

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.

1 Most people get more immediate benefit from consuming their income
2 than from saving it (the miser who takes joy in his huge stacks of coin which
3 he will never use is the exception, not the rule). When most of us save, we
4 do it for the benefit of the person we will become. The fact that many of us,
5 as we get older, regret not having saved more in our youth, implies that our
6 younger selves either discounted our futures or made mistakes. The interest
7 rate is the price of the trade-off between the present and the future — it is
8 what the market says we should be paid for not consuming today so that
9 we can consume more in the future. The role of banks is to take money
10 from those who wish to save (and thereby earn interest) and give it to those
11 who want to spend more than their current income and are willing to pay
12 the going interest rate to do so. The market interest rate will be the interest
13 rate that equates the quantity of money that people want to save with the
14 quantity that other people want to borrow.

15 However, the previous statement ignored the gap between the savings
16 and lending interest rates that provides income for the bank. Most gov-
17 ernments want their banks to finance the maximum amount of produc-
18 tion expanding investment possible. Thus, these governments would like to
19 minimize the gap between savings and lending interest rates. In contrast,
20 banks want to maximize profits which can be achieved with a much larger
21 gap between the savings and lending interest rates than what the govern-
22 ment wants. Theoretically, the gap between the savings and lending interest
23 rates should also reflect the short-term nature of most savings versus the
24 longer-term nature of most investments.

25 If there are so many banks that any one bank cannot affect the interest
26 rate (i.e., if the loanable funds market fits the economic model of pure
27 competition), then the gap between the savings and lending gap should be
28 as small as it possibly can be. However, financial liberalization, which has
29 swept over the globe in the 1980s and 1990s, has led to a tremendous con-
30 solidation of financial institutions, moving the market further away from the
31 purely competitive ideal. Leightner and Lovell (1998) show that financial
32 liberalization in Thailand increased the ability of banks to increase profits
33 much more than it increased the financing of production increasing invest-
34 ment. Financial liberalization does this in several ways — some of which
35 make it possible for banks to earn fees, move long-term investments off of

1 their personal accounting books, and/or take advantage of other participants
2 having imperfect information.

3 **Financial Liberalization and its Consequences**

4 In most countries, the number of financial institutions is falling while the
5 size and power of the remaining financial institutions is increasing. For
6 example, in 1984, there were 17,914 commercial banks or savings institu-
7 tions in the USA; however, in 2012, the number had decreased to 7,083 for
8 a 60% decline (<http://www2.fdic.gov/hsob/HSOBRpt.asp>). Between 1996
9 and 2006, the number of banks has fallen from 80 to 43 in Argentina, from
10 87 to 40 in Brazil, from 27 to 12 in Hong Kong, from 61 to 46 in India,
11 from 65 to 35 in Indonesia, from 148 to 124 in Japan, from 29 to 16 in
12 South Korea, from 34 to 21 in Malaysia, from 27 to 8 in Mexico, from 22
13 to 11 in Peru, and from 15 to 8 in Singapore. Meanwhile, the share of total
14 assets held by the three largest banks (the three-firm concentration ratio)
15 increased between 1996 and 2006 from 0.35 to 0.6 in Brazil, from 0.4 to 0.6
16 in Chile, from 0.65 to 0.85 in Hong Kong, from 0.35 to 0.55 in Indonesia,
17 from 0.25 to 0.5 in South Korea, from 0.55 to 0.65 in Mexico, and from 0.6
18 to 0.9 in Singapore (Olivero *et al.*, 2009).

19 These changes have occurred in the context of the world embracing
20 financial liberalization — a reduction in the regulations and rules that gov-
21 ernments use to monitor and control their financial institutions. Presum-
22 ably, financial liberalization frees up banks to innovate, and the resulting
23 advances in technology are good for the entire world. The financial crisis
24 that began in the USA in 2007–2008 has led to this presumption being
25 questioned. The US Senate’s Financial Crisis Report states that the crisis
26 was “the result of high risk, complex financial products; undisclosed con-
27 flicts of interests; and the failure of regulators, the credit rating agencies,
28 and the market itself to rein in the excesses of Wall Street” (US Senate,
29 2011, p. 1). These “high risk, complex financial products” were devel-
30 oped under financial liberalization and include CDOs (Collateralized Debt
31 Obligations), CDS (Credit Default Swaps), ABX (Asset-backed Securities
32 Index), and RMBS (Residential Mortgage Backed Securities Indices) —
33 all of which played important roles in the financial crisis.

1 Consider CDOs. When I purchased my house in the 1990s, my bank
2 told me that I could afford a house that cost three times as much. When
3 this revelation did not change my mind, the bank representative patiently
4 explained to my wife and I that Americans increase their net worth by
5 purchasing the most expensive houses that they can. We were told that
6 because all US houses were increasing in value, buying a more expensive
7 house would make me ultimately wealthier. The bank also informed us that
8 our mortgage might be sold on a secondary market. We insisted on buying
9 the house we had selected which cost one-third of our limit, and the bank
10 did not sell our mortgage on the secondary market. The bank knew our
11 mortgage was solid and that it was a good investment for the bank.

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

24 Many of the mortgages included in these bundles did not even meet
25 minimum underwriting standards. Richard M. Bowen III testified to the
26 Financial Crisis Inquiry Commission that he was promoted to Business
27 Chief Underwriter for Correspondent Lending in the Consumer Lending
28 Group of Citigroup in early 2006 and that in this role he was in charge of 220
29 underwriters. By mid-2006, he discovered that 60% of the US\$90 billion of
30 mortgages going through his office were “defective” (not underwritten to
31 policy) and that this defective rate increased to “over 80%” in 2007 (Bowen,
32 2010, pp. 1–2).

33 The US Senate’s Financial Crisis Report argues that US banks some-
34 times work contrary to their client’s interests.

35 In the case of Goldman Sachs, the practices included exploiting conflicts of interest
36 with the firm’s clients. For example, Goldman used CDS and ABX contracts to

1 place billions of dollars of bets that specific RMBS securities, baskets of RMBS
2 securities, or collections of assets in CDOs would fall in value, while at the
3 same time convincing customers to invest in new RMBS and CDO securities.
4 In one instance, Goldman took the entire short side of a \$2 billion CDO known
5 as Hudson 1, selected assets for the CDO to transfer risk from Goldman's own
6 holdings, allowed investors to buy the CDO securities without fully disclosing its
7 own short position, and when the CDO lost value, made a \$1.7 billion gain at the
8 expense of the clients to whom it had sold the securities In another instance,
9 Goldman marketed a CDO known as Abacus 2007-AC1 to clients without dis-
10 closing that it had allowed the sole short party in the CDO, a hedge fund, to play
11 a major role in selecting the assets. The Abacus securities quickly lost value, and
12 the three long investors together lost \$1 billion, while the hedge fund profited by
13 about the same amount. (p. 319).

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

32 The bigger the bank, the bigger and more complex the financial instru-
33 ments it can create and the higher the fees it can collect. This results in bank
34 profits being positively related to the size of the bank. This, in turn drives
35 many mergers and acquisitions resulting in the number of banks in the
36 USA decreasing by 60%, as mentioned above. If these consolidations were
37 driven by cost savings, then they might be good for society; however, if they
38 are driven by returns to market power or returns from deception, then they

1 are definitely bad for society. Leightner (2006) found that very small Thai
2 banks were able to provide loans and buy securities at a much lower average
3 total cost than large banks. This implies that there are diseconomies to
4 scale for banks in the provision of loans and securities, and, thus, relatively
5 small banks are best for society. Leightner (2006) points out that this result
6 is consistent with most empirical studies of banks around the world. His
7 study further shows the average price Thai banks receive increases much
8 faster than the average cost increases. Thus, he concludes that banks have a
9 profit incentive to get as big as possible, even though relatively small banks
10 are best for society. The reason that average price increases as banks get
11 bigger and bigger is that larger banks can earn more money off of fees, like
12 the fees earned by selling mortgages on the secondary market, and these
13 fees are more profitable than the making and holding of standard loans and
14 the holding of standard securities (the things that directly finance growth).

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

29 All of the above analysis is already in the existing literature, which
30 is much more vast and detailed than what I have cited. This book’s most
31 important contribution lies in its tracing these and other problems back to
32 a global surplus of savings. Why did the banking system create investment
33 funds like CDOs and its siblings? The answer to this question is the return
34 from investing in production expansion was less than the return from earning
35 fees from making risky mortgages and selling them on a secondary
36 market. Yes, the government needs to change the underlying structure of

1 the US financial system so that the conflicts of interests and the deception
2 that played such an important role in the US banking crisis cannot happen
3 again. However, these types of structural changes are only addressing half
4 of the problem. The other half of the problem is why is the return from
5 investing in production expansion so low?

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

14 **Thailand**

15 From 1986 to 1994, Thailand was one of the fastest growing countries in the
16 world, had successfully maintained a fixed exchange rate since November 4,
17 1984, and was a favorite country for foreign investment. However, by 1993,
18 the Thai government was very concerned because wages in Thailand were
19 rising while wages in Cambodia, Laos, Vietnam, Myanmar, and southern
20 China were not rising. Wages in Malaysia were also rising but not as fast
21 as Thailand's. The Thai government was concerned that Thai businesses
22 would move to neighboring countries in order to reduce their costs.

23 Although the Thai government's response to this concern may bewilder
24 many westerners, the ancient Chinese philosopher Confucius would have
25 applauded it. The Thai government decided to help its neighbors grow.
26 Top Thai officials organized meetings of government officials and business
27 leaders in the major cities of Thailand. I attended one of those meetings. At
28 the meeting, the Thai government told Thai businessmen that they wanted
29 Thai business to invest in Thailand's neighbors. The Thai government also
30 promised to do whatever it took to make such investment successful; it
31 offered to help with negotiations, to provide foreign exchange, to give tax
32 incentives, etc. At the meeting I attended in Chiang Mai, the Thai offi-
33 cials suggested building gas pipelines from Myanmar to Thailand, build-
34 ing dams and hydro-electric plants in Laos, and setting up manufacturing

1 plants in Vietnam and southern China. On the surface, it looks as if the
2 Thai government was encouraging exactly what they feared — Thai firms
3 moving to Thailand's neighbors where wages were lower. However, the
4 Thai government was actually trying to become the patron of Indo-China.
5 The theory was that if Thailand helped its neighbors grow, then Thailand's
6 neighbors would be obligated to be loyal to Thailand and not do anything
7 that would hurt Thailand. The whole region could grow together like one
8 big, happy family with Thailand in the lead.

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

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

30 In 1996, the Bangkok Bank of Commerce ran into some major prob-
31 lems that involved a political scandal, a major bank official stealing two
32 suitcases full of money from the bank and fleeing to Canada, and a failed
33 cover-up by Thailand's central bank. In the spring of 1997, Somprasong
34 Land Company defaulted on a US\$3 million interest payment on some
35 European Debentures. On March 3, 1997, the Thai government suspended
36 trade of all financial company stocks and bonds on the stock exchange of

1 Thailand, increased reserve requirements for all financial institutions, and
2 shut down 10 weak finance and securities companies.

3 These events, as well as some others, provided the ammunition for
4 currency speculators, like George Soros, to launch a speculative attack on
5 the Thai baht. The Thai government's defense of the Thai baht consumed
6 most of Thailand's foreign reserves — Thailand's foreign reserves were
7 approximately 36 billion in December 1996 but were between 1 and 5 billion
8 on July 2, 1997 when Thailand gave up its fixed exchange rate. The Thai
9 baht fell from 25 baht per dollar on July 1, 1997 to 54 baht per dollar in
10 January 1998. On August 19, 1997, Thailand took out a US\$17.2 billion loan
11 from the IMF and the World Bank. The conditions that Thailand accepted in
12 exchange for the IMF/World Bank loan included the IMF's typical austerity
13 measures plus a promise not to rescue any more Thai financial institutions.

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

22 Under this threat, bank managers decreased the amount of new loans
23 they made to almost zero. A severe credit crunch resulted. Many firms that
24 owed money to Thailand's financial institutions stopped paying on their
25 loans and started stock piling cash because they knew that their chances
26 of getting new loans was almost nil. This made the non-performing loan
27 problem of banks worse. Some borrowers leveraged the desperation of
28 banks to get their non-performing loans under control by asking the banks
29 for bribes, write-downs of part of the principle that they owed, and/or lower
30 interest rates. The resulting incidence of "strategic non-performing loans"
31 became epidemic. The Thai government rewrote Thailand's bankruptcy
32 code so that the bankruptcy process that previously took four or five years
33 could be completed in one year. However, the bankruptcy court that heard
34 the first major case under the new rules threw the case out of court because
35 the company was technically not bankrupt — they had the money to pay
36 back their loans, they just were not doing it.

1 The Thai financial crisis also led to the political rise of Thaksin
 2 Shinawatra, massive street protests, a mob of protesters taking over
 3 Bangkok's biggest international airport, a coup against Thaksin, more
 4 protesters taking over the central business area of Bangkok, Thaksin's sister
 5 being elected prime minister, and another round of massive street protests
 6 in Bangkok as I was finishing this book in December 2013. In other words,
 7 the consequences of Thailand opening its doors to the global surplus of
 8 savings in 1993 were still being felt in Thailand in 2013, 20 years later
 9 (Leightner, 1999, 2002a, 2002b, 2007b).

10 **Cyprus**

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

25 The European Central bank, the International Monetary Fund (IMF),
 26 and the European Commission proposed a tax on deposits under €100,000
 27 of 6.75% and a tax of 9.9% on deposits above that limit. Cyprus' government
 28 rejected this proposal causing much fear that Cyprus would be forced to
 29 abandon its use of the euro. Ultimately, a deal was accepted that preserved
 30 the total value of deposits under €100,000, but will cause much steeper
 31 losses for deposits exceeding €100,000. How steep these losses will be
 32 are currently unknown; however, some estimate that they will range from
 33 60 to 100% (Jenkins, 2013). As a consequence of this crisis, most Cyprus'
 34 businesses are now operating on a "cash only" basis (Persianis *et al.*, 2013).

1 **Ireland**

2 Like Thailand between 1986 and 1996, Ireland was viewed as a great suc-
3 cess before its crisis. Due to demographic factors, rising education levels,
4 and a surge in female labor force participation, Irish employment rose from
5 1.1 million to 2.1 million between the late 1980s and 2007. Meanwhile,
6 labor productivity increased and economic growth averaged 6.3% per year
7 between 1987 and 2007.

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

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

15 The first stage of establishing the European Monetary Union (EMU)
16 was to allow the free movement of capital between member states, and
17 this stage was to be implemented between July 1, 1990 and December 31,
18 1993. This free movement of capital allowed European savings to enter
19 Ireland causing mortgage interest rates, which prior to the EMU were in
20 excess of 10%, to fall to less than 5%. European savings sought out Ireland's
21 real estate market because of Ireland's economic success, growing popula-
22 tion, rising incomes, and initial low per capita housing stock. According to
23 estimates made by Somerville (2007), Ireland had the smallest per capita
24 housing stock in the European Union as of 2000. As a result of these forces,
25 Ireland's housing prices quadrupled between 1996 and 2007; by way of
26 comparison, US housing prices only doubled during that time frame.

27 Ireland's total stock of houses grew from 1.2 million in 1991 to 1.4 mil-
28 lion in 2000 and then to 1.9 million in 2008. After 2002, per capita new
29 house completions surged to four times higher in Ireland than they were
30 in the USA. Indeed, new "house completions went from 19,000 in 1990 to
31 50,000 in 2000 to a whopping 93,000 in 2006" (Whelan, 2013, p. 6).

32 After 2003, the rapid expansion of property lending was largely financed with
33 bonds issued to international investors. From less than €15 billion in 2003, inter-
34 national bond borrowings of the six main Irish banks rose to almost €100 billion
35 (well over half of GDP) by 2007" (Whelan, 2013, p. 11).

1 In other words, what financed Ireland’s real estate bubble was the global
2 surplus of savings.

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

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

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