

Limits of regulation

The US economist JK Galbraith noted that '*Regulation outlawing financial incredulity or mass euphoria is not a practical possibility*'. Better regulation is essential. It should be targeted at financial leverage, since this is always the ultimate source of financial crises. However it will not ensure there will never be another financial crisis. Indeed, a survey of history leads to the conclusion that another crisis requiring taxpayer assistance is inevitable.

The need to take decisive action

The measures in the consultation document that help the authorities respond swiftly to circumstances that might lead to a financial crisis are useful. Ultimately however they will always rely on the exercise of judgement by one person, or a few people, in authority. It is easy to say now, with hindsight, that such people would be robust, market aware, and bold, acting with a long term perspective in mind. However, at times of financial euphoria the pressures are great and we are usually described as being in a 'new world' where the old rules no longer apply. In such an environment, it is essential that regulators and others will be able to exercise their judgement.

Unintended consequences

I am confident that the risk of unintended consequences is being assessed. I suggest further attention be given to how markets will react in the face of any intervention: I felt the document could have discussed the dynamics of markets and crises.

Regulatory arbitrage

These measures to intervene when banks appear to be in trouble need to be closely coordinated internationally. While it may be true that similar measures will apply in all financial centres, given that the exercise of judgement is essential, it is possible that market participants will scrutinise regulators closely to assess which are likely to be stricter in their approach to risks. This may lead to a discount in valuations of banks in jurisdictions where a firmer approach is perceived, regardless of the actual position.

Insurance for taxpayers and incentives

The taxpayer benefits from a successful financial sector, driving the rest of the economy by channelling funds to profitable investment opportunities. Every few years however the taxpayer is expected to spend or risk billions of pounds preventing financial and economic catastrophe.

Regulation is essential but we should consider also using a tax.

Banks have conceded that government intervention is essential for the survival of financial markets. The taxpayer should demand an insurance premium from banks against future disasters. This would be in the form of a regular tax, the proceeds of which would be used to reduce the national debt. This would strengthen the government's fiscal position in preparation for the next bail-out.

Of course, such a tax could tempt a future government looking for ways to increase revenue. To avoid this, we should cede direct control of this tax to the Bank of England. It could vary the tax rate along a scale according to its level of concern about asset price inflation and financial leverage. The Bank warned last year about levels of risk. If financial euphoria returned it could raise the 'insurance premium' since the probability of a crisis would have increased. The increased tax revenue would put the government in a better position to deal with the next crisis but it could only be used to pay down national debt (unless the government was running a surplus).

There is a further potential objection. Government could take advantage of the improved fiscal position to spend more or cut taxes, so stimulating the economy during times of financial euphoria. Due to time lags affecting the impact of taxation and expenditure policies, it is possible that the reverse may happen and a fiscal stimulus arrive just as a financial bubble is bursting. However, the concern can probably be addressed by adjusting the government's fiscal rules to ensure prudent government finance is still encouraged.

As with any insurance scheme, it is important to avoid moral hazard. The existence of insurance could change banks' behaviour and encourage them to take on more risk. This could be prevented if the government was not obliged to rescue banks in future. The nature of government intervention in a future crisis should remain at least partially obscure.

Banks would probably resist such a tax which, as with financial regulation, should apply in some form across financial centres. It would however encourage them to examine their balance sheets to ensure they were not overstretched. The tax would help improve the government's fiscal position *and* act as an economic incentive, which may be effective even if rules fail.