New Approaches to Economic Challenges

The Financial System

27. Bad policies encourage and tolerate excessive fragility

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Developed economies rely on chains of commitments between individuals and businesses of all sizes to enable consumption and investments and to share risks. Intermediaries such as banks and institutional investors are often important participants in these chains, making loans to individuals and businesses, investing their own and other people's money in the financial claims of large corporations. Financial firms also create and facilitate trade in asset-backed securities representing claims on baskets of assets, and in derivative securities whose payoffs depend on the realisation of certain events.

Central banks and governments play a critical role in the financial system. Government bonds trade alongside other securities in financial markets. Central banks lend to financial institutions, and increasingly participate directly in the markets by buying or accepting as collateral not only government bonds but also mortgage securities and corporate bonds. By setting the terms of the loans they make and determining which assets to purchase and at what quantities, central banks and governments impact the allocation and pricing of financial claims, effectively choosing winners and losers. How others in the economy are affected by government and central bank actions can depend critically on decisions made by financial intermediaries and other corporations, for example whether they use funds to make payouts to shareholders or invest in employees' welfare or otherwise.

Excessive borrowing by households and financial institutions, combined with ineffective regulations, were key causes of the 2007-2009 financial crisis. Many troubled banks received massive support from governments and central banks during and since the crisis, and they benefitted from the rescue of others (such as the insurance company AIG or the Greek Government). The lingering weakness of banks and households lengthened the post-crisis recession.

Many claim that reforms have made the financial system much safer, but in fact the system has not changed substantially in the last decade, and it remains too fragile, opaque and distorted. Policymakers failed to learn the lessons of the financial crisis and the new rules are complex, poorly designed and inadequate, exposing the public to unnecessary risk.

Perhaps the most glaring regulatory failure in the run-up to the financial crisis in 2008 and through the last decade that included highly profitable years for the banking sector, was allowing them to deplete their ability to absorb losses by making payouts to shareholders (in the form of dividends and share buybacks) rather than retain these and reinvest these profits on behalf of their shareholders and to be better prepared for economic shocks. Cash paid out to shareholders is no longer available to repay depositors and other creditors. When governments and central banks rescue banks, the shareholders and managers who had benefitted from the prior gains effectively pass on some of the losses to innocent taxpayers.

The distorted incentives of heavily indebted corporations are not unique to banking. Making payouts to shareholders, continuing to borrow, and selling assets (or laying off employees) instead of retaining profits and raising new equity can benefit managers and shareholders by shifting costs, risks and losses to others. A "leverage ratchet" dynamics makes corporate borrowing addictive and inefficient. This problem is particularly relevant for banks, whose love of borrowing is due to their naturally high level of indebtedness (in the process of taking deposits) and is further enabled and encouraged by explicit and implicit guarantees. Unless regulators intervene, and with supports from central banks, dysfunctional "zombie" banks may persist for extended periods of time, hiding their weaknesses and gambling for resurrection.

Corporate tax codes in most jurisdictions, which subsidise debt relative to equity, are among the key reasons corporations borrow excessively. These tax subsidies have no good rationale or justification. They

are as perverse as subsidising a polluting technology when clean and otherwise equally costly alternatives are available. The persistence of bad and harmful policies is no excuse for allowing it to continue. Abolishing distortive debt subsidies is long overdue.

We find counterproductive debt subsidies in other parts of the economy. For example, some nations, such as the United States and the Netherlands, provide tax and other subsidies to mortgage debt, which encourages excessive borrowing to invest in real estate and distorts household decisions and housing markets. If home ownership is worthy of public subsidies, governments can find ways to subsidise equity rather than debt funding of homes. Similarly, the student debt crisis in the United States reflects counterproductive policies in the name of supporting higher education. The policy creates heavy and harsh debt burden, subsidises for-profit colleges, including those providing sub-par education, and raises the cost of higher education.

When borrowers default or become insolvent, they may file for bankruptcy. The legal processes that ensue vary in different jurisdictions and for different borrowers, and they can be complicated, lengthy and costly. Cross border resolution of large multinational financial institutions is virtually intractable, a problem that has been known for decades yet remains largely unsolved. Worse, some bankruptcy provisions, such as broad “safe harbor” exemptions to derivatives and repo (sale and repurchase) agreements favor some creditors, mostly from within the financial system, over others, and ultimately encourage fragility. Finally, distortions in the setting and implementation of accounting rules, auditing, and credit ratings further increase the opacity of the financial system.

Fueled by persistently low interest rates and by yield-chasing investors willing to overlook risks, corporations have binged on debt in recent years, planting the seeds of a debt crisis before the onslaught of COVID-19. The disruptions caused by the pandemic led numerous affected individuals and businesses to financial distress and the inability to fulfil all the promises they had made. Governments and central banks stepped in to prevent some defaults or delay harsh consequences, for example by mandating temporary freezes on foreclosures and evictions, providing unemployment benefits, cash grants, and loans. Central banks have poured trillions into financial institutions and asset purchase programmes.

These actions have propped up financial markets, but they have also created distortions and added to the already high mountain of debt, which will have to be dealt with at some point. Similar to the financial crisis of 2007-2009, the extraordinary interventions favour investors and corporations and do not reach many parts of the economy that are most in need, creating disconnect between financial markets and the rest of the economy and exacerbating income and wealth inequality. Despite the risk of massive losses from the slowdown of the economy, many banks are still allowed to make payouts to shareholders and harm the public.

Recklessness in finance goes beyond excessive borrowing and includes many cases of fraud, money laundering and other law evasion, only some of which are periodically revealed. Large fines, with no major consequences for individuals who could have done more to prevent wrongdoings, fail to prevent repeated scandals. We must re-examine the workings of our justice systems in a corporate context.

In some parts of our lives, such as aviation safety, complex systems operate remarkably safely, including across national borders. In the financial sector, however, recklessness persists because of political economy forces and the benefit that many who collectively control the system derive from its fragility. COVID-19 might serve as a wake-up call.

Sources

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