FROM THE FOUNDER

How Washington Blinked

America's economic future remains uncertain in part because of a lack of courage by policymakers in dealing with banks.

The economics profession and most of the world investment community remain deeply divided over the long-term significance of the George W. Bush/Barack Obama effort to spend $700 billion bailing out the U.S. banks. Here's the troubling part of the bank bailout story: Other nations have followed in America's footsteps, with major and growing government involvement in their banking systems. As a result of governments' growing presence in financial affairs, the world of banking will likely never be the same.

Today we have a dollar-based global financial system dominated by roughly twenty-five government-subsidized international megabanks, with some of the biggest owned by China. These giant financial institutions control roughly $50 trillion in bank assets. That's 60 percent of the world's total bank assets and today only five of these twenty-five megabanks are American-owned, according to Leto Market Insight. We now have a global financial system largely controlled directly by non-U.S. banks and indirectly by their governments. What this means for the direction of long-term global investment, nobody knows.

When the history of this period is written, it is likely that Barack Obama and George W. Bush will be lumped into the same category on the subject of the U.S. banking bailout. Incredibly, both offered the big Wall Street banks $700 billion in taxpayer funding with no stipulation that the banks actually lend the money, which for the most part they haven't been doing except in relatively modest amounts.

The perception now is that Washington has entered a new era of "political banking." Notwithstanding the demagoguery on bank bonuses, the well-connected and the "large" receive all the breaks. The U.S. Treasury bailed out the banking sector so that it could start lending again. But the big banks aren't lending; they have been buying securities as a means of

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bolstering their balance sheets and profiting from the steepening yield curve.

In other words, just like the Japanese banks in the 1990s, they can borrow from the central bank for next to nothing, because the large Wall Street banks have access to the Fed's discount window for cheap loans. Even a high-risk firm like Goldman Sachs now has access to the U.S. taxpayer safety net via the Fed's discount window. The banks use this borrowed capital to buy guaranteed government debt, taking the difference in yields as riskless profit.

There is a reason the U.S. banks haven't been lending: Sure, they've been fearful of the weak economy, but they also don't have to add to their reserves when they buy government securities, which they would have to do if they lent to risky yet job-creating businesses in the private sector. While the U.S. banking industry's current practice of buying securities and curtailing lending may help repair bank balance sheets, the situation has been detrimental to the U.S. economy.

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True, as an alternative to bank financing, America's large corporations have had access to a healthy corporate bond market. They sold more than $1 trillion in bonds in 2009, the fastest pace on record. But that has not been the case for medium- and small-sized companies and entrepreneurial startup ventures, which have been credit-starved since the outbreak of the financial crisis. President Obama has said that these smaller firms and startups are responsible for 70 percent of our economy's net new jobs. Yet despite rhetorical lip-service, they are barely a blip on Washington's radar screen, even as the unemployment rate has soared.

In October, a Japanese financial strategist visited my office in Washington and stunned me with this chicken-and-egg question: "Why didn't the U.S. Treasury, when the healthy bailed-out banks such as Goldman Sachs and J.P. Morgan asked to return their TARP bailout money, insist that the banks first spend the next three years lending the TARP money before returning it? Wouldn't it have been better to save the economy first and then repair the bank balance sheets? Why wouldn't American policymakers have learned from Japan's mistakes in the 1990s?"

Of course, the healthy banks returned the money precisely because of the fear that if they kept the dough, Washington would question their bonus and salary structures. As a result, banks are lending the smallest portion of their deposits in fifteen years, and their bonuses are being questioned anyway. And now, ironically, Washington wants to tax those bonuses as a giant populist parade has begun to roll down Main Street spurred by the anxiety of rising joblessness exacerbated by the decline in bank lending.

In a sense, America's economic future remains uncertain because of a lack of courage by policymakers in dealing with the banks. A year ago, leading bankers such as Chase's Jamie Dimon and Goldman Sachs's Lloyd Blankfein and others might have lost their jobs had Washington forced all banks to clean their balance sheets of their toxic assets, as was the U.S. Treasury's original game plan. This would have been a risky exercise, a chaotic period of deep uncertainty. There might have been blood on the floor. But the result would have been a leaner, cleaner banking sector far more amendable to lending. But the big cleanup never happened and, for the most part, neither did efforts to create enhanced transparency in the securitized asset markets. The reason? Politically inspired timidity carried the day. Banks used the excuse that they were too big to fail. Yet banks that are too big to fail are simply too big.

Before the outbreak of the financial crisis, the U.S. financial services industry represented an incredible 40 percent of U.S. corporate profits and 30 percent of the U.S. stock market's value. This, of course, was an unsustainable situation that made little sense. Today no one knows what will replace this large hole in America's GDP left by the shrinking of the financial services industry. No doubt that is one reason why Washington seems unwilling to confront that industry in an effective manner. Another reason is that bankers are politically powerful. Today nearly one-fourth of the United States Senate sits on the Banking Committee, a committee which has become a premier source of campaign dollars.

In the great stare-down with the bankers, our policymakers lacked much courage. In the end, they blinked. And that's the case with the tepid "musical chairs" version of financial regulatory reform being proposed by Congress as well.

—DAVID M. SMICK
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