

Gordon Brown's

The former prime minister didn't save the world after the Great Crash of 2008. Instead, his actions only made things worse

BY TIM CONGDON

An amazing feature of modern societies is that people believe what they read in the newspapers. As a result, consensus narratives become established from hurried guesswork about facts and instant opinion based on that guesswork. If people want to read newspapers and to believe the narratives they spew out, they are likely also to buy books that distil these narratives and reconfirm their views. The reconfirmed views then become the “conventional wisdoms” which motivate political dialogue and government action.

As Britain's prime minister, Gordon Brown was one of the most prominent participants in the financial crises of 2007 and 2008 that preceded the Great Recession of 2009. In his book *Beyond the Crash* (Simon & Schuster, £20), he has set out his version of these events, and it must be said that future historians will be grateful to him for the clarity and seriousness of the account. However, the book is largely a reworking of the consensus narrative that was forged, above all, by the *Financial Times* in 2007 and 2008, and endorses the now prevalent orthodoxy about the allocation of blame.

According to the consensus narrative, financial institutions in the main advanced countries had indulged in an irresponsible credit binge in the years leading up to the closure of the international inter-bank market in August 2007. By implication, the subsequent inability of many commercial banks to fund their assets showed that they were “bust”. When these banks asked the central banks in their respective nations for finance to replace the lost funding, they were deemed to be supplicants for “bail-outs” at the expense of the taxpayer.

The implied conventional wisdom is that the crisis can and should be blamed on the financial system, and has exposed a deep-seated flaw in free market capitalism. Moreover, since according to this view the banks were responsible for the disaster, they should “clean up their balance sheets”. The recommended acts of cleansing include “fessing up” the true value of so-called “toxic assets”, and then selling them and accepting “the hit” to profits. Detractors take it for granted that the bankers were lying about the quality of their assets and that these lies were part of a larger wickedness.

Is it going too far to suggest that the anti-banker rhetoric has resembled the demands for ritual contrition and purification found in some religions? At any rate, in late 2008 and 2009 renouncing the toxic assets was only part of the envisaged process of rehabilitation. If the banking industry really wanted to return to a state of grace, a concerted move to greater balance-sheet safety was seen as the main priority. The conventional wisdom defined the move to safety in two main ways. First, on the liabilities side of the balance sheet, banks should operate with higher ratios of capital to total assets than before, protecting the interests of their other creditors, particularly their depositors. Secondly, in the management of their assets, banks should place more emphasis on safety and liquidity. They should hold both more cash and more easily-sold assets like government securities, again relative to total assets.

During the crisis Brown played a key role in promoting the conventional wisdom. One message of *Beyond the Crash* is that he has no doubts that he was right in every opinion he expressed and every action he took. The book is not a subtle exercise in dialectic which recognises that there are other points of view. On the first page of the introduction, Brown scorns “the head of one of Britain's biggest banks”—presumably Fred Goodwin—who told him on October 7, 2008, that the “only problem was cash flow”. According to Brown, this bank's problems “were not short-term or simply about liquidity”, but “structural and fundamental” because it “owned assets of unimaginable toxicity and had been left with too little capital to cover its losses”. This is the conventional wisdom with knobs on.

But hold on. Banks have at all times to comply with regulations, including regulations on their capital positions. Meanwhile auditors have to pass judgment and produce accounts—every six months for British banks and every three months for their American counterparts—on banks' asset quality and capital adequacy. Many top regulators and auditors have spent most of their working lifetimes looking at banks' books. The truth is that in 2006 and 2007 these professionals had not raised doubts about the solvency of any of the major British banking groups. They may have been wrong, but they had far more experience and a much deeper understanding of the subject than Gordon Brown.

Like love, corporate solvency is a many-splendoured thing. Countless businesses have operated for years on end with negative cash flow and net assets, because their stakeholders believe that in due course their operations will generate significantly positive cash flows and make the investment worthwhile. A large number of early-stage pharmaceutical companies and high-tech computer startups have become successes only after repeated injections of cash.

At the worst point in every financial crisis, a high proportion of banks are likely to have inadequate capital relative to regulatory norms or even to be insolvent, in the sense that assets if suddenly liquidated would be worth less than non-equity liabilities. This is just life. There is little doubt, for example, that National Westminster was “bust” in strict accountancy terms in the crisis of 1974. A recognised purpose of central banks is to lend to cash-strapped commercial banks, to give them time to resolve their problems. Over a few years, banks' operating profits—the principal source of positive cash flows—will come through and may outweigh losses on bad assets. Moreover, assets that were “bad” in 1974 might have recovered their original value in 1977 or 1980 because of a cyclical upturn in house and property values.

Yes, National Westminster was bust in late 1974 if the assets had to be liquidated in a fire-sale. But over the next 30 years it did generate positive cash flows and paid a massive stream of dividends to shareholders. Measured properly from the standpoint of 1974, the value of that stream of dividends was far in excess of National Westminster's then capital as it appeared on the balance sheet. In jargon, the economic value of a business can be above its book value and ►

a multiple of its fire-sale value. Indeed, there is nothing unusual in banks and other businesses having undoubted economic value, and enjoying immense market capitalizations on the stock exchange, although they could not pay back all their creditors if these creditors demanded immediate payment of their debts. Every accountant—and indeed every serious businessman—recognises the difference between the value of a company as a going concern and on a fire-sale liquidation basis.

Brown claims that in late 2008 the banks were bust or, in other words, that the problem was one of insolvency; the bankers claim that in late 2008 their institutions had good assets and sufficient capital, and that the problem was one of illiquidity. Can Brown's statements in *Beyond the Crash* be proved beyond contradiction? When—if ever—will we know whether Brown or the bankers were indeed correct?

We now know, with certainty, that National Westminster was solvent in 1974. Will we be able at some point to say the same thing about RBS and Lloyds in late 2008? The short answer is that we will know if and when the state makes a profit on its transactions with the banks. If the state does make a profit and the banks are capitalized at least as well as before the crisis, then the banks will have repaid from positive cash flows any loans or capital injections they have received from the state. As there are already many signs that the state will in fact make a profit from its involvement in UK banking, their problem in late 2008 must have been one of illiquidity.

On this topic, which is basic to the argument of *Beyond the Crash*, Brown was wrong. But, even if his interpretation of the crisis had been correct, his handling of it turned out to be catastrophic. Brown has always fancied himself as a path-breaking political figure who directs history onto a new course. As Chancellor of the Exchequer he therefore eliminated officials, even very senior officials with huge experience, who said that in a particular policy area change was unnecessary. In 1998 he connived at the removal of Terry Burns, the Permanent Secretary he had inherited from the Conservatives, partly on the grounds that Burns had monetarist leanings.

Brown would define the world anew and run the economy without regard to the quantity of money. But managing an economy without reference to money is like steering a ship without radar. In their famous book *A Monetary History of the United States, 1867–1960*, Milton Friedman and Anna Schwartz showed that the Great Depression of the early 1930s was caused by a collapse in the quantity of money. By “the quantity of money” they meant the sum of all money-type assets, including notes, coin and bank deposits. Of these, bank deposits were much the most important. In other words, Friedman and Schwartz demonstrated that the Great Depression was caused by a collapse in bank deposits.

In the traumatic conditions of late 2008, when all sorts of scare stories about another Great Depression were going the rounds, it should therefore have been a priority to ensure continuing growth in the quantity of money. The trouble was that, because of the consensus narrative and conventional wisdom that had then already been articulated, policy-makers took wholly misguided decisions. These decisions were certain to reduce bank deposits and so to destroy money.

For Brown, the first item on the agenda in October 2008 was to force the banks to raise large amounts of capital in a short period of time. In the prologue to *Beyond the Crash* he glorifies the moment when he underlined twice “Recapitalize NOW.” (“I wrote it on a piece of paper, in the thick black felt-tip pens I’ve used since a childhood sporting accident affected my eyesight. I underlined it twice.”) But could Brown not see that the initial effect of bank capital-raising might be to make the recession worse?

The point is that, when a financial institution buys equity or bonds recently issued by a bank, it pays for the new assets from its bank balance. So bank deposits and the quantity of money go down. In normal conditions, bank capital-raising proceeds steadily and inconspicuously, and does not figure in political memoirs. But Brown was intent on such a vast programme of bank recapitalization that in 2009 it was to prove a major contractive influence on the quantity of money. True enough, if banks maintain a given ratio of capital to assets, they ought to decide after a large capital-raising exercise to expand their balance sheets at a faster pace. They have more capital

and so ought to make more loans. But the requirement that banks operate with a relatively stable capital-to-asset ratio is essential.

It is here that we come to perhaps the most shocking blunder of the Brown premiership. In a crisis, banks are likely to have losses, which cut into capital. But they dislike having to upset customers by closing credit lines and shrinking assets, and try to manage the cyclical fluctuation by temporarily operating on a lower capital-to-asset ratio than normal. All being well, credit lines are kept open, no loans are repaid and the quantity of money is at worst unchanged. Once the recovery is under way, part of the operating profits can be retained and the usual capital-to-assets ratio is restored. A plunge in the quantity of money, and an associated large downturn in demand and output, is avoided.

But in late 2008, British officialdom determined that banks had to operate on much higher capital-to-asset ratios than before. Given the context, this was crazy. Despite the capital raising into which they had been bullied, the banks were therefore deemed still to have too little capital relative to newly-imposed regulatory rules. As a result, they had no option but to withdraw credit lines and to shrink their balance sheets. This was part of the ritual cleansing mandated by the conventional wisdom, but the macroeconomic consequences were disastrous. With banks selling off loan portfolios to insurance companies and pension funds, and with their customers repaying loans, the quantity of money stopped growing. Far from the bank recapitalization exercises of October 2008 halting the slide in the economy, they were followed by a drastic deterioration in demand and output.

During the crisis Brown and Alistair Darling, his Chancellor of the Exchequer, claimed that the bankers “didn’t get it”. In other words, the bankers did not understand why officialdom was in such a tizzy about their alleged iniquities and the supposed imperative to recapitalize. One message of *Beyond the Crash* is that Brown now does not “get it”. Although the six months from October 2008 saw the steepest falls in output and employment for over a generation, he has not understood that the bank recapitalizations and increases in banks’ capital ratios caused the quantity of money to go down, and hence were responsible for the macroeconomic trauma.

Brown claims that in mid-2008 he sensed that “with the major industrial economies hurtling towards depression”, policy-makers were “facing a perfect storm” and “economic orthodoxy was proving irrelevant”. Well, that depends on what is to be understood by the notion of “economic orthodoxy”. Contrary to the impression given by *Beyond the Crash*, the official focus on bank lending and banking system capital in the crisis of 2008 and 2009 was new. In previous downturns policy-makers had paid relatively little attention to these matters, which were regarded as a technical sideshow to be sorted out by the banks in private discussions with their regulators and auditors. Economic orthodoxy had instead been concerned with money, the quantity of deposits, rather than credit, the quantity of loans.

Given the importance of money to economic activity, the most straightforward answer to a slump is action by the state to boost the quantity of money. That was indeed the conclusion drawn by Friedman and Schwartz about the Great Depression. According to their analysis, the American central bank, the Federal Reserve, ought in the early 1930s to have conducted expansionary open market operations in order to boost the quantity of money. In late 2008, with the key pointers to the economy still worsening, officials at the Treasury and the Bank of England started to prepare papers on how such operations might be organised in a programme of “quantitative easing” (or QE). As Mervyn King, the Governor of the Bank of England, said in a BBC interview in February 2009 ahead of the policy’s adoption, the aim would be deliberately to boost the quantity of money.

In *Beyond the Crash*, Brown does mention QE. In the section “August 2008” he is boastful and conceited, and dramatises his role. In his words, “The more I explored the lessons from the past and cross-referenced them with the data from the present, the more it became clear that a huge fiscal stimulus and substantial quantitative easing would both be necessary.” Anyone reading this might be fooled into thinking not only that QE was Brown’s brainchild, but that he was alert to its potential long before its actual implementation.

Brown Hole: After shares crashed, the prime minister was forced to consider quantitative easing



Unfortunately for Brown there is a rival account of these events, based on evidence from a large number of participants, in Andrew Rawnsley's *The End of the Party*. The fact is that in August 2008 Brown knew next to nothing about QE. According to Rawnsley, Brown's first reaction to the QE idea was "horror", so that "publicly and privately he ruled it out". It was only in late December 2008, with financial markets and the economy in turmoil, and the bank recapitalization clearly not working, that he started to contemplate QE. Again to quote Rawnsley, "When he left London for his Christmas break in Fife, he took with him holiday reading composed of a large number of papers on quantitative easing." For anyone well-versed in monetary theory and much derided economic orthodoxy, QE was a relatively obvious remedy to falling national expenditure. But to Brown and his colleagues it was a desperate measure, a leap in the dark that they had to try because everything else (including "the huge fiscal stimulus") had failed.

Brown has a tendency to link world-shattering events (or what he thinks are world-shattering events) to the trivia of his everyday life. Of his visit to New York in late September 2008, he writes, "Addressing first the United Nations and then the Clinton Global Initiative, I laid out the arguments I had first formulated during my hours of reading in Suffolk in the summer." So a holiday in a Southwold cottage becomes the stuff of geopolitics. Melodrama is never far away. "At the time [September 2008], no other government was proposing the actions that we determined on as our plane powered through the darkness." What on earth has a plane powering through the darkness got to do with banking system capital?

As the discrepancy between the Brown and Rawnsley versions on the timing of the QE decision shows, Brown is unreliable and dishonest, and embroiders the story in order to exaggerate his own role. The acknowledgements in *Beyond The Crisis* contain friendly references to a large number of people, including Darling, to whom an "unpayable" debt is said to be owed. Rawnsley presses a different button. According to *The End of the Party*, in August 2008, when

Brown was doing all that reading in Suffolk (and "hating every minute of it" because he "couldn't wait to get to Scotland"), Darling was worrying about his future. In the book's words, "The spinning against [Darling] from within Number 10 was becoming more nakedly aggressive as the Prime Minister's acolytes sought to displace blame for the Government's travails."

Sadly, people do believe what they read in the newspapers. In the consensus narrative of the Great Financial Crisis, Gordon Brown is something of a hero, because he took on the banks and slew the dragon of finance. But both the consensus narrative and *Beyond the Crash* are riddled with lies. Brown's reputation owes much to Paul Krugman who, at a pivotal moment in the crisis, praised him in a *New York Times* column. Krugman even said that the UK's bank recapitalization plan was a model which should be copied in other countries and so would "save the world". However, Krugman—like Brown—has always dismissed money as irrelevant, and during the key period he failed to advocate the easiest and most effective antidote to recession (ie, an increase in the quantity of money).

The introduction of Quantitative Easing in March 2009 heralded a sharp rebound in the British economy. Absurdly, by spring 2010, Brown entered the general election contest enjoying widespread esteem for his economic competence. The truth is that bank recapitalization exercises and open market operations to boost the quantity of money are totally different approaches to macroeconomic difficulty. Since bank recapitalizations at first reduce the quantity of money, these two purported remedies cannot both be right. If QE had been announced in September 2008 instead of bank recapitalization, the disastrous slide into recession in late 2008 and early 2009 could have been prevented. That is the important lesson to be learned from the events of the period. Brown's celebrations in a Southwold cottage in the summer of 2008 did not save the world. On the contrary, they were part of the thinking that led to the worst macroeconomic catastrophe that this country has experienced since the 1930s. ■