

Bank-bashing with a vengeance

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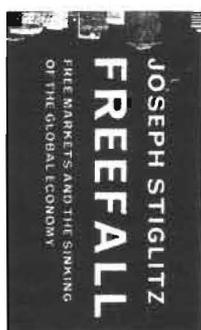
FREEFALL

by Joseph Stiglitz

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Over the decades of (relative) macroeconomic stability in the second half of the 20th century, profit-seeking commercial banks and state-owned central banks worked together to lower the cash-to-asset ratios in the banking industry. An understanding grew that profitable and well-capitalised commercial banks should be able to borrow cash from the central bank if they had trouble maintaining a positive cash reserve balance. The

associated arrangements were technical and complex, and were of no interest whatever to politicians and journalists. Fashionable economic commentators regarded them, or rather ignored them, as the municipal drainage of the financial system.

Meanwhile the long period of peace between the world's leading nations encouraged lending between banks in different countries to an astonishing extent, so that by early 2007 the value of the international inter-bank market was on some measures over \$40,000 billion or almost two-thirds of global output. In the middle of 2007 this market suddenly closed. Banks that had been relying on it to finance their asset growth found, in many cases, that they were actually or potentially short of cash. Even if their assets were good, their capital was ample and they had complied with regulations, they had a cash problem. Of course, if their assets were partly of low-quality (or 'toxic', in the argot) and their capital stretched, the cash problem was severe.

But even in the exuberance of 2006 and early 2007 all banks — including those taking the greatest risks — had to comply with regulations, not least because only by such compliance could they qualify for central bank cash loans or equivalent support measures. When the international inter-bank market closed on 9 August 2007, skilful management of the emerging crisis and responsible commentary on its main features were essential to avoid a macroeconomic calamity. Instead the management (by central bankers, regulators and so on, as well as the commercial bankers) has been low-grade and often chaotic, while the commentariat has indulged in spiteful banker-bashing. The result has been a disaster, with tens of millions of jobs destroyed and avoidable output losses running into trillions of dollars.

As the crisis was breaking, particularly valuable would have been quality advice from leading economists. High hopes might have been held, for example, of a worthwhile contribution from Joseph Stiglitz, who shared the 2001 Nobel economics prize, mostly for his work on so-called 'information asymmetries' in the financial system. Instead, Stiglitz has been a prominent and articulate banker-basher. *Freefall* is the fourth of a series of popular books from Stiglitz which started in 2002 with *Globalization and its Discontents*. It is also the worst.

A clear differentiation between grants (sums given outright, with no expectation of return), loans (sums extended for a period and due to be repaid with interest) and injections of 'equity' or 'capital' (sums invested, to collect the residual amounts after meeting other claims) is basic to any meaningful discussion of financial questions. Further, a

very creditworthy agent — such as the state itself — may guarantee the payment of sums by other agents, usually for a fee. According to common usage, a business that receives a loan, a guarantee on its liabilities and/or a capital injection has not been given anything. It must repay the loan, honour the guarantee and do its best to ensure a positive return to shareholders.

Nowhere in the present crisis has the government 'given' money, in the sense of making an outright grant, to the banks. Instead, central banks have made loans, in accordance with understandings reached before the crisis, and governments have guaranteed liabilities and made capital injections. But in *Freefall* Stiglitz — along with dozens of other Left-leaning intellectual glitterati — repeatedly asserts that the American and European governments have 'given' money to the banks, and that the state must now seek a return over and above what they are supposed to have 'given'.

Hence the argument for the bankers' bonus tax, the British government's assorted levies on UK banks (including those it has appropriated from shareholders), ever more stringent regulations and so on. These measures are of course hurting and shrinking the banks, but — because banks have to cut their loans and deposits (i.e., the quantity of money) — they are also hurting and shrinking the wider economy.

The correct answer to the crisis was either for central banks to clarify that, with full government support, they would lend without limit to solvent banks (and charge a high interest rate) or for government to extend a blanket guarantee on the liabilities of any bank asking for one (and demand an expensive guarantee fee). The inter-bank market could then have reopened. That would have stopped the tens of millions of job losses and trillions of output foregone. Tidying up the financial system thereafter might have taken five to ten years, but the macroeconomic disaster of 2009 could have been avoided. In only one advanced country, Australia, did officialdom see clearly what had to be done when it introduced a general deposit guarantee in October 2008. Uniquely it has not had a recession.

Stiglitz's tirade in *Freefall* symptomises the Left-wing's intellectual bankruptcy in responding to the crisis. Hayek, who won the Nobel in 1974, warned that future laureates ought to take 'an oath of humility never to exceed in public pronouncements the limits of their competence'. Some members of the Nobel family are reported to feel so let down by the economics prize that they want their name dissociated from it. There is nothing wrong with Nobel prize-winners writing books for a lay audience, but — precisely because they are Nobel prize-winners — they should make every effort to ensure that their popular writing is accurate, responsible and even-handed. □

