Chapter 2

BANKING POLICY

Utility maximization theory is one of the foundation models of economics. According to this theory, people choose to maximize their personal benefit subject to a budget constraint. If all people are given the freedom to choose, they will each maximize their personal benefit, resulting in a maximum of social well-being given the current income distribution. This theory works best when applied to individual decisions that do not affect other people and when applied to relatively short time frames. If what maximizes my utility produces pollution that makes someone else sick, then social well-being may not be maximized. Furthermore, since utility maximization is subject to a budget constraint, how income is distributed will affect who benefits the most from their choices and the total amount of benefit produced. These are important issues, but the issue I want to focus on here is the time frame used for utility analysis.

Utility theory implicitly assumes the time frame of the chooser. If the chooser is addicted to crack cocaine and, thus, is only focusing on his desperate need to get a fix in the next few minutes, then he will make choices that maximize his benefit over the next few minutes; however, these choices may not be in his long-term best interest. Indeed, in the long run, he is likely to regret the choices he makes in the next few minutes. In contrast, if someone focuses on a time frame that encompasses the remainder of her life, then she will make optimal decisions for the rest of her life if her assumptions about the future hold true. However, the future is uncertain, as the world economic crisis that started in 2008 has well demonstrated. Thus, someone who considers the time frame that encompasses the rest of her life must factor in the uncertainty of the future.
Most people get more immediate benefit from consuming their income than from saving it (the miser who takes joy in his huge stacks of coin which he will never use is the exception, not the rule). When most of us save, we do it for the benefit of the person we will become. The fact that many of us, as we get older, regret not having saved more in our youth, implies that our younger selves either discounted our futures or made mistakes. The interest rate is the price of the trade-off between the present and the future — it is what the market says we should be paid for not consuming today so that we can consume more in the future. The role of banks is to take money from those who wish to save (and thereby earn interest) and give it to those who want to spend more than their current income and are willing to pay the going interest rate to do so. The market interest rate will be the interest rate that equates the quantity of money that people want to save with the quantity that other people want to borrow.

However, the previous statement ignored the gap between the savings and lending interest rates that provides income for the bank. Most governments want their banks to finance the maximum amount of production expanding investment possible. Thus, these governments would like to minimize the gap between savings and lending interest rates. In contrast, banks want to maximize profits which can be achieved with a much larger gap between the savings and lending interest rates than what the government wants. Theoretically, the gap between the savings and lending interest rates should also reflect the short-term nature of most savings versus the longer-term nature of most investments.

If there are so many banks that any one bank cannot affect the interest rate (i.e., if the loanable funds market fits the economic model of pure competition), then the gap between the savings and lending gap should be as small as it possibly can be. However, financial liberalization, which has swept over the globe in the 1980s and 1990s, has led to a tremendous consolidation of financial institutions, moving the market further away from the purely competitive ideal. Leightner and Lovell (1998) show that financial liberalization in Thailand increased the ability of banks to increase profits much more than it increased the financing of production increasing investment. Financial liberalization does this in several ways — some of which make it possible for banks to earn fees, move long-term investments off of
their personal accounting books, and/or take advantage of other participants having imperfect information.

**Financial Liberalization and its Consequences**

In most countries, the number of financial institutions is falling while the size and power of the remaining financial institutions is increasing. For example, in 1984, there were 17,914 commercial banks or savings institutions in the USA; however, in 2012, the number had decreased to 7,083 for a 60% decline (http://www2.fdic.gov/hsob/HSOBRept.asp). Between 1996 and 2006, the number of banks has fallen from 80 to 43 in Argentina, from 87 to 40 in Brazil, from 27 to 12 in Hong Kong, from 61 to 46 in India, from 65 to 35 in Indonesia, from 148 to 124 in Japan, from 29 to 16 in South Korea, from 34 to 21 in Malaysia, from 27 to 8 in Mexico, from 22 to 11 in Peru, and from 15 to 8 in Singapore. Meanwhile, the share of total assets held by the three largest banks (the three-firm concentration ratio) increased between 1996 and 2006 from 0.35 to 0.6 in Brazil, from 0.4 to 0.6 in Chile, from 0.65 to 0.85 in Hong Kong, from 0.35 to 0.55 in Indonesia, from 0.25 to 0.5 in South Korea, from 0.55 to 0.65 in Mexico, and from 0.6 to 0.9 in Singapore (Olivero et al., 2009).

These changes have occurred in the context of the world embracing financial liberalization — a reduction in the regulations and rules that governments use to monitor and control their financial institutions. Presumably, financial liberalization frees up banks to innovate, and the resulting advances in technology are good for the entire world. The financial crisis that began in the USA in 2007–2008 has led to this presumption being questioned. The US Senate’s Financial Crisis Report states that the crisis was “the result of high risk, complex financial products; undisclosed conflicts of interests; and the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street” (US Senate, 2011, p. 1). These “high risk, complex financial products” were developed under financial liberalization and include CDOs (Collateralized Debt Obligations), CDS (Credit Default Swaps), ABX (Asset-backed Securities Index), and RMBS (Residential Mortgage Backed Securities Indices) — all of which played important roles in the financial crisis.
Consider CDOs. When I purchased my house in the 1990s, my bank told me that I could afford a house that cost three times as much. When this revelation did not change my mind, the bank representative patiently explained to my wife and I that Americans increase their net worth by purchasing the most expensive houses that they can. We were told that because all US houses were increasing in value, buying a more expensive house would make me ultimately wealthier. The bank also informed us that our mortgage might be sold on a secondary market. We insisted on buying the house we had selected which cost one-third of our limit, and the bank did not sell our mortgage on the secondary market. The bank knew our mortgage was solid and that it was a good investment for the bank.

If, however, we had been persuaded by the bank to buy the most expensive house we could “afford,” the bank probably would have sold our mortgage on the secondary market. In this case, the more expensive the house we purchased, the larger the fee the bank would get from writing our mortgage. Therefore, the bank has a financial incentive to push home buyers into the most expensive houses possible. Our mortgage could have then been bundled with other mortgages into a CDO. The mortgages in the CDO would be layered and the different layers given different credit ratings and then sold to investors. Theoretically, the bundling of many mortgages together reduces the overall risk. However, in reality, banks had the incentive to make loans to everyone, whether they were good risks or not, because the bank earned the fees no matter how risky the loan.

Many of the mortgages included in these bundles did not even meet minimum underwriting standards. Richard M. Bowen III testified to the Financial Crisis Inquiry Commission that he was promoted to Business Chief Underwriter for Correspondent Lending in the Consumer Lending Group of Citigroup in early 2006 and that in this role he was in charge of 220 underwriters. By mid-2006, he discovered that 60% of the US$90 billion of mortgages going through his office were “defective” (not underwritten to policy) and that this defective rate increased to “over 80%” in 2007 (Bowen, 2010, pp. 1–2).

The US Senate’s Financial Crisis Report argues that US banks sometimes work contrary to their client’s interests.

In the case of Goldman Sachs, the practices included exploiting conflicts of interest with the firm’s clients. For example, Goldman used CDS and ABX contracts to
place billions of dollars of bets that specific RMBS securities, baskets of RMBS securities, or collections of assets in CDOs would fall in value, while at the same time convincing customers to invest in new RMBS and CDO securities.

In one instance, Goldman took the entire short side of a $2 billion CDO known as Hudson 1, selected assets for the CDO to transfer risk from Goldman’s own holdings, allowed investors to buy the CDO securities without fully disclosing its own short position, and when the CDO lost value, made a $1.7 billion gain at the expense of the clients to whom it had sold the securities. In another instance, Goldman marketed a CDO known as Abacus 2007-AC1 to clients without disclosing that it had allowed the sole short party in the CDO, a hedge fund, to play a major role in selecting the assets. The Abacus securities quickly lost value, and the three long investors together lost $1 billion, while the hedge fund profited by about the same amount. (p. 319).

When lauding the virtues of free markets, economists usually assume perfect information — the seller knows his or her true cost of production and the buyer knows the true value of what he or she is purchasing. If there are many buyers and many sellers in such a world (and several other assumptions are also true), the market produces an efficient outcome. Clearly, the preceding examples show that there is not perfect information in banking and that some banks were seeking to earn a return from deception. The local bank that makes a mortgage loan has the most complete information — that bank knows the local real estate market, how different neighborhoods vary, which neighborhoods are associated with the best schools, etc. However, pre-crisis bankers ignored all that information because they could make a fast dollar by pushing buyers to buy the most expensive house possible and then selling the resulting mortgage on the secondary market to investors who had no idea what the true risks were. What is the solution to this problem? Some would argue for more regulation or more paper work; however, a simpler solution that produces the best information is to make banks hold on to all the mortgages they originate. In other words, make CDOs, RMBSs, ABXs, etc., illegal.

The bigger the bank, the bigger and more complex the financial instruments it can create and the higher the fees it can collect. This results in bank profits being positively related to the size of the bank. This, in turn drives many mergers and acquisitions resulting in the number of banks in the USA decreasing by 60%, as mentioned above. If these consolidations were driven by cost savings, then they might be good for society; however, if they are driven by returns to market power or returns from deception, then they
are definitely bad for society. Leightner (2006) found that very small Thai banks were able to provide loans and buy securities at a much lower average total cost than large banks. This implies that there are diseconomies to scale for banks in the provision of loans and securities, and, thus, relatively small banks are best for society. Leightner (2006) points out that this result is consistent with most empirical studies of banks around the world. His study further shows the average price Thai banks receive increases much faster than the average cost increases. Thus, he concludes that banks have a profit incentive to get as big as possible, even though relatively small banks are best for society. The reason that average price increases as banks get bigger and bigger is that larger banks can earn more money off of fees, like the fees earned by selling mortgages on the secondary market, and these fees are more profitable than the making and holding of standard loans and the holding of standard securities (the things that directly finance growth).

The notion that extremely large banks are “too big to fail” compounds these problems. If a bank manager believes that his bank is too big to fail, then he has the incentive to do extremely risky things that would pay off with high profits if they succeed since, if they fail, the government will bear the loss. In this case, the bank manager only considers the upside of risks. Furthermore, the Thai case demonstrates that public trust in the entire banking system is a “public good.” If one bank breaks the public trust, then customers tend to flee all banks in that country’s banking system creating a system-wide banking crisis (Alam and Leightner, 2001). Indeed, there are some economic models of crises that are built on massive bank runs (Diamond and Dybvig, 1983; Diamond, 2007). Clearly, the government’s goal of having a stable financial system that finances growth is inconsistent with bank managers taking excessive risks because they believe they can avoid all negative consequences due to being too big to fail.

All of the above analysis is already in the existing literature, which is much more vast and detailed than what I have cited. This book’s most important contribution lies in its tracing these and other problems back to a global surplus of savings. Why did the banking system create investment funds like CDOs and its siblings? The answer to this question is the return from investing in production expansion was less than the return from earning fees from making risky mortgages and selling them on a secondary market. Yes, the government needs to change the underlying structure of
the US financial system so that the conflicts of interests and the deception that played such an important role in the US banking crisis cannot happen again. However, these types of structural changes are only addressing half of the problem. The other half of the problem is why is the return from investing in production expansion so low?

The return from investing in production expansion is so low because the supply of loanable funds (savings) has increased as the rich get richer while the demand for loanable funds has fallen because there is insufficient consumption to provide a reason to invest the savings in ways that would increase production. In such a world, savings seek a return from owning things or from deception, like bundled mortgages, instead of from expanding production. Consider specifically how the global surplus of savings affected the banking systems of Thailand, Cyprus, and Ireland.

Thailand

From 1986 to 1994, Thailand was one of the fastest growing countries in the world, had successfully maintained a fixed exchange rate since November 4, 1984, and was a favorite country for foreign investment. However, by 1993, the Thai government was very concerned because wages in Thailand were rising while wages in Cambodia, Laos, Vietnam, Myanmar, and southern China were not rising. Wages in Malaysia were also rising but not as fast as Thailand’s. The Thai government was concerned that Thai businesses would move to neighboring countries in order to reduce their costs.

Although the Thai government’s response to this concern may bewilder many westerners, the ancient Chinese philosopher Confucius would have applauded it. The Thai government decided to help its neighbors grow. Top Thai officials organized meetings of government officials and business leaders in the major cities of Thailand. I attended one of those meetings. At the meeting, the Thai government told Thai businessmen that they wanted Thai business to invest in Thailand’s neighbors. The Thai government also promised to do whatever it took to make such investment successful; it offered to help with negotiations, to provide foreign exchange, to give tax incentives, etc. At the meeting I attended in Chiang Mai, the Thai officials suggested building gas pipelines from Myanmar to Thailand, building dams and hydro-electric plants in Laos, and setting up manufacturing
plants in Vietnam and southern China. On the surface, it looks as if the
Thai government was encouraging exactly what they feared — Thai firms
moving to Thailand’s neighbors where wages were lower. However, the
Thai government was actually trying to become the patron of Indo-China.
The theory was that if Thailand helped its neighbors grow, then Thailand’s
neighbors would be obligated to be loyal to Thailand and not do anything
that would hurt Thailand. The whole region could grow together like one
big, happy family with Thailand in the lead.

A good patron also provides financing for growth. Thus, Thailand set
up the Bangkok International Banking Facility (BIBF) in 1993. The BIBF
in essence eliminated Thailand’s capital controls (laws that restrict how
much foreign money can come in and/or go out of a country). The goal of
the BIBF was to attract large inflows of money from Japan, the USA, and
Europe which would be lent to Thailand’s neighbors. However, interest
rates in Thailand were approximately 5% higher than they were in the
rest of the world and much higher than they were in Thailand’s neighbors.
Consequently, the BIBF was able to attract huge inflows of foreign savings;
however, that savings preferred to stay in Thailand where its return was
higher (Leightner, 1999, 2007b).

More foreign savings came flooding into Thailand than could be pro-
ductively used and speculative bubbles were the result. Jitrapanun and
Prasartset (2009) estimate that these bubbles resulted in excess supply in
relationship to market demand becoming 150% in iron and steel, 192%
in motor cars, 195% in petrochemicals, 200% in metropolitan Bangkok
housing, and 300% in private hospitals. When investors take out loans to
build factories, or houses, or office buildings that are far in excess of mar-
et demand, then they have difficulty selling what the investment produces
and, thus, they have difficulty re-paying their loans. A banking crisis is
the result.

In 1996, the Bangkok Bank of Commerce ran into some major prob-
lems that involved a political scandal, a major bank official stealing two
suitcases full of money from the bank and fleeing to Canada, and a failed
cover-up by Thailand’s central bank. In the spring of 1997, Somprasong
Land Company defaulted on a US$3 million interest payment on some
European Debentures. On March 3, 1997, the Thai government suspended
trade of all financial company stocks and bonds on the stock exchange of
Thailand, increased reserve requirements for all financial institutions, and
shut down 10 weak finance and securities companies.

These events, as well as some others, provided the ammunition for
currency speculators, like George Soros, to launch a speculative attack on
the Thai baht. The Thai government’s defense of the Thai baht consumed
most of Thailand’s foreign reserves — Thailand’s foreign reserves were
approximately 36 billion in December 1996 but were between 1 and 5 billion
on July 2, 1997 when Thailand gave up its fixed exchange rate. The Thai
baht fell from 25 baht per dollar on July 1, 1997 to 54 baht per dollar in
from the IMF and the World Bank. The conditions that Thailand accepted in
exchange for the IMF/World Bank loan included the IMF’s typical austerity
measures plus a promise not to rescue any more Thai financial institutions.

By May 1998, 56 of Thailand’s 91 finance and securities companies
had been shut down and 7 more had been taken over by the government.
About 4 of Thailand’s 15 commercial banks were also taken over by the Thai
government. In the course of taking over these financial institutions, the Thai
government fired all of their senior leadership and wrote down their capital
to 1/1,000th of its previous value. The Thai government also announced if
the remaining financial institutions did not get their non-performing loans
under control, then they would be treated in the same way.

Under this threat, bank managers decreased the amount of new loans
they made to almost zero. A severe credit crunch resulted. Many firms that
owed money to Thailand’s financial institutions stopped paying on their
loans and started stock piling cash because they knew that their chances
of getting new loans was almost nil. This made the non-performing loan
problem of banks worse. Some borrowers leveraged the desperation of
banks to get their non-performing loans under control by asking the banks
for bribes, write-downs of part of the principle that they owed, and/or lower
interest rates. The resulting incidence of “strategic non-performing loans"
became epidemic. The Thai government rewrote Thailand’s bankruptcy
code so that the bankruptcy process that previously took four or five years
could be completed in one year. However, the bankruptcy court that heard
the first major case under the new rules threw the case out of court because
the company was technically not bankrupt — they had the money to pay
back their loans, they just were not doing it.
The Thai financial crisis also led to the political rise of Thaksin Shinawatra, massive street protests, a mob of protesters taking over Bangkok’s biggest international airport, a coup against Thaksin, more protesters taking over the central business area of Bangkok, Thaksin’s sister being elected prime minister, and another round of massive street protests in Bangkok as I was finishing this book in December 2013. In other words, the consequences of Thailand opening its doors to the global surplus of savings in 1993 were still being felt in Thailand in 2013, 20 years later (Leightner, 1999, 2002a, 2002b, 2007b).

Cyprus

Due to Cyprus’ relatively low corporate tax rate and the strong legal protections that come with being a European Union country, many foreigners (especially Russians) put their savings into Cyprus’ banks (Alpert, 2013). This has led to Cyprus’ banking sector being eight times the size of the country’s GDP; Cyprus’ banks had more savings than domestic production expanding investments could absorb. Therefore, these banks invested in assets that would earn rent, like Greek government bonds. Apparently, as the Greek economy fell into crisis and many foreigners were exiting Greek bonds, Cyprus’ banks were buying Greek government bonds because they were bargain priced and because Cyprus’ banks did not believe that the European Union would allow the value of those bonds to decline. When the values of Greek bonds were drastically decreased, Cyprus’ banks were severely damaged. Cyprus’ financial sector accounts for 45% of Cyprus’ economy (Stevis et al., 2013); thus, the entire economy was at risk.

The European Central bank, the International Monetary Fund (IMF), and the European Commission proposed a tax on deposits under €100,000 of 6.75% and a tax of 9.9% on deposits above that limit. Cyprus’ government rejected this proposal causing much fear that Cyprus would be forced to abandon its use of the euro. Ultimately, a deal was accepted that preserved the total value of deposits under €100,000, but will cause much steeper losses for deposits exceeding €100,000. How steep these losses will be are currently unknown; however, some estimate that they will range from 60 to 100% (Jenkins, 2013). As a consequence of this crisis, most Cyprus’ businesses are now operating on a “cash only” basis (Persianis et al., 2013).
Ireland

Like Thailand between 1986 and 1996, Ireland was viewed as a great success before its crisis. Due to demographic factors, rising education levels, and a surge in female labor force participation, Irish employment rose from 1.1 million to 2.1 million between the late 1980s and 2007. Meanwhile, labor productivity increased and economic growth averaged 6.3% per year between 1987 and 2007.

This exceptional economic growth allowed the Irish government to achieve a holy grail that was the envy of politicians around the world: They lowered tax rates and raised public spending year in and year out and yet economic growth delivered sufficient tax revenues to generate a string of budget surpluses (Whelan, 2013, p. 3).

However, a housing bubble funded by an inflow of European savings destroyed Ireland’s exceptional economic performance.

The first stage of establishing the European Monetary Union (EMU) was to allow the free movement of capital between member states, and this stage was to be implemented between July 1, 1990 and December 31, 1993. This free movement of capital allowed European savings to enter Ireland causing mortgage interest rates, which prior to the EMU were in excess of 10%, to fall to less than 5%. European savings sought out Ireland’s real estate market because of Ireland’s economic success, growing population, rising incomes, and initial low per capita housing stock. According to estimates made by Somerville (2007), Ireland had the smallest per capita housing stock in the European Union as of 2000. As a result of these forces, Ireland’s housing prices quadrupled between 1996 and 2007; by way of comparison, US housing prices only doubled during that time frame.

Ireland’s total stock of houses grew from 1.2 million in 1991 to 1.4 million in 2000 and then to 1.9 million in 2008. After 2002, per capita new house completions surged to four times higher in Ireland than they were in the USA. Indeed, new “house completions went from 19,000 in 1990 to 50,000 in 2000 to a whopping 93,000 in 2006” (Whelan, 2013, p. 6).

After 2003, the rapid expansion of property lending was largely financed with bonds issued to international investors. From less than €15 billion in 2003, international bond borrowings of the six main Irish banks rose to almost €100 billion (well over half of GDP) by 2007” (Whelan, 2013, p. 11).
In other words, what financed Ireland’s real estate bubble was the global surplus of savings.

Whelan (2013) clearly sees the role that foreign savings played in Ireland’s crisis; however, he places the primary blame for the crisis on Irish government policies.

Some in Ireland blame the low interest rates associated with euro membership for the housing bubble and resulting crash. I think the weight of blame is better placed on domestic fiscal and regulatory policy. While the authorities may not have been able to do much about the low interest rates brought by euro membership, they had the power to place limits on mortgage lending (limiting multiples of income or requiring large down-payments) and to restrict the exposure of individual financial institutions to property development. In addition, rather than “lean against” the property bubble, Ireland’s government provided a host of tax-based incentives that encouraged property speculation (pp. 27–28).

Whether or not Whelan is correct in placing the primary blame on the Irish government, my thesis remains unaltered. In the wake of these crises, everyone is talking about how governments could have better regulated their economies, and I admit that the regulation issues are extremely important to address. However, no one seems to be talking about how the global surplus of savings continues to plague our world and what should be done to eliminate it. We need to fix the regulation issues and seriously address the global surplus of savings.