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Too Big Not To Fail

We need to stop using the bailouts to rebuild gigantic financial institutions.

By Eliot Spitzer

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Last month, as the financial crisis and the government rescue plan dominated headlines, almost everyone overlooked a news item that could have enormous long-term impact: GE Capital announced the acquisition of five mid-size airplanes—with an option to buy 20 more—produced by CACC, a new, Chinese-government-sponsored airline manufacturer.

Why is that so significant? Two reasons: First, just as small steps signaled the Asian entry into our now essentially bankrupt auto sector 50 years ago, so the GE acquisition signals Asia's entry into one of our few remaining dominant manufacturing sectors. Boeing is still the world's leading commercial aviation company. CACC's emergence—and its particular advantage selling to Asian markets—means that Boeing now faces the rigors of an entirely new competitive playing field and that our commercial airplane sector is likely to suffer enormously over the coming decades.

But the second implication is even bigger. The CACC story highlights the risk that current bailouts—a remarkable $7.8 trillion in equity, loans, and guarantees so far—may merely perpetuate a fundamentally flawed status quo. So far, at least, we are simply rebuilding the same edifice that just collapsed. None of the investments has even begun to address the underlying structural problems that are causing economic power to shift away from the United States, sector by sector:

- Our trade deficit has ballooned from about $100 billion to more than $700 billion annually in the past decade, and our federal deficit now approaches $1 trillion. These twin deficits leave us at the mercy of foreign-capital inflows that may diminish as Asian nations, in particular, invest increasingly at home.
- Our household savings rate has been close to zero—and even negative in some years—not permitting the long-term capital accumulation required for the investments we need; China's savings rate, by comparison, is an astonishing 30 percent of household income.
- U.S. middle class income has stagnated over the past decade, while the middle class in China—granted, starting from a lower base—has seen its income growing at about 10 percent annually.
- Our intellectual advantage could soon turn into a new "third deficit," as hundreds of thousands of engineers are being created annually in China.
- We are realizing that the service sector—all the lawyers, investment bankers, advertising agencies, and accountants—follows its clients and wealth creation. This, not over-regulation, is the reason investment-banking activity has begun to migrate overseas.

The great irony is that our new place in the global economy is a direct consequence of our grand victory over the past 60 years. We have, indeed, converted virtually the entire world into one integrated capitalist economy, and we must now bear the brunt of serious and vigorous competition. In the immediate aftermath of World War II, the United States was essentially the only nation with financial capital, intellectual capital, skilled labor, a growing middle class generating consumer demand, and a rule of law permitting safe investment. Now we are one of many nations with these critical advantages.

This long-term change frames the question we should be asking ourselves: What are we getting for the trillions of dollars in rescue funds? If we are merely extending a fatally flawed status quo, we should invest those dollars elsewhere. Nobody disputes that radical action was needed to forestall total collapse. But we are creating the significant systemic risk not just of rewarding imprudent behavior by private actors but of preventing, through bailouts and subsidies, the process of creative destruction that capitalism depends on.

A more sensible approach would focus not just on rescuing pre-existing financial institutions but, instead, on creating a structure for more contained and competitive ones. For years, we have accepted a theory of financial concentration—not only across all lines of previously differentiated sectors (insurance, commercial banking, investment banking, retail brokerage, etc.) but in terms of sheer size. The theory was that capital depth would permit the various entities, dubbed financial supermarkets, to compete and provide full service to customers while cross-marketing various products. That model has failed. The failure shows in gargantuan losses, bloated overhead, enormous inefficiencies, dramatic and outsized risk taken to generate returns large enough to justify the scale of the organizations, ethical abuses in cross-marketing in violation of fiduciary obligations, and now the need for major taxpayer-financed capital support for virtually every major financial institution.

But even more important, from a structural perspective, our dependence on entities of this size ensured that we would fall prey to a "too big to fail" argument in favor of bailouts.

Two responses are possible: One is to accept the need for gigantic financial institutions and the impossibility of failure—and hence the reality of explicit government guarantees, such as Fannie and Freddie now have—but then to regulate the entities so heavily that they essentially become extensions of the government. To do so could risk the nimbleness we want from economic actors.

The better policy is to return to an era of vibrant competition among multiple, smaller entities—none so essential to the entire structure that it is indispensable.

The concentration of power—political as well as economic—that resided in these few institutions has made it impossible so far for this crisis to be used as an evolutionary step in confronting the true economic issues before us. But imagine if instead of merging more and more banks together, we had broken them apart and forced them to compete in a genuine manner. Or, alternatively, imagine if we had never placed ourselves in a position in which so many institutions were too big to fail. The bailouts might have been unnecessary.

In that case, vast sums now being spent on rescue packages might have been available to increase the intellectual capabilities of the next generation, or to support basic research and development that could give us true competitive advantage, or to restructure our bloated health care sector, or to build the type of physical infrastructure we need to be competitive.

It is time we permitted the market to work: This means true competition with winners and losers; companies that disappear; shareholders and CEOs who can lose as well as win; and government investment in the long-range competitiveness of our nation, not in a failed business model of financial concentration and failed risk management that holds nobody accountable.

This point will be all too well driven home when the remaining investment bankers in New York board a CACC jet to fly to Washington to negotiate the terms of a government bailout of yet another U.S. financial institution that was deemed too big to fail.

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