The odd couple who presided over disaster

Alistair Darling was the luckless understudy to Gordon Brown and Mervyn King as they led Britain into an avoidable recession

BY TIM CONGDON

Banks have debts to two kinds of people: their depositors and the rest. As bank deposits can be converted into cash at 100 pence to the pound, they can be used to make payments and are money. America’s Great Depression in the early 1930s showed that widespread bank failures and a sharp fall in the quantity of money cause macroeconomic disaster. Modern liberal democracies therefore coddle the depositors with an assortment of structures and regulations to ensure that—come hell or high water—deposits are indeed always repaid at 100 pence to the pound.

What about “the rest”? They are a far more motley crew than depositors. They include both bondholders and equity shareholders. Since banking involves lending money and charging interest, they are readily caricatured as the spivs and slickers of contemporary capitalism. As the ongoing Great Financial Crisis since 2007 has shown, modern liberal democracies certainly do coddle them. Many commentators have been alarmed that losses on loans and alleged “toxic securities” might erode the asset cover for depositors. Banks have been forced by governments and regulators to raise immense quantities of capital—by issuing more equity capital and bonds—to protect depositors. The spivs and slickers have had to cough up, and they don’t like it.

In late 2008 the crisis was at its most intense. That October British officialdom pressed the clearing banks into the largest recapitalisation exercise of all time and decided to inject government money if the private sector was reluctant to participate. With the bewildered shareholders of RBS and HBOS unable to put the money together, a large chunk of the British banking system fell into public hands.

Alistair Darling’s memoir Back from the Brink (Atlantic, £19.99) is another addition to the growing kiss-and-tell literature on the period. Readable and sometimes quite funny, it throws fresh light on the shambles of so-called “government” in the Gordon Brown premiership. On page 89 “the chaotic atmosphere in No 10 worsened”; on page 96 “Mervyn was seething and told me in no uncertain terms that he blamed No 10”; on page 103 the “operation in No 10” was its “usual” chaos; on page 106 “Gordon’s attack dogs” unleashed “the forces of hell”; on page 231 “forty-eight hours before its presentation, we had no Budget.” And so on.

But—for all the jollity—Darling’s three years as Chancellor of the Exchequer raise important points for future public policy. Two issues are central: was the official response to the banking crisis well-designed and appropriate? Could anything have been done to prevent the severity of the downturn in late 2008 and early 2009?

Darling has himself and his colleagues on the back. In his view, they faced “enormous decisions”, and “had we got them wrong, which could easily have happened, the results would have been catastrophic.”

But is that the correct verdict? Let us take the official response to the banking crisis first. Basic to any assessment is the official claim—which Darling naturally accepts—that the sudden, large-scale bank recapitalisation of late 2008 was essential; and fundamental to that assessment is the extent to which the spivvy “rest”, the capital providers, were protecting depositors from banks’ actual and prospective losses. Complete data are now being published by central banks, including the Bank of England, for the critical period. They tell us most of what we need to know.

Let us take the four years 2007 to 2010 inclusive as defining the Great Financial Crisis (or at any rate the Great Financial Crisis so far), the years in which—if some media reporting were to be believed—our banks concealed trillions of pounds of “toxic securities”, squandered hundreds of billions of pounds and had to be “bailed out” by the taxpayer. In fact, in this four-year period the UK resident banking system as a whole had a profit of £16.6 billion and was a small net taxpayer. Admittedly, in the two worst years 2008 and 2009 by themselves, the banks had a loss of about £32 billion, and—as we know—the losses were dangerously concentrated in such organisations as RBS and HBOS. Nevertheless, over the whole crisis period Britain’s banks were profitable, not loss-making, and they were not a drain on the taxpayer.

And how much of a threat to the depositors was implied by the losses of 2008 and 2009, which admittedly were bad? According to numbers in the Bank of England’s Bankstats database, the sterling liabilities (in terms of deposits and deposit-like instruments) of Britain’s banks at the end of the third quarter of 2008 were just under £2.500 billion, while “other liabilities”—the liabilities to the usurious capital providers—were £388 billion. Yes, £388 billion, about a quarter of gross domestic product. So the losses in 2008 and 2009—those two dreadful years when capitalism was supposed to be disintegrating—were actually less than 10 per cent of the capital that “the rest” had in place to protect the depositors.

The question must be asked: were we really “on the brink”? The title of Darling’s book and millions of column inches would have us believe so. Throughout the crisis the bankers and officialdom were at loggerheads about the nature of the problem. The bankers insisted that they had good assets and good businesses, and that in the years leading up to the furiously rows of October 2008 they had complied with rules on capital provision and liquidity. Sure enough, mistakes had been made, and RBS, HBOS and some of the mortgage banks had done some particularly silly things. But—in the UK at least—the bad assets were insignificant compared with the secondary banking crisis of the early 1970s, the Third World debt crisis of the early 1980s and the property crash of the early 1990s.

The bankers argued that the trouble was not that they were insolvent, but that the closing of the inter-bank market in August 2007 meant that they were having difficulty funding their
assets. They needed help from the Bank of England, not to remedy a lack of capital, but to provide long-term funding. The problem was one of liquidity, not of solvency. The numbers now published by the Bank of England suggest that the bankers knew what they were talking about. RBS and HBOS were in a spot of bother. Nevertheless, given a calm macroeconomic environment of the kind that had been enjoyed in the previous decade, even these institutions ought to have been able to rebuild capital—over, say, five years—by retentions from profit and a series of capital issues. A big hullabaloo was not needed.

However, in the fateful period (essentially the 18 months to the end of 2008) the Governor of the Bank of England, Mervyn King, refused to make long-term funding available and contended that the central bank’s job was not to act as banker to the banking system. Darling’s book mentions a meeting in his Edinburgh home at Christmas 2007 with Fred Goodwin, the chief executive of RBS, where Goodwin explained the increasing strains in the inter-bank market. Goodwin and other bank CEOs had met King some weeks earlier, and King had spelt out the doctrine of “moral hazard”. In King’s view loans from the central bank to the commercial banks set a bad precedent, because the commercial banks would come to regard the central bank as a soft touch and would repeatedly return for more loans in future.

One surprise in Darling’s book is his clear scepticism about the doctrine of moral hazard and indeed his suspicion of King more generally. To quote from the pages just before Goodwin’s visit to his home, the underlying problem may have been “lack of capital, but the immediate cause was lack of liquidity. Moreover, if a liquidity problem remains untreated, it has a tendency to make a problem with solvency worse.” Quite so. That is why pre-emptive central bank action to inject liquidity is helpful and even necessary in banking crises.

Indeed, the doctrine of moral hazard is false and King’s deployment of it in the crisis period was disingenuous. The truth is that King had a strong personal dislike of banking and bankers and did not want to help them. As Bagehot discussed in his 1873 classic *Lombard Street*, the central bank should make loans readily available to solvent organisations with a cash problem, but only at a penalty rate. In a 1993 lecture to the London School of Economics, Eddie George, King’s predecessor as governor, reiterated Bagehot’s principle. In a 2008 speech, King said: “Any support will be on terms that are as penal as we can make them, without precipitating the collapse we are seeking to avoid.” If the central bank makes clear to any supplicant bank that it will stint them on the loans they receive, they will not repeatedly return for more loans at a later date.

It has been widely surmised that in early 2008 Gordon Brown was reluctant to reappoint King as second term as governor. Darling confirms that Brown would have liked someone else, but his own advice was that no obvious alternative candidate was available. At any rate, King was reappointed, and Darling worked in tandem with Brown and King in the bank recapitalisation exercise of late 2008. He shows no sign of repentance about it in this book.

Brown’s *Recessional*, *Standpoint*, March 2011, and “Burdening banks will sink the recovery—and the Tories”, September 2011. Anyhow the facts speak for themselves. The six months from October 2008 were among the most calamitous in British economic history, with a sharp plunge in demand and output, and the loss of over half a million jobs. The collapse occurred despite a slashing of interest rates to virtually zero. (Imagine what would have happened if base rates had stayed at the 5 per cent level of September.) But perhaps even more eloquent is that the capital rebuilding now being implemented under the international Basle rule arrangements (and our own Vickers Commission proposals) is to be phased over almost a decade to 2019. Most sensible people realised that to compress the process into a few months would renew the disastrous conditions of early 2009.

So the official response to the banking crisis was not well-designed and appropriate. What about our second question? Could the severity of the downturn in late 2008 and early 2009 have been prevented? Here Darling gives the answer away, without appearing to notice the significance of his remarks or the scale of the admission that he is making. Bank recapitalisation—to add capital to banks’ balance sheets, so that in principle they are more creditworthy in the inter-bank market and can lend more—purports to be one way of halting a downturn in economic activity. In fact, it is counterproductive and misguided. But a more traditional and straightforward approach is available, which is for the state to use its financial muscle to expand the quantity of money. Darling does not say much about the programme of “quantitative easing” (QE) inaugurated in March 2009, but the little he does say is fascinating. Apparently “the Bank of England and the Treasury had been working on the scheme for weeks before the announcement” (note the absence of references to Brown and King as such). For Darling “the key thing is that it worked.”

Exactly: QE worked. The large-scale creation of money by the state is the most powerful stimulus policy imaginable. Contrary to an unfortunate and mistaken thesis in Keynes’s 1936 *General Theory*, such money creation can halt any recession. But the success of QE in 2009 has a disturbing message for Darling and, more particularly, for Brown and King, the main architects of October’s bank recapitalisation. The message is simple: QE could have been announced in October 2008 instead of the recapitalisation. If the emphasis in official policy had been on the quantity of money, instead of on punishing banks and their allegedly desppicable capitalist management and shareholders, the catastrophic macroeconomic numbers of early 2009 could have been prevented.