

# Public Finance

## Banking on a solution

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Free marketeers have been thrown into confusion by the collapse of the banks. But the Conservatives are hoping they have found a political way out. How do parties supportive of the free market respond to a global financial crisis that includes a loss of faith in markets themselves? This has been the dilemma for Right-wing parties around the world since the shockwaves of the current crisis began to be felt. US presidential candidate John McCain first appeared to waver when it came to discussion of bank bail-outs and, some argue, might have lost himself the election in the process.

In the UK, the Conservatives have also been deliberating for some time over the best way to respond – both philosophically and practically – to the global economic malaise. Earlier this week shadow chancellor George Osborne finally set out the Conservatives' stall in some detail with proposals for reforming the UK's system of financial regulation. The major change outlined was a decision to radically restructure the Financial Services Authority and give its regulatory powers back to the Bank of England. A new consumer protection authority would also be created to help protect the public, while retail banks engaging in high-risk activities would be required to set aside substantial capital reserves as an insurance against future public bail-outs of banks.

Vince Cable, Osborne's counterpart on the Liberal Democrat team, argues in his recent book, *The Storm*, that banks have almost become a public good – they are now so large and so important to the economy that governments can no longer allow them to fail. Osborne's white paper refutes this analysis by aiming to reduce risk-taking – and the burden on taxpayers – and by trying to create a more competitive market in banking. His recommendations include looking at whether there has been too much consolidation in the retail banking sector. The Office of Fair Trading and the Competition Commission would be given the remit to potentially break up some of the larger banks such as Royal Bank of Scotland and Lloyds Banking Group.

Last but not least, a dedicated minister would be appointed to liaise with Brussels, where various proposals for reform of financial regulation are being debated, including the creation of a European Systemic Risk Council and a European System of Financial Supervisors – a kind of supra-regulatory body. It would be vital to ensure these proposals worked in our interests and did not stifle the City of London's role as a main financial centre. The Conservatives' proposals are detailed and will no doubt be given a greater airing over the coming months – particularly given the likelihood of the party forming the next government. The biggest concerns relate to the complexity of splitting up the FSA's powers as well as worries that the Bank of England would become so powerful that no-one would be able to challenge its authority, even if, as other regulators have done before, it fails to spot a crisis coming down the line.

Osborne and Tory leader David Cameron have naturally courted the City, as do all potential incoming administrations, and they will be hoping for a broadly positive response – although they have been bold enough to take some unpopular positions, such as breaking up large retail banks. But, more so, the Tories will be aiming to win over voters still highly sceptical of markets in general, and of financial markets in particular. A CBS News poll taken in the US in 1986 found that 41% of respondents thought the government regulated business too much and 22% thought it regulated it too little. In 2009, when the same question was asked, the figures were reversed.

It might seem an irony but, in fact, the greater the Conservative Party's belief in free markets, the more it will need to grasp the nettle of effective financial regulation. Without it, there will remain too much instability and too much opportunity for excess risk-taking. The Tories have made positive strides this week. At the very least they now agree on a clear strategy. They have also accepted that the best route to restoring faith in markets and leading the UK back to recovery is to set 'the rules of the game' fairly and then, despite public misgivings, allow the markets to do the rest. The devil, of course, will now be in the detail.