

# A good crisis gone to waste

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**The turmoil following the collapse of Lehman Brothers three years ago was an opportunity to reform the world's financial system. It was missed, and the new crisis promises little change**

“You never want a serious crisis to go to waste,” Rahm Emanuel, then chief of staff to President-elect Obama, said in November 2008, describing the opportunities for reform presented by the financial meltdown. The day of believing in the unchecked rule of markets was over. Since the convulsions triggered by the collapse of Lehman Brothers on 15th September that year, everything had changed, we were told.

But three years later, very little has changed. Not only are investment banks back to business as usual, they have successfully transferred most of the consequences of their own failure to governments and the rest of the economy. Governments have assumed public and private debt. Three years ago the mortgage market seemed to be the source of the problem; today's crisis is perceived as originating in sovereign debt. Europe and the United States both suffer from a continuing malaise, in which problems with their roots in the financial sector overshadow the activities of ordinary businesses. If the 2008 crisis was an opportunity for fundamental reform of the system, as Emanuel suggested, it did indeed go to waste.

When the crisis first hit, the political right initially floundered. Free market ideologues struggled to rationalise the public subsidy of capitalism's most aggressive institutions. Only later did they devise an explanation: events that superficially appeared to be the fault of greedy bankers and market dysfunction were, of course, the fault of government. They were the result of negligent regulation, the promotion of home ownership, and loose monetary and credit policies. The public, not convinced by this account, remains bemused and angry.

The political left offered no diagnosis or new ideas, and it gained no electoral advantage. Instead, across Europe, the parties that had waited a century for capitalism to collapse under its own contradictions congratulated themselves that such collapse had been averted by the injection of incredible amounts—trillions of dollars—of taxpayer funds into the banking system.

The events of 2007-08 were unanticipated, but the underlying problems had been evident for some time. Their origins lie in the development of derivative markets in the 1970s, in the deregulation of the financial services industry—particularly the removal of restrictions on creating conglomerates—and in the rapid growth of the sector that followed.

In both Britain and the US, the principal functions of financial services traditionally had been kept separate. Banks provided payment services, deposit taking, and corporate lending; investment banks issued securities; insurance companies promoted

risk cover and managed long-term savings; and securities trading was handled by brokers and jobbers or specialists. Wide-ranging structural reform of the system, which strongly reinforced this separation, had followed the Wall Street crash of 1929 and the banking failures that followed. The period from then until the 1970s was one of historically exceptional stability.

During that time, Europe's biggest banks were conservatively structured and managed. That inward-looking culture is part of the reason why Paris and Frankfurt never became global centres. But during the late 1970s and 1980s, as the modern model of investment banking was developed by firms in New York and London, many European banks reinvented themselves on Anglo-American lines and established presences in the US and Britain.

These new conglomerates posed acute management issues. In the "Big Bang"—the deregulation of the City in 1986—retail banks acquired broking and trading operations. These purchases were unsuccessful. Retail bankers had been groomed in larger bureaucracies, whose performance depended principally on the accurate routine processing of millions of daily transactions, and they could not handle the more entrepreneurial cultures they had acquired. In time, the traders and corporate advisers, who were smarter and greedier, took control of the much-enlarged businesses. Although the main activities, and the vast majority of the employees, of the large conglomerate banks are still in retail banking, the most senior positions are now mostly taken by those with a background in investment banking.

These changes put a trading culture at the centre of the global financial system. There were early signs of the instability that might result: the first emerging market debt crisis in the early 1980s; the global stock market crash of 1987; and the Japanese asset price bubble which peaked at the end of that decade. Demonstrations of fragility grew in scale and consequence. A second emerging market debt crisis occurred in 1997-98, and the dotcom bubble came soon after.

Recurrent crises are endemic features of modern finance and are inherent within the structure of the industry. The proximate causes of the various booms and busts have been very different, but a basic mechanism is common to all. Asset prices are bid up in some market or other. The underlying cause is often a genuine economic, political or technological trend such as the commercialisation of the internet, growth in east Asia or Latin America, or the creation of a common European currency. Consultants and journalists, gurus and financiers have a common interest in exaggerating the significance and extent of these developments. The resulting herd behaviour creates cumulative mispricing—artificially high prices for assets—and profits follow. Overvaluations feed on themselves. Much of the apparent gain is paid to individuals associated with the process, and their bosses. The mispricing is eventually corrected and investors take losses. Governments intervene to mitigate the consequences of these losses, pumping large amounts of money into support of asset prices. That fuels a new crisis in another asset class.

The common assertion that financial innovation made the world less risky is simply absurd. Most people would think you were joking if asked whether, over the last two decades, it had done so. The main impact on the uncertainties of ordinary life was the transfer of much of the risk associated with providing pensions from companies to

individuals. The innovation of these decades might have allowed financial institutions to manage risk better—but that expectation was refuted by the most severe crisis in 80 years. The formation of conglomerates might have reduced risk by diversification—as defenders of the industry still assert. In reality, however, the interdependence of the different operations aggravated risk. Essentially well-run institutions such as AIG and Royal Bank of Scotland were brought down by activities that were very small relative to their overall operations. Retail deposits, guaranteed by government, provided collateral for speculative activities.

Many such conglomerates were simply unmanageable. They resembled collections of unruly barons who would depose any king restricting their wealth and power. The risk concealed in convoluted corporate structures and complex instruments was generally beyond the comprehension of senior management.

Why was the political response to the catastrophic events of 2008 so feeble? We must begin with the wider intellectual and political background. The consensus on the mixed economy fell apart in the 1970s and 1980s, after the decisive events in the two largest centrally planned economies: the collapse of the Soviet Union and the abandonment of its empire, and the opening of China to the market. At the same time, reaction in the US and Britain against what was seen as increasingly sclerotic corporatism led to the rise of the radical right under Reagan and Thatcher. In the developing world, achievements in economic growth were correlated with enthusiasm for capitalist models.

And so the right, which had often dominated the levers of economic policy, came for the first time in a century to dominate the terms of economic debate. A market fundamentalism, which had a short time before been advocated only by an extremist fringe, became a mainstream ideology.

Market fundamentalism rests on several assumptions: greed is the dominant motivation in economic affairs; markets populated by self-interested individuals are the only efficient form of economic organisation; and interference with markets is justified only in the event of a limited class of defined market failures. The role of the state is appropriately limited to the enforcement of contracts and property rights, and perhaps the provision of a minimal welfare safety net.

The doctrine implied that more markets were better than fewer markets and the more trade that occurred in these markets, the more prosperous the economy—or at least the advocates of this philosophy—would be. The policy response towards the financial sector was to encourage the proliferation of new securities and markets. It promoted, in the name of increasing liquidity, an explosion of trading and the development of highly complex new products.

Such fundamentalism is a travesty of how market economies, of which there are many varieties, really operate. Markets function only because they are embedded in context. Property rights and contracts are social constructions. The pursuit of greed destroys both the organisations that exemplify it and the legitimacy of the system that supports it, as the events of 2008 proved. The organisation that said: “Let’s make nothing but money” (Bear Stearns’s notorious self-description), proved in the long run not even to make that. The most important risks in society—including the risk of collapse in

financial markets themselves—are handled not through markets, but by social institutions. Complex modern economies require far more co-operative activity than the purist account would allow.

True believers in market fundamentalism were never more than a small minority, although business interests were ready to espouse its convenient rhetoric. The subtle but important distinction between policies that support a market economy and those that support the interests of large firms was not widely appreciated by policymakers on either right or left. Free market policies could therefore be interpreted as the promotion of a wishlist for corporate lobbyists. And no group of lobbyists was better-funded or more assiduous than that of the finance industry.

In 2008 the free market doctrine, which implied that failing businesses should be allowed to collapse, conflicted with the practical fact that these businesses included the largest and most politically well-connected corporations in Europe and America. Unsurprisingly, then, the doctrine did not last long: at most, the 48 hours from the collapse of Lehmans to the bailout of AIG. The most strident business advocates of a market doctrine made it clear that they had never intended the principle of survival of the fittest to apply to them. If markets seized up, the responsibility of government was to provide support to enable these markets to trade freely.

In this intellectual milieu, the notion of putting a \$700bn slush fund for failed businesses at the discretion of Hank Paulson, secretary of the US treasury who was himself the former CEO of Goldman Sachs, seemed entirely natural and coherent. It is difficult to exaggerate the sense of entitlement felt, and still felt, in the City of London and on Wall Street.

Market fundamentalism had set the political left on the back foot for three decades, during which time it simply failed to come to terms with the triumph of the market. There had been—and remains—an opportunity to explain that effectively functioning markets are the product of a social context. But attempts by Bill Clinton and Tony Blair to point to a “third way” collapsed. The pragmatic but intellectually incoherent response was to accept the primacy of the market with bad grace.

So when the banking system collapsed in 2008, the political left, bereft of ideas or analytic framework, acquiesced in the process by which governments provided much of the capital and underwrote the liabilities of the major banks. Frightened of the word “nationalisation,” far less its reality, a Labour government in Britain would not countenance discussion of the issue.

At that moment, however, many on the political right would have been easily convinced that such measures were the best way of reorganising banks and keeping their essential functions going during the inevitable restructuring. But simply writing large cheques saved thought, and averted a confrontation for which politicians were, and continue to be, completely unprepared.

The statement “there should be more regulation” is a hopelessly inadequate response to the problems modern finance poses for the real economy. There is no point in saying there should be regulation unless there is clarity about what it should do. Despite the plain evidence not so much of the past failure of regulation, but of its

continuing irrelevance, ludicrously exaggerated expectations of what banking supervision might achieve remain widespread. If the CEOs and boards of financial institutions had difficulty understanding and controlling what was happening within them, the same had to be true of external regulators.

The issue was not that regulators lacked powers. They have always been able to apprehend Bernie Madoff, block the acquisition of ABN Amro by RBS, or prohibit off-balance sheet vehicles with huge liabilities that banks would be expected to underwrite. The issue is that regulators lacked political authority and technical competence to intervene. They still do.

At present, the main aim of regulation appears to be to stabilise the existing structure of financial institutions and maintain confidence. That is the declared purpose of the new regulatory bodies in Britain. This approach is not surprising, since regulatory capture is widespread and in some cases the regulators are directly controlled by the financial services industry; more often, the institutions are manned by people who see the industry through its own eyes because they have no other perspective. As a result, the aim of financial stability has been conflated with that of industry stability. In fact, since the major problems originate in the structure of the industry, accomplishing “industry stability” is almost certainly a guarantee of further, and potentially more damaging, crises.

Although poorly organised to manage their own affairs, large financial institutions are well organised to manage external relations. Investment bankers are generally politically adroit if not managerially skilled. Policymakers recognised the intelligence and the range of contacts of investment bankers, overestimated their economic importance, and had little appreciation of what they did, beyond the fact that it was difficult to understand.

In the US, regulation has been corrupted by political funding. In Europe, policies and politicians cannot be so easily bought. But the instinctive corporatism of much of continental Europe leads to a natural equation between the interests of Germany and the interests of Deutsche Bank.

Britain has neither American corruption, nor the extremes of German or French industrial policy, and yet political and regulatory capture is equally powerful. There is an element of awe, almost intimidation, of politics by finance. The global leadership of the City of London is seen as a valuable asset, its activities complex, and the assertion that any action might damage City interests perceived as a powerful objection to any proposal. Few politicians or officials have the knowledge, or inclination, to challenge such assertions.

And so financial institutions in general, and investment banks in particular, have become the most powerful industrial lobbies in the west. Simon Johnson, the academic and former chief economist for the IMF, has drawn an analogy between Wall Street and the Russian oligarchs—or medieval barons—who operated in a self-reinforcing style, in which political power enhanced economic power and vice versa. It is, he suggests, a cycle that will be broken only by revolution or external intervention.

Rahm Emanuel's desire not to let a crisis go to waste did not last long. The economic appointments Obama made when he was president-elect, signalled clearly that serious financial reform was not part of his agenda, and the 2010 Dodd-Frank legislation, designed to prevent further crises, has been steadily eroded by industry lobbying and Republican gains in Congress.

As things stand, it will be impossible to avoid successive crises, of potentially increasing amplitude. France and Germany have swept the problems of their large banks under the carpet—and the dust escapes with increasing frequency. In Britain, the establishment last year of an independent commission on banking was a belated recognition of the structural origins of the crisis.

But the world's policymakers have failed to respond to that crisis. Now, the best we can do is attempt to shield our domestic economies from the consequences.