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Is America the new Russia?

By Martin Wolf

Decisive restructuring is needed to solve this crisis

Is the US Russia? The question seems provocative, if not outrageous. Yet the person asking it is Simon Johnson, former chief economist at the International Monetary Fund and a professor at the Sloan School of Management at the Massachusetts Institute of Technology. In an article in the May issue of the *Atlantic Monthly*, Prof Johnson compares the hold of the “financial oligarchy” over US policy with that of business elites in emerging countries. Do such comparisons make sense? The answer is Yes, but only up to a point.

“In its depth and suddenness,” argues Prof Johnson, “the US economic and financial crisis is shockingly reminiscent of moments we have recently seen in emerging markets.” The similarity is evident: large inflows of foreign capital; torrid credit growth; excessive leverage; bubbles in asset prices, particularly property; and, finally, asset-price collapses and financial catastrophe.

“But,” adds Prof Johnson, “there’s a deeper and more disturbing similarity: elite business interests – financiers, in the case of the US – played a central role in creating the crisis, making ever-larger gambles, with the implicit backing of the government, until the inevitable collapse.” Moreover, “the great wealth that the financial sector created and concentrated gave bankers enormous political weight.”

Now, argues Prof Johnson, the weight of the financial sector is preventing resolution of the crisis. Banks “do not want to recognise the full extent of their losses, because that would likely expose them as insolvent ... This behaviour is corrosive: unhealthy banks either do not lend (hoarding money to shore up reserves) or they make desperate gambles on high-risk loans and investments that could pay off big, but probably won’t pay off at all. In either case, the economy suffers further, and, as it does, bank assets themselves continue to deteriorate – creating a highly destructive cycle.”

Does such an analysis make sense? This is a question I thought about during my recent three-month stay in New York and visits to Washington, DC, now capital of global finance. It is why Prof Johnson’s analysis is so important.

Unquestionably, we have witnessed a massive rise in the significance of the financial sector. In 2002, the sector generated an astonishing 41 per cent of US domestic corporate profits (see chart). In 2008, US private indebtedness reached 295 per cent of gross domestic product, a record, up from 112 per cent in 1976, while financial sector debt reached 121 per cent of GDP in 2008. Average pay in the sector rose from close to the average for all industries between 1948 and 1982 to 181 per cent of it in 2007.

In recent research, Thomas Philippon of New York University’s Stern School of Business and Ariell Reshef of the University of Virginia conclude that the financial sector was a high-skill, high-wage industry between 1909 and 1933. It then went into relative decline until 1980, whereupon it again started to be a high-skill, high-wage sector.* They conclude that the prime cause was deregulation, which “unleashes creativity and innovation and increases demand for skilled workers”.

Deregulation also generates growth of credit, the raw stuff the financial sector creates and on which it feeds. Transmutation of credit into income is why the profitability of the financial system can be illusory. Equally, the expansion of the financial sector will reverse, at least within the US: credit growth and leverage masked low or even non-existent profitability of much activity, which will disappear, and part of the debt must also be liquidated. The golden age of Wall Street is over: the return of regulation is cause and consequence of this shift.

Yet Prof Johnson makes a stronger point than this. He argues that the refusal of powerful institutions to admit losses – aided and abetted by a government in thrall to the “money-changers” – may make it impossible to escape from the crisis. Moreover, since the US enjoys the privilege of being able to borrow in its own currency it is far easier for it than for mere emerging economies to paper over cracks, turning crisis into long-term economic malaise. So we have witnessed a series of improvisations or “deals” whose underlying aim is to rescue as much of the financial system as possible in as generous a way as policymakers think they can get away with.

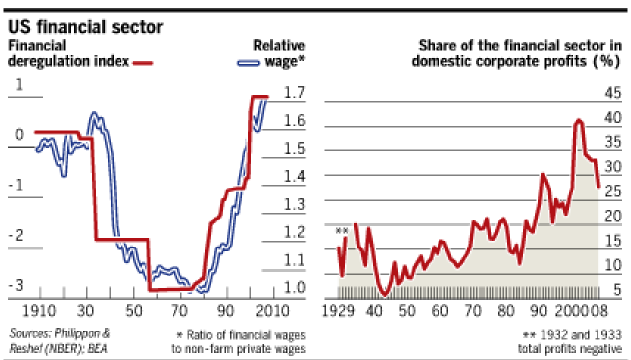
I agree with the critique of the policies adopted so far. In the debate on the Financial Times’s economists’ forum on Treasury secretary Tim Geithner’s “public/private investment partnership”, the critics are right: if it works, it is because it is a non-transparent way of transferring taxpayer wealth to banks. But it is unlikely to fill the capital hole that the markets are, at present, ignoring, as Michael Pomerleano argues. Nor am I persuaded that the "stress tests" of bank capital under way will lead to action that fills the capital hole.

Yet do these weaknesses make the US into Russia? No. In many emerging economies corruption is egregious and overt. In the US, influence comes as much from a system of beliefs as from lobbying (although the latter was not absent). What was good for Wall Street was deemed good for the world. The result was a bipartisan programme of ill-designed deregulation for the US and, given its influence, the world.

Moreover, the belief that Wall Street needs to be preserved largely as it is now is mainly a consequence of fear. The view that large and complex financial institutions are too big to fail may be wrong. But it is easy to understand why intelligent policymakers shrink from testing it. At the same time, politicians fear a public backlash against large infusions of public capital. So, like Japan, the US is caught between the elite's fear of bankruptcy and the public's loathing of bail-outs. This is a more complex phenomenon than the "quiet coup" Prof Johnson describes.

Yet decisive restructuring is indeed necessary. This is not because returning the economy to the debt-fuelled growth of recent years is either feasible or desirable. But two things must be achieved: first, the core financial institutions must become credibly solvent; and, second, no profit-seeking private institution can remain too big to fail. That is not capitalism, but socialism. That is one of the points on which the right and the left agree. They are right. Bankruptcy – and so losses for unsecured creditors – must be a part of any durable solution. Without that change, the resolution of this crisis can only be the harbinger of the next.

**Wages and Human Capital in the US Financial Industry 1909-2006, January 2009, www.nber.org*



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