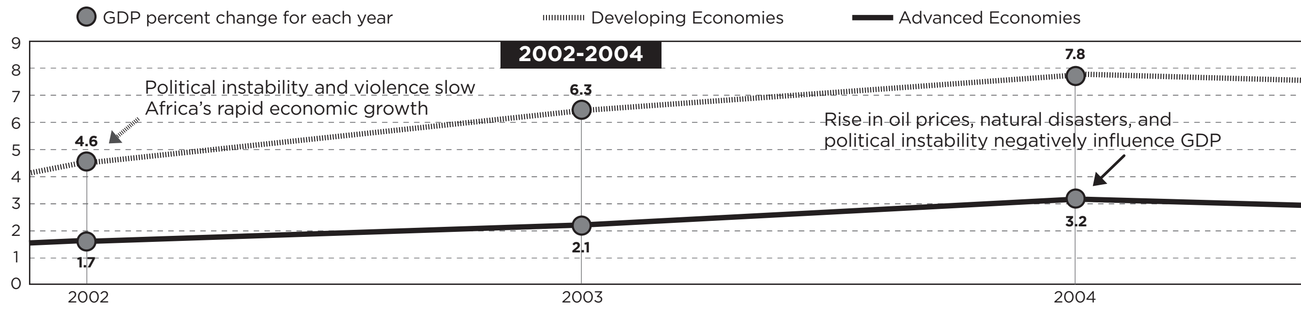
CURRENCY

Sugar Daddies of Global Finance

STANLEY PIGNAL



LONDON—One of the cornerstones of Marxist-Leninist thinking is that the state should control the "commanding heights" of an economy—industry, agriculture, infrastructure, and, perhaps above all, money and banking. That vision has largely perished, with one gaping exception. Government remains omnipotent in the financial system, not only on Wall Street or Threadneedle Street, but far beyond. Across the world, the state weighs in on all sides of the ledger, insuring both a bank's assets (mortgages and loans) and its liabilities (deposits). State intervention in banking ranges from muscular day-to-day regulation through to crisis-time bailouts, and is an entirely accepted feature of the financial system. Financiers complain about excessive red tape, because that is what all businessmen do. But absent the state's involvement in their sector, it is a safe guess far fewer would still be gainfully employed following the carnage of 2008. Those who survived would likely find their ensuing careers to be nasty, brutish, short, and entirely devoid of outsized bonuses.

The government's control of finance's commanding heights pre-dates the spectacular bailouts of six years ago. Decades before it became the epicenter of the financial universe, Wall Street was a political venue, just as London was the capital of an empire on which the sun at one time never set. From the earliest days, the nexus of finance and government has only ever grown stronger, on both sides of the Atlantic, and far broader afield as big finance spread to Tokyo, Hong Kong, and São Paolo.

BEWARE THE BAILOUT

Alexander Hamilton, America's first Secretary of the Treasury, paved the way not only for the first U.S. treasury bond and America's first central bank, but also for another financial institution—the bailout. By 1792, just three years after George Washington's inauguration, the federal government was stepping in to support the price of treasury bonds and prop up the banks that had run into trouble as a result of their investment in those securities. There are contemporary bailout echoes across much of Europe and the eurozone.

Today, more than two centuries later, the way banks and states, currencies and debts are intertwined transformed a downturn based on fiscal concerns into a debacle that has strained Europe's very democratic fabric. It is remarkable that the proposed solution to the eurozone's woes has not been an overhaul of the European Union's treaties, as was once moot-

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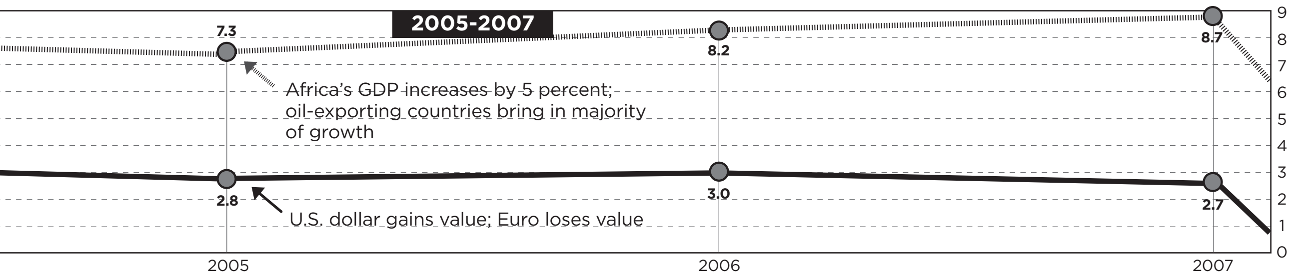
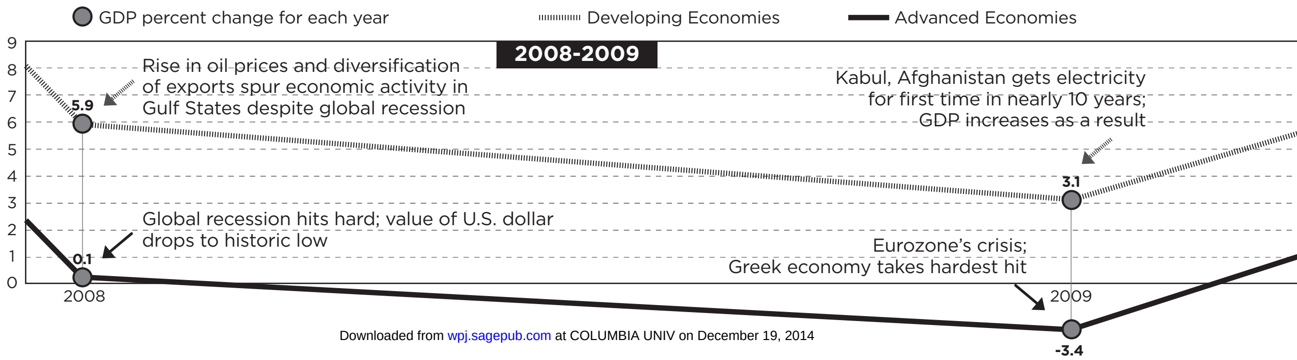


ed. Instead, the EU states settled on the creation of a "banking union" that would change the way finance would be regulated. The continued existence of the EU, a bulwark for post-war peace and prosperity, apparently depends on how banks do their business. That, and the availability of a pan-European pot of money to bail out the next bank that gets into trouble. Undoubtedly, Hamilton would approve of this federalization of the bloc's debt through the back door.

How did finance, which after all is just one facet of a modern market economy, secure its place in the heart of the political web? One answer is that commercial banks create nearly all the money in an economy. Contrary to popular perception, banks don't just repackage Peter's deposits into a loan for Paul. Their core activity is to create—taking in a single dollar for Peter and leveraging it to make loans worth $20, thus making money out of thin air. When calculating the amount circulating in a country, counting the bills and coins in circulation is merely a starting point. As the Bank of England explains: "Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money." How many taxpayers who stood behind bank bailouts and nationalizations even understand this? One can only guess how many would agree to have this wobbly system propped up at every turn by their government.

As if this weren't enough, the government makes sure that the public knows it will get its money back if it lends it to a bank in the form of deposits. That way customers demand lower interest rates than if they feared it might be lost. Tottering banks—not merely titans like Goldman Sachs or HSBC, but hundreds of smaller outfits too—are able to tap their central banks for funding at a cost markets would not bear. These handouts add up. The International Monetary Fund recently calculated that big banks in rich countries receive as much as $590 billion of implied government subsidies a year, because it is assumed they will be rescued by government if things get hairy. That is the equivalent of their entire profits, more or less.

The flipside of bailouts is even more pernicious. Since banking depends on government, government needs to regulate banking. From London to Frankfurt, Tokyo to Washington, and on to lesser financial capitals, banks and governments interact with great gusto. Not only is it justifiable—if public money is at risk, the public interest warrants close supervision—but it satisfies politicians' urge to meddle. The corollary is that what could be one of the most innovative sectors in a free market is "a giant hole at the heart of our market economies," in the words of



Financial Times columnist Martin Wolf. Ingenuity is channeled around regulation—shuffling debts into a convenient oblivion from an inconvenient line on a balance sheet. For an industry that sucks up a disproportionate number of the world's brightest people, one might hope for the sort of exciting innovations that the tech or pharmaceutical sectors uncover relentlessly. Yet beyond pockets of creativity, such as credit cards and securitization, we bank much the same way our forebears did a century ago. From the public's point of view, Paul Volcker, the former Fed chairman, wasn't far off when he quipped that the ATM was modern banking's only useful innovation.

DISENTANGLING ENTANGLEMENTS

The state-finance miasma has become impossible to disentangle. Temporary measures put in place in times of crisis, like America's government insurance of mortgages in the 1930s, have a knack for becoming permanent. Reform of high finance is possible, as has happened since 2008, particularly in Europe and the United States. But it is of an incremental sort. Banking is less a free industry than a "partnership between government and a group of bankers," in the words of Charles Calomiris of Columbia University and Stephen Haber of Stanford University.

It is worth speculating how a modern-day Alexander Hamilton might proceed if tasked with designing a new financial system. Frustrated by bankers' cronyism and their firms' repeated bailouts, might he ban them entirely? After all, there is little apparent virtue to the general public putting its life savings in an institution which funds itself with 95 percent of debt and just 5 percent of equity (a more customary ratio for a non-financial business would be 50-50). Such a ban would thrill big finance's foes, starting with "Occupy" types who have protested in New York, London, and elsewhere. It's also worth reminding them that the local community banks they praise in *It's a Wonderful Life* are just as state-backed as a JPMorgan or Goldman Sachs, if not more so.

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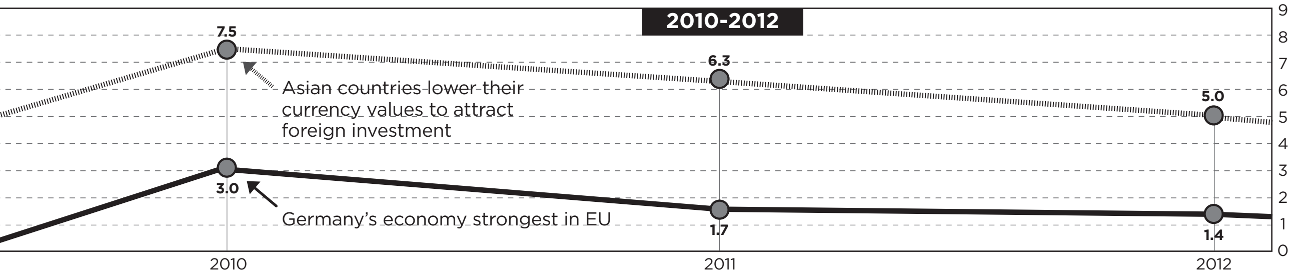
Look at the banks that were demonstrated to be the dodgiest during the most recent financial crisis: Fortis of Belgium, Dexia of Belgium and France, Britain's Northern Rock, Germany's Landesbanken, and Spain's Cajas. These are not wheeling and dealing "casino banks" reviled in public discourse. Northern Rock, a regional British mortgage specialist, was the first to tumble, and was as far removed from Wall Street as a bank can be—eight miles from the North Sea



on the northeastern coast of England in Newcastle-upon-Tyne. Like the others, it wasn't floored by derivatives and fancy finance, instead having made atrocious lending decisions and misunderstood credit markets.

Banking, at its core, is a system that should play a crucial role in a free market by funneling money and currency toward profitable ventures and away from dodgy ones. Far from banning it, what is needed is a way to rescue it from the clutches of its current government minders.

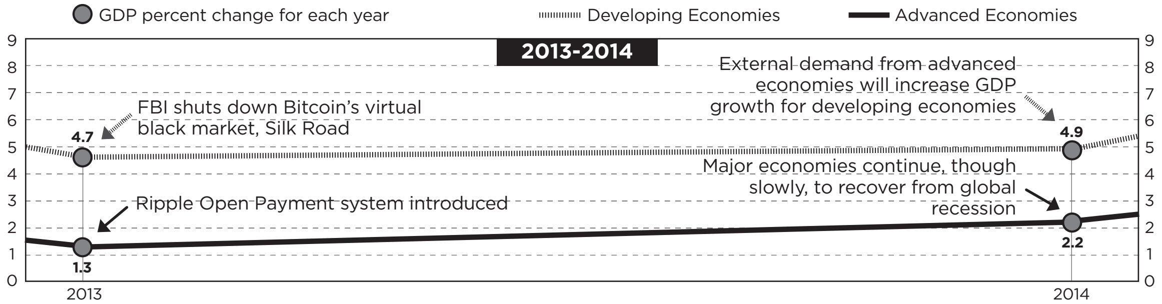
PAYING THE PIPER

A good start would be to make sure financial groups that benefit from state largesse pay for it. In Hamilton's day, a lender that needed emergency funding from the central bank got charged the then usurious rate of 7 percent—the maximum allowed by law. It is now common to see banks borrowing money at rates less than that paid by governments, putting up flimsy collateral in exchange. Indeed, European governments bailed themselves out in late 2011 through their banks, which were encouraged to borrow from the European Central Bank at around 1 percent, then lend the money to governments sometimes at 7 percent or more. Not surprisingly, European banks suddenly became profitable. It's hardly clear to taxpayers what they did to deserve such largesse.

Similarly, if a government agency is going to be held accountable for depositors' losses when a bank runs into trouble (up to a whopping $250,000 in the United States and around €100,000 in most of Europe), the banks that benefit from such arrangements must stump up. And when banks are bailed out, shareholders should be wiped out and losses imposed on bondholders. Happily, there are encouraging signs this will happen in the next crisis, following recent regulatory reforms.

BUTTING OUT

More generally, a reformed banking system set free from government intervention would lead to money being allocated to its most productive use, not just to where red tape has artificially created high returns. Politicians laud certain bits of finance (three cheers for loans to small businesses! hurray for mortgages!) with little awareness that the bits they like are often the most likely to crash the entire system. They fret about CDS's and CDO's—among the alphabet soup of complex instruments that are perfectly laudable when used in moderation, as they often weren't in the lead up to 2008—and other acronyms which on the whole don't deserve the opprobrium which politicians heap upon them. The regulators decide where money flows through measures that seldom receive public attention.



In the same way traders are told not to "fight the Fed," bank bosses know better than to try and expand into areas regulators don't like. Japan has long been able to run a national debt worth over twice its GDP because it can lean on pliant banks to hold a disproportionate percentage of its sovereign bonds. Governments have plenty of ways to make sure their pet causes—a given infrastructure project, for example—get the bank financing it requires.

One effect of government butting out would be to level the playing field between banks and new rivals keen to muscle in on bank-like activities. They may be anathema to Occupy Wall Street, but lightly-regulated hedge funds are wonderful from a regulatory standpoint. Those that serve up lousy returns regularly shut up shop with no ensuing financial panic. That is a far cry from the havoc that arises when a bank fails. And hedge funds are keen to lend to businesses and even to consumers, the very same ones banks are loath to service today. Private equity, another lightly-regulated field, is steadily moving from buying stakes in companies to lending to them instead—competing directly with banks. The likes of BlackRock, which manages over $4 trillion in assets, a sum that dwarfs even the biggest banks, are also active in this field. Though both hedgies and private-equiteers use leverage to juice their returns, borrowing money to place ever larger bets, they are still infinitely more conservative than banks. Because they pass on investment losses to their clients, there is little question of their ability to function after a housing crash, for example. They don't tap the Fed for cheap money, nor do they get bailed out.

It is a shame that this trend of non-banks extending credit is often dubbed "shadow banking," a term that makes the endeavor seem far more sinister than it really is. Bits of it are shady—those very bits that try to replicate the banking system that is so fragile by its very nature. However, anything that removes money from the fundamentally unstable banking sector while simultaneously performing the bank's one useful role should be entirely welcome. ●