'Failure is good'

April 5 2010, by Peter Dizikes

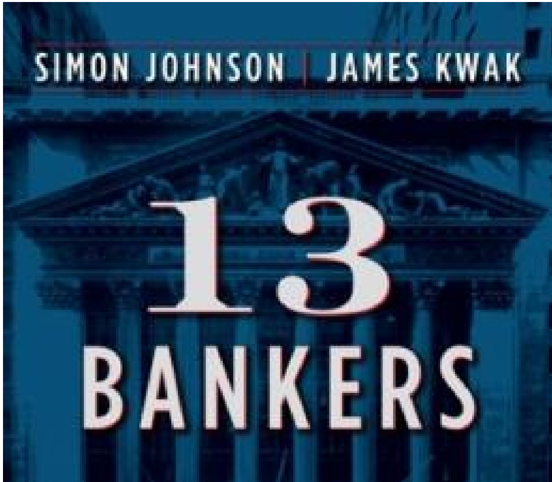

Image: Knopf Doubleday

“Greed is good” became a popular phrase in the aftermath of the 1987 movie Wall Street, implying that the riches of individual financiers were justified by the role those people played initiating large-scale wealth creation throughout society.

Two decades and several financial meltdowns later, that slogan could probably use an update, something gamely attempted by Simon Johnson in a talk on campus Friday, supporting his new book about the financial crisis, *13 Bankers* (Knopf Doubleday, 2010).

“Failure is good,” said Johnson, the Ronald A. Kurtz (1954) Professor of Entrepreneurship at the MIT Sloan School of Management. “This

country is based on our ability to take risks, to create new things — and our ability to fail, individually and in a corporate setting. If you become too big to fail, it's no longer a market economy."

Over the last 18 months, Johnson has become one of America's most prominent critics of both the banking industry and what he sees as an ineffectual government effort to straighten out those banks in the wake of the financial crisis September 2008. As Johnson sees it, the whole notion that financial institutions can become "too big to fail" is a distortion of basic market incentives; instead, risks and rewards must co-exist so that banks, rather receiving bailouts after losing billions, will have motivation to perform well.

"Ask yourself this," said Johnson, speaking to a packed house at Wong Auditorium. "If you had a lifetime exemption from speeding tickets, would you speed? You might say, 'No, no, I'm a responsible driver, I'm really very careful all the time.' But … who in this room would be able to withstand the temptation of speeding under those circumstances? That's how it is in banking."

To be sure, in 13 Bankers, Johnson and his co-author James Kwak allow that government intervention in September 2008 helped prevent a larger economic disaster. But Johnson and Kwak believe that as the ill health of the banks lingered, the Obama administration did not extract enough reforms in return for the hundreds of billions of dollars it made available to financial firms.

Additionally, Johnson believes finance does not help the overall economy as much the industry's leaders claim. In 2003, he noted, the financial sector accounted for 40 percent of corporate profits in the United States, an all-time high. "That's extraordinary," said Johnson. "That's incredible. That's ridiculous."

As Johnson and Kwak point out in 13 Bankers, financial-sector profits grew six-fold from 1980 through 2009, whereas the non-financial industry profits only doubled during the same time. If Wall Street were truly driving overall growth, those rates of increase would be more similar. “There is no evidence that this process has benefited the broader, non-financial economy,” Johnson said on Friday.

Is too big really too bad?

As a remedy for what they see as oversize banks, Johnson and Kwak would like to limit how much money banks can lend to each other. Still, the authors acknowledge that more active oversight will also be required.

“We’re not saying fixing bank size is sufficient,” Johnson said. “But it is necessary.”

That issue was emphasized in a lively question-and-answer session. MIT Sloan Professor Erik Brynjolfsson, for one, asked Johnson and Kwak whether a system of more numerous but smaller banks wouldn’t be prone to the same kinds of bubbles and meltdowns.

Kwak, who joined Johnson onstage to answer questions, said in response, “It’s certainly theoretically possible that if you had 10 small Goldman Sachses, they could all adopt the exact same strategy, but … if you have competing banks, their strategies are less likely to be completely correlated.”

In turn, Johnson suggested that a critical problem with large financial institutions is not just economic, but political: Bigger banks hold more influence in Washington, reducing government latitude for action. Johnson, the former chief economist of the International Monetary Fund, calls this industry “capture of the state.”

As for the future of financial regulation, Johnson doubts the current bills in Congress will become law (even though, Johnson noted, Senate Banking Committee Chairman Chris Dodd, a Democrat from Connecticut, has been reading 13 Bankers this week).

“I don’t think this will get fixed in this legislative cycle,” Johnson said. His campaign critiquing the banks “is about changing the consensus,” he added, concluding: “Without that, we will not make any progress in this country.”

Provided by Massachusetts Institute of Technology

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