Economist's View

« "Two and a Half Cheers for Education" | Main | links for 2011-01-09 »

Sunday, January 09, 2011

"The Bill Daley Problem"

Simon Johnson discusses how Obama's choice of Bill Daley to be his Chief of Staff might impact his views on "a huge time bomb," the continued existence of too big to fail banks:

> The Bill Daley Problem, by Simon Johnson: Bill Daley, President Obama's newly appointed chief of staff, is an experienced business executive. By all accounts, he is decisive, well-organized, and a skilled negotiator. His appointment, combined with other elements of the White House reshuffle, provides insight into how the president understands our economy – and what is likely to happen over the next couple of years. This is a serious problem.
>
> This is not a critique from the left or from the right. The Bill Daley Problem is completely bipartisan – it shows us the White House fails to understand that, at the heart of our economy, we have a huge time bomb.
>
> Until this week, Bill Daley was on the top operating committee at JP Morgan Chase. His bank – along with the other largest U.S. banks – have far too little equity and far too much debt relative to that thin level of equity; this makes them highly dangerous from a social point of view. These banks have captured the hearts and minds of top regulators and most of the political class (across the spectrum), most recently with completely specious arguments about why banks cannot be compelled to operate more safely. Top bankers, like Mr. Daley's former colleagues, are intent on becoming more global – despite the fact that (or perhaps because) we cannot handle the failure of massive global banks. ...
>
> Today's most dangerous government sponsored enterprises are the largest six bank holding companies: JP Morgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley. They are undoubtedly too big to fail – if they were on the brink of failure, they would be rescued by the government, in the sense that their creditors would be protected 100 percent. The market knows this and, as a result, these large institutions can borrow more cheaply than their smaller competitors. This lets them stay big and – amazingly – get bigger.
>
> In the latest available data (Q3 of 2010), the big 6 had assets worth 64 percent of GDP. This is up from before the crisis – assets in the big six at the end of 2006 were only about 55 percent of GDP. And this is up massively from 1995, when these same banks (some of which had different names back then) were only 17 percent of GDP.
>
> No one can show significant social benefits from the increase in bank size, leverage, and overall riskiness over the past 15 years. The social costs of these banks – and their complete capture of the regulatory apparatus – are apparent in the worst recession and slowest recovery since the 1930s.

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Recent Posts

Paul Krugman: Climate of Hate (30)
Fed Watch: Are Oil Prices About to Undermine the Recovery? (17)
"Zombie Economics and Just Deserts" (12)
links for 2011-01-09 (6)
"The Bill Daley Problem" (32)
"Two and a Half Cheers for Education" (42)
links for 2011-01-08 (13)
"What is the Treasury Up To?" (3)
"Congresswoman Gabrielle Giffords Shot in Tucson" (39)
"Bush, the Bubble, and the Deficit" (26)
"Have We Underestimated the Likelihood and Severity of Zero Lower Bound Events?" (6)
links for 2011-01-07 (34)
"Greenspan Challenges Critics to Prove Him Wrong" (31)
Fed Watch: More of the Same (11)
The Employment Report is Weaker than Expected (21)
Paul Krugman: The Texas Omen (36)
"On the Dole, Corporate Style" (27)
links for 2011-01-06 (18)
"Recovery Act Kept 4.5 Million People Out of Poverty in 2009" (43)
"Time to Cut the Cord" (28)
The CBO Rebuts Republican Claims About the Affordable Care Act (35)
Fed Watch: Generally Positive (11)
links for 2011-01-05 (23)
"The Income Distribution" (108)
"Debt Ceiling Politics" (9)
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> Paul Volcker gets it; no wonder he has resigned. ... Gene Fama, father of the efficient financial markets view, gets it better than anyone. I discussed the issue in public for two hours at the American Financial Association (AFA) meetings in Denver on Friday with two presidents of the AFA (Raghu Rajan and John Cochrane) and a Nobel Prize winner (Myron Scholes). This is not a left-wing or marginal group... The top minds in academic finance understand the problem vividly and are articulate about it – there is no rebuttal to the points being made by Anat Admati and her distinguished colleagues.
>
> This is not a left-right issue – again, look at the list of people who co-signed Professor Admati's recent letter to the Financial Times. This is a question of technical competence. Do the people running the country – including both the executive branch and the legislature – understand economics and finance or not?
>
> If the country's most distinguished nuclear scientists told you, clearly and very publicly, that they now realize a leading reactor design is very dangerous, would you and your politicians stop to listen? Yet our political leadership brush aside concerns about the way big banks operate. Why?
>
> Top bankers, including Bill Daley, have pulled off a complete snow job... Most smart people in the nonfinancial world understand that the big banks have become profoundly damaging to the rest of the private sector. The idea that the president needed to bring a top banker into his inner circle in order to build bridges with business is beyond ludicrous.
>
> Bill Daley now controls how information is presented to and decisions are made by the president. Daley's former boss, Jamie Dimon, is the most dangerous banker in America – presumably he now gets even greater access to the Oval Office. Daley is on the record as opposing strong consumer protection for financial products; Elizabeth Warren faces an even steeper uphill battle. Important regulatory appointments, such as the succession to Sheila Bair at the FDIC, are less likely to go to sensible people. And in all our interactions with other countries, for example around the G20 but also on a bilateral basis, we will pursue the resolutely pro-big finance views of the second Clinton administration. ...
>
> Let's be honest. With the appointment of Bill Daley, the big banks have won completely this round of boom-bust-bailout. The risk inherent to our financial system is now higher than it was in the early/mid-2000s. We are set up for another illusory financial expansion and another debilitating crisis. ...

I've been calling for someone -- anyone -- to point to evidence of scale economies in banking for some time now so that we can evaluate the costs and benefits of breaking up banks that are too politically powerful to be allowed to fail. However, in all the time this topic has been discussed I've only come across one paper looking directly at this issue, and it is not all that convincing. (I understand that small banks can also pose systemic risk if there is a widespread financial collapse, but the risk is still lower with small instead of large banks, and -- importantly -- eliminating big banks reduces the ability of the banking sector to capture the political process).

I think the null hypothesis ought to be that size is a problem. The potential costs of too big to fail banks are large and well known, and unless there are demonstrable benefits to offset the known costs, there is sufficient basis for breaking the banks up. But yet, with scant evidence of the benefits, but plenty of evidence about the

Promise to Cut Spending (59)
Does Statistical Significance Stink? (50)
A Laffer Curve for Inequality? (86)
links for 2011-01-04 (42)
Facing a Marked Global Reversal (22)
Fed Watch: A Solid Start To 2011 (8)
"What Is Rubin's Legacy?" (13)
links for 2011-01-03 (23)
Rogoff: Armageddon Can Wait (7)
Paul Krugman: Deep Hole Economics (66)
Robert Johnson: Deficit Fantasies in the Great Recession (8)

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bakho on links for 2011-01-09
anne on "Two and a Half Cheers for Education"
anne on "Two and a Half Cheers for Education"
anne on "Two and a Half Cheers for Education"
cm on "Two and a Half Cheers for Education"
Mark A. Sadowski on "Two and a Half Cheers for Education"
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costs, too big to fail banks not only persist, the banks are getting bigger. To me, that speaks directly too regulatory capture, and not in a kind way.

Here's a repeat of a post from last April on this topic:

"Breaking Up Big Banks: As Usual, Benefits Come with a Side of Costs": David Altig warns that breaking up big banks could reduce efficiency:

> Breaking up big banks: As usual, benefits come with a side of costs, by David Altig, macroblog: Probably the least controversial proposition among an otherwise *very* controversial set of propositions on which financial reform proposals are based is that institutions deemed "too big to fail" (TBTF) are a real problem. As Fed Chairman Bernanke declared not too long ago:
>
>> As the crisis has shown, one of the greatest threats to the diversity and efficiency of our financial system is the pernicious problem of financial institutions that are deemed "too big to fail."
>
> The next question, of course, is *how* to deal with that threat. At this point the debate gets contentious. One popular suggestion for dealing with the TBTF problem is to just make sure that no bank is "too big." Two scholars leading that charge are Simon Johnson and James Kwak (who are among other things the proprietors at The Baseline Scenario blog). They make their case in the New York Times' Economix feature:
>
>> Since last fall, many leading central bankers including Mervyn King, Paul Volcker, Richard Fisher and Thomas Hoenig have come out in favor of either breaking up large banks or constraining their activities in ways that reduce taxpayers' exposure to potential failures. Senators Bernard Sanders and Ted Kaufman have also called for cutting large banks down to a size where they no longer pose a systemic threat to the financial system and the economy.
>>
>> …We think that increased capital requirements are an important and valuable step toward ensuring a safer financial system. We just don't think they are enough. Nor are they the central issue…
>>
>> We think the better solution is the "dumber" one: avoid having banks that are too big (or too complex) to fail in the first place.
>
> Paul Krugman has noted one big potential problem with this line of attack:
>
>> As I argued in my last column, while the problem of "too big to fail" has gotten most of the attention—and while big banks deserve all the opprobrium they're getting—the core problem with our financial system isn't the size of the largest financial institutions. It is, instead, the fact that the current system doesn't limit risky behavior by "shadow banks," institutions—like Lehman Brothers—that carry out banking functions, that are perfectly capable of creating a banking crisis, but, because they issue debt rather than taking deposits, face minimal oversight.

Hate

anne on Paul Krugman: Climate of Hate

anne on links for 2011-01-09

Tom on Paul Krugman: Climate of Hate

eightnine2718281828mu5 on "Zombie Economics and Just Deserts"

mark on Paul Krugman: Climate of Hate

kthomas on Paul Krugman: Climate of Hate

anne on links for 2011-01-09

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Icarus Lives on "Two and a Half Cheers for Education"

Alex Tolley on "Zombie Economics and Just Deserts"

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ComradeAnon on Paul Krugman: Climate of Hate

beezer on Fed Watch: Are Oil Prices About to Undermine the Recovery?

ComradeAnon on Paul Krugman: Climate of Hate

bakho on links for 2011-01-09

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Brad DeLong

Senator Durbin of Illinois

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In addition to that observation—which is the basis of calls for a systemic regulator that spans the financial *system*, and not just specific classes of financial institutions—there *is* another, very basic, economic question: Why are banks big?

To that question, there seems to be an answer: We have big banks because there are efficiencies associated with getting bigger—economies of scale. David Wheelock and Paul Wilson, of the Federal Reserve Bank of St. Louis and Clemson University, respectively, sum up what they and other economists know about economies of scale in banking:

> …our findings are consistent with other recent studies that find evidence of significant scale economies for large bank holding companies, as well as with the view that industry consolidation has been driven, at least in part, by scale economies. Further, our results have implications for policies intended to limit the size of banks to ensure competitive markets, to reduce the number of banks deemed "too-big-to-fail," or for other purposes. Although there may be benefits to imposing limits on the size of banks, our research points out potential costs of such intervention.

Writing at the *National Review Online*, the Cato Institute's Arnold Kling acknowledges the efficiency angle, and then dismisses it:

> There's a long debate to be had about the maximum size to which a bank should be allowed to grow, and about how to go about breaking up banks that become too large. But I want to focus instead on the general objections to large banks.
>
> The question can be examined from three perspectives. First, how much economic efficiency would be sacrificed by limiting the size of financial institutions? Second, how would such a policy affect systemic risk? Third, what would be the political economy of limiting banks' size?
>
> It is the political economy that most concerns me…
>
> If we had a free market in banking, very large banks would constitute evidence that there are commensurate economies of scale in the industry. But the reality is that our present large financial institutions *probably* owe their scale more to government policy than to economic advantages associated with their vast size.

I added the emphasis to the "probably" qualifier.

The Wheelock-Wilson evidence does not disprove the Kling assertion, as the estimates of scale economies are obtained using banks' cost structures, which certainly are impacted by the nature of government policy. But if economies of scale are in some way intrinsic to at least some aspects of banking—and not just political economy artifacts—the costs of placing restrictions on bank size could introduce risks that go beyond reducing the efficiency of the targeted financial institutions. If some banks are large for good economic reasons, the forces that move them to become big would likely emerge with force in the shadow banking system, exacerbating the very problem noted by Krugman.

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> I think it bears noting that the argument for something like constraining the size of particular banks implicitly assumes that it is not possible, for reasons that are either technical or political, to actually let failing large institutions fail. Maybe it is so, as Robert Reich asserts in a Huffington Post item today. And maybe it is in fact the case that big is not beautiful when it comes to financial institutions. But in evaluating the benefits of busting up the big guys, we shouldn't lose sight of the possibility that this is also a strategy that could carry very real costs.

I'd like to know the source of the scale economies. The paper linked above estimates returns to scale, but not their source. As noted in the introduction (and also noted by David):

> Our results indicate that as recently as 2006 banks faced increasing returns to scale, suggesting that scale economies are a plausible (though not necessarily only) reason for the growth in bank size...

Without knowing the source of the changes in costs as banks increase in size, the (non-parametric) results -- results that differ from most previous work -- are hard to evaluate. I've been hoping for good estimates of the size and nature of the economies of scale for banks, but I'm not fully convinced by this evidence.

Posted by Mark Thoma on Sunday, January 9, 2011 at 10:44 AM in Economics, Financial System, Market Failure, Politics | Stumble, Digg, del.icio.us, Reddit, Tweet, Share on Facebook, Like on Facebook | Permalink Comments (32)

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Comments

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jim said...

I find it interesting that even among so-called 'leading' economists, the debate is framed using very bad economics. The TBTF banks are large, that's a fact. But they are only partly large in scale. The TBTF banks are also extremely large in scope.

I agree with Mark and Simon that the sources of the alleged economies of scale are not evident. I don't see them. But even if there were actual efficiencies or fixed costs that result in economies of scale, it still wouldn't explain the large scope of the banks. It is the scope, the participation in so many different, distinct lines of business and financial products that makes the TBTF banks so systemically risky these days. It is also what makes resolution so difficult when they fail.

Just because we don't talk about economies of scope and how they are different from economies of scale in micro 101 textbooks is no excuse for ignoring insights industrial organization economists developed long ago.

Reply Sunday, January 09, 2011 at 11:16 AM

Mark Thoma said...

I intend for the term/reference to include economies of scope. E.g., I've used phrases such as this many times when I've been more careful about making sure people understand that both types are included (the distinction is not always as clear as your comment implies and relies on the definition of what constitutes a distinct product/market):

"But I'd like to have more precise information about how large these firms need to be until the economies of scope and scale begin bottoming out. If it's so large that