Flawed Financial System: Governments Held Hostage by the "Too Big to Fail" Banks (TBTF)

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The G-7 summit brought up too-big-to-fail (TBTF) financial institutions as a systemic risk to be addressed. The odds are low that any real reform will materialize. Removing this flaw could trigger a big global downturn. No major government has the stomach to go through with it.

The flawed global financial system essentially holds all major governments hostage. Whenever a crisis happens, the policy priority is to stabilize the financial system for short-term economic stability. This tends to favor TBTF financial institutions. Every crisis makes the problem bigger.

The vicious cycle between short-term economic stability and long-term financial risk begins with central banks easing monetary policy to stimulate growth. The systemic distortion of the price of money rewards speculation, which tends to make some financial institutions bigger and bigger over time.

True global stability will only come when major governments are willing to sacrifice short-term growth for long-term stability. That threshold will only be reached when the short-term situation is beyond repair. An inflation crisis is what it takes to change the policy dynamic.The situation needs to get worse before it gets better.

Too big to fail grows up

TBTF financial institutions were considered a key factor contributing to the 2008 global financial crisis. Five years later, the problem is worse.

> While one too big to fail problem remains, another is rapidly growing. Some of the players in the shadow banking system, like hedge funds, non-bank lenders and insurance companies, have also become TBTF. If some of these players fail, the cascade effect on their investors and borrowers could lead to a systemic breakdown. Governments and central banks may be forced into bailing out some speculative outfits in the next crisis.

The surviving banks account for bigger shares of the global financial system. The lesson of Lehman Brothers is that even a mid-sized financial institution can't be allowed to go bust. Hence, it would be unimaginable to allow any of the big banks to fail now.

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How could the TBTF problem become bigger? It has been in the spotlight for a long time. Most governments have been talking about reforms aimed at it. The main reason is that today's policy goal is dominated by short-term economic impact.

Short-term economic growth has become the primary political objective in all major economies. Monetary policy is considered the cheapest instrument available. Hence, since the crisis, policies backing near zero interest rates and quantitative easing have gone mainstream.

The artificially low price of money promotes speculative activities. As speculation is highly scalable — one person could manage up to $10 billion with the same work — prolonged super-loose monetary policy inevitably leads to the rise of some successful speculators.

The scalability applies to banks too. The TBTF banks receive low-cost funding.

When the policy interest rate is 5% and the credit risk premium is 1% for big banks and 3% for small banks, the cost difference between the two isn't too big to overcome in market competition. When the policy rate is zero, the difference becomes too big for customers to ignore. Hence, an environment of low interest rates favors TBTF banks.

So many TBTF shops

Throughout modern economic history, finance has been a fragmented business. Even the biggest names in the business had assets tiny compared to gross domestic product.

The reason is that it is a labor-intensive business. Understanding the credit risk of a borrower takes close following. Someone has to keep an eye on the borrower all the time. Hence, financial players like banks and stockbrokers tend to be regional, deriving advantage from local knowledge.

In the past quarter century, some financial institutions have become huge, qualifying as TBTF. The top ten banks in the world have assets close to one-third of global GDP.

It is unthinkable that any of the top banks would go bankrupt. If one is allowed to fail, the global economy would go into recession. Indeed, if any one of the top 100 fails, it would take down a country or two. It is difficult to see that any government or governments would tolerate that.

The shadow banking system may be more dangerous. A hedge fund can leverage up ten to twenty times through derivative instruments. Hence, a fund with $10 billion could rival the impact of one of the top 100 banks in the world. There are numerous hedge funds with over $10 billion.

The original sin

Optimal business size is in theory due to economies of scale. The automobile industry tends to have large companies because the development cost for a car is big. The big size gives a car company the ability to launch multiple models to spread risk.

Companies in the oil industry have become much bigger than before because it takes so much more to discover and develop an oil field. It is possible that some changes could turn a fragmented industry into a concentrated one. Could such changes explain the rising concentration of the financial industry?

The rise of information technology has had a big impact on the financial industry. Many top banks spend billions of dollars on information technology. Some mergers of financial institutions could be justified in cutting IT costs.

Technology is a significant contributing factor, but not the decisive one. The most important factor is Alan Greenspan. His style of monetary policy-making favored the bigness of financial institutions.

Greenspan is the father of today’s financial industry. He pioneered the policy-making of cutting interest rates aggressively in a downturn, but increasing them slowly in a recovery. The asymmetry increased money stock to GDP ratio, allowing more and more assets to be liquid and tradable. The asymmetry also subsidizes debtors with low average interest rates. Taking on debt is profitable in the Greenspan world.

Take the S&P 500 index (SNC:SPX) as an example. It rose above 1,500 in 2000 and collapsed by half, rose above that in 2007 and collapsed by half, and has risen above that again recently. Is this normal market behavior or policy-induced fluctuation?

I think the latter. If the Fed had maintained a sensible and neutral monetary policy, the S&P 500 would have climbed slowly and now be above 1,500 without the two crises in between. The U.S. economy would be quite healthy today.

But, when Greenspan was making the economy recover quickly in a downturn, he was praised as a maestro. His policy was short-term gain, long-term pain.

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Unnecessary volatility leads to wealth redistribution. When 100 people engage in a game of flipping coins to determine a reward, eventually one guy gets all the money.

When asset markets fluctuate like the S&P 500, it has the same effect. This is the main reason that wealth inequality has increased so rapidly and so many wealthy people are from finance.

What’s worse is that Greenspan’s volatility isn’t random. The people who understood him had an advantage. These are the big banks and hedge funds. Every cycle made them bigger.

Ben Bernanke has followed Greenspan’s policy, putting short-term economic performance above long-term financial and economic stability. No wonder that TBTF has become worse under his reign. A quarter of a century after Greenspan started, not just the United States, but the whole world trembles before the TBTF institutions.

Short-term fixes won’t work

The accepted remedy for TBTF is to increase regulations, sort of turning big banks into semi state-owned banks. China is already there. If the government takes on the downside, why not become the owner to get the upside too.

What Western governments are doing is to decrease the downside risk, not taking the upside. Neither is likely to work. Financial institutions tend to work for employees, not shareholders, customers or governments.

The U.S. government is trying to limit what banks can do. European governments try to limit bankers’ compensation. The Chinese government is trying to tell banks who to lend to. All have limited effectiveness and have incentivized shadow banking.

It is widely believed that U.S. banks have deleveraged, which is touted as one benefit of the Fed’s policy of low interest rates. But, the total debt outstanding for U.S. financial institutions, though down from the crisis level in 2008, is similar to that in 2006 when America’s housing bubble peaked.

When the interest rate is near zero, what would be the incentive for banks to decrease leverage? It should be the opposite.

The euro zone banking system is over three times GDP in asset size. Any conceivable speed of deleveraging would take a decade or two to bring it down to a safe level. Regardless of what euro zone banking policies are, the TBTF problem will remain for the conceivable future.

In the past five years, banks in emerging economies have grown at two to three times nominal GDP due to cheap liquidity inflow from developed economies.

TBTF has become a big risk to their financial stability. Indeed, due to the rapid growth of credit, emerging economies may see financial troubles within two years. Some sort of emerging market crisis is a distinct risk to the global economy.

Talk is cheap

Every year, world leaders gather multiple times to discuss major problems facing the global economy. The G-7, G-20 and International Monetary Fund/World Bank are some examples. Good sound bites come out of every meeting.

But, five years after the global financial crisis, the world is stuck with the same problems. How could that be? Aren’t these leaders supposed to be powerful and in a position to make changes?

The problem is that political leaders are incentivized by short-term impact. For the global economy to move beyond the crisis and establish a foundation for long-term prosperity, serious structural reforms are required. TBTF is one of the issues.

However, such reforms will necessitate some short-term dislocation. All political leaders promise a speedy economic recovery. They can't stomach another downturn. They aren't incentivized to enact tough reforms for long-term good.

The reform talk is just talk, hoping that its psychological impact would do some good. Multinational companies are reluctant to invest due to their view of sluggish growth ahead.

One of the reasons for the bearish view is that the structural problems aren't being addressed. If they believe that reforms are coming, they should invest to prepare for higher growth ahead. Hence, the talk might lift growth, if people believe. But, few are taking the bait.

Short-term orientation is why monetary policy is so loose everywhere. Too much debt drove the global economy into the financial crisis. The zero interest rate incentivizes taking on more debt. It can't be a solution to the global malaise. It may well worsen it.

Bubbles are happening again. The junk bond market is an obvious example. The property bubble has revived in London and New York. Stock market valuation is close to bubble territory. Whatever benefit monetary policy brings, it is through the so-called wealth effect, a euphemism for a bubble effect. The short-term gain will be paid with long-term pain, when these bubbles burst.

An inflation crisis

Political incentives won't change any time soon. As long as there are short-term measures to prolong the status quo, no serious reforms will follow.

A zero interest rate hides the troubles of debtors and supports the economy through bubbles. It seems painless in the short term. This is why politicians will always support monetary stimulus.

The status quo will only change with an inflation crisis. It will change the political incentive from short-term growth to price stability. The current global inflation rate is about 50% higher than real GDP growth rate. The gap could become 100% in two years. Would that be enough to change the incentive?

I think that the tipping point is likely a 5% inflation rate in developed economies and 10% in emerging economies. It may take five years to get there. Before then, global economy will remain stuck. Reforms will just be talk.

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