

A PROVEN FRAMEWORK TO END THE US BANKING CRISIS
INCLUDING SOME TEMPORARY NATIONALIZATIONS

Testimony Before The Joint Economic Committee of the U.S. Congress
Hearing on “Restoring the Economy: Strategies for Short-term and Long-term Change”

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Chairwoman Maloney, Members of the Committee, thank you very much for inviting me to testify today at this critical juncture in American economic policymaking. I am especially honored to be following the testimony of Paul Volcker, one of the greatest public servants this country has had in the economic sphere, to whose wisdom we all would do well to listen.

Today, we face extreme financial fragility and as a result serious risks to our economy’s prospects for a sustainable recovery from its current troubles. Congress must grapple with difficult choices about America’s banks, and make those choices soon. Making the right choices now will require money upfront, large amounts of taxpayer money, and thus it is necessary as well as right for Congress to lead on this issue. But making the right policy choices now will restore US economic growth much sooner, at much lower cost, on a more sound basis, than trying to kick the trouble down the road or waiting for events to force the issue. Members of this committee are well-familiar with such warnings, usually with respect to far off economic problems. This time and this problem, however, are costing our citizens jobs and homes and hard-earned savings right here and now. And the correct policy response right now will make all the difference.

Luckily, although the scale of the banking problem that we now face is unfamiliar to us, the kind of banking problem we face today is familiar, and in fact well-understood. We have seen this before in the US in the mid-1980s Savings and Loan crisis, in Japan’s post-bubble Great Recession of the 1990s, in the Nordic countries from 1992-1995, and many times in many other countries. It is reasonable to ask why these kinds of crises keep happening, and how to prevent them in future – I would be happy to discuss that, but that is of lesser importance to our

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current circumstances. It is also reasonable to ask why economists who did not foresee the current crisis can be trusted to give advice with great assurance now that the crisis has hit. I would say this is analogous to the doctor who does not foresee that his patient's common cold will turn into pneumonia (or at least saw it as quite unlikely), but knows how to treat the pneumonia once it occurs.

So today I would like to advise you on how to cure our financial pneumonia, rather than letting it run its course, before it causes permanent damage or leads to hospitalization of our economy. And the prescriptions I will give are based on many prior cases, particularly what worked to bring financial recovery in the US in 1989 and in Japan in 2001, which are the ones most similar to our current condition.² In brief, I would urge the Congress to have the US government:

- Recognize that the money is gone from the banking system, and banks already are in a dangerous public-private hybrid state;
- Immediately evaluate the solvency and future viability of individual banks;
- Rapidly sort the banks into those that can survive with limited additional capital, and those that should be closed, merged, or nationalized;
- Use government ownership and control of some banks to prepare for rapid resale to the private sector, while limiting any distortions from such temporary ownership;
- Buy illiquid assets on the RTC model, and avoid getting hung up on finding the 'right price' for distressed assets or trying to get private investment up front, which will only delay matters and waste money;
- When reselling and merging failed banks, do so with some limit on bank sizes;
- And do all of this before the stimulus package's benefits run out in mid-2010.

This set of decisive actions is feasible and can be rapidly implemented, and follows a proven path to the resolution of banking crises. Implementing this program should spare us the fate of squandering additional national wealth and of postponing recovery for years that resulted from

² I draw on a wide range of research by myself and others. A good overview is given in *Japan's Financial Crisis and Its Parallels with US Experience*, eds. Ryoichi Mikitani and Adam Posen, PIIE, 2001.

policy half-measures in Japan in the 1990s and in the United States in the 1980s. Similar policy frameworks were adopted and resolved those crises in the end, but only after delay cost dearly.

Recognize that the money is gone from the banking system, and banks already are in a dangerous public-private hybrid state. There are statements in the press of late by bank managers and unnamed administration sources that some major banks currently under suspicion of insolvency actually have sufficient capital, or, slightly less dubiously, would have sufficient capital if only they were not forced to mark their assets to current low market values. These statements should be treated with extreme skepticism if not disdain. There are certainly *some* American banks that are either solvent, or sufficiently close to solvency that they can be returned to viability at little cost, despite the severe recession and market declines. But I agree with the vast majority of independent analysts and the obvious market verdict that sadly for many of our largest banking institutions solvency is but a far-off aspiration at present.

And it is the present condition that matters. In the mid-1980s in the US and most of the 1990s in Japan, bank supervisors engaged in regulatory forbearance, meaning they held off intervening in or closing banks with insufficient capital in hopes time would restore asset values and heal the wounds. One can easily imagine the incentives for the bank supervisors, well-documented in historical cases and the economic data, not to have a prominent bank fail on their watch. The problem, also evident in these historical cases and in the economic data, is that top management and shareholders of banks know that supervisors have this interest, and respond accordingly. The managers and shareholders do everything they can to avoid outright failing, which fits their own personal incentives.

That self-preservation, *not* profit-maximization, strategy by the banks usually entails calling in or selling off good loans, so as to get cash for what is liquid, while rolling over loans to bad risks or holding on to impaired assets, so as to avoid taking obvious losses, and gambling that they will return to value. The result of this dynamic is to create the credit crunch of the sort we are seeing today, and to only add to the eventual losses of the banks when they get recognized.³ The economy as a whole, and non-financial small businesses in particular, suffer in order to spare the positions of current bank shareholders and top management (and on the firing line bank supervisors).

³ Arguably, repeated forbearance of this kind when major American banks previously made poor decisions about emerging market lending and regional real estate booms, also contributed to getting us in to the terrible situation of today, by encouraging the largest banks to believe that they would always be bailed out without having to take the worst losses.

The guarantees that the US government has already extended to the banks in the last year, and the insufficient (though large) capital injections without government control or adequate conditionality also already given under TARP, closely mimic those given by the Japanese government in the mid-1990s to keep their major banks open without having to recognize specific failures and losses. The result then, and the emerging result now, is that the banks' top management simply burns through that cash, socializing the losses for the taxpayer, grabbing any rare gains for management payouts or shareholder dividends, and ending up still undercapitalized. Pretending that distressed assets are worth more than they actually are today for regulatory purposes persuades no one besides the regulators, and just gives the banks more taxpayer money to spend down, and more time to impose a credit crunch.

These kind of half-measures to keep banks open rather than disciplined are precisely what the Japanese Ministry of Finance engaged in from their bubble's burst in 1992 through to 1998, and over that period the cost to the Japanese economy from bad lending quadrupled from 5% to over 20% of Japanese GDP. In addition, this 'convoy' system, as the Japanese officials called it, punished any better capitalized and managed banks that remained by making it difficult for them to distinguish themselves in the market; falsely pumping up the apparent viability of bad banks will do that. That in turn eroded the incentive of the better and more viable banks to engage in good lending behavior versus self-preservation and angling for government protection.

I believe, regrettably, that is what is happening now in the US under the current half-measures. This is why further government intervention in the banking system, based on recognizing real losses and insolvencies is to be welcomed, not feared. So long as American banks have partial government guarantees and public funds to play with, but retain current shareholders and top management, they have perverse incentives and losses will mount. Think of Fannie Mae and Freddie Mac gambling with taxpayer dollars when having government guarantees but private claims on the profits and thus incentives for management and shareholder self-preservation. Hybrids are a good technology for autos – public-private hybrids are a terrible form for financial institutions. Thus, bending over backwards to keep all of the banking system in private hands without changing their management, while extending further government guarantees and investments is a recipe for disaster on the public's accounts.

Immediately evaluate the solvency and future viability of individual banks. The first step to ending these perverse incentives, and getting us away from the destructive undercapitalized private-public hybrid banking we now suffer under, is to get the books in order *without*

hesitation about declaring banks insolvent based on current valuations. It was that kind of aggressive, intrusive, and published honest evaluation by Japanese officials of their banks in 2002 that was the first policy step in finally ending their banking crisis. Treasury Secretary Timothy Geithner has acknowledged the need for evaluations, and will shortly be implementing 'stress tests' on the 20 largest US banks. Unfortunately, it remains to be seen whether the supervisors and regulators sent in to make these evaluations will be sufficiently merciless in discounting the value of current assets. The administration has given conflicting signals on this point so far. Much of the opening rhetoric in the Secretary's statements on the matter is tough, which I applaud.

The statement that the stress tests will be implemented in a 'forward-looking' manner, however, potentially opens the door to backsliding. We are in the midst of a very severe recession, and a huge asset price decline, when most things that could have gone wrong have gone wrong. So it seems reasonable that the current situation is about the most stress that bank balance sheets could be expected to come under; and why bother considering worse situations, since all too many banks will fail the tests under the present stresses. In the US in the 1980s with the savings and loans, and in Japan in the 1990s with all their banks, forward-looking (by other names) assessments ended up being forms of forbearance. When the assessments took into account future periods when conditions would be calmer and asset values would be higher than they were during the crises, they gave the banks an unjustified reprieve.

Granting such a self-defeating lifeline would also seem to be consistent with the repeated administration statements that they wish to keep the examined banks not only open and lending, but under continued private – and thus current – shareholder and management control. If this is the case, and I hope I am worrying unduly, it would be a grievous mistake. The fact that bank shares for many suspect banks have stopped dropping with the announcement of these programs, however, is another signal that many believe the stress tests will be beneficial to current bank shareholders. This stabilization if not bump in bank share prices cannot be based on a belief that the suspect banks will be revealed by the stress tests to be in truly better shape than the market believed them to be up until now, for then the private money sitting on the sidelines would be moving to acquire the (in that case) undervalued banks.

Another red herring, that I also fear indicates reluctance to do what is needed, are the occasional statements that the process will take several weeks or more, and will be difficult to implement given staffing constraints and complexity of the balance sheets. There is no shortage of unemployed financial analysts looking for consulting work, and there is no need to be all that

caught up in getting precisely the 'right' price on various distressed assets (as I will explain). The implementation difficulties of such evaluations are surmountable, as they were in other countries such as Japan that had a new unproven Financial Services Agency in place when it got tough in 2002, and here at home when the first Bush administration took on the S&L crisis in 1989-1991. Furthermore, what have the bank supervisors of the FDIC, the Federal Reserve Bank of New York, et al, been doing for the last several years if not getting some sense of these banks' balance sheets? The Treasury cannot make public claims that the banks' balance sheets will be revealed to be better than expected, based on supervisory information, at the same time that it claims that making the evaluations of the balance sheets will be daunting.

So strict immediate evaluations of bank balance sheets are agreed upon in at least form. Regrettably, there is some risk that the forward-looking stress tests may indeed be yet another transfer of taxpayer dollars to current bank shareholders. The people's representatives in Congress should not stand for this. If it turns out that Congressional insistence on tough love for the banks merely stiffens the spine of the Treasury, FDIC, and Federal Reserve to do what they intended to do anyway, so much the better. Their apparent reluctance to pull the trigger on tough evaluations may be based on fears in the administration that such forced write-offs would require the unpopular steps of another injection of public funds and/or round of closures, either way involving some government ownership of those banks. Those fears can be forestalled through your committee clearly stating that this kind of tough evaluation is in the public interest, and the benefits outweigh the costs. You and your colleagues can and should make the stress tests work.

Rapidly sort the banks into those that can survive with limited additional capital, and those that should be closed, merged, or temporarily nationalized. Banks think with their capital. As discussed, when their capital is too low, the incentives for their top management and shareholders are perverted, and contrary to the public interest. Simply giving capital to all the banks that are judged to need some, however, is a mistake. It spends taxpayer money we do not need to spend, and it rewards bad behavior by treating all banks equally, no matter how much capital they squandered. It is better to triage the banks quickly into categories by their viability on the basis of capitalization.⁴ This is what the Swedish government did rapidly with great success in 1992, when their banking crisis hit, and is what the Japanese government got around to finally doing in 2002, when their banking resolution became serious.

⁴ We are already sorting banks on the basis of systemic risk by virtue of stress testing the largest, and thus probably most systemically important, banks first. No one worries about closing small banks, usually.

The capitalization criteria should not be simply whether the net position after strict balance sheet evaluation is above or below zero, i.e., solvency. As we learnt during the Savings and Loan crisis, and as therefore reflected in FDICIA, which allows supervisors to take over banks which have capital ratios of 2%, by the time you get to zero it is too late (of course, right now, the problem is that capital ratios will already be well below zero for many of the largest banks). So the three categories should be:

1. Banks with clearly positive capital that only need a topping-up to return to health and healthy behaviors;
2. Banks with low or slightly negative capital where removal of limited bad assets could restore viability; and,
3. Banks with clearly negative capital and large, difficult to unwind, portfolios of bad assets.

The first category should receive their capital topping up from public fund injections through preferred shares or other loans of liquid non-voting capital. This format, combined with a clean-bill of health from credible inspections, should lead to rapid repayment of these banks' public funds. Yes, this is what was tried in the early days of the crisis and TARP; that did not work because it was wishful thinking at best to do so for all the major banks indiscriminately before credible balance sheet evaluations were completed. But for those banks within striking distance of solidly positive capital ratios, this is the right way to go.

The second category of banks likely includes many of the mid-to large-size, but not the largest size, banks in our system. These are banks that cannot get back to clearly positive capitalization, once their bad assets are fairly written off, but whose balance sheets can be rapidly cleaned up by bad asset sales and whose capital needs are not overwhelming. Banks in this category are usually sold off, in part or whole, to other banks, or are merged with stronger banks combined with some injection of public capital. As part of this process, current top management is usually replaced (perhaps 'naturally' in a merger process), and current shareholders' equity is diluted (though discounted purchases of bank components, public minority ownership of some common equity, or both).

It is the third category that grabs the political attention, and that unfortunately is likely to include some of our most systemically important banks. Clearly insolvent banks with no rapid way to sell off their assets at a discount would be unwound in an orderly fashion under

FDICIA, but in essence liquidated over time *if they were small and did not present a systemic risk*. That has already happened during this cycle to a few American institutions, such as Indymac, and even in Japan's lost decade, some minor institutions (like Hokkaido Tokushoku bank, Japan's number 19 or 20 by size in 1998 when it was allowed to fail) were wrapped up in this fashion, despite the general reluctance to close banks. Obviously, the issue is what to do about systemically important large institutions with difficult to unwind balance sheets. And this is the category for which temporary nationalization of the insolvent banks is the right answer.

In short, nationalization is only relevant for a part of the banking system under crisis, even for only a part of the technically insolvent banks, but it is necessary for the most systemically important banks that are insolvent. These banks must be kept in operation and have their positions and bad assets unwound in deliberate fashion. They also must have top management replaced and current shareholders wiped out. This is because the amount of capital required to restore them back to functionality is so large, and the process of restructuring their balance sheet so complex, with both having the potential to influence markets for other banks' equity and asset prices, that only the government can do it. There will likely be private buyers a plenty for such a bank when the recapitalization and unwinding process is complete, but not before the restructuring begins.

In a corporate takeover that requires significant restructuring of the acquired company, new private owners will always demand majority voting control and removal of current top management who are accountable for the accumulated problems. The American taxpayer would be ill-served to receive anything less for putting in the vast amount of money needed to restructure and recapitalize these failed private entities. And the American taxpayer, just like any acquirer of distressed assets, deserves to reap the upside from their eventual resale. That basic logic is why failed banks that are too systemically important to shut down should be nationalized temporarily. That is what the Japanese government ended up doing with Long Term Credit Bank and Nippon Credit Bank, two of Japan's systemically most important banks at the start of the 1990s, and thus unable to be simply shut down.

Use government ownership and control of some banks to prepare for rapid resale to the private sector, while limiting any distortions from such temporary ownership. Nationalization of some banks is solely the damage-limiting option under the current crisis circumstances. It beats the alternative of taxpayer handouts to the banks without sufficient conditionality, leaving financial fragility undiminished. Nationalization has its costs, however, beyond the upfront money provided and risks assumed by the government. No one in their right mind wants the US

or any government owning banks for any longer than absolutely necessary.⁵ The Mitterand government nationalized French banks in the early 1980s as a matter of socialist ideology, not necessity, intending to keep the banks in the public sector – and that was a huge mistake. The resultant misallocation of capital interfered with innovation and discipline in the French economy, and reduced the annual rate of growth in productivity and GDP by a three or four tenths of a percent, which compounded over several years makes a huge difference.⁶ But that was an unneeded governmental takeover of viable banks kept in place for a long period. The key is that government control is kept temporary, with sell offs of distressed assets and viable bank units back to the private sector to commence as soon as possible, some of which can begin almost immediately.

The historical record suggests that this kind of turnaround is not so difficult to achieve. That is what was seen with what became Shinsei bank in Japan (purchased by American investors after Long-Term Credit Bank was nationalized and cleaned-up) as well as with the top five banks in Sweden in 1992-95. In both Japan and Sweden, most nationalized banks were re-privatized within two years, all within three. And in all these cases there were private buyers when the governments were ready to privatize the banks, something that did not exist for these failing institutions before the government undertook restructuring. As is well-known, in these cases the responsible governments made back at least 80% of their costs, in the Swedish case turning significant profits for the taxpayers.

Furthermore, these banks continued most of their day-to-day operations during the nationalization period, retaining most personnel except top management. Given government majority ownership, it is possible to set up independent management, just as boards representing owners, public or private, always delegate to managers of complex organizations. New managers could be easily brought in from the amongst the many bank executives who specialized in traditional lending and banking, and ended up on the outs when American banks emphasized investment banking and other bonus-based securities businesses in recent years. The new managers could even be incentivized properly, the way we should consider incentivizing all bank managers: with long-term stock options instead of annual bonuses (some

⁵ I have been on the record attacking state ownership and subsidization of banks in Europe for years. See, for example, Adam S. Posen, “Is Germany Turning Japanese?”, Peterson Institute for International Economics Working Paper # 03-5 (condensed version published in *The National Interest* under the title “Frog in a Pot”, Spring 2003). That is completely different than temporary bank nationalization.

⁶ There is a vast and empirically robust literature on the effect of differing financial systems on economic growth, led by the contributions of Jerry Caprio, Stijn Claessens, and Ross Levine, with their numerous co-authors, from which I take this simplified estimate.

combination of public service motivations, very high upside potential, and facing unemployment would yield sufficient numbers).

Of course, there will be some pressures for politically-driven lending, but transparency arrangements could go a long way to limiting that – and it is difficult to imagine that remaining shareholders and top management of banks in the current public-private hybrid situation would not have every (destructive) incentive to politically pander in hopes of keeping their job and their stake. The difference in efficiency and politicization of lending between the current situation and full nationalization of some banks will not be all that great (which is what was seen with the zombie banks in Japan in the late 1990s, and our Savings and Loans in the mid- to late 1980s, just pandering to politically connected borrowers in order to stay open as private concerns).

Importantly, the existence of nationalized banks in banking systems that still had private banks operating as well did not lead to excessive pressures on their private competitors, let alone significant shifts of business or deposits away from those private banks. This can be seen today in the United Kingdom where the government's large ownership stakes in some major banks such as RBS and HBOS has not led to closures of or runs on the remaining private banks; in Switzerland, where the *de facto* public takeover and guarantee of UBS has not noticeably harmed still private Credit Suisse; and in Germany and France, where private banking firms have continued to operate despite the ongoing presences of Credit Lyonnais and the Sparkassen as government subsidized and part-owned entities.

Again, nationalization is not cost free, for over time such public ownership arrangements do eat away at the private banks profitability and proper allocation of credit, which in turn hurts productivity and income growth. But additional inaction today regarding the fragile US banks leaving current management in charge has the prospect of rapidly adding several full-percentage points of GDP to the total of bad loans and losses in just the span of months, which is a much bigger cost. It also risks a failure of a major financial institution without warning, before the government can respond, which would have large negative repercussions in the current environment – nationalization wins out on the stability criteria as well, versus our status quo, *in the short-run*. Japan in 1998 demonstrated the unfortunate lesson that half-measures stopping short of nationalization backfire, when it gave the private banks more capital, only to find them running out of money and having accumulated further bad assets when a new more actively reformist government took power three years later.

Buy illiquid assets on the RTC model, and avoid getting hung up on finding the 'right price' for distressed assets or trying to get private investment up front, which will only delay matters and waste money. To complete the full restructuring of the nationalized banks, or for that matter even the more minor capital topping off of the viable banks, when starting from honest evaluations of balance sheets, someone has to get the bad assets off of the banks' books. The utility of so doing is widely recognized. The Treasury has proposed setting up a complicated not-bad- but-aggregator public-private entity to serve this purpose. As with the stress tests, if the current US Treasury only says such things to sugar coat a tougher less passive intent in practice, so much the better. The American government should be benefitting the taxpayer by paying as conservatively low price as possible for our banking system's distressed assets, and if that means having to increase the capital injections on one hand to make up for the write-offs from low prices on the other, in terms of net public outlay it is little different, but more of the future claims on the bad assets' value is kept in US taxpayers' hands. As Alan Greenspan has observed, if we nationalize the banks, we do not need to worry about the pricing.⁷

The Treasury's proposal for creating a complex public-private aggregator bank instead of a wholly publicly-owned simple RTC-like bad bank is motivated by two aspirations: to mobilize 'smart money' currently sitting on the sidelines to share the upfront costs of buying the bad assets; to generate price discovery about what the bad assets are really worth, particularly for illiquid assets for which there is no market. These are well-motivated aspirations, but in my opinion penny wise and pound foolish with taxpayer funds at best, and simply unattainable at worst. It is worth noting that there is no historical precedent for making such an attempt for price discovery and costs sharing with the accumulated bad assets. Simple publicly-owned RTC-like entities sufficed in the Swedish and Japanese cases, and of course in the US Savings and Loan case that set the precedent. A new and clever approach always could be an improvement *in theory*, but this particular one seems to share with the reverse auction ideas of the initial TARP proposal a desire to be too clever by half.

It is just as arbitrary to set prices for the bad assets by deciding how much guarantee or subsidy the private investors receive from the government to induce them to get back into the game, as it would be to go into the banks and just pay what the markets are offering or zero right now. There will not be any price discovery through private sector means by undertaking such a program because the only difference between these assets unwanted now and then is the value of the government guarantee (subsidy) on offer. Private investors are obviously not buying the

⁷ Quoted in the *Financial Times*, February 18, 2009.

distressed assets now, which they could at the current low price, so the price will be set by the amount of the US government's transfer to these private buyers. At best, this gets the toxic assets off of the various banks' balance sheets, but at a far higher eventual cost to the taxpayer than would arise if the government purchased them outright and recouped the entire upside when there is eventual restructuring of and then real demand for these assets later. It is again Congress' role to stand up for the American taxpayer, to say to the administration that they should not fear having to put up more money upfront if in the end it will save the taxpayer significant money to do so now.

At worst, employing such a complicated scheme trying to hold restructuring up until meaningful prices somehow emerge (when the only change in the assets is a government subsidy with purchase) leads to a worse outcome. Uncertainty hangs over our banking system for longer, with all the noted perverse incentives for good and bad banks that induces. Possibility of a disorderly outright bank failure persists since the illiquid assets are not rapidly moved off of the balance sheets of some of the most vulnerable banks. The US government ends up overpaying for some assets in terms of guarantees and subsidies versus simply buying them at today's low values, but only manages to sell the more liquid and attractive upside assets to the voluntary private participants. In short, the US taxpayer gets left with the lower future return lemons, while paying for the privilege of having private investors get the assets with the most upside potential. Eventually, there has to be a wholly public RTC-type bad bank anyway, but now only for the worst remaining parts of the portfolio.

A wholly public simple RTC-type bad bank approach not only avoids these risks, but offers an advantage that the public-private hybrid (again a bad idea) aggregator bank does not. In fact, the additional complexity, and thus toxicity or illiquidity, of today's securitized assets versus what our original RTC or Japan's or Sweden's faced is an additional argument for having them all be bought by the US government outright: If the US government buys most or all of entire classes of currently illiquid assets from the banks, it would have a supermajority or 100% stake in most of the securitized assets that have been at the core of our problems in this area. That would make it feasible to reassemble sliced and diced securities, going back to the underlying investments (such as mortgages). This would detoxify most of these assets, making them attractive for resale by unlocking their underlying value, removing the source of their illiquidity, and thus offering the possibility of significant upside benefit entirely for the US taxpayer when sold back to the private sector. It would be an actual value-added transformation, not just an attempt to game the pricing.

In theory, a set of private sector investors or public-private partnership also could do this kind of reassembly voluntarily, but in practice the coordination problems are insurmountable, as seen in the complete lack of market for these assets at present. The use of the word 'toxic' to describe these assets leads to an apt and valid analogy: Just as the EPA can go to a Superfund site, one on which no one can currently live and no private entity is willing/able to clean up, it can literally detoxify that real estate by changing its underlying nature, and then have it come back on the market at a good value. The Treasury and FDIC can do the same with these currently toxic securities – if the US government has ownership and puts up the funding and effort to do the clean-up. Without a wholly public RTC initially owning the supermajorities, such a literal detoxification of the assets is impossible. And without that kind of fundamental change in the nature of the bad assets on the banks' books, it is difficult to see any reason for private smart money to buy them except to pick up a sufficiently large government subsidy. A hedge fund or sovereign wealth fund or private equity firm with cash is not staying out of these markets for distressed assets at present just because the prices have not yet 'fallen enough'; such investors are staying out because the assets are indeed toxic with indeterminate prices.

When reselling and merging failed banks, do so with some limit on bank sizes. One aspect of the financial crisis so far is that it has put pressure on banks and supervisors to increase concentration in the US banking system. When the government for understandable reasons will treat bigger banks as systemically important, and thus subject to bailouts and guarantees, it advantages them over smaller banks in the eyes of some potential depositors and borrowers. In addition, in each successive wave of banking fragility we have had up until now, US bank supervisors have tended to encourage stronger banks to merge with or buy up weaker banks – which is indeed in line with the standard crisis response best practice I outlined above, but also has contributed to greater concentration of the US banking system into fewer bigger businesses. The deregulation of interstate branching has also played a role. In each case, concentration was a side effect of well-motivated policies, and never became a major problem on its own terms (obviously many smaller and community banks continue to do business just fine).

We now approach a situation, however, where the US government will have capital stakes in a large portion of the US banking system, biased towards larger investments in the bigger institutions, and where there will be additional instances after triaging the banking system that seem to require mergers. Given that structural leverage over the US banking system inherent in upcoming decisions, and the sheer scale of the potential upcoming further consolidation, it is time to consciously put a limit on this process. As Paul Volcker has pointed

out in the recent G30 Report, if we get into trouble with banks being simultaneously too big to manage their portfolio risks *and* too big to be allowed to fail, we probably should not have banks that big.⁸ This is not a matter of the normal anti-trust consumer protection against monopoly, since these developments have largely benefitted consumers on the usual pricing and choice criteria, but of other public interests at stake.

Economically speaking, there is no clear logic to encouraging banks to be as big as possible. Years and years of empirical research by well-trained economists in the US and abroad have been unable to establish any robust evidence of economies of scale or of scope in banking services. In other words, banks do not perform their key functions more efficiently or cheaply when they produce them in greater volume, and banks do not gain profitable synergies by expanding their range of services and products.⁹ There was another reasonable theory that larger banks might be able to diversify their risks across a broader and more varied portfolio than smaller banks, and thus be more stable – the developments of the last two years in the US, United Kingdom, Switzerland and elsewhere, as well as those seen in Japan's highly concentrated banking system in the 1990s, however, reject that hypothesis rather dramatically (as do more formal econometric studies).

Finally, some people concerned with US economic competitiveness have argued that larger banks confer advantages, either because they allow for easier large-scale funding of US export industries, or because they allow US banks to compete better for market share in global finance, and thus export financial services. Unlike the previous two testable hypotheses, which were confronted with rigorous data analysis, these competitiveness claims have not been seriously studied. But the major threat to financing for American non-financial companies is market disruption caused by systemic bank failures, not limits on the credit available to them in normal times, and the export of financial services has been no more in the US national interest than picking any other single 'strategic industry,' a thoroughly discredited practice.¹⁰

⁸ Federal Reserve Bank of Minneapolis President Gary Stern has been calling attention to this potential problem for some years now. More recently, my PIIE colleague William Cline has written about it as well.

⁹ In some trivial sense, back office consolidation of certain types of processing of transactions could yield economies of scale, but even attempts to find evidence for these have proven unsuccessful – perhaps because so many of those services are available on an outsourced and competitive basis these days.

¹⁰ Some top US economic officials during the 1990s and earlier this decade sincerely believed that financial liberalization was in the economic self-interest of developing countries and thus was in the foreign policy interest of the United States. That is probably valid, and I am broadly sympathetic to that view, subject to some important cautions raised by Dani Rodrik, Joseph Stiglitz and others. But some of these officials then took that to mean that promoting the export of financial services by US financial institutions, and opening of foreign markets to US financial institutions' investment and sales were in the

So the Treasury, FDIC, and Federal Reserve should show some regard for excessive bank size and concentration in the US banking system when they are required to make decisions about banking structure upon returning parts of the system to fully private control. They cannot duck this, for even a non-decision to go with the likely outcomes of other priorities would result in defaulting to greater bank concentration at the end of the process. Unfortunately, unlike with regard to other aspects of the banking crisis resolution framework I have outlined, there is no well-established practice for how to deal with this issue.

I would suggest that two guidelines be employed: First, when any of the fully nationalized banks, which are likely to include among them some of the largest of current US banks, are brought back to market from public ownership, they be broken up, whether along functional or geographic lines. This has the additional advantage of allowing some parts of the temporarily nationalized banks to return to private hands sooner, and the return of investment to the US taxpayer also to arrive sooner. There will be some component operating units of the largest failed banks whose own sub-balance sheets can be cleaned up rather quickly. Second, preference be given to mergers of equals for the publicly recapitalized but not nationalized banks that normally would be encouraged by regulators to be merged or taken over by other banks. Since this group of banks is likely to be of a smaller average size than the nationalized group, this should be feasible. While it remains for Congress to pass regulation to determine the rules of how the US banking system should be structured in future, I believe that current law does give our bank supervisors enough authority and discretion over mergers of banks, especially for those involving a distressed institution, that this guideline can be followed when the bank clean-up moves forward in the near term (as it must).

And do all of this before the stimulus package's benefits run out. Implementing the preceding framework for resolving the US banking crisis will restore financial stability, as quickly as possible, at the lowest cost possible (though still high) to American taxpayers.¹¹ The experience of other countries, notably of Japan in the 1990s, but also of the US itself in the 1980s, is highly relevant to today's dangerous situation. Those historical examples show not only the right way to resolve our banking problems, but also that the rapidity and sustainability

US foreign policy – as well as export – interest. This was an unnecessary step, and one that is backfiring on the US reputation now that our financial 'model' and aggressive advocacy thereof is being blamed (excessively, but not entirely unfairly) for the current global crisis.

¹¹ See for example what I recommended for Japan in 2001, which was largely and successfully implemented by Japanese financial services minister Heizo Takenaka in 2002-03 ("Japan 2001: Decisive Action or Financial Panic," <http://www.iie.com/publications/pb/pb.cfm?ResearchID=72>). Many current senior US economic officials, such as Treasury Secretary Geithner and NEC Chair Summers, advocated the same for Japan and for the Asian countries during the 1997-1998 financial crisis there.

with which the US economy will recover from its present financial crisis is directly dependent upon our willingness to tackle these problems aggressively – including in some instances temporarily nationalizing banks. When the US government engaged in regulatory forbearance with undercapitalized S&L's in the mid-1980s, and when the Japanese government similarly pandered to its bankers and dawdled through the entire 1990s, the losses grew larger, and the problems persisted. When the US government truly took on the Savings and Loan crisis in 1989-1991, and when the Japanese government truly confronted its banking crisis in 2001-2003, following this framework, the financial uncertainty was lifted and growth was restored.

The only thing that makes the US different from other countries facing banking crises has nothing to do with the nature of our banking problems. What is special about the US in this context is the fortunate fact that we as a nation we are rich enough, with enough faith in our currency, to be able to engage in fiscal stimulus to soften the blow to the real economy while the bank clean-up is done. Emerging markets and even most smaller advanced economies generally have to engage in austerity programs, further cutting growth, at the same time that they tackle their banking crises in order to be able to pay for the clean-up. This gives us a window of opportunity, but the clock is ticking.

If we can resolve the US banking crisis in the next 18 months before the stimulus runs out of impact on the economy, the private sector will be ready to pick up the baton from the public sector – demand will grow, and recovery will be sustained. And following the common framework I have set out, it would be feasible to resolve most of our financial problems, if not return the entire banking system back to private ownership, within that time frame if we start right now. If we fail to move aggressively enough on our banking problems, this window will close because even the United States cannot afford to engage in deficit spending indefinitely – as President Obama rightly explained to Congress and the nation on Tuesday night. In that case, when the fiscal stimulus runs out, the private sector will be unable to grow strongly on its own, because the banking problems will prevent it from doing so. Japan showed us that fiscal stimulus indeed works in the short-term, but growth cannot be restored to a self-sustaining path without resolution of an economy's banking problems.

I ask the members of this Committee to carefully scrutinize and oversee the proposed programs of the US Treasury for banking crisis resolution. If those programs live up to their associated rhetoric, and are thus tough enough on the current shareholders and top management of our undercapitalized banks, we can in 2011 be like Japan in 2003, at the beginning of a long and much needed economic recovery. If unneeded complexity of the bad

bank construct, excessive reliance on and generosity to private capital, and unjustified reluctance to temporarily nationalize some US banks, turn the proposed bank clean-up programs into only half-measures, then we will be like Japan in 1998 – squandering national wealth and leaving our economy in continuing decline, only to have to take the full measures a few years down the road when in greater debt. I am hopeful that the Obama Administration with strong congressional oversight will do what it is need in time.