The rich country trap

By Simon Johnson
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Until about 10 years ago, it was fashionable among policy makers to suppose that relatively rich countries had grown or evolved beyond the stage where they would be vulnerable to debilitating financial crises. The reasoning was that financial markets had become sophisticated, in part because big companies knew how to diversify their risks. And with a large continent-wide real (i.e., nonfinancial) economy, what could possibly go wrong on a scale that would be large enough to shake the American or the European financial system?

This view proved completely wrong; think about what we have seen since 2003. In the United States and Europe, the financial system proved able to destabilize the real economy. Risks were created and mismanaged on a grand scale. The largest banks were quickly and repeatedly among those in the most trouble.

The problem was not any lack of smarts, but rather that people were paid based on their return on equity without appropriate adjustment for risk. In that context, the clever thing to do is to borrow as much as possible, particularly if you think that downside insurance will be available in some form from the government.

When middle-income "emerging markets" encounter a financial crisis because of dysfunctional incentives in the banking system, the obvious reaction is to adopt reforms that make banks safer. The people who run those local banks may well oppose such changes – no one wants to see the end of a great money-making scheme – but even the most influential of those people do not have much power immediately after a crisis. Prominent people in other sectors are deeply annoyed at the collateral damage caused by excessive risk-taking by bankers.

And in most middle-income countries, the financial sector comprises at most a few percentage points of gross domestic product. The most powerful economic interest groups are those in manufacturing, for example oriented toward export markets – companies like Samsung in South Korea.

In contrast, in a country like the United States or Britain, the financial sector is much larger as a percent of G.D.P. – from 7 to 9 percent, depending on how exactly you measure it. This is a direct result of having accumulated more financial assets – a direct result of prosperity and the reasonable desire to save for retirement.

In addition, because rich countries are able to issue a great deal of government debt in the short-term and have central banks with credibility in limiting inflation, they are able to provide very large amounts of support, direct and indirect, that prevent prominent financial companies from collapsing.

There is no sector in the modern United States or Britain that is willing to stand up to big banks in the political arena. And top financial-sector executives continue to enjoy such high prestige that they are still called upon to run public finances. Politicians continue to defer to the supposed wisdom of these individuals.

Five years after the worst crisis since the 1930s, the conventional wisdom in Washington is once again that United States is a bastion of global stability and that it is important for the national interest that the financial sector should remain basically as is.

There is no desire to discuss how financial crises affect fiscal deficits and push up government debt. There is no inclination to recognize that providing support to parts of the financial sector undermines the legitimacy of the central bank.

Downside insurance of this scale is, of course, not available to everyone. For example, many homeowners would be in better financial shape if they had been provided with "liquidity loans" during the crisis.

But such credits were available disproportionately to large financial intermediaries and to the people who run them.

Such practices are unfair. They also confirm and reinforce the distorted incentives that caused the problems in the first place.

But the last five years have made it abundantly clear that we will be stuck with this problem for a long time in the United States and many other rich countries. The financial sector has become large as an employer and as a contributor to politicians. The government has developed enough capacity to support big banks and their creditors in a crisis, but not enough will to change the terms of this support.

Middle-income countries have done better in the aftermath of their crises, but they too will fall into the rich country trap as they grow more prosperous.

The rise of finance is a mark of success – and it can also be most helpful to sustaining economic growth. But the political power of big financial institutions means trouble, because it provides cover for a high degree of private leverage that is prone to collapse.

These powerful companies and their well-connected employees will continue to work hard in 2014 to increase the willingness of the government to provide huge amounts of downside protection to their sector, essentially at no charge.

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