Banks aren't the Problem

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Companies fret about "silos" in which employees obsess about the wrong thing and miss opportunities because they don't see a bigger picture.

Wonkery has its silos too, and one of them is too big to fail.

The 2008 crisis did not begin in a handful of too-big-to-fail banks, but in incentives cast far and wide among home buyers, mortgage brokers, lenders and others to underwrite tax-advantaged, one-way bets on home prices.

Too big to fail was implicated in only one way: Fannie Mae and Freddie Mac were too big to fail in the eyes of their own lenders, including the Chinese government, which did no due diligence on the U.S. housing boom because they expected Washington to bail them out.

Much later did the biggest institutions like Citibank and Merrill Lynch become threatened with liquidity panics and regulatory insolvency. The reason: Market uncertainty over how regulators would treat their illiquid holdings of exotic Triple-A mortgage derivatives that, as history would later show, were well insulated from the uptick in subprime defaults.

We know this because taxpayers made profits bailing them out from a confidence crisis mostly caused, in circular fashion, by undeft government itself.

Big banks aren't automatically bad or badly managed because they are big, but it's hard to believe big banks would exist without an explicit and implicit government safety net underneath them.

Big banks are government creations. In 2008, these creations were the vehicles by which a maladroit government turned a housing bust in a few U.S. states into a global financial meltdown. They were also the vehicles by which government promptly halted the panic simply by guaranteeing the liabilities of the biggest institutions.

None of this has changed since Dodd-Frank, none of it is likely to change. Too big to fail is wonkery of surpassing irrelevance. At the moment, regulators are hand-waving over the inadequacy of the "living wills" that were supposed to make giant banks easier to wind up if they stumble—never mind that living wills are irrelevant to the circumstances that actually cause the solvency of giant banks to be questioned and irrelevant to the (inevitable) government decision to support them.

"The biggest American banks, nearly eight years after the financial crisis, are still too big to fail," fretted a New York Times front-pager last week after Fed and Treasury stress tests.

"That suggests that if there were another crisis today, the government would need to prop up the largest banks if it wanted to avoid financial chaos."

Well, yes. The sentence is a tautology. To halt a crisis caused by fears that government might stop propping up the biggest banks, it would have to prop them up.

The "crisis" in this sentence appears immaculately. In fact, we know where the crisis will come from and how it will be transmitted to the financial system. The Richmond Fed's "bailout barometer" shows that, since the 2008 crisis, 61% of all liabilities in the U.S. financial system are now implicitly or explicitly guaranteed by government, up from 45% in 1999. Citigroup estimates that the top 20 advanced industrial economies, in addition to their enormous, recognized public debts, face unrecorded additional debts of $78 trillion for their unfunded pension systems.

Six years after a crisis caused by excessive borrowing, McKinsey estimates that even visible global debt has increased by $57 trillion, while in the U.S., Europe, Japan and China growth to pay back these liabilities has been slowing or absent. In their desperation to avoid the real problem, central bankers lately have started bruiting “helicopter money”—the jokey term for printing money and giving it to consumers, businesses or governments to spend without incurring an offsetting debt. How does this solve any problem when so many businesses and households are already sitting on cash hoards they are afraid to spend or invest? As former Israeli central banker Jacob Frenkel told a conference in Italy two weeks ago, “What they need is not money. What they need is confidence and productive opportunities in front of them.”

Exactly. They need to see their leaders taking actions to restore confidence in the ability of the world’s premier economies to grow and to afford their debts. President Obama, it must be said, has been a world-historical disappointment on this score, a man who ran on and won a strong mandate for bipartisanship in 2008, who chose instead to concentrate on penny-ante liberal wish-list items, a crybaby who now justifies his choices by citing “Republican intransigence.”

And yet Mr. Obama looks good next to Bernie Sanders or Donald Trump. The question that ought to keep central bankers up at night is whether their ministrations to buy time for the politicians are only buying politicians time to make matters worse.