

The history of money and banking economics essay

[Finance](#), [Banks](#)



The term ' Too Big to Fail' or TBTF was first used to describe the ' eleven largest US banks' (Halme, Liisa et. Al) before the financial crisis of Continental Illinios in 1984. It is a doctrine proposing that government must intervene to save certain firms that get too big to fail. It is argued that big financial institutions qualify for TBTF status because of the ripples it can send through whole financial system for a country or throughout world.

The essay predominantly deals with the TBTF doctrine from an American perspective in banking sector. It can explain similar policies adopted by Reserve Banks throughout world during recent global financial crisis (GFC). We discuss " Moral Hazard" as predominant argument against TBTF doctrine. We further discuss banks financial contagion, interconnectivity and other issues affecting government and fed policies (pro TBTF).

Defining TBTF

Moosa (2010) interprets TBTF as a doctrine that certain firms cannot fail or left to fail, simply because they are too big. The reasoning provided is that big firms benefit from economies of scale and enhanced bargaining position because of their sheer size. During recent GFC financial institutions were saved from turmoil caused by their own mistakes or unethical practices using taxpayer's money. This causes an ethical dimension -Moral Hazard related to TBTF doctrine.

Moral Hazard

Moral hazard is an effect of the concept of TBTF, where bank can take big risks in investments, which could earn them a fortune or nothing at all, and in that case, the taxpayers will have to cover the burden and not the bank.

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John Marshall (1976) defines moral hazard as ‘excessive expenditure due to the eligibility for insurance benefits’. When big banks are guaranteed near-zero or zero liability for their action, they are more inclined to take higher risks. This causes an unfair advantage to smaller banks because they are not covered by this insurance and do not get the profits and growth of bigger banks. Due to banks having relationships with other banks; the government does not want a bank to fold in the system. If a bank does fold, these relationships will collapse and it will take a considerable time for these relationships to reform. Therefore, the government will support banks if things go wrong as banks provide growth to the economy through loans new and current businesses. Disruptions to the banking can cause anxiety amongst depositors and will cause bank runs, not just to the bank that is folding but also to other banks due to close relations to each other. Larger banks are more at risk to the reliance on one another and therefore the government will print more money to cope with this stress of too little money on the larger banks. During recent GFC, financial institutions were saved from turmoil caused by their own mistakes or unethical practices using taxpayer’s money.

Systematic Risk, Financial Contagion and Interconnectivity

Schwarz (2008) links financial contagion within the study of systematic risk concept. It defines systematic risk as “the risk that an economic shock such as market or institutional failure triggers (through panic or otherwise) either the failure of a chain of markets or institutions or a chain of significant losses

of financial institutions, resulting in substantial financial market price volatility (as increase in the cost of capital or decrease in its availability).”

Martinez (2010) suggests two main events leading to systematic risk: first, failure of financial mechanism which affects few institutions and followed by a contagion mechanism which transmits its impacts to other related institutions.

Han (2000) imply that financial contagion is not a recent phenomenon but was rather vague in earlier decades as financial markets were less sophisticated. Factors such as increased international capital flows, globalisation of financial market, financial engineering (securitisation etc) and faster communication links have led to additional risk associated with financial markets. Although there is an

additional risk, international financial market integration is highly desirable as this contributes to an improved risk sharing through “ financial engineering” such as securitisation and more efficient allocation of capital.

Ahrend & Goujard (2012) shows the Bank-balance-sheet contagion during the global financial crisis. International financial integration through bank flows in advanced economies lead to strongest contagion shocks during GFC (Appendix Fig 2). Systematic Risk, Financial Contagion and Interconnectivity are important for our topic as they are the factors that force politicians and policy makers to grant TBTF status to Banks readily.

TBTF-associated arguments

According to Moosa (2010), there are mounting arguments against TBTF doctrine both by policy makers who support more regulations and “laissez faire” economists. The Economist (2009) suggests GFC as a failure of Efficient Market Hypothesis (EMH). We can draw similarity for the article to suggest that TBTF doctrine also indicates a failure of EMH as a failed institution could be sold at its fair value rather than spending tax payer money for bailouts. TBTF policies results in distortion of competition and fiddling with market free hand.

Moosa (2010) present us with several arguments against the TBTF doctrine and policies adopted, such as:

Both pre and post failure bailouts appear to be triumph of unethical practices of bankers especially where no civil lawsuits are held against directors.

Money spent on bailouts could be seen as a subsidiary to inefficient sectors thus resulting in more unproductive activities, rather Government could have boosted productive sectors of economy that could have produced more jobs (Keynesian economics)

TBTF doctrine creates a monstrous moral hazard issue. When taxpayers money is spent on bailing out uncompetitive (perhaps unethical as well) banks, its shifts the risk to tax payers but all the reward stays with bankers.

This appears to be big failure of competitive market model (divergence of associated risk and reward)

TBTF implicitly provides a sense of safety for big banks.

TBTF policies in financial institutions often results in even bigger institutions; hence bigger associated contagion and systematic risks for future besides decreasing competition in market.

The only argument in favour of TBTF doctrine is containing the systematic risk and financial contagion due to interconnectivity realised through financial engineering. The Economist (2009) suggests that letting Lehman Brothers fail, to signal a position against TBTF doctrine wasn't best response in middle of GFC crisis. Stern & Feldman (2009) issue a concern over “make them smaller” doctrine postulated by many researchers. It argues that instead of addressing TBTF and associated costs, more work should be done on better management of financial spillovers. Paul Krugman (2010) disagrees about limiting the size and scope of banks as the core issue in banking reforms. It suggests regulating what banks do rather than making regulations in regards to its size and ratios. Krugman also sees the rescue of banks under TBTF doctrine as a necessary step even though it establishes a dangerous precedent.

Conclusion

Post GFC, argument is not about whether to grant TBTF status to financial institutions or not, but how to avoid paying taxpayers money to save institutions in future. The challenge for regulatory bodies across world will be to safeguard and reinforce the benefits of greater integration on the one hand, while at same time minimising the contagion or spill over risk

volatility. Perhaps economists need more research to see how markets suddenly become inefficient and how to manage moral hazard. Therefore it is important for government to get a balance between how much they cover and who they cover to minimise the effect of moral hazard.