Banking and Government: An Unholy Alliance

Judy Shelton

In the back of my mind, I keep hearing the strains of the song from the film *Cabaret:* "Money makes the world go around, the world go around . . ." Indeed, money is the driving force behind the global economy. My goal here is to focus on the extent to which the regulatory environment affects how banks make the money go around.

That *is* what banks are supposed to do, is it not? Interestingly, at the more abstract levels of finance theory it is difficult to justify the existence of financial intermediaries because if everyone had perfect information (and the existence of perfect information is a typical assumption in theoretic formulations), there would be no reason to pay banks to act as middlemen for channeling financial capital to productive investment projects. Individuals would just do it directly for themselves.

In the real world, though, what banks are presumably selling to depositors *is* their expertise in evaluating investment opportunities. For that, bankers take a cut of the return from their loan portfolios and pass on some lesser rate of return to the depositors.

Distorting Impact of Government-Imposed Standards

Now into this fairly straightforward relationship among depositors and borrowers, with bankers in the middle bringing the parties together and channeling the money into those projects that offer maximum return with minimum risk, we introduce a hugely distorting factor—federal deposit insurance.

The unholy alliance that exists between government and the banking industry is well-known. Bill Niskanen and other contributors to this

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The author is a Senior Research Fellow at the Hoover Institution, Stanford University.

volume allude to it. The alliance boils down to this: The presence of government-provided deposit insurance opens the door for government surveillance and regulation of banking operations and management. Such a Faustian arrangement engenders tremendous conflicts of interest and invites governmental abuse of power. Imposition of the Basle International Capital Adequacy Standards will only serve to strengthen efforts to institutionalize this compromised relationship at the global level.

The strongest argument put forward in favor of the BIS capital standards is encapsulated in the weighty word: "prudence." It is difficult to be against prudence in banking. Therefore, when government monetary and banking authorities from the world's most powerful nations join together in asserting that these rules will make private bankers behave more prudently, and that these rules will harmonize the supervision of banking on a global scale, citizens should presumably feel much relieved.

However, when it comes to maintaining the viability and soundness of banking—or any business—I personally have more faith in the aggregate impact of the profit motive. Generally, in order to make profits, one has to stay in business. It is the mammoth role of the government in the banking industry that distorts what would normally be a sufficiently reliable incentive to exercise prudence voluntarily. Evidence is already accumulating to support the concern we should have had from the outset that the standards would have perverse effects. The Basle Accord steers commercial banks toward government lending rather than making loans to private business. Indeed, there is a capital penalty associated with making loans to business. That is not merely a perverse effect, it is a violation of the raison d'etre of banking. A U.S. Treasury bond is considered the "riskless asset." Why do depositors need the special expertise that banks offer in evaluating risky investments if their savings are going into Treasury obligations?

Speaking of riskless assets, or government-issued bonds, the BIS capital standards with their various risk-weighted classes do not differentiate among borrowers within a given risk class. So a bank can escape the capital penalty by making "sovereign" loans to governments—which are zero risk-weighted—without having to take into consideration whether those loans are to the U.S. Treasury or to an obscure newly-formed country. The same illogic is applicable under the BIS standards to private business loans, where a bank is penalized with the 100 percent risk weight requiring the full 8 percent capital backing: It does not matter whether the loan goes to a top-rated corporate borrower or to a venture capital start-up company. A banker who finds himself operating in a framework of rules that are set up to ensure that there are minimum costs, in terms of required capital backing associated with lending to government (any government), and maximum revenues associated with lending to the riskiest business clients, seems to have no choice but to embrace the regulatory authority's definition of banking prudence and discard his own.

Therein lies a grievous problem with the Basle capital adequacy standards: They elevate form over substance. They cause bankers to satisfy superficial rules rather than fulfill underlying objectives. Such artifice fosters a certain cynicism in the business. The financial industry is nothing if not innovative when it comes to getting around regulations. Playing a game that requires continuous mutation, banking institutions invent new forms of instruments (derivatives, options, swaps) providing a constant stream of tailor-made financial devices for coping with changing economic and regulatory circumstances. The sad irony is that government-imposed standards cause bankers to focus on the letter of the law even when it works against the intent—which is, presumably, to manage bank assets and bank liabilities responsibly.

Money and Banking: Conflict of Interest

There is something even more disturbing about global regulatory supervision over banking. It goes back to the question of conflict of interest and the potential for governmental abuse of power.

The BIS standards permit governments to tighten their hold over the banking industry. They enable governments to borrow money to finance their excess spending by coercing banks to use depositors' money to buy government bonds: clearly, a conflict of interest. Consider, too, that governments exert control over the money supply and currency values domestically and abroad through their central banking systems—again, a conflict of interest. No central bank is truly independent of government. Even the Bundesbank caves in when political pressures become sufficiently intense.

Projecting forward, we seem to be moving toward a world where the function of banks is to operate a network of collection sites for the government. The savings of the people are received by banks and passed through to the government where they go directly into the budget to pay for domestic spending, a process very much in keeping with Lenin's vision of banking; that is, a nationalized collection system with branches in every rural town through which the savings of the peasants automatically become the working capital of the government. That is the way the Soviet banking system worked, in fact. Or did not work.

A similar process is beginning to characterize a large segment of the banking industry in Japan. In the last two years, Japan's small depositors, mostly housewives charged with managing the family savings, have been quietly taking their money out of commercial banks and moving it to postal savings accounts. Japan's postal system, which is overseen by the Ministry of Post and Telecommunications, now holds 30 percent of Japanese individuals' deposits, equal to about $1.4 trillion dollars, easily making the Japanese postal system the world's largest financial institution. Deposit growth at Japan's commercial banks has slowed by half since spring 1991, while money has flowed into postal savings accounts. These accounts—which are called *teigaku* accounts—pay higher interest than bank time deposits, savers can withdraw money freely after six months without giving up any interest, and with 23,000 branches (there are post offices in the most remote corners of the country), they are quite convenient. The postal savings system is not a member of the Deposit Insurance Corporation and pays no taxes or shareholder dividends. As its officials like to point out: "The Ministry of Post and Telecommunications will not go bankrupt." Why should Japanese savers *not* take their money to the post office—which then recycles it to the government—if commercial banks are doing essentially the same thing by making government loans, and at the same time extracting a larger cut from the depositors for it?

The point is this: Excessive regulation at the national and now the international level is transforming banking into less a private business activity and more a mechanism for funding the growth of government.

The Tyranny of "Peer Pressure"

My final observation concerns the perceived power of enforcement behind the Basle Accords. Officially, compliance with the accords is expected to be achieved through peer pressure. What exactly does that mean? Vagueness about enforcement is a classic bureaucratic tool for keeping those affected off-balance. When one does not know whether or not actions are punishable, or what penalities will be imposed, one is more tempted to circumvent the rules.

Enforcement of a very subtle nature is likely to be exercised by the Group of Seven (G-7). Just as central banks often end up accommodating the fiscal mismanagement of their governments, the Bank for International Settlements—the central banks' central bank—is likely to end up serving the interests of the Group of Seven.

Lately, the G-7 has engaged in acts of political and financial armtwisting rather than friendly coordination. From Japan's perspective, it must seem as if the Group of Seven has transmogrified into the "Gang of Six"—all aligned against Japan and demanding that the

Japanese government step up domestic spending to stimulate its economy. Why? Because Japan is seen as the only G-7 country that can afford to spur world growth while the United States and others are limited by budget deficits caused by excessive spending. Such a rationale is reminiscent of the earlier doctrine: From each according to his abilities, to each according to his needs.

The G-7 has no real enforcement mechanism it can utilize, unless one considers that certain off-the-cuff remarks might constitute a show of power or a shot across the bow. Treasury Secretary Lloyd Bentsen has publicly noted that he is not necessarily in favor of a weak dollar. But he would like to see a stronger yen. According to accounts in the financial press, top Japanese officials found that particular remark by Secretary Bentsen "annoying." But as the Gang of Six is quick to suggest, a strong yen is actually good for Japan because it reduces the value of its foreign loans and that helps Japanese banks meet the BIS capital requirements. Plus, since a strong yen causes Japanese exports to be more expensive, fewer American and European consumers will buy them, and that will help defuse pressures on the Gang of Six to impose protectionist measures against Japan. How comforting, how reassuring.

In closing, I would like to make reference to the problem of "moral hazard" which is so often invoked when discussing the banking industry. In my opinion, the greatest moral hazard threat to global financial stability stems not from the profit-driven motivations of bankers, but from the increasing ability of government to divert financial capital away from private business and into their own coffers. Imposing new global regulatory standards, which serve to strengthen the hold of government over the banking industry, gives increased momentum to that dangerous trend.