The Crisis and the Road Ahead: New Directions for Regulating Finance

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When we sift through the many symptoms of the crisis afflicting the global economy since the middle of 2007 there are three features in particular that seem to define the crisis. The first and most visible symptom is that a range of assets varying from plain equity to collateralised debt obligations to housing and real estate have lost hugely in value. In some cases this collapse in values is obvious. In others it is only becoming clear gradually and over time, since it is difficult to value them directly and there is no trading in markets in which their values can be established. The second feature is the undeniable evidence that the core of the financial system, the banking sector, is faced with pervasive insolvency in a large number of countries, necessitating State support of a kind that amounts to nationalisation. Third, what started out as a financial crisis has now become a full-fledged economic crisis, with the real economy contracting in many countries. This implies that though it was argued for long that finance was expanding independent of and at the expense of the real economy, the truth was that the real economy needed the financial boom to sustain whatever growth and profitability it displayed.

Understanding the crisis, therefore, requires tracing the roots of each of these developments. The first of these problems arose, we now know, because in an environment of excess liquidity and low interest rates created to keep growth in the US and elsewhere in the developed world going, lightly regulated financial institutions expanded credit by lending to those who were earlier not considered creditworthy. These institutions believed that this would not lead to excessive losses because credit risk could be transferred out of firms that generated the relevant credit assets and socialised through securitisation to ensure that the risks borne by individual investors were minimised through diversification.

The transformation of banking and finance

This form of expanding business was not the norm for the banking system but resulted from a transition that occurred in the 1970s and later. Prior to that, the US financial sector was an example of a highly regulated and stable financial system in which banks dominated, deposit rates were controlled, small and medium deposits were guaranteed, bank profits were determined by the net interest margin or the difference between deposit and lending rates adjusted for intermediation costs, and banks were restrained from straying into other areas like securities trading and the provision of insurance. To quote one apt description (OECD 2000), that was a time when banks that lent to a business or provided a mortgage, "would take the asset and put it on their books much the way a museum would place a piece of art on the wall or under glass – to be admired and valued for its security and constant return." This was the "lend and hold" model. This was a comfortable world in which banks were almost guaranteed a profit: but that rate of profit was relatively low.

It needs to be noted that banks in the US were being regulated in this fashion since the passage of the Glass-Steagall Act in 1933, because they were too important to fail. There are, *inter alia*, two factors why banks needed to be prevented from failing. First, they are at the centre of the payments and settlements system in a modern economy, or the institutions, instruments and procedures that facilitate and ease transactions without large scale circulation and movement of currencies. If there is systemic failure in the banking system, the settlements system can freeze, causing damage to the real economy. Second, banks were seen as the principal risk-carriers in an economy, because their intermediation is crucial to mobilising financial savings in relatively small

lots, from depositors who have a high liquidity preference and expect to be insured against risk and channelling these savings to borrowers looking for large sums of capital to be invested in illiquid assets characterised by significant risk. Even if banks lend largely for working capital purposes, this role they play is crucial for the real economy.

Unfortunately, this role implies that banks carry the burdens associated with the risk and maturity mismatch implicit in a system where household savings are being mobilised for private investment. They have to be protected from failure and therefore from competition of a kind that forces them to adopt risky strategies in search of larger business volumes and higher margins. This is precisely what interest rate regulation, deposit insurance and curbs on risky investments and exposures were designed to achieve. But the result was that the profit from banking was limited. This, however, served the US well. Banks performed their expected role during the post-War Golden Age when a regulated banking system was not a constraint on high growth with low unemployment and low inflation, and was no overwhelming tendency towards bank failure.

In the US, however, there was a deep contradiction that was implicit in this financial framework, determined by the fact that banks were privately owned. While banks were being regulated because they were too important to fail, that regulation meant that, though banks were important, they earned lower returns than non-bank financial companies and non-financial firms. This inner contradiction resulted in banks constantly attempting to circumvent regulation or lobbying for the dilution and dismantling of regulation that limited their profits. This problem did not, of course, surface in contexts were public ownership of banks aligned the objectives of the regulators and bank managers.

The regulatory breakdown occurred finally in the 1980s and after when a host of factors linked, among other things, to the inability of the United States to ensure the continuance of a combination of high growth, near full employment and low inflation, disrupted this comfortable world. With wages rising faster than productivity and commodity prices—especially prices of oil—rising, inflation emerged as the principal problem in the 1970s. The response to inflation resulted in higher interest rates outside the banking sector, threatening the banking system (where interest rate regulation meant low or negative inflation-adjusted returns) with desertion of it depositors. Using this opportunity, non-bank financial companies expanded their activities. With US banking being predominantly privately owned, this situation where there were more lucrative profit opportunities outside of banking but banks were not allowed to diversify into those activities was untenable. The contradiction between private banking and strict regulation could no more be easily managed. The era of deregulation followed, paving the way for the transformation of the financial structure.

That transformation, which unfolded over the next decade and more, had many features. To start with, banks extended their activity beyond conventional commercial banking into merchant banking and insurance, either through the route where a holding company invested in different kinds of financial firms or by transforming themselves into universal banks offering multiple services, often as agents of other non-banking financial firms. Second, within banking, there was a gradual shift in focus from generating incomes from net interest margins to obtaining them in the form of fees and commissions charged for various financial services, permitting them to increase their profits and move returns closer to that earned by non-bank or quasi-banking financial entities. Third, related to this was a change in the focus of banking activity as well. While banks did provide credit and create assets that promised a stream of incomes into the future, they did not hold those assets any more. Rather they structured them into pools, "securitized" those pools, and sold these securities for a fee to institutional investors and portfolio managers. Banks transferred the risk for a fee, and those who bought into the risk looked to the returns they would earn in the long term. This "originate and distribute" model of

banking meant, in the words of the OECD Secretariat (OECD 2000), that banks were no longer museums, but parking lots which served as temporary holding spaces to bundle up assets and sell them to investors looking for long-term instruments. This meant that those who originated the credit assets tended to understate or discount the risks associated with them. Moreover, since many of the structured products created on the basis of these credit assets were complex derivatives, the risk associated with them was difficult to assess. The role of assessing risk was given to private rating agencies, which were paid to grade these instruments according to their level of risk and monitor them regularly for changes in risk profile. Fourth, the ability of the banking system to "produce" credit assets or financial products meant that the ultimate limit to credit was the state of liquidity in the system and the willingness of those with access to that liquidity to buy these assets off the banks. Within a structure of this kind periods of easy money and low interest rates increased the pressure to create credit assets and proliferate risk. Fifth, financial liberalisation increased the number of layers in an increasingly universalised financial system, with the extent of regulation varying across the layers. Where regulation was light, as in the case of investment banks, hedge funds and private equity firms, financial companies could borrow huge amounts based on a small amount of own capital and undertake leveraged investments to create complex products that were often traded over the counter rather than through exchanges. Finally, while the many layers of the financial structure were seen as independent and were differentially regulated depending on how and from whom they obtained their capital (such as small depositors, pension funds or high net worth individuals), they were in the final analysis integrated in ways that were not always transparent. Banks that sold credit assets to investment banks and claimed to have transferred the risk, lent to or invested in these investment banks in order to earn higher returns from their less regulated activities. Investment banks that sold derivatives to hedge funds, served as prime brokers for these funds and therefore provided them credit. Since securitised credit assets could not be always be sold immediately banks had an inventory of them in their vaults as well, waiting to be disposed off. And, finally, when it appeared that non-bank institutions were earning high returns from investing in these assets, the banks too decided to retain some of them, . Credit risk transfer neither meant that the risk disappeared nor that some segments were absolved from exposure to such risk.

It is now clear that the direct and indirect exposure of leading banks in the US, UK and Europe was huge. The implications of this for their solvency was long concealed because of the "marked-to-market" method of asset valuation in which in the absence of regular trading assets could be valued at much more than their actual values. But as time passed, defaults on direct exposures increased and as banks strove to push securities linked to these assets off their balance sheets, their worthlessness came to light. The consequences were massive write downs that challenged the solvency of the banks: the second of the defining symptoms of the crisis noted above. This in turn necessitated the huge infusion of government funds that effectively nationalised these banks, since there were few private players who were willing to take over these large banks burdened with large profits.

The Contours of the Financial Crisis

That the complex structure which delivered extremely high profits to the financial sector was prone to failure has been clear for some time. For example, the number of bank failures in the United States increased after the 1980s. During 1955-81, failures of US banks averaged 5.3 per year, excluding banks kept from going under by official open-bank assistance. On the other hand during 1982-90 failures averaged 131.4 per year or 25 times as many as 1955-81. During the four years ending 1990 failures averaged 187.3 per year (Kareken 1992). The most spectacular set of failures, was that associated with the Savings and Loans crisis, which was precipitated by financial behaviour induced by liberalisation. Finally, the collapse of Long Term Capital Management pointed to the dangers of leveraged speculation. Each time a mini-crisis occurred

there were calls for a reversal of liberalisation and increased regulation. But financial interests that had become extremely powerful and had come to control the US Treasury managed to stave off criticism, stall any reversal and even ensure further liberalisation. The view that had come to dominate the debate was that the financial sector had become too complex to be regulated from outside; what was needed was self-regulation.

In the event, a less regulated and more complex financial structure than existed at the time of the S&L crisis, was in place by the late 1990s. In an integrated system of this kind, which is capable of building its own speculative pyramid of assets, any increase in the liquidity it commands or any expansion of its universe of borrowers (or both) provide the fuel for a speculative boom. Increases in liquidity can come from many sources: deposits of the surpluses of oil exporters in the US banking system; increased deficit-financed spending by the US government, either based on the printing of the dollar (the reserve currency) or on financing from abroad; or reductions in interest rates that expand the set of borrowers who can be fed with credit.

Factors like this also fuelled the housing and mortgage lending boom that led up to the sub-prime crisis. From late 2002 to the middle of 2005, the US Federal Reserve's federal funds rate stood at levels which implied that when adjusted for inflation the "real" interest rate was negative. This was the result of policy. Further, by the middle of 2003, the fed funds rate had been reduced to 1 per cent, where it remained for more than a year. Easy access to credit at low interest rates triggered a housing boom, which in turn triggered inflation n in housing prices that encouraged more housing investment. Many believed that this process would go on.

Sensing an opportunity based on that belief and the interest rate environment, the financial system worked to expand the circle of borrowers by inducting subprime ones, or borrowers with low credit ratings and high probability of default. Mortgage brokers attracted these clients by relaxing income documentation requirements or offering sweeteners like lower interest rates for an initial period, after which they were reset. The share of such sub-prime loans in all mortgages rose sharply, from 5 per cent in 2001 to more than 20 per cent by 2007. Borrowers chose to use this "opportunity" partly because they were ill-informed about the commitments they were taking on and partly because they were overly optimistic about their ability to meet the repayment commitments involved.

On the supply side, the increase in this type of credit occurred because of the complex nature of current-day finance centred around the "originate-and-distribute" model. Financial players discounted risk because they hoped to make large profits even while transferring the risk associated with the investments that earn those returns. There were such players at every layer involved. Mortgage brokers sought out willing borrowers for a fee, turning to subprime markets in search of volumes. Mortgage lenders and banks financed these mortgages not because they wanted to buy into the interest and amortization flows associated with such lending, but because they wanted to sell these instruments to less regulated intermediaries like the Wall Street banks. The Wall Street banks bought these mortgages in order to expand their business by bundling assets with varying returns to create securities that could be sold to institutional investors, hedge funds and portfolio managers. To suit different tastes for risk they bundled them into tranches with differing probability of default and differential protection against losses. Risk here was assessed by the rating agencies, who not knowing the details of the specific borrowers to whom the original credit was provided, used statistical models to determine which kind of tranche can be rated as being of high, medium or low risk. Once certified, these tranches could be absorbed by banks, mutual funds, pension funds and insurance companies, which can create portfolios involving varying degrees of risk and different streams of future cash flows linked to the original mortgage. Whenever necessary, these institutions can insure against default by turning to the insurance companies and entering into arrangements such as credit default swaps. Even government sponsored enterprises like Freddie Mac and Fannie Mae, who were not expected to

be involved in or exposed to the subprime market had to cave in because they feared they were losing business to new rivals who were trying to cash in on the boom and poaching the business of these specialist firms.

Because of this complex chain, institutions at every level assumed that they were not carrying risk or were insured against it. However, risk does not go away, but resides somewhere in the system. And given financial integration, each firm was exposed to many markets and most firms were exposed to each other as lenders, investors or borrowers. Any failure would have a domino effect that would damage different firms to different extents.

The problems began with defaults on subprime loans, in some cases before and in others after interest rates were reset to higher levels. As the proportion of default grew, the structure gave and all assets turned illiquid. Rising foreclosures pushed down housing prices as more properties were up for sale. On the other hand the losses suffered by financial institutions were freezing up credit, resulting in a fall in housing demand. As housing prices collapsed the housing equity held by many depreciated, and they found themselves paying back loans which were much larger than the value of the assets those loans financed. Default and foreclosure seemed a better option than remaining trapped in this losing deal.

It was only to be expected that soon the securities built on these mortgages would lose value. They also turned illiquid because there were few buyers for assets whose values were unknown since there was no ready market for them. Since mark-to-market accounting required taking account of prevailing market prices when valuing assets, many financial firms had to write down the values of the assets they held and take the losses onto their balance sheets. But since market value was unknown, many firms took much smaller write downs than warranted. But they could not hold out for ever. The extent of the problem was partly revealed when a leading Wall Street bank like Bear Stearns declared that investments in two funds it created linked to mortgage-backed securities were worthless. This signalled that many financial institutions were near-insolvent.

In fact, given financial integration within and across countries, almost all financial firms in the US and abroad were severely affected. Fear forced firms from lending to each other, affecting their ability to continue with their business or meet short term cash needs. Insolvency began threatening the best and largest firms. The independent Wall Street investment banks, Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley and Goldman Sachs, shut shop or merged into bigger banks or converted themselves into bank holding companies that were subject to stricter regulation. This was seen as the end of an era were these independent investment banks epitomised the innovation that financial liberalisation had unleashed. In time closures, mergers and takeovers became routine. But that too was not enough to deal with fragility forcing the state to step in and begin reversing the rise to dominance of private finance, even while not admitting it.

Finance and the real economy

The third defining symptom if the crisis is that the collapse of finance, triggered a contraction of the real economy as well. There were many ways in which the crisis was transmitted from the financial sector to the real economy. First, the expansion of finance had at different points in time triggered an asset market boom. Stock and housing market booms followed each other, making those exposed to these markets believe that they were wealthier than they had expected to be. This encouraged spending, resulting in a decline in the savings rate, most dramatically in the US. This much-discussed "wealth effect" had as its corollary a boom in the non-financial sector, since it expanded demand for products delivered by that sector. When the financial and

housing boom collapsed, the "wealth effect" operated in reverse, discouraging spending and contracting demand and production.

Secondly, the transformation of finance discussed earlier from a "buy and hold" to an "originate and distribute" regime was also accompanied by a change in the nature of the accumulation regime in developed capitalism. Earlier capitalist growth, especially that of manufacturing and services was sustained by tow drivers: the internal "external market" created by state expenditure for the private sector and the actual external market in the form of exports. The relative role of these varied, with state expenditure dominating in the US and exports playing an important role in Japan, for example. However, after the rise to dominance of the new finance the role of state expenditure declined in importance in the US and countries like Japan (even if not always Japanese firms, which relocated capacities to los cost locations) lost their export competitiveness. In this environment, credit financed housing investment, automobile purchases and consumption and credit finance investment came to play an extremely important role in stimulating demand. When crisis afflicted the financial sector, however, the willingness of banks and other financial institutions to lend evaporated and the ability of borrowers affected by the crisis to take on new debt also declined. This was a second contributor to the crisis that afflicted the real economy.

The third route through which the financial crisis was transmitted to the real economy was through the freezing of credit to firms in the real economy when they were faced with rising inventories and declining utilization, resulting often in bankruptcies and real contraction.

These features answers the question as to why players outside the financial sector, especially players in the real, productive economy did not push for curbs on this speculative spiral which was visible for long and was seen by many as damaging to productive investment. The answer lies in the "benefits" that the rise to dominance of finance delivered to the real economy. The first of these stems from the impact that financial proliferation had on the demand for manufactures. The increase in liquidity that accompanied that proliferation resulted in an expansion of credit at relatively low interest rates for housing investment, automobile purchases and consumption.

Offtake of this credit tended to be high because financial proliferation also triggered a speculative boom in stock and credit markets, to which households were directly or indirectly (through mutual funds and pension funds) exposed. Even though the stock market boom collapsed at the end of the 1990s, the housing boom followed. Thus for a long period the wealth-status of US households, defined by the value of their stock and housing equity, improved considerably, reducing the pressure to save and encouraging the desire to consume. Households were in fact willing to borrow to consume, often in excess of their incomes, resulting in a sharp fall in the average rate of saving. A credit-financed housing investment and consumption boom followed with positive growth implications for the manufacturing sector.

Finally, the speculative boom in the stock markets resulted in a sharp increase in the market capitalization of firms, exploiting which they resorted to leveraged takeovers or mergers. Managers and shareholders were beguiled by the increase in their paper wealth, which appeared to have substantially increased their command over real resources. In the event it is not the profits from productive activity alone which came to define corporate success, but the returns implicit in the appreciation in equity values as well. Firms increasingly strengthened their Treasury departments and some indulged in fraud and manipulated their accounts to drive up stock prices.

For all of these reasons the expectation that the rise to dominance of finance would result in a contradiction between finance and industrial capital remained unrealised. There was no

corrective to the speculative spiral, till the bubble itself went bust. The crisis had a number of consequences. It made households whose homes were now worth much less more cautious in their spending and borrowing behavior, resulting in a collapse of consumption spending and housing investment. It made banks and financial institutions hit by default more cautious in their lending, resulting in a credit crunch that bankrupted businesses and reduced debt-financed consumption. It resulted in a collapse in the value of the assets held by banks and financial institutions, pushing them into insolvency. All of these effects soon translated into a collapse of demand and a crisis in the real economy with falling output and rising unemployment. This is only worsening the financial crisis even further.

A crisis of this nature requires holes to be plugged at many places simultaneously. While there is wide agreement that what is needed is a globally coordinated and huge fiscal stimulus, the actual effort on the ground remains fragmented and meagre. Because of this results are disappointing, threatening to make this crisis the most protracted in a long time.

The road to nationalisation

After much dithering, high drama and every effort to avoid the inevitable for fear that it would straightjacket capitalism, governments in the developed industrial countries bought new equity in private banks to recapitalise them, effectively nationalizing a large part of the private banking system.

These moves came at the end of a long series of interventionist efforts that pointed in two directions. First was that governments believed that the problem facing the financial sector in the wake of the subprime crisis was not one of generalised insolvency, but one of inadequate liquidity resulting from fear and uncertainty. The second was that to the extent that there were individual firms faced with insolvency, the problem could be resolved on a case by case basis, through closure (Lehman), merger (Wachovia) or state take over (American International Group). It was only when efforts based on these perceptions failed to stop the slide that measures to deal with generalised insolvency, such as buying out all impaired assets or recapitalizing banks with public investment were resorted to. But even these are focused on the banking system. In a world where non-bank financial institutions play an extremely important role and the banks themselves are integrated in various ways with these institutions, it is unclear whether these steps would be enough.

The perception that the problem was one of liquidity because financial markets were freezing up given the difficulty of assessing counterparty risk yielded a host of responses, especially in the US, that filled the media with acronyms: MLEC (Master Liquidity Enhancement Conduit), TAF (Term Auction Facility), TSLF (Term Securities Lending Facility) and PDCF (Primary Dealer Credit Facility) (Shiller 2008). By the end of it the Federal Reserve in the US had offered to accept as collateral the bundles of worthless assets that were lying with financial firms, and extend its credit facilities to entities outside the regulated banking system. Interest rates too had been substantially cut to make credit cheaper. When even this was not yielding the expected results and halting a slide in stock markets, recognition that other measures were needed dawned. Some effort at dealing with insolvency was called for.

But even this was initially half-hearted and pursued on a case-by-case basis. Further, across cases the attitude was different. On March 14, 2008, Bear Stearns was put on life support with what appeared to be an unlimited loan facility for 28 days delivered through Wall Street Bank J.P. Morgan Chase. That life support came when it became clear that, faced with a liquidity crunch, Bear Stearns would have to unwind its assets by selling them at prices that would imply huge losses. This would have had spin off effects on other financial firms since the investment bank had multiple points of interaction with the rest of the financial community. Besides being a

counter party to a range of transactions that would turn questionable, its efforts to liquidate its assets would affect other investors holding the same or related securities and derivatives through a price decline. Fearing that the ripple effects would lead to a systemic collapse, the Fed, in collaboration with JP Morgan, sought to prop up the investment bank. The *Financial Times* quoted an unnamed official who reportedly declared that Bear Stearns was too "interconnected" to be allowed to fail at a time when financial markets were extremely fragile.

However, this lesson had not been learnt in full. When in September 2008, troubled Lehman Brothers Holdings Inc., the fourth largest investment bank on Wall Street came to the table with requests for support, it was refused the same. The refusal of the state to take over the responsibility of managing failing firms was supposed to send out a strong message. Not only was Lehman forced to file for bankruptcy, but a giant like Merrill Lynch that had also notched up large losses due to sub-prime related exposures decided that it should sort matters out before there were no suitors interested in salvaging its position as well. In a surprise move, Bank of America that was being spoken to as a potential buyer of Lehman was persuaded to acquire Merrill Lynch instead, bringing down two of the major independent investment banks on Wall Street.

This was, however, only part of the problem that Lehman left behind. The other major issue was the impact its bankruptcy would have on its creditors. Citigroup and Bank of New York Mellon were estimated to have an exposure to the institution that was placed at upwards of a staggering $155 billion. A clutch of Japanese banks, led by Aozora Bank, were owed an amount in excess of a billion. There were European banks that had significant exposure. And all of these were already faced with strained balance sheets. When it became clear that the closure of Lehman brothers had devastating consequences for the rest of the financial sector, the willingness to let the market work declined. Fannie Mae and Freddie Mac were nationalized. AIG was rescued with a huge infusion of public funds. Yet, soon trouble broke in banking markets with a spurt of bank failures seeming inevitable. In the US, and elsewhere in the world, the problem confronting the banks was seen as two-fold: ensuring adequate access to liquidity so that they are not victims of a run; and, cleaning up their balance sheets by writing off or getting rid of their bad assets.

In what followed, central banks pumped huge amounts of liquidity into the system and reduced interest rates. In the US, the Federal Reserve offered to hold the worthless paper that the banks had accumulated and provide them credit at low interest rates in return. But the problem would not go away. By then every institution suspected that every other institution was insolvent and did not want to risk lending. The money was there but credit would not flow through the pipe with damaging consequences for the financial system and for the real economy.

But signs of recognition that there was a problem of potential generalised insolvency requiring nationalisation took time to emerge. The first significant response to the crisis in the US was TARP (Troubled Assets Relief Program). Declaring that the system was faced with financial collapse of a kind that could drive the economy to recession, the Treasury Secretary backed by the Chairman of the Federal Reserve, badgered Congress into authorising a $700 billion bailout package, which was primarily geared to buying out the near-worthless or "impaired" mortgage-related assets from financial institutions, as also any other assets from any other party so as to "unclog" their balance sheets and get credit moving.

This plan, like the early efforts to dismiss the problem as being one of inadequate liquidity in the system, did not clearly recognise that generalised insolvency was a potential problem. This was clear from the fact that the bailout plan sought to use market-based methods to buy up troubled assets. Since the prevailing market price of those assets was close to zero, this would imply that the institutions selling those assets would have to take large write-downs onto their balance

sheets and reflect these losses. This would undermine their viability and result in failure unless they were recapitalised with an infusion of new funds.

"Good" and "bad" banks

It was at this point that it was realised that what needed to be done was to clear out the bad assets with the banks. Among the smart ideas thought up for the purpose was the notion of splitting the system into 'good' and 'bad' banks. If a set of bad banks could be set up with public money, and these banks acquired the bad assets of the banks, the balance sheets of the latter, it was argued, will be repaired. The bad banks themselves can serve as asset reconstruction corporations that might be able to sell off a part of their bad assets as the good banks get about their business and the economy revives.

This idea missed the whole point, because it did not take account of the price at which the bad assets were to be acquired. If they were acquired at par or more, it would amount to blowing taxpayers' money to save badly behaved bank managers, since the assets were likely to be worth a fraction of what they were actually bought for. On the other hand, if some scheme such as a reverse auction (or one in which sellers bid down prices to entice the buyer to acquire their assets) is used to dispose of the bad assets, then the prices of these assets would be extremely low and good banks would incur huge losses which they would have to write down leading to insolvency. The only way out it appeared was if these banks just wrote down their assets and were saved from bankruptcy by the government through recapitalisation or the injection of equity capital into them. Additional equity injection leading to nationalization seemed unavoidable. What is more as the dimensions of the problem needing resolution became clear the extent of the nationalization required seems substantial.

In its update to the Global Financial Stability Report for 2008, issued on January 28, 2009, the IMF has estimated the losses incurred by US and European banks from bad assets that originated in the US at $2.2 trillion. Barely 2 months back it had placed the figure at $1.4 trillion. Loss estimates seem to be galloping and we are still counting. The IMF estimates that these banks that have already obtained much support including capital would need further new capital infusions of around half a trillion. With that much and perhaps more capital going in, public ownership of banking would be near total in some countries. By late January 2006, Bloomberg estimates, banks had written down $792 billion in losses and raised $826 billion in capital, of which $380 billion came from governments.

Direct infusion of funds seemed inevitable. It was the UK, having experimented with liquidity infusion and limited nationalization, which first went beyond the Bush administration. Gordon Brown announced that his government would resort to an "equity injection" to buy ordinary and preference shares worth £37 billion in three of the biggest banks in the country: Royal Bank of Scotland, Lloyds TSB and HBOS.

Existing shareholders have the option of buying back the ordinary shares from the government. But if they do not, as seems likely, then the government would have a stake of 60 per cent in RBS and 43.5 per cent in the combined entity that would emerge after the ongoing merger of Lloyds TSB and HBOS. This clearly amounts to State takeover, which brings with it new obligations. The three banks will not be able to pay dividends on ordinary shares until they have repaid in full the £9bn in preference shares they are issuing to the government. The Treasury appointed new directors to the boards of RBS and the combined Lloyds-HBOS to oversee the government's interests. And restrictions were imposed on executive salaries and bonuses that had ballooned during the years of the speculative boom.

The decision to "nationalize" was forced on the UK government because the problem facing the banking system was not just one of inadequate liquidity resulting from fears generated by the subprime crisis. Rather credit markets had frozen because the entities that needed liquidity most were those faced with a solvency problem created by the huge volume of bad assets they carried on their balance sheets. To lend to or buy into these entities with small doses of money was to risk losses since that money would not have covered the losses and rendered these banks viable. So money was hard to come by. This is disastrous for a bank because rumours of its vulnerability trigger a run that devastate its already damaged finances.

What was needed was a large injection of equity to recapitalize these banks after taking account of losses. Wherever the sum involved was small, a private sector buyer could play the role, otherwise the State had to step in. Thus, in the case of some banks recapitalization through nationalization was unavoidable because, as UK chancellor Alistair Darling put it, "this is the only way, when markets are not open to certain banks, they can get the capitalisation they need". Others such as Barclays hoped to attract private investors so as to avoid being absorbed by the government.

The spread of nationalization

After having failed to salvage a crisis-afflicted banking system by guaranteeing deposits, providing refinance against toxic assets and pumping in preference capital, governments in the US, UK, Ireland and elsewhere are being forced to nationalize their leading banks by buying into new equity shares. What is more, even staunch free market advocates like former Federal Reserve Chairman Alan Greenspan, who made the case for regulatory forbearance and oversaw a regime of easy money that fueled the speculative bubble (which he declared was just "froth"), now see nationalization as inevitable. In an interview to the *Financial Times*, Greenspan, identified by the newspaper "as the high priest of laisser-faire capitalism", said: "It may be necessary to temporarily nationalise some banks in order to facilitate a swift and orderly restructuring. I understand that once in a hundred years this is what you do."

This ideological leap has come at the end of a long transition during which the understanding of the nature of the problem afflicting the banks in these countries has been through many changes. Initially, when the subprime crisis broke, this was seen as confined to subprime markets and to institutions holding mortgage-backed securities. Since banks were seen as entities which had either stayed out of these markets or had transferred the risks associated with subprime mortgage loans by securitizing them and selling them on to others, the banking system, the core of the financial sector, was seen as relatively free of the disease.

In practice, however, the exposure of banks to these mortgage-backed securities and collateralized debt obligations was by no means small. Because they wanted to partake of the anticipated high returns or because they were carrying an inventory of such assets that were yet to be marketed, banks had a significant holding of these assets when the crisis broke. A number of banks had also set up special purpose vehicles for creating and distributing such assets which too were holders of what turned out to be toxic securities. And finally banks had lent to institutions that had leveraged small volumes of equity to make huge investments in these kinds of assets. In the event, the banking system was indeed directly or indirectly exposed to these assets in substantial measure.

It needs noting that even if the exposure of banks to these assets was a small proportion of the total amount in circulation, the effect of such assets turning worthless can be debilitating for the banks for two reasons. First, even if the proportion of derivative assets held by the banks was small, the value of that exposure tended to be high because of the large volume of such assets circulating in the system. Because securitization is geared to transferring risk off the balance

sheet of the originator of the base asset, the tendency in the system is for the creators of such assets to discount risk and create large volumes of excessively risky credit assets, as happened in the subprime mortgage market. The effects of this tendency to sharply increase the volume of asset-based securities was aggravated by the easy money environment that was created by the Federal Reserve under Greenspan as part of an effort to keep a credit-financed boom going in the system.

Second, the equity base of most banks is relatively small even when they follow Basel norms with regard to capital adequacy. Banks can use a variety of assets to ensure such adequacy and the required volume of regulatory capital can be reduced by obtaining assets with high ratings (which we now know are not an adequate indicator of risk). This results in the available regulatory capital being small relative to the risky asset-backed securities held by the banks.

The difficulty with these kinds of bad assets is that they are valued on marked-to-market principles, implying that since these assets are not all being traded, the there is a lag in the recognition of which the losses suffered through holding such assets. In the US, the process of price discovery began a long time back when in August 2007 Bear Stearns declared that investments in one of its hedge funds set up to invest in mortgage backed securities had lost all its value and those in a second such fund were valued at nine cents for every dollar of original investment. What was noteworthy was that Bear Stearns was a highly leveraged institution holding assets valued at $395.4 billion in November 2007 on an equity base of just $11.8 billion. Thus it was not just that the assets held by the bank were bad, but that there were many other institutions, including banks, that were exposed to bad assets through their relationship with Stearns. Yet they were slow in recognizing their potential losses.

Though the problem originated in the US nationalization occurred first in Iceland (where the need was immediate), in Ireland starting with Anglo Irish Bank and expected to be necessary in the case of Bank of Ireland and Allied Irish Banks and in the UK were Royal Bank of Scotland and Lloyds Group are now under dominant public control, and others are expected to follow. However, even here the willingness to declare the process as nationalization is still lacking. In the US, the government initially found ways of providing capital but not demanding a say. But this proved disastrous, since it became clear that old habits of managers used to being paid to speculate die hard. Huge salaries and bonuses were being paid out of money meant to save dying banks. So intervention became necessary and is part of the plank being espoused by President Barack Obama. Yet, when the threat of inevitable nationalization resulted in a sharp fall in the share values of the likes of Bank of America and Citigroup, that are surviving on government money, White House spokesman Rober Gibbs told reporters that "The President (Barack Obama) believes that a privately held banking system regulated by the government" is what the US should have. Whatever the perception, in practice, huge common equity capital acquisitions ensued.

What was missed is that the inevitability of public ownership that is now being recognized stems from a deeper source. The problems that drove the system to inevitable nationalization arose because of the transition in banking from a structure that was based on a "buy-and-hold" strategy (where credit assets were created and held to maturity) to one that relied on a "originate-and-sell" strategy in which credit risk was transferred through a layered process of securitisation that created the so-called toxic assets. The deregulation of banking was crucial for this transition. It permitted securitisation and also allowed a geographically extensive banking system to create credit assets far in excess of what would have been the case in a more regulated system, so that they could be packaged and sold. The role of banks as mere agents for generating the credit assets that could be packaged into products meant that risk was discounted at the point of origination, since banks felt that they were not holding the risks even while they were earning commissions and fees. This transition was made possible by the process of deregulation that

began in the 1980s and culminated in the Gramm-Leach-Bliley Modernization of Act of 1999, which completely dismantled the regulatory structure and the restrictions on cross-sector activity put in place by Glass-Steagall in the 1930s.

Why did deregulation occur, when a system regulated by Glass-Steagall and all it represented served the US well during the Golden Age of high growth in the US? It did because implicit in the regulatory structure epitomised by Glass -Steagall was the notion that banks would earn a relatively small rate of return defined largely by the net interest margin, or the difference between deposit and lending rates adjusted for intermediation costs. Thus, in 1986 in the US, the reported return on assets for all commercial banks with assets of $500 million or more averaged about 0.7 per cent, with the average even for high-performance banks amounting to merely 1.4 per cent. This outcome of the regulatory structure was, however, in conflict with the fact that these banks were privately owned. What Glass-Steagall was saying was that because the role of the banks was so important for capitalism they had to be regulated in a fashion where even though they were privately owned they would earn less profit than other institutions in the financial sector and private institutions outside the financial sector. This amounted to a deep inner contradiction in the system which set up pressures for deregulation. Those pressure gained strength during the inflationary years in the 1970s when tight monetary policies pushed up interest rates elsewhere but not in the banks. The result was a flight of depositors and a threat to the viability of banking which was used to win the deregulation that gradually paved the way for the problems of today. What became clear was that Glass-Steagall type of regulation of a privately owned banking system was internally contradictory. It would inevitably lead to deregulation. But as we know now such deregulation seems to inevitably lead back to nationalisation. So what capitalism needs for its proper functioning is a publicly owned banking system. That implies that the current move to "inevitable" nationalisation cannot be just "temporary" as Greenspan wants it to be.

What needs to be noted, however, is that nationalization is not the end of the matter. In addition, the UK government has chosen to guarantee all bank deposits, independent of their size, to prevent a run. It has also decided to guarantee inter-bank borrowing to keep credit flowing as when needed.

Once the UK decided to take this radical and comprehensive route, others were quick to read the writing on the wall. What followed was a deluge. Germany with an estimated bill of €470 billion, France with €340 billion, and other governments with as yet unspecified amounts pitched in, with plans to recapitalize banks with equity injections, besides guaranteeing deposits and inter-bank lending. The banking system was being saved through State take-over, not just with State support.

Finally, the US, which was seeking to avoid State acquisition fell in line, but in a form the shows the influence that Wall Street exerts over the Treasury. It too has decided to use much of the $700 billion of bailout money to acquire a stake in a large number of banks. Half of that money is to go to the nine largest banks, such as Bank of America, Citigroup, Wachovia and Morgan Stanley. The minimum investment will be the equivalent of one per cent of risk-weighted assets or $25 billion—whichever is lower. With capital adequacy at a required 8 per cent, this is indeed a major recapitalisation. Further the government, through the Federal Deposit Insurance Corporation, is guaranteeing all deposits in non-interest bearing accounts and senior debt issued by banks insured by the FDIC.

However, Wall Street's influence has ensured that this intervention is biased in favour of Big Finance. The support comes cheap: banks will pay a dividend of just 5 per cent for the first five years, only after which the rate jumps to 9 per cent. During that time, they have the option of mobilising private capital and buying out the government. Interestingly, the government is not taking voting rights and would be able to appoint directors only if the bank misses dividend

payments for six quarters. While there are restrictions on payment of dividends to ordinary shareholders before clearing the government's claims and limits on executive compensation, the government only reserves the right to convert 15 per cent of its investments into common stock. In sum, the American initiative overseen by Henry Paulson, an old Wall Street hand from Goldman Sachs, has virtually cajoled the banks to accept a government presence, unlike what seems true in the UK and Europe.

Whether it is occurs in part-punitive fashion or as a sop, the back-door takeover of major private banks is a desperate attempt to stall the financial meltdown in the advanced economies resulting from the decision to allow private financial players unfettered freedom to pursue profits at the expense of all else. That threat has forced governments to drop their neo-conservative bias against State ownership and markets that hollered at government intervention in the past have now applauded such action.

Fall-out for the real economy

However, the threat of recession has not receded. Even if the banks are safe, though there is no definite guarantee as yet, there are many other institutions varying from hedge and mutual funds to pension funds that have suffered huge losses, both from the subprime fiasco and the stock market crash, eroding the wealth of many. Moreover, housing prices are still falling sharply. The effects of that wealth erosion on investment and consumption demand are only now unravelling, indicating that there is much to be told in this story as yet.

The crisis had a number of consequences in the developed countries. It made households whose homes were now worth much less more cautious in their spending and borrowing behaviour, resulting in a collapse of consumption spending. It made banks and financial institutions hit by default more cautious in their lending, resulting in a credit crunch that bankrupted businesses. It resulted in a collapse in the value of the assets held by banks and financial institutions, pushing them into insolvency. All this resulted in a huge pull out of capital from the emerging markets: Net private flows of capital to developing countries are projected to decline to $530 billion in 2009, from $1 trillion in 2007 (World Bank 2008). The effects this had on credit and demand combined with a sharp fall in exports, to transmit the recession to developing countries. All of these effects soon translated into a collapse of demand and a crisis in the real economy with falling output and rising unemployment. This is only worsening the financial crisis even further.

As 2008 entered its final month, predictions of where the world economy is heading turned dire. The World Bank projected world output to grow by a mere 0.9 per cent in 2009 (as compared with 2.5 per cent in 2008 and a high of 4 per cent in 2006) and world trade to contract by a significant 2.1 per cent (compared to positive rates of growth of 6.2 per cent in 2008 and a high of 9.8 per cent in 2006).. Moreover, the World Bank could identify no possible driver for a recovery in the coming months.

The independent agency which is the more widely accepted arbiter of the cyclical position of the US economy is the Business Cycle Dating Committee of the National Bureau of Economic Research (2008). This committee, which adopts a more comprehensive set of measures to decide whether or not the economy has entered a recessionary phase, has announced that the recession in the US economy had begun as early as December 2007. At the time of writing (March 2009) there is no clear end in sight.

The lessons

What then are the lessons to be learnt? To start with, it is clear that when private players make financial decisions, limited interventions such as accounting standards, disclosure norms, behavioural guidelines and capital adequacy requirements, are inadequate restraints on the extent

of risk accumulation in the system. The financial meltdown triggered by the sub-prime mortgage crisis has changed the terms of the debate over financial regulation, offering an opportunity for major, even radical, reform. We can, therefore, think of elements of a new regulatory structure that goes beyond what seemed feasible thus far.

At the centre of the Basel framework was a set of beliefs on how financial markets functioned and therefore should be regulated. The first of these was that if norms with regard to accounting standards and disclosure were adhered to, capital provisioning, in the form of an 8 (or more) per cent capital adequacy ratio, was an adequate means of insuring against financial failure. Second, capital adequacy would work if it is specified that the relative size of regulatory capital be based not on the actual value of assets but on a risk-weighted proxy of that value, where risk was assessed either by rating agencies or by the banks themselves by using complex algorithms. Risk-weighting was expected to achieve two results: it would inflate the size of regulatory capital required as the share of more risky assets in the portfolio of banks rises; it would discourage banks from holding too much by way of risky assets because that would lock up capital in forms that were near-barren. Third, this whole system was expected to be even more secure if the market was allowed to "innovate" and generate instruments that helped, spread, insure or hedge against risks. These would include derivatives of various kinds, including the collateralised debt obligations and credit default swaps that were at the centre of the subprime mortgage-linked financial crisis. Fourth, use of this kind of framework was seen as a way of separating out segments of the financial system that should be protected from excessive risk (for example, banks, in which depositors trusted their money) and those where sections which could be allowed to speculate (high net worth individuals) can legitimately do so (through hedge funds, private equity firms, and even investment banks)

Implicit in these beliefs was the idea that markets, institutions, instruments, indices and norms could be designed such that the financial system could regulate itself, getting off its back agencies that imposed structural and behavioural constraints to ensure the "soundness" of the financial system. The intervention of such agencies was seen as inimical to financial innovation and efficient provisioning of financial services. There was an element of systemic moral hazard involved here. If the system is seen as designed to self-regulate and is believed to be capable of self-regulation, then any evidence of speculation would be discounted. In fact, it would be seen as a legitimate opportunity for profit, leading to responses that reinforce such speculation.

If there are no structural and behavioural constraints, such as the restrictions on cross-sector activity put in place by Glass-Steagall, financial firms find ways of increasing profits by circumventing regulation. One form that took was the transition in banking from a buy-and-hold to originate-and-sell strategy, which allowed a geographically extensive banking system to create credit assets far in excess of what would have been the case in a more regulated system. This had a number of implications. First, the role of banks as mere agents for generating the credit assets that could be packaged into products meant that risk was discounted at the point of origination, since banks felt that they were not holding the risks even while they were earning commissions and fees. Their capital adequacy requirements did not constrain the overhang of risk in the system they created, making Basel a poor instrument to control systemic risk exposure. Second, a risk-weighted CAR based on either ratings by private firms or internal models really meant that this regulation could be diluted by 'obtaining' a high rating on assets that were risky. That this did happen is reflected in the fact that highly rated assets were rendered worthless in a short period when the crisis began. Third, the transition in banking meant that though banks were important from the point of view of depositors and real economy borrowers looking for short term capital, other segments of the financial system became as or more important within the overall financial structure. The Wall Street investment banks, which epitomised financial innovation, were not banks in the conventional sense and were therefore lightly regulated and not subject to the kind

of capital adequacy requirements applicable to banks. They, along with the hedge funds, private equity firms and insurance companies, came to occupy crucial intermediary positions within the financial system. Moreover, the circumvention of regulation resulted in banks, which were in search of higher returns, exposing themselves to these institutions involved in more risky and highly leveraged operations. This damaged the belief implicit in the Basel framework that regulation of banks is regulation of the core of the financial system and that guidelines which treated banks differently so as not to expose ordinary depositors to high risk were effective in cordoning off the banking sector.

Fourth, the thirst for profit meant that the earnings of top managers were linked to the (accounting) profits their firms made, through bonuses that exceeded salaries. As a result, the appetite for risk among private decision-makers increases tremendously. What was introduced as an incentive for performance became an incentive to speculate. Fifth, so long as fully private players adopted these aggressive strategies, even government sponsored entities and public banks had to follow this route if they were not to lose their business to private players. Public or quasi-public ownership became meaningless from the point of view of regulating behaviour. Nothing illustrated this more than the fate of Fannie Mae and Freddie Mac. Sixth, the freedom to innovate resulted in maturity mismatches in the system, as was true for example of auction rate securities which used liquid short term funding for long term purposes. When liquidity froze, those who were convinced that they were holding liquid securities found them to be illiquid, worsening the crisis. That is innovation increased the areas of vulnerability. Finally, capital adequacy proved meaningless when the crisis came because losses stemming from this structure of asset holding were adequate to wipe out the capital base that had been provided for by many banks, necessitating equity infusion and nationalisation.

The way ahead

These lessons from the ongoing financial crisis make clear that the accumulation of risk and the manufacture of crisis are inevitable in a private-led, deregulated financial system that makes short term profits the prime objective. Limited intervention cannot fundamentally alter financial behaviour to avoid such an outcome. When financial markets are left unfettered, the system goes through a sequence of events that inevitably generate a financial and real economy boom that soon goes bust. Strong regulation is called for. One form that such regulation can take is that put in place since the passing of the Glass-Steagall Act. This in itself may not be a full solution today, and there could be contexts where a degree of financial integration could play a role. In particular, countries which want to use the financial structure as an instrument to further broad-based growth may need to opt for universal banks that follow unconventional lending strategies, when compared with the typical commercial bank. Many years ago Gerschenkron had pointed to the role which certain institutional adjustments in the financial sector played in the success of late-industrialisers like France and Germany. Basing his arguments on the roles played by Crédit Mobilier of the brothers Pereire in France and the 'universal banks' in Germany, Gerschenkron (1962) argued that the creation of "financial organisations designed to build thousands of miles of railroads, drill mines, erect factories, pierce canals, construct ports and modernise cities" was hugely transformative. Financial firms based on the old wealth were typically in the nature of rentier capitalists and limited themselves to floatations of government loans and foreign exchange transactions. The new firms, were "devoted to railroadisation and industrialisation of the country" and in the process influenced the behaviour of old wealth as well.

As Gershcenkron argued: "The difference between banks of the credit-mobilier type and commercial banks of the time (England) was absolute. Between the English bank essentially designed to serve as a source of short-term capital and a bank designed to finance the long-run investment needs of the economy there was a complete gulf. The German banks, which may be

taken as a paragon of the type of the universal bank, successfully combined the basic idea of the credit mobilier with the short-term activities of commercial banks." (Gerschenkron 1962: 13).

The banks according to Gerschenkron substituted for the absence of a number of elements crucial to industrialisation: "In Germany, the various incompetencies of the individual entrepreneurs were offset by the device of splitting the entrepreneurial function: the German investment banks—a powerful invention, comparable in economic effect to that of the steam engine—were in their capital-supplying functions a substitute for the insufficiency of the previously created wealth willingly placed at the disposal of entrepreneurs. But they were also a substitute for entrepreneurial deficiencies. From their central vantage points of control, the banks participated actively in shaping the major—and sometimes even not so major—decisions of the individual enterprises. It was they who often mapped out a firm's paths of growth, conceived far-sighted plans, decided on major technological and locational innovations, and arranged for mergers and capital increases." (Gerschenkron 1968: 137).

An opportunity in the current bail-out

Thus, setting up Chinese Walls separating various segments of the financial sector may not be the best option. Nor could investment banks and hedge funds be abolished. What could however be done is to monitor investment banks and hedge funds and subject them to regulation, while seeking an institutional solution that would protect the core of the financial structure: the banking system. Fortunately, the current bail-out has provided the basis for such a transformation by opting for state ownership and influence over decision making.

Can this be an important step in shaping an alternative regulatory structure in developing countries, in particular? Public ownership of banks could serve a number of overarching objectives:

- It ensures the information flow and access needed to pre-empt fragility by substantially reducing any incompatibility in incentives driving bank managers, on the one hand, and bank supervisors and regulators, on the other. This is a much better insurance against bank failure than efforts to circumscribe its areas of operation, which can be circumvented.
- By subordinating the profit motive to social objectives, it allows the system to exploit the potential for cross subsidization and to direct credit, despite higher costs, to targeted sectors and disadvantaged sections of society at different interest rates. This permits the fashioning of a system of inclusive finance that can substantially reduce financial exclusion.
- By giving the state influence over the process of financial intermediation, it allows the government to use the banking industry as a lever to advance the development effort. In particular, it allows for the mobilization of technical and scientific talent to deliver both credit and technical support to agriculture and the small-scale industrial sector.

This multifaceted role for state-controlled banking allows policies aimed at preventing fragility and avoiding failure to be combined with policies aimed at achieving broad-based and inclusive development. Directed credit at differential interest rates can lead economic activity in chosen sectors, regions and segments of the population. It amounts to building a financial structure in anticipation of real sector activities, particularly in underdeveloped and under-banked regions of a country.

The importance of public ownership to ensure financial inclusion cannot be overstressed. Central to a framework of inclusive finance are policies aimed at pre-empting bank credit for selected sectors like agriculture and small-scale industry. Pre-emption can take the form of

specifying that a certain proportion of lending should be directed at these sectors. In addition, through mechanisms such as the provision of refinance facilities, banks can be offered incentives to realise their targets. Directed credit programmes should also be accompanied by a regime of differential interest rates that ensure demand for credit from targeted sectors by cheapening the cost of credit. Such policies have been and are still used in developed countries as well.

Credit pre-emption, aimed at directing debt-financed expenditures to specific sectors, can also be directly exploited by the state. In many instances, besides a cash reserve ratio, the central bank requires a part of the deposits of the banking system to be held in specified securities, including government securities. This ensures that banks are forced to make a definite volume of investment in debt issued by government agencies. Such debt can be used to finance expenditures warranted by the overall development strategy of the government, including its poverty alleviation component. Beyond a point, however, these roles have to be dissociated from traditional commercial banks and located in specialized institutions.

Inclusive finance of this kind inevitably involves the spread of formal financial systems to areas where client densities are low and transaction costs are high. Further, to ensure sustainable credit up-take by disadvantaged groups, interest rates charged may have to diverge from market rates. This regime of differential or discriminatory interest rates may require policies of cross-subsidization and even government support to ensure the viability of chosen financial intermediaries. Intervention of this kind presumes a substantial degree of "social control" over commercial banks and development banking institutions.

It implies that "social banking" involves a departure from conventional indicators of financial performance such as costs and profitability and requires the creation of regulatory systems that ensure that the "special status" of these institutions is not misused. In sum, "inclusive finance" as a regime is defined as much by the financial structure in place as by policies such as directed credit and differential interest rates. To ensure compliance with financial inclusion guidelines, governments can use and have used public ownership of a significant section of the banking/financial system to ensure the realization of developmental and distributional objectives. This was recognized by governments in many countries in Europe, where banking development in the early post-World War II period took account of the vital differences between banking and other industries. Recognizing the role the banking industry could play, many countries with predominantly capitalist economic structures thought it fit either to nationalize their banks or to subject them to rigorous surveillance and social control. France, Italy and Sweden are typical examples in this respect. Overall, even as late as the 1970s, the state owned as much as 40 per cent of the assets of the largest commercial and development banks in the industrialized countries (United Nations, 2005). An example of a more recent successful transition to inclusive finance through nationalization of a significant part of the banking system is India post-1969.

Public Ownership and Inclusive Finance in India

India's achievements with regard to financial sector development after bank nationalisation have been remarkable. There was a substantial increase in the geographical spread and functional reach of banking, with nearly 62,000 bank branches in the country as of March 1991, of which over 35,000 (or over 58 per cent) were in rural areas. Along with this expansion of the bank branch network, steady increases were recorded in the share of rural areas in aggregate deposits and credit. From 6.3 per cent in December 1969, the share of rural deposits in the total rose to touch 15.5 per cent by March 1991 and the rural share of credit rose from 3.3 per cent to 15.0 per cent. More significantly, with the target credit-deposit (C-D) ratio set at 60 per cent, the C-D ratios of rural branches touched 64-65 per cent on the basis of sanctions. Sectorally, a major achievement of the banking industry in the 1970s and 1980s was a decisive shift in credit

deployment in favour of the agricultural sector. From an extremely low level at the time of bank nationalization, the credit share of the sector grew to nearly 11 per cent in the mid-1970s and to a peak of about 18 per cent (the official target) at the end of the 1980s.

Conclusion

This example illustrates the positive effects that public ownership can have in varying contexts. But this is not to say that this one advance can resolve the crisis and guard against future instances. Unfortunately, efforts are already on to prevent such a direction in policy. In November 2008, Nout Wellink, Chairman of the Basel Committee, announced plans to formulate "a comprehensive strategy to address the fundamental weaknesses revealed by the financial market crisis related to the regulation, supervision and risk management of internationally-active banks." "Ultimately, our goal is to help ensure that the banking sector serves its traditional role as a shock absorber to the financial system, rather than an amplifier of risk between the financial sector and the real economy," Wellink reportedly said. However, many feel that if we drop the hyperbole this amounts to nothing more than choosing to apply grease paint on a spent actor. By way of curtain raiser all that the Committee can offer are likely decisions "to strengthen capital buffers and help contain leverage in the banking system arising from both on- and off-balance sheet activities." According to the Committee's press release, the key building blocks of the strategy would include:

• Strengthening the risk capture of the Basel II framework (in particular for trading book and off-balance sheet exposures);

• Enhancing the quality of Tier 1 capital;

• Strengthening counterparty credit risk capital, risk management and disclosure at banks; and

• Promoting globally coordinated supervisory follow-up exercises to ensure implementation of supervisory and industry sound principles.

In short, more of the same, perhaps with a new title such as Basel III. Coming after a crisis that showed that the Basel framework is no insurance against a crisis and in fact contributes to precipitating it by permitting banks to operate with inadequate reserves, this is an unconvincing response at best. In fact, many see it as a manoeuvre to avoid much-needed reregulation. Others see it as an exercise to salvage the Basel framework, which some policymakers have demanded should be scrapped.

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