Ahead of Pittsburgh, Little Progress on Financial Reform

Simon Johnson says the Obama administration is not doing much to fix the financial system, and the G-20 summit may do even less.

Steven R. Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Simon Johnson, senior fellow at the Institute, has been a prolific blogger and writer assessing the state of the economy and the state of the Obama administration's proposals for regulating the future of the financial system. Thanks for joining us on the eve of the Pittsburgh G-20 summit, Simon.

Simon Johnson: Nice to be with you.

Steven R. Weisman: Simon, let's begin by talking about the summit, which is a week or 10 days away. What is your hope and/or expectation for the G-20 in Pittsburgh when the leaders of the G-20 meet?

Simon Johnson: Well, Steve, honestly my expectation at this point is pretty low. I think you always know pretty much what's coming in this kind of meeting because there are all these technical meetings ahead of time—the deputy ministers and of course, the minister of finance and then it leads into the head of government. At least, as far as I can see, there's really nothing substantial on the agenda, for example, with regard to reregulating finance or addressing the underlying problems that brought us the calamity of the last year. I think that the G-20 is not going to even talk about the real substance, let alone adopt measures that will make any difference.

Steven R. Weisman: How impressed are you with the strength of this recovery, if you want to even call it that?

Simon Johnson: Yeah, I think I'll call it recovery. I think that the strength is actually not bad. Ben Bernanke said at Brookings on Tuesday [September 15, 2009] that the recession is very likely over, and I completely agree with that. It's actually not that uncommon after a financial crisis to have a quicker bounce back than you initially expect in the depth of the crisis—a point that Mike Mussa, our colleague, has been making very forcibly and I think persuasively.

The question is what happens next, right? Have you removed the underlying vulnerabilities? Have you fixed the problem? Or have you—and in my view, as you've created the situation, for example, through the way in which the banking system was handled, in which the vulnerabilities and the tendency towards future crises—actually exacerbated [the problem]?

Steven R. Weisman: Let's talk about global financial regulation. Morris Goldstein, our colleague here at the Institute, who has been devoting a lot of his study to the issue of regulation, has looked, as you have, at the Treasury proposal that was floated at the finance ministers' meeting in London. And that, as you have written in your blog, calls for strengthened capital requirements, leverage ratios, requirements on the quality of capital, and on liquidity of banks. You seem not impressed with these steps. Why not?

Simon Johnson: I think, Steve, when you're managing this kind of process, it's very important, not just the direction, where you're heading, but also the size of the measures. So if I say let's increase capital requirements, everyone is going to pretty much agree with that. But how much, right? And the administration won't tell you. But we have some pretty heavy hints from talking to people who are close to the conversation, and Morris follows this very closely, as you said, and there are other people who see parts of it.

We also see the reaction of the finance industry. And we see, for example, the finance industry is very opposed to the Obama proposal on the consumer financial protection agency, and they're fighting that very, very strongly on Capitol Hill. I'm actually on the side of the Obama administration on that one. But in terms of the capital requirement adjustments and these other technical measures you're talking about, big finance doesn't have any objection at all, which tells you, I think, that what the administration has in mind is a very small increase in capital requirements, I think a completely inadequate increase.

Steven R. Weisman: Another problem is that this has to be negotiated internationally. So not only do you have to discuss this or negotiate or brief the financial institutions affected in the United States, but you have to get agreement in Europe and elsewhere to avoid regulatory arbitrage on a global scale. Do you have any sense of who in the administration or internationally is pushing for the kind of thing you'd like to see?

Simon Johnson: I don't think anyone is pushing for it really. There'll be some—I'm sure—technical groups. There'll be some lip service to this. But in terms of big political initiative, you know, is President Obama [pushing]? I mean, it has to reach his level, right? This is a G-20 heads of government meeting. Is President Obama pushing for a big increase in capital requirements? The answer is no. He didn't say that when he spoke in the Federal Hall on Monday. That's not what the finance industry is hearing, and with good reason. And I think it's just simply not going to happen.

Steven R. Weisman: Am I wrong in thinking that the most important set of issues address the issue of "too big to fail"?

Simon Johnson: I think "too big to fail" is the critical issue, and there are sort of two broad approaches to "too big to fail." One is what the administration is pursuing, which is kind of subtle, and they think a resolution authority would make a difference, ignoring the fact that they're not going to get any global or international component to that. So I don't see how that helps at all.

They think that having a so-called system regulator is going to make a difference, although to my mind, the Fed has played that role since, at least since 1913 when it was founded. But you know the mantra of the day is, "We didn't have so-called macro prudential regulation, and that was our problem." I think that's what they call at MBA school, "buzz word bingo." And it doesn't really add up to anything. All of this, it's window dressing. It's smokescreen, Steve.

You know, if you're a bureaucrat handling this matter, you'd say, "Well, we have to say we're going to do something." You can't say, "Oh, big financial crisis, no consequences." But we don't actually want to do anything meaningful. We don't want to push finance. They're not having a big argument with finance, Steve, right? The fact that my blog post, to the left, if you want to call it, of the administration, and engendering some reaction from some vested interests, I think tells you there are points out there that finance can and will object to, from its own special interest point of view.

The administration is not getting that, except on consumer protection. On consumer protection, there's some bite to their proposals. Everything else: complete hogwash.

Steven R. Weisman: What about compensation as well? Aren't they getting some pushback on that?

Simon Johnson: I think they already had the pushback, and they're not going for any meaningful constraints. But that is a tough one, by the way. Executive compensation is relatively easy to develop workarounds to find ways to hide, conceal, or change the structure of compensation.

So that, to me, is a symptom and the symbol of the problem. It's not where you put most of your efforts. You put most your efforts on making the biggest banks smaller and on raising capital requirements, and what I'm calling jamming the revolving door between Wall Street and Washington. We have a situation, Steve, right now where you can go from running a failed Wall Street bank one day, to next day walking to Treasury and helping to design the bailout program that will save that bank and its close friends.

How is that okay? When the United States sees that in any other country, if the United States sees that in a Brazil or Korea or Indonesia—in 1997, actually, that's exactly what happened—the United States is very, very tough in its criticism. Crony capitalism—remember crony capitalism?

Steven R. Weisman: Let me ask you about something you just said that you also wrote in your blog this week, which is that the largest financial institutions have to be made smaller. How do we do that?

Simon Johnson: First of all, Steve, let me frame what I'm going to say by pointing out that in President Obama's speech on Monday in Federal Hall on Wall Street, how many CEOs of major US banks attended that speech, do you think?

Steven R. Weisman: You pointed out none.

Simon Johnson: It's extraordinary. Every single one of them was too busy, when the President came to their neck of the woods, to attend? That's incredible, right? That speaks to the arrogance of the culture and the attitude. They're not, you know, grateful. They're not sorry. They're not even respectful. This guy saved their jobs…

Steven R. Weisman: At least, they didn't yell, "You lie!"

Simon Johnson: Well, at least that guy showed up. I mean the bankers didn't come to the speech, Steve. And the speech had two components. There was the regulatory piece, which

I think is weak, and it's not probably [going to] get through Congress anyway. And the president said that. And then, there was the piece where he asked them really nicely, please don't do it again. But they didn't come. They didn't come to the speech.

Steven R. Weisman: Come back to this issue, which in theory sounds good: let's make them smaller. You've been writing, making a lot of comparisons to the turn of the previous century, the Progressive era, antitrust, making the big industrial combines smaller in the era of Teddy Roosevelt, Woodrow Wilson, Lewis Brandeis, who was Wilson's economic adviser. Okay, so given today's complexities, have you figured out how we need to break up the large financial institutions in a globalized economy?

Simon Johnson: It's actually very simple, Steve. Okay, much easier, much more straightforward than Teddy Roosevelt's task. And the key point is the banks are already highly regulated. Everything the banks do is subject to the approval of regulators, and that includes, as you know, an insurance payment for deposits. All of these banks, all of these issues we've talked about now, the frontline of what we have to worry about, are that bank holding companies are subject to the jurisdiction of the Fed. Now, what you need to do is have a progressive—you can call it capital charge or you can call it insurance payment, whatever works for you—but basically, make that sufficiently progressive so that being above $100 billion in assets is just not worth your time, right?

Steven R. Weisman: So you would take the proposals for capital requirements, leveraging, all those things, and plus the insurance that backs the FDIC or that is involved with the FDIC, and you would make it increasingly more expensive or tougher the larger the bank holding company is.

Simon Johnson: Sure. Look, it's an insurance payment, right? And if your house is less safe because you haven't installed smoke detectors, then you should pay a higher insurance premium. If you run a bigger, more dangerous bank, you pose more risk to the system—we all agree on that—and you should pay a higher insurance premium. And if insurance were priced fairly given the data we now have on the extent to which you really pose quantifiable damage—potential damage to the world economy—that would be a very large amount of money, which would make it absolutely not worth the while of people who run these massive banks. And of course, if they were to break the banks up—you broke Goldman Sachs into ten pieces, for example, which is what would reduce them from…

Steven R. Weisman: Standard Oil a hundred years ago…

Simon Johnson: Exactly. So this breaking of Standard Oil was not bad for Standard Oil shareholders. It turned out to be great because out of that breakup came, I don't know, six or seven world-class huge companies, right, over the past century.

But the key point is CIT Group, which was allowed to fail, which was turned out for bailout earlier in the summer, has about $80 billion, $80 billion in assets, okay. And the Treasury, even this Treasury, felt that that was not too big to fail. So it said, go ahead, fail so that the creditors go bankrupt; your choice, right? If the biggest financial institutions we had were all under $100 billion in assets, it's not a panacea. It's definitely safer than what we have now.

Steven R. Weisman: A lot of members and staff in Congress have come to you and you've testified. Do you detect—this is my last question—any sentiment for this in Congress?

Simon Johnson: I testified in June, I believe, to Barney Frank's committee. And I think, Chairman Frank, of the House Financial Services committee, was open to this and he was interested. And I think there's a lot of middle ground here, where you could either have it come from Congress or the president could also directly decide to push this through regulators, for example. And I think it's a pretty tough one to turn down if you get the right people on board. But whether that's going to emerge out of the political process right now, I don't know. And I see no evidence that the G-20, for example—which would be an excellent place to push this idea forward—is going to pick up anything like this, this kind of approach.

Steven R. Weisman: Simon, thanks. Very interesting. And as this unfolds, we'll have you back obviously. Thanks again.

Simon Johnson: Thank you.