

The Treacherous Lure of Nostalgic Capitalism

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With every new week, the financial crisis grows more serious and more complex.

The easy, 'classic' part was the way it was triggered by a downturn in the US property market. But the crisis is primarily defined today by interdependence between different market segments tied to new and sophisticated financial instruments. These are affected successively by a collapse of trust, a drop in prices, an outbreak of extreme volatility, and the drying-up of liquidity leading to the absence of usable market signals.

In this global game of tag, borders have become irrelevant. In Europe the term 'national financial system' rings increasingly hollow.

While all public authorities are subject to the same shocks, going it alone is as often as not doomed to failure. Thus the Bank of England, after trying to profile itself by refusing to help what it considered to be incautious banks, finally bowed to the example of the European Central Bank after the Northern Rock debacle.

The complexity and de-territorialisation of finance, at the core of this crisis, have in turn caused violent reactions of rejection.

Politicians, media figures, business leaders and even some financiers are using very strong language in vilifying financial innovation, which is currently almost as reviled as Enron-style 'creative accounting'. France's president, followed by both his parliamentary majority and the opposition, has been denouncing 'speculator capitalism'.

Nostalgia is discernable for the good old days of simple, efficient finance, which served the interests of other sectors of the economy rather than constituting a risk factor for them.

But this nostalgia is misleading, unfair and dangerous.

It is misleading, because it glorifies a past which did not exist. In the industrial expansion of 1850-1929, finance was just as arrogant and internationalised as today. To get a taste, just read 'Money' by French writer Emile Zola (1891), which describes the rise and fall of a Paris-based bank involved in complex overseas project finance.

Later and up until recently in continental Europe, finance was brought under the tight control of the state, at the cost of considerable inefficiency. But it has never been the humble servant of the 'real economy'.

It is also unfair, because an appeal to the good old days of capitalism fails to acknowledge the recent contribution of the financial system to growth.

Securitisation and financial innovation more generally have received bad press. There have certainly been some excesses. But these techniques have on the whole paved the way for a substantially more efficient allocation of capital and management of risk. They are one of the factors behind the exceptional global expansion of the last fifteen years.

It is dangerous, finally, because pining for an idealised past may have the opposite effect to the one sought. Several of the avenues mooted in the public debate could prove worse than the original ill, and delay the corrective response of the market.

Regulating rating agencies risks buttressing the current oligopoly without improving the quality of ratings. Emulating the US Glass-Steagall Act of 1933 (repealed in 1999) to separate the activities of regulated commercial banks and deregulated investment banks would only apparently cap public exposure, since large investment banks would continue to bear systemic risk and thus benefit, in fact if not in law, from a public guarantee. Requiring originators of securitised products to keep part of the credit risk on their books would reduce in equal measure the economic benefit of risk dissemination.

The financial crisis has laid bare major malfunction and calls for a public response. But it is vital that the response does not fight yesterday's war by focusing on aberrations which the market has already started fixing since last August.

It is most likely that we are experiencing a serious crisis of growth and digestion of the frenetic financial innovation activity of the past two decades, rather than any radical departure from it.

What is required at this point includes: better collective understanding of the risks; tighter disclosure rules for banks and above all tighter enforcement; and redefinition of the respective responsibilities of different levels of public authority, based on the experienced gathered in the last few months.

In short, we need better management of tomorrow's risks. This cannot be done that using yesterday's solutions.

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