Don't knock the system: politics caused this crisis of capitalism

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With turmoil in the world's markets, politicians and commentators have been demanding more regulation and control of the financial sector. Their reaction is entirely predictable--but entirely wrong.

This crisis was not caused by capitalism being fatally flawed. It was caused by politicians forcing the banks to give out bad loans, monetary authorities flooding the West with cheap credit and regulators being asleep at the wheel.

Indeed, one can date its origin precisely, to 12 October 1977, when US President Jimmy Carter signed the “anti-redlining” law. Before then, lenders generally denied loans to people in poor neighborhoods, believing that the local mix of low incomes and a weak housing market would lead to many people defaulting. But the politicians--with good intent--wanted to make home ownership available to all Americans. So lenders were forced into giving out risky mortgages: what we now call “sub-prime” loans.

By 1985, this torrent of bad business had nearly bankrupted America's Saving & Loan institutions. So the government took on their bad debt and encouraged them to consolidate--unwittingly making them too big to be allowed to fail.

Meanwhile, several other problems worried the monetary authorities. In 1987, the US stock market plummeted, fearing that other lenders could collapse. Asia's markets sank. Mexico, Argentina and even Russia defaulted on their loans. Over-valued dotcom stocks crashed. And then there was 9/11. Each time, the Western authorities responded by flooding the markets with cash.

After 9/11, the Federal Reserve took US interest rates down from 6.25% to just 1%, fearing this blow to investor confidence could sink the markets. But again, their action boosted the wrong market by sustaining the credit bubble. With loans now six times cheaper, mortgage applications soared. Lenders, awash with the Fed's cash, happily issued more sub-prime loans. With more people buying homes, house prices soared. Buying a house seemed a certain money-maker, so more people got more loans and bought more houses, continuing the spiral.

Over the last ten years, Gordon Brown's government has been spending well beyond its means. The difference has been funded by borrowing--an extra £280bn of it injected into our economy, equivalent to £10,000 per household.

Meanwhile, with China and other parts of the newly globalized world sending us cheap goods, prices should have been falling. But the Bank of England has kept interest rates low, happy to see inflation at its 2% target. Low interest rates prompted us all to take out mortgages and buy houses, which then went up in price, making us think we were rich and could afford even bigger credit-card bills. Personal indebtedness soared.

So for ten years, economies boomed, the champagne flowed and everyone had a great party. But it was financed by fake money--printed by the authorities solely to keep the party going. When the dawn of realization broke, the long party turned into the inevitable hangover we suffer today.

The regulators, meanwhile, were unconscious on the floor. The US mortgage institutions, Fannie Mae and Freddie Mac, had 200 regulators on their case but still went bust for US$5 trillion. These semi-governmental companies allowed investors to believe the bad mortgages were guaranteed by government, causing credit rating agencies to give their dodgy bonds high scores.

Mortgage lenders re-packaged these bad debts round the world but nobody cried foul. Institutions were lending thirty times their asset base. Though the Bank of England knew that the huge mortgage lender Northern Rock was failing, the 2,500 staff of the Financial Services Authority seemed to do nothing until it actually collapsed six months later. Even then, they, the Treasury and the Bank had no coherent plan.

When the government is persuading the casino to hand out free chips and the regulators are standing drinks at the bar, you shouldn't be surprised if the customers place a few risky bets. It's the management and not the system that deserves our scorn for breaking the basic rules of economics: there ain't no such thing as a free lunch.

Any sustainable solution has to get finance back to those basics. But the US bail-out package includes so many treats for special interests that it could save the culprits without helping the victims.

But it's a big world out there. China, now the world's fourth biggest economy, continues to grow at nearly 10%. India and other emerging economies are expanding too. Even with the West in recession, world growth next year will probably be near 4%. That's pretty good.

Western capitalism has been dealt a severe blow by inept politicians and officials. But global capitalism continues to pull hundreds of millions of people out of poverty. It's a great system. Let's not break it.

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