Putting Finance Capitalism “Back in Its Box”

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So writes Philip Augar in an April 13 Financial Times (FT) op-ed. He’s a former UK investment banker/broker and author of The Death of Gentlemanly Capitalism, The Greed Merchants, and most recently Chasing Alpha: How Reckless Growth and Unchecked Ambition Ruined the City’s Golden Decade. More on his newest book below.

He quotes Nicolas Sarkozy, a questionable choice, at the G 20 summit saying “The all-powerful market that is always right is finished,” then on departure adding “a page has been turned.” For Augar, that depends on whether a “free-market” successor is constructed, something “entrenched interests in America and Britain would be well-advised to encourage if they wish to remain centre stage.”

Things unraveled after Bretton Woods collapsed – the post-war monetary system of convertible currencies, fixed exchange rates, free trade, the dollar as the world’s reserve currency linked to gold, and those of other nations fixed to the dollar. Absent that, Chicago School economists “persuade(d) the Reagan and Thatcher administrations to adopt laissez faire policies and deregulation.” We then printed money freely, spent and lived beyond our means, and created an illusion of prosperity and wealth that led to the current crisis.

Earlier, academics and consultants embraced “free markets” and built a “coherent” business strategy on them. Regulation-freed investment bankers sold “the whole package” to CEOs. Once “derivatives theory (and securitization took hold, they) opened the door to share options and performance-based compensation (followed by) three decades in which tooth-and-claw capitalism ruled supreme.” In other words, anything goes, checks and balances are out the window, let buyers beware, but look what it brought us.

“Conditions are now right for another radical rethink. The old model is busted. The big beasts of free-market economics, Britain and America, are more wounded” than most – among developed nations, that is.

So far, “governments, central banks and regulators (the few of the latter still around) are groping unconvincingly for solutions.” It’s high time for new ideas. Clearly the current ones don’t work and must be replaced by something else. But to happen, Washington must take the lead followed by “a more effective and creative” academic response than we’ve seen up to now.

It “requires finance to be put back in its box.” Knock it off its “commanding heights” under (Goldman Sachs) bankers like Robert Rubin, Jon Corzine and Hank Paulson, who “upheld the American tradition of Wall Street titans taking public office” and engineering disaster while there. The same thing happened in Britain with former investment bankers in high Treasury posts giving advice beneficial to themselves and companies.

In both countries, money bought influence, the way it always works. The more spent, the more other voices got crowded out, again the usual result.

Former government and Wall Street insider turned activist, Catherine Austin Fitts, recalls an Indonesian cab driver asking her: “Why do you let Goldman Sachs run your government?” Until recently, it’s hard imagining that comment in America.

Surely not from mainstream academia. Instead of stimulating debate, the majority go along and are well paid for it. The few dissenters are “dismissed by economic liberals as living in the past or told that the new financial system had ‘transformed risk’ and raised global living standards” – despite clear proof otherwise. Markets were having a party, and nothing would was allowed to interrupt.

Finance capitalism took over at most business schools, training a young cadre of adherents. Wall Street, High Street, and hedge funds recruited academics with quantitative skills with offers of “life-changing sums in consultancy (and compensation) fees.” Little wonder then that finance capitalism drew such interest and that “so much academic output” supported it.

Change is now vital lest other nations displace America and Britain with alternative models. In addition, “academics need to recapture their heritage,” their integrity, their “independent thinking, and throw off the (pernicious) influence of finance.” Short of that, today’s financial titans may discover soon enough that “the page has indeed been turned and they are no longer on it.”

Augar’s new book, Chasing Alpha, attracted considerable UK attention but not in America. A financial definition calls alpha a “coefficient which measures risk-adjusted performance (of a) specific (investment to) the overall market.” The higher it is, the lower the risk, the idea being to find the holy grail of high, sustained returns.

London did it for 10 years, but it’s now chastened by a dark era replacing its “golden” one. How spectacular it was while it lasted, and the same is true for America and elsewhere.

The Sunday Times’ David Smith expects many books on the global crisis, but Augar’s “distinguishes itself by tracking the rise of the City’s various components,” including its prestigious High Street addresses favored by the financial community.

When Labour took office in 1997, London was booming, and it looked like the good times would last forever – buoyed by a strong pound, a supportive media, and the City’s new hero class, its bankers. Real estate took off. Asset prices rose, and deregulation was the order of the day. Forgotten was the early 1990s “trials” when the insurance market was in trouble. So was Barings from the Nick Leeson scandal, and “Morgan Grenfell, one of the City’s oldest and proudest names, (was) mired in a messy legal dispute.”

New Labour at first was feared, yet inaugurated what Augar called “the most prosperous period in (London’s) history….The (City’s) hedge fund business came out of nowhere; between 2003 and 2006, more than 200 new firms and more than 600 new funds were established.” Finance capitalism was on a roll with domestic and foreign-owned banks enjoying unprecedented prosperity until mid-2007 when it hit a wall. The scheme for sustainable growth couldn’t last. Some officials noticed but not all.

In June 2007, new prime minister Gordon Brown congratulated London on its "global preeminence and saw it continuing thanks to 'light-touch regulation, a competitive tax environment, and flexibility." As finance minister in 2004, he told an audience of bankers: "What you have achieved for the financial services sector, we as a country now aspire to achieve for the whole of the British economy." He'll be living down that comment forever.

In contrast, Bank of England Governor Mervyn King was circumspect. He cautioned about risky financial instruments and the rise of leveraged debt. "Excessive leverage is the common theme of many (past) financial crises," he said. Are we so much cleverer than the financiers of the past?" Indeed not, and perhaps King knew something ordinary investors didn't, but wasn't letting on at the time.

Soon enough he had to as the global crisis emerged. Northern Rock was early victim enough for Britain to have its first bank run in 150 years. Others followed, big names, forcing Labour to take controlling stakes in much of Britain's banking sector. "The game was up, certainly for investment banks and many hedge funds (and unknown then) for most banks" needing government prop them up – in Britain, America, across Europe, and elsewhere.

It was big enough for Augar to produce "a useful contribution....about the biggest financial crisis for decades," a story of greed, excess, and fraud by an insider willing to take the gloss off a "busted model" and suggest something more workable in its place.

Given today's crisis, The UK Guardian's Larry Elliot headlined his April 4 commentary "We're doomed: he told us so," referring to Vince Cable's new book, The Storm: The World Crisis & What It Means. He cites finance minister Gordon Brown (in November 2003) praising Britain for avoiding the worst of the dot.com debacle, claiming finance capitalism "abolished boom and bust," and took aim at nay-sayers for their skepticism.

Cable is a British MP, the former Liberal Democrats leader, and, as a former Shell Oil Company chief economist, its main financial spokesman since 2003. In Parliament, he suggested that Britain's prosperity was illusory based on consumer borrow and spend binging, like in America. He spotted trouble early on and used his public stage to expose it.

His book isn't an "I told you so" exercise, but is full of scathing comments like:

"Without diminishing in any way the global origins and nature of the crisis, it is also necessary to debunk the self-serving myth that Britain has, in Gordon Brown's words, created an economic environment of 'no more boom and bust,' and that the country is uniquely well placed to ride out the global storm."

On the contrary, it's reeling under it and in grave trouble, the result of the same excesses as America's and larger-scale than for other developed countries. Being over-dependent on banking and financial services exposed Britain to the "full force of the gale that is blowing through international finance markets."

Both Conservatives and Labour embraced the notion that High Street was the future and manufacturing the past, the same sin America committed, and both are paying the price. According to Cable, a "brutal reappraisal" is now underway.

High Street wizards have been defrocked. These "brilliant financial innovators have been recognised as greedy or reckless or incompetent, or all three. Self-proclained, buccaneering entrepreneurs in the banking industry have been reduced to rattling a begging bowl and (now depend on) government (to bail) them out."

Looking ahead, Cable says reformists are in three camps:

— "New Interventionists" citing Washington Consensus neoliberalism, deregulation, and privatization as the villain and wanting to replace it with a 1950s – 1960s mixed economy;

— "Old Liberals" who want regulatory reform, but, on balance, "good markets" outweigh "bad" ones; and

— Cable's view that markets repeatedly produce bubbles, panics, and crashes, but produce benefits as well; in other words, "don't throw the baby out with the bathwater," but what else would a former corporate official and politician say.

Nonetheless, Cable wants real reform, such as:

— banks required to hold more reserves in good times to limit excess and reckless lending;

— the Bank of England "leaning against the wind" on interest rates; former Fed chairman William McChesney Martin's notion of "taking away the punch bowl" when the party got going; in other words, raise interest rates when it's unpopular but prudent; and

— splitting Britain's banking sector into highly regulated High Street banks on the one hand and riskier investment ones, hedge funds, and shadow banks on the other with no state guarantees as backup; in other words, no bailouts if they get in trouble, a very sensible idea indeed.

Cable is unforgiving of "wheelerdealers" like Northern Rock's Adam Applegarth and Royal Bank of Scotland's Fred Goodwin and asks why were "these pillars of respectability" allowed to let their banks become "debt factories" placing their shareholders and the nation at risk. As a result, he wants banks to become "safe but boring," the equivalent of highly regulated utilities, their traditional role in the first place and not the casinos they've become.

On one other point he's hard line. After 16 years of prosperity, Britain is now in decline. "We placed out trust in housing equity (now evaporating), lavish public services (now unaffordable), an independent central bank (now discredited), a debt economy (now demanding repayment), and financial services (now bust)."

The good years were for naught. We're back to square one, says Cable, and have to rebuild from the wreckage. Income redistribution should be a component to help the needy and reduce wealth extremes. He also finds it ironic that New Labour ministers "who once read Trotsky" let finance capitalism run wild. All of Britain is now paying the price.

In his April 14 Financial Times column, Martin Wolf asked if America is the new Russia given the strength of its "financial oligarchy." He cites the sector's "massive rise," as reflected by its percent of US corporate profits in a deregulatory environment that sustained it while it lasted. Decisive "restructuring is (now) necessary" for two purposes:

— to make financial institutions "credibly solvent;" and

— assure that "no profit-making private institution (is) too big to fail....bankruptcy must be a part of any durable solution;" short of that, "the resolution of this crisis can only be the harbinger of the next."

On April 16, even the Wall Street Journal stepped out of character in publishing "Reverend Billy's Bailout – One Street Preacher Makes the Case for Propping Up Community Banks."

"Would Jesus take a bailout," asked Billy? Reformers have a "once-in-a-century choice," to either prop up financial supermarkets or "lift up community banks and street-level economies."

Reverend Billy Talen leads the Church of Stop Shopping and says "government has a moral obligation to support communities (over) big banks." They're so broken that even Journal writer David Weidner says "Billy may be on to something….It's hard to argue against the system he envisions….neighborhood banks (lending) to local businesses (so) profits could stay in the community..The most basic and sound form of risk management" is knowing your customers and living near them.

Billy is no longer a fringe figure. A Wall Street feature story shows he's mainstream enough to run for New York City mayor on the Green Party ticket, campaigning on a community-first platform – support them over a bubble and bust economy. It's gaining resonance but way short of enough to depose Wall Street dominance.

That and a lot more is needed, including exposing financial fraud, huge cash rewards in spite of it, and deceptive quarterly sales and profits reports to present an illusion they're working.

Case in point is Goldman Sach's April 13 Q 1 profits – according to Bloomberg $1.81 billion "as a surge in trading revenue outweighed asset write-downs, beating" consensus forecasts by a wide margin. Unreported was how they did it – by changing their reporting periods to a calendar year beginning in the current period.

FY 2008 ended in November making December an "orphan month" so results reflected a January – March quarter. At the same time, Goldman took a large year end $1.3 billion write-off handled legally in a separate filing, but the business media headlined the good news, not the bad – conveniently at the same time a new stock offering was announced to enhance its attractiveness to the public.

The New York Times Floyd Norris cited Goldman's report in his April 14 blog. Titled "Case of the Missing Month," he asked: "Would the firm have had a profit if it had stuck to its old calendar, and had to include December and exclude March?" Clearly Goldman acted in its own self-interest and presented a deceptive picture of its health.

So did Wells Fargo (WFC) in its latest announcement – that it expects to earn a record $3 billion in Q 1 2009, putting a brave face on a troubled bank according to analyst Dave Krantzler in an article headlined: "Wells Fargo revisited – A Case of Unmistaken Fraud." He cites deteriorating assets and states:

— "WFC will be forced to incur at least $283 billion in future asset write-downs and will thus require at least that much in capital to service the corresponding liabilities….(its) CEO fraudulently conveyed the financial position of the bank he runs," and Street analysts let him get away with it.

It's these type shenanigans that get Augar and others to call "the old model busted" and needing reform. Better yet, scrap it for a radical new one. Make no mistake. "Tooth-and-claw" capitalism is pernicious and toxic. End it or it'll destroy us. What better proof than the current crisis heading America for neo-feudal bondage unless a mass-awakening comes soon enough to stop it.

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