Simon Johnson[1]
Massachusetts Institute of Technology

I will lay out my view of the problem as it relates to the United States, the approach to a solution, and the risks posed by a failure to make real reforms.

The Problem

1. The underlying fiscal problems of the United States have significantly worsened as a direct result of the manner in which the financial crisis of 2008–09 was handled.

2. The U.S. economic system has developed relatively efficient ways of handling the insolvency of nonfinancial firms and small or medium-sized financial institutions. A large number of these institutions have failed so far this year without causing major disruption to the economy.

3. The United States does not yet have a similarly effective way to deal with the insolvency of large financial institutions. The dire implications of this gap in our system have become much clearer since fall 2008 and there is no immediate prospect that the underlying problems will be addressed by the regulatory reform proposals currently on the table. In fact, the banking system's underlying problems are likely to become much worse.

4. The executives who run large banks are aware that the insolvency of any single big bank, in isolation, could potentially be handled by the government through the same type of receivership process led by the Federal Deposit Insurance Corporation for regular banks. However, these executives also know that the failure (i.e., default on obligations) of more than one such bank could cause massive economic and social disruption across the United States and the global economy. The prospect of such disruption, they reason, would induce the government to provide various forms of bailout. They also invest considerable time and energy into impressing this point on government officials in a wide range of interactions.

5. Even more problematic is the underlying incentive to take excessive risk in the financial sector. Given the limitation on the downside provided by generous government

[1] This material draws on joint work with James Kwak (including "The Quiet Coup," *The Atlantic*, May 2009, and *13 Bankers* (New York: Pantheon, 2010) and with Peter Boone (including "The Next Financial Crisis: It's Coming and We Just Made It Worse," *The New Republic*, September 8, 2009). A version of this document at BaselineScenario.com provides links to supplementary material.

guarantees of various kinds, the head of financial stability at the Bank of England has bluntly characterized our repeated boom-bailout-bust cycle as a “doom loop.” The implication is repeated bailouts and recovery programs led by fiscal stimulus.

6. The implementation of the Troubled Asset Relief Program (TARP) exacerbated the perception (and the reality) that some financial institutions are “too big to fail.” Being too big to fail lowers their funding costs, enabling them to borrow more and to take more risk. The consequences include a contingent fiscal liability—both for specific bank rescue measures and, on a larger scale, the fiscal stimulus needed to offset a potential future credit crisis.

7. U.S. national debt will increase substantially as a result of direct bank bailouts and, more important, the discretionary fiscal stimulus needed to keep the economy from declining—as well as the standard deficit due to cyclical slowdown (a feature of the automatic fiscal stabilizers). Privately held government debt as a percentage of GDP will increase from around 40 percent to the 70–80 percent range.

8. Any country that provided unlimited government support for its financial system—while not implementing orderly bankruptcy-type procedures for insolvent large institutions and refusing to take on serious governance reform and downsizing for major troubled banks—would be castigated by the United States and come under pressure from the IMF. Yet this is the approach that the U.S. has implemented.

9. At the heart of every crisis is a political problem—powerful people, and the firms they control, have gotten out of hand. Unless that problem is dealt with as part of the stabilization program, all the government has done is provide an unconditional bailout. That may be consistent with a short-term recovery, but it creates major problems for the sustainability of the recovery and for the medium-term. Again, this is the problem in the United States looking forward.

10. The Obama administration argues that its regulatory reforms will rein in the financial sector in this regard. Very few outside observers—other than those at the largest banks—find this convincing.

Toward a Solution

1. As legislation on restructuring the banking industry moves forward, attention on Capitol Hill is increasingly drawn to the issue of bank size. Should our biggest banks be made smaller?

2. There is a strong precedent for capping the size of an individual bank: the United States already has a long-standing rule that no bank can have more than 10 percent of total national retail deposits. This limitation is not for antitrust reasons, as 10 percent is too low to have pricing power. Rather, its origins lie in early worries about what is now called “macroprudential regulation” or, more bluntly, “don’t put too many eggs in one basket.”

3. This cap was set at an arbitrary level—as part of the deal that relaxed most of the rules on interstate banking—and it worked well (until Bank of America received a waiver).

4. Probably the best way forward is to set a hard cap on bank liabilities as a percentage of GDP; this is the appropriate scale for thinking about potential bank failures and the cost they can impose on the economy. Of course, there are technical details to work out—including how the new risk-adjustment rules will be enacted and the precise way that derivatives positions will be calculated in measuring size. But such a hard cap would the benchmark around which all the specifics can be worked out.

5. What is the right cap on the size of a bank's liabilities: 1 percent, 2 percent, 5 percent of GDP? No one can say for sure, but it needs to be a number so small that we all agree that any politician who cares about our future would have no misgivings about the failure of a bank at that size limit and would be confident that if it did fail, our entire financial system would not be at risk.

6. A hard cap at 4 percent of GDP seems about right for a bank with the most conservative possible portfolio. This would mean that no bank in our country would have more than about $500 billion of liabilities, even with a relatively low risk portfolio. On a risk-adjusted basis, most investment banks would face a cap of around 2 percent of GDP.

7. A large American corporation would still be able to do all its transactions using several banks. They would even be better off—competition would ensure that the margins would be low and that the banks give the corporates a good deal. This would help end the situation in which banks take an ever-increasing share of profits from our successful nonfinancial corporations (as seen in the rising share of bank value-added in GDP in recent decades).

8. Indeed, the whole world would soon realize that our banks are more competitive and offer better pricing than others.

9. If, as might occur, the Europeans subsidized their big banks with cheap finance and implicit subsidies, the United States should let our nonfinancial corporates benefit and understand that our banks may become ever smaller. We can let Europeans subsidize banking because we all get better deals through their taxpayer subsidies, and then our corporates will have more profits to bring back to America.

10. Today our politicians and regulators lack credibility. They have bailed out too many banks and need to show they have truly regained the upper hand—by installing such a hard size cap without exception.

11. The litmus test is simple. Does Goldman Sachs continue to grow and, because it has demonstrated it is too big to fail, continue to be regarded as almost as good a risk as the U.S. government? (Goldman's credit default swap spread is currently only about 70 basis points above that of the United States.) Or will the government impose a cap on the size of such institutions and require Goldman Sachs to find sensible ways to break itself into pieces—becoming small enough so that it will not be bailed out again next time?

In the Absence of Real Reform

1. In the absence of real reform, progress toward reducing the risks inherent in the U.S. financial system is unlikely. As long as there are financial institutions that are too big to fail, we face a potential fiscal cost. We should recognize that cost in our government budget and balance sheet accounting.

2. The overriding principle behind IMF fiscal assessments is the need to capture true total fiscal costs. Best practice for the United States needs to reflect this approach.

3. All subsidies and taxation—including the entire cost of supporting the continued existence of large banks—should be reflected transparently in the budget and subjected to the prioritization of the budgetary process.

4. Our current accounting for guarantees and government assumption of other contingent liabilities creates the impression that government actions to support the banking system are costless. This is a dangerous illusion—as seen in the recent increase in the U.S. federal government deficit and debt.

5. If we don't recognize these costs explicitly, we run the risk of taking on an ever greater contingent liability. If the financial system reaches the point at which its failure cannot be offset by fiscal (and monetary) stimulus, then a Second Great Depression threatens.