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FD Finance & Development

Riskless Capitalism

5/30/23 (Upcoming June Issue)

The US government decision to cover uninsured deposits at Silicon Valley Bank undermines free market discipline

Did uninsured depositors in the failed Silicon Valley Bank (SVB) need to be saved? The argument is that even though everyone knew that deposits over $250,000 were uninsured, if uninsured depositors had not been made whole, panic would have coursed through the banking system. Large depositors' withdrawals from other banks would have compromised financial stability.

Perhaps! But if large depositors are always protected in the name of financial stability, why aren't they at least charged the insurance fee that burdens the insured deposits? There are many low-cost ways for corporate treasurers to mitigate the risk of having money in a transaction account at a bank. They can keep only the amount needed to meet payroll and other immediate transactions in a demand deposit (checking) account and put additional soon-to-be needed cash in liquid money market funds. Yet too many firms did not practice elementary risk management. Streaming device maker Roku had more than $450 million in deposits at SVB, according to Reuters. While shareholders in SVB were deservedly wiped out and management let go, large depositors enjoyed riskless capitalism as the government changed the rules to benefit them.

A haircut could have been imposed on SVB's large depositors. Based on past interventions by the Federal Deposit Insurance Corp (FDIC) this would have cost uninsured depositors about 10 percent of their balances. A few red-faced corporate treasurers would have justifiably lost their jobs. And if there were signs of contagion to other banks, the government could have announced a blanket implicit guarantee for all deposits, as US Treasury Secretary Janet Yellen eventually did. But the FDIC would have saved $20 billion and retained the principle that at least some of those who took risks paid the consequences. SVB would then be seen as capitalism penalizing the incompetent, rather than as an aberration—setting a precedent that will likely engender more attempts at riskless capitalism.

More generally, as the Federal Reserve's own investigation put it, SVB failed "because of a textbook case of mismanagement by the bank." If so, flighty uninsured demand deposits can be a feature, not a bug, in the system. If uninsured depositors pay attention, they can shut down incompetent or greedy bank management quickly, saving the taxpayer immense sums. If they are anesthetized because regulators invoke the tired argument that "this is not the time to worry about moral hazard," uninsured depositors will not pay attention in the future.

A government that repeatedly shows its willingness to bail out has little credibility when it says next time will be different.

The government decision was made after immense lobbying, including many cries for help from venture capitalists. David Sacks, of Craft Ventures, tweeted, "I'm asking for banking regulators to ensure the integrity of the system. Either deposits in the U.S. are safe or they're not." Billionaire hedge fund titan Bill Ackman tweeted, "If private capital can't provide a solution," a government bailout should be considered. One politician praising the bailout was California Governor Gavin Newsom. Three of his wineries were clients of SVB, and an SVB executive sits on the board of his wife's charity, according to the *Intercept*. Newsom's holdings have been in a blind trust since he was elected governor in 2018.

That the system's insurance rules could be bent in a way that benefits large depositors brings to mind an intrinsic contradiction in the venerable Chicago tradition of economics that we pointed out 20 years ago in our book *Saving Capitalism from the Capitalists.* On one hand, the Chicago tradition claims the free and fair working of markets requires primarily the existence of well-defined and well-enforced property rights. On the other, it argues that any form of regulation is liable to be captured by vested interests. If vested interests can capture regulation (and the Federal Reserve's post-mortem report on SVB acknowledges changes in rules in 2019 that allowed banks like SVB to operate with less transparency and fewer checks), why are they not able to capture the definition and enforcement of property rights? Why can powerful venture capitalists not simply redefine uninsured deposits as insured, invoking some larger public good?

If they can, then free enterprise capitalism is not the inevitable product of a minimalist government, but a political creation, which can develop and survive only under very specific conditions. Otherwise, the natural state it tends to is rampant cronyism or, in its milder form, pro-business capitalism, rather than pro-market capitalism.

In our book, we focused on the development and survival of financial markets because these markets are probably the most fragile, but the argument is more general. We argued that "capitalism's biggest political enemies are not the firebrand trade unionists spewing vitriol against the system, but the executive in a pin-striped suit, extolling the virtues of competitive markets with every breath while attempting to extinguish them with every action." Rather than creating and supporting markets, the capitalists undermine the working of the market because they feel threatened not only by the competitive market itself but also by the institutions that make markets work. “The economically powerful are concerned about the institutions underpinning free markets because they treat people equally, making power redundant.”

We recognized that “markets cannot flourish without the very visible hand of the government, which is needed to set up and maintain the infrastructure that enables participants to trade freely and with confidence.” But that raises the question of who “has an interest in pushing the government to support the competitive market? For even though everyone collectively benefits from the better goods, the services, and the equality of access that competitive markets make possible, no one in particular makes huge profits from keeping the system competitive and the playing field level. Thus, everyone has the incentive to take a free ride and let someone else defend the system.”

Free enterprise capitalism, then, is not the final stage of a deterministic process of evolution. “It is better thought of as a delicate plant, which needs nurturing against constant attack by the weeds of vested interests.”

We identified four conditions necessary to encourage this delicate plant to grow. First, there should be no incumbent businesses that are very powerful. Instead, each business must have only modest power, so that it needs the state to play the role of impartial enforcer.

The second condition is an effective welfare system. “Competition triggers failures. These failures are essential to the creative destruction process, but are extremely painful for the people affected. The bigger the cost of adjustment imposed on them, or the larger the numbers of the distressed, the stronger the political demand to intervene,” which can be easily manipulated. One way to prevent the politicization of relief is to have an explicit safety net offering basic support directly to affected individuals. Firms should go bust; people should not.

The third condition is reducing the power of incumbent firms by forcing them to compete with firms from some other country that does not protect the inefficient. “The most effective way to reduce the power of incumbents to affect legislation is to maintain domestic markets open to international competition.” It is not a coincidence that the banking industry is one of the most politically influential, because it does not really face international competition when its business is largely domestically focused.

Finally, we believe in the need to persuade the public of the imperative for free, competitive markets. “If the wider public sees the benefits of free markets, and understands their political fragility, it will be harder for narrow interest groups to push their own agenda.”

Why is there so little concern with the SVB bailout today? Are the conditions in the United States today less conducive to competitive markets than when we wrote the book? In some ways, the disconcerting answer is, “Yes.”

Consider the conditions we laid out in reverse order. After the massive direct bailouts of banks during the global financial crisis that began in 2008, and the indirect bailouts during the pandemic (via transfers to households and firms that then repaid their bank loans), periodic bank bailouts now seem inevitable and have even gained intellectual respectability.

Furthermore, competition between systems, which would highlight the inefficiencies associated with such cronyism, is increasingly threatened by old-style protectionism, often hiding behind geopolitical concerns. When the accent is on trading only with other countries that have similar values (and also, incidentally, similar vested interests), everyone will suffer similar inefficiencies, and there will be less pressure from competition for change. In 2008, Germany, the United Kingdom, and the United States bailed out banks in quick succession.

Arguably, one reason industrial countries are so reluctant to see the losses associated with market adversity play out is that they fear the wrath of the electorate, which believes the gains from capitalism have not been fairly distributed and that competition, especially from across the border, is unfair. Yet this fear then entrenches inefficient practices and preserves incompetent firms— indeed it worsens their behavior by eliminating the free market’s penalties for mistakes.

Finally, though SVB was only the 16th largest bank in the United States, its clientele included very powerful and politically connected venture capitalists and firms. Antitrust authorities using the usual metrics of market dominance would have been unconcerned. Those who understand clout are concerned. We need to develop better metrics based on political influence to limit the political power of firms.

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