Verdict on the Crash: Causes and Policy Implications

EDITED BY PHILIP BOOTH
WITH CONTRIBUTIONS FROM
JAMES ALEXANDER
MICHAEL BEENSTOCK
PHILIP BOOTH
EAMONN BUTLER
TIM CONGDON
LAURENCE COPELAND
KEVIN DOWD
JOHN GREENWOOD
SAMUEL GREGG
JOHN KAY
DAVID LLEWELLYN
ALAN MORRISON
D. R. MYDDELTON
ANNA SCHWARTZ
GEOFFREY WOOD

iea
The Institute of Economic Affairs
## CONTENTS

The authors 11  
Foreword by John Blundell 17  
Summary 19  
Editor's preface 21  

### PART ONE: THE CAUSES OF THE CRASH OF 2008 25

1 **Introduction** 27  
*Philip Booth*  
The causes of the crash 27  
Conclusion 34  

2 **The successes and failures of UK monetary policy, 2000–08** 37  
*John Greenwood*  
Introduction 37  
Benign beginnings 37  
Policy derailed 39  
Concluding lessons 41  

3 **Origins of the financial market crisis of 2008** 45  
*Anna J. Schwartz*  
Factors contributing to the crisis 45  
How to avoid a replay of the three factors that produced the credit market debacle 49  
References 50
4 The financial crisis: blame governments, not bankers
Eamonn Butler
The deep roots of the crisis 51
How politicians forced bankers to make bad loans 52
Bad loans and booming markets 54
The inevitable bust 55
The moral: it's government failure, not market failure 57
Bibliography 57

5 Market foundations for the new financial architecture
Michael Beenstock
Information runs 59
Regulatory failure 61
Evidence 64
Principles of financial misregulation 66
The future 67
References 70

6 The failure of capital adequacy regulation
Kevin Dowd
Rationale 73
Process 74
Rules and effects 76
Conclusions 79
References 80

7 Regulatory arbitrage and over-regulation
James Alexander
The credit cycle 82
The banks and credit 82
11 Ratings agencies, regulation and financial market stability
Alan D. Morrison
The information content of bond ratings 118
Too much maths, not enough economics 120
Credit ratings, regulation, and incentives 123
Conclusion 126
References 126

12 The global financial crisis: the role of financial innovation
David T. Llewellyn
Introduction and key themes 129
Financial innovation and efficiency 130
Financial innovation and stability 131
What is new in financial innovation: credit risk shifting 133
Risk analysis: shifting versus changing 136
Financial innovation and a new economics of banking: the ultimate cause of the crisis 137
Conclusion 139
References 141

13 Moral failure: borrowing, lending and the financial crisis
Samuel Gregg
Introduction 145
Not a new issue 146
Indispensable basic virtues 147
Can we replace prudence with regulation? 149
Conclusion 151
References 152
PART TWO: THE REGULATORY RESPONSE

14 More regulation, less regulation or better regulation? 157
   Philip Booth
   Introduction 157
   Public choice economics 159
   Insights from Austrian economics 161
   Specific regulation to address specific problems 162
   Lessons from Part One 164
   New approaches to UK bank regulation 166
   Complementary policy changes 167
   Conclusion 169
   References 169

15 Thoughtful regulation 171
   Geoffrey Wood
   Introduction 171
   The regulation of all banks 171
   The regulation of larger banks 173

16 The future of financial services regulation 177
   John Kay
   The difficulties of discretionary regulation 177
   The casino and the utility 178
   The impossibility and undesirability of regulating the casino 179
   The protection of retail customers 180
   Preventing the casino from destroying the utility 181

17 The global financial crisis: incentive structures and implications for regulation 183
   David T. Llewellyn
   Causes of the crisis: incentive structures 183