

Testimony

The Impact of the Troubled Asset Relief Program on the US Financial System and Economy

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Testimony submitted to the Congressional Oversight Panel hearing on “The overall impact of the Troubled Asset Relief Program (TARP) on the health of the financial system and the general US economy”

November 19, 2009

This testimony draws on joint work with Peter Boone, particularly "The Next Financial Crisis: It's Coming and We Just Made It Worse" (New Republic, September 8, 2009), and James Kwak, particularly "The Quiet Coup" (Atlantic, April, 2009).

Summary

- 1) In the immediate policy response to any major financial crisis—involving a generalized loss of confidence in major lending institutions—there are three main goals:
 - a. to stabilize the core banking system;
 - b. to prevent the overall level of spending from collapsing; and
 - c. to lay the groundwork for a sustainable recovery.
- 2) IMF programs are routinely designed with these criteria in mind and are evaluated on the basis of: the depth of the recession and speed of the recovery relative to the initial shock; the side-effects of the macroeconomic policy response, including inflation; and whether the underlying problems that created the vulnerability to panic are addressed over a 12–24 month horizon.
- 3) This same analytical framework can be applied to the United States since the inception of the Troubled Asset Relief Program (TARP). While there were unique features to the US experience (as is the case in all countries), the broad pattern of financial and economic collapse, followed by a struggle to recover, is quite familiar.
- 4) The overall US policy response did well in terms of preventing spending from collapsing. Monetary policy responded quickly and appropriately. After some initial and unfortunate hesitation on the fiscal front, the stimulus of 2009 helped to keep domestic spending relatively buoyant, despite the contraction in credit and large increase in unemployment. This was in the face of a massive global financial shock—arguably the largest the world has ever seen—and the

consequences, in terms of persistently high unemployment, remain severe. But it could have been much worse.

- 5) There is no question that passing the TARP was the right thing to do. In some countries, the government has the authority to provide fiscal resources directly to the banking system on a huge scale, but in the United States this requires congressional approval. In other countries, foreign loans can be used to bridge any shortfall in domestic financing for the banking system, but the United States is too large to ever contemplate borrowing from the IMF or anyone else.
- 6) Best practice, vis-à-vis saving the banking system in the face of a generalized panic involves three closely connected pieces:
 - a. Preventing banks from collapsing in an uncontrolled manner: This often involves at least temporary blanket guarantees for bank liabilities, backed by credible fiscal resources. The government's balance sheet stands behind the financial system. In the canonical emerging market crises of the 1990s—Korea, Indonesia, and Thailand—where the panic was centered on the private sector and its financing arrangements, this commitment of government resources was necessary (but not sufficient) to stop the panic and begin a recovery.
 - b. Taking over and implementing orderly resolution for banks that are insolvent: In major system crises, this typically involves government interventions that include revoking banking licenses, firing top management, bringing in new teams to handle orderly unwinding, and—importantly—downsizing banks and other failing corporate entities that have become too big to manage. In Korea, nearly half of the top 30 precrisis chaebol were broken up through various versions of an insolvency process (including Daewoo, one of the biggest groups). In Indonesia, leading banks were stripped from the industrial groups that owned them and substantially restructured. In Thailand, not only were more than 50 secondary banks (“finance houses”) closed, but around one-third of the leading banks were also put through a tough clean-up and downsizing process managed by the government.
 - c. Addressing immediately underlying weaknesses in corporate governance that created potential vulnerability to crisis: In Korea, the central issue was the governance of nonfinancial chaebol and their relationship to the state-owned banks; in Indonesia, it was the functioning of family-owned groups that owned banks directly; and in Thailand it was the close connections between firms, banks, and politicians. Of the three, Korea made the most progress and was rewarded with the fastest economic recovery.
- 7) If any country pursues (a) unlimited government financial support, while not implementing (b) orderly resolution for troubled large institutions, and refusing to take on (c) serious governance reform, it would be castigated by the United States and come under pressure from the IMF. At the heart of every crisis is a political problem—powerful people, and the firms they control, have gotten out of hand. Unless this is dealt with as part of the stabilization program, all the government has done is provide an unconditional bailout. That may be consistent with a short-

term recovery, but it creates major problems for the sustainability of the recovery and for the medium term. Serious countries do not do this.

- 8) Seen in this context, TARP has been badly mismanaged. In its initial implementation, the signals were mixed—particularly as the Bush administration sought to provide support to essentially insolvent banks without taking them over. Standard FDIC-type procedures, which are best practice internationally, were applied to small- and medium-sized banks, but studiously avoided for large banks. As a result, there was a great deal of confusion in financial markets about what exactly was the Bush/Paulson policy that lay behind various ad hoc deals.
- 9) The Obama administration, after some initial hesitation, used “stress tests” to signal unconditional support for the largest financial institutions. By determining officially that these firms did not lack capital—on a forward-looking basis—the administration effectively communicated that it was pursuing a strategy of “regulatory forbearance” (much as the United States did after the Latin American debt crisis of 1982). The existence of TARP, in that context, made the approach credible—but the availability of unconditional loans from the Federal Reserve remains the bedrock of the strategy.
- 10) The downside scenario in the stress tests was overly optimistic, with regard to credit losses in real estate (residential and commercial), credit cards, auto loans, and in terms of the assumed time path for unemployment. As a result, our largest banks remain undercapitalized, given the likely trajectory of the US and global economy. This is a serious impediment to a sustained rebound in the real economy—already reflected in continued tight credit for small- and medium-sized business.
- 11) Even more problematic is the underlying incentive to take excessive risk in the financial sector. With downside limited by government guarantees of various kinds, the head of financial stability at the Bank of England (Andrew Haldane) bluntly characterizes our repeated boom-bailout-bust cycle as a “doom loop.”
- 12) Exacerbating this issue, TARP funds supported not only troubled banks, but also the executives who ran those institutions into the ground. The banking system had to be saved, but specific banks could have wound down and leading bankers could and should have lost their jobs. Keeping these people and their management systems in place poses serious trouble for the future.
- 13) The implementation of TARP exacerbated the perception (and the reality) that some financial institutions are “too big to fail.” This lowers their funding costs, enabling them to borrow more and to take more risk.
- 14) The Obama administration argues that its regulatory reforms will rein in the financial sector in this regard. Very few outside observers—other than at the largest banks—find this convincing.
- 15) In fact, TARP also allowed the US Treasury to make it clear that some individuals are “too connected to fail.” Financial executives with strong connections to the current and previous leadership of the New York Fed (e.g., through network connections of various kinds) have great power and enormous market value in this situation.

- 16) The US recovery strategy hinges on continued low interest rates (and a continuation of quantitative easing). This creates risks of a new global asset bubble, funded in dollars and driven by exuberance about prospects in emerging markets. The Fed has already signaled clearly that it will not raise interest rates for a long while.
- 17) Unless bank regulators limit the direct and indirect risk exposure of US financial institutions to this new supposedly low-risk “carry trade,” we face the very real prospect of another even larger crisis.

The remainder of this testimony provides supportive background material, in terms of the global macroeconomic context within which TARP has operated and some important details about the program’s implementation.

Global Macroeconomic Context

After a deep recession, the world economy is experiencing a modest recovery after near financial collapse this spring. The strength of the recovery varies sharply around the world:

- a. In Asia, real GDP growth is returning quickly to precrisis levels, and while there may be some permanent GDP loss, the real economy appears to be clearly back on track. For next year consensus forecasts have China growing at 9.1 percent and India growing at 8.0 percent; the latest data from China suggest that these forecasts may soon be revised upward.
- b. Latin America is also recovering strongly. Brazil should grow by 4.5 percent in 2010, roughly matching its precrisis trend. We can expect other countries in Latin America to recover quickly also.
- c. The global laggards are Europe and the United States. The latest consensus forecasts are for Europe to grow by 1.1 percent and Japan by 1.0 percent in 2010, while the United States is expected to grow by 2.4 percent (and the latest revisions to forecasts continue to be in an upward direction). Unemployment in the United States is expected to stay high, around 10 percent, into 2011.

The current IMF global growth forecast of around 3 percent is probably on the low side, with considerably more upside possible in emerging markets (accounting nearly half of world GDP). The consensus forecasts for the United States are also probably somewhat on the low side.

As the world recovers, asset markets are also turning buoyant. Recently, residential real estate in elite neighborhoods of Hong Kong has sold at \$8,000 US per square foot. A 2,500 square foot apartment now costs \$20 million. Real estate markets are also showing signs of bubbly behavior in Singapore, China, Brazil, and India.

There is increasing discussion of a “carry trade” from cheap funding in the United States toward higher return risky assets in emerging markets. This financial dynamic is likely to underpin continued US dollar weakness.

One wild card is the Chinese exchange rate, which remains effectively pegged to the US dollar. As the dollar depreciates, China is becoming more competitive on the trade side and it is also attracting further capital inflows. Despite the fact that the Chinese current account surplus is now down to around 6 percent, China seems likely to accumulate around \$3 trillion in foreign exchange reserves by mid-2010.

Commodity markets have also done well. Crude oil prices are now twice their March lows (despite continued spare capacity, according to all estimates), copper is up 129 percent, and nickel is up 103 percent. There is no doubt that the return to global growth, at least outside North America and Europe, is already proving to have a profound impact on commodity markets.

Core inflation, as measured by the Federal Reserve, is unlikely to reach (or be near to) 2 percent in the near future. However, headline inflation may rise due to the increase in commodity prices and the fall in the value of the dollar; this reduces consumers' purchasing power.

This nascent recovery is partly a bounce back from the near total financial collapse that we experienced in the Winter/Spring of 2008–09. The key components of this success are three policies.

- First, global coordinated monetary stimulus, in which the Federal Reserve has shown leadership by keeping interest rates near all-time lows. Of central banks in industrialized countries, only Australia has begun to tighten.
- Second, global coordinated fiscal policy, including a budget deficit in the United States that is projected to be 10 percent of GDP or above both this year and next year. In this context, the Recovery Act played an important role both in supported spending in the US economy and in encouraging other countries to loosen fiscal policy (as was affirmed at the G-20 summit in London, on April 2, 2009).
- Third, after some U-turns, by early 2009 there was largely unconditional support for major financial institutions, particularly as demonstrated by the implementation and interpretation of the bank “stress tests” earlier this year.

However, the same policies that have helped the economy avoid a major depression also create serious risks—in the sense of generating even larger financial crises in the future.

A great deal has been made of the potential comparison with Japan in the early 1990s, with some people arguing that Japan's experience suggests we should pursue further fiscal stimulus and continued regulatory forbearance for banks. This reasoning is flawed.

We should keep in mind that repeated fiscal stimulus and a decade of easy monetary policy did not lead Japan back to its previous growth rates. Japanese outcomes should caution against unlimited increases in our public debt.

Perhaps the best analysis regarding the impact of fiscal policy on recessions was done by the IMF. In their retrospective study of financial crises across countries, they found that nations with “aggressive

fiscal stimulus” policies tended to get out of recessions two quarters earlier than those without aggressive policies. This is a striking conclusion—should we (or anyone) really increase our deficit further and build up more debt (domestic and foreign) in order to avoid two extra quarters of contraction?

A further large fiscal stimulus, with a view to generally boosting the economy, is therefore not currently appropriate. However, it makes sense to further extend support for unemployment insurance and for healthcare coverage for those who were laid off—people are unemployed not because they don’t want to work, but because there are far more job applicants than vacancies. Compared with other industrial countries, our social safety net is weak and not well suited to deal with the consequences of a major recession.

America is well placed to maintain its global political and economic leadership, despite the rise of Asia. But this will only be possible if our policy stance toward the financial sector is substantially revised: the largest banks need to be broken up, “excess risk taking” that is large relative to the system should be taxed explicitly, and measures should be implemented to reduce the degree of nontransparent interconnectedness between financial institutions of all kinds.

TARP Specifics

In a financial panic, the critical ingredients of the government response must be speed and overwhelming force. The root problem is uncertainty—in our case, uncertainty about whether the major banks have sufficient assets to cover their liabilities. Half measures combined with wishful thinking and a wait-and-see attitude are insufficient to overcome this uncertainty. And the longer the response takes, the longer that uncertainty can sap away at the flow of credit, consumer confidence, and the real economy in general—ultimately making the problem much harder to solve. Instead, however, the principal characteristics of the government’s response to the financial crisis have been denial, lack of transparency, and unwillingness to upset the financial sector.

First, there was the prominent place of policy by deal: when a major financial institution got into trouble, the Treasury Department and the Federal Reserve would engineer a bailout over the weekend and announce that everything was fine on Monday. In March 2008, there was the sale of Bear Stearns to JPMorgan Chase, which looked to many like a gift to JPMorgan. The deal was brokered by the Federal Reserve Bank of New York—which includes Jamie Dimon, CEO of JPMorgan, on its board of directors. In September, there were the takeovers of Fannie Mae and Freddie Mac, the sale of Merrill Lynch to Bank of America, the decision to let Lehman fail, the destructive bailout of AIG, the takeover and immediate sale of Washington Mutual to JPMorgan, and the bidding war between Citigroup and Wells Fargo over the failing Wachovia—all of which were brokered by the government. In October, there was the recapitalization of nine large banks on the same day behind closed doors in Washington. This was followed by additional bailouts for Citigroup, AIG, Bank of America, and Citigroup (again).

In each case, the Treasury Department and the Fed did not act according to any legislated or even announced principles, but simply worked out a deal and claimed that it was the best that could be done under the circumstances. This was late-night, back-room dealing, pure and simple.

What is more telling, though, is the extreme care the government has taken not to upset the interests of the financial institutions themselves, or even to question the basic outlines of the system that got us here.

In September 2008, Henry Paulson asked for \$700 billion to buy toxic assets from banks, as well as unconditional authority and freedom from judicial review. Many economists and commentators suspected that the purpose was to overpay for those assets and thereby take the problem off the banks' hands—indeed, that is the only way that buying toxic assets would have helped anything. Perhaps because there was no way to make such a blatant subsidy politically acceptable, that plan was shelved.

After the “Paulson plan” was passed on October 3, 2008, it was quickly overtaken by events. First the United Kingdom announced a bank recapitalization program; then, on October 13, it was joined by every major European country, most of which also announced loan guarantees for their banks. On October 14, the United States followed suit with a bank recapitalization program, unlimited deposit insurance (for noninterest-bearing accounts), and guarantees of new senior debt. Only then was enough financial force applied for the crisis in the credit markets to begin to ease, with London Interbank Offered Rate (LIBOR) finally falling and Treasury yields rising, although they remained a long way from historical levels.

The money used to recapitalize (buy shares in) banks was provided on terms that were grossly favorable to the banks. For example, Warren Buffett put new capital into Goldman Sachs just weeks before the Treasury Department invested in nine major banks. Buffett got a higher interest rate on his investment and a much better deal on his options to buy Goldman shares in the future.

As the crisis deepened and financial institutions needed more assistance, the government got more and more creative in figuring out ways to provide subsidies that were too complex for the general public to understand. The first AIG bailout, which was on relatively good terms for the taxpayer, was renegotiated to make it even more friendly to AIG. The second Citigroup and Bank of America bailouts included complex asset guarantees that essentially provided nontransparent insurance to those banks at well below market rates. The third Citigroup bailout, in late February 2009, converted preferred stock to common stock at a conversion price that was significantly *higher* than the market price—a subsidy that probably even most *Wall Street Journal* readers would miss on first reading. And the convertible preferred shares that will be provided under the new Financial Stability Plan give the conversion option to the bank in question, not the government—basically giving the bank a valuable option for free.

Note that this strategy is not internally illogical: if you believe that asset prices will recover by themselves (or by providing sufficient liquidity), then it makes sense to continue propping up weak banks with injections of capital. However, our main concern is that it underestimates the magnitude of the problem and could lead to years of partial measures, none of which create a healthy banking system.

The main components of the administration's bank rescue plan included:

- stress tests, conducted by regulators, to determine whether major banks can withstand a severe recession, followed by recapitalization (if necessary) in the form of convertible preferred shares; and
- the Public-Private Investment Program (PPIP) to stimulate purchases of toxic assets, thereby removing them from bank balance sheets.

The administration as much as said that the major banks will all pass the stress tests, making it appear that the results were foreordained. Essentially, this was used to signal that the government stood behind the 19 banks in the stress test and would not allow any of them to fail. Effectively, the government signaled which banks were too big to fail.

We also do not expect the PPIP to meet its stated objective of starting a market for toxic assets (both whole loans and mortgage-backed securities) and thereby moving them off of bank balance sheets. In essence, the PPIP attempts to achieve this goal by subsidizing private sector buyers (via non-recourse loans or loan guarantees) to increase their bid prices for toxic assets. Besides the subsidy from the public to the private sector that this involves, we are skeptical that the plan as outlined will raise buyers' bid prices high enough to induce banks to sell their assets. From the banks' perspective, selling assets at prices below their current book values will force them to take writedowns, hurting profitability and reducing their capital cushion.

As long as the government's strategy is to prevent banks from failing at all costs, banks have an incentive to sit the PPIP out (or even participate as *buyers*) and wait for a more generous plan. Again, the key question is how the loss currently built into banks' toxic assets will be distributed between bank shareholders, bank creditors, and taxpayers. By leaving banks in their current form and relying on market-type incentives to encourage them to clean themselves up, the administration has given the banks an effective veto over financial sector policy. There is a chance that the PPIP will have its desired effect, but otherwise several months will pass and we will be right where we started.

Ultimately, the stalemate in the financial sector is the product of political constraints. On the one hand, the administration has consistently foresworn dictating a solution to the financial sector, either out of deep-rooted antipathy to nationalization, or out of fear of being accused of nationalization. On the other hand, bailout fatigue among the public and in Congress, aggravated by the clumsy handling of the AIG bonus scandal, has made it impossible for the administration to propose a solution that is too generous to banks, or that requires new money from Congress.

One problem with this velvet-glove strategy is that it was simply inadequate to change the behavior of a financial sector used to doing business on its own terms.

This continued solicitousness for the financial sector might be surprising coming from the Obama Administration, which has otherwise not been hesitant to take action. The \$800 billion fiscal stimulus plan was watered down by the need to bring three Republican senators on board and ended up smaller than many hoped for, yet still counts as a major achievement under our political system. And in other ways, the new administration has pursued a progressive agenda, for example in signing the Lilly Ledbetter law making it easier for women to sue for discrimination in pay and moving to significantly increase the transparency of government in general (but not vis-à-vis its dealings with the financial sector).

And the Obama administration has pushed hard for a new agency to better regulate financial products offered to consumers. This is a commendable effort that is likely to succeed, despite opposition from the financial sector. Unfortunately, there has been no parallel effort to rein in the economic and political power of our largest financial institutions.

The power of the financial sector goes far beyond a single set of people, a single administration, or a single political party. It is based not on a few personal connections, but on an ideology according to which the interests of big finance and the interests of the American people are naturally aligned—an ideology that assumes the private sector is always best, simply because it is the private sector, and hence the government should never tell the private sector what to do, but should only ask nicely, and maybe provide some financial handouts to keep the private sector alive.

To those who live outside the Treasury–Wall Street corridor, this ideology is increasingly not only at odds with reality, but actually dangerous to the economy.