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Wall Street Will Reform Washington

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Obama gained some political momentum after bringing his case for bank reform to New York. But even if financial reform passes, the markets will still find ways to overpower government.

Jin Lee / Bloomberg via Getty Images

There is now massive momentum for financial reform, spurred by the SEC's charges against Goldman Sachs, the president's intensifying involvement, and a bevy of new initiatives—such as renewed interest in the Senate in clamping down on derivatives and even breaking up mega-banks. In addition, the Financial Crisis Inquiry Commission is issuing its first subpoenas, to Moody's, the credit rating agency. And, on a global level, the usually diffident IMF is proposing that banks be subject to special punitive taxes.

> It is not very satisfying to think that it will be the Goldman Sachses, the Citigroups, the Deutsche Banks, and the Credit Suisses of the world who will, one way or another, be the task masters and ultimate decision-makers of our times.

One could get the feeling that Washington and other governments will be taming the markets. But the truth is, on the big issues of the day—the solvency of the United States, the future of the European Union, the links between the U.S. and China—it will be the markets that hold sway over politicians no matter what kind of legislation emerges from Washington. That has been the historical trend over the last 30 years, and it will only intensify as democracies and authoritarian regimes alike prove unable to make the hard decisions on highly complex issues, and will be pushed in one direction or another by the way that capital flows, the way that markets move currencies, the ups and downs of interest rates, and, yes, the prices put on credit default swaps.

The evidence is all around us. In the case of Greece, the 16 governments of Europe that use the euro represent about 25 percent of the global economy. That's political power, right? You would have thought that they could figure out a plan to help tiny Greece, especially given the potential knock-on effects of a Greek default on Spain, Portugal, and others. But they couldn't and didn't—until, that is, global investors threatened to withhold funds except at punishing interest rates. Then Germany and France were forced into devising a detailed rescue plan, which, in fact, is unfolding this weekend. Will it be enough? German Chancellor Angela Merkel, French President Nicolas Sarkozy and their colleagues haven't a clue. The markets will soon tell them by setting rates on Greek bonds and by pushing the euro up or down.

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A landmark election is being held in Britain, pitting incumbent Prime Minister Gordon Brown of the left-leaning Labour Party against David Cameron of the Conservatives. The big debate is how to get Britain out of a horrendous problem of debt and deficits. Big policy issues are at play—to raise taxes or lower them, to invest in the improvement of government services such as mass transit or to privatize them? Truth is, after the May 6 elections, the big decisions won't be made by either

Brown or Cameron. The referendum that will have counted will not be the one at the ballot box but the one that investors around the world will conduct the minute the new prime minister takes a bold decision—or fails to. It will be a very transparent vote by investors from New York, London, Frankfurt, Dubai, Hong Kong and Tokyo; just watch the value of the British pound or the interest rates on its bonds and you'll know the verdict.

Want to know the shape of U.S.-China relations in the next decade? Don't read Obama's speeches, don't listen to President Hu's clichés, don't bother with pundits' assertions of superpower geopolitics. Instead, just track the dollar-yuan relationships.

Here in the U.S., the markets will also determine our path to national solvency. After all, who among us believes that our polarized political system will be able to make the excruciatingly tough decisions to rein in our trillion-dollar deficits? What evidence could possibly be mustered to conclude that Congress is capable of the following actions, all of which will be necessary: cutting entitlements, cutting defense spending, raising taxes on not just the rich but the middle classes via some combination of a national sales tax, and a tax on oil or carbon? Fact is, it will be credit agencies downgrading our debt, foreign investors withholding funds, the dollar tumbling precipitously, and interest rates shooting up to keep money from flowing out that force our politicians to act in ways they otherwise could not.

It is not very satisfying to think that it will be the Goldman Sachses, the Citigroups, the Deutsche Banks, and the Credit Suisses of the world who will, one way or another, be the task masters and ultimate decision-makers of our times. It is even less appealing that so much of the world's money is accruing to government-owned institutions in China and the Persian Gulf. But nothing can stop the growth and power of the capital markets, which have, even through multiple national and international crises these past 30 years—the 1987 stock market crash, the savings and loan disaster, the collapse of Drexel, the Enron scandals, the Asian financial crises, and so much more—produced capital flows around the world that are 10 times larger than they were in 1980 and have grown from 5 percent of global GDP to more than 11 percent today. Hopefully, the legislation moving through Congress now will raise the standards of transparency and integrity of the banking world, and will make it more difficult for financial wizards to take mindless risks. Still, we cannot escape the fact that no matter how the financial-reform bill evolves, it is a trickle destined to be swamped by a flood.

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