

Financial Markets, Bloated Governments and the Misallocation of Capital

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Abstract

Through this paper the author discusses the phenomenon of excessive Government borrowing and the factors that lead Governments to be so dependent on financial markets. It is argued that the combined effect of unregulated financial intermediaries, hedge funds and Credit Rating Agencies in managing investment risk and the expanded role of banks in investment and private banking as well as their own involvement in financial derivatives has led towards a situation of systematic gross misallocation of capital whereby money is channelled to Governments and other unproductive uses outside the real productive economy. To break this vicious circle it is necessary to check and constrain Government borrowing, confine the role of banks to that of traditional savings and loans and control and regulate financial derivatives and the activities of financial intermediaries and hedge funds.

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JEL classification numbers: D61, G17, G21, G32, G33, H43

Keywords: Repayment capability, project evaluation, corporate lending, credit risk

1 Introduction

The world seems to be at the mercy of the financial markets. How is it that the public sector of most of Europe and the United States have borrowed an amount which is almost as big, and in many cases bigger, than their annual Gross Domestic Product (GDP)? Historically, such huge amounts of borrowing by Governments were only justified in order to finance wars. One may indeed wonder for what purpose these massive amounts of Government borrowings were used for. Were they employed to build crucial infrastructure like roads, ports, dams, transport, communication networks and so on? With very few exceptions, the answer is most definitely not. The money was used primarily to expand Government through paying the constantly rising salaries and pensions of an ever increasing public sector and to fund subsidies and social benefits of the welfare state and more recently of course to bail out Government owned companies and banks in times of financial crisis. In short, successive Governments used finance from foreign and local borrowing unproductively to fund the bloated Government machine, their own pet projects and to keep themselves in power.

Government borrowing is a form of indirect taxation because sooner or later the people are called upon to pay for it. This is done either through austerity measures in the form of tight control of expenditures and additional taxation for a long period of time but which however more often than not also stifle real economic growth or through an increase in the money supply which is used to service the bonds and repay the loans but which also raises the prices of goods and services (inflation) and makes the local currency fall in value as compared to the

value of other international currencies (devaluation).

There are opposing schools of thought as regards which is the best way to pursue salvation once the finances of a nation get so screwed up that one or other of the above measures have to become the order of the day. For the increase in the money supply and inflation route to be an option at all however a nation should have control of its own currency or be part of a group of states that share a common currency but which, unlike today's Euro zone countries, do not have conflicting interests and objectives regarding the side effects of the alternative medicines to be administered to cure the patient. For Germany and some other European countries in the north inflation is anathema and as a result the only objective of the European Central Bank as was recently declared is to keep inflation under control. If inflation sets in, Euro zone countries like Germany will lose in more ways than one. Their products will become more expensive and less competitive but equally importantly, German investors holding European bonds will find that the value of their investments will decrease sharply. On the other side of the table, for southern countries who find themselves with Government debts which cannot possibly be repaid, inflation is not necessarily all bad. Inflation is perhaps the only cure in a highly leveraged world. The enormous Government debts of Greece, Italy, Spain and many other European countries including France cannot possibly be eradicated by austerity measures. Not only is it very unlikely that such measures can be sustained for decades but even if it was possible to do so, their impact on reducing the debt would be very small.

The debate so far has been driven by a rather unchallenged assumption that what needs to be done for a country in trouble is to gradually improve its credit rating and get back to borrowing from the financial markets. I beg to differ. Why should a country be borrowing for anything other than to finance specific properly assessed viable projects which can stimulate and foster economic development? Most of these types of projects do not even need to be undertaken by the public sector and can be selected and financed on pure project finance criteria and

possibly, some may argue preferably, under a Public Private Partnership model of development. Government borrowing which does not relate to specific development projects and is not entered into on the basis of proven economic return and repayment capability is a form of indirect taxation because sooner or later the people will be called upon to pay for it. Indeed, any repayment capability attributed to a Government, by the Credit Rating Agencies primarily, has to do with the finances of the country (such as the level of Government debt compared to actual and expected GDP) but also on the ability of the Central Authorities to impose new taxes and/or apply spending cuts on its people. Why is it legal, therefore, for Governments to borrow and thereby impose an indirect tax on its people when clearly if they tried to justify and apply such new taxes directly they would fail and possibly fall from power?

Classical economists clearly prescribed the cure for this for a long time now. What is needed is legislation which forbids Governments from entering into debt and renders unconstitutional any non-project related borrowing by the public sector. Thomas Jefferson and Milton Friedman have been advocating something like this as being the only way by which the people will ensure that their Governments are kept under control and they do not thus condemn future generations to decades of poverty and subversive measures at the mercy of the “money masters” of the world. Thomas Jefferson wanted to enact legislation that would “simply forbid the general government from going into debt” while Milton Friedman actually went so far as to propose “an amendment to the Constitution” which will ensure that they never regain control².

It is quite intriguing and rather scary that in the midst of what is possibly the worst financial and economic crisis that the world has ever had to face no-one actually

² Quoted from: A Program for Monetary Stability, by. Dr. Milton Friedman, Fordham University Press (N.Y. 1960, 1992), pgs. X, 66-76, 100-101; and, Free to Choose by Dr. Milton & Rose Friedman, Harcourt Brace & Co, (San Diego 1980, 1990), pgs. 307-308.

brings up the issue of why and when Governments should be going into debt. The problem is perceived as one of weathering the storm in order to get the Governments back to borrowing from the financial markets as soon as possible. It is astonishing that no-one really questions why indeed Governments are allowed to continue to go deeper and deeper into debt where the citizens are providing the collateral. It is indeed quite incredible why not even economists discuss the issue of uncontrolled Government borrowing and instead they are only concerned on how they can get them back to the disastrous road of debt which inevitably will lead to even more bloated Governments, for which, of course, future generations will have to eventually pick up the bill.

2 Money and the flow of capital in the Real Economy

But what are the causes leading to the predicament that the world finds itself today. If we can understand what has created this dire economic situation we may hope to give some guidelines as to the structural changes that must be in place to avoid something like this happening again in the future. But in order to do that we must first understand what is the link between money and the real economy.

Money is just a medium of exchange. Money is not a good. It does not add to the wealth of a nation any more than a distant vacuum in space does. This is because money cannot be consumed. The only way one can consume money bills is by burning them to produce heat. The total of goods and services in the World at any point in time is a finite number. When one consumes a product (i.e. eat a banana) the total World wealth is reduced by the value of the product that has just been consumed. When money is used in a transaction the stock of money in circulation remains exactly the same. The money just changes hands from one person to another. Money can be increased or decreased (through money issues or fractional banking –credit) but has no intrinsic value. As Williams [15] pointed

out as early as 1938, real value and market prices are two separate and distinct things. Therefore, the real economy (which can in theory at least work just as well as a barter economy) is totally different from the money market economy. The theory of free market economy refers to the former, not the latter. Distortions in the money market do have an impact on the real economy however because decisions taken in financial markets inevitably affect the allocation of capital in the real economy and inevitably cause a redistribution of wealth.

As demonstrated in Figure 1 below, the normal flow of money from Households to Firms and vice versa is subject to leakages. There are leakages to the Government in the form of taxes and of course leakages which take the form of savings. The latter are directed towards the financial sector which traditionally re-channel this back into the real economy in the form of injections of loans and direct capital investments³. The argument made is that the Financial Sector has been re-directing Savings to the Public Sector bloating Governments rather than back to the private sector economy as well as in purely unproductive uses such as derivatives, futures and default swaps on the pretext of hedging investor risk. In truth, not only the real economy is deprived of much needed capital injections but through their effect on the price mechanism these measures distort the optimum allocation of resources in the real economy.

The major players determining the flow of capital are shown in Figure 1. The first player is “investors”. These may be individual investors, organisations as well as pension and trust funds which seek to position savings so that return is maximized and risk minimized. Traditionally, these would be the major providers of equity capital to the real economy (industry, transport, trade, services, tourism and so on).

³ We ignore the Imports-Exports adjustment because in a trans-national world perspective they cancel themselves out

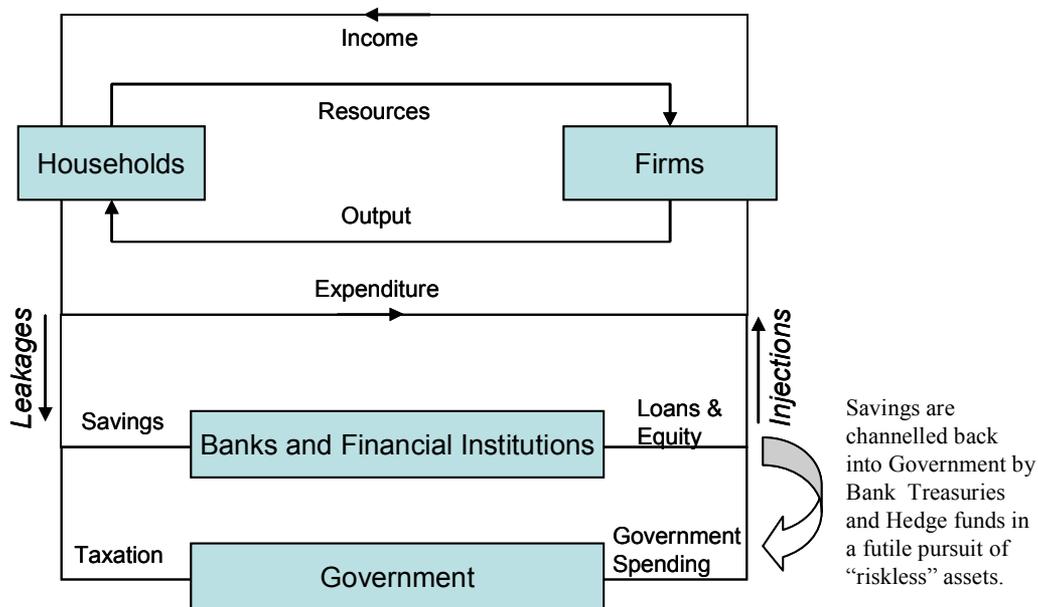


Figure 1: The Circular Flow of Money

The second player is “banks”. Banks’ purpose is to safe-keep the deposits of their customers and to lend out part of these deposits while taking every care so that the capability to repay the loan is deemed adequate and recourse is firmly in place for those, hopefully rare occasions of default.

The third player is “Governments”. Governments make and enforce the law while they provide the necessary infrastructure and administration bodies which are necessary to run an orderly state. Governments should run on a balanced budget of income and expenditure. Taxes should provide the funds necessary to sustain the smooth running of the Public sector (including the salaries of Government employees) and to finance any worthwhile investments which are properly and independently assessed to have a positive economic return. It is therefore the duty and obligation of a responsible Government to manage its income and expenditure and come up with a balanced budget.

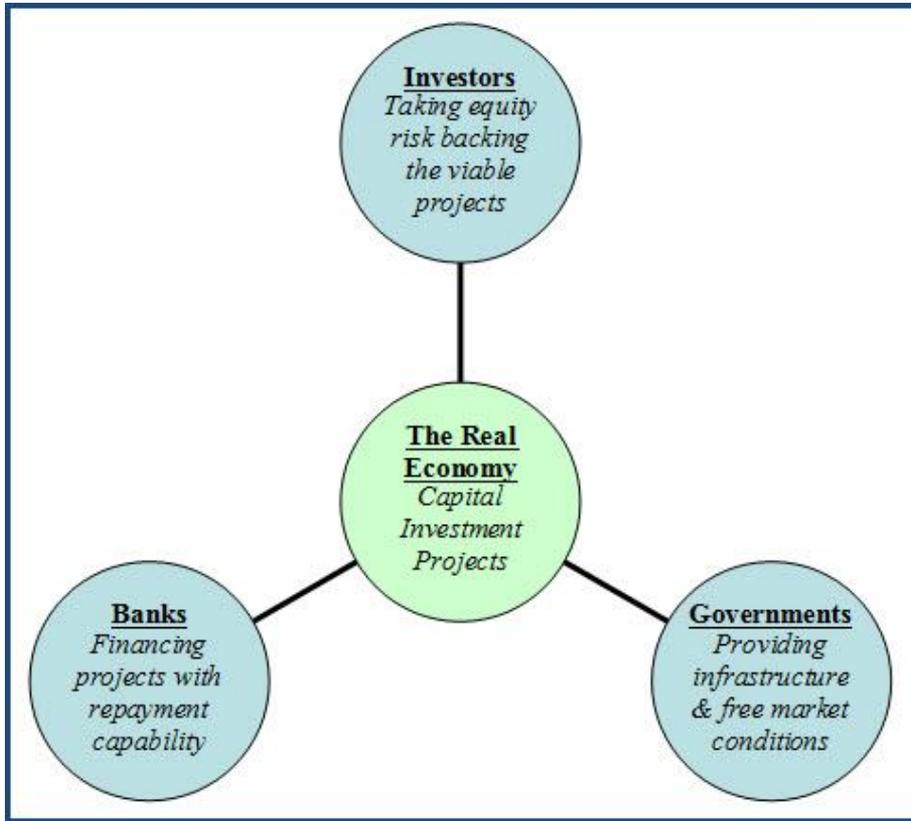


Figure 2: The flow of capital with the real economy at the centre

In theory, at least, Governments should never have to resort to borrowing for financing a deficit. Why is it then that more often than not practically all the modern Governments have a deficit budget which they then seek to finance through borrowing?

The world has lost track of the real economy as shown in Figure 2. Instead of having Investors, Governments and Banks being focused on issues such as which capital investment projects are likely to have a good economic and financial return and are capable to repay their loan obligations, the financial intermediaries have the world taking bets on how to make no risk (“hedged”) returns on their moneys, a process which only creates the conditions for “risk free” profits for the

shareholders of huge banking and finance conglomerates and hedge funds that they represent. The problem is that they go about trying to achieve that by adding nothing to the real economy. As a result there is a decoupling of money from production; a separation of the financial alchemists and their quests for a quick profit from the real productive economy.

Financial intermediaries immerse themselves in the complexities of the capital markets having lost almost total touch with the real world. They trade trillions by looking at a graph and calculating whether prices are likely to go up or down and by devising complex mathematical algorithms which they themselves often do not fully understand. They use this self induced complexity, to create options and financial derivatives which they then sell to each other for the purpose of hedging or even eliminating risk and then price into an “investment” product to be sold to the client. These are in truth no more than bets in a para-economy of money which they have created with the collaboration of the Governments whose endless appetite for more and more borrowing they satisfy in this manner.

All this is “justified” on the promise of reducing and eliminating risk in a portfolio through hedging, credit default swaps and complex derivatives. The focus of capital markets has thus shifted from the classical model of having investors taking equity risk on specific viable capital investment projects and the banks backing these through loans granted on the basis of demonstrated repayment capability to the realm of “risk management” by positioning capital through financial intermediaries and investment banks on assets which are designed with the sole purpose of off-setting or hedging the possibility of risk. The sad irony however is that despite the fact that the model has blatantly failed, the financial gurus continue to drive the world economy into the abyss leveraging their derivative products at the expense of the real economy.

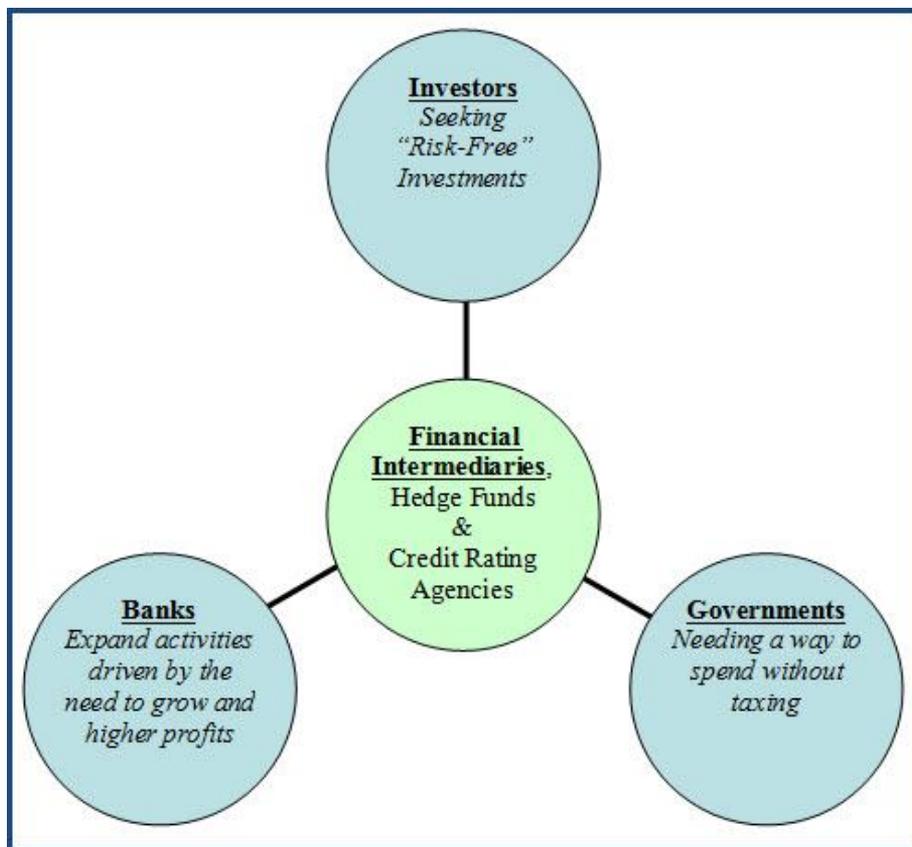


Figure 3: The flow of capital with Financial Intermediaries at the centre

Hedge funds have been created and trusted to managers which supposedly can handle diversified portfolios and reduce risk thereby attaining an optimum of near risk free return to the underlying investors. The Credit Rating Agencies provide false hope to investors for a risk free investment by classifying most Western Governments as “AAA”, while the Banking Regulatory Bodies have categorized lending to Sovereigns as zero risk weighted for the purpose of calculating capital adequacy requirements for banks. This is truly astounding. Governments should not be rated “AAA”, even if their economy is doing well, as they do not have the ability to repay anything without taxing their people. In fact, if Governments were willing to impose new taxes to their people they would not be any need for them to borrow in the first place. The unfortunate thing is that by

artificially lowering the hurdle of borrowing for Governments a huge misallocation of economic resources is encouraged and has in fact been taking place in recent years at the expense of a much needed investment in the private productive sector.

There are three things that must change therefore in order for the real economy to get back on track and in order to ensure that the world does not again come up against such dire straits as it is facing today:

- **Banks:**
 - Banks should be banks⁴. Banks are special institutions in a free capitalist economy whose role is to diligently channel savings into economically viable investments in the economy. The focus of banks should return to proper credit risk assessment and the financing of viable projects in the real economy with demonstrated repayment capability⁵.
 - Banks should not be involved in any form of equity risk positions (either for themselves or on behalf of their clients) and should not be implicated in proprietary trading. At the very least the Vocker rule should be adopted and applied globally⁶. Banks should also be constrained and regulated in as far as they lend each other money.
 - The idea that the total exposure of a bank should be determined by some notion of capital adequacy by calculating “risk weighted” assets as per Basel II Banking regulations should be re-examined and gradually be abandoned. Banks should be confined to lending

⁴ Savvides [9]

⁵ Savvides [12], Harberger [1]

⁶ Volcker [14]

out only an amount covered by their equity capital plus a fraction of their deposits as determined by Central Banks.

- Last but not least, banks should be adequately capitalised and, if need be, allowed to fail without bail. Given that banks will be concentrating only on their main activities of deposit taking and lending they will not be too big to fail and not in a position to blackmail Governments into submission.
- **Governments:** Governments should be constrained by law against borrowing and obliged to have a balanced budget. Governments can grow or even become bloated as long as they can persuade their citizens that doing so is to their own benefit given that they will have to tax them in order to make that happen. It should be a constitutional right of every citizen to hold his Government accountable for its actions in regards to spending the people's hard earned money.
- **Financial intermediaries:** The law governing financial intermediaries and "investment banks" should change so that those advising investors are held responsible for their actions. Governments have a duty to ensure that the price mechanism is allowed to work in a free market economy so as to maximise efficiency and economic welfare. That should not be confused however with the money economy. Permitting people to use money to bet on the success or failure of real projects or country economies, rather than promoting the cause of capitalism freedom, has the opposite effect in that it distorts the invisible hand that channels resources into its more economically productive uses. Why should anyone risk his savings on a risky project in the real world when financial experts, governments and credit rating agencies combine to create a sense of risk-free return panacea? Hedge Funds and other financial intermediaries leverage the money market and misdirect the factors of production into a virtual and non-productive

economy. Hence, while the real economy should remain free, the money market should be very closely regulated and controlled.

3 Conclusion

In conclusion, Risk is part and parcel with Return. They are two sides of the same coin. You can not eliminate risk in the real world by financial alchemy and complex derivatives. You can only reduce project risk by carefully optimising the formulation and application of real capital investment projects. But equity risk has nothing to do with exotic products or financial derivatives. Risk is the challenge for which Return is the reward in a real life investment project. And it is real life investment projects that drive the world and improve our economic welfare. Financial intermediaries become mere distortions to a free capitalist market. Banks are special institutions with a vital role to play in a free market economy. But they should not be allowed to deviate from their primary function and purpose.

The almost complete “liberalization” of banks and financial institutions was passed with the blessings of influential economists, notably Alan Greenspan, who supported free market economic principles. Whether intentionally or not however these economists and politicians failed to distinguish between the real economy (where the free market mechanism is as efficient and true as the law of gravity) and the financial economy which is only a facilitator to the productive markets and should thus always be regulated so as not to misallocate resources and send shockwaves to the real economy. Money and finance should make possible the smooth and efficient operation of the real economy, not vice-versa.

To a large extent the problems we face today stem from what I think is the biggest misconception in finance theory. That is, what is really risk? Risk in the real economy is about the probability of an investment yielding a negative

economic return. In finance, risk is about the volatility in a stockholder's portfolio of investments. The two are not always the same. The former is the actual result of an investment in the real world usually calculated in net present value measured against the initial capital investment. The latter depends largely on the expected returns of the portfolio of shares one holds and whose price is set on the floor of a stock exchange. The real economy is driven by project risk of capital investment projects. The financial economy is driven by speculation, fear and greed.

The current economic problems are the result of an almost total and rather suicidal deregulation of financial institutions which in turn allowed and accelerated an unchecked appetite for Governments to borrow ever more for mostly unproductive uses and a seriously flawed banking regulation which classified loans to sovereigns and the public sector in general as carrying zero risk weight in terms of a bank's capital adequacy requirements. The combination of the above was further exacerbated by a dubious centralized credit rating system which is controlled by two or three private institutions.

The almost complete freedom of financial institutions (which more often than not are affiliated to banks) to trade in risk derivatives whose aim is supposedly to eliminate, mitigate or manage risk is where the cause of most of the world's current problems lies. Credit default swaps (CDS) in particular is the biggest culprit. Why? Because it touches an area that should be sacred for the proper functioning of banks. In an efficient open market economy, the prime function of lending by banks is to channel financial resources to the most productive and viable economic uses. This is how economic development and growth are bolstered. Without a proper credit risk assessment of the projects that the intended loans will aim to finance it is inevitable that a misallocation of scarce economic resources will ensue.

While the Governments of the World were loosening control over financial institutions, Banking regulatory bodies, notably through the Basel Accord, were lowering the hurdle and encouraging banks to increase lending to Governments.

By limiting the level of lending towards private institutions and individuals while at the same time classifying lending to Sovereigns as zero risk weight in reality they have imposed a comparative cost for banks to lend to the private sector vis-à-vis the public sector. In effect, banks could follow a near infinite path of lending to Governments and thus pursue their aggressive growth objectives. Moreover, this potentially explosive situation found fertile ground on which to grow because very few, if any, of the countries in the world constitutionally limit the amount that their Governments can borrow.

One must of course distinguish between public sector borrowing which takes place on the basis of a project's assessment of repayment capability and the structuring of an appropriate financing package⁷. This type of financing by a public sector body should not even need a Government guarantee unless the Government is also the borrower. But the kind of borrowing that has brought the world to a standstill is not project finance related. This was done mostly through the issue of Government bonds which were then sold to investors based on the ratings of a few private credit rating agencies. Those same credit rating agencies incidentally that had Iceland as "AAA" only days before it defaulted! And with credit default swap holders playing for very high stakes at the world's frantic financial casino it is not too hard to imagine how the interests of financial intermediaries may take precedence over issues regarding the real world economy. A real economy which has been dwarfed by the sudden and uncontrolled expansion of the financial para-economy with all its contradictions and conflicting interests.

It is no wonder therefore that banks lost sight and focus on their special role for fostering economic development and facilitating growth in the real economy as prudent and careful lenders to the private sector. With these twisted set of rules and in an effort to quickly maximise returns to their shareholders and bolster their

⁷ Savvides [12]

own bonuses, banks quickly joined in the game diverting financial resources from private to public sector entities. And they did this without even being concerned about credit risk; and why should they? Most Governments they lent to were classified as “AAA” and their new exposures did not even have any impact on their capital adequacy. They could, at least in theory, continue towards a path of unlimited growth. The formula is very simple. Provide financing for sovereign bodies (no need to even be concerned about repayment capability), insure yourself by buying a credit default swap option in the event of default, a cost which in any case you factor in the price at which you offer the loan or bond and move on. One can go on indefinitely doing this over and over again and as long as the house of the world economy does not fall on you, it is possible in theory to have “risk free” eternal growth.

It is as if Banks and Governments conspired to serve each other’s greed. Bank Executive Officers would have huge bonuses and Governments would satisfy their insatiable thirst for more and more funds to sustain their pet projects and maintain themselves in office without the need to pursue unpopular measures by imposing new taxes on their citizens. Why resort to a transparent tax when a disguised tax would do just as well.

What most of our politicians failed to understand and unfortunately many economists seem to forget is that Banks have a special role and mission in a free market economy. They are the means or mechanism by which savings are channelled into productive investments. Banks should therefore be banks and not anything else. Their main purpose is to provide prudent lending to industry, trade and individuals a function which they cannot possibly discharge if at the same time they are allowed and encouraged to behave as equity players in the financial markets, or even worse, take bets that they will make money if someone else defaults.

By the same token, Government borrowing is really additional taxation in disguise. A government issuing bonds to the public raises funds which can only

be paid back by further taxation. For a while, it may be possible to postpone further taxation by continuing to borrow. Since, in their wisdom, the regulators have thought best to classify and assess Government credit risk practically as non-existent, the world has entered a vicious spiral of escalating debt with no end in sight. Until such time of course, when finally, things get so wrong when something has to give as is currently the case in Europe. Greece is only the tip of the iceberg⁸. Public sector world debt is a multiple of the value of the real economy. This is not sustainable. Prices of goods and services have to increase to offset this discrepancy but in Europe they are artificially kept in check because of the common currency.

Our politicians should tackle the causes rather than the symptoms of the failing world economy. We need to go back to basics and rebuild the rules of the game by changing the self inflicted distorted foundations. The problem is not the free market. On the contrary, without the free market, it would be hard to imagine how things will not get even worse than they are today. What we need to correct however is the role of banks and Governments. Banks should be just banks⁹. They should not forgo or bypass proper credit risk assessment because they can pass on the risk to someone else. Governments on the other hand should have their ability to borrow contained by amendments to the constitution. Credit default swaps should not be legal as it is rightly not allowed in insurance for one to benefit out of the loss of another. In the case of the banks it is not only wrong but critically it creates such huge distortions that inevitably prevent the normal functioning of the real economy.

At the root of the problems the world faces today lies a gradual shift of emphasis over the last few decades from the basics of capital investment return towards one of hedging an individual investor's risks. Through this process, banks

⁸ Savvides [13]

⁹ Savvides [9]

have lost focus and Governments collaborated in allowing them to expand in areas that are and should always remain outside their scope. Unfortunately, this has cultivated a culture of “moving the passengers to a higher, perhaps more luxurious, cabin while the Titanic has been sinking”. One may even argue that this collaboration has created the iceberg on which the world economy has crashed on.

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