Gladstone, Bair and Broken Capitalism

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Across Cyprus there are quite a few streets named after William Gladstone, the British statesman and politician. In Cyprus, like another Englishman the poet Lord Byron, he is lauded for action and polemic against the Ottomans who once governed here. For many though his time as Chancellor of the Exchequer stands out.

Gladstone was without doubt a politician of his time: the 19th Century. It was a century that ushered in the industrial age together with electoral reform that eventually culminated in universal suffrage. It was a time when the unincorporated trading trust took on the corporate form of limited liability and the courts of equity laid down the legal authority of the standard of care expected of a trustee; that of the 'ordinary prudence of a businessman'.

In fact prudence describes the centre of gravity of Gladstone himself. He was a committed advocate of the balanced budget and guardian of the public purse. To him the stewardship of public funds was a kind of sacred trust. He refused to borrow from the future through the increase of the national debt in order to pay for the Crimean War preferring to raise the very income tax he had in mind to abolish.

Here then was a politician rarely seen in British politics since Baroness Thatcher who acted resolutely and shied away from taking account of opinion polls when administering the public's finances. It is no surprise that Margaret Thatcher's convictions while in office as she rolled back the frontiers of the state and unleashed supply side reforms permitted her to regard herself as a 'Gladstone Liberal'.

Of his long and repeated tenure in public office, there are three contemporary and integral themes that stand out, these being (i) prudential finance, the (ii) abolition of many duties and (iii) electoral reform. His time as Chancellor in the first government of the new Liberal Party was seminal (1859-1866). It was when he said:

"In time of peace nothing but dire necessity should induce us to borrow."

In his first budget he cut the number of indirect taxes dramatically from over 400 to less than 50 and raised income tax instead. True to his convictions however he was able to reduce income tax later, even from the paltry level of about 3%, arguing that government was wasteful with taxpayers' money and through economic reforms and the avoidance of war, private, and not public investment, could and ought to be more dominant.

Finally, he had the foresight to marry electoral reform to wider dissemination of political knowledge. He deftly achieved this through the abolition of the duty on paper known as the 'tax on knowledge'.

The Great Recession

Can Gladstone tell us something about the difficult economic times we are living in now? And what to believe: that history teaches us nothing or he who forgets past mistakes is condemned to repeat them? History certainly allows us to make comparisons that may be applicable to the present. Few would suggest that this century could or ought to return to the levels of income tax and national debt of Gladstone's time. However, I should argue that the present political consensus throughout the developed economies has not delivered the sustainable growth and wealth distribution over the last 15 years as it would have done had there been more Gladstone Liberal's in places of influence.

Just as Gladstone lived during 'England's time'; we are now witnessing America's. An understanding of the economic state we are in could begin there. When she sneezes, the majority of us catch a cold and the first sneeze might be said to have been when Senator Phil Gramm, a zealous spokesman of financial deregulation, led the repeal of the Glass-Steagall Act. In 1999 for the first time since the great Depression of the 1930s, there was no longer any separation between commercial banks that accepted deposits and investment banks that issued securities. At the same time it was no longer unlawful to serve on the board of both kinds of bank making it possible to lend conservatively with the left hand and invest speculatively with the right.

Not long after this and the September 2001 attack on New York's Twin Towers, the Federal Reserve under Chairman Alan Greenspan decided to lower the federal funds rates then set at 3.5%. Gradually the rate was dropped lower and lower on account of a weak stock market and several accounting scandals until it reached 1% in 2002. Considerably below America's level of inflation this course of action led to mimicry by other central banks around the world. It was only a matter of time before these stimuli would accrue and unleash a speculative nightmare.

Bair and the Federal Deposit Insurance Corporation (FDIC)

Of course not every public servant in America fostered speculation watching the money on the table get bundled up as sub-prime mortgages, rated as 'triple A' then sold on to international banks. There was a latter

day People's William, as Gladstone became fondly known, a women by the name of Sheila Bair, chairing the FDIC government agency, which was created out of the very same Glass-Steagall Act and responsible for the orderly receivership of insolvent banks.

It was she who from 2006 challenged all of the inappropriate practices of the sub-prime scandal and challenged the orthodoxy of the US Treasury and Federal Reserve. In her exit interview last year with the New York Times' Joe Nocera, she described herself as someone who believes in 'regulations that reinforce incentives'.

Her incumbency is marked by her (i) dogged resistance to Basel II, (ii) tempered promotion of mortgage modification for trapped borrowers and (ii) receivership of Washington Mutual, the largest US savings and loan association at the time.

Single-handedly it seems, she prevented Basel II from being adopted by US banks. She was concerned that her agency and by derivation US taxpayers would pick up the financial consequences of allowing US banks to compound Gramm's loosening with even more. Basel II threatened this through the 'risk weighting' of assets and the deployment of 'in-house' modelling. No surprise then that European banks, whose governments did sign up and in what has to be a fantastic irony, used Basel II to great and disastrous effect loading up on high yielding US sub-prime products. Furthermore, in another bizarre twist the German Landesbank, whose 'sugar daddy' had for some time been the German Federal Government, when confronted with the advance of EU competition law and the consequent loss of privilege, took their last chance decisively converting cheap German public funding into speculative US sub-prime; a move which cost billions.

After Gladstone again, Chairwomen Bair argued for mortgage modification to relieve the hard pressed, but with little success because the vested interests of finance and banking fought her “tooth and nail”. Strikingly the USD50 billion allowance for modifications provided for as part of the USD700 billion TARP was “barely touched” by the US Treasury. With reports last year that one fifth of US home owners are in negative equity, along with one million in default or foreclosed, it is not difficult to envisage the economic consequences. Surely these exceptional circumstances could justify an arrangement that would share the burden of responsibility. Such a way would lead beneficially to less forced selling and damage to neighbourhoods, she argued.

But of course, the FDIC also has to be ready to deal with the resolution of a failed bank when preventative measures have been insufficient. The agency is known widely and regarded highly for slipping quietly into a failed bank's offices on a Friday and by Monday the only thing customers can see is that there is a new name on their bank statements. Meanwhile the busted bank's risk capital comprising of bondholders and shareholders has been separated; parked in a file marked 'pending the denouement'. New risk capital would then be sold to the market under a new and reasonable business model and the old risk capital would be restructured receiving the net proceeds of the bank's sale. Meanwhile the customers of the bank continue as though nothing had happened.

Unjustifiably, this impressive commonsensical receivership model of the FDIC was not deployed in the case of Bear Stearns because the US Treasury argued against it saying that Bear Stearn's failure was somehow systemic. Mrs Bair fought her corner valiantly but to no avail. Indeed the pernicious creep of bondholder power appears to go back some way. As long ago as 1993 James Carville, the political consultant to Bill Clinton and Tony Blair famously said, having revised his preference from president or pope:

> “But now I want to come back as the bond market. You can intimidate everyone.”

These bondholders certainly scared the life out of Ben Bernanke whose Federal Reserve lent USD30 billion of non-recourse finance to JP Morgan in 2008 in exchange for taking over Bear Stearns for USD2.

The People's Sheila was not impressed however:

> “They should have let Bear Stearns fail. [It] was a second-tier investment bank, with what – around USD400 billion in assets? I'm a traditionalist. Banks and bank holding companies are in the safety net. That's why they have deposit insurance. Investment banks take higher risks, and are supposed to be outside the safety net. If they make enough mistakes, they are supposed to fail.”

Broken Capitalism

It seems traditionalists though are few and far between in Europe too. Whichever way you look bondholders of the banks and member states of the EU are arguing for preferential status in a way no ordinary bondholder could imagine. According to Amyas Morse, Comptroller and Auditor General of the British National Audit Office:

> "It was originally assumed that [British bank] subordinated debt holders would absorb losses in times of difficulty, as they were being paid a correspondingly high interest rate. In the event, taxpayers are actually paying to support the banks and are taking on the risk that should have fallen to investors."

Banning short selling, introducing a financial transaction tax and skewing the attack against bank bonuses are just the deliberate distractions of rhetoricians. Far too often, despite the lifting of 'taxes on knowledge', we allow politicians to treat us like the children of bad parents – subjects to be controlled and not the recipients of the virtues flowing from their good offices. The cat though could be out of the bag. Taxpayers cough up and economic growth dries up when banks' assets are not valued conservatively, insolvent banks are not restructured and bank risk capital comes with an ostensible government guarantee. Bank risk capital is not systemic.

Today's protesters on Wall Street and outside of St Paul’s Cathedral have unfortunately parked their tanks on the wrong lawn. The bondholder’s great escape is costing taxpayers billions. They should de-camp and move to Washington, Westminster and Brussels. There they should demand for the return of functional capitalism that is primarily centred on private savings and prudential finance. Countries' and banks' balance sheets still have to be restructured. Probably EU arrangements too. Greece et al have to either leave the Eurozone or wealthy member states pool and share their capital with the PIIGS; an arrangement that already exists between the nation states that make up the United Kingdom of Great Britain and Northern Ireland.

Zombie, Crony or Denial Capitalism is not the answer. Gladstone would undoubtedly agree.

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