
“The U.S. has been taken over by a financial oligarchy.”

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C. Otto Scharmer: What are two or three formative experiences that shaped you as a person and the kind of work that you are doing now?

Simon Johnson: I have to go back quite a long way. I've worked on crises since the mid-1980s. I was a PhD student at MIT. **I was very interested in inflation because the people I worked with, Stan Fischer and Rudi Dornbusch, were interested in inflation, and it was a hot topic in the '80s.** I was interested in how that affected countries and how they got into very high-inflation situations. I graduated in 1989, had a post-doc at Harvard, and I went to work in Eastern Europe. **I worked in Eastern Europe one way or another for ten years.** We were looking at countries that had crises, trying to help governments in various ways get out of their economic problems, and getting drawn through that work into thinking about political economy.

So, a lot of times it wasn't the technical economic issues which were studied in the 1980s as much as the politics of the situation, and that brought me towards a research agenda that was very focused on those issues. I started working with Daron Acemoglu in the economics department, who was also looking at these political economic issues on a related but somewhat different direction. Together we wrote quite a large number of papers that I think brought our ideas together and applied them in a historical context.

On the basis of that, **I went to work at the International Monetary Fund**, initially in the research department working with Raghuram Rajan from Chicago, who also has a physical fiscal economic take on how the economy really functions. After a few twists and turns, **I became chief economist at the IMF while the international crisis was brewing. Trying to make sense of that took a while, I think for all of us, but ultimately brought me to a restatement of some of things that**

Daron and I worked on, some of the things we'd seen in Eastern Europe but applied to the context of the United States.

So, I wrote this article with a little help from some of my friends earlier this year **saying the U.S. has been taken over by a kind of financial oligarchy**. Not a Russian oligarchy exactly or a Korean oligarchy or an Argentine oligarchy. It was something very specific to the United States, a form of cultural capture by the financial sector. The people who run economic policy really believe that the financial sector as currently structured is a good thing, and I have come to the view then, and I continue to work on this very actively, that **the financial sector currently operating in the United States and many other countries is actually very dangerous for growth and for the prosperity of most citizens**.

COS: So, when you wrote that piece, what was the reaction, the response that you got?

Simon Johnson: Overwhelmingly positive, actually. It's kind of interesting. A lot of people said it's a very brave piece to write, and I didn't feel that way at all. It seemed to me, first of all, quite obvious. Secondly, it needed to be said, and it arose out a number of things that I had done on the blog and also an interview I did with Bill Moyers on his TV show. The *Atlantic* people saw the interview with Moyers and had a look at my blog and said, "Why don't we write this into a longer piece?" Originally they commissioned 4,000 words. I think we ended up, just because they kept asking for more things, closer to 8,000 words.

But to me it never felt very scary. I don't want to be a banker. I imagine if I wanted to be the CEO of a big bank it would have rather impeded my progress. That's not my career track anyway. **I'm just an academic who calls things as he sees them. I worked in this policy role**, for example, with the IMF, but also I've worked with other countries against the IMF or with the IMF but from the other side of the table.

I think everyone who doesn't work at the very top level of the biggest banks appreciates what we said and why we said it. I find, across the political spectrum, that the message resonates with a lot of people. Now, they may disagree, left versus right, on what to do about it. **But the idea that the financial sector became too powerful and too dangerous actually makes a lot of sense to people.**

COS: Looking at the proposition, what do you think are the root causes of the crisis and situation we're in?

Simon Johnson: Obviously this is a huge question that has many different dimensions. If I just take the financial piece that I'm most focused on right now, **I would say what happened was that the financial sector made a lot of money in the 1980s because of deregulation**. They plowed that money back into political lobbying in various forms, including campaign

contributions—throwing the cash around matters. **Wealth is very important in this society, as you know, but a lot of these contributions were about intellectual capture. A lot of economists and financial economists, academic and nonacademic, and the people who think and write about these issues, became convinced that we'd discovered some new driver of growth called financial innovation,** and that this was just like non-financial innovation, that it was a really good thing and **would improve productivity and be generally shared in the same imperfect ways that productivity improvements have been shared over the past 200 years in the American economy.**

That mindset, that thinking, is not limited to Republicans. It was the Clinton administration, Robert Rubin and Larry Summers and the people who work with them, who I think are most emblematic of the thinking people's view. They're also, obviously, a vested interest that want lots more deregulation. I think Rubin and Summers are very smart people. Larry Summers, absolutely his own man, very independent thinker, really did believe that financial innovation was good for growth and therefore facilitated a lot of deregulation in the 1990s, which has come back to haunt us.

So, if my view is right, then it's a pretty big, bad problem that needs to be fixed. It can be fixed if it's something that you can take back over 30 years. **I don't think there's an inherent rottenness in the nature of American society—that capitalism necessarily leads to crisis. In the 1950s, '60s, '70s we had very highly regulated banking system. We had plenty of growth. We had tons of innovation. We were doing good on financial innovation. The three big bank innovations of the last hundred years are venture capital, the automated teller machines (ATMs), and credit cards.** Those all came out of the '50s, '60s, '70s.

So, anyway, **there's nothing wrong with regulating the financial system, and it doesn't prevent growth,** but somehow, the financial sector doesn't want it that way.

COS: What's the blind spot in current mainstream economic theory that is allowing that to happen?

Simon Johnson: Interesting question. Paul Krugman, of course, wrote an influential *New York Times* piece about this, and Justin Fox has written a book about this, *The Myth of the Rational Market*. I'm still reflecting on this and still writing up some of my own ideas, but I think right now it goes somewhat deeper. To my mind, there's nothing wrong with the idea in neoclassical economics that you are maximizing something, you're pursuing your self-interest.

The problem is that most economists don't see the political economy aspect as essential. They see it as either a tangential, small thing or something that happens in other countries. When you talk about the economy, and I do this in my academic work, if I tell you a story of

Indonesia or Korea or even Japan in which **the political economy is central to the macroeconomic output**, people will say, "Yeah, that makes sense."

That's a big change from twenty years ago. When you talk about political connections or the kinds of things we take as drivers of growth or crisis in Indonesia or Argentina, and you suggest that's the case in the United States, people are absolutely horrified. It doesn't fit with American economists or economists who study America with the view of how the United States operates. For them it is all technocratic parameters.

To me, there's nothing wrong with economics, but economics is a big field, and there are lots of views. I think my friends who work on political economy got it right; they have more impact so far on long-term growth, on human development, and on thinking about prices not in the context that people thought mattered for the United States.

COS: So, why then do very high-profile economists like you or Paul Krugman or Joseph Stiglitz propose a different approach for dealing with the banking sector, and why hasn't that approach been accepted? It is not being discussed. *It looks like we are now going back to business as usual.* How do you explain that?

Simon Johnson: Well, **this is the cultural capital and the cultural capture mechanism at work. The people running the government**, the Obama administration, also the Bush administration, believe that finance as currently constructed is pretty much okay and can be relied on to do fine in the future. That's what they believe; this is what they really think. Why they think that, that's an interesting bigger conversation. **I don't think it's explicit corruption. I do think that campaign contributions play a role, but I think it's more just how they see the world. They don't understand, and they haven't realized, that finance has become really dangerous. Financial innovation is nothing like non-financial innovation. Financial innovation can be good, hence the ATM and credit cards; it can also be really dangerous.**

There's no sector other than finance, no sector other than banking in modern society that can come to you and say, "Oops, you have to give us a massive bailout; otherwise we collapse and the rest of the economy will collapse." The automobile industry can make that pitch. They come to you and you can say: "We'll give you a bridge loan in some very difficult circumstances because you don't want to trigger a panic, but it will come with a lot of conditions."

A bailout of the automobile sector will cost us \$50 billion I would guess, give or take \$10 billion. The financial sector fiasco costs us less growth, it's cost a lot of people their jobs; it's cost taxpayers trillions. **The final net cost will be trillions! It is a different magnitude what they can get away with. Now they're going back to business as usual with very light regulation.**

COS: *So, what's your prediction for the next five to ten years? What are the possible scenarios you see playing out for the next 5-10 years?*

Simon Johnson: I think in this regard **the United States has become very much like an emerging market.** Emerging markets have cycles, very sharp cycles. They go down, as we went down last year, and it is shocking and terrible, and everyone gets very pessimistic, and then they start to bounce back because there are various self-correcting mechanisms in any economy. In emerging markets it's usually export growth, and in the U.S. with a big diversified economy there are lots of pieces that can pick up. And the government ultimately stands behind the banking system in emerging markets and in the United States.

Actually, best practice, they usually fire more CEOs and clean up more banks in emerging markets because they are taught to do so by the United States.

COS: By the IMF?

Simon Johnson: By the United States acting directly and through the IMF, yes. **But we're going to come back with the same financial sector that led us into this struggle,** the same financial sector that took on these kinds of financial crises. But that, again, is very much an emerging market pattern. **There's a reshuffling of the oligarchic structure. It doesn't have zero impact, but it has relatively small impact. There is a big government lifeboat, and a few guys are pushed off the lifeboat, and everyone else stays on the lifeboat.**

So, you rerun the same thing, and you can have the same kind of crisis repeatedly. Whether it happens every 2, 5, 7, or 12 years is an interesting question. I think there is a lot of randomness in the economy that makes the frequency very hard to predict. **But we have this potential instability and this vulnerability crisis now very well established.** The surviving banks are bigger than they were before. They have more political clout. They feel invincible because they got a big bailout, so why should they change their behavior? President Obama asked yesterday in his speech at Federal Hall in New York, "Please behave better." That's where I think the selfish, neoclassical view applies, because look at the guy's incentives. There's no way. I mean, organizational culture matters. But the culture is mostly shaped by their incentives and how they get their bonus, and that is not going to change because you ask them nicely.

COS: *Goldman Sachs says that they repaid the bailout they got. So, what would you say to that? What is it that they repaid and what not?*

Simon Johnson: They repaid the top funds, which was the injection of capital. They received more support than that. The key thing – it is huge – is that they were allowed to become a bank holding company at the end of September 2008, and that allowed them to access credit from the Federal Reserve. Without that conversion, they would have been out of business. It is not a maybe, a could be; no, they would be out of business. They would be finished. So the taxpayer saved the entire business. I don't want the state to run investment banking; I don't think that the

government should acquire 100% of Goldman Sachs. **But if you ask what did they get from the taxpayer: everything they've earned since that point, because they were saved by the taxpayer.**

COS: What would you advise Barack Obama about three key actions he could take?

Simon Johnson: Today? I was making plenty of proposals along the way, which would have been a more auspicious moment. Given where we are today—and I am a big believer of moving on and recognizing we are where we are—I would say, **first of all, you need a much clearer diagnosis of the problem.** There's a great book written by Louis Brandeis, based on some magazine articles he did right before World War I, about what was then called “the money trust.” Brandeis basically laid out how finance worked and what he regarded as the basic problem, which is excessive concentration of power in the financial sector. Brandeis never saw what we saw. This would have blown his mind. What he was looking at was a pretty small problem compared to all this. I think the first thing, **the most important thing is to have the President make a much more honest, clear statement of the problem.** The speech he gave yesterday was better than previous speeches, but it was still very wishy-washy, very unclear about who did what and when. The president's role as an agenda setter and as a definer of the issue is absolutely critical. That is number 1.

COS: Number 1 is to state what the real issue is! Which is...?

Simon Johnson: ...it is **the oligarchy that has taken over. It has gotten out of control. I don't think you want to be anti-finance.** Every economy needs financial institutions, **but the way it is structured today in the United States is not good for most of society.** I am not saying he will ever say that. This is just my recommendation.

The second thing is that the most important set of measures you need to adopt are the ones that **make the biggest banks smaller.** The CIT Group is a financial institution with about \$80 billion in assets. Early this summer it asked for a bailout and was turned down even by this Treasury, which said, “You are small enough to sort out your creditors, and even if you fail we don't care.” CIT Group screamed and said “all the world could end, all the small and medium-sized businesses that borrowed from us in the United States will collapse.” Their bluff was called, and there was no dramatic impact on the overall economy. **Lehman had over \$600 billion, and these other banks we struggle with have over \$800 billion up to \$2 trillion in total assets. So the CIT Group experiences say very clearly that if you had few banks that were over \$100 billion you would be in much better shape. So, I would make them smaller.**

Now, President Obama doesn't have the ability to decree that, but he can say that's the goal, and he can pursue that objective through the legislative process. Then whenever these banks need financial assistance in the future he can set that as a parameter. That would have a huge impact.

I think this administration is obsessed with passing things through congress, and they are saying, "We couldn't possibly propose anything that wouldn't pass." How do you know it won't pass unless you propose it? That's 1 and 2. Unless you propose it, unless you frame the debate, you won't get anywhere. That's their role. That is their responsibility. It would help them if the debate became polarized.

There's this desire [on the part of the Obama administration] to get everyone together, and I think it's crazy because the Republicans don't want regulation. **My personal view is that all financial systems are regulated. An unregulated financial system does not exist.** Even the Republicans would not want this. **So, if you're going to regulate you need to regulate properly and thoroughly you need to prevent these same problems from happening again.** Let's say the Republicans oppose or filibuster the kind of reform proposals that I am talking about in the Senate and defeat them. So, next time there is crisis they are responsible! Seriously, this is the kind of issue that can define politics for generations.

Number 3 is the most sensitive and most controversial, and I am sure President Obama would never touch it, which is the revolving door between Wall Street and Washington. So, how could it be okay to go from running a big failing and failed Wall Street firm on Friday to being in charge of and designing the big bailout program for that and other firms on Monday? When and if the United States sees that kind of behavior in any other country I can assure you from my experience with the IMF and from other work that I have done that they would be very hard on it and say that is an unacceptable conflict of interest. And they are right. People say the Americans are being high-handed, and sometimes it is true. But they are right on principle. **But when it comes to ourselves, we feel that the only guy with the expertise to design this kind of program, or to manage these issues, is the guy who was previously at Citi or Goldman Sachs or JP Morgan who had responsibility for managing the risk for those organizations and failed completely in his previous job.** That is an extraordinary statement about expertise, the nature of our society, and what finance has become. Let's say it is true that the only guy who can fix this problem is the guy at AIG who was in charge of a certain issue, and that in order to fix it you have to bring him into the government and make him deputy assistant or under secretary. That is crazy. In a society of 300 million how can you give a single individual that sort of veto power? Again I am coming back to neo-classical economics and my own self-interest. If the guy is completely altruistic, maybe it's OK. But in the real world that is crazy. That is an irresponsible way to run an economy. You cannot give an individual person such a power.

COS: What is the reception you get to your ideas in Washington?

Simon Johnson: I'm not an official economic advisor to anyone in Washington. I talk to plenty of people. I think at the staff level a lot of people are very supportive and sympathetic. But the people that have power see things very differently. I am not sure why that is; this is an interesting question. Maybe it is campaign contributions, maybe it is the way they see the world. Maybe they all try to do deals.

I don't think the principles that I am putting forward will shape the current reforms in any way. **But I think the reforms are basically meaningless. They are window-dressing, with the**

exception of the consumer financial protection agency, which is a good idea but does not make the financial system stable.

What I am doing is to prepare the ground for the next round. **If you have one crisis of this kind the oligarch can get away with it. But if you have another one it is much harder for them to say, “lightning struck twice.”**

I think the point is also to prepare the consensus, by trying to move people who are very moderate, very practical people towards the views that I am expressing, which is that there is a power structure issue which has to be confronted. Next time you have a crisis there will be a window of opportunity. When the banks need money from you because otherwise they are out of business, then you can get a lot. Once you give them the money and they get off the hook, they will return to their old habits politically as well as economically. That is a very typical emergent market cycle.

COS: You wrote in your recent *Republican* article that, given the quick-fix syndrome, the next financial crisis is probably going to happen sooner rather than later.

Simon Johnson: The timing is very hard to predict. Sometimes you can keep it going for quite some time. A lot of times there are people who become known as Cassandras and say, "Bad things are going to happen," but then it goes on for several years more than you thought would be possible. That is a standard feature of financial cycles.

In five years' time, if the crisis hadn't occurred, even you would probably say, “Simon seemed quite plausible at the time, but five years have gone by and everything's fine. I guess he was just exaggerating.” I don't know whether this is human bias or how our modern societies are. It could be the cycle of our democracies: the Senate election every two years, the presidential elections every four years set a cycle. And Europe is similar.

People don't worry enough about things that are five, seven, ten years down the road. Let me put it like this. Was Alan Greenspan a good or great chairman of the Federal Reserve Board of the United States? In 2001 and 2005, people would have unanimously said that he's the greatest one ever. Looking back now, they would say that he was the most disastrous central banker in the history of any industrialized country. That's a twenty-year perspective. You have to see the full thing work out: what did we become, what happened to our society and our financial structure over two decades? We don't do that.

COS: If you look at the evolution of capitalism from the perspective that you developed—the financial oligarchy and how it relates to the overall economy—*how would you contrast Chinese capitalism with U.S. capitalism and European capitalism?*

Simon Johnson: Well, this is a very big question. There are always people in charge. There's always an elite or a set of oligarchs. **As Schumpeter said, “Everyone has elites. The important thing is to change them from time to time.”** And I believe the U.S. style is actually quite good at this type of turnover.

John Kenneth Galbraith wrote the book *The New Industrial State* in 1967, in which he said the problem is big corporations and corporate power. And in a sense you could argue that he is right. But when you look at the corporations that Galbraith specified, those that he thought would be entrenched, immovable, and present forever, most of those corporations are now gone.

So, to my mind, the interesting question about China is whether it will have the ability to update and change or whether it will tend to get ossified. Mancur Olson wrote this great book, *The Rise and Decline of Nations*, about Western capitalism, and the UK as an example. He was worried about trade unions, but I would take his point more broadly. What I would say is that any society that does well tends to build up vested interests. And then vested interests become more powerful and over time, and they don't want to change. If the world changes around them, that country is in trouble. That links up with my historical research that finds that some countries have breakthroughs because new groups arise. We have a paper on the rise of Western Europe, for example, where we argue that it was the rise of Atlantic traders and the opening of new trade routes that became a new force. As they got more money they channeled it back into politics and created more favorable trade regimes for themselves, and also new political regimes—not everywhere, but in some cases favorable to industrialization. So, that dynamic can be present. The Chinese situation is a little bit of an enigma to everyone. It is hard to know whether they have that updating capacity over generations. That is the timeframe.

COS: Going forward, what are, in your view, the most important questions?

Simon Johnson: I'm interested in a lot of different issues, particularly in finance—where financial innovation works, where it doesn't work. I am trying to quantify that because people often ask. We are trying to understand the political economy of reform, how you break with these kinds of elites and how you don't. And also the impact on entrepreneurs. I am a professor of entrepreneurship, **and one of the points I am trying to get across to people is that letting the financial system get out of control like this is very bad for non-financial entrepreneurs.** It means high taxes for them; it means a more unstable economy. Actually, **it is bad for the whole society except for the finance guys in the big banks. The community banks, as I am trying to explain to them all year, have been terribly bad hit.** And now the community banks are starting to realize as they start to fail what the big banks have brought upon them. So, for me what is of research interest is the intersection between applied economy and finance and the macro economy and a lot of attempts to find practical solutions, including reform strategies.

COS: What is the difference between the real economy and the finance economy? Is that a differentiation that is being made, and what are the implications given recent experiences?

Simon Johnson: This is a very important point. So, what you have here is an iPhone, so this is the real economy. This is the real innovation. This is either transforming the life or really annoying the people you live with, depending on how you view it. This is something you can see in cars. My grandmother, who passed away a few years ago, was born in a time when there were no cars and electricity was relatively new. The idea that you could travel more than 30 miles an hour was preposterous. They were worried about going faster than 30 miles per hour. She saw the *Titanic* launched in Belfast. So, those are all real things.

When you look around, it's hard to see a single item in this room that isn't the result of the Industrial Revolution. Basically, everything in this room is produced through technology invented over the last 100 years.

What is finance? Finance is basically the connection between savers and investors. You've got some money that you don't want to spend today, but you want it to be available for you to buy iPhones in the future. You want to park that somewhere where it's not going to lose a cent.

I have some crazy ideas for making real things. You lend me the money directly, or you put the money in the bank and the bank lends it to me, or I issue stock and you buy the stock. There's a variety of ways for intermediating. Intermediation is nothing except a connection between you and me. Financial intermediation services used to account for between 1 and 2 percent of GDP. That was a well-functioning financial system. That was the United States in the 19th century. That was also the United States in the first half of the 20th century, when basic intermediation went well, lots of innovations were financed. Yes, there were cycles, and people were worried about these cycles in the early 20th century, but there was still a functioning financial system. The financial system we have today peaked at 8% of GDP. That is a very big part of the economy. GDP would be the value added, so mostly the wages in the finance sector. There are also the buildings you are using, the other kinds of infrastructure you are using, that could be used by someone else.

This is the biggest financial sector that the U.S. has ever had. The financial sector in the U.S. accounted for 40% of the profits in 2003. And people say, oh, look at how successful they have been. No, not really. If they were so successful, and so competitive, they should be passing on their brilliant new ideas to other sectors. Other sectors should become more profitable. What the profits told you is something about the rents or the monopoly type of profits that these guys acquire through various means, including totally misleading consumers, as we now see in retrospect.

Also, of course, the profits are high because in the kind of accounting system we currently have you do not properly state the risks. So, if I make massive profits today, the costs for that, the account is a risk to be realized tomorrow. And you do not account for the risk in GDP. If you have debt, you would not fully recognize the income. You have to have a line item for the bad debts in your accounts. The same should be true for macro-risks.

COS: So, that distinction is not fully implemented?

Simon Johnson: It's not implemented at all. The French, Mr. Nicolas Sarkozy, have an idea about restating GDP, redefining GDP with things that matter to the French, such as long vacations. I would suggest that much bigger items need to be restated.

COS: Thank you! I am aware that our time is up. Thank you so much for this interview.

Simon Johnson: Thank you!