Our anger with banks is boosting their profits

They've got us in a chokehold: we demand more lending and less risky behaviour. How to fix this paradox?

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The bankers have done it again. After almost destroying the economy and strangling small businesses by refusing desperately needed credit, they are now declaring record profits and are again enjoying giant bonuses.

That is the standard interpretation of the latest twist in the credit crunch morality play and it contains more than a germ of truth. But economics is not a morality play. While bankers are cashing in outrageously, the primary responsibility for this perversion of justice lies not with the bankers, but with populist politicians who have been most vociferous in demanding punishment for the banks.

There are three broad reasons for this paradox. First, and most important, the recession and sudden disintegration of government budgets around the world was not caused by the greed and stupidity of bankers but by the naive and inadequate responses of politicians to this behaviour.

Governments believed dogmatically that financial markets would correct their own excesses. They should have recognised that financial markets sometimes make catastrophic mistakes and intervened much earlier to stop them damaging the real economy.

The failure of politicians to grasp that government intervention is sometimes inevitable leads to the second reason why bankers are paradoxically benefiting from populist revulsion against banks.

In a modern economy based on paper money, banks can always rely on government support, as a cascade of failures would lead to the total collapse of the economy. As banks will always receive state support in a crisis, they, with their shareholders, employees and customers, should pay for this in advance. But banks and bankers are understandably reluctant to do this, just as many drivers would resist paying for car insurance if they could.

We need to suspend normal rules and encourage risk-taking

This is why the strongest opposition to comprehensive guarantees of the kind that could have prevented the Northern Rock and Lehman failures has come from the big banks. Ironically, the populist outcry against individual banks and bankers serves their interests by distracting attention from the special taxes justified by the inherent instability of the banking business, however efficiently or altruistically it is run.

This leads to the third explanation for the paradox of financial affluence amid economic squalor. We may rail against banks and bankers, but we desperately need an expansion of credit to revive the economy. The more public spending is cut, the more urgently private bank lending is required. The banks, therefore, have society in a chokehold. If regulators try to make the system safer by increasing capital requirements for bank loans, they demand larger profits to build up this capital. If banks cannot make big profits, they will reduce lending, so the authorities must create conditions to make banking highly profitable.

But even when banks do make huge profits, they prefer to hoard the money instead of lending it, especially to small businesses, as regulators look askance at the potential losses from such "risky" lending and demand ever more capital to be accumulated as a guarantee against such risks.

What is needed in these conditions is for regulators to suspend their normal rules and to encourage banks to take more risks — whereas the backlash against reckless "casino banking" has done the opposite.

How can these paradoxes be overcome? The most important step is to recognise that the root of the problem lies in economic policy, not banking. Conventional wisdom maintains that the boom-bust cycle in housing and the subsequent credit crunch was the underlying cause of the global recession and the collapse of government budgets. This makes no more sense than blaming the Wall Street crash of 1929 for the Great Depression. What caused the Great Depression was not the crash, but the perverse response by governments of cutbacks, trade barriers and so on.

Instead of toying with the irresponsible idea of allowing big banks to fail, governments around the world should have offered unlimited — but temporary — guarantees, to all financial institutions much earlier in the crisis, ideally in the autumn of 2007, when Northern Rock and other banks first began to experience runs as a result of the US sub-prime crisis.

Banks are loath to pay insurance just as many car drivers are

Had government-led financial support, backed by near-zero interest rates been implemented then instead of a year later, a global recession and now the need for drastic public spending cuts would probably have been avoided.

Thus to blame greedy bankers for unemployment, business failures and cuts is a classic case of shooting the messenger when it is serious thinking about the message that is required.

That message is as simple as it is controversial — financial markets can make disastrous mistakes and cannot be relied on to correct their own excesses. That, in turn, means that governments must sometimes override the judgment of financial markets and the autonomy of bankers.

First and foremost, governments must accept their responsibility for macro-economic management and keep stimulating their economies until they return to full employment.

Second, governments and voters must realise that banks will always, in the final analysis, be able to depend on government support. It is an illusion to suggest that they can be made safe to fail by cutting them down to size or by restricting their speculative activities. Instead banks must be forced to pay in advance, through special taxes or insurance levies, for this implicit support.

Finally, governments must enforce lending targets on banks that have benefited from a public rescue, especially where the government has majority control. The UK Government should not be a passive, arm's-length investor, trying to maximise profits like a private shareholder. The Government's goal should not be to maximise the profits of the banks that it owns, but to maximise economic prosperity and growth.

The goals of private profitability and national prosperity normally coincide, but sometimes they diverge sharply. Today we are living in such a time — just ask the bankers.

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