Bankers are Masters of the Universe again

It's a paradox but the unfocused rage against the financiers is one reason for their sudden rehabilitation

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The lunatics have taken over the asylum. This will presumably be the instant reaction to the news that Bob Diamond and Stephen Green, two of the most powerful bankers who shot to public prominence during the 2008 financial crisis, have been promoted to even more important positions in British society: Mr Diamond as the new chief executive of Barclays Bank and Mr Green as Trade Minister.

Is it possible that the post-crisis witch-hunt against bankers will be transformed into another gilded age for financiers? The answer is "yes" for two good reasons and two very bad ones.

The first good reason is that banking and finance will always be among the most important and profitable business activities in any market economy. The prosperity of banks and bankers follows inevitably from their role in allocating capital in a market economy and converting personal savings into commercial investments. Just as politicians and state planners are always among the richest and most powerful people in communist states or corrupt oil-producing dictatorships, so financiers will always be among the rich and powerful in a market economy. As a result, banking will tend to attract many intelligent, ambitious and energetic people, as well as its share of lazy dullards and chancers who just get lucky. And some of these successful people will naturally get involved in politics once they have satisfied their desire for wealth.

The second good reason for bankers to be rehabilitated and even brought into government applies especially to Britain. Britain, even more than the US, has natural competitive advantages in banking, just as France has in wine, Kuwait in oil production and Germany in the manufacture of luxury cars. Given that banking will remain a very important and generally prosperous business in the global economy, it would be foolish for Britain to suppress financial activity. Consider currency trading, which is often described as socially useless.

The blame has been deflected on to politicians and officials

Currency trading is undoubtedly a zero-sum game for the world as a whole, in the sense that every currency trader's profit represents a cost borne by some other trader, business or consumer. Despite this, however, currency trading can be hugely profitable for Britain, if most of the profits are made in the City of London, and most of the losses are borne in some other country. Thus it is perfectly natural that bankers should play a large role in the public life of Britain.

Now for the bad reasons behind the surprisingly rapid rehabilitation of bankers. First, the financial crisis and subsequent recession has forced the adoption of macroeconomic policies that inevitably generate huge profits for the banks. The problem lies not with these policies, above all the necessary and sensible decisions of central banks all over the world to keep interest rates near zero for the indefinite future. Rather, the problem lies with the way that bankers have been allowed to exploit zero interest rates for their own personal benefit, rather than the interests of society.

In a nutshell, the banks are borrowing money for nothing from the Bank of England and investing it in risk-free government bonds that pay more than 3 per cent. A large part of the guaranteed profits racked up by this simple strategy is then distributed to their employees as salaries and bonuses.

Banks should be forced to lend on to businesses and consumers more of the free money that they are receiving from the Bank of England. They should also be prevented from distributing as much of the interest revenue they receive to their employees. But this is not happening, which brings us to the last — and most worrying reason — for the rapid rehabilitation of the banks.

The blame for the financial crisis and subsequent recession, initially heaped on banks and bankers, has been deflected on to politicians and public officials.

Why then have the bankers emerged stronger than ever, while the politicians who attacked them have been largely discredited? The answer is, paradoxically, that the exaggerated attacks against bankers ended up distracting attention from the real causes of the crisis and the feasible, but moderate, reforms they implied. The media witch-hunt against bankers inspired politicians, economists and financial regulators to propose radical solutions such as the break-up of "too-big-to-fail" banks that never had any serious chance of being enacted. Instead, they should have focused on small but important technical changes such as the creation of unlimited deposit insurance and introduction of compulsory levies to cover the cost of the Government's bailout insurance.

Spending cuts have nothing to do with the causes of the crisis

To make matters worse, politicians have since found it irresistible to blame their political opponents for the economic consequences of the crisis, instead of explaining patiently to the voters the rather complex linkage of events that led to recession and the explosion in public deficits around the world. This chain of events began with the slow and incompetent response of the Bush Administration to the financial turbulence after the collapse of Lehman. It now continues with the absurd view promoted by some governments, including most prominently David Cameron's Government, that the recession was some kind of divine retribution for too much government spending and can be ended only by slashing public spending to expiate this economic version of original sin.

The upshot in America has been that Barack Obama is now getting all the blame for a recession and financial crisis that had nothing to do with his actions. In fact, his policies have done a great deal to ameliorate the effects — so much so that the US, where the crisis started, has suffered a smaller loss of economic activity and wealth than any other developed economy in the world.

In Britain, too, the media and political hysteria has been a godsend to the bankers, albeit in a slightly different way. The false diagnoses coming from everyone, from the populist newspapers to the Chancellor and the Governor of the Bank of England, have produced a set of prescriptions — above all cuts in public spending — that have nothing to do with the causes of the crisis. These false prescriptions will shift the pain of economic adjustment from financiers on to relatively low-paid public sector workers and beneficiaries of the welfare state. Meanwhile, the bankers will be laughing all the way to their ever more powerful banks.