Wolf: the challenge of halting the financial doomsday m...

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Martin Wolf wrote in the FT last week:

Can we afford our financial system? The answer is no. Understanding why this is so is a necessary condition for evaluating ideas for reform. The more aware of the risks one is, the more obvious it becomes that radicalism is the safer option.

John Christensen of the Tax Justice Network has considered the article in depth, and with his permission I reproduce his thinking here:

In his latest Financial Times column, Martin Wolf asks a starkly fundamental question: can we afford the financial system in its current state? Unsurprisingly, his answer is no. Especially for countries with ageing populations and under-funded pension schemes, the impact of another financial crisis along the lines of 2007/08 crash would be unimaginable. As Wolf notes in respect of the current crisis, while asset prices in the private sector have bounced back in response to fiscal stimuli, the real losers have been the public, who will have to carry the burden of increased public debt:

If only a quarter of the world's loss of output during the recession were to prove permanent, the present value of these losses could be as much as 90 per cent of annual world product.

Where did things start to go wrong? While others still hark back to failing sub-prime mortgage markets in the United States and elsewhere, Wolf takes the longer view. Referring to a fascinating speech by the Bank of England's Andrew Haldane, he notes that since 1986 - the epoch of London's Big Bang and the return of laissez-faire financial capitalism - leveraged debt has been the driver of banking profits, and banks have become wildly more profitable and more risky. The U.K. provides an extreme example:

The UK case is dramatic, with banking assets jumping from 50 per cent of GDP to more than 550 per cent over the past four decades. Capital ratios have fallen sharply, while returns on equity have become higher and more volatile.

And this is where things have gone off the rails, since the bankers can take on foolish risks secure in the knowledge that as their industry becomes more concentrated into fewer and larger players, the potentially devastating impact of a major failure, which would inevitably spill out in the wider economy, forces the hands of governments. Banks and state have become locked together in a mutually destructive embrace, made worse by the fact that limited liability status protects bank's owners from the consequences of actions taken on their behalf by bank executives who pull the political strings in the first place:

The combination of state insurance (which protects creditors) with limited liability (which protects shareholders) creates a financial doomsday machine. What happens is best thought of as "rational carelessness". Its most dangerous effect comes via the extremes of the credit cycle. Most perilous of all is the compulsion upon the authorities to blow another set of credit bubbles, to forestall the devastating impact of the implosion of the last ones. In the end, what happens to finance is not what matters most but what finance does to the wider economy.

But one aspect of the doomsday machine is missing from Wolf's account (though it may be covered in the second part of his article next week): what role has offshore played in this process? Well several actually. First, huge sums of hot money have accumulated offshore, in deposit accounts, hedge funds, private equity funds, providing the liquidity on which so much of the leverage finance is based. These sums go largely untaxed and unregulated. Judging from the paucity of official statistics in this area, the volume of these funds is probably underestimated to a significant degree.

Second, offshore activities have contributed enormously to financial market opacity. It is no coincidence that collateralised debt obligations (the securitised instruments at the heart of the mortgage crisis) were invariably issued and traded through offshore financial centres like Cayman, Jersey, Delaware and London. Securitisation encouraged the banks to leverage up since they (wrongly) thought that risk had been more evenly distributed. This proved to be an illusion, and the other so-called benefits of securitisation, such as the claims that it would make home-ownership more affordable, have also proved something of a chimera.

Third, banks are by far the largest players in the offshore markets and they are well-placed to maximise the opportunities available for regulatory arbitrage and tax avoidance: it is no coincidence that most if not all shadow banking structures (typically structured investment vehicles) are registered in secrecy jurisdictions. What this means is that for decades banks have been "optimising" their tax bills while maxing on their risks in the expectation that taxpayers will bail them out when the inevitable happens. Meantime the infernal machine creates an unsustainable and grotesquely inequitable economy in which wealth and income has become concentrated in that hands of a tiny minority of gamblers. Britain's HM Revenue and Customs, for example, has revealed that in 2008 less than two percent of London's working population pocketed over a quarter of the total income paid out in the capital that year. With no evidence of the trickle-down effect so favoured by delusional orthodox economists, and equally no sign that the tax system will remedy this economic perversity. As Wolf comments:

A large part of the activity of the financial sector seems to be a machine to transfer income and wealth from outsiders to insiders, while increasing the fragility of the economy as a whole. Given the extent of the government-induced distortions in the system, even the fiercest free marketeer should accept this.

Where do the solutions lie? Should governments push for piecemeal reform, as is currently the case, or are more radical steps required? Wolf will be answering this question in his column next week, and TJN hopes that his analysis takes account of how captured states on small island tax havens have driven the race to the bottom in both tax and regulatory degradation, and the part that banks have played in driving this process.