Is Financial Repression Leading America Down a Road to Ruin?

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By Eric Grover

I would sleep better if I knew that Bernanke, Geithner, Bachus, Sen. Tim Johnson, Obama and Romney all kept dog-eared copies of Kevin Mellyn's "Broken Markets" on their nightstands.

Mellyn, a former McKinsey consultant, discusses the implications of America's "finance-driven economy," the financial crisis, policy-makers' and the banking industry's response, and the risk of another crisis – which, with Spanish banks receiving a $125 billion bailout, the fifth European national banking bailout Cyprus queued up, and Italy teetering on the brink, is no idle worry.

The book is a tour de force, full of profound and important insights. Bankers, policymakers, and anyone with a stake in the financial system and growth, will find it a compelling read.

Over the last several decades a dynamic and in cases reckless financial-services sector transformed and propelled the U.S. and global economies.

Behemoth banks diversified far beyond traditional banking, which largely consists of providing credit intermediation between savers and borrowers and supporting payment systems. Capital markets supplanted much bank credit. Nonbanks such as First Data, Heartland Payment Systems, MasterCard, PayPal and Visa play growing roles in payments.

Banks nevertheless remain critical to a functioning modern economy, but they have been tarred in the public eye. The popular and, for advocates of bigger government, politically useful narrative is that rapacious and unscrupulous bankers and Wall Street villains caused the financial crisis and tanked the economy.

The banks deserve some of the blame. Mellyn criticizes "financial markets that facilitated the financialization of wealth and the rise of the CEO class" which turned "consumer debt into a viable substitute for income." Financial

institutions made mistakes, and, as he notes, "many senior bankers came to think of formal regulation and compliance with it as a substitute for prudence." When JPMorgan Chase has 120 embedded regulators, one can understand, if not forgive, management's confusion.

Now banks need to reestablish trust and to correct the story. The primary culprit was Washington, not feckless greedy bankers. The government pressured the financial sector to weaken mortgage credit standards, guaranteed and purchased trillions in mortgages, and the Federal Reserve supplied easy credit, fueling an unprecedented housing bubble and tsunami of risky mortgages.

Asset bubbles correct, sometimes gently, sometimes not. The U.S. housing bubble and mortgage house of cards imploded, causing the financial crisis and Great Recession. Dodd-Frank imposed a regulatory straightjacket on the financial services industry, attempting to substitute the wisdom of an anthill of regulators for management prudence and market discipline.

The too-big-to-fail problem is worse than ever with the top five U.S. banks having assets equal to almost 60% of gross domestic product. And, notwithstanding the Federal Deposit Insurance Corp.'s mandate to liquidate failed financial institutions, Dodd-Frank institutionalizes too-big-to-fail. Neither the market nor management believes Goliaths such as Bank of America, JPMorgan Chase or Citigroup would be permitted to go belly up.

Fear and greed are both vital to free-market capitalism. During the Great Moderation that began in the mid-1980s, many financial firms acted on the assumption that upside profits were theirs and the state would backstop failures. Now we're in a political environment where financial institutions are vilified simultaneously for making too much profit and for losses, most recently JPMorgan Chase's trading loss, which the media and Washington gleefully pounced on.

Banking chiefs' most important masters now are Washington mandarins, not their customers and shareholders. But regulators can't match the dynamic intelligence and relentless discipline of markets punishing failure, rewarding success, and reallocating resources to better uses.

Mellyn is optimistic that global markets will eventually innovate around the most regulated sectors, but rightly worries about the enormous cost of several generations of foregone growth.

While he focuses on the financial sector, Mellyn's analysis is sweeping, compassing the improvident and unsustainable macro fiscal and monetary path. Absent a course correction, retirement incomes and household savings will be eroded by government stoking inflation to reduce its debt and/or continuing to keep interest rates artificially low to minimize debt-service costs.

Mirroring the political scientist Angelo Codevilla's framework, Mellyn sees an America divided into "ruling" and "country" classes. Everyman's savings and income are whittled away by financial repression while, vindicating Sir James Goldsmith's warnings about globalization, elites are insulated from their improvident policies' costs.

Mellyn, like historian Niall Ferguson, is a fan of liberalism's golden era with Pax Britannica (a period of relative peace worldwide in the nineteenth-century heyday of British sea power), free trade and capital flows, the gold-backed pound as the world's reserve currency, and economist Walter Bagehot cogently arguing in panics that the Bank of England should serve as an expensive market lender of last resort, for otherwise sound institutions crimped by the panic, but should not bail out fundamentally unsound banks. Mellyn questions, however, the U.S.'s ability to play Britain's role this time around.

Mellyn's work is a fascinating, important, and eminently good read and should inform the debate on overhauling the U.S. and global financial regulatory systems and sustainable macro fiscal and monetary policy.

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