

INTERVIEW WITH SIMON JOHNSON

PAM

... the game, the rules of the road, and why that's important, and why that isn't important. I'm trying to give you an overview, and then I'm gonna delve right in and ask you specific questions.

SIMON

Ok.

PAM

So if you're looking at the camera... My very first question, and that is, if you would set the stage for us, as a snap shot, before investment banks went bye bye, and after, how we came out of it when we wind up with commercial banks ruling the day. If you just sort of give a description of the landscape.

SIMON

Sure, well obviously, we had a great financial sector boom in the United States, and in other countries, since the 1980s, and part of that boom was the rise of some big banks. Wall Street banks actually, especially. And by the early 2000s, these banks were making incredible amounts of money. About 40 years ago, the financial sector accounted for almost 40% of all corporate sector profits in the US. That's amazing, it's quite an achievement from their point of view. And so what we had by 2005, 2006, 2007, was a boom, that many people thought would run forever. There were lots of stories, lots of sophisticated people who could explain to you why this time was really different, and there would be no significant slowdown, and certainly the idea of a crisis was regarded as crazy, certainly by most people and yet we find ourselves today, looking at the world, through very different eyes given what we've seen recently.

PAM

How so, and what do you mean by WS banks, cuz I tend to think that Wall Street is investment banks, and I always thought of commercial banks as being separate, being Glass-Steagall or what have you. So exactly what do you mean by, when you talk about big WS banks, then and now?

SIMON

So in the US since the 1930s we've had a strong separation between commercial banks, that make loans to individuals and businesses, and investment banks, that are in the business of brokering investments, selling securities and trading those securities. This was the outcome of the Glass-Steagall act, which was repealed in the 1990s I would emphasize, a very important point. So these two parts of the banking system started to be entwined again like they had been before the 1930s, and until very recently, there were very distinct WS animals in the banking sector. Very aggressive, relatively risk taking, and extremely successful, I would say, paying very large salaries. And then there was a range of commercial banks that were engaged in all sorts of commercial loan activities, some of which seems like it wasn't risky, and of course, that view was mistaken there, we've got to mortgages. But they were involved, these banks we involved in

much more mundane day to day banking activities, that would be much more recognizable to people on the streets. Take your cash out of the ATM, get a loan to buy a car, that was handled by commercial banks.

PAM

Now what were the big investment banks doing at that time, what was their main role?

SIMON

Well, the big investment banks have always been into issuing securities. So if you're a company and you want to issue equity, you want to go public, then you go to one of these investment banks. If you want to issue debt, and debt is a huge part of the day to day business of WS, then again, you need an investment firm to issue the debt and manage the debt. And increasingly, over the past 10-15 yrs, these WS banks also became what is known as "proprietary trading operations," which means they traded based on their own capital and they used information from various interactions from customers to give them insight into what was happening in markets, and they would place bets on which way markets were going. Was the dollar getting weaker, was the dollar strengthening for example, or what was happening to different kinds of stock prices, or debt prices, and they did very well, on that, and they felt that they were managing the risks of those bets extremely carefully. So they had a lot of very smart people, a lot of people with PhDs in math and physics, and they had some of the most sophisticated software in the world, with regard to assessing risk and they felt, and they convinced many people, that they were running sophisticated trading operations with very little risk, and they were therefore a good investment, so people put more money with these firms, and they were able to build up huge businesses on that basis [Pam walked on last couple words]

PAM

Are you talking about what specifically? You're talking investment banks, like the likes of...

SIMON

Well, [Pam speaks] yes of course the big investment banks were Lehman and Bear Stearns, which are no longer with us, also, Merrill Lynch, Morgan Stanley, and Goldman Sachs. And of course some of the big conglomerates all in one bank, such as Citigroup, were also very much involved in these activities. Other commercial banks, famous commercial banks, Bank of America, Wells Fargo for example, were not as much, into investment trading activities, although in the course of last yr, Bank of America bought Merrill Lynch, gave them, they thought, access to great opportunities, but it also, as it turns out, brought with it, great risks and probabilities and problems.

PAM

So if Glass-Steagall had not been shattered, would that have made a difference here? What is the significance of G-S having worked, and then being removed?

SIMON

Well, that's a great question and people are arguing about that a lot. My own view is, it would not have made that much difference, given the other, broader, deregulatory measures underway. Basically, during the 1990s, during the peak of the administration there was a very big push to reduce and remove regulation around financial markets. Any one piece seen by itself, didn't look all that radical, but when you put the whole thing together, you had a big transformation of what all kinds of banks were allowed to do, and this included the origination and the selling what we now call sub-prime mortgages it included how people are allowed to insure against risks by credit default swaps. Things that are you know, relatively complicated perhaps sounding, but actually pretty straightforward, which is how much risk are banks allowed to do, and to what extent are they allowed to, in dealing with ordinary people, misrepresent the costs of those services, and the likely downside for people who take out mortgages for example. Where initially they have a low teaser rate, and the payments go up a lot, quite soon. [Pam walked on last two words]

PAM

Are you saying then that before G-S, the big commercial banks were not allowed to do what vs after the repeal of G-S?

SIMON

Well again, it's not...

PAM

Why would anybody care?

SIMON

It's not...

PAM

... at a consumer level.

SIMON

Absolutely, again, it's not G-S per say it is the range of deregulatory measures taken mostly during the 1990s but some were taken in the 1980s and this movement towards freeing the capital markets of regulatory constraints continued under the Bush administration. So the key point from a consumer, customer, ordinary person point of view, is what the banks were allowed to sell to you. What they were allowed to say to you, how they were allowed to entice you into products that were not really as represented. That changed during the 1990s. And as a result, we've seen an enormous amount of abuse of customers, who were told or believed who were lulled into thinking that they were getting into one kind of product for example, on their credit card, but once they were in, once they were hooked, once they have a level of debt they couldn't get out of very easily, they quickly found out that interest rates went up a lot. There were a lot more charges, and the banks basically abused those customers.

PAM

So if I'm kinda looking down, I'm standing on WS, and a tumbleweed is blowing by me, and I'm looking down the street and saying, huh, WS, I'm a tourist here, WS my how things have changed. Let me count the ways, give me some examples of how things have changed in the game, going forward, in terms of this all happens or maybe helping, be invisible to ??

SIMON

Well, I think it's not just, nothing much has changed in substance, as well as inform. If you visit WS, you won't see much that's different honestly, and beneath the service, this is the remarkable and I think, rather scary point, which, despite all the problems we've encountered, despite the fact that these big banks, evidently, completely mismanaged risk, didn't even understand the risk they were taking on, and of course some of them collapsed. Those banks that have collapsed have been picked up and remerged into other big banks, so it's business as usual... We seemed to have learned nothing, and changed nothing, as a result of the crisis of the last few years. That's remarkable and amazing, and quite unusual in the American political context.

PAM

That's exactly the point I'm doing the... That's exactly what this episode is about. You gotta understand, I don't have anywhere near your knowledge in any sense, but I've been doing this for 10 yrs 15 yrs, before that I was a retail stock broker [explain credentials] ... Ws has been in the news every single day, headlines, for 2 yrs now, and yet, you just said, remarkably, business as usual. I mean, that's incredible to me. What do you find so incredible about that? What do you think that means going forward?

SIMON

Well usually in the US, very open, democratic society, when there's a major problem or catastrophe or disaster, or a big accident for example, we have quite quickly an investigation, a lot of facts are laid out, there may be some area of controversy or room for judgement, but a lot comes out, remarkably quickly. And then there's a push to make sure it doesn't happen again, so perhaps you pin down an aircraft crash, pin it down to 2 or 3 potential causes, you can't say definitively, exactly which one is the main problem, but you know what the cluster of problems was like, and then there's a very pragmatic approach to make sure none of those problems individually or collectively again. We haven't done that, we're not doing that for the financial system. The govt has had no systematic investigation, there are various kinds of accusations banded around. The financial sector lobby, of course, has rallied, is sticking together, and is insisting, that there be no substantive change going forward, and we'll see, but my assessment of the legislation that will come through congress, is that it will make no difference, and the big banks will be allowed to go back to running their businesses as they did before, which is very risky for them and their shareholders, and incredibly dangerous for US taxpayers, and US, American consumers.

PAM

So... so if we just continue along this, sort of almost in a sense the blind leading the blind in that maybe ?? managing risk b/c there don't seem to be any revelation coming out of it. No big "Ah ha!" moment kind of thing. Then what's the danger, what's wrong with that, one could argue hey fine we've been doing this for decades what's the problem? You're saying but we haven't been doing this for decades, we had something that was working quite well for a few decades where we didn't even have a bad bad banking crisis for a number of yrs. I mean you had your bad banking crisis at the beginning of the century before that, there haven't been that many crises, and now expecting out of this we're gonna go back to a situation where we see a bank in crisis more often?

SIMON

Yes, I think that's exactly what happened. After the Great Depression, after all the problems in the financial sector that manifests itself in the late 1920s, early 1930s, we had a financial sector that was very tightly regulated, and run on a safety first basis and it didn't pay high compensation relative to other sectors. That was the 1950s, 60s, and 70s, well what happened from the 1980s was we allowed the financial sector to become deregulated. We allowed or encouraged them to take more risk. And they were able to pay higher wages, and attract very high quality people on the basis on that. We had a financial sector boom, and it went too far. It was not sustainable, whether it was, one thing we can do was de-escalate, move those resources elsewhere in the economy, perhaps we'll wait, perhaps we'll have other crises, before we finally confront this situation. Perhaps it will have to be a bigger, even nastier problem before people focus on it, I don't know. But it is remarkable at this moment and time, that both the big powerful people in the private sector think there should be business as usual, and the really important people in the public sector, in the govt, seem to be going along with it, in that same view. Let's re-inflate the bubble, let's get everybody back working pretty much on the same basis as before. And let's not have any substantial changes in the rules. That's what the conventional wisdom is, that's what the official orthodoxy is, I think it's a problem, I think it's going to lead us into great danger and great difficulties.

PAM

Now as far as the big banks who are, who are standing? The ?? we've blown by, who's left standing on WS?

SIMON

Well, JP Morgan Chase is the largest bank left, independent bank, outside of the supervision of the govt. Citigroup and Bank of America are both important players, although they retain a closer link to the govt b/c of the bailout money they received and have not yet paid back. And Goldman Sachs and Morgan Stanley of course, are very important, independent investment firms still at this point. And there's a number of smaller banks that are significant players also.

PAM

Well that was gonna be my next question. Out of the 8200 or so banks that exist, let's talk for a second about smaller banks, community banks and what their role will be going forward, will it change, will it be bad news, good news, or indifferent?

SIMON

Well, I pray there aren't going to be difficulties for many of those banks particularly b/c they lend all the money to finance commercial real estate. So when ppl put up office buildings or want to own and operate a retail space, a lot of the funding for that comes thru smaller community banks, commercial banks. Now commercial real estate is starting to turn down, there's a lot of retail space that's becoming vacant, and rents are going down in many parts of the country for commercial real estate. So that is going to put a lot of pressure on these smaller banks and I'm afraid they are a very unfortunate, experiencing very unfortunate collateral damage, arising from the mistakes and the arrogance and the hubris of the biggest banks. The small commercial banks didn't take on risk but they have exposure thru commercial real estate to what happens in the real economy. And obviously the real economy is doing and going to do quite badly, b/c of the problems in the credit system caused by the misfeasance, the messing up although legal messing up of the biggest banks. So it's really quite sad for them.

PAM

So going forward, I've been a big fan of small community banks that didn't take on all that risk and they've managed their liability their assets very well and not like savings and loans did in the 80s, mom and pop banks give loans and service those loans and everything else, is there gonna be a tsunami of erosion, of profitability of those banks or will ?? And they'll actually have to fold up under this heavy handed, whatever this new regulations are that would prevent bigger banks from doing what they're gonna do to get into the business of the smaller banks in other words.

SIMON

A lot of the smaller banks are gonna have trouble. The FDIC is slowly taking them over, managing the fail of those banks at the rate of 3, 4, 5 a week. All the depositors are protected, the FDIC has enough resources to make sure no one should fear that, but as a business, and as a provider of jobs and supporter of credit in local communities, these banks are under pressure.

PAM

Under pressure, b/c I don't think that these guys are like Hallelujah, I am in good shape, I can continue to do my business, but you're saying they're gonna come under pressure, a lot more pressure?

SIMON

Absolutely, ppl are losing their jobs all around this country. When you lose your job you don't have income, you don't go shopping, so anyone has lent to you against your home mortgage, anyone who lends to the businesses where you usually buy your goods and services, is going to find that the ppl who are borrowing that money are going to have a harder time servicing the loans. Banking is always about risk, banking is always about deciding who the safe borrowers

are and less safe, and pricing your loans accordingly. But the small banks did not anticipate the kind of economic collapse, that we really experienced in this country, and it's possible that they'll be a rapid turn around and that'll make all these problems go away, but it seems more likely that there's going to be a sluggish recovery. In that slow, painful recovery, a lot of ppl will default on their loans and that is going to negatively impact the small community banks.

PAM

Ok, alright, I want to stay away from things that are very in the news right now, but I like what we're hitting on, fundamentals, and fundamentals over longer time periods. You wrote that a recovery will fail unless we break the financial oligarchy [tape hiccup] ... and if we are to prevent a true recession, we're running out of time.

SIMON

Yes we are running out of time. Unfortunately this oligarchy, or ppl who have big political power based on their economic power in this society. It's not being addressed it's not being reformed. It's not being changed really in any substantive way, and instead we are going ahead with the kind of structure that got us into this much trouble. Look the amount of debt, privately held public debt, is rising from about 40% of GDP where we started, to about 80% of GDP so a doubling of our govt debt. Just b/c of the way our financial sector messed up, and what govt had to do in a series of stop gap measures, stop the damage from becoming too extensive. Now that is a terrible terrible thing for any economy to have to do, but you might think ,once you've done that you might try and remove the underlying causes and prevent it from happening again but we're not. The govt hasn't taken decisive measures. The same ppl, with the same powers, and the same attitudes, are still in place. And this is very dangerous, down the road it can absolutely come back to hurt us in a much bigger way and yes of course, we can repeat the experience of the 1930s and have another Great Depression, if we're not careful. If we don't learn the lessons and we don't apply them, we don't overcome the political forces that oppose responsibility and sensible change and the reduction of risk at the level of overall economy, then we're asking for trouble.

PAM

What does sensible change look like?

SIMON

Well the most important thing, is to make sure that banks don't get so big that they can't fail. See when a small bank fails, b/c it made a bad decision or it got unlucky, we know how to manage that. We're very good in this country at managing the failure of small or medium sized banks. The FDIC does that, one of the best organizations in the world at closing down that kind of bank but when a bigger bank fails, it becomes insolvent, we blink, oh we can't deal with this, we can;t go thru any kind of bankruptcy process or negotiate a conservatorship it's called, that's what they did for Continental Illinois in the 1980s for example. But now the said, they said, this yr, oh no these banks are too big, it's too scary too difficult, we have to provide them with a great deal of additional bailout money and that's why the govt debt has gone up so much. Bailouts that

have been providing or indirectly providing those banks. Well that's crazy! That's irresponsible going forward, that has to change, but it's not changing, this administration thinks that we can go ahead, with essentially the same structure that brought us to this point. That's like saying we just had an airplane accident, we know roughly where the problem was, we're not gonna fix it, we're gonna keep the planes flying on the same basis. Doesn't make any sense to me, and doesn't make any sense to other ppl. But the ppl who control policy in the administration and on Capital Hill seem to be going ahead on that basis.

PAM

So in a really practical sense, if you had 1, 2, and 3, the order of priority when talking about these kinds of changes, that would make sense, that would change attitudes, [explain 1, 2, 3 choices] what would they be?

SIMON

Well I just have two actually. One is making the biggest banks smaller. Small enough to fail. Anything that is too big to fail is too big to exist. And it creates big potential danger. And the second thing is consumers need to be much more protected than they have been in the past. And on this point there is some glimmer of hope b/c the administration has proposed a consumer protection agency with regards to financial products. I'm concerned they're not pushing hard enough, concerned the financial industry is rallying against it, and these ppl are very powerful, but but if you can get consumer protection into place, that would be a major achievement. But they also need to make sure, that these banks that are regarded as too big to fail, actually become much smaller, so they can fail and they don't take the financial system with them.

PAM

Too big to fail doesn't even make sense. [mumble] it's true, it doesn't make any sense. How can you have too big to fail if you're gonna operate against the backdrop of free market? And not let them fail. [question] with regards to financial product and ?? consumer regarding financial products, what exactly are you talking about?

SIMON

Well I think it's pretty obvious at this point that many consumers were lured into financial products that they didn't understand that were not really in their best interests. This would include various kinds of mortgages and various kinds of credit card offers. Where initially the payments are pretty low, and it looked like a good deal, but if you look at the full stream of what you're gonna have to pay, and what you'll end up owing, it's really unappealing and many of these products basically imply that you're going to default down the road... [Pam walked on the last words]

PAM

Yeah thats set up to fail

SIMON

Exactly! [Pam speaks] which is fine if consumers know that but if consumers don't know that, or get it, it's a big problem.

PAM

Any other items you can think of in regards to ordinary investors? How will ordinary investors go about or will business as usual be completely invisible to them?

SIMON

I think business as usual from an investor point of view will mean not much change in the look and feel of the financial system. At least until there's another crisis of course. When they'll realize, system changed... system changed quite a long time ago, system changed 15-20 yrs ago, became much more risky without that being advertised or being understood more broadly. And that point may have to be hammered home to many ppl again and again and again before they get it and before they understand the way the system actually works.

PAM

Where does the Federal Reserve fit in in all of this?

SIMON

Well the Federal Reserve plays a critical role in overseeing how the federal system works. It has a potential role in authority to effect change if it wants to and it has that kind of mandate. And it may get stronger power as a result of the legislation that goes through this yr. Whether that changes anything really, remains to be seen. I'm highly skeptical. The Fed you have to remember was a big cheerleader, the leading cheerleader under Alan Greenspan, for the financial sector boom, and the ideology of the Fed was that the markets could do no wrong. And if there was a private transaction underlying then that was fine, leave it alone. That turns out to be a huge mistake, a huge misunderstanding but we see no evidence really that they're gonna change their attitudes on that in any way.

PAM

What are you telling your student? What do you think are some of the most important messages that need to be out there?

SIMON

Well the most important message is obviously, the financial sector has become very risky. It needs to be reformed top to bottom to bring those risks under control to make sure powerful players, highly compensated ppl can't take on the same kinds of risks as in the future. They can't jeopardize the financial system they can't get to the point where they put a gun to our heads and say, give us a huge amount of money, 40% of GDP in bailout money otherwise the economy is going to collapse. Now if you reach a point where they can have that conversation with you then you know your options are all horrible. The point is to prevent that from happening again, and this is not incredibly complicated in economic terms, but politically it's a struggle. These big banks are very very powerful, and you have to go at this full force, with enormous effort, top

leadership of the country has to be focused on this and they're not, they are absolutely not right now. They've taken their eye of the ball, they've let it drift away, and as a result, it's back to business as usual, and unfortunately, more likely than not, we'll face another, could even be a bigger crisis, down the road.

PAM

Did you say the financial sector was 40%?

SIMON

Yes the financial sector was 40% of corporate profits, all corporate profits, all profits owned by companies, 40% of them came from the financial sector. That's amazing, financial sector is quite big, it's like GDP too big probably not sustainable in itself. But any sector historically it had corporate profits in the 10-15% range. To go up to 40% was really an indication that something was brewing that was not entirely healthy. Financial sector insiders of course have made out like bandits throughout this whole process.

PAM

If the share was up to 40% before what is it now?

SIMON

Well that's a good question, we're just now seeing earnings reports now it looks like the financial sector will be quite profitable and of course the rest of the corporate sector is really hurting. Total profits are down a lot b/c of the econ, b/c of the recession, the massive blow that many non-financial businesses have taken. Due to problems in the credit system. So ironically and really tragically, the financial sector in the short term may end up being a big chunk of corporate profits again. Down the road I think that will change, down the road I think the financial structure will struggle. Ppl increasingly realize how badly it's been run and how terribly how these big financial firms actually did, and I think eventually we'll be re-regulation re reform. Proper reform of the sector, but it'll take 3, 4, 5 yrs. It will prevent them from taking massive risks, it will lower that profitability also.

PAM

Not red tape regulation? Regulation that provides framework?

SIMON

Yes, but honestly, all regulation comes with red tape. That's very hard to avoid and the question is what do you prefer regulation that slows down the sector makes it more boring like a power co? Or the mad cap race, generating enormous risks? Jeopardizing the jobs and incomes of millions of ordinary Americans? Those are your choices. Either you let them damage the economy again and again and again down the road, or you put them under control and slow them down.

PAM

Worried about stupid actions by less savvy commercial bankers?

SIMON

Well first and foremost, the ppl who were running Lehman, Bear Stearns are not savvy investors, they didn't understand risk. Irrespective of what they told you and what they believed about themselves and how the pop culture perceived them as being very smart sophisticated ppl, they weren't. They completely messed up, they destroyed they're firms they wiped out an enormous amount of value. They forced the govt into this position where they throw out bailout money and run up big additional debt. Now will the commercial bankers do any better? I dont know. I think any kind, any background that is too big to fail, perceived as being too big to fail by the govt, will get in trouble, b/c they figure they can get a big bailout, maybe escape whole, maybe escape with bonuses, so why manage their operation carefully? There's no reason, there's simple incentives. You're allowing them to take. So the commercial banks could mess up just as badly as the investment banks, investment banks that have become commercial banks could do badly and vice versa, it doesn't make much difference. Anything that's too big to fail, is too big to exist. That is the key message, ppl have to focus on that, think that one through talk to elected reps and do something about it. Maybe sooner rather than later, we can sort this out, reduce this political risk that we have from the power of these big entities. It's going to be a struggle, it's going to take a long time to really change this.