The Economy Cannot Recover Until the Big Banks Are Broken Up

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A lot of people still haven't heard that the economy cannot recover until the big banks are broken up.

But as everyone from Paul Krugman to Simon Johnson has noted, the banks are so big and politically powerful that they have bought the politicians and captured the regulators.

In addition, as Fortune pointed out last February that the only reason that smaller banks haven't been able to expand and thrive is that the too-big-to-fails have decreased competition:

> Growth for the nation's smaller banks represents a reversal of trends from the last twenty years, when the biggest banks got much bigger and many of the smallest players were gobbled up or driven under…
>
> As big banks struggle to find a way forward and rising loan losses threaten to punish poorly run banks of all sizes, smaller but well capitalized institutions have a long-awaited chance to expand.

Read more at: http://www.huffingtonpost.com/2009/05/11/justice-department-plans-_n_201409.html

So the very size of the giants squashes competition.

Small banks have been lending much more than the big boys. And the giant banks which received taxpayer bailouts actually slashed lending more, gave higher bonuses, and reduced costs less than banks which didn't get bailed out.

JP Morgan Chase, Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley together hold 80% of the country's derivatives risk, and 96% of the exposure to credit derivatives. Experts say that derivatives will never be reined in until the mega-banks are broken up.

As I pointed out in December 2008:

> The Bank for International Settlements (BIS) is often called the "central banks' central bank", as it coordinates transactions between central banks.
>
> BIS points out in a new report that the bank rescue packages have transferred significant risks onto government balance sheets, which is reflected in the corresponding widening of sovereign credit default swaps:

> > The scope and magnitude of the bank rescue packages also meant that significant risks had been transferred onto government balance sheets. This was particularly apparent in the market for CDS referencing sovereigns involved either in large individual bank rescues or in broad-based support packages for the financial sector, including the United States. While such CDS were thinly traded prior to the announced rescue packages, spreads widened suddenly on increased demand for credit protection, while corresponding financial sector spreads tightened.

> In other words, by assuming huge portions of the risk from banks trading in toxic derivatives, and by spending trillions that they don't have, central banks have put their countries at risk from default.

Now, Greece, Portugal, Spain and many other European countries – as well as the U.S. and Japan – are facing serious debt crises. See We are no longer wealthy enough to keep bailing out the bloated banks. We have serious debt problems. See this, this, this, this, this and this. By failing to break up the giant banks, the government is guaranteeing that they will take crazily risky bets again and again and again, and the government will wrack up more debt bailing them out again. (Anyone who thinks that Congress will use Dodd-Frank to break up banks in the middle of an even bigger crisis is dreaming. If the giant banks aren't broken up now – when they are threatening to take down the world economy – they won't be broken up next time they become insolvent, either. And see this).

Moreover, Richard Alford – former New York Fed economist, trading floor economist and strategist – recently showed that banks that get too big benefit from "information asymmetry" which disrupts the free market.

Nobel prize winning economist Joseph Stiglitz noted in September that giants like Goldman are using their size to manipulate the market:

> "The main problem that Goldman raises is a question of size: 'too big to fail.' In some markets, they have a significant fraction of trades. Why is that important? They trade both on their proprietary desk and on behalf of customers. When you do that and you have a significant fraction of all trades, you have a lot of information."
>
> Further, he says, "That raises the potential of conflicts of interest, problems of front-running, using that inside information for your proprietary desk. And that's why the Volcker report came out and said that we need to restrict the kinds of activity that these large institutions have. If you're going to trade on behalf of others, if you're going to be a commercial bank, you can't engage in certain kinds of risk-taking behavior."

The giants (especially Goldman Sachs) have also used high-frequency program trading which not only distorted the markets – making up more than 70% of stock trades – but which also let the program trading giants take a sneak peak at what the real (aka "human") traders are buying and selling, and then trade on the insider information. See this, this, this, this and this. (This is frontrunning, which is illegal; but it is a lot bigger than garden variety frontrunning, because the program traders are not only trading based on inside knowledge of what their own clients are doing, they are also trading based on knowledge of what all other traders are doing).

Goldman also admitted that its proprietary trading program can "manipulate the markets in unfair ways". The giant banks have also allegedly used their Counterparty Risk Management Policy Group (CRMPG) to exchange secret information and formulate coordinated mutually beneficial actions, all with the government's blessings.

Again, size matters. If a bunch of small banks did this, manipulation by numerous small players would tend to cancel each other out. But with a handful of giants doing it, it can manipulate the entire economy in ways which are not good for the American citizen.

No wonder so many independent economists and financial experts are calling for the big banks to be broken up, including:

- Nobel prize-winning economist, Joseph Stiglitz
- Nobel prize-winning economist, Ed Prescott
- Former chairman of the Federal Reserve, Alan Greenspan
- Former chairman of the Federal Reserve, Paul Volcker
- Former Secretary of Labor Robert Reich
- Dean and professor of finance and economics at Columbia Business School, and chairman of the Council of Economic Advisers under President George W. Bush, R. Glenn Hubbard
- Simon Johnson (and see this)
- President of the Federal Reserve Bank of Kansas City, Thomas Hoenig (and see this)
- President of the Federal Reserve Bank of Dallas, Richard Fisher (and see this)
- President of the Federal Reserve Bank of St. Louis, Thomas Bullard
- Deputy Treasury Secretary, Neal S. Wolin
- The President of the Independent Community Bankers of America, a Washington-based trade group with about 5,000 members, Camden R. Fine
- The Congressional panel overseeing the bailout (and see this)
- The head of the FDIC, Sheila Bair
- The head of the Bank of England, Mervyn King
- The leading monetary economist and co-author with Milton Friedman of the

leading treatise on the Great Depression, Anna Schwartz

- Economics professor and senior regulator during the S & L crisis, William K. Black
- Economics professor, Nouriel Roubini
- Economist, Marc Faber
- Professor of entrepreneurship and finance at the Chicago Booth School of Business, Luigi Zingales
- Economics professor, Thomas F. Cooley
- Economist Dean Baker
- Economist Arnold Kling
- Former investment banker, Philip Augar
- Chairman of the Commons Treasury, John McFall
- Leading bank analyst, Chris Whalen
- Economics professor, James Galbraith

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