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A short history lesson on banks and government debt

By **Ashley Owen** on July 19, 2013 in **Strategy**

The current European government debt crisis has seen the media full of stories about the 'unprecedented' government defaults and 'unimaginable' bank failures. The big banks have been designated 'too big to fail' as governments rush in to prop them up using taxpayers' money, and the bankers keep their jobs and their bonuses.

Recent events have many historical precedents

Fascinating though the current events are, they are hardly new. Not much changes – even across thousands of years. For example in the year 1345 AD, defaults on government debts caused the collapse of the Italian banking industry which financed trade and commerce across the whole of Europe.

Wind the clock back a further 1,000 years to the collapse of the Roman Empire in the 4th century AD, the result of a combination of factors including imperial over-stretch and a breakdown in the monetary system and society following rampant inflation from excessive money printing to finance wars and the expanding government. The collapse of the empire, and the monetary system that supported it, plunged Europe into the Dark Ages – a thousand years of barter and feudalism, without an effective financial system to oil the wheels of trade and commerce.

After 1,000 years of economic stagnation following the collapse of the Roman Empire, the Italian city states led the re-birth of the European Renaissance, and Florence emerged as the centre of European trade and commerce, underpinned by its widely trusted gold coin, the florin, first minted in 1252. By the early 1300s two great banking groups in Northern Italy, the *Bardi* and the *Peruzzi*, had come to dominate the European banking industry, lending to businesses and governments all over Europe.

One of the biggest borrowers was England, which needed funds to finance its wars against France. The debt pile kept mounting up until finally in 1345 the English government finances collapsed under the weight of debt. The English Crown (Edward III) defaulted on its loans of 600,000 gold florins from the *Bardi* and 900,000 florins from the *Peruzzi*. As these debts were in a hard currency backed by gold and not England's soft paper money, England could not simply print more currency to repay the loans. The English default bankrupted both the *Bardi* and the *Peruzzi* banking groups, triggering the collapse of the whole of the Florentine banking system due to counterparty holdings with all of the other banks.

The bankruptcy of the Italian and European banking system was a painful but necessary process – debts were written off, shareholders were wiped out, depositors lost their savings, bankers lost their jobs, their fortunes and their standing in society, and businesses across Europe were starved of capital and failed. But lessons were learned, and it cleared the way for a new breed of much stronger, better managed banks, led by the *Medici*, that went on to prosper and underpin the tremendous economic, social, political and cultural revival of Europe in the centuries that followed.

Little has changed in all these years. Governments are still the largest borrowers from banks, and they are still defaulting on their debts. Britain’s most recent default (these days quaintly called ‘restructure’) was its humiliating bailout by the IMF in 1976. Even before Greece’s shock default and restructure last year, Greece had been in eight separate debt restructure cycles lasting a total of 92 years out of the 181 years since its independence. Virtually every country (including Australia in 1932) has defaulted on its government debts at one time or another.

Banks again holding piles of government debt

In the latest government debt crisis, banks are once again using their power to pressure governments into bailing them out by propping them up with citizens’ taxes and future pensions, and again the bankers keep their massive salaries and bonuses.

These days banks are geared at more than 20 to 1 (even the new Basel 3 rules will only require a leverage ratio of 3% equity to total assets, ie 33:1 gearing), meaning that a decline in value of its assets of only a few percent would render a bank insolvent. European banks are grimly clutching onto huge piles of government debt they know are worth significantly less than their face value. Governments are terrified of the idea of banks failing because the widespread loss of public savings could easily trigger public revolt and perhaps revolution that would end the incumbent politicians’ privileged lifestyles.

The end game is inevitable in the long term – the end of the current greatly flawed banking system riddled with moral hazard and distorted incentives. But the end of that system will probably require large scale default and collapse of major banks, where shareholders are wiped out, bankers lose their jobs, their fortunes and their reputations, and businesses are starved of capital, but where lessons are learned and the decks are cleared in order for new, stronger, better managed banks to emerge in their place.

In Japan after the 1990 collapse of the debt-fuelled asset bubble, it took seven years for the government to recognise the problem, another five years to start to fix it, and the job is still only half done more than 20 years later.

In China following the 1983 *li gai shui* reforms and the 1984 *bo gai dai* reforms, the five big state-owned banks went on a wild lending binge from 1985 to 1993, lending vast amounts of money to provincial governments and state owned enterprises to fund politically motivated, uneconomic projects. That credit bubble collapsed in 1993 in a mountain of bad debts that rendered all of the major banks insolvent and the government was forced to recapitalise them. The economy collapsed and unemployment soared, but what did the government do to kick start the economy and find people jobs? It forced the same banks to lend to the same loss-making state owned enterprises for even more unprofitable, politically motivated projects. The result was the same – another pile of bad debts, insolvent banks and more recapitalisations in 1998, and then again in 2004. Then since 2009, those same big banks have been at it again, shovelling vast amounts of credit to the same provincial governments and the same state owned enterprises to fund even more politically motivated and uneconomic projects. No lessons learned there.

In the current crisis it looks as if Europe is heading the same way as Japan. Governments are still in denial, trying to prop up the existing system with taxpayers’ money. Unlike in China, European taxpayers have votes and so the road to reform is littered with endless cul-de-sacs of compromise and side deals. Progress is being slowed even further by the need to get 17 different countries to agree to every tiny step of the way.

The United States was much quicker to eliminate the bad banks, restructure and recapitalise the survivors, but still same old managers are pocketing massive salaries and bonuses, and the surviving banks are bigger and more complex than ever before. Bankers' lobby groups still have an unhealthy influence in Washington, watering down and delaying any real reforms.

(I was a lending manager at Citibank in the early 1980s when the global Chairman of Citibank, Walt Wriston, declared that "Governments can't go broke!" – right before Mexico and 15 other Latin American countries defaulted on their debts. Citibank was the biggest lender in the great Latin American debt binge but Wriston was able to use his political power and scare tactics to get the US government to use taxpayers' money to bail Citibank out – and not for the first or last time!)

Bank bail outs continue … for now

The end game is still many years away it seems. Politicians are still in the pockets of the banks, bowing to their will and bailing them out. The 'too big to fail' banks are now bigger than ever. One day politicians will have the courage to stand up to the banks and allow countries to default, and allow banks to fail. In some countries it may be triggered by popular uprisings that replace the existing governments and political parties, and we are seeing this trend gather pace in southern Europe. Bepe Grillo came very close in Italy earlier this year. People everywhere are coming to realise that simply replacing the government with the opposition doesn't solve the problem.

Only with the end of the current flawed system will there be a birth of a new financial system that is strong, flexible and responsive enough to fuel the next great stage of economic growth and prosperity.

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