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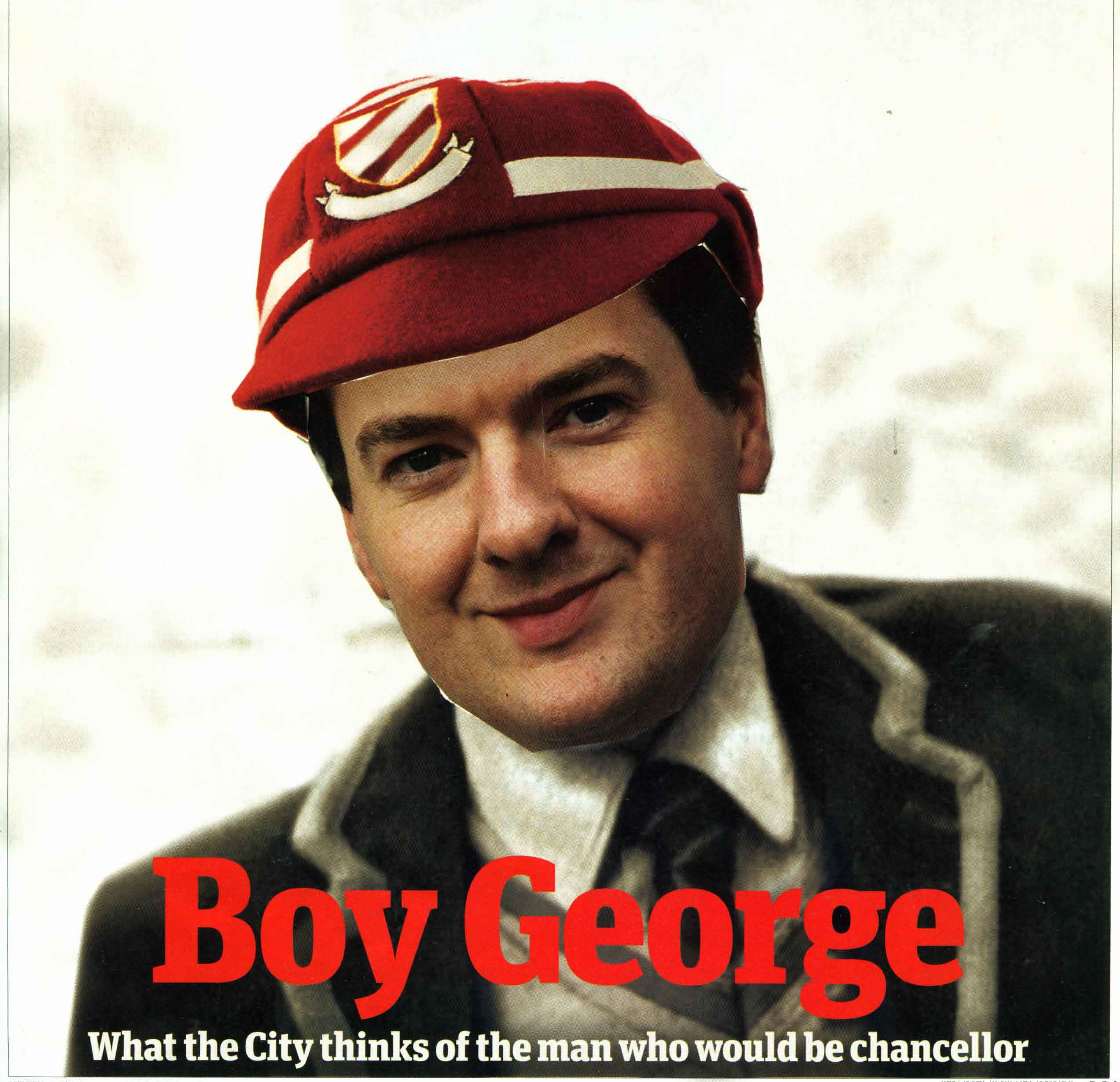

Boy George

What the City thinks of the man who would be chancellor

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PICTURE BOOK OF THE WEEK

Ladies' Day, Aintree Racecourse, Merseyside, 4 April 2008. **Little did the rather dishevelled denizens of the grandstand at Aintree know that financial catastrophe was only months away. This and other photographs of the "English outdoors", taken by Simon Roberts between August 2007 and September 2008, portray a country sleepwalking through the last days of the long boom. Roberts's *We English* (Chris Boot, £40) establishes him as an heir to Martin Parr**

or beast." However, the triumph of theories praising unregulated markets testifies to the political power of the financial lobby: both the US and the UK governments, for example, had "close links" with Goldman Sachs.

The policies designed to help us emerge from the Great Contraction have been dominated by various forms of government "stimulus". Stimulus policies take two forms – monetary stimulus, based on near-zero interest rates and "quantitative easing" (printing money), and fiscal stimulus, based on deliberate expansion of the government's deficit. While not denying the importance of the first, Bootle robustly engages with those monetarists who believe that printing money is a sufficient condition of recovery. As he points out, this presupposes a stable relationship between the supply of money and the demand for loans. This may be true in normal times, but these are not normal times. If the banks are afraid that if they lend money or buy assets they will lose it all, why should they be eager to do either? Better to sit on their enlarged cash balances and wait and see. And the same is true of investors, who may refrain from borrowing, even at very low rates of interest. This is not just theory, but history. In the 1990s, the Japanese central bank flooded its member institutions with money in an attempt to revive the stagnant Japanese economy. The supply of credit, and the demand for it, however, lagged way behind. The same is happening in western economies today. So, escape from prolonged recession will have to be achieved mainly through fiscal policy, whatever the dangers for the long-term sustainability of government finance.

Bootle goes through the conventional roster of reform projects, adding neat touches of his own. He suggests breaking up banks into a three-tier structure: narrow banks, limited to offering basic services to depositors and in the assets they can hold; wider commercial banks, with more freedom to operate, but still not allowed to engage in investment banking; and investment banks, which can engage in risky banking but should also be allowed to fail. The basic principle is that banks whose deposits are guaranteed by the taxpayer should not be allowed to gamble with their depositors' money. Bonuses at regulated banks should be paid in stock not cash, and clawed back if profits fall.

More novel – though it echoes Adair Turner, chairman of the Financial Services Authority (FSA) – is Bootle's suggestion for a "Tobin tax" on financial transactions. He points out that the UK already has such a tax in the form of stamp duty. It would have a "clear intellectual rationale. . . . Frantic trading takes up massive resources, generates volatility, and adds nothing to human welfare." What Bootle does not emphasise sufficiently is that recovery needs to come before reform. The banks are earning their way out of a hole. To reduce their profitability now would be counterproductive.

There is a good discussion of macro policy. Bootle is rightly critical of the large deficit incurred by this government before the crisis struck, which left it in a weak position from which to expand the deficit to deal with the downturn. He suggests that in future the normal ratio of debt to GDP should be kept to 20 per cent, to enable governments to run larger deficits in downturns without provoking fear of default. This rule should be enforced by an independent fiscal policy committee.

Bootle points out that for the Bank of England to set interest rates solely to hit an inflation target within two years leaves it powerless to prevent asset bubbles, whose effect on the price level develops over a longer period. He proposes two reforms to deal with this problem. The first is "macro-prudential" banking regulation: bank margins and capital ratios should be adjusted counter-cyclically; that is, they would be required to rise during a boom and fall in a slump. The second is that the Bank should aim to achieve price stability over five years, not over two. These reforms should result in greater variability in the inflation rate, but greater stability in asset prices. He does not say whether, in such a regime, it still makes sense to keep the FSA separate from the Bank of England.

To deal with the problem of excessive reserve accumulation by China and others, Bootle would create an international reserve currency, in which countries would hold at least part of their reserves. This international money would be issued and managed by a global central bank. Its distribution would be automatically tilted towards deficit countries.

This harks back to Keynes's rejected plan for an International Clearing Union, first put forward in 1942. Such a regime would simultaneously force China away from relying on export-led growth – as it would lose control over at least part of its current account surpluses – and end the "exorbitant privilege" of the US dollar as the unique reserve currency. But beyond saying that such a reform would benefit both China and the US (as well as the world), Bootle does not tell us how it can be made to happen.

Indeed, this is part of a larger problem. If, as Bootle implies, economic ideas and government policies are hugely influenced by the dominant financial interests, how, once these have been restored to profitable health, is that influence to be diminished? This raises the question of the relationship between ideas, policies and power that is the main unwritten story of the present crisis. ●

Robert Skidelsky is the author of "Keynes: the Return of the Master" (Allen Lane, £20)