Looking Back with Morris Goldstein: Part II

Morris Goldstein traces the history of recent battles to reform the banking system and the reasons why banks have resisted adjustments needed to avoid another global financial meltdown.

Steve Weisman: This is Steve Weisman with Morris Goldstein at the Peterson Institute for International Economics, reviewing Morris' career here at the institute and the IMF. We've just been talking about exchange rates, but Morris just mentioned that bank capital and the stability of the banking system has been another important lifelong interest, especially since the crisis of 2007 and 2008. How is the world coming to grips with the weaknesses in the system?

Morris Goldstein: I think we're not doing very well. We're doing a little better than before the crisis. The major international agreement on that was Basel III, which raised the minimum capital requirement from banks, the common equity requirement, from sort of 2 percent to 7 percent, once you added in a few other things. But that's just way to low.

The problem is if banks don't have enough capital -- that's really the self-insurance -- when they get into a big mess where the value of their assets falls by a large amount, as we've seen in this crisis with all the subprime real estate holdings and the like, they become insolvent or close to it. People in the market realize it. There's a run on them and in the end the government has to bail them out.

If you want to stop that and all the bad things associated with that, you have to require them to have more self-insurance. Instead of 7 percent, we probably need 15 to 20 percent. But people don't want to admit that and the banking industry is a terribly effective lobby against it. Despite everything that's happened in the crisis, they continue to argue against it. They continued to argue that this would be disastrous for the economy and so we don't get there and that's unfortunate.

Steve Weisman: It certainly is tougher for the banks to get the profits they want with those requirements. Are they pursuing their profit interests instead of pursuing stability for the whole system?

Morris Goldstein: They like to have a lot of leverage. A lot of leverage increases return on equity when times are good. Unfortunately, when times go bad, the return on equity goes very negative and then we have these disasters. But with high return on equity, it's easy for them to argue for very high pay levels, particularly in the senior ranks. This is just socially very, very harmful.

Steve Weisman: This crisis was worse than any of us ever expected to see. Was this something that you always feared might happen?

Morris Goldstein: I didn't think it was going to be as bad as it turned out to be. We have these credit excesses. We've had them in a number of cases. I had studied banking crises. When this crisis was forming, I was working on China mainly and wasn't perhaps as focused on this as I wish I had been. But the scale of it was very, very big and we had it in a number of large countries.

Steve Weisman: What about the push-back from the system? Is that a shock to you?

Morris Goldstein: I'm not shocked that people look after their own narrow interests. I am shocked that people accept it and believe it and don't examine it as critically as they should. I think it's scandalous what the banking industry still argues in face of what we've gone through.

Steve Weisman: Do you think it's still possible to break up the biggest banks as another avenue to a solution?

Morris Goldstein: I think we're inching our way in that direction. The Volcker rule, the [Sir John] Vickers report [from the Independent Commission on Banking], the other report that's come out of the European Union -- they're all sort of looking at the various ways of controlling the banks. But in the end, I think it would be better to break them up. If we can't break them up, we certainly need much higher capital, much higher self-insurance. But breaking them up has the great advantage that it limits the liability that the rest of us have to pay.

In that case, if they fail and they're half the size that they are now, we would face half of the liability. I can't really see from looking at the evidence, what we're getting from that extra size. It doesn't seem to be economy to scale. It doesn't seem to be something particularly good about it. They just seem to get so large that they can't be managed effectively. And then when things go badly, they present the rest of us with the bill. So it just seems to me to be a bad deal.

It seems revolutionary to do it. But on the other hand, the other remedies seem to go only half way. They don't really seem to tackle the problem, so I'd like to see us move in that direction.

Steve Weisman: I hope in your retirement that you'll continue to weigh in on these issues Morris. And I wish you all the best. Thanks very much.

Morris Goldstein: Thank you Steve.