



## Lingering Perils of Bank Insolvency

*Simon Johnson argues that despite some signs of stability in the financial system, US economic recovery is likely to be anemic without more aggressive bank reforms.*

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Our guest, Simon Johnson, senior fellow at the Peterson Institute and also a professor at the MIT Sloan School of Management, has been testifying a lot lately on the current state of the financial rescue by the Obama administration. Thank you for letting us catch up, Simon.

Simon Johnson: Anytime, Steve.

Steve Weisman: What's your opinion of the how the stress tests and the public-private partnership approach to banks are faring? You expressed skepticism at the outset when the plans were announced. Now there's a lot of talk that the financial system has stabilized. Do you think the two are connected?

Simon Johnson: I think the stress tests were used to buy time. I think the government strategy is very much one of forbearance: Allow the economy to begin to turn around, and of course the fiscal stimulus enacted in February is part of that turnaround. There's a general restoration of confidence in financial markets that helps them.

In that context, the stress tests allowed them to delay any kind of decision about the banking system until the situation was getting somewhat more positive. But there was unanimity today at a subcommittee of the science and technology committee among all the witnesses and the committee members who spoke that the stress tests were not really particularly indicative of how the bank system would do under stress. In other words, the stress tests didn't do what they're supposed to do. People still felt it was sort of OK, that muddling through may work. We're in this funny, a little bit tense, odd situation where people think the stress tests came out OK, but they don't feel great about how we're going to recover from this situation.

Steve Weisman: Remind me why you think the stress tests don't really test the banks under greater stress than they are under now.

Simon Johnson: At this morning's hearing, I think the most articulate person on this point was Dean Baker, who went through in some detail what the parameters of the stress tests are compared to what you would expect them to be. And his favorite example was credit cards: Look at the amount of credit card losses that are

projected in the stress tests compared to the loss we've already seen. We're almost at the stress level and we're just having a regular recession now.

According to the government, we're going to be coming back out of it. A stress scenario is supposed to look at worse outcomes than your baseline projection, and the government stress scenario is much more positive, say, than the IMF stress or downside scenario. So the stress scenario is too optimistic, too positive.

Steve Weisman: What was the stress scenario on unemployment? Wasn't it greater than 10 percent?

Simon Johnson: A little bit above 10 percent. But again, you can see unemployment rising more. I think the key is the credit losses. How much will unemployment spill over into credit card losses, commercial real estate losses? And of course, residential mortgages would be a big, big part of the problem.

The idea of the stress tests is a good one, Steve. But you're supposed to stress the system, see how much stress it can handle. If you don't do that, it's like going to the doctor and saying, "I'd like to have my heart checked." He'd say, "Great, get on the treadmill, but sit in this nice comfortable chair while you're on the treadmill and we'll see how your heart does." It's not really a stress test.

Steve Weisman: You mentioned in your testimony that the government strategy was not one of stress tests, but of forbearance. Explain what you mean by that.

Simon Johnson: Well, forbearance is what the United States did in the early 1980s, after the Latin American debt crisis. We say, "Well, OK, probably our banks have got an issue on their balance sheet. We'll provide them with enough credit, big Fed lines of credit right now in the United States, and FDIC guarantees on the debt they get in the United States right now. So they'll be able to raise money, they'll be able to keep this all going on a cash basis, and we'll just turn a blind eye to the issue of whether or not they're insolvent on their balance sheet, whether their assets are worth less than their liabilities."

Now, it's not a crazy strategy. It can work. Today's situation is much harder than the early 1980s, because this is a securitized world, it's not a world of hold loans, which you hold on your books more or less to maturity, and the securitized loans are taking a big beating. And the world is a much tougher place than the early 1980s, the world is not booming right now. But it might work. It's just very risky and I think it's an unnecessary risk at this point.

Steve Weisman: If it doesn't work, your judgment is that the cost to the taxpayer, to the system, will be greater than biting the bullet now?

Simon Johnson: Yes. You'll get a slow recovery. You'll be tempted to do more fiscal stimulus, and that of course is debt that is ultimately paid off by the population. And you may have to do more bailouts. The experience from the Savings and Loans crisis in

the late 1980s was that forbearance, also applied then, did not turn out very well, and the losses actually went up. And the FDIC did a retrospective assessment of the S&Ls. And it said basically, whatever you do, let's not follow this forbearance strategy again. Well, that is what we're doing.

Steve Weisman: If this stress test strategy is so problematic, why have the markets responded somewhat positively?

Simon Johnson: I think the point is that the government has demonstrated through the stress tests and through other measures that it's going to support the banks through whatever means. In fact, this has even been featured on *Saturday Night Live*, the fact that the banks are too big to fail and they will be bailed out and supported and rolled over. And I think, in the short term, the market feels somewhat reassured by that. But that doesn't mean that you're going to get growth; it doesn't mean you're going to get a strong recovery. It just means they feel that there's going to be a lot of government support so taxpayers are paying out to help the shareholders of banks. So it's good to be a shareholder in the banks, so bank prices, stock prices go up.

Steve Weisman: You're the author I think of the phrase, "an L-shaped recovery." What's your latest feeling about that holding up?

Simon Johnson: Well, I got the idea of the L shape from a friend of mine who helps run a big central bank. He was calling it the bathtub-shaped recession. I thought a bathtub had a lot of L-type characteristics, L was a little simpler, and it was a pushback against the view that there's going to be a V-shaped or a sharp recovery.

Right now, Steve, as you know, the data are quite mixed. The latest retail sales are not encouraging. Clearly, there's a lot of job losses still under way and many people, including in the *Wall Street Journal* today, and this committee meeting today also, were very worried about commercial real estate.

And the global economy is going bad. Don't forget that Europeans have really not gotten their hands around the size of the problems in their banking system. A lot of people say they should do the same sort of stress tests or maybe better stress tests than the United States. The Europeans are basically still in denial about this. So it all adds up to a pretty tough global picture; hard to see the world economy bouncing back very fast from this situation.

Steve Weisman: By the way, speaking of the Europeans, you blogged earlier this week about the Germans. The German finance minister is saying the stress tests were, I forget his words...

Simon Johnson: Worthless.

Steve Weisman: Worthless. But you found that an ironic comment in light of the European performance.

Simon Johnson: Well, this was a comment made by Peer Steinbrück, the German finance minister, who tends to be ironic at many levels when he speaks.

Steve Weisman: Intentionally?

Simon Johnson: I don't know. We should get him in here and ask him. One level of course is that the Europeans have not done a good job looking at various stress tests of their own banks. The second point is of course, at least on the face of it, these were not standard genuine stress tests in the United States. So they didn't have the kind of value you'd expect to get from that.

They did, I think, have value. They weren't worthless. They did tell you what the government was going to do, which is follow a strategy of forbearance. It's going to roll over the banks. It's going to evergreen them, allow them to become zombies, if that's where this is headed, or let them earn their way back to decent capital levels, a slightly more positive way of saying the same thing.

So I think that they weren't worthless. They were informative. They were not genuine stress tests, and we haven't unfortunately recapitalized our banks to anything like the level that you would like under these circumstances.

Steve Weisman: But they did set a target for recapitalizing some of the banks. And aren't they going to do that, and isn't that a healthy development?

Simon Johnson: They set a low target for recapitalizing most banks and it does seem like some of the biggest banks were allowed to negotiate their way down to a much lower number. Yes, it's a step in the right direction. It's much better than the European situation, where they're denying they need any substantial new capital. But I think the US measure was partial, incomplete, and ultimately will turn out to be frustrating.

Steve Weisman: What is your sense of the outlook for the global economy and particularly the poorer countries of the world?

Simon Johnson: I think a lot of the poorer countries are getting hammered. It's a big global traffic accident, and they've gotten caught up in it through no particular fault of their own, although perhaps they could have been more cautious. But they were doing as they were supposed to do. They were following the advice of the IMF and the views of the G-7, expressed directly and through the IMF.

For many of those countries and for some of the poorest people in those countries, this is a very sad outcome. And we're talking about millions of people falling off the ladder, this very precarious ladder to prosperity that they got on, even quite recently. And you don't know when they're going to get those opportunities again, so they've been sideswiped pretty badly.

There are some more resources coming from the IMF, which will help in some circumstances. But honestly, the way the overall structure of the global system

operates, and the way that the IMF is able to put money into these kinds of situations, it's at the margin and in some of the most difficult cases it will prevent collapse hopefully. But it won't do that much to help people from falling back into poverty. It's quite tragic what we and what Wall Street have done to the world.

Steve Weisman: Let me come back to the stress test and also the toxic asset question. You said a second ago that, well, this might work. When will we know definitively that it's not working, if that's how it turns out?

Simon Johnson: Mike Mussa, back when we had our debate about whether we will see a V- or an L-shaped recovery, said it will take about a year before we know how the recovery is going. I think that's right. I think it's probably about the same amount of time for the banks. It doesn't become clear right away.

Probably we go through the next round of losses, we'll see where unemployment peaks, we'll see how that feeds over into credit, and losses of various kinds. We'll look at the ability of the banks to earn their way out of it. I think it's going to be a long, hard slug, personally. We will recover, of course, but it's going to take longer than you might hope, it'll be slower than you might expect, given the usual way the US economy responds.

Steve Weisman: It is possible that the banks will earn their way out of it, if only because their money is so cheap and they're charging reasonable rates for lending?

Simon Johnson: Yes, that's right. They're of course gouging, sorry, I mean raising prices, on people in credit cards, overdraft fees, and in various mortgage facilities, also because they feel political protection allows them to get away with charging prices to earn their way back. Remember, that hits consumers pretty hard. So on the one hand, we're hoping the consumption will lead the recovery; on the other hand, we're letting the banks choose their earnings. Now, they could be pursued by some regulatory agency maybe, but they have a lot of political protection because earning your way out has been endorsed at the highest levels, in the White House, for example.

Steve Weisman: So there's a philosophical contradiction that you see between the strategy that is telling the banks, "we want you to earn your way out," and also beating up on them for the way they're charging people exorbitant amounts on their credit cards?

Simon Johnson: I would put the contradiction this way, Steve. You're transferring more wealth and income from consumers to banks at a time when you're worried about consumption. You're worried about people not spending enough. That doesn't actually make a lot of sense. I mean it would have been much better to do an upfront recapitalization rather than less capital upfront, more gouging as a way to earn your way out.

And of course, there's going to be a big regulatory backlash. So the banks think they've won, because they got a pretty good deal. I think they haven't won at

all. I think if you look at the likely regulatory future, they're going back to the 1970s, 1960s, and 1950s in terms of what they're allowed to do, the kinds of compensation they can pay.

And they blew it. They blew the whole thing, in my view. We may throw a little bit of the baby out with the bath water, and it's because of the way the finance industry took risk, mismanaged risk, and then totally refused to come to terms with the problem, and tried to distort the political process in their direction. So we may lose sensible innovation, product improvement of various kinds.

We may go back too far, with more of a backlash on the regulatory side, because we didn't do enough upfront recapitalization of the banking system. We didn't get the incentives cleaned out. We didn't, by the way, fire many, if anyone. Hardly any executives who managed their banks into this cataclysm have been forced to exit from their positions, which is an astonishing breakdown of corporate governance, on top of the breakdowns of political governance and all the regulatory failures we've seen in the last few years.

Steve Weisman: Simon, thanks for bringing us up to date. However grim the prospects look to you, it's always great to hear your latest assessments.

Simon Johnson: The prospects are not grim, Steve. The prospects are always good in this country. It's America. We will bounce back. We will make a better system. It just is not going to be smooth and painless. It's not going to be a V, in my opinion. And we hopefully will do it with some different bankers than the ones who got us into this mess.

Steve Weisman: Thanks, Simon.

Simon Johnson: Thank you.

