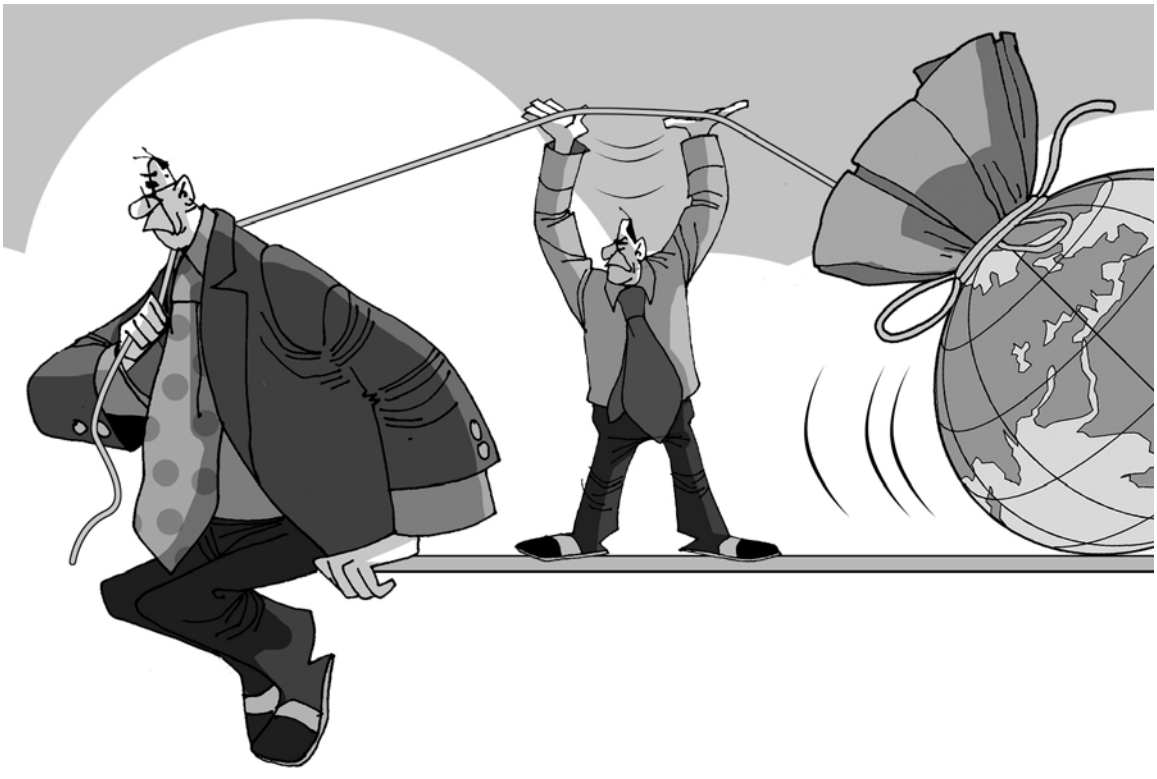

Illustration by BINAY SINHA

A new financial order?

It remains important to remember that finance is at best a handmaiden and not the engine of growth, says DEEPAK LAL

The Obama administration's financial White Paper and Mervyn King's Mansion House speech provide some insight on the possible lineaments of a new financial system in the two major Anglo-Saxon economies. Their common feature is that central banks are likely to be given the power to monitor and ensure the stability of their financial systems, in addition to their traditional role of maintaining monetary stability. But whilst King seemed to advocate something akin to a re-establishment of the separation between investment and deposit-taking commercial banks, the Obama administration seems to have eschewed this option, probably for political reasons. Thus, in both countries it is by no means certain that domestic politics will allow a rational framework — to prevent future gambles by investment banks with the taxpayer-insured deposit base — to emerge.

The most cogent statement of how a refurbished financial system should look is in Mervyn King's open bid for the Bank of England to take over the power to regulate financial services which, in the tripartite system created by Gordon Brown when he granted Bank of England its independence, had been given to the Financial Services Authority. The first step in this process has already been granted by the Banking Act 2009, which gives the Bank the power to resolve bankruptcies of domestic financial institutions. But this leaves the problems of bankrupt banks with large international operations, and the problem of universal banks gambling with the taxpayer-insured deposit base. As King put it: "The Bank finds itself in a position rather like that of a church whose congregation attends weddings and burials but ignores the sermons in between…Warnings are unlikely to be effective when people are being asked to change behaviour which seems to them highly profitable." His "macro-prudential" toolkit to "protect the economy from the banks" would consist of recognising that "if some banks are thought to be too big to fail, then,…they are too big. It is not sensible to allow large banks to combine high street retail banking with risky investment banking or funding strategies, and then provide an implicit guarantee against failure." Quite! As, over the last two years, this column has repeatedly argued.

Second, to deal with the complications in sorting out bankrupt banks with international operations he wants "any regulated bank itself to produce a plan for an orderly wind-down of its activities…Making a will should be as much a part of good housekeeping for banks as the rest of us…And it would be sensible for the various authorities to work across national boundaries to identify detailed plans for how each large cross-border financial institution could be wound down." This is a clear, cogent and impressive statement of how financial stability can be ensured, and it is to be fervently hoped that it will be implemented.

Though much more ambiguous and less far-reaching, given the fragmentation of the US regulatory system, and the important say that Congress has in implementing any technocratic plan from the executive, the US architects of the planned new regulatory framework, whilst also hoping for a similar final outcome, have produced a more nuanced plan which keeps universal banks, but give the Fed overall charge to control institutions deemed "too big to fail". Is either plan likely to be adopted, or will politics determine that it is back to business as usual?

An important clue to the political economy behind the current crisis in its epicentre (the US) is provided in a recent article by Simon Johnson (a former Chief Economist at the IMF). Like many of us who have been involved with Third World debt crises, he asks: who are the 'rent-seekers' who created the crisis and whose reluctance to take a 'hair cut' prevents the domestic polity from accepting the obvious cures? So that ultimately the intervention of an external agency like the IMF is need to administer the necessary cures. The crisis was caused by financiers taking ever risky gambles with the complicity of the government. This is reflected in the changing share of US domestic corporate profits that have gone to the financial sector. From 1973 to 1985 it was 16 per cent. In the 1990s it oscillated between 21 per cent and 30 per cent. In the last decade it reached 41 per cent. This was accompanied by a dramatic increase in pay: which rose from 99-108 per cent of the average for all domestic private industries to 181 per cent in 2007. This great increase and concentration of wealth has created a new financial oligarchy similar to the one in the early years of the last century. It has great political weight in the US. At its head is Goldman Sachs. It has provided Treasury secretaries under the last two US presidents and numerous alumni have held and continue to hold influential posts in devising and implementing US economic policy. (see Simon Johnson: "The Quiet Coup", *The Atlantic Online*, May 2009).

It is ironic that just as the century-old rise, decline and now fall of GM marks the end of American industrial ascendancy, we are now seemingly in an era where "what is good for Goldman is good for America" or more generally Wall Street. I suspect that, apart from some tidying up of the myriad regulatory agencies, and with the Fed providing more effective resolution of failed and failing mega universal banks, the systemic risks posed by the repeal of the Glass-Steagall Act in the US will remain.

By contrast, with the Conservatives openly supporting Mervyn King's diagnoses and remedies, the UK is more likely to create a more stable financial system. But, with its financiers already complaining that this will put London's role as a financial centre at risk, it remains to be seen if the UK financial oligarchy will prevail against a thoroughly demoralised political class.

For India, if it moves towards the financial liberalisation recommended in my last column, Mervyn King's Mansion House speech provides the ideal template. For it remains important to remember that finance, like foreign trade, is at best a handmaiden and not the engine of growth.