LSE Centre for Economic Performance: Financial Regulation – Can we avoid another Great Recession?

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A new series of Election Analyses is now available from the LSE's Centre for Economic Performance (CEP). The series will discuss the research evidence on some of the key policy battlegrounds of the 2010 General Election, including macroeconomic policy, immigration, health, education, crime, poverty and inequality, labour market policy, regional policy, energy and the environment, financial regulation and bankers' bonuses, and foreign aid.

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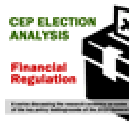
The financial meltdown of 2008 led to the worst recession experienced by the UK and other advanced economies since the Great Depression. The latest Election Analysis from the Centre for Economic Performance (CEP) – by Professors Luis Garicano and John Van Reenen – examines what went wrong with the regulatory system for finance and how can it be fixed.



The publication is summarised below and can be found in full on the CEP website here: http://cep.lse.ac.uk/_new/publications/series.asp?prog=CEPEA

- The Great Recession of 2008-2010 had its roots in the crisis of financial markets, which spread to the real economy.
- The structural problem with the financial sector is that there is strong 'contagion' between institutions within the financial sector and also between the financial sector and other parts of the economy. A large bank can pull down the financial sector, which can, in turn, pull down large parts of the rest of the economy in a 'domino effect'.
- Because of these contagion effects, governments will inevitably bail out banks; and because banks know this, they take excessive risks. This structural 'moral hazard' problem has not been dealt with by the existing regulatory regime.
- To deal with the problem, we need to (a) make bankruptcy more credible; (b) shrink the size of banks so that there are fewer organisations that are 'too big to fail'; and (c) improve existing regulations in a variety of ways.
- Most current proposals do not deal with this fundamental problem. Improving corporate governance, reforming bankers' pay and crude taxes on all banks and/or financial transactions are mainly distractions.
- Without reform, the risks of a repeat of a repeat financial crisis have increased. There is LESS uncertainty that governments will bail out banks, and key sectors like investment banking are more concentrated.

Co-author Professor Luis Garicano concludes:

'The fundamental regulatory problem in the financial system is that the government will bail out the banks because of the risk of contagion from organisations that are ‘too big to fail’ to the rest of the economy.’

‘This structural ‘moral hazard’ problem causes large financial firms to take excessive risks.’

‘To deal with this we have to operate on the fundamental problem, which means increasing the real threat of bankruptcy and shrinking down the organisations that pose such systemic risks.’

‘We should not get distracted by reforms such as changes in corporate governance, bankers’ pay, bank levies, Tobin taxes or competition inquiries.’