NAKED CAPITALISM

The Banking Crisis: From Speculation to Sustainability

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We have experienced a comprehensive failure of the banking system at all levels. The banks have failed to govern themselves effectively; senior managers failed to understand the investments being made in their name; risk management and due diligence was seemingly ignored; and the non-executive directors, often eminent and hugely experienced individuals, failed in the proper scrutiny of the banks' activities. The regulatory system has also failed in its duty…This failure extends to the so-called shadow banking system which is now disintegrating before our eyes….after the extraordinary self-induced implosion of the financial system, the future of the market system now rests in the hands of governments. The politicians are the only show in town.

This statement was made by John McFall, Chair of the U.K. Treasury Select Committee writing in The Guardian newspaper in January 2009. Yet by the summer of 2009, the banks were bouncing back, and the remaining investment banks were forecasting record bonuses. Banks were paying off government loans in order to be free to “reward success.” There appeared to be no penalty for private sector failure and no bonus for the financial support of the public sector. Though banks still had balance sheets totalling many times national GDP, they were back to the practices that had caused the global financial crisis in the first place. Desperate to get their economies going, governments engaged in fiscal stimuli and money creation—quaintly named “quantitative easing”—treasure troves of money that the consumer retail banks sat on or used to rescue their balance sheets. Meanwhile, households and non-finance businesses foundered. Despite the fact that governments around the world had provided around $14 trillion in various forms of guarantee and direct support for their banks, the casino was starting to roll again.

The fuel that had driven the crisis was the growth of trading and speculation in various kinds of “debt instruments,” so-called leverage. Debt had become the new bonanza commodity; it was bought and sold, sliced and swapped. Debt as leverage allowed speculators to amplify marginal changes in price by enhancing investment with borrowed money by multiples of up to forty times or more. Leverage also allowed private equity companies to capture non-financial businesses and load them with a sea of debt. Debt enabled households to augment their low pay and engage in the consumer society, particularly home ownership. It is not without irony that it was the overburdened and exploited poor, tricked into inappropriate and expensive loans, who brought down the system.

What the banking crisis revealed was that the private banking sector was not private at all. It was private in benefit, but public in responsibility. A pivot point was the rescue of the U.S. investment bank, Bear Stearns; the state was not only bailing out commercial banks, but finance capital as well. The attempt to isolate the speculative sector from consumer retail banking through letting the New York-based global financial services firm, Lehman Brothers, collapse only served to undermine the wider banking system even further. This is because within a privatized banking system, profit and speculation must always be at the heart of the process. Capitalist control of the banking system is not compatible with the delivery of banking services to the mass of the
population. Deposit-based banking is an inherently unstable system. As savings deposits are withdrawable on demand, consumer retail banks are always borrowing short to lend long and are therefore always threatened by problems of liquidity or solvency. Borrowing from the money market appeared to overcome the limits of banks’ deposit-based balance sheet, only to open up wider systemic instability. Cash or capital reserves don’t help, because they can never be sufficient to meet a possible systemic crisis without undermining banking profitability. In a profit-driven banking system, the aim must be to hold as little reserve as possible, since the reserve funds are “dead money” that earn no profit.

The banking and financial crisis has shown that governments have to stand full square behind the whole of their interconnected financial system if basic banking services are to survive. The state cannot separate out the strands of a privatized financial system. The U.S. Glass-Steagall Act managed to hold the sectors apart for a time, but the demands of capital were too strong. Consumer retail banks started to get involved in financial speculation, not only as a lender to speculators, but speculating with their own reserves. All of this followed the logic of the search for profit. In the boom times, banks produced good returns and rode high in the stock market. The financial spiral twisted as shareholders sought higher dividends and capital growth, which drove the banks to take more risks. The clear lesson is that securing people’s savings is not compatible with operating as a profit-driven business. Deposit-based banks hold the money of the people and provide the banking services that allow economies to function. Governments cannot let those banks fail, and in a privatized banking system, the state can only achieve this by supporting the whole capitalist financial system.

Bank credit is the fuel that drives capitalist growth. It constantly creates new money, expanding before the crisis at the rate of around 8 percent per year in the U.K. This is a dangerous tool to have in the hands of capitalist finance. Because there is no direct link between bank deposits and bank lending (all deposit holders have a right to demand their money regardless of what loans are outstanding), bank credit is, as Galbraith noted, effectively fresh air money. The question is who controls that money issue and whom does it benefit? The answer in the run-up to the crisis was largely speculators and householders chasing the illusion of perpetually rising house prices.

Capitalism must be cut off from the oxygen of bank credit. Speculative investment must be based on already issued money in real time. That is, the saver/investor must wait until the debt is cleared or the investment sold to be repaid. There is only one way to achieve this separation of banking services from speculative finance: the deposit-based banking system must be socialized. More regulation is not enough, and separating out “narrow” banking from investment banking will not work if they both remain in the private sector. All banks that deal with the people’s money should be based on not-for-profit principles. Equally, the issue of new money should be subject to democratic control and social priorities. Bank-issued credit should be directed to socially necessary expenditure whether through the state, community, or productive sector. Only in this way can unnecessary growth and financial speculation be driven out of the economy and principles of sufficiency and social justice be pursued in their place.