



## A brighter tomorrow? – the future of the financial and banking sector

History may well recall 2008 as a year of economic destruction, the end of an era. However, there is hope that 2009 could be a year of reconstruction, bringing in a new age.

The priority today is to restore confidence as trust is the keystone of dynamic economic growth, and the capacity to take risk and invest vital to the proper functioning of financial markets. But more than re-building, the world needs different re-building. Liberalism as the ideology, and capitalism as the social and economic system, have been the basis of world growth for many decades. Nevertheless, today both are strongly criticised for their excesses, seen by many as the main culprits of the current crisis. Yet, as bad as this crisis may have been, it will not be the death-knell of liberalism or capitalism, if only because of a lack of a credible alternative. However, views are mounting that the world needs a change, that a 'new' liberalism is required. What should it look like then?

### Past mistakes

Over the last months, the global economy has entered a deep recession. Consumers have reduced their spending, companies have cut production and delayed investment, unemployment has increased. The financial system is crippled, trade is much slower and the emerging countries are not spared (as their economies were unable to 'de-couple' from the US slowdown). When it comes, the recovery is expected to be weak. A few years of slower growth and higher taxes can reasonably be expected, as well as increasing public deficits. Financial investments should be less profitable, but more sustainable, as investors turn away from leverage.

We now know that not one but several different factors have brought about the current economic demise. Many experts mainly blame the deleterious impact of the (excessively) long expansionary cycle of the US monetary policy, leading to an abundance of credit<sup>1</sup>, which eventually went massively into highly leveraged and speculative investment instruments. Also, governments, especially in the US, added to the problem by providing strong legal and financial incentives to use credit in an environment of abundant liquidity – whether to invest in property, or simply to consume, sustaining GDP growth through private demand – allowing, through a lax legal system, even un-creditworthy households to acquire real estate, and masking a stagnating real economy. To a large extent, growth was artificially built on credit, and a lot of credit came from pure money creation<sup>2</sup>.

Problems started when the credit and real estate bubbles burst. The financial sector, which has grown significantly over past years, involves many external elements and has become the most linked sector of the global economy. Aware of the implied risk of this situation, regulators have created rules and control systems in an attempt to limit the damage finance could cause to the rest of the economy. Lately however, an exceptionally long cycle of prosperity led to a high level of trust in the system and little interest in the warnings of regulators and other experts; in the end, increasingly complex financial structures completely escaped the scrutiny and even proper understanding of regulators – and many others. Inappropriate regulations and poor oversight of existing rules failed to act as safe-guards and allowed the financial problems to spread to the rest of the global economy.

The crisis has highlighted many issues and revealed the limits of the current system. The failure of risk management has emphasised the importance of its true independence - like the judiciary – so that it can be heard, even in times of euphoria when no one wants to listen. Only a system where the adoption and implementation of rules and regulations are strictly separated from business decisions ensures freedom of opinion, the setting of relevant rules, an increased respect for their strict enforcement and, thereby, a safer environment. Although today we hear many voices saying we need more rules, what the financial system needs first and foremost is a better, more sensible regulation and its effective enforcement.

<sup>1</sup> *The private sector credit market in the US has ballooned from 50% of GDP in 1950 to 300% now (\$42 trillion). George Lo, Global Risks and Opportunities, Lloyds TSB IPB, April 2009.*

<sup>2</sup> *Pascal Salin, La crise financière: causes, conséquences, solutions, Lausanne, Institut Constant de Rebecque, 2009.*

## Liberalism or not?

According to liberal economic theory, markets should act freely, with no intervention – the 'laissez-faire'. Following this ideology, some believe that markets as well as the real economy should have been allowed to crash, to adjust on their own, arguing that this, although undoubtedly painful, would have cleared up the mess and brought a fresh and healthy start. It follows from such thought that, by 'artificially rescuing the world', massive government intervention is creating a highly distorted system with wrong incentives (such as, if those who acted unwisely are being saved, why should they and millions of others not do it again?), an arbitrary allocation of capital and long-term inefficiencies.

However, others believe that given the magnitude of the crisis, the social cost would have been so high that strict obedience to the liberal paradigm was politically unacceptable. Indeed, people around the world expected their leaders to save them from disaster. Under pressure, governments tried to avoid a repeat of the Great Depression or Japan's 'Lost Decade' (years of deflation and sluggish growth) where slow and inadequate government response made things worse. Thus, they strove not only to do something but to do the right thing and to do it in a timely manner. The financial system was bailed out not to save the 'bad guys' but to try and save everyone else. It is nevertheless ironic that governments, who contributed so much to the problems, were the very ones called upon to solve them. But what alternative did we have?

Today, one of the main questions on everybody's mind is: will the changes brought about by the crisis be structural and lasting or only linked to the current environment and therefore temporary? Most experts believe that the changes should be structural, notably in the field of financial regulation<sup>3</sup>. Consideration of the monetary policy also needs to be addressed with a long-term perspective. Indeed, following the high-inflation decade of the 70s, monetary policy has mainly focused on inflation control. At a high cost, we have come to realise that this is not satisfactory anymore<sup>4</sup>. The period of considerable increase in US monetary supply (2001-2004) did not lead to inflation growth, so no one worried. Instead, the massive supply of credit went into financial assets and real estate, creating bubbles. We now know that the political capacity of central banks, especially the US Federal Reserve, to create 'cheap' money (by decreasing interest rates) does not stimulate the economy in a sustained way: it only brings instability and distorted incentives through artificially low rates of interest.

The involvement of the public sector should be as light and short-term as possible. It is interesting to note that interventionism is not something new. History shows that many governments (and the US not the least) have a long tradition of supporting and even rescuing their national businesses – via protectionist measures, subsidies, financing of R&D, appropriation of natural resources, etc...<sup>5</sup>. So, although the magnitude and coordination of the latest rescue is unprecedented, significant government intervention does not represent a drastic departure from 'liberalism' as we have known it. However, a certain tradition and the necessity to respond to a real threat should not overshadow the fact that, ultimately, governments are not in the best position to run businesses (think of the USSR). Deep, long-term government involvement in the management of the economic and financial system comes with a high risk of having political interests determine economic decisions, as the influence of special interests (lobbies) develops, leading to distortions, inefficiencies, slower growth and growing public deficits. Therefore, today, swift re-privatisation of the business is a priority.

## The emergence of new values

But it does not necessarily follow that we should go back to the so-called 'neo-liberalism' and its excesses. Indeed, over the past years, various elements have hinted that liberalism, as we know it, may be running out of steam. The dominant economic theory is shifting towards more socialist thinkers, such as Paul Krugman and Joseph Stiglitz; research by the IMF, the World Bank or the OECD nowadays allows the questioning of the neo-liberalism supremacy; and emerging economies, such as China or India are firm believers in a state-controlled development<sup>6</sup>. A consensus seems to be emerging that a 'new' and different liberalism is needed as the ideological basis of the future economic and financial system, one that puts the individual at the centre. After all, money (capitalism) and the State exist to serve the individual, not the other way around. Attempts at creating a more moderate, better regulated and more humane liberalism should help to restore confidence in the markets and the financial and banking sector, without killing the positive forces of the market and the incentives to do business.

<sup>3</sup> Rajna Gibson, *Faire de Genève un centre de recherche spécialisé en finance*, L'Hebdo, No 18, 30 avril 2009.

<sup>4</sup> Jean-Pierre Danthine, *Il faudra un développement majeur de la science économique*, L'Hebdo, No 17, 23 avril 2009.

<sup>5</sup> Jean-Philippe Buchs, *La longue histoire de l'interventionnisme étatique*, Bilan, No 258, 08 octobre 2008.

<sup>6</sup> Christian Chavagneux, *L'avenir du libéralisme*, No 41, février 2009.

Every crisis comes with its share of lessons; however, let us not kill capitalism whilst trying to learn those from the current meltdown<sup>7</sup>. After a necessary period of interventionism, we consider it paramount to get back to some form of liberalism. Because in truth, the overall result of this ideology for the past 30 years is very positive. One should indeed not forget that capitalism has raised millions of people out of poverty, and will continue doing so if we let it. Liberalism spurs creativity, competition and prosperity, and in spite of regular crises and aspects of inequality, capitalism remains the best economic system so far to steadily raise standards of living around the world.

At Lloyds TSB International Private Banking, we believe it is now time to look to the future, inspired by the lessons of the past. Tomorrow holds promises for anyone who can see the opportunities and adjust to the required change. We have faith in the coming system and its values, which we already very much share: we put our clients at the heart of everything we do; we adhere to and respect a strict legal framework; we encourage sustainable investment practices. So let us now all turn the experience of this crisis into an opportunity to build a better future. Through these improvements, we can all emerge wiser and stronger.

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<sup>7</sup> *Bary Becker, Kevin Murphy, Do not let the 'cure' destroy capitalism, Financial Times, 19 March 2009.*