Has Financial Globalization Peaked?

A leading economics journalist offers a look behind the curtain.

BY DANIEL GROSS

Wall Street is once again paying large bonuses, as hedge fund titans are hoovering up trophy assets. About 40 percent of recently minted Harvard MBAs rushed to the finance sector. In Europe, private-sector bondholders are bringing once-proud nations to their knees. Well-paid lobbyists in Washington are brazenly trying to weaken new financial regulations. Yes, at times it seems as if the Panic of 2008 never happened and that debt-fueled global finance is in the ascendance.

Or maybe not.

A look at the continuing public- and private-sector reaction to the chain of debacles of 2008–09, changing attitudes toward debt, and the current dynamics driving growth in the global economy yields a counter-narrative. Today, the global economy is growing at a decent clip (4.3 percent, according to the International Monetary Fund's most recent projection.) But it is far less reliant on banks, private-sector finance, and a cross-border willingness to extend credit recklessly than before.

There comes a time in every trend when the system and culture become so saturated that it has reached the height of its influence, utility, and relevance. Analysts have been talking about Peak Oil for nearly a generation. In the United States, muted consumer spending and the rise of e-commerce point to Peak Mall. With Facebook beginning to lose mem-

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bers in North America, wags are suggesting (hoping?) that we may soon encounter Peak Social Media. And while finance matters a great deal, there are hints that we may have reached Peak Global Financialization. Yes, global levels of credit, debt, and monetary interconnection are likely to continue to grow in absolute terms. But the assumption that the only way to get economic growth is for creditors to finance debt-ridden governments and consumers with unrelenting internal and cross-border capital flows is being put to the test.

Leverage is the force that lets you lift more than you could under your own strength. And leverage has been—and is—being driven out of big chunks of the global private financial system. In the United States, the species of unregulated investment bank, leveraged at 30-1 and capable of amassing hundreds of billions of dollars in debt, has become extinct. Lehman and Bear Stearns are gone, and the rest of the big five (Merrill Lynch, Goldman, and Morgan Stanley) have evolved into staid commercial banks via acquisition or regulatory shift. The publicly held debt vehicles launched on an unsuspecting public by private-equity outfits like KKR and the Carlyle Group, which borrowed $30 for every dollar in capital in order to buy debt assets, are likewise a bad memory. Citi, the bank formerly known as Citigroup, once sported a trillion-dollar balance sheet with a phyllo-thin equity layer. In its most recent report, Citi reported a Tier 1 capital ratio of 13.6 percent. According to the Federal Reserve, financial sector debt stood at $14.1 trillion in the first quarter of 2011, down 17 percent from $17.123 trillion in 2008.

In the United States, the epicenter of global financialization, finance today occupies a significantly smaller footprint in the culture, in the economy, and in the markets. As a percentage of the total value of the S&P 500, the financials are about half what they were at their peak. The Keefe, Bruyette & Woods bank index (BKX) trades at its August 1996 price.

The story is similar in Iceland, Ireland, and the United Kingdom, where banking sectors used international capital to swell to dangerously obese proportions. And there's much more to come. It's unclear what the end game will be in Europe, where public fiscal crises have translated into private banking crises in the afflicted countries, as well as in Germany and France. But all signs point to a European banking system that is (proportionally) smaller, less-leveraged and better capitalized, and less inclined to embark upon foreign adventures. Next, the new round of global banking regulatory standards will push banks in the United States, Europe, and all over the world to run with lower levels of leverage. In the future, pinstriped bankers will still zap billions of euros, francs, and dollars around the world at a moment's notice. But they'll be doing so with far less abandon.

Consumers, especially in the United States, helped create the credit crisis. And in the United States, at least, data point not just to a deleveraging consumer, but to a consumer-based economy that doesn't rely on debt nearly as much as it used to. The U.S. economy in late 2010 regained its late 2007 output peak, driven in part by resilient consumers. But between 2008 and the first quarter of 2011, total financial assets rose 20 percent (from $37.8 trillion to $45.5 trillion), while total liabilities fell 3.9 percent (from $20.1 trillion to $19.3 trillion). Through a combination of default, pay-downs, and shifting to rentals (today, the homeownership rate in the United States is just 66.4 percent, down from 69.1 percent in late 2005), Americans have shucked nearly a trillion dollars in mortgage debt since the crisis. Revolving credit (credit cards and so forth) peaked at $974 billion

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in August 2008, and has fallen 18.5 percent since then, to $793 billion in May 2011. But monthly retail sales, which plummeted from $373.2 billion in August 2008 to $335.6 billion in December 2008, have bounced back, and in June 2011 stood at a record $388 billion. Translation: Americans have significantly increased spending in the past two years while slashing their credit card and mortgage bills.

To a degree, the reduction in private-sector leverage has simply been replaced by a boost in public-sector leverage. But there are signs that the process through which developed-country governments suck in huge streams of foreign cash may be coming to a peak as well. The single greatest source of global financialization—the U.S. supply of federal government debt—may be tapering off. Quiet as it is kept, in the first nine months of fiscal 2011, federal revenues were up 8.5 percent, while spending rose only up 3.9 percent. Whether Washington strikes a big deal, a small deal, or no deal on deficits, America's demand for cash is likely to be smaller in fiscal 2011 than it was in fiscal 2010, and to shrink in coming years. (If Congress does nothing, its specialty, many of the Bush tax cuts will expire at the end of 2012.) It's not just the United States—fiscal consolidation is the watchword in pretty much every developed economy. Even Italy has managed to pass a significant deficit-reducing austerity package.

The Federal Reserve has increased its balance sheet mightily, as has the European Central Bank. But here, too, there are signs of a peak. Federal Reserve Chairman Ben Bernanke has signaled that he's not inclined to set sail on QEIII. The Fed's weekly release on factors affecting reserves reflects a slow-motion tightening. Crisis-era initiatives like the TALF (Term Asset-backed Lending Facility), and the Maiden Lane vehicles, which took assets off the hands of Bear, Stearns and AIG, are in run-off mode, while the balance of mortgage-backed securities the Fed holds slowly dwindles.

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Another point to consider. Monthly, the shape of the globe's economic geography shifts, with China and the global south (India, sub-Saharan Africa, and South America) accounting for larger chunks of activity. And many of the large, populous nations that account for a big slice of global growth simply don't have a well-developed culture of credit in the financial or personal sectors. (The debt picture in China, of course, is unclear and potentially scary.) Sub-Saharan Africa, growing at a 5 percent clip, is essentially a cash economy. *New York Times* columnist Andrew Ross Sorkin was shocked to discover earlier this year that Patria, a Brazilian private equity firm in which Blackstone Group now owns a 40 percent stake, uses no debt in its deals. Yes, these economies will use and require more debt as they continue to grow. But proportionally, they will require much less debt than Europe and the United States are accustomed to using.

Proclaiming a Peak in a phenomenon is a much less bold (and much less risky) gambit than the pundit's other favorite trope of proclaiming an End to a phenomenon. And the same holds with global financialization. Rising trade needs to be financed. Commercial ties inevitably result in credit being extended across borders. But surveying the scene, it sure seems as if the developed world, the cause of the debt crisis past and present, is getting religion. Three years after the bust, the global banking system is locked in a quasi-permanent era of deleveraging and muddling through. The shadow banking system is a shadow of its former self. The prospect of something like AIG, or Lehman Brothers, or RBS marrying a massive balance sheet to astonishing incompetence, and emerging from India or Brazil, or even from the United Kingdom or the United States, seems rather remote. Regulators may continue to slumber, but the markets, still scarred by the Panic of 2008, are likely to be less forgiving. ◆