

Burdening banks will sink the recovery—and the Tories

The Vickers report will call for tighter banking regulation. But George Osborne should beware of the economic and political consequences

BY TIM CONGDON

Britain's economic outlook, like that of most developed countries, is difficult. Recent data suggests that the recovery is feeble and unimpressive, and that even in 2012—almost five years from the onset of recession—output may fail to grow faster than the long-run trend rate. Prime Minister David Cameron is reported to have become impatient with his Chancellor of the Exchequer over the economy's sluggishness, fearing that a continued lacklustre performance will undermine support for the Conservatives at the next general election.

Chancellors of the Exchequers are not magicians. George Osborne has many abilities, but he cannot be expected single-handedly to improve the productivity of British companies. Much that is wrong with the economy in the Great Recession reflects mistakes made under New Labour, while both the Gordon Brown and David Cameron governments have been prepared to sacrifice economic efficiency for the sake of political correctness. For example, it is Cameron, not Osborne, who wants to maintain Labour's policies on renewable energy and the environment, and is pressing that the United Kingdom takes an international lead in reducing carbon emissions. The Chancellor of the Exchequer has no choice in the matter. He has to accept that an official programme to reduce the UK's carbon emissions is under way, that it will raise energy costs for heavy industries and that the adverse effect on economic growth is important.

Nevertheless, this article will suggest that at least some of Osborne's difficulties—particularly in banking regulation and monetary policy—are self-inflicted and avoidable. Some of its supporters in the City of London may have hoped that, once in office, the Conservative Party would check officialdom's attack on their businesses. In the event the government's reluctance to rock the boat of political correctness has extended to its treatment of the financial sector, now by far the most politically incorrect part of the economy. In its final stages the last Labour government indulged in a large-scale programme of bank-bashing; in its first year the present Conserva-

tive-led coalition has continued that programme. Osborne has gone along with the consensus post-crisis argument that Britain's banks must be more tightly regulated, with higher capital relative to their assets and new restrictions on their operations.

The focus of debate in the next few weeks will be the final report of the Independent Banking Commission, due out on September 12. The final report will no doubt tweak the conclusions of the interim report, but little more than tweaking is in prospect. The Commission has been chaired by Sir John Vickers, the warden of All Souls College, Oxford, and a former chief economist at the Bank of England. In the interim report Vickers and his team recommended—among other things—a further increase in banks' capital ratios, with systemically important institutions to maintain equity capital equal to a minimum of 10 per cent of their so-called "risk-weighted assets".

This may sound like mumbo-jumbo, but—as we shall see shortly—the technicalities have great social and political significance.

'Even a politician like George Osborne must recognise the relevance of arcane debates in economic theory to practical decision-taking'

(To be vulgar, they could even affect the results of general elections.) The phrase "systemically important institutions" is code for "the large UK clearing banks". So a common interpretation of the Vickers recommendations is that the ratios of equity capital to risk assets at the UK clearing banks will have to be 12 or 13 per cent. Superficially, this may sound reasonable. Given the consensus view that the banks were taking excessive risks before the crisis began, and that the excessive risk-taking was the cause of the slump in economic activity, there appears to be a compelling case for Britain's major banks to operate in future with more ample and comfortable capital cushions.

Indeed, the consensus on the need for more bank capital is so widely shared that

Osborne is expected to endorse Vickers's recommendations with little hesitation. But Osborne needs to think harder and seek a wider range of advice. The role of banks in modern capitalist economics is extraordinarily complex, with macroeconomic variables interacting in countless, often perverse ways. Even someone like Osborne—who confesses to being a politician to the fingertips—must recognise the relevance of arcane debates in economic theory to practical decision-taking. The truth is that his response to the Vickers report will have a strong influence on the pace of the economic recovery and hence on the outcome of the next general election. He should keep his distance from the Vickers report for several reasons.

For a start the Vickers assault on the banks makes sense if the banks, and only the banks, were to blame for the Great Recession of late 2008 and 2009. But the widespread readiness to condemn the banks is highly debatable. Certainly, some banks did silly things in the run-up to the crisis. In 2006 and 2007 HBOS and RBS were lending money with the assumption that asset prices—and, more specifically, the prices of houses and commercial property—would behave in the next few years as they had done in the previous few. Naively, they had believed Gordon Brown when he proclaimed that the boom-bust cycle would never return. In retrospect RBS and HBOS were too confident that the non-inflationary, consistently-expansionary environment of the 15 years from 1992 would continue forever. That confidence, and the resulting complacency on asset prices and borrowers' capacity to repay debt, must now be judged a dreadful mistake.

Nevertheless, the British banking system as a whole has made profits during the Great Recession, while banks have honoured their obligations to each other in their daily settlements and depositors have at all times been able to withdraw cash. Some banks tend to have trouble in most financial crises, but recessions of the severity of late 2008 and 2009 are exceptional, once-in-a-lifetime events. An argument can be made that the cause of the Great Recession was

*Penny for them:
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not the misdeeds of the banking industry, but shocking blunders in the official response to the problems that a handful of banks undoubtedly faced.

Some history helps to explain and understand these blunders. In their path-breaking 1963 study *A Monetary History of the United States* Milton Friedman and Anna Schwartz showed that the dominant cause of the US's Great Depression in the early 1930s was a collapse of over a third in the quantity of money. The UK's boom-bust cycles of the 1970s and 1980s were also characterised by extreme fluctuations in the growth rate of the quantity of money. During the booms the annual rate of money growth ran in the high teens or even the twenties, whereas in the busts it would fall to low single digits. The historical record suggests that, as Friedman recommended on numerous occasions, policy-makers should try to ensure that money growth is fairly steady from year to year.

What, in fact, were UK monetary trends before the Great Recession? And what has been the pattern during the Great Recession itself? The short answer is that—yet again, as in other periods of macroeconomic turmoil—the quantity of money has been subject to drastic instability. In the three years to the third quarter of 2007, when the run on Northern Rock signalled the start of the crisis, the annual rate of money growth was too high, at just over 10 per cent. By contrast, since early 2008 the quantity of money has grown at under 2 per cent a year. (The quantity of money here is the usual broadly-defined measure, M4, but with some awkward customers known as “intermediate other financial institutions” cut out of the picture. Roughly speaking, M4 consists of all the notes and bank deposits held by non-bank private sector agents. “Intermediate other financial institutions” are semi-banks, neither banks nor non-banks. As

their balance sheets can be artificially inflated by transactions within banking groups, they need to be eliminated from the data.)

The obvious next question is, “Why did the annual rate of money growth tumble from a double-digit rate in 2006 and 2007 to almost nothing from the start of 2008?” The answer is, “Partly because some banks had got it wrong, but mostly because of officialdom's misguided reaction to the crisis.” To understand why officialdom's reaction was misguided, a few words are needed on how banks operate and, in particular, how they balance risk and return in the management of their capital. Banks are unusual businesses, in that their obligation to repay depositors with cash forces them to hold very safe assets. But safe assets deliver a low interest rate. In order to make a healthy return on capital, banks need to offset the low interest rates by high leverage. By the standards of the corporate sector as a whole, their assets and liabilities are an exceptionally high multiple, often 20 or more times, of their capital. But leverage must not go too far, otherwise the risk of insolvency would be unacceptable. Regulators and customers would be unhappy if the capital/asset ratio were only 1 or 2 per cent.

It has to be admitted that some banks' mistakes were one element in the collapse in money growth seen at the start of the Great Recession. RBS's and HBOS's heavy losses eroded their capital. In the best of all possible worlds, that erosion of capital implied that they would have had to sell off some assets and reduce their balance sheets. And that reduction in balance-sheet size would have meant a decline in their deposit liabilities, which constitute most of the quantity of money.

But officialdom made matters much worse. Old-fashioned central bankers, such as the top brass at the Bank of England 50 or

100 years ago, had frequently themselves been bankers in the private sector. Their response to the threat of a major business downturn was to cut interest rates and, if necessary, extend loans to banks short of cash. They did not demand large increases in banks' capital at the most difficult moment in the cycle. To be frank, there was a lot of chumminess between old-fashioned central bankers and the commercial banking industry, particularly in a society like Britain riddled with networks of privilege and mutual back-scratching. Nevertheless, the traditional tendency of old-fashioned central bankers to be soft on banks during the crisis had benign effects. It maintained credit availability, and so prevented collapses in banks' assets and hence in the quantity of money. To that extent the chumminess and mutual back-scratching served a social function, as well as the often tacky purposes of the private individuals involved.

In the Great Recession the key people in central banks were no longer ex-bankers. Instead they were typically economists with little or no hands-on experience of business and finance in the private sector. They reacted to the events of late 2008 by being hard on the banks. They demanded not only that banks increase their capital relative to their assets, but also that the move to higher capital/asset ratios had to take place quickly. Whereas the old-fashioned central banker would help commercial banks with loans (probably very expensive loans, by the way) to give them time to sort out their affairs, the economist-as-central-banker of late 2008 and 2009 insisted on rapid and large-scale bank recapitalisation. (In the UK Mervyn King, the Governor of the Bank of England, was the most prominent of these economists-as-central-banker. He had a major political ally in the recapitalisation exercise, in the shape of the then Prime Minister, Gordon Brown, as I ►



Pointing the finger: Sir John Vickers holds the banks solely responsible for the Crash

discussed in my review of Brown's book, *Beyond the Crash*, in the March 2011 issue of *Standpoint*.)

It was the combination of the increase in capital/asset ratios and the bank recapitalisation that caused the severe collapse in money growth. This statement is so important in understanding the Great Recession that it cannot be emphasised too strongly. The decisions to raise the capital/asset ratios and to enforce the large-scale recapitalisations were of course taken by officialdom, particularly by Brown and King. Senior bankers—people who had spent their entire working lives in the profit-seeking private sector—could see what the results would be, and were aghast. The blame for the disaster falls mostly on officialdom, not the bankers.

First, with their capital given, banks can respond to an externally imposed increase in their capital/asset ratios only by shrinking assets. That is—or should be—obvious. With loans to the private sector as their main asset, they had to tell their borrowers that in future facilities would not be available on the same scale or would be more expensive. In other words, the withdrawal of credit lines and the increase in the cost of bank finance in late 2008 and early 2009 were the direct result of the increase in capital/asset ratios imposed on the banks by officialdom (Brown, King, etc.), in its determination to be tough on the City of London.

Secondly, banks' liabilities take two main forms: deposits, mostly owed to the general public, and capital. Capital can be either equity or bonds, but we need not bother too much over the details here. Deposits are money, capital is not. If banks' balance sheet is given, the effect of recapitalisation—of raising the proportion of capital to total liabilities—must be to reduce the quantity of deposits (that is, of money).

More concretely, when a financial institution subscribes for newly-issued bank equity, it pays over a sum from its deposits to the bank. The deposits disappear from the economy. Money is destroyed and new claims on the bank, ordinary shares, are created.

Brown and King might protest that in 2008 and 2009 officialdom's insistence on more bank capital served vital objectives. It made banks less risky, which was important in protecting the taxpayer (in case Northern Rock, RBS and so on could not repay loans from the Bank of England) and giving them greater creditworthiness in the global inter-bank market where they needed to raise new funds. Even old-fashioned central bankers would acknowledge that, ultimately, banks must try to be well-capitalised so that they can justify themselves in the marketplace. Commercial banks should avoid dependence on exceptional (and expensive) support from the central bank.

All the same, the demands that banks shed risk assets and build up their capital were responsible for the drastic change in financial conditions in 2007 and 2008, and hence for the crash in the rate of money growth. Indeed, an article in the Bank of England's *Quarterly Bulletin* earlier this year contained some fascinating numbers on the subject. It quantified the extent of the damage to the quantity of money from both the weakness of bank lending and "banking sector stabilisation", as it termed the recapitalisation exercise. In its words, the issuance of new equity and bonds by the banks "acted as a negative shock to the supply of broad money". The article's authors judged that "a reasonable estimate" of the "total drain" on broad money from the net issuance of equity and bonds was "around £240 billion since the recession began". (The *Quarterly Bulletin* article was called

"Understanding the recent weakness in broad money growth" and written jointly by Jonathan Bridges, Neil Rossiter and Ryland Thomas. To get a sense of scale, £240 billion is much more than 10 per cent of the UK's M4 quantity of money. Remember that Friedman and Schwartz believed that a fall of a third in the quantity of money was responsible for the US's Great Depression.)

We are now in a better position to see why Osborne should take a sceptical view of Vickers's recommendations. The mishandling of Britain's banks and a collapse in money growth blighted the closing years of the 1997-2010 Labour government, and caused a deep recession which wrecked Gordon Brown's reputation for competence in running the economy. The central mistake was to be so tough on the banks that they stopped expanding their businesses, which checked the growth in the quantity of money.

It would be nice to be able to say that the deliberations of the Independent Banking Commission were fresh thinking from truly independent authorities. But they are nothing of the sort. On the contrary, Vickers—who was appointed the Bank of England's chief economist on King's personal say-so—shares the same mistaken premises as King and his senior Bank of England colleagues. They all have an obsessive and ideological attitude towards bank capital and the supposed imperative to de-risk the banking system; they do not care enough about the implications of their decisions for the quantity of money. The message must be reiterated. If banks are required to hold more capital relative to their assets, the quantity of money will stagnate and the economy will struggle to grow.

That is a proposition in economic theory; it is also a basic fact for the party political debate. Osborne should be far more pragmatic and easygoing in his approach to the banks than Gordon Brown and Alistair Darling. If he accepts the Vickers prescription of yet further increases in banks' capital and continued shrinkage of their risk assets, two or three more years of sluggish money growth are to be expected. The economy may recover, but it will not pick up enough speed before the next general election to reduce unemployment and establish a feel-good factor for the Conservatives.

And just how sharp are Osborne's (and Cameron's) political antennae? Risk assets include the bank lending to small and medium-size enterprises about which so many crocodile tears are shed. But they also include mortgage loans for the purchase of houses by the British middle classes. If Vickers's recommendations are adopted in full and without reservation, banks and building societies will be more reluctant to help "middle Britain" to acquire its favourite asset.

Much went wrong in the 1980s, or so we are told. But much went right too, and Margaret Thatcher and her supporters appreciated the importance of a vibrant housing market and growing mortgage lending to their electoral fortunes. **S**