Leviathan of last resort

State subsidies and guarantees are once again corroding the financial sector and creating new dangers

EVER since Lehman Brothers went bankrupt in 2008 a common assumption has been that the crisis happened because the state surrendered control of finance to the market. The answer, it follows, must be more rules. The latest target is American housing, the source of the dodgy loans that brought down Lehman. Plans are afoot to set up a permanent public backstop to mortgage markets (see page 77), with the government insuring 90% of losses in a crisis. Which might be comforting, except for two things. First, it is hard to see how entrenching state support will prevent excessive risk-taking. And, second, whatever was wrong with the American housing market, it was not lack of government: far from a free market, it was one of the most regulated industries in the world, funded by taxpayer subsidies and with lending decisions taken by the state.

Back in 1856 one of this newspaper's editors, Walter Bagehot, blamed crashes on what he called "blind capital"—periods when credulous cash, ignoring risk, flooded into unwise investments. Given not only the inevitability of such moments of panic but also finance's systemic role in the economy, a government had to devise some special rules to make finance safer. Bagehot invented one: the need for central banks to rescue banks during crises. But Bagehot's rule had a sting in the tail: the bail-out charges should be punitive. That toughness rested on the view that governments should as far as they could treat financiers like any other industry, forcing bankers and investors to take as much of the risk as possible themselves. The more the state protected the system, the more likely it was that people in it would take risks with impunity.

That danger was amply illustrated in 2007-08. Having pocketed the gains from state-underwritten risk-taking during the boom years, bankers presented the bill to taxpayers when the bubble went pop. Yet the lesson has not been learnt. Since 2008 there has been a mass of new rules, from America's unwieldy Dodd-Frank law to transaction taxes in Europe. Some steps to boost banks' capital and liquidity do make finance more self-reliant: America's banks face a tough new leverage ratio (see page 76). But overall the urge to regulate and protect leaves an industry that depends too heavily on state support.

Turning in his grave

The numbers would amaze Bagehot. In America a citizen can now deposit up to $250,000 in any bank blindly, because that sum is insured by a government scheme: what incentive is there to check that the bank is any good? Most countries still encourage firms and individuals to borrow by allowing them to deduct interest payments against tax. The mortgage-interest subsidy in America is worth over $100 billion.

Even Bagehot's own financial long-stop has been perverted into a subsidy. Since investors know governments will usually bail out big financial firms, they let them borrow at lower rates than other businesses. America's mortgage giants, Fannie Mae and Freddie Mac, used a $120 billion funding subsidy to line shareholders' pockets for decades. The overall subsidy for banks is worth up to $110 billion in Britain and Japan, and $300 billion in the euro area, according to the IMF. At a total of $630 billion in the rich world, the distortion is bigger than Sweden's GDP—and more than the net profits of the 1,000 biggest banks.

In many cases the rationale for the rules and the rescues has been to protect ordinary investors from the evils of finance. Yet the overall effect is to add ever more layers of state padding and distort risk-taking.

This fits an historical pattern. As our essay this week shows, regulation has responded to each crisis by protecting ever more of finance. Five disasters, from 1792 to 1929, explain the origins of the modern financial system. This includes hugely successful innovations, from joint-stock banks to the Federal Reserve and the New York Stock Exchange. But it has also meant a corrosive trend: a gradual increase in state involvement. Deposit insurance is a good example. Introduced in America in 1934, it protected the first $2,500 of deposits, a small multiple of average earnings then, reducing the risk of bank runs. Today America is an extreme case, but insurance of over $100,000 is common in the West. This protects wealth, and income, and means investors ignore creditworthiness, worrying only about the interest-rate offer, sending deposits flocking to flimsy Icelandic banks and others with pitiful equity buffers.

The overall effect is not just to enrich one industry, but to mute the beneficial effects of finance. Healthy financial markets speed up an economy, channelling credit to firms that need it. They can also make an economy fairer and more competitive, providing the funds for those without them to challenge incumbents. Modern finance is a more slanted system in which savings are drawn towards subsidies and tax distortions. Debt-fuelled housing goes wild while investment in machines and patents runs dry. All this dulls growth.

Blame the grandparents

How can the zombie-like shuffle of the state into finance be stopped? Deposit insurance should be gradually trimmed until it protects no more than a year's pay, around $50,000 in America. That is plenty to keep the payments system intact. Bank bosses might start advertising their capital ratios, as happened before deposit insurance was introduced. Giving firms tax relief on financing costs is sensible, but loading it all onto debt rather than equity is not. And still more can be done to punish investors, not taxpayers, for failure. A start has been made with "living wills", which describe how to wind down a megabank, and loss-absorbing bonds, which act as buffers in a crisis. But Europe is far behind America here, and the issue of how to resolve huge, cross-border banks remains.

The chances of politicians withdrawing from finance are sadly low. But they could at least follow Bagehot's advice and make the cost of their support explicit. The safety net for finance now stretches well beyond banks to undercapitalised clearing-houses and money-market funds. Governments should report these liabilities in national accounts, like other subsidies, and exact a proper price for them. Otherwise, they have merely set up the next crisis. ■