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Gordon Brown hasn't beaten off the EU financial regulators

Efforts to reform the financial sector have not turned out as Labour planned, argues Irwin Stelzer.

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Gordon Brown: Markets just seem to move faster than ministers

A funny thing happened on the way to the reform of Britain's financial sector. Several funny things, in fact. While policy-makers were deciding how to limit bankers' bonuses, Goldman Sachs announced record payouts to partners and staff. While the Treasury was worrying about the viability of the nation's banks, those banks began recording substantial profits, raising capital, and planning to pay back the bail-out money that had saved them from ruin only a short while ago.

While the Prime Minister was trumpeting his schemes to pump credit into needy businesses, the banks cut their lending. And while he planned to continue borrowing and investing at a mad pace, the markets recoiled, driving up interest rates and threatening to

uproot any green shoots. Markets just seem to move faster than ministers – and often in a different direction.

Even funnier, is the dispute over just how to reform and restructure the financial sector. Last week the Prime Minister returned from an EU summit, having denied the Europeans the right to determine which financial institutions he, or his successors, would have to bail out in the future.

Or so he says, and may even believe. In fact, France's Nicolas Sarkozy was closer to the truth when he proclaimed that "Anglo-Saxon" capitalism has been altered by the establishment of new pan-European regulatory bodies. Prepare yourself to learn new agency titles: the European Banking Authority; the European Insurance and Occupational Pensions Authority; the European Securities and Markets Authority; the European Systemic Risks Councils. You couldn't make it up, as our tabloid cousins say.

These new agencies will not only provide jobs for the boys: they have binding powers to investigate and oversee cross-border banking, insurance, pensions and securities, and can issue binding orders to resolve disputes between member states.

Sarkozy has only scorn for Gordon Brown's claim that these bodies have very limited power. "We have agreed a European system of supervision with binding powers. My conviction is that its scope will increase."

History is on the French president's side – efforts to hold EU institutions to their original remit have uniformly failed. Surely, Lord Mandelson, a Europhile whose next project is the replacement of sterling with the euro, knows this. Whether he shared that insight with his ostensible boss we do not know, but it is a reasonable guess that his Lordship neglected to warn the PM of the pending loss of still more national sovereignty. When the Prime Minister said that "candour" is the new watchword of his government, he surely did not expect it to apply to his new best friend.

Perhaps the funniest thing of all, however, is the demolition of the still-Chancellor by the Governor of the Bank of England.

Alistair Darling is desperately trying to rearrange the deck chairs on the HMS Financial Titanic. He sees the problem primarily as one involving the creation of a new organisation chart – this chore gets moved over to the FSA, that chore deposited somewhere else. But the structure of the financial services sector is to remain virtually unchanged. The underlying theory is that if he can get the regulatory organisation right, and perhaps add a few features such as new, higher capital requirements, armies of regulators will, by sheer weight of numbers and regulatory edict, defeat the fleet-of-foot entrepreneurs and innovators who populate the Square Mile.

Mervyn King knows better. If you allow plain vanilla banks that take deposits and lend money to continue to participate in riskier investment banking, backed by the knowledge that if things go pear-shaped a government bail-out will be available, there is virtually no

limit to the risks bankers will take. Heads they get the profits, tails the taxpayers pay for the losses.

King hasn't quite brought himself to mention Glass-Steagall, the US statute that separated commercial from investment banking and was repealed, to the plaudits of anti-government conservatives on both sides of the ocean. But that is where he is heading. After all, without such restructuring, the disease known as moral hazard – the encouragement of anti-social behaviour by insuring the actor against its consequences – will become pandemic. If you keep picking up the toys a child tosses out of the pram, you should expect a lot more toy-tossing.

King also exploited a problem that confronts poor Darling, in the process taking delicious revenge on the Prime Minister who left the governor swinging in the wind while dithering over his reappointment.

Darling knows that continued spending at current levels will bring inflation, a falling pound, rising interest rates, the loss of Britain's AAA bond rating, and a return visit from the International Monetary Fund (IMF). But his boss refuses to countenance "Tory cuts", and vows to continue increasing the rate of "investment", Brown-speak for "spending". King made it clear that the Chancellor and the Prime Minister are so at odds that only the Governor of the Bank of England can put things right.