Back to ownership

1. An *Oresteia* for the financial system

In the heat of battle, with the double-axes swinging and severed limbs flying through the air as the blood spurts, it's almost impossible to distinguish between the immediate events and the patterns that underlie them. But this is exactly what we want to attempt – just as in Aeschylus' tragedy the immediacy of the action holds the audience's attention, even as the essential inevitability of the disaster always remains tangible in the background. As we know, the *Oresteia* has a happy end: it's not so clear that this will be the case with the financial market crisis.

The underlying pattern: it all started, as is so often the case, with good intentions. The idea, unexceptionable in itself, and in principle more or less uncontestable, was that the financial system should be so constructed that there could never again be such a disastrous situation as in the 1930s, when the collapse of American bankers and brokers set off a global economic crisis. In the following 70 years, the stability of the system was continually worked on and tinkered with. More and more regulatory authorities were installed, regulations piled on regulations, and the control systems made ever more rigorous and exacting. In doing so, the goal of ensuring that the financial system could never again be the source of a serious threat to the real economy became confused with the idea that there could never again be a serious accident within the financial system itself. This is the root cause of the tragedy. Decades were devoted to systematic work on a construct that could be described – in allusion to F. A. von Hayek's *The Mirage of Social Justice* – as "the mirage of a risk-free game".

It is unsurprising that the bodies entrusted with this noble purpose – and which multiplied exceedingly in its pursuit – were joined by the players on the financial markets in making every effort to transform this illusion into reality, for, to the extent that this were possible, it would reduce their financing costs. And so it did – for a while, at least.

In the various episodes in 1987, 1991, 1998 and 2001, the outside world was systematically led to believe, with ample assistance from the central banks, and the Fed in particular, that there was some kind of ultimate insurance against major accidents. A safety net for those too big to fail, or so closely networked that their collapse would inevitably drag others down as well. The result was that risk premiums on the financing costs of the big players fell to virtually zero, and this state of affairs continued uninterrupted until 2007. People believed that they were living in the best of all possible times, confident that the goal of zero accidents had largely been achieved.

How was it possible for the previous Governor of the Fed, Alan Greenspan, to pursue this policy of monetary accommodation without inflationary consequences? It's a particularly insidious trick of history, which also plays its part in this *Oresteia*, that this happened at precisely the time the world was opening up, and an unparalleled surge in technological development was expanding the capacity of the global economy. The huge "output gap" between effective and potential capacity made it impossible for inflationary pressure to be generated. Had it not been for the exogenous geographical and technological shocks, Greenspan's monetary generosity would have come to an end as early as 1998. As it was though, the policy of accommodation and pacification could be pursued more or less without fear of the consequences. The signals sent to the financial community were as fiendishly seductive as they were utterly dangerous: "Whatever you get up to, we will sort it out, and in any case, we've got you under control, thanks to our cunning risk measurement and control processes".

In economic terms, the result of such an assumed ultimate insurance policy (the implicit state guarantee) was a large-scale, sustained subsidization of the financial system. This took the form, as already mentioned, of excessively low risk premiums or guarantees that nobody actually funded. And, as ever when subsidies come into play, there was overproduction and overindulgence. Not a butter mountain or a wine lake this time, but rather a huge sewer of excessive debt, created over the last five years. And accompanied – how else could it be? – by excrescences of the most unattractive variety, from the semi- or wholly criminal "golden parachutes" for terminated top managers to the no less dubious distribution systems for pushing mortgages at almost insolvent American families.

Much has been said, and will be said, about the ethical aspects of the business of finance. It is certainly not difficult to identify a great deal of irresponsibility, or even just thoughtlessness, throughout the system. The real problem, however, is the unethical axiom on which the financial system has been based in recent years: the illusion that the absence of risk is a certainty. As it breaks over our world in successive waves, the financial market crisis is a process that explodes this axiomatic illusion, and makes a mirage of certainty. It is impossible to overestimate the extent and importance of this process: our *Oresteia* will only come to an end when it is completed.

2. More than just a sub-prime problem

If we accept as analytically accurate the basic pattern of the disaster outlined above – years of subsidization of the financial system – then it becomes clear that the crisis must be comprehensive and global, and not simply a relatively local American problem to do with hopelessly overvalued shacks. It may have been the sub-prime mortgages that triggered the blaze, but there was tinder lying around all over the place. So it should be no surprise that the blaze has now crossed over to Europe, and even such supposedly safe investments as bonds are suddenly without a liquid market. The excessively low risk premiums for financing were not restricted to the USA, but applied worldwide. This is why there was, and still is – to the extent that it has not been eliminated by the crisis – a global excess of debt.

What does "excess" mean? Thought fully through, it means that too many projects, either real or virtual, were made possible by the provision of capital. Too many holiday homes on the Costa Brava in Spain, for example. Or too many Internet boutiques. Or too many lottery-like financial products. "Too many": debt financing always assumes a very high probability of repayment; that is, a very high probability of success, or, conversely, a very low probability of a big mistake.

Excessively low risk premiums are seductive, but poisonous. They stimulate just about anything that can be stimulated – on an illusionary basis, but nevertheless very effectively – and are thus highly attractive to both the public and the private sector.

"Too much" leverage means that the tendency to ever more mistakes and disappointments inevitably associated with such enthusiastic activism becomes multiplied by the scale of the debt. As repayments are required to be 100 percent, and on time, there is no real possibility of correcting the mistakes. Debt has an absolute character, in both material and chronological terms. Operationally, it results in fixed costs, which may become dangerous, depending on the revenue situation. And sooner or later, excessive debt results in an excessive death rate for projects. Poison remains poisonous, no matter how seductive it is.

This sort of basic understanding of the nature of debt is essential for any estimate of which parts of the global banking system may be endangered by the crisis, and where the future hot spots will be located. An immediate a priori suspect must be the sudden increase over the last two or three years in the banks' balance sheets. For there can be no doubt that here the rate of mistakes and disappointments has risen disproportionately to the increase in volume. Pride of place is occupied by Iceland, with its wholly inflated banking sector, in particular its three big banks, Landsbanki, Kaupthing and Glitnir. This beautiful island state in the Polar Sea has already been overtaken by events: it has had to nationalize its banks and support its currency with a loan from Russia (!).

The unconstrained domestic growth of countries such as Spain or Ireland also give cause for concern, however. But the global nature of the debt problem is reflected most strikingly in the situation in the United Kingdom. Banks such as Halifax Bank of Scotland (HBOS), the Royal Bank of Scotland and Barclays have caught a packet over sub-prime mortgages; they have been very exposed to the overheated English real estate market for a long period; they have also been going it large with their own financing business. The only big British bank able to steer clear of the pitfalls in this second phase of the financial crisis seems to be HSBC. It was hit hard by sub-prime losses in 2007, and had to recapitalize, but apparently now possesses a sufficiently diversified international portfolio, and thus the necessary degree of credibility.

Germany's banking problems require a more differentiated perspective. There too, an excessive amount of debt has been generated. German banks are well known to have had a surprisingly large share of the overall American sub-prime stake; "extracurricular" activities on such a scale themselves suggest a disproportionately high error rate. To make matters worse, the German banking system is distinguished by record levels of inefficiency. The average return on equity, an informative metric for the profitability of the capital deployed, despite all reservations, does not even reach 7 percent, despite an apparently dangerously low equity base of around 5 percent. ROE in the Netherlands, by comparison, is around 20 percent. Germany has always sought structural preservation in the banking sector; the supervisory boards of the approximately 2,000 banks are composed of more or less deserving politicians of every hue, entirely lacking in banking knowledge, but enjoying their well-lined sinecures.

Particularly if Europe as a whole slides into recession, the mutation of the sub-prime crisis into a general financial crisis, with the concomitant defaults in further credit sectors, will hit the German banks in a phase of extreme weakness. The collapse of Hypo Real Estate was, in our view, only a foretaste of what is to come. There is at least one big bank with questionable structures and a meager equity base; there is little justification for the survival of at least two provincial banks, and half the savings banks could disappear entirely without any damage to the provision of banking services for the German market. Au contraire.

The USA, Iceland, Ireland, Spain, the UK, Germany, Switzerland: what exactly is going on? The disposal of assets that no longer have any value is one aspect. The other, considerably more important aspect is the removal of an estimated 30 to 50 percent of overcapacity in the financial system. Even if the system is now renovated and subsidized on an unparalleled scale, the question of capacity will arise. We are, as it were, at the transition from intensive farming to extensive farming. The bloodbath now taking place in our *Oresteia* is more than justified.

3. Disconnected pipes

Whereas Act One of the tragedy was all about successive write-offs and recapitalizations, Act Two could be described as a desperate struggle for liquidity. Since March 2008, it has been almost impossible for large institutions that were hard hit in the first phase of the crisis to find voluntary investors, whether private investors or far-distant sovereign wealth funds. The collapse in prices after Act One of our *Oresteia* has been too extreme.

Equity remains the most important problem, but it is no longer the most urgent one. Rather, since this summer, more and more banks have been struggling to meet their short-term liabilities. A bank's balance sheet is a constant flux of payments received and payments made; the day-by-day financing of liabilities is a key function within banking operations. If the flow of funds is inadequate, because there are too few loyal savers, for example, liquidity must be acquired elsewhere, from other banks, for instance. This normally happens as a matter of course, without question and frequently, and to a degree comprehensibly, without the provision of any securities. When needed, securities take the form of fungible assets with later maturities – positions that cannot be used to meet the immediate need for liquidity. Interest rates in interbank business normally include a small risk premium (or rather, one that has for too long been too low). In reality, for a very long time the banks had no need to really concern themselves with attracting funds. The skills this needs – the ability to manage the liabilities side, a decisive capability in banking – were thus very largely lacking.

The flow of funds between banks resembles a vast network of intercommunicating pipes, through which money flows as required, without much external intervention. The banks are like the many skyscrapers in New York that have on their roofs water tanks that are usually assumed to be full. The problem in this second act of the financial markets' *Oresteia* is that there is widespread concern as to the watertightness of these tanks, and how full they are. Indeed, there is justified suspicion that a good many pipes in some skyscrapers are leaking, or still worse, some of the sprinkler systems are running and cannot be turned off.

What then does the prudent caretaker do to safeguard his own skyscraper? He disconnects the external piping, so that his tank does not empty itself into the skyscraper next door. He does not allow himself to be sweet-talked by his neighbor's promises that the water supply next door will be working properly again tomorrow or the day after, and that the leaks are being mended anyway. No deal – solidarity at the wrong moment can prove very expensive! Water today is worth more than any number of promises about future water supplies.

So, there is no alternative: the public water supply must lay emergency pipes and increase its provision of water to those skyscrapers that seem to be of particular importance. According to current opinion concerning the function of central banks in crises, this should be done when there is still some reasonable justification for emergency supplies; that is, when the tank and the piping in the skyscraper are not leaking unstoppably – i.e. the bank is not overindebted. Comparisons are never exact, but they are unavoidable when trying to depict, even partially, the extremely complex processes in a system that seems largely beyond our imagination. The parable of the skyscrapers offers a much better explanation than the idiotic domino theory of why it is so important to the central banks that the banking system remains sufficiently liquid: in a system with an unmanageably large number of interconnected pipes the sudden and uncontrolled failure of a tank can lead to losses of pressure elsewhere, with the result that all the prudent caretakers turn their taps off.

The last few weeks have seen a loss of trust between the banks on an unparalleled scale. The risk premiums in interbank business, depicted in the first part of this investment commentary as the cause of the disaster, on account of their protracted (virtual) non-existence, have recently shot up to over 4 percent. Some banks have had to pay significantly over 10 percent for overnight money. That gets expensive, given the way the banks' balance sheets have become overinflated in recent years.

In the USA this extremely dangerous second act of the *Oresteia* has resulted in a consolidation in the banking sector that would until recently have been inconceivable even in the worst of nightmares. And certainly not with this speed. Investment banks as such have ceased to exist – Bear Stearns has been force-fed to the commercial bank JP Morgan, Merrill Lynch consumed by Bank of America, Morgan Stanley and Goldman Sachs transformed into commercial banks, and Lehman Brothers has ceased to be. The illusion that it is possible to obtain sufficient financing from the market at any time, without the need to possess sufficient reserves of one's own, and so run a skyscraper of almost unlimited height, is gone for good.

4. A special troupe of players

In addition to the dramatic lack of liquidity, this second act of the *Oresteia* is characterized by the highly vocal presence of a very important and rather special troupe of players: the representatives of the public sector. They also played a role in Act One, of course, but now they have more or less taken over the stage. We shall refrain at this point from asking the (standard) question of whether state intervention is necessary or desirable, or whether it represents a betrayal of capitalism and the market economy. (What capitalism and what market economy, we may ask, in the light of its decade-long subsidization by the public good of a supposed absence of risk?) An investment commentary is not an ideological polemic. We shall limit ourselves to the neutral, non-judgmental statement that the state players are now active, and likely to remain so for some time to come. We shall also try to assess what consequences their activities may have for the further development of the drama.

The attempt to remain as non-judgmental as possible may be assisted by a degree of relativization of the effective regulatory ability of many public bodies. Most of the supervisory authorities, most of the finance ministers and most of the governors of the central banks were in place at the beginning of the crisis, when the cumulative aberration got under way. There are vast numbers of bodies whose sole raison d'être is the avoidance of financial crises. They were meeting ten years ago, they were meeting five years ago, they were meeting two years ago, and they are still meeting today. It is in no way judgmental to point out that they have all, without exception, failed and are therefore useless. What, for example, shall we think of the efforts of a "Financial Stability Forum", when we now see financial stability itself under such threat? What can be said about "Basle II", now that the banking system is on the verge of collapse in the wake of its introduction? What body ever queried the excessively low risk premiums, or pointed to the dangerous accumulation of carry trades? Who ever warned of the increasing amount of credit being offered to the weakest part of the American real estate market – and if they did, how effectively? The BIZ, the OECD, the IMF, the World Bank?

Or, more specifically, to one of the main proponents of the state's leading role: Treasury Secretary Henry Paulson. Less than a year ago, he and Ben Bernanke, the Governor of the Fed, estimated the scale of the total credit market problem at "a maximum of 50 billion US dollars". And where are we today? In February Paulson said: "I don't think . . . the American taxpayer needs to be stepping in with more taxpayer dollars. We are so far away from seeing something that would have me calling for a bail-out that I don't see it." In May 2008: "There's no doubt that things feel better today, by a lot, than they did in March . . . the worst is likely to be behind us". In July 2008: "This is a very manageable situation." And just two weeks ago: "If [the $700 billion bail-out] doesn't pass, then heaven help us all." Without wanting in any way to be judgmental – we might have said and done far worse in his shoes – why should we think that Secretary Paulson sees things any more accurately today than he did in February and in May and in July?

In short: this troupe of players that has made its entrance with such a flourish is probably descended from the blinded Cyclops Polyphemus. They know as little as the rest of us. So we should not be expecting miracles. In this crisis over the end of an illusion, it is important that no new illusions arise.

5. Intervention: multi-optional or chaotic?

One thing must be said for our troupe of players: their interventions are enormously varied. Examples? First, the already-mentioned shotgun marriage of Bear Stearns to JP Morgan: a unique achievement, only possible in the USA, with its peculiar division of responsibilities between the SEC as supervisory authority and the Fed. It was not possible for the Fed to keep Bear Stearns liquid, so the possibly still entirely solvent (i.e. not overindebted), but illiquid investment bank had to be taken over by a commercial bank subject to the Fed's authority. At least it came with a kind of dowry, in the form of a guarantee from the Fed for 28 billion dollars. The guarantee is, though, so incredibly complexly structured and dependent on conditions that it may itself become the next problem, but this time for JP Morgan.

Example no. 2, Lehman: the investment bank Merrill Lynch having just suffered a similar fate to Bear Stearns, and been taken under the wing of Bank of America, there was nobody left to take on this potential bride, so Lehman was left to go broke. Whether or not Lehman was really overindebted at that point, or whether a classic bridge loan by the Fed would not have been appropriate here, is hard to say. What is clear, however, is that this is a troupe that loves arbitrariness and surprise effects; there is no other explanation for the unequal treatment of Bear Stearns, Merrill Lynch, Lehman, Goldman Sachs und Morgan Stanley. The latter two (Example no. 3) were transformed into commercial banks by decree, in order for them to be able to be connected to the Fed's emergency supplies.

Quite another matter is the direct involvement of public bodies in actual business activity, as has occurred, for example, in the quasi-nationalization of the two American mortgage institutes, Fannie Mae and Freddie Mac (Example no. 4). Here, it can at least be said that these two agencies operating as guarantors of US mortgages have always been quasi-state institutions, as reflected, among other things in their lobbying expenditure. Between 1998 and 2008, Fannie and Freddy pumped a total of 175 million dollars into the political system: no surprise, then, that Washington wants to keep them going at any price. Their new environment, under the "conservatorship" of the Federal Housing Finance Agency (FHFA) is not really so new after all. The extent to which this change of ownership will purge them of semi-criminal organizations remains to be seen.

Entirely different, by contrast, is the situation of the insurance and finance conglomerate AIG (Example no. 5), which now also belongs to the American taxpayer. To stick with Greek mythology, AIG resembles a hydra with numberless heads and tentacles. This is why no-one dared to let it go broke. It is hard to tell whether a future administration – of whatever political hue – will be able to find a Hercules ready to cut the monster apart. AIG will in any event remain a heavy burden. The Fed is currently in the process of raising its promised credit from 85 to 123 billion dollars.

Europe (Example no. 6) also now seems to be going the route of direct state involvement. It remains to be seen to what extent this involvement will be accompanied by the preservation of structures and capacities that can no longer be justified. Right now, all that matters is putting the fire out.

A further variety of state intervention is represented by the American government's so-called bail-out (Example no. 6). It essentially involves a transfer – voluntary or enforced? – of assets between the crippled banks and the Treasury. The idea is that this will enable the recreation of a "clean" banking environment, with institutes that are thought highly unlikely to have any immediately dangerous assets on their balance sheets, and can thus be trusted again. The Treasury, with its longer-term perspective, can then manage and "process" the acquired assets – mainly sub-prime mortgages – over the years ahead.

As we saw, this rescue package found it difficult to attract broad political support. In Congress, electoral considerations went hand in hand with fundamental reservations. The rescue package is now a done deal, after the addition of some politically motivated sweeteners. The package's basic – economic, not political – shortcoming is, however still present: Secretary Paulson has so far not been able to answer the absolutely most important question, namely, at what price the exchange of assets should take place. Nor has a possible process really been defined. It is difficult for trust to be regained in these circumstances. Paulson has nominated Neel Kashkari, a 35-year-old previous employee of Goldman Sachs, as the "auctioneer in chief". Nothing against youth, but the recovery of trust will require people who were not until recently running around downtown New York in brightly colored braces.

Example no. 8 is the recapitalization envisaged by the British government for distressed or endangered banks. As a sweetener for the taxpayer, the shares taken up by the state are to be preference shares, with the condition that the banks thus supported will have to engage actively in the financing of the real economy.

Then we have the hectic pace at which governments in continental Europe are giving guarantees with regard to the banks or their clients. Existing investment protection schemes are being verbally enhanced, though what is being said is often very vague, and is probably creating more confusion than confidence. To take the example of Germany (Example no. 9), what exactly did Frau Merkel mean with her across-the-board guarantee at the beginning of October? Savings accounts with all the German banks? That adds up to a good 500 billion euros. Or did she also mean to include sight deposits, the lifeblood of business? That would be another 875 billion. And what about the short-term time deposits (645 billion), or the longer-term time deposits (another 800 billion)? The Merkel guarantee might be "worth" almost 3,000 billion – a sum that would overshadow all the other rescue packages in the world. Are the German banks really in such a bad way that they need something like this? Or is it based on the speculation that the worst case will not materialize, so that the guarantees will remain insubstantial? Is that an acceptable course of action in such an acute crisis? The failure probably lies with Frau Merkel's spin-doctors, or with her choice of them. Culpa in eligendo.

Lastly (Example no. 10), legal structures are being turned inside out at high speed. The USA has effectively abolished investment bank status, accounting standards are being watered down, and state regulation of the future activities of the banks is under discussion.

Whatever: it looks as if the wide variety of these rescue packages indicates trial and error at best, but is rather an expression of the fundamental helplessness of the bodies involved. This insight appears empirically correct, for the financial markets have so far failed to react positively to any single one of these schemes. Rather, it seems to us that since this remarkable troupe of players has made its entrance, our *Oresteia* has gained in tempo. And no-one can show that this would necessarily have happened without these interventions. All we can do as observers is to accept them as a given.

In an attempt to order our own thoughts, we have put together a small typology of the state interventions during the credit market crisis. The figure should be self-explanatory, and is provided as an appendix to the Investment Commentary.

6. Short-term survival vs. long-term demise?

One thing is already clear: state intervention in the financial crisis, whether unavoidable, necessary or (hopefully) eventually helpful, will have immense consequential costs. It is argued that Secretary Paulson's rescue package might ultimately result in a profit for the Treasury. This would be the case when the real estate market in the USA has recovered, which must happen one day, given the growing population. Maybe, or rather, let's hope so. Meanwhile, the additional 700 billion of debt will have to be taken up by the Treasury on the capital market, and interest paid on it. The Treasury competes on the capital market with the private economy, which must also be financed – particularly when a recession threatens. This effect, known as "crowding out", has hardly been discussed so far. The interest payments required will burden the budget and give future administrations less room for financial maneuver.

With a grain of salt, this applies to all the forms of state intervention listed above: they constrain and they cost. This is obviously the price to be paid to keep the financial system functional. But the price will increase by multiples if the state interventions are aimed not only maintaining functionality, but also at preserving existing structures. If our analysis is correct, and the financial system must shrink by a third, because it has overexpanded on this scale over the last five years, then every dollar, euro and franc invested in structural preservation is wasted money.

Everything now invested unnecessarily in structural preservation in the financial system will restrict growth and prolong the coming recession. We will then have survived in the short term, but have little to look forward to in the longer term. What this might mean in a Europe inclined to political radicalism does not bear thinking about.

With all due reservations about what it may mean in terms of structural preservation, the recapitalization of the banks by the state does seem to us to be a reasonably appropriate approach. Additional capital – more cash, above all – creates room for maneuver, and may help to regenerate some small measure of trust. Above all, it will give the banks time to solve their self-generated problems. The governance of such state holdings is however confronted with immense challenges in terms of minimizing the structural- preservation components as far as possible. Thus, for instance, voting rights for the state are to be avoided, for the state is simultaneously a supervisory authority. Further, recapitalizations should not be attached to socio-political conditions. Otherwise in a few years' time we shall be confronted not with just Fannie Mae and Freddie Mac, but with a global network of semi-state banking agencies, with in all probability no less semi-criminal qualities.

Regardless of the politics, of the apparently unlimited generosity of national exchequers, of loudly proclaimed but improvident guarantees, the basic problem of partially worthless assets and excessive capacities will have to be solved one way or another – however much defenseless taxpayers become involved and however extensive the further complicity of the representatives of public bodies.

7. Debt to equity

De-leveraging, debt reduction and capacity reduction are the order to the day. But what does this actually mean? Can all these excessive liabilities simply vanish into thin air? Should they? Is this acceptable? Shall we become a generation that survives on the dividends of bankruptcy? By no means. The default rate in the American subprime sector is not 100 percent, but “merely” 20 percent. And the repossessed properties of this 20 percent who can’t pay or won’t pay are not worthless. They will find buyers, if at a significantly lower price.

A debt crisis is resolved when the pendulum swings back from absolute, apparently secure liabilities to a share in ownership, where success is only relatively probable. Depending on the transformation process now being set up, this will happen more quickly, more slowly, painfully, completely or only partially. Nevertheless, the way is clear: supposed certainty will have to give way to apparent uncertainty. Ownership can grow, can become exhausted, can fail: there can be no reliance on it. But because we know this, ownership does not cause crises fed by illusion. This is the paradigm shift that we are currently experiencing.

With their peculiarly brutal speed of execution, the stock markets have already anticipated this process in an unparalleled learning experience. The historic price collapse in week 41 was due to the “offsetting” of positions. “Offsetting” means the liquidation of stock holdings that are in any way debt-financed. What remains is a – considerably lower valued – stock market that is made up practically entirely of genuine owners.

We have a lot to learn. The idea, much loved by investors, that there is such a thing as above-average returns without corresponding risk is now being torn out by the roots, in the bloodbath among the hedge funds. “Absolute return” is now dismissed with a weary smile as the devalued concept of a past era. Rightly so. For “absolute return” is conceptually nothing other than a belief in entitlement to the benefit from social debt structures. With the difference perhaps that it tends to be the idea of financially potent “high net worth individuals” rather than of potential recipients of social benefit.

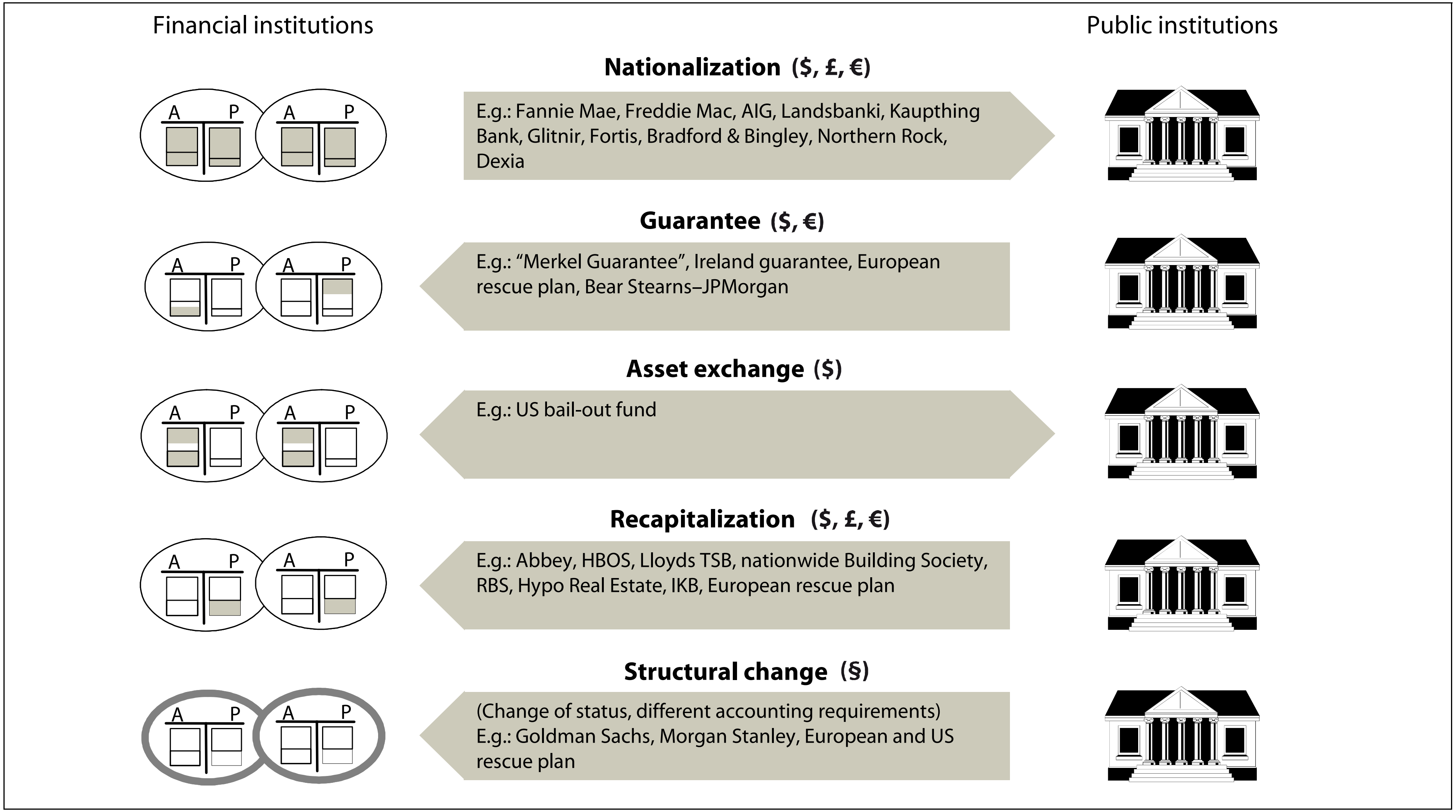
We have a lot to learn. The idea, much beloved by institutional investors, that the portfolios they owned (!) could be lent to the depositary bank in return for a few basis points of (absolute!) additional return came to an abrupt end with the bankruptcy of Lehman, which resulted in a hectic pursuit of securities that had been lent and lent again. Anglo-Saxon law evidently provides far too little protection for ownership, particularly in bankruptcy situations. The leverage phase within the financial system rode roughshod over “ownership” as a legal concept, and not only in Anglo-Saxon legislations. In the wake of the financial crisis, gaps will undoubtedly have to be closed in the legal system, particularly with regard to the lending of securities.

Perhaps – and this would, in terms of a learning experience, really reflect the well-known saying about “crisis as opportunity” – the world might now accept the need to reduce intrinsic debt levels, in the insight that the concept of risklessness is an illusion. Social benefits, pension funds with state-decreed minimum returns, demands on the provisions of public institutions: these are all in essence leveraged systems; that is, structures whose certain future performance is assumed. In economic terms they could be regarded like a bond. It is not only the financial system that has produced far too many such “bonds” in recent years, the social benefit systems are at least equally dangerously overindebted. The state, which is currently being treated as the funder of last resort for the defaults in the financial system, is also the ultimate sheet anchor for all the debt-based social systems. If this crisis does not produce the insight that the state’s capacity for debt has its limits (hello Iceland!), then the next, far more serious crisis is inevitable: the collapse of the Western states as the overburdened ultimate sheet anchors of society.

We have a lot to learn. And emergencies encourage thought. Aeschylus’ *Oresteia* ends with Athene showing mercy to the blood-stained Orestes, out of the insight that revenge cannot be a permanent condition. The financial crisis will end in the insight that absolute concepts must inevitably result in excessive, unrealizable demands. The future will be one of more moderate “entitlement” to a relatively uncertain return.

KH, 13.10.2008

A small typology of state intervention



Note: The gray shade in the bank balance sheets indicates the impact of the state intervention.
Source: analysis