Quantitative Easing - Too Small to Fail Part IV

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For the most part of the first decade of the 21st century the financial system has been dealing with the effects of markets, investments and assets bubbles. During these times, leading and important organizations have been weakened by anemic internal controls, betting excesses and in some cases, just bad decision making processes.

We can summarize the overall factors that induced the crisis as follows: very high risk lending and adjusted rate mortgages; regulatory failure and incapacity to validate adequacy of financial business practices; inflated credit ratings and an outdated method to evaluate business adequacy after financial system de-regulation during the 90s; and investment bank excesses and conflicts of interest while handling transactions.

As we have stated during this series of articles, the main results were:

1. Money supply restrictions on a global scale.
2. A systemic credit crunch for the global financial system.
3. The erosion of wealth and net worth in balance sheets on a corporate and the household level.
4. The stalling of overall consumption and a deep transformation of consumers behavioral patterns.
5. Investment capital frozen and being overly cautious.
6. High risk monetary policy responses from governments to try to jumpstart in economic activity.
7. Quantitative easing utilization as the last resort option to untighten financial markets.

Among the many interesting aspects of developing monetary policy is the fact that the Federal Reserve System, was unusually concerned about the viability of big institutions it helped to create during the latter part of the nineties. The vulnerability (according to the FRS) in the financial system was attributed to the capacity of these big firms to maintain the overall economic activity. Hence the TOO BIG TOO FAIL answer from government to justify bailouts and cash infusions to the same businesses responsible for the fallout that became the nightmare scenario in 2007 and 2008.

Obviously, some things needed to be done and actions were required. But an aspect that was not openly discussed by policy makers during those times was the fact that the economy is constituted by mid and small sized businesses and also is composed of households that pull demand for products and services.

While, the big corporations got the quick lifeline from government, the other players in the economy were put on a second tier set of priorities and very slow responding support programs. THE MAIN POINT WE ARE MAKING IS THAT IF ANY CONSTITUENT SHOULD FALL DOWN WHILE THE ECONOMIC ACTIVITY IS TRYING TO BE REACTIVATED, THEN THE POSSIBILITY OF A SUSTAINABLE UPTURN BECOMES A VERY REMOTE POSSIBILITY.

This approach to focus on the biggest institutions seemed like a basic pareto analysis applied to a full-blown systemic crisis. As stated by many distinguished scholars, including Russell Lincoln Ackoff (the father of Systems Theory), if you hope to optimize a very complex financial system by just focusing efforts on optimizing a small group of players within it, then the outcome will leave behind a huge amount of participants that won’t be able to contribute to strengthen the system. The aim should always be at managing and strengthening the inter-relationships of the parts that constitute the entire system. Just because others are involved in the game you are playing doesn’t mean they are playing the same game.

The main logic that was used to focus on a small number of corporations (ten banks) followed this cognitive stream:

1. A direct cash injection (QE) increases asset prices, unblocks corporate credit markets and increases the overall money supply in the economy. (The Federal Reserve System flipped the coin)
2. An increase in asset prices has the effect of increasing total wealth, as enhanced asset prices make people wealthier directly or indirectly. (This is a very fallible logic, particularly when you take into account the huge amount of credit defaults on first and second mortgages during the 2007-2010 period)
3. Also, an increase in asset prices has the effect of decreasing borrowing costs, as higher assets prices mean lower yields, making it cheaper to households and businesses to finance spending. (Assuming that there is low unemployment rate and mid-small businesses and households are effectively managing their debt and did not went bankrupt during the crisis. For the record, THIS WAS NOT THE CASE.)
4. An increase in money in the economy has the effect of increasing bank lending because there is more money available in reserves and it has the mathematical effect of strengthening their balance sheets and enabling their capacity to lend to businesses and households. (This sudden health in balance sheets is induced by government policy; it is not a real creation of wealth. Furthermore, this logic assumes that financial institutions will lend money even when regulators are establishing new restrictive guidelines to lend money, making it more difficult to access credit)
5. As total wealth increases, cost of borrowing decreases and bank lending increases, then (and only then) spending and income increase spurring consumption of products and services all throughout the economic sectors. (This final aspect assumes that households and businesses should be more willing to spend money, this in turn should improve employment prospects and raise incomes…)

While this logic was deployed, millions of households went bankrupt, small and mid-sized organizations disappeared, incomes eroded, job creation has been erratic and spending has started to slowly pick-up. Thus, it was critical to define and establish a collateral strategy to ensure a sustainable recovery of the economic system. We call this collateral strategy the TOO SMALL TO FAIL policy; the same refers to a set of principles for nurturing programs that could be effectively deployed to help the more vulnerable participants in the economy.

Some of the main elements of the TOO SMALL TO FAIL policy would include:

1. Protecting consumers from predatory lenders and provide a safety net for households encroached by unreasonable credit terms.
2. Providing small scale financial institutions access to capital and small and mid-sized business access to credit through special short-term programs.
3. Create a Trust Fund for Community Banks (92% of the US banking industry) and Credit Unions that meet certain federal standards in terms of size, investment in their local communities and adequate equity capital. The objective would be for the Trust Fund to purchase and acquire preferred stock in institutions that were looking for capital to grow, just as the Federal Reserve System did with banks during 2008.

The large bias toward big institutions during the last three decades, created some systemic risks that became a reality during the last five years; the primordial need to nurture a financial system that is more resistant to financial malaise is visible, concrete and dramatic.

It is improbable that economic activity will reach the growth level registered before the 2007-2008 global financial crisis. Although now there is more stability within the world financial system, the sustainability of the recovery is in question as many leading indicators are providing mixed signals at the moment.

In the meantime, we hope that some good signals maintain a steady course for the rest of the year; that there are no more closet skeletons in the financial market and its big institutions; and that inflation keeps in check as a buffer to restore investors and consumer's confidence for the long-term. If a system can really learn from its previous mistakes it will figure out what is potentially wrong and find ways to fix it before citizens or customers have to figure out how to do it themselves!

God bless you all!

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