Centre for Policy Studies

Pointmaker

FROM BOOM TO BUST

A PLAIN GUIDE TO THE CAUSES AND IMPLICATIONS OF THE BANKING CRISIS

HOWARD FLIGHT

SUMMARY

- The banking crisis has its roots in mistaken monetary and economic policies; and in regulatory failure.
- In the UK, the main monetary policy failure was the imposition of a single cost of living inflation target on the Bank of England. This led to excessive money supply growth and is the underlying cause of excessive borrowing and mortgage and consumer lending.
- The economic failure was to assume that boom and bust had ended; to conflate consumption growth with economic growth; and, as long as five years ago, not to have recognised that lending, debt and house prices were rising too fast.
- The regulatory failures were to remove responsibility for banking oversight and regulation from the Bank of England; and to neglect the clear signals of imminent problems in the banking sector.
- These failures (all largely the responsibility of the Labour Government) created the preconditions which made a banking crisis inevitable in the UK sooner or later.
- The UK outlook is for vicious house price deflation; a severe recession, a falling stock market and a large Sterling devaluation.
- The depth of the current crisis is such that government borrowing is likely to rise to over £100 billion this year and for the next two years. There is a growing case for trying to advance private sector infrastructure investment and for cutting taxes. The short-term objective must be to sustain the money supply and economic activity, particularly in the SME sector.
- In the longer term, the UK needs a smaller and more efficient public sector to free up the resources to improve productivity and economic growth.

BACKGROUND

Banks are the oil of the economy. They provide both the system of payments and the inter-mediator between short-term deposits and longer-term lending commitments.

The role of banks is to borrow short and to lend long, prudently. Confidence is everything and always has been. For an individual bank, if confidence is lost and customers withdraw their deposits, that bank quickly becomes insolvent if there is no central bank support. For the banking system as a whole, as we have witnessed, there can quickly be a domino impact leading to runs on all but the strongest banks.

In the 18th and most of the 19th centuries, banks in Britain were predominantly regional; when a major local enterprise went bust it invariably brought down the local bank with it, leading to several years of local depression. It was against this background that Walter Bagehot, the great 19th century economist, was largely responsible for the creation of the first British national bank, capable of withstanding regional losses – the Westminster Bank. Bagehot was also largely responsible for developing the Bank of England's Lender of Last Resort doctrine – that when a run on the banking system occurred, the Central Bank should lend unlimitedly, to banks that are honestly run, taking security from them for so doing.

1974

The last significant run on the banking system in the UK was in 1974. The money supply had been increased excessively over the previous three years; a degree of banking deregulation had led to the formation of a number of new banks entering the market, lending largely to finance property developments and providing consumer finance, and who financed themselves from the wholesale money markets. When the property market started to fall, the interbank money market woke up to the dangers and these new banks were cut off lending limit lists. They lost their funding.

At that time, as well as having the job of monitoring and regulating the banking system, the Bank of England had more authority than it does today. A wider banking crisis was avoided by the activities of what was known as the 'Lifeboat', under which the Bank of England 'requested' larger banks to take over the exposed banks before a wider banking run developed. Even then, there was wider contagion through the wholesale money markets where many local authorities had deposits with vulnerable banks: interbank money market lines were cut to some of the larger banks who were thought to be vulnerable to large property loan losses. At that time, the wholesale interbank markets were already sufficiently developed as a source of wholesale deposit funding to make the whole banking system vulnerable to a loss of confidence, if their liquidity dried up.

There are two major differences between the 1974 banking run and today's banking crisis and its causes. First, today's crisis is also global, hitting the US and the rest of the world as well as the UK. It was the perceived exposure to losses from, and the sudden illiquidity of, sub-prime, Collateralised Debt Obligations (CDOs) – bundles of bad and good US mortgage paper sold and traded on a securitised basis – which started the banking problems in both the US and UK in the summer of 2007.

Secondly, in the UK, whereas in 1974 the actions of the Bank of England Lifeboat succeeded in containing the UK banking run, there was no Lifeboat this time. Now it has also been the major banks with the problems, which have ended up requiring Government support.

There are, however, some important analogies with 1974. In both cases, several years of excessive expansion of the money supply had led to lax bank lending. This in turn had inflated asset values (in particular property). When confidence in the bubble was pricked, asset values collapsed. In 1974, the executives of the new banks who had made imprudent property loans, and funded their banks from the wholesale money markets, were criticised; and the whole capital base of the UK banking system was damaged by write-offs on property loans. This led to a Stock Market crash and a 30% fall in house prices.

In 1999, the then Chancellor, Gordon Brown, introduced the Financial Services and Markets Act. This legislation separated responsibility for the regulation of the banking system and monetary policy and created the Tripartite Authority, comprising the FSA, the Bank of England and the Treasury. I had lived through the 1974 Lifeboat experience and so warned on more than one occasion in Parliament that this would risk undermining the ability to act promptly and effectively to maintain banking confidence, should another run on the banking system occur in the future.[1]

2007-08

This paper is not intended to be an apologia for the imprudent bank funding and lending that has occurred in recent years; or for the irresponsibility encouraged by excessive bonuses, based on short-term performance; or for the poor, senior management of some of our banks. Rather, it seeks to examine the 'big picture', the preconditions and precipitants which led to imprudent banking, and the probability of a banking crisis occurring in the UK sooner or later.

The responsibility for the probability of a UK banking crisis can be laid largely at the current Government's door. The roots are in mistaken monetary and economic policies; and in regulatory failure. These effectively encouraged banks to lend imprudently as there was too much money around to lend cautiously.

Excessive monetary expansion goes back to 1999. Yet the banking problems did not start until the summer of 2007. The crisis was not inevitable: it could have been contained by appropriate anticipatory action by the UK, US and other Treasuries and banking authorities. What triggered the crisis and the near collapse of the banking system was the US failure to arrange for a bail out of Lehman Brothers. The extent of the resulting defaults of Lehman's immense derivative contractual obligations ($450 billion in total) led to international panic.

It is extraordinary that governments, regulators and bankers did not recognise the impending crisis. It is also extraordinary that they did not foresee a few years ago the results of excessive lending and borrowing. And it is also extraordinary that they failed to act effectively when the crisis started over a year ago.

THE US DIMENSION

It was not just the UK which experienced an excessive expansion of its money supply over the last decade. So too had the US, where the Federal Reserve had presided over too lax a monetary regime for a decade. This led to reckless mortgage lending, encouraged by US government legal requirements. Much of this mortgage lending was packaged up into CDOs – and sold on to the banking system, particularly throughout Europe as well as in the US. The Bank of England current estimates are

1 For example: "In the area of banking supervision, it is crucial that decisions are taken speedily when a systemic crisis arises. Although the same Bank of England team has moved to the FSA and there will be ongoing consultation, we are concerned that, in a systemic crisis, two different arms will deal with the institutions involved." Hansard, 28 June 1999.

that UK banks will need to write off £123 billion against CDOs; US banks $1,577 billion (£1,020 billion); and continental European banks €785 billion (£628 billion) – albeit that mark-to-market valuations may overstate the eventual losses.

To make matters worse, there was no transparency: these instruments were mostly owned via off-balance sheet, financing vehicles; the securitised packages of CDO mortgages were structured to include good and bad loans and were 'cut and diced' so that some packages included different parts of the mortgage obligations (eg interest flows and principal repayment obligations). Moreover they had no recourse to the borrower with only the property security as the ultimate source of repayment.

The origin of toxic US mortgage lending was President Clinton's extension of the Community Redevelopment Act, a well-intended Carter era law designed to encourage minority home ownership. This obliged Fanny Mae and Freddie Mac to provide large and easy mortgage lending terms to underprivileged Americans who would otherwise never realistically have hoped to own a home of their own. This led to the creation of the market in high-risk, sub-prime securitised loans on a massive scale. Both Government and central banks encouraged the securitisation of these mortgage loans as this was seen as both a way of spreading banking risk and making such mortgage loan financing more liquid.

Following two years of falling US house prices, the more prudent banks in the US and UK began to realise, in the summer of 2007, that many of these CDO packages contained a significant element of bad loans, unlikely to be repaid or serviced. The banks who had bought them on the basis of their mistaken AAA Credit Agency ratings, frequently did not fully understand the risks which they contained. The interbank market in CDOs went illiquid, in turn putting pressure on the overall liquidity of the banking system in both the US and the UK. Northern Rock, which had lent imprudently and which had relied heavily on financing its mortgage loans by borrowing from the interbank market and by on-selling securitised packages of its mortgages became the first UK victim of the crisis. It should be noted that the problems faced by Northern Rock were entirely domestic in origin.

THE PRECONDITIONS OF UK FRAGILITY

There were three main areas of UK Government policy which rendered the UK banking system vulnerable to crisis:

- monetary policy
- wider economic policy
- deregulation and regulatory failure.

UK Monetary policy and globalisation

It is a tragic irony that the once highly-acclaimed, 1997 Bank of England reforms have turned out to have been the main underlying cause of the unsustainable rise in house prices; and of the excessive increase in consumer debt. Together these have destabilised both the UK banking system and the wider economy.

In the more closed economic conditions, which prevailed for 40 years after World War II, excessive growth of the money supply led quickly to wage cost-push inflation. This was the era of 'stop-go', requiring the application of the economic brakes whenever consumer spending and inflation started to get out of control.

Since the 1980s, in the far more open global economy, excess monetary growth leads to asset price inflation as opposed to cost of living inflation: and the accompanying excess demand feeds through to rising imports and a growing current account deficit (rather than retail price inflation).

In the UK, money supply, particularly, from 2002 onwards, grew far faster than the rate of economic growth. This was clearly leading to imprudent lending by the banking system. Indeed, when I visited the Bank of England five years ago as a Shadow Treasury Minister, I asked if they were concerned at the excessive increase in consumer credit and house prices. The reply I was given was that the Bank could not pursue more than one objective at the same time and the objective it was bidden to pursue by the Government was a rate of retail price inflation of 2.5% p.a. The Bank of England told me that while they recognised that credit and house prices were increasing too fast, they did not have the remit to address this.

Also for a decade, until two years ago, the impact of globalisation served to conceal the real underlying rate of UK inflation and to increase living standards in the UK beyond the rate of domestic economic growth, as the terms of trade moved significantly in our favour, and Sterling remained strong. Manufactured goods from Asia got cheaper and cheaper while the prices of our exports, particularly of professional services, rose. In simple terms, the measure of UK inflation was a mixture of higher 'domestic' inflation, offset by imported deflation. Thus the long-term underlying UK inflation rate was higher than the official inflation measures. This led to inappropriately low UK interest rates which were set to meet the 2.5% Government inflation target. To make matters worse, three years ago the Government switched from the RPIX inflation measure (which included an element for housing costs, not values) to the European RPI measure (which excludes any housing cost ingredient and which has, historically, registered a lower inflation figure than the RPX measure). As we all know from everyday experience, the RPI inflation measure has understated the UK retail price inflation. This encouraged and enabled people to borrow more, particularly to finance house purchases, and so driving up house prices.

The excess consumer demand in the economy, rather than driving up consumer inflation, flowed through to rising imports; and as the Bank of England was meeting the Government's inflation target, monetary policy was not tightened sufficiently when it should have been. Excess demand only started to register in the Government's prescribed inflation measure 18 months ago, when the terms of trade started to move against us, with the cost of oil and food imports rising substantially and Sterling weakening. This then led the Bank of England to raise interest rates, which in turn led to the bursting of the house price and credit bubbles.

The outlook is for vicious asset (house price) deflation and recession. Consumer inflation is also likely to fall away as citizens reduce their spending and oil and food prices weaken. A significant cut in interest rates is now appropriate to reduce the risks of a 'debt deflation', but the Bank of England is constrained while it is obliged to follow an interest rate policy to meet the 2.5% RPI inflation measure, and by the sharp fall in Sterling.

To conclude, the Government's instruction to the Bank of England to meet a 2.5% retail price inflation measurement was deeply flawed. It led to an excessive increase in the money supply, as a result of which banks lent incautiously; this caused an unsustainable rise in house prices, the unwinding of which will cause economic pain for all – and particularly for those who bought at the wrong time; and is also now likely to cause substantial banking losses. For the UK, an inflation target for monetary policy should have included a heavy weighting for asset, and, in particular, house price inflation; and should have also targetted the underlying rate of UK retail price inflation, exclusive of imported deflation.

As long ago as 2002, at Treasury Question Time, I asked Gordon Brown whether he was concerned about the sharp rise in mortgage borrowing and house prices.[2] He answered that, with lower interest rates, citizens could afford to service more debt. Sadly, the other side of this story is unfolding: excessive growth in the money supply and too low interest rates led to unsustainable levels of mortgage borrowings which drove up house prices excessively. This is the precondition for, and the underlying cause of, the UK's banking crisis, which is now leading to a painful recession.

Wider Economic Policy

It is becoming apparent that Brown's economic miracle of ending boom and bust was a mirage. Since 2002, economic growth came not from any material increase in output. Rather it was based on consumption growth, financed by unsustainable mortgage and consumer borrowing, and the massive increase in public sector spending. The UK has been living on borrowed time for at least the last four or five years.

The collapse in the savings rate illustrates this. It has fallen from around 9% in 1997 to – 1% on the latest measures. This downward trend in the UK savings' rate was an important signal that UK monetary and fiscal policy was wrong. It should have been a warning of financial and economic problems ahead. With bank and credit card borrowing now being curtailed and citizens more cautious, a sharp rise in the savings' rate – potentially back to 10% as occurred after the 1974 banking crisis – would mean a 10% fall in consumption. The impact of this on retail economic activity would be dire.

Regulation, deregulation & the Bank of England

A knee-jerk reaction in the middle of a crisis for more regulation risks long-term over-regulation and could damage economic recovery.

It is implicit, however, that deregulation, while positive in encouraging innovation and economic activity, can cause animal spirits to run wild, and can lead to bubbles in asset prices.

Banks are different from other economic sectors: they cannot be permitted to fail; and, of their nature, banks are vulnerable to runs. This is why the central bank, 'Lender of Last Resort' role is so important and why the major restraints imposed on it in this crisis worsened the problems of illiquidity in the interbank markets. This in turn invited runs on banks, perceived as vulnerable.

It was the collapse of Lehman which triggered the panic. This was because of the extent of Lehman's derivative obligations with commercial banks. Here, the issue is that commercial banks participated in territories previously limited to investment banks, where the usage of derivative financial instruments had also exploded. Because commercial banks participated in these instruments (both to make money and to lay off risks), their capital bases were vulnerable to the failure of any major counter-party and where they were a counter-party to Lehman's London subsidiary's obligations. In addition to all the derivative instruments associated with short sales or taking long positions, the banks have made extensive use of instruments known as Credit Default Swaps (CDS). These instruments are designed to provide insurance against risks attaching to particular financial assets. If the counter-party defaults the insurance is

2 "Standard and Poor's has just listed the UK, for the first time ever, as an economy facing major potential stress on its banking system because of the possible bursting of the house price bubble and ballooning consumer debt problems. What assumptions has he made in his borrowing forecasts about house prices, consumer debt and the implications for the economy of the warnings not just from the IMF, the Bank of England and Standard and Poor's but from the permanent secretary?" Hansard, 12 December 2002.

gone and the value of the assets has to be written down. The CDS market is gigantic in gross terms (estimated at $67,000 billion) although most contracts overall net out. After Lehman, another major participant in the market could not be allowed to fail without leading to financial mayhem. It was a major mistake on the part of the US authorities to have allowed the non-US part of Lehman to fail. As a result, there followed the necessity to raise emergency capital to reduce loans, to meet margin calls and to close open derivative positions, estimated to exceed $450 billion. As Warren Buffet warned, these instruments have acted as weapons of mass destruction.

There was thus sense in the historic US Glass-Steagall Act (which prevented commercial banks participating in investment banking activities and instruments). Because of the importance of commercial banks and because ultimately central banks and governments have to bail them out to protect the real economy, the moral must be that commercial banks should at least be limited in the extent to which they can participate in investment banking activities and instruments which can wipe out their capital.

In addition, the risk-weighting calculations required of banks, under the Basel guidelines, would appear to have been significantly evaded, largely by the use of off-balance sheet, special purpose vehicles. Off-balance sheet entities have been the major holders of CDOs, where the extent of banks' involvement in these instruments did not readily show up.

The Bank of Spain appears to have done a better job of regulating banks than other regulators, by forcing them to post reserves against special purpose vehicles. Northern Rock's dangerous expansion of mortgage lending would have been constrained had it been forced to provide such reserve capital against its refinancing, special purpose vehicle.

More widely, in the UK, for political reasons the main focus of financial regulation has been on the retail markets in order to protect the consumer. Until recently the accepted wisdom was that the institutions could look after themselves. At the time of the Financial Services and Markets Act, I made the point that if things went wrong with the larger institutions, this would constitute a threat to the banking system and the whole economy; and that financial regulators need to monitor the larger financial institutions assiduously and to have the powers to restrain them, if their activities are exposing the banking system to excessive risks.

It is also wrong that regulators and financial institutions have been forced to spend disproportionate time, effort and expense in anti-money laundering requirements, when nothing was done about the far more serious risks to the banking system which were developing. Since the crisis broke the FSA has performed well, but previously it was far behind the curve.

The most important job of regulators must be to seek to ensure the resilience of the financial system with respect to economic shocks. To this end, they should have the mandate to speak out publicly, when they perceive Government-induced monetary or fiscal policy is a threat to the soundness of the financial system, as was the case in the UK and US. Experience has also shown that regulation should not rely on self-regulation which is in effect deregulation. Allowing institutions to determine their own capital levels based on their own risk models, amounts to letting them set their own capital level. Where capital requirements are deemed appropriate they should also be implemented in a way that can be monitored by supervisors on the basis of fully inclusive balance sheet data.

It is also apparent that the focus of regulation needs to be as much on the health of the overall financial system as the prudential practices of individual institutions. This will require regulatory efforts to limit excesses when times are good and to avoid degearing in difficult times, when this can increase pressures on the overall financial system and the economy.

Another regulatory failure has been the Basel-imposed ‘mark to market’ requirements for bank assets. These can only worsen a downward spiral when the market for assets, such as CDOs, has collapsed.

It is axiomatic that any regulatory regime must also address the risks arising from parallel banking activities. Too much borrowing short and lending long has been practised not only by banks but also by bond guarantors, hedge funds and insurance companies. If capital requirements are raised on banks only, problems may be exacerbated as activity moves to those entities that are not regulated or are less regulated. Back in 2005, I advised the Chief Executive of the FSA that I believed that there needed to be some regulation of hedge funds because of possible contagion to the wider banking and financial system

In the UK, it was clearly a mistake to have removed responsibility for banking regulation from the Bank of England. The tripartite committee – the Bank of England, the FSA and the Treasury – has not worked well, albeit that as the banking crisis has got more serious all three parties have pulled together. Although banking is now much more complicated than in the past, the Bank of England did a good job in preventing a banking crisis getting out of hand for 100 years. Because commercial banks are different to other financial service businesses, the organisation responsible for overall monetary policy – the Central Bank – should have a better insight into the dangers facing banks. Moreover, restoring the wider powers of the Bank of England would give it greater natural authority to act to head off risks and crises that, inevitably, are faced by any banking system from time to time.

PRECEDENTS

100 years ago there was a specialised small department attached to the Cabinet Office, whose job it was to monitor and analyse historical precedents, as a policy input to Government. It covered virtually all areas of Government activity. In contrast, it appears that the Treasury looked at relevant historic precedents only once the crisis was in full swing.

The most relevant precedent, although on a much smaller scale, was the Swedish banking crisis at the beginning of the 1990s. The underlying background to this was credit market deregulation in 1985 which led to Swedish credit conditions becoming too expansionary. This also coincided with a tax system which favoured borrowing and over expansionary Government economic policy. The combination led to a rapid growth in private sector debt – the GDP ratio for private sector debt moved from 85% to 135%; the credit boom led to rising property and share prices. As with the UK over the last six years, the expansion of credit was also associated with excessive real economic demand. Private savings collapsed and, as Sweden was then a relatively closed economy, inflation accelerated.

Matters came to a head in 1990 when higher interest rates led asset prices to fall. The real economy went into recession, with GDP dropping 6% between 1990 and 1993 and unemployment rising from 3% to 12% of the labour force. The public sector deficit worsened to 12% of GDP. A tidal wave of bankruptcies led to the banking sector having to make provisions for losses equal to 12% of Swedish GDP. The seven largest Swedish banks were all in trouble and their loan losses more than wiped out the banking sector's capital base.

In response, in 1992 a united Swedish Government and Opposition announced a general guarantee for the whole banking sector. This provided protection from losses for all creditors, but not for shareholders. The Government injected capital into the banking system amounting to over 4% of GDP and set up a Special Authority to administer the bank guarantee and the banks in which the Government had been obliged to invest equity. Sweden's Central Bank supplied liquidity to the banking system without the requirement for collateral, and on an unlimited basis. The Banks applying for support had their assets valued by the Bank Support Authority, using uniform criteria. The Swedish Bank Support Authority decided in favour of requiring banks to disclose all expected loan losses and to assign realistic values to real estate collateral, rather than deferring the reporting of losses for as long as possible and using current income to finance a gradual write off of the banks' losses.

It was judged that the policy of making full provision, and thus knowledge available of how much Government support was required, would promote confidence; although inevitably it served to exaggerate the magnitude of the problems at the time.

THE UK GOVERNMENT'S MEASURES

Faced by impending banking collapse, the UK Government has followed the Swedish precedent intended to sustain, and to restore confidence in, the banking system; and to improve the willingness and ability of banks to lend into the real economy. A global depression on a 1930s scale looks to have been avoided – but only just. A fast and vicious recession now looks a certainty.

The priorities are to restore liquidity to the inter-bank markets on which the liquidity of the banking system depends and to sustain the capital base of the banking system to stop banks being obliged to reduce their lending. The capital bases of banks have been eroded by losses on derivatives and CDOs and will be hit by further mortgage and SME losses as the UK economy turns down and house prices fall further, currently estimated by the Bank of England at £130 billion over the next five years.

The Bank of England needs to return to the Bagehot doctrine of Lender of Last Resort. Since the Barings' failure, there has been a dangerous lack of clarity here. The understanding has been that the Bank of England would support any bank which was too large to be allowed to fail. Northern Rock was a test case where clearly the Bank of England did not think Northern Rock fell into this category. But manifestly it did. Given the actions of individual Northern Rock depositors in withdrawing their deposits, there would have been a run on many of the other mortgage lending institutions if the Government had not supported Northern Rock.

The terms of the Government's subscription for ordinary and 12% preference shares in three of the main British banks are not yet clear. The main shareholders of the banks are pension funds and individual savers. There is at least the possibility that the Government could be seen to have used its bullying powers to have exploited the vulnerability of these shareholders at a time of crisis. In my judgement, the 12% rate for preference share capital is too high. The Dutch Government, for example, is charging 8.5% on the preference share capital it is providing to ING and is offering equity financing on a basis which does not dilute ordinary shareholders.

It is also not clear how the Government's constraints on the bank dividends will work in practice. Pension funds and individuals hold bank shares for their dividend income. If no dividends are allowed, there would be undesirable pressure on them to sell and switch into other stocks with reasonable dividend yields. The Government has culpability for the underlying causes of the banking crisis in its monetary, economic and regulatory policies. It should not penalise shareholders 'unfairly' in its attempt to put things right.

Over time, it should reasonably be expected that both the capital injections into the banking system and the liquidity made available to the banks will be recovered and will not be a cost to the taxpayer. Equally, nor should they turn out to deliver a major gain to the Government as the result of exploiting its power. It is to be hoped that both ordinary and preference share injections will be able to be repaid by the banks within the near term. Here the model should be the experience of Sweden where the Government sold its bank shareholdings once the economy and banking system had recovered and was thus able to recoup the cost of its support.

The Government is right in encouraging banks to lend into the economy and to seek to maintain overall 2007 lending levels. SMEs are particularly vulnerable to banks cutting their borrowing facilities. SMEs employ 14 million people. If a lack of bank financing leads to large numbers of insolvencies and job losses, this could compound the collapse in house prices. There is already the prospect that house prices may fall as much as 50% from the over-valued prices of the easy money times. Here, the economic storm is yet to come.

Considerably lower interest rates and financial innovation will also be needed to revive mortgage lending. The principle of Covered Bonds needs to be considered, where mortgage obligations can be financed by securitisation but subject to including a guarantee of all the loans made by the original lending banks.

The Government's borrowing requirements are already overshooting massively, largely as the result of a fall in expected tax revenues. VAT revenues will decline as consumption falls. The total tax arising from the financial services sector, comprising both the tax paid by businesses and the income tax and indirect taxes paid by its employees, has been running at around 30% of the total tax take. A sharp rise in unemployment will also balloon welfare payments. The UK economy will be particularly hard hit because of its historic dependence upon the financial services sector and because it has experienced the largest relative increase in both consumer debt and mortgage borrowing/house prices.

THE OUTLOOK

The 2008 banking crisis has, unfortunately, much in common with 1929. But it is to be hoped that Governments and central banks will act to prevent so steep an economic downturn as was experienced then. The key point in the US in the early 1930s was that, as the result of the collapse of so many local banks, the money supply fell by a third. (The bottom of the downturn, moreover, was not reached until 1932).

The Government is correct to be requesting Banks to keep up their lending to levels prevailing in 2007 and to go slowly on home repossessions, when mortgage borrowers have lost their jobs. It remains to be seen to what extent frightened bank management can be persuaded to act counter-cyclically, but to do so is likely to prove commercially, as well as economically, correct. In a crisis, an element of 'Chinese style' state directed capitalism and particularly state directed bank lending, may have their merits.

The financial crisis is also having a knock-on effect on exchange rates. Sterling is likely to remain vulnerable although this may be helpful to the economy in improving competitiveness. There are, however, also dangers of Sterling depreciation getting out of control. The recent speech in Manchester by the Governor of the Bank of England could only have been intended to cause a run on Sterling, analogous to coming off the Gold Standard in 1930.

It is possible that the Euro may also come under considerable strain, where Germany is unlikely to be willing to support other EU economies and in particular the Italian economy, where Italian banks are rumoured to have a relatively larger exposure to sub-prime CDOs. The major cause of the overheating of the Irish economy, and its knock-on effects on property values and on Irish banks, has been Ireland's membership of the Euro. Euro interest rates have been too low in relation to Ireland's rate of inflation, and encouraged excessive borrowing at virtually zero interest rates, driving up property prices.

The US economy is likely to pick up ahead of the UK and continental European economies. This implies a period of relative Dollar strength. Moreover, a significant amount of US international indebtedness, where this has been financed by the sale of sub-prime CDOs to overseas banks, will also end up being written off, as the result of the losses sustained by overseas banks on CDOs currently estimated to be approximately $1.2 trillion.

WHAT NEXT?

Monetary and banking reform

1. For the short term, the Government should override or at least suspend its monetary policy directive to the Bank of England. Interest rates need to be reduced significantly. While the current, historic, cost of living inflation rate is worryingly high, this is likely to come down sharply with, the fall in oil prices and reduced consumption. Here again the Government's instructions to the Bank of England to target an historic 2.5% RPI are inappropriate and unhelpfully pro-cyclical.

2. In the longer term, the Government's guidelines to the Bank of England in the management of monetary policy need to be reconsidered. The Federal Reserve has a mixed and conflicting brief to both restrain inflationary pressures and to encourage economic activity; The first objective of the ECB in the Euro area is to maintain financial stability. Judged by results it would appear that the ECB brief has been more successful than that to the Bank of England or Federal Reserve.

3. Aside from the contraction in the capital base of the banking system which would force a reduction in bank lending and the money supply, and which the Government measures seek to address, the major continuing factor reducing money supply is illiquidity in the interbank markets. The Bank of England should, therefore, also lend aggressively into the interbank market to help improve liquidity. The outlook here is mixed. There are still many areas of vulnerability (in particular the CDS overhang) which will make banks cautious and motivated to continue to hoard liquidity against potential liability exposures; (one of the reasons why banks have been 'hoarding' the funding they have obtained from central banks has been that they expected heavy calls on them to meet margin calls and to close open derivative positions and where they had underwritten the risk on Lehman obligations under CDS agreements, or also lost CDS insurance

cover underwritten by Lehman). Here the Government guarantee scheme for interbank lending appears to be starting to improve the situation.

4. To revive mortgage lending, Covered Bonds should be introduced. Banks or building societies should guarantee the individual mortgages that they advance, thus making securitised packages of mortgages safer, and more liquid, assets.

5. In banking regulation, three key areas need to be addressed:, first, how to reduce the potential exposure of commercial banks to the higher risk activities of investment banking; at their centre the banks have been behaving like Hedge Funds. Secondly, to control the amounts that can be lent as mortgages in relation to both property values and earnings' multiples (arguably this should not be completely rigid as the risks are entirely different at the top and the bottom of house price cycles). Thirdly, the use by commercial banks of off-balance sheet, special purpose vehicles should be banned or at least tightly controlled and monitored.

Economic Measures

The UK economy contracted by 0.5% in the third quarter of this year – more than twice as much as was generally expected. The Chancellor of the Exchequer has commented that Britain is facing 'a credit crunch that is probably the worst since the 1930s.' City economists are warning of soaring unemployment, sharply falling house prices with widespread negative equity problems and slumping profits. The stock market has already virtually halved from its peak (and its level eight years ago) and is continuing to fall sharply, anticipating major recession. Sterling is also falling sharply, down 25% from its level against the Dollar earlier this year. The Deputy Governor of the Bank of England has warned that Britain is facing a 'once-in-a-lifetime crisis' and that 'in terms of impact on the real economy we are still in the early days.' The prospects are for a long and painful recession, for at least the next three years.

The Chancellor has stated that he will be looking to implement Keynesian infrastructure, public spending measures to help to sustain the economy. The potential severity of the recession which Britain is now facing justifies Keynesian infrastructure spending, but this would better be achieved by the relevant parts of the private sector – such as advancing the timetable for Cross Rail and fast-tracking the construction of new nuclear power stations which are anyway needed. As occurred in the 1930s, infrastructure projects not only provide direct employment to those laid off in the building industry but also have a multiplier effect as the people employed (who would otherwise be unemployed) spend their earnings into the economy.

There are two problems with the Government's stated approach:

- Planning and consultation requirements may delay the speedy implementation of infrastructure projects, preventing them from being implemented now, when they are needed.

- Statist interventionist policies are likely to undermine what is needed in the long term – a down-sizing of the state and sorting out the public sector in order to free up the resources to increase long-term productivity growth and economic growth.

Recommendations

1. Interest rates should be cut substantially. With the fall in consumption now occurring and the destruction of wealth and money supply, the near-term risks are of deflation. The short-term objective must be to sustain the money supply. But once there is evidence of the economy coming out of recession it will be necessary to tighten monetary policy, in good time.

2. Keynesian infrastructure investment should be encouraged where this can be implemented speedily, and where such projects are largely financed by the private sector – in the interests of both efficiency and containing public expenditure. The Government needs to collaborate with the energy, water and transportation industries to review which investment projects could be brought forward to sustain the construction industry.

3. If the recession turns out to be as severe as I anticipate, both personal and corporate taxes should be cut to help sustain demand. But tax cuts should be designed to be sustainable, as if they were reversed in the near term, they could serve to prolong rather than alleviate the agony, as has occurred in the US.

4. The SME sector is highly vulnerable to reductions in bank lending and needs to be supported. The existing scheme for Government guarantees of loans to small companies urgently needs to be 'beefed up' and made more easily accessible. The Government should consider incentives to the banks to maintain 2007 levels of SME lending.

Public Borrowing

The public sector deficit was £37.6 billion in the first half of this year, 75% greater than in the first half of 2007. It looks to be heading for at least £100 billion this year. While it is inevitable that government expenditure and borrowing rise in a recession, it was gross mismanagement of the public finances for the Government to have been in significant deficit rather than surplus when the economy was over-heating prior to the credit crunch. This must constrain the scope for tax cuts. If the Labour government embarks on major, and potentially ill-considered, publicly-financed, Keynesian infrastructure spending this would add to the burden of debt to be serviced and paid off in the future and potentially constrain the private sectors' recovery in due course.

The next Government will have a difficult task on its hands. It will need to see through, responsibly, measures to pull the country out of recession where this Government may have committed the country to misguided, publicly-funded Keynesian measures. Once the economy is recovering, it will be essential to pull back public expenditure and the trend towards degenerating into an inefficient, over-large and over-powerful Socialist state. History has shown that free market economies have increased the living standards of people dramatically more than Socialist economies. But, by their nature, free market economies are vulnerable to excesses and crises. In such circumstances, there can be a short-term case for pump-priming by the state to sustain aggregate demand against the prospect of depression. This is not a role, however, which makes sense in normal times.

This paper is the first in a series of publications on the 2008 banking crisis.

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