How much have we learned 10 years on from the banking crash?

Most commentators and bankers now accept that big mistakes were made in the middle of the last decade allowing commercial banks and investment banks to borrow too much money, to lend too much money out to people and companies, and to develop too many clever financial products that recycled the debts around the market. The favourite excuse at the time was the globalisation of markets and the creation of mega banks allowed them to run more overall risk, because it was spread over so many different instruments, currencies, jurisdictions and borrowers. Those of us who worried about these things were told we did not understand how good financial markets and banks had become at spreading and managing risk.

As it turned out, the older idea that a bank should keep a decent amount of cash and reserve capital against future losses was a better one. That has now become fashionable again, with banks typically required to keep more than twice as much cash and capital as they did at the peak of the boom relative to their risk assets or loans, with many of them choosing to have rather more than the minimum.

Fewer commentators accept that a second important mistake was made in 2007-9 by the Central banks and government authorities. They decided to raise rates and reduce liquidity in the markets too much, bringing down the over exposed balance sheets by deflating them too quickly. If Central banks withdraw cash from the market, it lowers the value of assets like property and shares. These are the backing for loans banks have advanced. As they fall in value so the solvency of the borrower is put at risk. As interest rates rise, so more people and companies struggle to pay their debt interest. Banks end up with a pile of bad loans and insufficient collateral or backing to meet the losses on the loans.

For a period of unreality in 2007 many were talking about a necessary correction for the masters of the universe in finance who they thought deserved to lose, in the belief that this could occur without harming the “real economy”. As a few of us warned at the time, bringing the excesses of the financial sector down would also bring down the real economy, closing a factories, collapsing businesses, costing people their non financial sector jobs. So it proved. The corrections, administered by the authorities in the first instance, soon became self fuelling. The advanced countries affected entered a severe depression.

The Finance Ministers and Central banks awoke to the full dangers early in 2009 and started to make large amounts of cash available to the markets to prevent more banks and other businesses failing. They went on to pioneer programmes of state money creation and government bond buying, as their way of replacing the money destroyed in the commercial banking crunch with public money issued via the Central banks. It was better than nothing. It lifted asset prices, which prevented more bad loans and failed banks.

The Central banks are now discovering that it is easy to distort economies by providing cash to boost asset values, but more difficult to wean an economy off such medicine. The USA is furthest advanced in this cause. It stopped money printing the earliest, and is now planning a gradual reduction in this stimulus as commercial banks take up the slack and as more real activity takes place. The UK has also now stopped QE, though it had an additional programme which was started last summer. The European Central Bank and the Japanese Central Bank still carry on with their Central Bank money creation.

One of the crucial lessons of 2007-9 must be that acting too stridently can cause grave damage. If you have high levels of debt, you need to tread carefully to get them down, in ways which most borrowers and lenders can handle. Any other course causes major dislocation for people who had nothing to do with the excess credit in the first place.