EC11/35

THE ROYAL ECONOMIC SOCIETY

Report of the 2011 Young Economist of the Year Competition

For the 2011 essay competition the titles chosen by the Royal Economic Society President and judges were:

1. "Is the rise of China good for America and Europe?"
2. "Has recent government policy towards banks reduced the chance of another big financial crisis - or increased it?"
3. "Would a 'fat tax' be an effective policy to counter obesity?"
4. "An NHS free at point of access is unsustainable in the 21st century and an alternative funding model is needed." Discuss
5. "Should governments go for growth or for happiness?"

From the final shortlist of essays drawn from a total entry in excess of five hundred, the judging panel of Professor Richard Blundell (RES), Charles Bean (Bank of England) and Stephanie Flanders (BBC) have selected three winners and wish to congratulate them all. The overall standard continues to be very high, with many schools entering the best essays after holding internal competitions.

A list of highly commended entries and also a list of the schools and colleges from the UK and overseas that joined in for the 2011 competition is published on the Tutor2U website.

This year the judges agreed that the best essay was **“Is the rise of China good for Europe and America” by Mayank Banerjee.**
The judges found this to be a brilliantly crafted essay displaying clear insights from well-organized economic reasoning. The essay is founded on a sound understanding of the economic history surrounding the development of China’s economy. Examining, in particular, different theories explaining the high saving rate, the savings rate, coupled with the Chinese demand for foreign currency reserves, is used to explain low bond yields and an increased demand for complex financial instruments. Despite the recent move toward domestic consumption in China, the implications for rising prices and rising borrowing costs leave many difficulties ahead for Europe and America. The essay concludes that there are potential positive aspects for the West from the increased demand for consumer exports and the impact on new ideas and productivity stimulated by the rise in Chinese human capital.
‘A thoroughly deserving winner of the RES 2011 Young Economist Competition.’

David Alam was awarded second place for his essay discussing “**An NHS free at the point of access is unsustainable in the 21st century and an**

alternative funding model is needed". This was a well-argued essay which set out to diagnose the NHS as a "special patient" born in the baby boom and now unable to deal with the ageing population. It provides an extremely good use of economics is assessing role of a market mechanism in health service provision. Using moral hazard arguments together with evidence from Europe and North America it rejects free market provision and makes a strong case for social insurance as a sustainable future funding model. This perceptive essay stands as an important contribution to the debate on the future of the NHS.

In third place was **Daniel Turner** who tackled "**Has recent government policy towards banks reduced the chance of another big financial crisis – or increased it?"**
The judges felt that this essay provided a clear understanding of the role of the financial sector in the effective running of the economy while providing a perceptive analysis of the key problems of self-regulation in the lead up to the financial crisis. There is a careful examination of financial securities as a means of spreading risk and the growth of CDOs. The essay argues that misaligned incentives encouraged banks to give mortgages and loans to those with dubious credit ratings. In addition to the internal separation of banking activities, a case is made for more radical reform, further strengthening current legislation to curb cash bonuses and requiring higher equity ratios.'

The 2011 Young Economist of the Year is therefore **Mayank Batterjee** of Dame Allan's Sixth Form, Newcastle Upon Tyne, who will receive the trophy and prize of £1,000. Second place goes to **David Alam** of Queen Elizabeth's Oakwood, Barnet and third place to **Daniel Turner** of Nottingham High School who receive £500 each. All three are invited to an award ceremony before the RES annual public lecture in London on 14 December and their winning essays will be published on the RES website.

Richard Blundell, Charlie Bean, Stephanie Flanders,

August 2011.

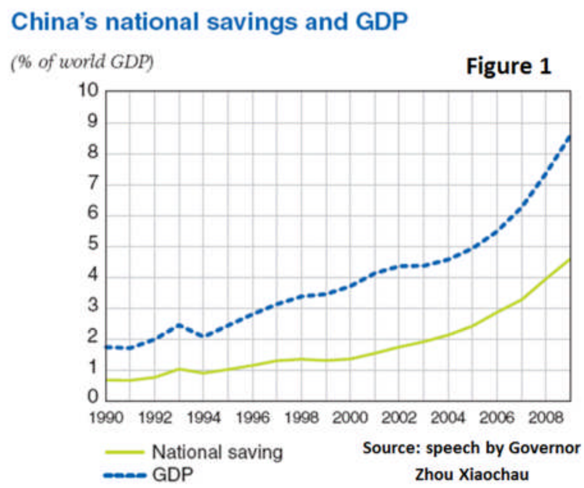
Question 1: Is the Rise of China good for Europe and America? By Mayank Banerjee

'Let her sleep, for when she wakes, she will shake the world' – Napoleon Bonaparte on China, 1803

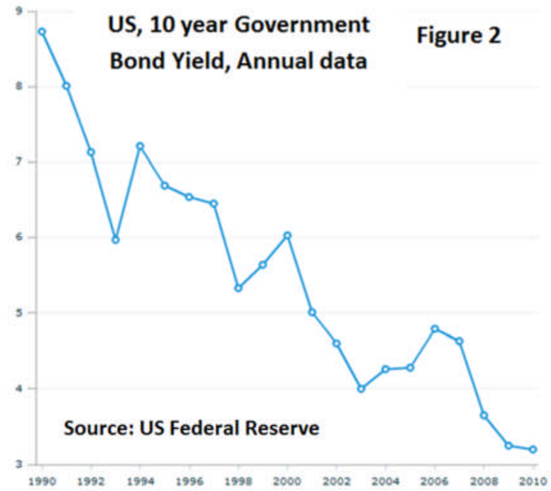
You have just been made redundant. Having worked on the factory floor all of your adult life, distant company directors in London have acted in the company's 'best interests', moving all production to China. Unsurprisingly, you are outraged. You know you are just another name to add to the thousands already forced to the steps of the jobcentre, but that does not lessen the pain. Still, as you stumble home dazed, you hope for at least a little respite from your own troubled thoughts. Yet, in all probability, the tea you drink would have been grown in the Yunnan region of China, you would watch a TV made in an industrial estate near Shanghai, and all the while you would silently curse the very workers whose low wages mean that you can afford the half price sofa you sit on.

The irony of this situation is one which can be seen repeated from Durham to Detroit, and illustrates the paradox at the heart of the West's relationship with the world's most populous country. On the one hand, both Europe and the US already have economies heavily dependent on the Chinese, yet politicians constantly fret about maintaining their economic supremacy over Beijing. With China recently overtaking Japan as the world's second largest economy, many feel we have reached a Rubicon for the West and its future economic role in the world, as one thing at least seems certain; China has finally awoken.

Arguably the most important impact of the Chinese economy is one which rarely merits a mention in the mainstream media. The Chinese national savings rate has hovered around 50% for much of the last decade, being in sharp contrast to the negative savings rate that America has had in recent years. This high propensity to save can be attributed to a number of reasons, from crude capital markets forcing firms to retain earnings to finance further investment to the relative scarcity of women in China forcing young males to concentrate on wealth accumulation to attract a spouse. Franco Modigliani's view that China's one child policy in the 70's distorted the cultural expectations of parents, who felt they could no longer rely on their offspring to provide for them in their old age, and therefore encouraged them to save more to insure themselves seems a particularly simple but likely explanation. Whilst the reasons for the high rate may be contentious, its impact cannot be denied; when the Chinese economy underwent rapid economic growth through the 2000s, its high savings rate meant that its proportion of total world savings also grew markedly, as did the volume of savings itself (**Figure 1**). This, as Ben Bernanke described during his 2005 speech on the



‘Global savings glut’, meant that in effect too many savings were chasing too few investment opportunities. When combined with Beijing’s decision to increase their foreign currency reserves by buying dollar, euro and sterling denominated sterling debt; this meant



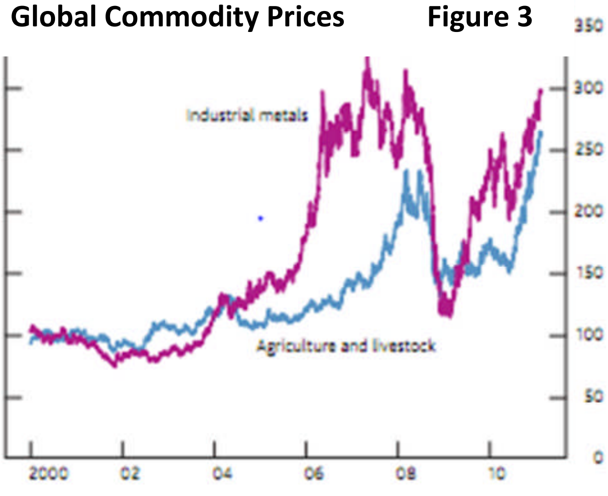
that bond yields, particularly on Western government securities **(Figure 2),** were reduced. Investors were now forced into ever more risky and complex financial instruments to make the same profits, with a particularly notable example being mortgage backed securities and derivatives in the US subprime market. Needless to say, this did not prove to be in the best interests of the global economy and explains why economists such as Mervyn King believe that the best long term method to combat financial crises in Western economies may be to rebalance the global economy, rather than rely on banking regulations.

On the surface then, Hu Jintao’s recent statements that suggest that the primary focus of the next Chinese 5 year plan will be to shift the task of driving future economic growth onto domestic consumption, seem a positive step forward. By trying to ‘promote global trade balances’ it seems the Chinese may already be doing their part to avert another crisis. However, a desire for a more balanced global economy comes with an important caveat for the Western world. It seems inevitable that, in the future, as the Chinese consume more domestically; their savings rate will fall. Without the same levels of savings, Beijing would be unable to continue to be a major buyer of EU and US government debt, thereby raising gilt yields across the West. Whilst the worst case scenario may come in the form of a major sovereign debt crisis, the recent Basel 3 regulations seem to encourage banks to invest in gilts due to their low risk ratings, suggesting that in the long term, governments will be able to consolidate debt when required, albeit at a higher cost. A more pressing concern is the link between low gilt yields and low corporate borrowing costs suggesting that if the costs of borrowing for governments rise, a similar increase can be expected in costs for businesses. This impact may also be passed through to the consumer via increasing mortgage rates, and so it is not hard to envisage a scenario where a falling Chinese savings ratio indirectly leads to western consumers being forcibly weaned off the ‘cheap’ credit to which they have become accustomed. Undoubtedly, this would act as a major impediment on economic growth, particularly as so many Western economies are already heavily dependent on consumer demand.

This view does seem to suggest that Europe and the US may have to change their model of economic growth, placing more emphasis on increasing net exports to make future growth sustainable. Unfortunately, out of the major Western countries, only Germany can be said to have a significant percentage of its growth coming from exports, and even the Germans benefit from using a Euro which is significantly weaker than its Deutschmark alternative would have been. The service sector, often the main contributor to GDP in Western economies, seems unlikely to be able to increase exports significantly, as most countries already run vast current account deficits, suggesting that the sector cannot be relied upon for increasing exports. Therefore, it seems that manufacturing, which is only around 13% of GDP in a country like the UK, may become more and more important to Western economies. Furthermore, due to the lower unit costs in emerging economies such as China, this newly improved manufacturing sector will have to be based around high tech capital, rather than the low value goods in which the emerging economies currently specialise. Yet, even here, there is a threat that the speed of Chinese growth could make this shift a futile one. Even if we ignore the painful consequences of such a significant change in the structure of the economy, it is a process likely to take decades. Considering that the country with the greatest number of university graduates in the world is actually China, and with the vast majority of these degrees being in STEM subjects, it seems that any technological advantage that the West may be able to build will be short lived. It is certainly not farfetched to imagine that by the time Western economies have switched their economic model to focus on high tech manufacturing, the Chinese will already be producing similar products, possibly even at cheaper unit costs, assuming wage rates do not converge as quickly as the comparative quality of human capital.

Clearly though, in order for the Chinese economy to get to a position to compete with the likes of Germany's mittelstand's, it will require vast amounts of resources. The Chinese have already embarked on the period of industrialisation on an unprecedented scale and its demand for raw materials can only increase. Already, China is close to overtaking the US in terms of energy usage and most economists would attribute to the last two major commodity price booms **(Figure 3)** on increased emerging market demand. With commodities being the vital building blocks for any economy, it seems likely that fast economic growth for China may also be accompanied by high inflation as the recent figure of 5.3% would attest to. Significantly, this effect is unlikely to be limited to just China, although, the danger for the Western economies is that, in the short to medium term at least, they cannot expect anywhere near the same rates of GDP growth to accompany high inflation. Arguably, the rise of China could herald a period of stagflation for the West as spiralling prices combine with weak post recessionary growth, leading to falling living standards. Looking even further

Global Commodity Prices **Figure 3**



Sources: Standard & Poor's and Thomson Reuters Datastream.

into the future, when consumer demand can be expected to recover, it seems that the 'Great moderation' years may yet be replaced by a higher inflationary world.

On the surface then, the rise of Chinese economy may come at the expense of those in the West. Consumers may have to tighten their belts just as the Chinese finally loosen theirs, and the structural change required in order to stay competitive is unlikely to be pleasant, particularly for those who find themselves unemployed. However, there is one possible benefit, which in the long run, may prove to outweigh all the potential costs combined. One point, sometimes made about the rapid economic growth being undergone by most emerging economies is that, it would be impossible without copying Western advances in science and technology. Whilst undoubtedly true, the fact remains that the Chinese economic boom has already helped to raise hundreds of millions above the poverty line. It stands to reason that as the Chinese economy grows, standards of living will start to converge with their richer counterparts in the Western world. Even if we ignore the social and moral benefits of this move, it is likely to herald an explosion of growth through technological innovation, as more than anything, the driver of real economic growth will always be improvement in capital. The simple law of averages suggests that if the potential talent pool for new inventors and scientists is increased by the billions in the emerging economies, life changing discoveries are not just more likely, but almost inevitable. Furthermore, as argued by Alex Tabarrok, by adding hundreds of millions to the potential market, firms are incentivised by the knowledge that any small advancement could lead to significant profits and so should, in theory, become willing to invest in research and development in the first place. This combination could lead to a wave of new ideas and innovations flooding the world market in the coming years, and in all likelihood, those in the Europe and the US will benefit just as much as their Asian counterparts.

In conclusion then, China's seemingly inexorable rise has become an issue capable of sparking tensions across much of the western world and the US and Europe may have to resign themselves to a world where they are no longer the only economic superpowers. Trying to maintain some form of ascendancy may not only require fundamental changes in the way domestic economies function, but is likely to be futile in the long term, such is the sheer size and scale of the Chinese challenge. However, there is no need for the emerging economies and the Western ones to be economic adversaries. Admittedly, China's boom will cause fresh economic problems for the West although many of these can be attributed to underlying issues in the Western economies themselves; the Chinese cannot be blamed if many in the EU and the US have become used to living beyond their means. If the emergence of China is used as a catalyst by Western governments to address the structural faults in their own economies, we may yet be on the verge of another period of accelerated global economic growth, albeit one where there is a more equitable sharing of the benefits. Although Napoleon's giant may finally have awoken, we can certainly hope that it will be a friendly one.

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Whilst much of the material I researched whilst writing this essay was relatively readable as an 18 year A level student, unsurprisingly I struggled with certain elements in my research, particularly the economic papers. Although much of the maths in them may have sailed over my head, I hope that I managed to gain the gist of their ideas from the rest of the text. The reason I have referenced them is not because I fully understood the materials, but rather that the limited amount I was able to take on board proved vital when writing the essay.

Mayank Banerjee

2000 words excluding references and bibliography

David Alam

<u>"An NHS free at point of access is unsustainable in the 21st century and an alternative funding model is needed." Discuss</u>

Here she comes: the NHS. Trudging in from the waiting room and onto the doctor's bed. She's always been battling away but recently she's been poorly with something she can't seem to shake off. Like any good doctor, I need to assess the symptoms of her ailment before I am able to diagnose what her exact illness is. Then I will present to her alternative funding models as possible treatments before declaring what I believe the cure is.

So firstly who is my special patient? The National Health Service (NHS) was created in 1948, by Minister for Health Aneurin Bevan with the belief that 'the essence of a satisfactory health service is that rich and poor are treated alike'. [1] Given the poor health of the United Kingdom following World War II, Clement Atlee's government established her to safeguard the nation's wellbeing. Today the NHS remains free at point of access and employs more than 1.5 million people with almost 50% of staff being clinically qualified. [2] This makes the NHS the largest public sector employer outside China and firmly cements its place as a state monopoly provider of healthcare in the UK.

The NHS is nearing an age of 63 and such retirement in the UK is precisely one of the problems only really emerging in the 21st Century. One main symptom of the NHS being unsustainable is an ability to deal with the UK's ageing population. A baby boomer herself, the NHS is struggling to deal with a change in the demographics as those born in the late 1940s and early 1950s begin to end their career and become more dependent on the state for healthcare. The dependency ratio is calculated by the number of people of working age (16-64 years) to each person over 65. It is predicted to fall dramatically from 3.7:1 at the end of the 20th Century to only 2.1:1 in 2040 [3]. With medical advances and new treatments, the UK's life expectancy is increasing meaning the number of people suffering from debilitating diseases such as arthritis and dementia rises. The NHS' funding model means a surge in demand for carers and nursing services will overwhelm her.

Income tax receipts at around £150 billion is the biggest contribution to the Treasury meaning those of working age pay the most in taxes. [4] Yet with the dependency ratio set to worsen given more than a third of the UK's population will be over 55 by 2025, [5] fewer workers will be able to fund the increased NHS expenditure that will be needed to deal with health problems of an ageing population. Government policy on improving the NHS has simply been to give her more and more money, in the hope that a bigger input creates a better output. Sadly this is not the case. The Lancet medical journal provided compelling evidence to suggest that despite its size and budget, the NHS fails to be Europe's best health service. The UK has 8.2 MRI and CT scanners per million people whilst the European average is 11 and in the UK there are only 2.5 doctors compared to 3.4 in France. [6] Such statistics often lead to claims of inefficiency, but the problem is more than just that.

A diagnosis shows that her symptoms stems from two problems of services being over-demanded and that there is no price mechanism to allocate resources. Healthcare which is free at the point of access means there is no need to curb use of the NHS. Therefore there is no incentive for smokers or obese people to quit their unhealthy habits as they can always fall back on free healthcare. This leaves doctors and hospitals struggling to cope with the high amount of demand and hence healthcare provided for free on the NHS becomes over-demanded as resources become stretched. This situation of over-demand is caused by moral hazard because those with an unhealthy lifestyle know that free healthcare will always be provided by the NHS to deal with any illness and so the unhealthy patient has no incentive to change behaviour.

When high demand is coupled with no application of a price to ration such a service, it soon becomes the case that patients suffer from a distinct lack of choice with healthcare treatment. In a typical market, price acts as a signal to suppliers but since NHS treatment is free, it is left up to government planners to estimate how each particular service should be provided. The difficulty in quantifying performance of the NHS and determine which indicators to use underlines the complexity of NHS investment decisions. Inevitably this means either too much or too little funding is available for specific services. The result is that some services like providing cancer drugs will be underfunded resulting in queues and longer waiting lists for patients.

At present it is only the richest UK citizens who are able to do something about being fed up with unresponsive NHS resource allocation – they can afford private medical insurance. But it is the poorest in society who currently have a distinct lack of choice with their treatment as they cannot afford private healthcare and must wait in line for the NHS to hand out a share: this costs lives. The World Health Organisation calculated if the UK had the same cancer survival rates as the European average, it would save 10,000 lives a year; if the UK had the best in Europe, it would save 25,000 lives a year. [7] It is obvious that the very problem the NHS set out to solve of sub-standard healthcare for the poorest has not been addressed and is still prevalent. The NHS has limited pressure to improve its services as it knows the silent majority have to put up with it and only once every 5 years at elections do citizens get a chance to change healthcare policy. That is why I am diagnosing the NHS as having being deficient of competition and choice.

Current treatment for the NHS' ill health is ineffective by continuing to pour millions into her each year which only magnifies the funding, not necessarily the quality of care. The more radical option is privatisation. The typical approach to dealing with a lack of choice is to break up the monopoly and introduce private firms. However privatisation of the NHS to end poor choice would come at the cost of exploitation of patients due to asymmetric information. In a funding model used by America, people pay for their own private medical insurance and the government provides insurance through Medicare (for those aged 65 or over) and Medicaid (for those on low incomes). However this is far from comprehensive as in 2007 it let 45.7 million Americans go uninsured with no guaranteed access to healthcare treatment. [8] Once again, moral hazard for those with private medical insurance means over-demand persists since people have no incentive to curb demand for healthcare if an insurer is going to pay for the cost. Also under privatisation, the profit motive means doctors have a vested interest in providing unnecessary treatment. There is an incentive to prescribe expensive treatment as patients will not have the medical knowledge to realise if the treatment they are paying for is actually needed. Therefore the symptom of over demand is still not addressed by either increasing NHS funding or privatisation.

A cure can be found by looking across to Europe rather than to America. An alternative funding model has had success in the Netherlands, Switzerland and Germany by using compulsory insurance schemes under a system of funding known as social insurance. This system uses the principle that those who can afford to pay for healthcare do, and that those who cannot afford it or are in worst health are then given free access. This is because it is possible to guarantee fair access to all citizens without a monopoly providing a nation's entire health service. Access to health care, like access to clothing, is a necessity but this alone does not justify monopolist government provision. The government does not have to run fashion stores, for example, to ensure that the nation has clothes. It simply gives cash benefits to poor families so that they can buy their own shoes, clothing and other essentials. This funding model can be replicated for health.

The cure proposed is one of competing social insurance schemes that are independent of government. Similar to driving a car, health insurance will be compulsory for all citizens, and the social insurance companies would be banned from refusing membership to anyone so that insurers are unable to cherry pick the healthiest citizens and deny insurance to those who need healthcare the most. The amount someone pays for their insurance would be approximately linked to income, similar to progressive taxation, with the premiums for the richest being highest. Those that can show insurers evidence of a change in lifestyle to improve health will be able to lower their premiums. For the poorest who fall below a determined income threshold and for those with a long term illness who cannot afford the insurance cost for regular treatment, their premiums will be paid by the state. Some hospitals will be kept state-run but many can be managed by charities, trusts and non-profit private firms, as is the case in Switzerland. It is important that social insurers are banned from also being healthcare providers in order to prevent insurers forcing patients to be treated at a certain hospital for private gain. The government acts as a regulator by making sure that a minimum standard of patient care is upheld.

Social insurance will clear up the symptom of over-demand as people will have an incentive to improve their health so that they can then pay less for insurance. It also helps to deal with the problem of ageing demographics because it ensures that pensioner wealth inequality is recognised. Those who have retired with generous savings and can afford insurance premiums will contribute towards their own healthcare costs, rather than being dependent on the tax revenues of the working population. However, pensioners living in poverty still have the safeguard of the state paying for their social insurance. Under social insurance there is superior choice as patients can choose which social insurance scheme they join and which hospital treats them. This element of choice has indirect benefits as it means that competing social insurers will have to lower premiums in order to attract people and also hospitals will use the technologically most advanced treatment and provide the best quality of healthcare in order attract patient trust. Under-provision of certain services like cancer drugs or geriatric care ends because hospitals that do not offer the same services as others are likely to lose patients. Superior healthcare for the poorest of patients is also achieved. There is no longer a two-tier system where the poor are left with basic NHS treatment whilst the richest can afford private healthcare because under social insurance the poorest are part of the same insurance schemes as the richest and have the same access to health providers. That means the poor can receive the same quality of care, be treated by the same doctors in the same hospital with the same drugs and have the same waiting times as the richest.

If the 2008 recession was of a severity only witnessed once in a lifetime, then the opportunity in the recovery for NHS reform must also be treated as a once in a generation's chance to make sure that healthcare in the 21st Century is based on a more sustainable principle. Healthcare must be funded through a social insurance model to cope with an ageing population and to allow the very poorest of citizens equal access to the best medical treatment – something previously only available to the richest.

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Has recent government policy towards banks reduced the chance of another big financial crisis – or increased it?

The financial sector is a key component of an economy's institutional structure, and its effectiveness will be vital in building a fluid and dynamic economy to adapt to competition and foster innovation in an increasingly globalised world. However, the financial crisis of the late 2000s revealed exactly how flawed the faith in self-correcting and self-regulating markets was, and that the new Eden of an economy built on the basis of 'ersatz capitalism' with central government spending from the tax income it generated was only ever a castle built on sand. The focus for the financial industry and its regulators should now be introspective - to consider exactly what went wrong, and how such catastrophic systemic failures can be avoided in future.

In order to contextualise any policy, we must have a clear understanding of what purpose banking ought to serve in any reconstructed economy. Financial services remain an integral element of an economy's structure, providing private equity to both consumers and businesses, and thereby allowing for an allocation of finance which takes into account both the potential value of any entrepreneurial endeavour and the potential risk of defaulting by means of market mechanisms. Thus, the financial services have come to manifest themselves primarily through mortgages to private consumers and loans to businesses (allowing for immediate investment) and through investment banking, placing equity into the hands of the most successful corporations to the benefit of economy – finance finds its way to those who put it to best use, theoretically at least. Though not particularly exhilarating, this basic banking system helps to facilitate enterprise and manage risk within an economy. Moreover, the oft-cited argument from 'moral hazard' when intervening in financial markets is broadly irrelevant – their necessity is such that support in Britain has always been implicit (it becomes explicit elsewhere, such as regional state-banks in Germany).

Evidently, this was not the world of post-Big Bang banking. HSBC did not gain $2.5 trillion in assets via mortgage interest repayments and financial transaction fees alone. What marked the explosion of the financial services, particularly from the late-nineties onwards, was the growth in new 'financial instruments', nominally as a means of diversifying risk but in reality as the vehicle of 'casino capitalism'.

To go some way to understanding the workings of modern finance, let us consider some of these instruments. Securities had their roots in the late seventies. Effectively, banks would take an array of contractual debt (be it in mortgages, loans or credit card debt obligations), package them together as a collateralised debt obligation (CDO) and sell them on as bonds to other investors. As a means of spreading risk, these CDOs allowed for some mortgages to default, in the faith that the CDO as a whole would still be profitable. Rating agencies and investors alike had tremendous faith in their potential, with the standard rating becoming an AAA (even for CDOs containing numerous individual junk-status debt obligations). The real turning point came, however, when banks started to trade these CDOs internally. Overconfidence by rating agencies led to massive information asymmetries – banks knew they were simply repackaging bad loans and selling them on as if they were zero-risk, fuelling (justified) suspicion that other banks were doing the same and driving up the cost of trading in terms of fees and interest to cover unknown risk. The intellectual incoherency is obvious – CDOs were designed to diversify risk, but through poor rating practices and a new market in CDOs, risk was being passed between banks, with huge handling fees to compensate. The 'greater fool' hypothesis came into play, as banks hoped to get rid of their own risky investments by passing them onto other banks. Much the same can be said for a second tool, derivatives. Derivatives are effectively an 'insurance policy' – a bet that something will go wrong on an investment, allowing banks to claw back some of the costs if an investment does go bad (they are 'derived' from other investments). When banks began to trade these derivatives, however, especially derivatives taken out on CDOs or other tradable investments, they were effectively acquiring vested interests in the failure of some investments, driving up handling fees to cope with the risk in much the same fashion as with CDOs.

The inherent risk in the trade of derivatives and CDOs is easily demonstrated (trade introduced new risks, when the devices sought to minimise old risk), though the practice was widespread nonetheless. I take this to be another vindication of the theory of 'animal spirits' in markets, and of herd mentality. When one financial institution begins to trade in new financial goods, making massive profits and transferring their own poor investments from their own balance sheets to those of other banks (as well as other examples of so-called 'creative accounting'), profits soar and share prices climb with them. The principle-agent problem leads to this being replicated across the sector, as bank executives champion short-sighted pursuit of profit over long-term sustainability. What is clear is that the traditional aspects of banking – trade in loans and mortgages, delivering profit through sensible investments and interest payments – were little more than a sideshow. The main use of these traditional instruments was now to form the basis of CDOs with all their associated risks. This led in turn to misaligned incentives for banks to give mortgages and loans to those with dubious credit ratings, as the risk of doing so could be neutralised through CDOs and high fees could be charged on top, with maximum gain to banks and minimal gain to consumers.

These two tools, along with others, helped sow the seeds for the self-destruction of the financial sector in 2007/08. Cheap and easy credit created a property and asset bubble, made possible by the extremely risky intra-bank trade in tools designed (ironically) to diversify risk. 'Common sense' told regulators and financial agents alike that this process had been successful (sustained economic growth, massive profits). Bankers were labelled 'magicians'; the poster-boys of capitalism. Risk had not been diversified in any meaningful way, though; merely moved around within the sector itself. When property bubbles burst throughout Europe and the USA, CDOs (based predominately on mortgages) collapsed along with house prices. Billions of pounds of assets were wiped off of bank's books, and losses were compounded by derivatives forcing up the costs of banking even higher. To the banks not forced under by these losses (Northern Rock in the UK, for example), lending soon dried up (triggering a negative spiral into recession).

With this understanding, we may identify several key areas fundamental to preventing another crash in the future akin to this. Almost immediately, there were calls from various corners to break up commercial banking from its more risky investment arm. The implications of this for CDOs are huge – investment banks would no longer be able to trade in debt derived from their commercial arms. Secondly, public anger at executive bonuses was a manifestation of a clearly flawed incentive structure in banking – short-termism and unrealistically high profits had distorted the world view of bankers. The normal rules of the market, the same ones heralded by lobbyists pushing for deregulation, no longer seemed to apply. The policies pursued thus far in Britain seem to have been targeted at these two issues in particular.

As to be expected, the response by government has been particularly clouded by the political realities of a powerful financial lobby. Whilst government could take radical steps to increase the sustainability and effectiveness of banking, at the cost of profit, it is unlikely to do so, given both the over-reliance on tax receipts at the Treasury (particularly during the coming period of fiscal austerity) and the threat of a banking exodus. In the days prior to the interim report of Sir John Vicker's Banking Commission in April 2011, Barclays, HSBC and Standard Chartered all warned they would leave London for Zurich or Hong Kong if the government went too far in its actions.

We can identify two key policies unilaterally employed thus far in Britain. The first is the windfall tax on bonuses introduced by Brown's government, raising £3.5 billion last year. It is difficult to consider this policy anything more than a knee-jerk reaction to public outrage, little more than a fine and an assertion of the government's view that such bonuses highlighted the distorted sense of entitlement and incentives in the financial sector. There are few signs of any substantial change bought about by this policy. Furthermore, there is 'Project Merlin' - an agreement between the new Coalition government and the four largest banks in the UK - regarding increased lending to businesses and a curbing of bonus culture. Whilst this is a welcome step away from the high-risk high-return culture of the past decade, the cordial agreement is just that – an informal contract based on articles of faith between entrenched financial executives and a government driven by neo-liberal instincts regarding the efficiency of markets.

Perhaps the most promising piece of recent legislation (in terms of delivering lasting change) has been the European Parliament's actions to curb bonus culture. Bankers will now receive no more than 30% of their bonuses in cash immediately (20% for larger bonuses), with the rest being deferred or in shares. This policy reforms incentives to provide incentives for sustainable, long-term investments, substantially addressing the identified problem of short-termism. As a pan-European initiative, it also weakens the threat of relocation to centres such as Paris or Madrid.

The aforementioned interim report by the Independent Banking Commission provides interesting clues as to the future of any government regulation. The cornerstone policies advanced by Vickers are the internal separation of commercial and investment banking, whilst forcing banks to hold 10% of their assets internally at any given point. The internal separation of banking ought to be designed to prevent the trade in risky CDOs, and to allow for a collapse of investment banking without necessitating a collapse of commercial banking. This latter issue created the 'too-big-to-fail' dilemma for governments, forcing them to insure investments to protect savers. The 10% equity ratio (internationally agreed levels currently stand at 7%) is another interesting proposal. The higher levels of equity would provide a cushion for the banks to shoulder the cost of, in this case, 10% of its loans or investments going bad.

Vickers' suggestions do not, however, go far enough. The policy of internal separation of banking activities is vague (the cross-over between banking sectors is less black-and-white than it appears, such as with CDOs), and his suggestions for raising the equity ratios to 10%, limiting profits of banks, smacks of damage limitation rather than damage prevention. Responding to criticism, Vickers himself acknowledged this, claiming that his measures would 'reduce the scale and the scope' of any future interventions. The aim of any reform should be to *prevent* another crisis.

Lord Turner, chair of the Financial Services Authority gave a speech earlier this year in which he called for equity ratios of in excess of 20% (already seen in China), a complete break-up of banks and for an extreme increase in tax on investment banking, on the grounds that economic growth on the back of retail banking has been illusory, as it has provided 'no increase in the size of the economic cake for the rest of us' – effectively redistributing wealth to a narrow financial elite. The opinions expressed by Lord Turner and other senior regulators, notably Mervin King, underline support for more radical reforms. Short-termism and the pursuit of profit (espoused by mismanaged financial devices) led to the failure of financial markets, and prevented real effective development of the economy through effective lending to small business. No government policy addresses this yet, and avenues such as significantly more regulation (to ensure minimal lending standards) or direct provision via regional state-banks should not be ruled out. Current government policy may act to narrow the risk, but they do not remove it, justifying their actions with the same market dogma which led to financial collapse in the first place.

Word Count: 2,000

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