

# THE DOOM CYCLE<sup>1</sup>

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We have let an unsustainable and crazy ‘doomsday cycle’ infiltrate our economic system.<sup>2</sup> This cycle has several simple stages. At the start, creditors and depositors provide banks with cheap funding in the expectation that if things go very wrong, our central banks and fiscal authorities will effectively bail them out. This is the “boom” phase – leading inevitably to an overexpansion of credit, a traumatic market, corporate, and household “bust” and, for as long as we can afford it, to huge bailouts roughly along the lines we saw in 2008-09.

This cycle will not run forever. One day soon, we’ll have the boom and bust phases, but when we try the usual bailouts, they won’t work. The destructive power of the down-cycle will overwhelm the restorative ability of the government, just like it did in 1929-31, when both the financial shock and the government capacity to respond were on a much smaller scale. The result, presumably, will be something that looks and feels very much like a Second Great Depression.

## RISKY BUSINESS

At the heart of this problem are today’s mega-banks such as Citigroup and Goldman Sachs – and many others in this past cycle – which use borrowed funds to take large risks, with the aim of providing dividends to shareholders and bonuses to management. Through direct subsidies (such as deposit insurance) and indirect support (such as central bank bailouts, including both special credit programs and cheap credit), we encourage our banking system to ignore large, socially harmful ‘tail risks’ – those risks where there is a small chance of calamitous collapse. As far as banks are concerned, they can walk away and let the state clean it up. This used to be known, somewhat light heartedly, as the “Greenspan put”, but there is nothing funny about our current predicament – which has become even worse since Greenspan left office.

And do not make the mistake of thinking that the costs of this “put” are entirely monetary, i.e., off balance-sheet as far as the fiscal authority is concerned. Privately held debt as a percent of GDP in the US will increase by about 40 percentage points as a direct result of the measures – including automatic stabilizers, discretionary stimulus, and direct bailout costs – that the federal government was forced to take. This moves us into dangerous territory with regard to our overall debt level, particularly given the lack of a credible medium-term framework for debt sustainability, making us more vulnerable to financial collapse in the future – a number of European countries, for example, have already something like a “debt limit” beyond which they cannot use fiscal stimulus under any circumstances. We are heading in the same direction.

Irresponsible risk-taking by the biggest players in our financial sector has placed us in fiscal jeopardy. But that is not the worst of it. We haven’t fixed – and, in fact, are not seriously addressing, the incentive problems of huge banks. They

will make similar “mistakes” again because, from their perspective, these are not mistakes – these are legitimate ways to maximize returns (as they see them) “over the cycle”.

The bankers, to be honest, are just doing their jobs – to make money. Regulators are supposed to prevent dangerous risk-taking. Adair Turner, chairman of the UK Financial Services Authority, is calling for more radical change than most regulators. In this regard, he is on the same page as Paul Volcker, former chairman of the Federal Reserve Board. But these are lonely voices.

Many bankers and policy-makers do well – financially or in terms of career advancement – during the collapse that they helped to create. They have very little personal or professional incentive to break this cycle, at least until it breaks the economy.

In the US and Western Europe today, banks wield substantial political and financial power, and because the system has become remarkably complex, regulators are effectively captured. The extent of regulatory failure ahead of the current crisis was mind-boggling. Prominent banks, including Northern Rock in the UK, Lehman Brothers in the US, and Deutsche Bank in Germany, convinced regulators that they could hold low amounts of capital against large and risky asset portfolios. The whole banking system built up many trillions of dollars in exposures to derivatives. This meant that when one large bank or quasi-bank failed, it could bring down the whole system.

Given the inability of our political and social systems to handle the hardship that would follow economic collapse, we rely on our central banks to cut interest rates and direct credits so as to bail out the loss-makers. While the faces tend to change, each central bank and government operates similarly. This time, it was Ben Bernanke and Tim Geithner who oversaw policy as the bubble was inflating. These same men are now designing our “rescue”.

When the bailout is done, we start all over again. This has been the pattern in many developed countries since the mid-1970s – a date that coincides with significant macroeconomic and regulatory change, including the end of the Bretton Woods fixed exchange rate systems, reduced capital controls in rich countries, and the beginning of 30 years of regulatory easing.

The real danger is that as this cycle continues, the scale of the problem is getting bigger. If each cycle requires greater and greater public intervention, we will surely eventually collapse – it is highly unlikely that we will always be able to counteract (growing) financial shocks with appropriately sized monetary and fiscal policy responses.

To stop the doomsday cycle, we need far greater reform than is currently under discussion. The headline-grabbing actions of Gordon Brown and Alistair Darling, calling for financial transactions taxes and a one-year super tax on bonuses – or

Barack Obama and Paul Volcker calling for limits on proprietary trading – have no impact on the fundamental problems in our system. Indeed, they are potentially harmful to the extent that they mislead taxpayers who want real solutions.

## NEW POLICIES NEEDED

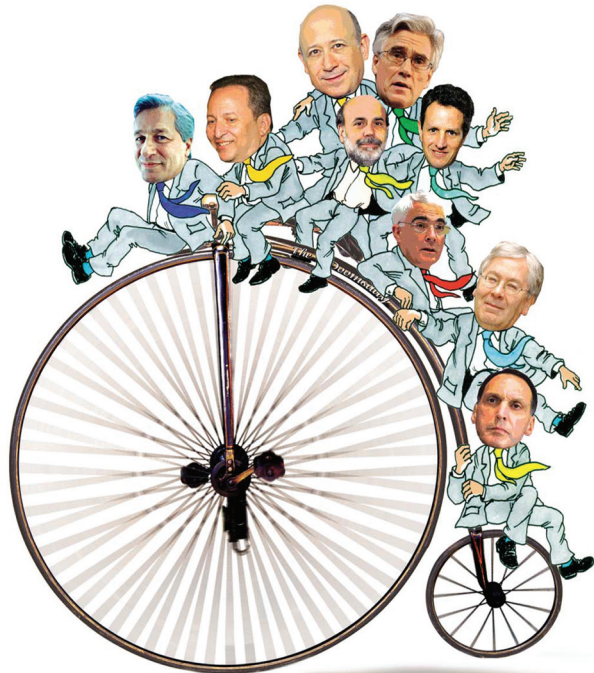
We need quite different and much more focused policies. These policies must be implemented across the G-20, with international coordination and monitoring – the US, the UK, and others with financial capabilities can take the lead on this front. Otherwise, financial services will move to the least regulated parts of the world, and it will be much more difficult for each country to maintain a tough stance

So what should be done? First, consider the regulatory problem: there are two broad ways to view past regulatory failures that have brought us to such a dangerous point. One is to argue it is a mistake that can be corrected through better rules.

That has been the path of successive Basel committees, which are now designing comprehensive new rules to ensure greater liquidity at banks and to close past loopholes that permitted banks to reduce their core capital. We both worked for many years in formerly communist countries, and this project reminds us of central planners' attempts to rescue their systems with additional regulations until it became all too apparent that collapse was imminent.

In our view, the long-term failure of regulation to check financial collapses reflects deep political difficulties in creating regulation. The banks have the money, they have the best lawyers and they have the funds to finance the political system. Politicians rarely want strong regulators – except after a major collapse (like the 1930s).

There are also big operational problems. For example, how should regulators decide the risk capital that should be allocated to new and arcane derivatives, which banks claim will reduce risk? When faced with rooms full of pa-



pers describing new instruments, and bank-hired experts bearing risk assessments, regulators will always be at a disadvantage.

The operational difficulties are further complicated by the intellectual undercurrents. When the economy is booming, driven by more leveraged bets, there is a tendency for the academic world to provide theories that justify status quo policies. This is clear from the growth of efficient markets theories, which infiltrated regulators' decision-making during the boom that preceded the most recent crisis.

No wonder that Tim Geithner, while president of the Federal Reserve Bank of New York, or Alan Greenspan and Ben Bernanke, as Fed chairman, did little to arrest the rapid growth of derivatives and off-balance sheet assets. It requires a strong leap of faith to believe that our regulatory system will never again be captured or corrupted. The fact that it has spectacularly failed to limit costly risk should be no surprise. In our view, the new regulations proposed for Basel 3 will fail, just as Basel 1 and Basel 2 have failed.

Such detailed proposals sound smart because they are correcting egregious errors of the past. But new errors will surface over the next five to ten years, and these will be precisely where loopholes remain, and where the system gradually becomes corrupted, again.

The best route towards creating a safer system is to have very large and robust capital requirements, which are legislated and difficult to circumvent or revise. If we triple core capital at major banks to 15-25% of assets – putting capital-asset ratios back to where they were in the United States before the formation of the Federal Reserve in 1913 – and err on the side of requiring too much capital for derivatives and other complicated financial structures, we will create a much safer system with less scope for 'gaming' the rules.

Once shareholders have a serious amount of funds at risk, relative to the winnings they would make from gambling, they will be less likely to gamble in a reckless manner. This will make the job of regulators far easier, and make it more likely our current regulatory system could work.

Second, we need to make the individuals who are part of any failed system expect large losses when their gambles fail and public money is required to bail out the system. While many executives at bailed-out institutions lost large amounts of money, they remain very wealthy.

Some people have clearly become winners from the crisis. Alistair Darling appointed Win Bischoff, a top executive at Citigroup in the run-up to its spectacular failure, to be chairman of Lloyds. Vikram Pandit sold his hedge fund to Citigroup, who then wrote off most of the cost as a loss, but Pandit was soon named their CEO. Jamie Dimon and Lloyd Blankfein, CEOs at JP Morgan and Goldman Sachs respectively, are outright winners from this process, despite the

fact that each of their banks also received federal bailouts – and they agreed to limit their bonuses for 2009.

Goldman Sachs was lucky to gain access to the Fed's 'discount window'; its conversion to a bank holding company averted potential collapse. We must stop sending the message to our bankers that they can win on the rise and also survive the downside. This requires legislation that recoups past earnings and bonuses from employees of banks that require bailouts.

Third, we need our leading fiscal and monetary policy-makers to admit their role in generating this doomsday cycle through successive bailouts. They need to develop solutions so that their institutions can credibly stop this cycle. The problem is simple: most financial institutions today have now proven too big to fail, as our policy-makers have bailed them all out.

The rules need to change so that creditors do not expect another bailout when the next crisis happens. There is some encouraging progress with plans for 'living wills' and measures to reduce the interdependency of financial institutions. But the litmus test for this will be when our leading policy-makers start calling for the break-up of large financial institutions and permanent robust limits on their size relative to the economy in the future.

Smaller institutions are naturally easier to let fail, and this will make creditors nervous when lending to them, so we can have more confidence that creditors will not lend to highly risky small institutions. There are feasible ways of doing this: for example, we could impose rising capital requirements on large institutions over the next five years, thus encouraging them to develop orderly plans to break up and shrink their banks.

### **DOOM CYCLE CONTINUES**

So where are we going with our current reforms? It is now obvious that risk-taking at banks will soon be larger than ever. Central banks and governments around the world have proved (once again) that they are willing to bail out banks at enormous public cost when things go wrong. Markets are now again providing very cheap loans to banks, with the comfort that the state will bail them out.

Today, Bank of America and the Royal Bank of Scotland are each priced to have just 0.5% annual risk of default above their sovereigns during the next five years in credit markets. This is a remarkably low implied risk, considering that both banks were near to collapse just a few months ago. Creditors are clearly very confident that they will be bailed out again if necessary. Indeed, they are more comfortable lending to large risky banks than to many successful corporations.

There is no doubt that the regulatory environment is going to be tougher for the next few years. But nothing has changed to make us believe the regulatory system will succeed this time, when it has failed so enormously – and repeat-

edly - in the recent past. To bring about the dramatic change that is needed also requires international cooperation and consistency.

Many of our current policy-makers - including Ben Bernanke - are the same ones that inflated the last bubble. So we know with great confidence that they are the types that will bail us out each time things go wrong. They are all currently on course for seeding our next rise and collapse: cheap rates and credit, with large moral hazard, are the initial stages of each cycle. Very few of these people, apart perhaps from Mervyn King (and Paul Volcker, if he is really back in a more active role), appear prepared to recognize their past role in creating our current problems and then to discuss resolutely how to change it.

The danger this system poses is clear. With our financial system now well-oiled to take on very large risk once again, and to gamble excessively, can we be sure that we can continue this cycle of bailing out eventual failures? At what point will the costs be so large that both fiscal and monetary policies are simply incapable of stopping the collapse?

In 2008-09, we came remarkably close to another Great Depression. Next time, we may not be so "lucky". The threat of the doomsday cycle remains strong and growing.

Over the last three decades, the US financial system has tripled in size, as measured by total credit relative to GDP. Each time the system runs into problems, the Federal Reserve quickly lowers interest rates to revive it. These crises appear to be getting worse and worse - and their impact is increasingly global. Not only are interest rates near zero around the world, but many countries are on fiscal trajectories that require major changes to avoid eventual financial collapse.

What will happen when the next shock hits? We may be nearing the stage where the answer will be - just as it was in the Great Depression - a calamitous global collapse.

## ENDNOTES

1. This chapter is based on "The doomsday cycle," which appeared in the London School of Economics' "Centerpiece," published by the Center for Economic Performance, Winter 2009/10 (<http://cep.lse.ac.uk/centrepiece/>). This material is used here with permission.
2. Andrew Haldane, executive director for financial stability at the Bank of England, has written an excellent paper describing a similar idea - the 'doom loop' (<http://www.bankofengland.co.uk/publications/speeches/2009/speech409.pdf>).

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