in rich countries and the beginning of 20 years of regulatory easing.

The real danger is that as this cycle continues, the scale of the problem is getting bigger. If each cycle requires greater and greater public intervention, we will surely eventually collapse.

Stopping the doomsday cycle

To stop the doomsday cycle, we need far greater reform than is currently under discussion. The headline-grabbing actions of Gordon Brown and Alistair Darling, calling for financial transactions taxes and a one-year super tax on bonuses, have no impact on the fundamental problems in our system. Indeed, they are potentially harmful to the extent that they mislead taxpayers who want real solutions.

We need quite different and much more focused policies. These policies must be implemented across the G20, with international coordination and monitoring. Otherwise, financial services will move to the least regulated parts of the world, and it will be much more difficult for each country to maintain a tough stance.

Tackling regulatory failure

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That has been the path of successive Basel committees, which are now designing comprehensive new rules to ensure greater liquidity at banks and to close past loopholes that permitted banks to reduce their core capital. We both worked for many years in formerly communist countries, and this project reminds us of central planners' attempts to rescue their systems with additional regulations until it became all too apparent that collapse was imminent.

In our view, the long-term failure of regulation to check financial collapses reflects deep political difficulties in creating regulation. The banks have the money, they have the best lawyers and they have the funds to finance the political system. Politicians rarely want strong regulators – except after a major collapse. So politics rarely favours regulation.

There are also big operational problems. How should regulators decide the risk capital that should be allocated to new and arcane derivatives, which banks claim will reduce risk? When faced with rooms full of papers describing new instruments, and their risk assessments, regulators will always be at a disadvantage compared with banks.

The operational difficulties are further complicated by the intellectual undercurrents: when the economy is booming driven by more leveraged bets, there is a tendency for the academic world to provide theories that justify status quo policies. This is clear from the growth of efficient markets theories, which infiltrated regulators' decision-making during the boom ahead of this crisis.

No wonder that Tim Geithner, while president of the Federal Reserve Bank of New York, or Alan Greenspan and Ben Bernanke, as Fed chairman, did little to arrest the rapid growth of derivatives and off-balance sheet assets.

It requires a strong leap of faith to believe that our regulatory system will never again be captured or corrupted. The fact that it has spectacularly failed to limit costly risk should be no surprise. In our view, the new regulations discussed in Basel 3 will fail, just as Basel 1 and Basel 2 have failed.

The proposals sound smart because they are correcting egregious errors of the past. But new errors will surface over the next five to ten years, and these will be precisely where loopholes remain, and where the system gradually becomes corrupted, again.

We believe that the best route to creating a safer system is to have very large and robust capital requirements, which are legislated and difficult to circumvent or revise. If we triple core capital at major banks to 15-25% of assets, and err on the side of requiring too much capital for derivatives and other complicated financial structures, we will create a much safer system with less scope for "gaming" the rules.

Once shareholders have a serious amount of funds at risk, relative to the winnings they would make from gambling, they will be less likely to gamble. This will make the job of regulators far easier, and make it more likely our current regulatory system could work.

Changing incentives

Second, we need to make the individuals who are part of any failed system expect large losses when their gambles fail and public money is required to bail out the system. While many executives at bailed-out institutions lost large amounts of money, they remain very wealthy.

Some people have clearly become winners from the crisis. Alistair Darling supported the appointment of Win Bischoff, a top executive at Citigroup in the run-up to its spectacular failure, to be chairman of Lloyds. Vikram Pandit sold his hedge fund to Citigroup, who then wrote off most of the cost as a loss, but Pandit was soon named their CEO.

Jamie Dimon and Lloyd Blankfein, CEOs at JP Morgan and Goldman Sachs respectively, are outright winners from this process, despite the fact that each of their banks also received federal bailouts. Goldman Sachs was lucky to gain access to the Fed's "discount window", so averting potential collapse.

We must stop sending the message to our bankers that they can win on the rise and also survive the downside. This requires legislation that recoups past earnings and bonuses from employees of banks that require bailouts.

The role of policymakers

Third, we need our leading fiscal and monetary policymakers to admit their role in generating this doomsday cycle through successive bailouts. They need to develop solutions so that their institutions can credibly stop this cycle. The problem is simple: most financial institutions today have now proven we big do fail as our policy makers have bailed them out. The rules need to change so that creditors do not expect another bailout when the next crisis happens.

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There is some encouraging progress with plans for "living wills" and measures to reduce the interdependency of financial institutions. But the litmus test for this will be when our leading policymakers start calling for the break-up of large financial institutions and permanent crude limits on their size relative to the economy in the future.

Smaller institutions are naturally easier to let fail, and this will make creditors nervous when lending to them, so we can have more confidence that creditors will not lend to highly risky small institutions. There are feasible ways of doing this. For example, we could impose rising capital requirements on large institutions over the next five years, thus encouraging them to develop orderly plans to break up and shrink their banks.

Prospects for effective reform

So where are we going with our current reforms? It is now obvious that risk taking at banks will soon be larger than ever. Central banks and governments around the world have proved (once again) that they are willing to bailout banks at enormous public cost when things go wrong. Markets are now again providing very cheap loans to banks, with the comfort that the state will bail them out.

Today, Bank of America and the Royal Bank of Scotland are each priced to have just 0.5% annual risk of default above their sovereigns during the next five years in credit markets. This is a remarkably low implied risk considering that both banks were near to collapse just a few months ago. Creditors are clearly very confident that they will be bailed out again if necessary. Indeed, they are more comfortable lending to large risky banks than to many successful corporations.

There is no doubt that the regulatory environment is going to be tougher for the next few years. But nothing has changed to make us believe the regulatory system will succeed this time, when it has failed so enormously – and repeatedly – in the recent past. To bring about the dramatic change that is needed also requires international cooperation and consistency. We doubt such change is truly on the table as so few policy-makers seem to demand it.

Many of our current policymakers – Ben Bernanke, Mervyn King, Alistair Darling and Gordon Brown – are the same ones that inflated the last bubble. So we know with great confidence that they are the types that will bail us out each time things go wrong. They are all currently on course for seeding our next rise and collapse. Cheap rates and credit, with large moral hazard, are the initial stages of each cycle. Very few of these people, apart from Mervyn King, appear prepared to recognise their past role in creating our current problems and then to discuss resolutely how to change it.

The danger this system poses is clear, as Figure 1 shows. With our financial system now well oiled to take on very large risk once again, and to gamble excessively, can we be sure that we can continue this cycle of bailing out eventual failures? At what point will the costs be so large that both fiscal and monetary policies are simply incapable of stopping the collapse?

Last year, we came remarkably close to collapse. Next time, it may be worse. The threat of the doomsday cycle remains strong and growing.

Editor's note: This first appeared in CEP's magazine, Centre Piece, <http://cep.ise.ac.uk/centrepiece/>. Reproduced with permission.

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Gentlemen,

Thank you for your article. It's important to keep the conversation about the "Doomsday Cycle" in the forefront of the cultural conversation to motivate meaningful action. While the idea of imposing capital requirements on the "too big to fail" institutions sounds like a viable solution to the problem of overleveraging, it does not address the concerns that emerge where the lending institutions have the wherewithal to seek modifications of financial accounting standards that enable them to massively overstate the value of assets on their books for the purpose of meeting capital requirements. But for the elimination of the "Mark to Market Rule," many of the "too big to fail" institutions would not be able to meet even the minimal capitalization requirements presently imposed on them. How do we make the Financial Accounting Standards Board invulnerable to the manipulations of these giant financial services institutions?

Very truly,
Jeff Prose
Pacific-McGeorge School of Law

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