

Breaking Up is Hard to Do

The financial crisis is usually dated as of mid 2007, but officials did not appear to coordinate an international response until Lehman's failure sent shock waves through the global financial system a little more than a year later. And even then it seemed like officials acted in concert, like slashing interest rates rather than pursuing a coordinated path. In fact, the failure of the UK government to support Barclay's attempt to purchase Lehman appears to have estranged the Anglo-American relationship.

The lack of coordination is particularly evident in dealing with the too big to fail doctrine, or what the British refer to as too *important* to fail. In Europe, the policy response that has emerged over the last couple of weeks is that such financial institutions need to be downsized.

Power

European and British regulators appear to be trying to create a more competitive banking system with smaller players. The EU insisted on the break-up of Dutch-based ING, while the UK government is forcing the dismemberment of its three largest banks. Swiss officials seem sympathetic to the proposition that too big to fail means too big.

Lord Acton is famous for his assessment that "power corrupts and absolute power corrupts absolutely". In some respects European banks operated in a stricter regulatory environment than U.S. banks (though on the whole, were more leveraged). Since oversight did not work, the next option appears to be to break-up these large banks. The economies of scale that are achieved are more than offset by the inability to manage risk.

The U.S. attitude toward power is different than Europe's. The policy implication that is drawn from Lord Acton's maxim is that power needs to be checked and balanced. It needs to be transparent, but it does not need to be dissolved. To be sure there are some vocal proponents of breaking up U.S. banks. Ironically there are both those on the political right and left which advocate precisely the same course. However, on balance, the Obama Administration appears to be more inclined to tighten the regulatory regime considerably rather than breaking up the banks, though the situation may be more fluid.

Banks and the Dollar

The performance of U.S. bank shares has been highly correlated with the dollar. We looked at the Financial Select Sector Index (IXM). It is a modified cap-weighted index of financial service companies in the S&P 500. There are 79 companies in the index, which serves as the benchmark for the Financial Select Sector SPDR exchange traded fund XLF.

The correlation between the IXM and S&P 500 (based on percentage change of daily data) is strong at 89% this year. What is noteworthy about this is that strong correlation between the financials and the overall market has not been impacted by the horrible financial crisis.

Looking at weekly data for the 2003-2006 pre-crisis period the IXM and the S&P 500 was correlated 89.7%. Since 2007 the correlation has been almost 88%.

What has changed has been the correlation of the euro and yen with IXM. The euro and IXM are 42% correlated this year using daily data. In the pre-crisis period, the correlation was less than a tenth of this (using weekly data). Since 2007, the correlation has been 20%.

In the pre-crisis period (2003-2006), the yen and IXM had a negative correlation of about 9%. Since 2007, the correlation has been a positive 34%, well above the euro's correlation. Using daily data for the year to date calculations the correlation is almost 29%.

What Happened To Glass-Steagall?

A fifth of U.S. banks failed after the stock market crash of 1929. The Banking Act of 1933, popularly known as Glass-Steagall after the senators that drafted the legislation, established the Federal Deposit Insurance Corp and insisted on the clear division between commercial and investment banks. This division has become known in the vernacular as the separation of the utility function of banks from the casino (risk-taking) function.

This seemed to be effective for about thirty years and as the personal links to that time faded, the prohibitions of Glass-Steagall were gradually diluted. In the 1960s, commercial banks began re-entering the municipal bond market. In the 1970s brokerage firms began encroaching on commercial banks turf by offering money market accounts, paying interest, allowing check writing privileges, and issuing credit and debit cards.

In the second half of the 1980s, the Federal Reserve began re-interpreting Section 20 of Glass Steagall that prevented commercial banks from “engaging principally” in the securities market to mean less than 5% of a bank’s gross revenue. In the late 1980s this was redefined as 10% and about seven years later it was again redefined as 25%. In 1997, Bankers Trust became the first bank to buy a securities firm (Alex Brown).

Following the Citibank-Travelers insurance merger in 1998, there was strong pressure to formally repeal Glass-Steagall and this was achieved in the Financial Services Modernization Act of 1999. It enjoyed broad bipartisan support, passing the Senate by a 90-8 margin and the House of Representatives by a 343-86 margin.

It is Political Economy

Adam Smith, David Ricardo, and Alfred Marshall did not think they were studying economics but political economy. To understand what happened to Glass-Steagall requires anchoring our understanding of economics in its political context. Banks seeking to respond to competitive pressures coupled with policy makers that believed in a minimal role for the state in the economy, joined forces to dilute the government imposed restrictions.

The calls for repealing the repeal of Glass-Steagall seem to ignore the political history of this economic regulation. Would not a new Glass-Steagall share the same fate?

Some observers note that there is precedent for breaking up large combines. Standard Oil is the favorite example, but Standard Oil of New York (Exxon) is presently the fourth largest company globally while Standard Oil of California (Chevron) is the ninth largest. Similarly, ATT was broken up in the 1980s, but today is the seventh largest company, in the world, according to Forbes. E.F. Schumacher’s best selling book, *Small is Beautiful* (1973) made for a nice treatise, but competitive pressures and the logic of the market provides powerful incentives for consolidation and concentration. It simply may be too late to try to freeze capitalism at the small proprietary stage.

Just like special investment vehicles (SIVs) seem to be an evolutionary dead-end, the financial crisis demonstrated a fundamental weakness of the investment bank model. Traditionally investment banks do not take deposits. They depend on markets for short-term capital. While this may be a strength in good times, it proved fatal or nearly so when the capital markets freeze up. They are left high and dry.

Lastly, consider the competitive climate. Several European banks are being broken up. By market capitalization, Chinese banks hold the top three places globally. In 2006, China did not have a single bank in the top 20 while the U.S. had 7, including the top 2 spots. Today, the U.S. has just three spots in the top 20 with the highest of these ranked at fifth place.

Europe may be unilaterally disarming in the financial battlefield just as Chinese banks begin to flex their muscles. Breaking up U.S. banks now would risk eviscerating them at an important competitive moment vis a vis both Europe and China. Some observers already see the demise of U.S. banks and the rise of Chinese banks as yet another sign of the decline of America and the rise of China. It is precisely this sentiment that contributes to the undermining of the dollar.

At the G20 meeting the moral hazards of too big to fail likely will be discussed. If for the sake of coordination the U.S. bows to pressure to break up its largest banks, look for the dollar to sell off, potentially in a destabilizing fashion as it may very well be understood by friend and foe alike as an abdication of global leadership.

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