



McLean Budden Perspective

Government and Bank Interests Are No Longer Aligned

August 2011



McLEAN BUDDEN
LOOK FORWARD®

Government and Bank Interests Are No Longer Aligned

Over the past 25 years the interests of Banks, including the broader financial community and that of Western Governments have increasingly been aligned. One of the consequences is the revolving door between governments and banks, especially at the higher echelons. The number of ex Goldman Sachs bankers in government or government institutions throughout the western world, euphemistically known as Governmentsachs is evidence of this symbiotic relationship.

It is becoming increasingly clear that this alignment of interest has reached its limits and is in the process of reversing. The latest proposal by Merkel and Sarkozy to impose a financial transaction tax as part of their latest agreement is a case in point. It's not the first time that such a proposal has been attempted but up until today bankers and lobbyists were persuasive enough to argue that increases in tax revenues would largely be offset by higher borrowing costs and be ineffective.

In the current case, the financial transaction tax proposal comes on the heels of the worst stock market action since the financial crisis where according to one source about USD 10 trillion in wealth was destroyed in 2 weeks worldwide.

Before the 2008 financial crisis, governments welcomed the financial community as they were the conduit to higher asset prices through innovative, but more often reckless, financial products. It was higher prices, in both real assets like housing and financial assets like the tech stocks in the 2000 market bubble, that kept the illusion of wealth translating into higher spending. As the economies stayed strong, politicians increased their chances for re election. It was a beautiful relationship. Germany is the exception while Japan experienced its asset bubble earlier and never recovered. The financial community was also large creators of well paying service jobs. Unfortunately it also attracted physics and math nerds who abandoned the labs of research and real life innovation for trading rooms and reckless innovation. Who will forget the CDO squared?

The aftermath of the crisis saw the end of the "innovative" products but the effects of QEI+ II which exacerbated the already low interest rate environment, left mountains of liquidity and speculative capital. That speculative capital was almost certainly at work during the latest market breakdown as well as the attacks on the Italian bond market and French banks. It's difficult to assess the size of this speculative capital but it may be massive. Could it bring down the French banking system? Could it take down a country in the Eurozone?

No one knows but what is clear is that the structure of the previously aligned interests between the financial community and their governments has broken down, I would argue decisively as a result of this latest market rout.

The financial tax proposal should not be seen exclusively as an attempt to dampen speculative capital. When reading comments by politicians it is clear many see it as a source of funds to finance their deficits. In fact it's not clear the extent to which Merkel and Sarkozy don't see such a tax as a money generating scheme to fund either their deficits or possibly the bail out fund. The fact the size of the bail out fund (EFSF) was not raised adds to that fear. History suggests that in times of economic difficulty, governments tend to go where the money is. Finance today continues to be where the money is.

It's possible the embedded bankers in government will succeed in scrapping this latest proposal which infringes on free flowing capital and ultimately the profits of their former employers but if it is defeated, it will almost certainly return at some later date. The direction is clear and it is now a matter of time.

Government and Bank Interests Are No Longer Aligned

The UK and London:

To be effective any financial tax will require co operation from London and the UK government. Otherwise even more trading will all be booked out of London to bypass any continental tax. Could the UK government abandon the Bank tax and provide support for some form of transaction tax in its place? While politically doable given the antipathy towards bankers in the UK, it makes little economic sense given finance remains the UK's single most important industry. It's not to say Frankfurt and Paris will not go ahead with such a tax but without the UK it will have limited impact, both on its ability to reduce speculation and future revenues that such a tax might generate. It would still be symbolic as it would lead the way for others to eventually follow.

The rationalization in banking and financial services appears far from over. There is currently overcapacity in investment banking after aggressive re hiring post the crisis with market activity too lacklustre to make decent returns. The fact risk taking has also decreased at investment banks does not help profitability. Investment banks no longer constitute the majority pool of speculative capital, as they did pre crisis, since that activity was transferred to either newly created or existing hedge funds. Financial suppression, and the search for higher returns, keep hedge funds in business and maintain their pool of speculative capital.

So the overcapacity is arguably both cyclical (post crisis) and structural as governments seek to clip the wings of speculative capital and find alternate forms of revenue generation.

Even if this tax does not come to pass, it's difficult to see how the market will not continue to anticipate a less politically friendly political environment for banks and financial institutions. While some of this might already be priced in the market it is difficult to assess what is being discounted for sovereign risk vs political risk. In either case the trend is up.

Contact Information

Toronto

145 King Street West
25th Floor
Toronto, ON
M5H 1J8
Tel 416 862 9800
Fax 416 862 0167

Roger Beauchemin,
President & CEO

Ralph Daghfal
Alan Daxner
Sue Eagleson
Ted Harris
Brad Hicks
Catherine Jackman
David Kilburn
Soami Kohly
Ed Kwan
Bob Livingston
Robert Spector

Montréal

1250 René-Lévesque
Blvd. W.
Suite 3010
Montréal, QC H3B 4W8
Tel 514 933 0033
Fax 514 933 8163

Patrick Fournell
Bill Healy
Alexandre Legault
Benoit Paradis

Vancouver

595 Burrard Street
Three Bentall Centre
Suite 3043
P.O. Box 49105
Vancouver, BC, V7X 1G4
Tel 604 623 3430
Fax 604 623 3436

Doug Andrews
David Davies
Dave Mason
Colin Sinclair

Chicago

4026 N. Bell Avenue
Chicago, IL
60618
Tel 773 866 9210
Fax 773 866 9211

Bruce MacNabb

United Kingdom

Netherwood,
Furzefield Chase
Dormans Park,
East Grinstead
West Sussex, UK, RH19 2LY
Tel 1342 329833
Fax 1342 770579

Stephen Watson

Institutional contacts:

Ontario/Atlantic
Québec
Western Canada
U.S.A.
Global

Alan Daxner
Benoit Paradis
Doug Andrews
Bruce MacNabb
Stephen Watson

Private Client contacts:

Ontario/Atlantic

Québec

Western Canada

Catherine Jackman
David Kilburn
Ed Kwan
Bob Livingston
Bill Healy
Alexandre Legault
David Davies
Dave Mason

Foundations/Endowments contacts:

Ontario/Atlantic

Québec

Western Canada

Global

Ted Harris
Brad Hicks
Patrick Fournell
Bill Healy
Alexandre Legault
Dave Mason
Colin Sinclair
Stephen Watson

Managed Asset Program contacts:

Ralph Daghfal
Sue Eagleson
1 877 8 BUDDEN (283336)

McLean Budden Mutual Funds for Canadian Investors:

Michael Bissonnette
1 800 884 0436

Finance & Administration

Barb Lockhart

