The Deepening Banking Crisis

Simon Johnson, noting that the banking crisis has deepened, proposes a government rescue to inject capital, acquire "toxic" assets, and return the system to full private sector ownership.

Steve Weisman: Welcome to Peterson Perspectives. This is Steve Weisman at the Peterson Institute for International Economics. Our guest today is Simon Johnson, a senior fellow at the Institute. Simon has been studying and writing about the stability of the American and global financial system and banks.

Today the *Wall Street Journa*l reports that most of the big banks that have received assistance under the Troubled Asset Relief Program or TARP have actually decreased their lending. Is that what you're finding?

Simon Johnson: Sure. I don't know if that's the heart of the problem. There is a so-called global deleveraging going on. Banks are cutting back on their credit everywhere, and some of that is sensible. There's a lot of wacky loans that were out there.

Steve Weisman: Right. Is this a good or bad thing that the banks are cautious about lending?

Simon Johnson: It's hard to say at that level of generality. For example, remember the G-20 has been emphasizing—continues to emphasize—the need to regulate more tightly, and for banks to be more careful with their lending. Well, one result of that is going to be they'll cut back on loans to both people who are dubious and people who are credit worthy. I think in the popular discussion, we go back and forth between those two things. We'd like the banks to lend to people who have business plans, who have sensible and reasonably stable businesses. Small business, in particular, I would be inclined to believe, is losing access to credit as result of these events. But we want the banks also to be more careful and not to make the kinds of highly speculative loans made either in the real estate sector or some of these financial transactions.

Steve Weisman: Even in the last month or two, the health of the banks is being revealed as more precarious. What are the dimensions of the problem in the United States and Europe and globally?

Simon Johnson: Well, I think, the heart of the matter, Steve, is that the banks are not yet telling the truth. If you were to mark their books at market now, take away all the pretense and the forbearance that they're actually using, they would be insolvent. They would have less capital and have negative capital. They'd have liabilities in excess of their assets; that's the first part. The second part of the problem is that the world economy still keeps going down. I think they would be insolvent at current marks. But as the world economy worsens, they're going to lose more money and assets are going to be worth less, and so they get deeper and deeper into that capital hole. And of course, compounding all the problems is we just don't know who has what kind of losses and what securities. The degree of uncertainty has if anything gone up not down since mid October, I would say.

Steve Weisman: This means, doesn't it, that the governments are going to have to fill the breach in supplying more capital to the banking system.

Simon Johnson: That's right. I mean, who else is there? There are private investors out there, private equity for example, but they won't come in until they feel that the situation is stabilized both in terms of the banks narrowly defined but also the broader macro economy. So, it's the government or no one. We're waiting basically for the government to get its act together and, I think, for the people in the Obama administration to make the case and persuade people in creating new consensus on the need for a really massive government action in this place.

Steve Weisman: We've heard a lot about the $800 billion stimulus program from the Obama administration, which I believe you think is a necessary step. But let's talk about what they plan to do for the banking system. We haven't heard very much about that, have we?

Simon Johnson: No. We've heard hardly anything. There were some hints what Larry Summers said on television, that Steve WeismanSimon Johnsonmore details will be forthcoming. But at the moment, we don't really have a clear signal on what they plan to do and the kind of scale they want to do it at. I think it'll be big. I hope it'll be comprehensive and decisive but I can't yet say that for sure. I do know that on Capitol Hill, the administration hasn't yet had an opportunity or hasn't yet chosen to spend a lot of time really trying to set the terms of the debate and explain to people what needs to be done and why and how much money is going to be involved.

Steve Weisman: There was some sticker shock on the Hill regarding the stimulus program. I think Congressman Boehner's words were "Oh, my God." What kind of sticker shock is there going to be for this element of the recovery program?

Simon Johnson: I think you could divide it into two parts: working capital the government needs to raise in order to run this operation, and then how much they'll likely lose on the whole deal. So, I would say, in order to recapitalize the banks properly and to clean up their balance sheets properly, we're talking about between $3 trillion and $4 trillion, which is quite a lot of money. The amount that you would lose on that if you do it properly is much less. But I think you should budget conservatively to lose between $1 trillion and $2 trillion.

Steve Weisman: Over how many years?

Simon Johnson: Well, this would be the total cost in cleaning up the banking system. The banking system cleanup is going to take two to three years. So the bottom line is how much you're going to add to the government's debt. The US government debt is currently around 41 percent of GDP. The kind of bank cleanup I'm talking about will add between 10 percent and 20 percent of GDP. That's okay, but keep in mind that we're also doing a fiscal stimulus and we're going into a deep recession from a not very strong budget position to start with. So, I think we're looking at ending up this entire process if we're lucky with debt to GDP between 70 percent and 80 percent. If we're not lucky, it will go over 80 percent.

Steve Weisman: How unhealthy is that?

Simon Johnson: Well, that's obviously the very big question…the 10-trillion-dollar question, I would say. It's roughly the amounts we're talking about. It's manageable. It does mean you need to get a grip on Social Security, and Medicare and Medicaid quicker than you might otherwise. That's where the United States has a really big medium-term or long-term problem in the budget already and net present value terms is terrible in the United States because we haven't yet dealt with those retirement programs.

Steve Weisman: Which, just to explain, add trillions of dollars in deficit spending projected over the next several decades.

Simon Johnson: That's right. Just based on the demographics and based on the level of the pensions that people have been more or less promised, and what's happened to healthcare costs, of course. Now, the question of whether 80 percent, let's say, of GDP is a problem, you can't answer that question without knowing what growth and interest rates are going to be like. So it's not a super complicated balance. But if you have debt to 80 percent of GDP and growth is high and real interest rates are low, then you'll be able to reduce that debt without necessarily having to run a very austere budget. If interest rates are high and growth is low, then you're in trouble even at 80 percent.

Steve Weisman: When you're borrowing that amount of money, don't you drive up the interest rates that you have to pay on that debt?

Simon Johnson: Probably, to some degree. But remember that as long as the United States retains its triple A credit rating, there's a big demand for US debt. And it is still seen as the ultimate safe haven around the world. There's a big liquid market for US Treasury securities and there's not much else that people really trust as a safe bet. Even the euro and many euro-denominated government bonds are called into question at the moment because there are serious problems within the eurozone.

Steve Weisman: Simon, we're still talking about how many trillions of dollars that will have to be injected into the banking system over the next two to four years, you think?

Simon Johnson: Yes. You use some of that money to recapitalize the banks, so that's the injection idea. And you use some of the money to buy the toxic troubled assets from them at market prices. There's a lot of those assets out there. So the $3 trillion to $4 trillion is the amount of money needed to fund this operation. Some of which will come out of the budget, some of which you could borrow, for example, from the Fed. The question that the Congressional Budget Office will look at is how much the final impact on the budget the debt is, and that's the lower number—$1 trillion to $2 trillion.

Steve Weisman: We're back to the idea, are we not, of buying toxic assets from banks? Is this going to be done through the TARP or some new vehicle?

Simon Johnson: I think they'll use a combination. The TARP will morph into something else. The scheme that we're discussing is not exactly or even substantially the same as the original Paulson-Bernanke scheme from September. That scheme was to buy these toxic assets at above market price. Remember that the premise was that the government knows better the price of these assets in the market. The market is liquidity-constrained for various reasons and therefore, the price is artificially low.

Now, no one really bought that idea, and they couldn't get it off the ground technically also. What we're talking about, though, is a scheme where you would systemically, on a much larger scale, recapitalize the entire banking system. You would also remove these toxic and problem assets from banks and you'd be very tough with them regarding loan loss provisions and mark-to-market in that context. We know that bank regulators can take over and close down the banks, relatively small banks or mid-sized banks. They haven't been able to do it for large politically powerful banks—and that needs to change.

Steve Weisman: But in the end, we will see a much smaller banking system in the United States, won't we?

Simon Johnson: Well, I'm not sure. If you mean smaller in credit to GDP, that's right. I think that would be lower. That's part of this deleveraging process that people talk about. There might be fewer banks. There might be some consolidation. We actually have a lot of banks in the United States. I think the big banks will actually be broken up. I think what will happen at the end of this process is the government will acquire control one way or another and the right to sell them to new owners, and they'll bring in private equity, and those guys will restructure them and that will involve breaking them up.

Steve Weisman: That brings me to nationalization. There's a lot of talk that this tremendous amount of activity including putting government back to capital into the banking system is effectively a quasi-nationalization. Terms like that can obscure as well as illuminate. How would you define the era that we're going into?

Simon Johnson: Well, I think it's important to point out that we don't want to nationalize. Nationalize is when the government takes over things and runs them. We don't want state ownership of banks. It would lead to a big mess for many reasons in the United States. And I think it will be messy in other countries where they do that. You need the government to get in to do the recapitalization, do the cleanup and then get out; and the question is, how to get out? Well, you have to structure it in such a way that the government doesn't have the incentive to dig in and get stuck owning the banks, and that can be done. It's a technical issue.

Steve Weisman: How many years will that take?

Simon Johnson: The whole in-and-out process, if you do it properly, I would guess is a two- to three-year process. I think that the Obama administration should aim to be exiting from this as they approach the next election.

Steve Weisman: Politically, I'm sure you're right.

Simon Johnson: And economically. Also, you can try and do a quicker claim, you do it quicker but it's really a hard slog. We're in a deep hole here and it's going to take a long time to dig ourselves out of it.

Steve Weisman: Well, thank you, Simon for your latest thoughts on the banking crisis and the global economic crisis. We'll see you soon on Peterson Perspectives.

Simon Johnson: My pleasure. Thanks very much.