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Global Economy Needs Recovery Before Reform

By Robert Skidelsky

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The financial crisis that started in 2007 shrunk the world economy by 6 percent in two years, doubling unemployment. Its proximate cause was predatory bank lending, so people are naturally angry and want heads and bonuses to roll — a sentiment captured by the current worldwide protests against Wall Street.

The banks, however, are not just part of the problem but an essential part of the solution. The same institutions that caused the crisis must help solve it. One way is to begin lending again. With global demand flagging, the priority has to be recovery without abandoning the goal of reform — a difficult line to tread politically.

The common ground of reform is the need to re-regulate the financial services industry. In the run-up to the crisis, experts loudly claimed that "efficient" financial markets could be safely left to regulate themselves. Reflecting the freebooting financial zeitgeist that prevailed at the time, the International Monetary Fund declared in 2006 that "the dispersion of credit risk by banks to a broader and more diverse group of investors ... has helped make the banking and overall financial system more resilient." As a result, "the commercial banks may be less vulnerable to ... shocks."

It is impossible not to hear in such nonsense the cocksure drumbeat of the Money Power, which has never failed to identify the public interest with its own. For 50 years after the Great Depression of the 1930s, the Money Power was held to account by the countervailing power of government. At the heart of the political check was the U.S. Glass-Steagall Act of 1933.

Glass-Steagall aimed to prevent commercial banks from gambling with their depositors' money by mandating the institutional separation of retail and investment banking. The result was 65 years of relative financial stability. In what economists later called the "repressed" financial system, retail banks fulfilled the necessary function of financial intermediation without taking on suicidal risks, while the government kept aggregate demand high enough to maintain a full-employment level of investment.

Then Money Power struck back, aided and abetted by its apologist cohort of economists. The Big Bang of 1986 in London ended the separation of banking functions in Britain. After prolonged lobbying by the financial-services industry, U.S. President Bill Clinton repealed Glass-Steagall in 1999. From that point on, commercial and investment banks could merge, and the composite entities were authorized to provide a full range of banking services, including underwriting and other trading activities.

This was part of a wave of deregulation that swept away former U.S. President Franklin Roosevelt's promise to "chase the money changers from the temple." Clinton also refused to regulate credit-default swaps, and the U.S. Securities and Exchange Commission allowed banks to triple their leverage. These three decisions led directly to the subprime extravaganza that brought down the U.S. banking system in 2007 and 2008.

Since that crash, efforts have been made to reconstruct the dismantled system of financial regulation to prevent the "overlending" that led to the collapse. The new doctrine is called "macro-prudential regulation." Under an international agreement known as Basel III, banks are to be required to hold a higher ratio of equity capital against "risk-weighted assets," and leverage is to be limited to a smaller percentage of such assets. National regulators are exploring ways to vary ratio requirements over the business cycle and have started subjecting banks to regular "stress tests."

In Britain, a financial policy committee within the Bank of England is to monitor the "systemic risk" of financial failure, with a prudential regulatory authority supervising systemically important institutions. According to monetary economist Charles Goodhart, a significantly faster-than-normal growth rate for bank credit, house prices and leverage will give the authorities sufficient warning of an impending crisis.

The new orthodoxy places its faith in regulators' ability to improve on banks' measurement of risk, while leaving the structure of the banking system unchanged. But when it comes to upping equity requirements against risk-weighted assets, who is to do the weighting and according to what methodology?

Goodhart concedes that banks' "risk weightings" in the pre-recession period were subject to political pressure and "financial-industry capture and manipulation." This is inevitable because, as John Maynard Keynes pointed out, the "riskiness" of many investments, being subject to inherent uncertainty, is immeasurable. In short, the new regulatory philosophy replaces the illusion that banks can safely be left to manage their risks with the illusion that regulators will do it for them.

Meanwhile, initial enthusiasm for restoring Glass-Steagall — breaking up banking functions into separate institutions — has fallen by the wayside. It is only logical that banks with state-guaranteed deposits should be safe and boring, with other necessary but risky activities hived off to separate companies. But little progress has been made in (re)implementing this idea.

The "Volcker Rule," whereby commercial banks would be barred from trading on their own account, and from owning hedge funds and private-equity firms, languishes in U.S. Congress. In Britain, an independent commission on banking, headed by Sir John Vickers, rejected separation of retail from investment banking, recommending instead "ring-fencing" deposits from the investment arms of universal banks.

Trust-busters argue that such "Chinese walls" always break down under pressure, owing to huge shareholder demand for universal banks to boost profits at the expense of a sound commercial banking core. And senior executives will still have a legal obligation to maximize profits. The Vickers commission's proposals also depend on sophisticated regulation, which assumes — against history — that regulators will always be one step ahead of bankers.

The Money Power never surrenders easily. Whether relying on regulation, or gesturing toward institutional separation, most proposals for banking reform remain at the drawing-board stage and are sure to be emasculated by financial lobbies.

Moreover, whatever their intrinsic merits, none of these proposals addresses the global economy's most immediate problem: the undersupply, not oversupply, of credit. In other words, the challenge is to revive lending growth in full awareness that we must begin devising ways to rein it in.

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