No Avoiding a New Bank Crash Without Glass-Steagall Act

by Paul Gallagher

May 26—Because of the extraordinary issuance of productive national credit by China since the 2007-08 financial crash, and the direction of huge amounts of that credit into new economic infrastructure, the trans-Atlantic nations can only watch and complain as China and Russia begin to exchange that credit for development projects and growth. A typically outraged complaint was published in *Fortune* May 23 by former Reagan White House official David Stockman, who fumed that China had issued many trillions in credit based on its $4 trillion in foreign reserves, and was "literally printing GDP," because "as the currency goes down, airports, high-speed railroads, highways, dams, housing construction come up."

Growth in the OECD countries, by contrast, was calculated in a recent presentation by a former Obama Administration economist as an 11% increase in GDP, total, over the past six years combined. The United States and EU member-states are priding themselves on whether they have managed to reach the same number of people employed in their economies as they had seven years ago—at significantly lower real wages and household incomes. Their governments have not invested in major infrastructure platforms in decades; their biggest banks lend less every year.

The central banks of the United States, Europe, and Japan have also, of course, issued trillions in new currency and liquidity credits since 2009, most famously in the "quantitative easing" policies of the Federal Reserve, Bank of England, and Bank of Japan. But this currency has been issued exclusively to banks—large banks, "too big to fail"—and those banks have deployed it in ways designed to puff up the securities markets and avoid the real economy like a plague. The central banks are not only aware of this; they have carried out "excess bank reserve"-creating policies which have ensured that big banks' lending to the real economy has fallen, even as they pumped up stock and securities markets, derivatives markets, etc.

The U.S. and European economies are headed for another, worse bank crash unless they break up their biggest banks by restoring the Glass-Steagall Act or (in Europe) enacting it. So far, with Wall Street and London banks threatening and bribing to stop Glass-Steagall, the trans-Atlantic governments and "regulators" have instead adopted a scheme called "bank bail-in" which combines the worst features of taxpayer bailouts, with deadly austerity and outright confiscation of wealth from the public to "capitalize" bankrupt banks.

Enacting Glass-Steagall is the only way to break this depressive cycle before another crash. Doing so may wipe out, quickly, $5 trillion or more in ultra-short-term, collateralized, and leveraged financial sector debt, and bring down Wall Street and London securities firms, but it will open the door to national credit and growth.

Ironically, former OMB Director Stockman strongly supports restoring the Glass-Steagall Act, on the evidence of his public speeches and interviews. But his knee-jerk opposition to the national credit and investment policies which must necessarily *follow* Glass-Stea-

gall separation in "the American System of economics," shows him a victim of Wall Street bank "economics" and influence. The same keeps many Republicans from sponsoring the Glass-Steagall legislation, which they instinctively recognize as the right and necessary action to take against too-big-to-fail bank bailouts.

Sane Observers See Crash Threat

The situation is worst in the EU, where some of the most leveraged and most London-dominated banks like Deutsche Bank, Barclays, and HSBC are now losing money, laying off large numbers of employees, and scrambling to raise capital. Former Bank for International Settlements (BIS) chief economist William White saw a bank crash coming in an interview published April 24 by the Swiss financial paper *Finanz und Wirtschaft*, headlined "I See the Same Price Bubbles as in 2007."

White said, "No one has ever seen anything like this. Not even during the Great Depression in the Thirties has monetary policy been this loose." He told *Finanz und Wirtschaft* that the fundamental problem is debt, not government, but rather private debt, held by banks and other financial institutions which is non-performing and/or impaired. It is being "evergreened" [extended at full book value] by the banks, White said, with the aid of the central banks' money-printing. That debt has to be written off, and it is governments' responsibility to act, not that of central banks. "Central banks can't rescue insolvent institutions," White says. Asked if massive write-offs won't further hurt the bank sector, he agrees. "But you see, we have a lot of zombie companies and banks out there. That's a particular worry in Europe, where the banking sector is just a continuous story of denial, denial, and denial. With interest rates so low, banks just keep evergreening everything, pretending all the money is still there. But the more you do that, the more you keep the zombies alive, they pull down the healthy parts of the economy."

"It all looks and feels like 2007," White concluded. "And frankly, I think it's worse than 2007."

In the United States, companies are flooded with debt and failing to invest, courtesy of the money-printing policy of the Federal Reserve, wrote *Washington Post* financial columnist Steven Pearlstein in a May 11 column full of striking figures.

U.S. non-financial corporations have taken on $3.4 trillion in additional debt since 2009. This, in itself, is no extraordinary amount—in fact, total bank lending fell steadily during most of that period—but what they borrowed it for, is extraordinary. Fully 87% of it, reported Pearlstein, has been used by the corporations for buybacks of their own stock, and to issue dividends to shareholders. Both are part of a strategy of driving up stock prices, without making real capital investments. In 2013, non-financial corporations spent about $500 billion on buybacks alone, the most since "the peak year of 2007" and 130% more than their fixed capital expenditures for the year.

Pearlstein noted that the Wall Street banks are using the money printed for them by the Fed's quantitative easing (QE), to fund this stock market debt bubble, which is equal in size to that other creation of QE, the "emerging market carry trade bubble." Non-financial corporations' cash/debt ratio has dropped to 40%, some 17% less than in 2007. Thus, despite the conventional financial wisdom which is repeated *ad nauseam*, companies are not "sitting on trillions in cash," "keeping it on the sidelines," etc. Rather, they are sitting on mountains of Fed-created QE debt. American households may have been forced to "deleverage," reducing their debt by a combination of defaulting and paying it off as their living standards sink; but the corporate "leveraged debt" and "junk-bond debt" bubbles are larger than they were just before the crash.

"This is why the U.S. economy remains stuck in second gear," is Pearlstein's quite-understated conclusion.

FDIC Vice-Chairman Thomas Hoenig, who has advocated restoring the Glass-Steagall principles of bank regulation, was explicit about the big banks' threat to crash in a May 7 speech to the Boston Economics Club. Calling his presentation "Can We End Financial Bailouts?" Hoenig answered, essentially, "No, we can't, because Congress hasn't separated the banks with Glass-Steagall." He bluntly cleared away much of the hype about Dodd-Frank and the changes which many people credulously believe it has imposed on the big banks.

On those big banks, he said they are larger, more complicated, and more interconnected than in the 2007-08 crash. The eight largest banks' assets equal 65% of GDP. Their *average* derivatives exposure of $60 trillion is 30% larger than in 2007. They are also more complex. "They have used the safety net subsidy to support their expansion across the globe. They have further combined commercial, investment banking, and broker-dealer activities. There have been no fundamental changes in the wholesale funding markets, in the reliance of bank-like money market funds, or in the use of

repos, which all are major sources of volatility in times of financial stress."

And they are also still wildly overleveraged, Hoenig said, with an average leverage ratio for the biggest eight of 22:1, despite the hyping of all the capital increases they have supposedly made.

Bail-in, Hoenig said, is bail-out of derivatives counterparties ("qualified financial creditors"). "Under Title II, unlike in bankruptcy [Title I], the Treasury is empowered to fund short-term creditors who, for example, would avoid becoming general [unsecured] creditors as they exit at the firm's operating units—the broker dealers, insurance companies, finance companies, trading companies that remain open. This only serves to perpetuate too big to fail." This is why the big banks *want* Title II, bail-in, he said.

Hoenig concluded by criticizing Congress for leaving the massive problem to the regulators: "To be sure, having regulatory agencies rather than legislators define the nation's financial structure and business activities is less than ideal. In the end, legislating the separation of highly subsidized commercial banks from non-bank trading and similar activities might be the better choice."

Bring Down Wall Street

For Wall Street, it is a bitter choice. The legislation they are most determined to defeat, with threats and massive lobbying funds, is the reinstatement of Glass-Steagall, especially the 21st Century Glass-Steagall Act introduced into the U.S. Senate by Sens. Elizabeth Warren, John McCain, Maria Cantwell, and Angus King—two Democrats, a Republican and an Independent—and co-sponsored by seven others.

Speaking May 23 at a Washington conference, Senator Warren did not mention her legislation until prompted by *EIR* representatives during the question period to "talk about Glass-Steagall." She then gave a strong seven-minute argument for the necessity of Glass-Steagall, which provoked a standing ovation by the audience of 250.

Warren said of the gradual elimination of Glass-Steagall from the late 1980s, ending in its repeal in 1999, that "This is what created 'too big to fail'" and "anything goes in banking," and that those banking conglomerates are now "38% bigger than when the government bailed them out unconditionally in 2008." They have, in addition, committed serious financial crimes, without punishment.

She described the 21st Century Glass-Steagall Act (S. 1282): "First, it will break these biggest banks up, and it is really only the biggest Wall Street banks that will be affected by this; and second, it will make the large, insured deposit-banking units use their resources on economic lending, otherwise, no support." Ridiculing President Obama's and former Treasury Secretary Tim Geithner's "bailouts with no conditions," Warren recalled that she had taught bankruptcy law: When new money is put into a firm in bankruptcy, "the stockholders get wiped out; the bondholders take a haircut; the top management is removed, and may be prosecuted."

"The big Wall Street financial firms," said Warren, "don't like this Glass-Steagall legislation," and there are money pressure and threats to stop it. She concluded: "What kind of a country do we want to work for? What kind of a future do we want to have? Do we want to work for Wall Street banks, to make them even bigger? Or, do we want to work for our children and grandchildren, to have a fighting chance?"

The choice of futures is immediate: Either we bring Wall Street down now, with its even more potent progenitor, the City of London, or another and more devastating financial and economic crash will be on us soon.