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From the Big Bang To the Big Hole

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I'm going to discuss with you the present state of our financial system and what can be learned from what is happening, and where we hopefully could go, with some effort.

The last great financial crisis we had was in the 1920s and 1930s, and when Glass-Steagall came into being, it was after substantial analysis and examination of what had caused the crisis of the Great Depression of the 1930s. It was recognized that the main reason for that depression had been the financial excesses of the 1920s. And those financial excesses were concentrated on, first of all, the weakening of deposit-taking banks, which had been taking too much risk with depositors' money; and secondly,

President Franklin D. Roosevelt signing the Glass-Steagall Act in 1933. The dismantling of Glass-Steagall began long before its actual repeal, in 1999.

substantial conflicts of interest among the various types of finance companies.

Therefore, what is globally known as the "Glass-Steagall System" provided, first of all, that banks that took deposits became very limited in the kinds of risks they could take; and secondly, that various banking functions had to be separated. Thus, the so-called investment banks, which would advise issuers about securities, had to be separated not only from commercial banks, but also from the brokerage activities—the brokers were advising investors—and also of trust banks, which held the securities in custody.

It was also recognized that a great part of the responsibility for the financial crisis came from the fact that shareholders, and more specifically, holding companies, had been having far too great an influence on companies, because, through holding-company structures, people who did not even have the legitimacy of owners of shares, could exert great influence on companies.

Thus, a lot of legislation was enacted in that time, to keep the financial sector at a reasonable size, and also to keep its profitability under control. There was little incentive at that time for banks and financial companies to market their services, because their profitability was limited. I personally have the view that credit is very useful in the right quantity, very much like drugs. Drugs can be very useful in a limited amount, but if you overconsume them, they can be very dangerous. Exactly the same is the case with credit. Credit is very useful if you use it well; excessively, it can cause great harm.

The 'Big Bang' of Deregulation

In the 1980s, for a number of reasons, political ones among others, it was decided to deregulate, in order to enhance innovation and particularly "financial innovation." It was believed that financial innovation would bring progress. What was called the "Big Bang" in London was a great movement of deregulation and "despecialization" of finance. Instead of being held to specialized activities, financial companies became free to engage in any kind of activity, and thus, of course, conflicts of interest reappeared immediately.

The center for financial deregulation and the new financial dynamism was, at that time, called the eurodollar market, which was centered in London. The eurodeposit market and the eurobond market had nothing to do with the euro as a currency, which did not exist yet. They involved simply any currency that, outside of its country of issuance, would be called a euro-currency.

It was felt, even in the 1970s, that this eurodeposit market would recycle the "petrodollars," the huge reserves that oil-exporting countries had accumulated. It became quite quickly obvious that this recycling had been a disaster, and throughout the '90s there were successive financial crises in, among others, many developing countries, which had been pushed to borrow far too much for their own good, very much as Greece has today, and those countries also had to undergo substantial crises because of financial misbehavior.

At that time also, takeovers became very normal, and hostile takeovers became the fashion on Wall Street. It was maintained that companies had to be "as big as possible," because size would allow economies of scale—which nobody ever checked or even understood—and that the larger the company, the better it would be.

The Parasite Grows

This culminated in the 1990s, when finance really became more of a parasite in the economy. Finance is normally something very respectable. I've been a banker all my life, personally, and I think finance can be very respectable; but finance is there only to help the real economy to transfer savings to people who need to borrow and to invest. Finance is there as a kind of transmitter. Finance can and should be done at the least possible cost.

Before 1975, financial companies had a weight of about 3% in our economies. From the beginning of the deregulation in 1975, until 1990, transaction costs in financial markets had substantially decreased. The commissions that were paid to those who do a financial transaction had substantially decreased. Thus, at the micro level, it was said that deregulation is a great success!

But if you look at the macro level, the earnings, the revenues of financial companies, had risen from 3% of the economy to 9% of the economy. And you could not really say that financial services were better; even to the contrary: Volatility had increased; many banks were not doing their credit selection work any more, but were outsourcing that work to rating agencies, and didn't apply their own judgment any more. Thus, the real added value of finance had certainly not improved, but its share in GNP had been multiplied by three.

During the '90s we also had to swallow the "market efficiency" theories, which said that financial markets are efficient, and thus that you could leave any kind of allocation to the market because they will deal with it efficiently.

By the way, even for the father of the liberal economy, Adam Smith, markets need transparency in order to work; they need competition, and they also need ethics. It is probably one of the biggest problems with the liberalized financial market, that this very important proposition of Adam Smith—that people have a self-interest in being ethical, which is one of the foundations of his reasoning—well, that is proven every day to be false.

Certainly in financial markets, it does not pay to be ethical, and it is very profitable to be unethical. Many people keep saying that you don't have to regulate too much; oh, you don't have to worry too much, because people who are unethical or dishonest will be thrown out of the system and nobody will trust them any more. This may be true on a personal level. If someone cheats on you, you will not do business with him any more. But for companies, that is certainly not the case. Companies can be dishonest, they can lie, while day after day people still do business with them.

Why? Because they are so powerful that they can make propaganda and advertising which will succeed in convincing you that even if they have cheated someone else, they will not cheat you. They will use propaganda. The banking lobby in Europe is known to spend more than $500 million a year on "information," as they say, and propaganda. Thus, companies can do propaganda in order to keep a good image, even though they are unethical and dishonest. And if they are really too dishonest, they change a few people, and they say, "Oh, now we have gotten rid of the culprits," and we are totally, totally clean and ethical again.

Anyway, even if we want to work with markets, one should realize that markets are fundamentally harmed by "market power," by opacity and manipulation. And very regularly, since the 15th Century, we have seen that markets, and especially financial markets, are driven by a euphoria which another economist has called "the madness of crowds." Financial markets unfortunately tend to encourage that.

In the 1990s, all of this very much increased, and the financial incentives, including the bonuses that were being paid in the financial sector, increased. The fight against bonuses paid in the financial sector is certainly not a matter of criticizing people who earn too much money, or of being jealous of people who earn more money; the problem of these bonuses is that they kill any sense of ethics which people would personally have.

Many people working in the financial service are, in themselves, fundamentally not dishonest people. Most of them have a personal sense of ethics and are personally decent people. They are being paid bonuses at the kind of level that you can read and hear about, to induce them to do things without asking themselves whether it is ethical. It is a kind of bribe to get them to apply the rules by which the system works.

Metamorphosis: Now a Vampire

Since 2007-08, the system has gone from being a parasite to being a vampire, and the financial sector is now sucking the blood of the economy. In 2005, the share of the financial sector in the GNP, in the United States at least—it is more or less the same in England, and a little bit less in continental Europe—went up to 15%, and is probably even higher today. And the share of the financial sector in corporate profits shot up to 25%.

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"My name is Count Greenspan."

With all of that said, the service provided by finance to the rest of the economy is not improving, rather the contrary: Volatility is increasing; prices are totally opaque, manipulated; there is insider trading everywhere, and therefore trust in the system is decreasing rather than increasing.

A very important lesson of the last years is that "market discipline" does not work. It was thought that so-called "market discipline" would make sure that people could not borrow too much, for their own good; that banks would be run well, because banks that were badly managed would disappear. Well, quite obviously, for public finances and for banks at least, market discipline does not work. The fact that Greece was able to borrow as much as it did, is a good example.

For those of you who are familiar with the rating agencies, in which many people believe: 18 months ago, the situation in Greece was pretty much as it is today, macro-economically, but Greece enjoyed a double-A rating. That means a rating just below the best possible rating. So, 18 months ago, Greece was considered by the rating agencies an excellent borrower. So it could borrow, and of course, it could borrow too much. Market discipline does not work, certainly not when it is adorned with such things as rating agencies.

The systemic risk has greatly increased, and also the so-called moral hazard, such that if you do anything wrong, you don't have to worry; if you are in a financial company, the state will come and save you. It is quite obvious now that the bonuses are deleting any ethical constraint.

Size has become an objective in itself, and it is surprising to see how many people are convinced that the bigger the bank, the better, even if there is no evidence of any economies of scale for banks. In many other companies there is no evidence either that bigger companies are better. But there is one field in which size seems to bring profitability: investment banking. In all financial-market-related activities, larger size seems to bring profitability.

When you take a closer look, you realize that this profitability does not come from "efficiency," as the economic theory would tell us, but rather from market abuse. Quite obviously, in investment banking and market-related activity, market abuse is very easy. In the so-called over-the-counter (OTC) markets—i.e., the unofficial markets where derivatives are traded—there is a total lack of clarity of prices. Thus the famous transparency which Adam Smith claimed as needed in markets is totally absent.

In the securities market, there is an enormous concentration of power. A few firms control the totality of the markets. And they are doing that through the rating agencies and through the financial analysts who advise stock investors. So, instead of having a market with a multitude of decision-makers, which, according to the market efficiency theory, are supposed to bring about good decisions, the markets are so concentrated that they are really a caricature of themselves.

Mergers and acquisitions (M&As) have also become an end in themselves, because they are very profitable activities for investment banks. You may be following from time to time the listing of a company on the stock exchange, what is called an Initial Public Offering (IPO), when for instance, a company like Google or Facebook, which are privately held companies, goes on the market; well, banks accompany this process of distributing the shares on the market.

The way these shares are distributed amounts to outright corruption. This has been documented; it was proven in 2001-02 at the end of the Internet bubble. However, these corrupt practices are still in place today, even though everybody knows about their nature. Such corrupt practices serve, of course, the large investment banks, the Goldman Sachses and Morgan Stanleys of

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The bank bailouts have made things worse! Shown are bailout sponsors and architects (from left) Rep. Barney Frank (D-Mass.), former Sen. Chris Dodd (D-Conn.), and G.W. Bush's Treasury Secretary, Hank Paulson.

this world, helping them to keep a tight network of what we would call the oligarchy. They are held together by these investment banks, which bribe them, among other ways, through hidden commissions and IPO allotments; they are bribing them to keep their business.

The financial crisis so far has made things worse. Quite obviously, governments felt they had to intervene to prevent banks from going bankrupt, and to prevent depositors such as you and I from losing all the money we had entrusted to banks. But banks have been saved to such an extent, and without sanctions being taken, that, in fact, impunity has increased as well. There even was a reward for failure in many cases! Bank bosses who obviously had mismanaged their banks were fired; they lost their jobs and yet received tens of millions of dollars in bonuses—what are called "golden parachutes"—for their good services.

Some banks disappeared, others were merged, thus, in the end, there is even more concentration. Regulation has not improved and it has even been weakened to some extent. Public finances are also weaker; governments have gone even more into debt in order to save their banks, and, in fact, banks have become again very profitable. They have received permission to hide their "toxic assets." Many banks do not report their losses on these toxic assets and do report large profits, to be able to pay large bonuses and large dividends. On top of that, they appear to be more professionally run than those politicians whose states are now financially weakened.

Moreover, we are consistently reminded that we have to follow a model of growth by consumption. Anything that a government might do to reduce consumption will immediately be criticized because it will reduce growth, as if consumption were the only means to promote and have a growing economy! And if you need consumption to keep a growing economy, then the banks appear necessary because they finance consumption.

The great risk at the moment is that, if the system does not collapse—and there is a chance that it would not collapse—if the system does not collapse, it is large companies that are going to take control. And particularly the large banks. Politicians are unfortunately not very credible and do not appear very legitimate; and bankers, with the enormous financial means they control, can use their propaganda to appear to be, in fact, the natural leaders of the economy. I mean the bankers and other members of this oligarchy.

Stop the Madness!

Would it be possible to stop the financial madness? I think it can be stopped. And therefore, I would strongly plead for a complete and thorough return to a Glass-Steagall system, which is not only a separation between commercial banking and investment banking. Let us remember that it was only in 1999 that the Glass-Steagall Act was repealed. Before that, it still existed, but the financial madness had already started to a large extent.

Among other reasons is the fact that already in the 1960s and 1970s, the Glass-Steagall Act had been considerably weakened. Thus, what we need is really a return to the financial system that existed in many countries before the 1980s, and that also existed in the United States since the 1930s.

It was a system in which financial intermediaries had to keep to a specific function. Deposit banks are deposit banks. They take deposits; they provide credit and have to limit their risks. They should not speculate in any way. Investment banks have to be separated not only from commercial banks, but also from brokering activities. If you advise issuers of securities, you should not also advise investors in securities. And also the transactions should go into central clearing systems, and certainly, the derivatives should become fully transparent, and the price should be fully transparent.

The role of rating agencies should be totally limited. It is abnormal that central banks decide whether to accept some assets or securities as collateral based on the rating that is published by three private companies. That is totally insane! Central banks have to make their own judgments; regulators have to make their own judgments. Bonuses should at least be taxed and limited.

In order to do all of that, I think one very important element, is that we need stronger regulation, but we also need a stronger public sector. One of the great problems that is obvious during this great crisis, is that the public sector is not enough of an alternative.

In Germany, the public banks are sometimes the worst managers and the biggest speculators in some of those toxic securities. Merely having public banks is not the answer. We need to have well-managed public banks. I think we need a well-managed public sector. If so many companies have been privatized, it is often because, being in the public sector, they were not really well managed. They hadn't even an objective or a mission. So, we need to have a profound reflection and analysis about what we want to have as public management of the sector. We also need to have good regulators.

If we want to have good regulators, we want to have civil servants of a high caliber. Therefore, we absolutely need to invest in good governance and management of the public sector and regulators, and then we will be able to offer not only more regulation for the markets, but also an alternative to the private-sector companies that do not perform well. As in the United States, we want to have a public option for health care, but it needs to be legitimate and credible.

Those were my remarks and recommendations. You can find some of this in a paper with Nastassia Leszczynska, "Does Size in Banking Bring Economic Efficiency, or Merely Market Abuse?" which you can access via my website: http://www.dekeuleneer.com/

Thank you, very much.