

What killed capitalism?

The crisis: what caused it and how to respond

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SUMMARY

- The UK Government's nationalisation of most of the UK's banking sector in the Autumn of 2008 (with the consent of the Opposition) marks the end of private capitalism.
- This is a disaster of the first order. Politicians appear not to understand what they have done.
- This paper sets out how we got here; what we should have done instead; and where we should go from here.

What caused the credit crunch?

- Genuinely valuable innovation.
- Over-confidence in regulatory badging.
- Use of novel products to by-pass regulatory requirements.
- Extreme moral hazard in respect of housing.
- Over-dependence on annual inflation targets.

What did NOT cause the credit crunch?

- Greed.
- Bonuses.

The UK Government's response to the escalation

- The removal of prudential supervision from the Bank of England, together with the Government's unwillingness to see any significant institution fail, escalated the crisis.
- The nationalisation of most of the UK's banking sector has created a new economic order of state capitalism.
- This strategy validated the poor decisions that led to the crisis. The banks took on too much bond-based debt at the expense of equity on the premise that debt was low risk.
- By sparing bondholders, the Government has made this judgement right — these bonds have, indeed, turned out to be as low risk as was thought. This rewards the behaviour that led to the failure of these institutions.

What should have been done instead

- Instead of sparing the bondholders and providing cash that enabled the companies to avoid restructuring, the correct policy should have focused on employing market mechanisms (rather than fearing them) so as to punish the bondholders and force the required restructuring.
- Formulaic prudential capital requirements that were intended to avoid such a crisis but actually made it worse once the crisis was here should have been suspended.
- The Bank should have been made the prudential supervisor.
- It should have provided solvent institutions with unlimited last-resort lending with no time limit. It should have provided insolvent institutions that would nonetheless have secure future profitability with time-limited last-resort lending. It should have placed failing institutions into a special administration regime.

- Retail depositors should have been made into preferred creditors (even above secured creditors).
- The real economy should have been supported with tax cuts.
- How much less bad would things have been if, instead of spending £200 billion (the IMF estimate of the cost of the bank bail out) on the financial sector, the Government had made £200 billion of tax cuts?

What to do from here

Short term:

- Stop the taxpayer bleeding — no more cash injections to insolvent institutions.
- Do not interfere with any more institutions — stay away from Barclays and HSBC. Rely on the preferred creditors regime for depositors.
- If a major institution fails, employ a deposit access fund.
- For institutions in which the government has a controlling stake, accept the role of shareholders. Force operational restructuring — no one else is going to. Force financial restructuring: make bondholders accept debt-equity swaps. Only honour bonds if the company is profitable after restructuring. If it can't be done, cut your losses. Let the bank fail.
- Don't pretend you can pin the recession on three or four individuals.
- Do not restrict above-100% mortgages or sub-prime lending.
- Focus funds on the real economy. Cut taxes. Reduce expenditure growth by at least £100bn.

- Insofar as financial sector funds must be employed, they should be focused on loans to solvent institutions and on capital for new lending institutions.
- Introduce a price-level target for 2014 at 15.9% above the current price-level (ie target 3% annual average inflation over the period). Use quantitative easing.

Longer term

- Have no nationalised banks.
- Focus financial regulation on assisting *caveat emptor*.
- Allow salesmen to be paid commissions, but ban them from calling themselves advisers.
- Introduce gilt aggregator accounts.
- Restrict deposit insurance to gilt aggregator accounts and current accounts.
- Ensure that (uninsured) time depositors are preferred creditors.
- Set the Bank of England the task of prudential regulation, explicitly paired with the role of lender-of-last-resort.
- If international prudential standards must be employed, then there should be: first, a prudential requirement that is a function of an international early-warning system; second, a prudential requirement that is a counter-cyclical instrument of monetary policy, employed by the Bank of England; third, an individual-firm prudential requirement.
- There should be a price-level target for the UK. The price index employed should include housing costs but no asset prices. Close attention should be paid to signals in monetary data, but no explicit monetary target should be set.

1. INTRODUCTION

We are in the grip of what may well be the worst financial sector crisis in history. This now appears to be either partially or wholly the result or cause (or both) of one of the worst ever recessions across the developed world. Falls in UK GDP of above 6% now seem likely. Falls of above 10% no longer seem impossible.

This paper sets out to:

- explain what caused the credit crunch;
- explain why many of the things attempted to address it did not work, and in particular how most of the things the authorities tried made things worse, rather than better;
- put forward the appropriate regulatory and other policy responses, both in the short term and in the longer term.

The “credit crunch” began in the summer of 2007 with the seizing up of interbank money markets and the lead-up to the run on Northern Rock. The events following the effective nationalisations of Fannie Mae and Freddie Mac (most famously the bankruptcy of Lehman Brothers) are referred to here as “the Escalation”.

2. WHAT CAUSED THE CREDIT CRUNCH?

The five key causes of the credit crunch can be summarised as:

- genuinely valuable innovation;
- over-confidence in regulatory badging;
- use of novel products to by-pass regulatory requirements;
- extreme moral hazard in respect of housing;
- over-dependence on annual inflation targets.

Genuinely valuable innovation

It is sometimes widely argued that CDOs and other new financial instruments played a major part in bringing about, or exacerbating, the financial crisis; that they increased risk; and that they should therefore be banned. Is this a false assumption? Or could they in fact have been a valuable innovation with the potential to generate long-term wealth?

The truth is that, over the past decade, some financial innovations have increased the extent to which it was possible to reduce risk. For example, if I own one one millionth of one million mortgages, I am less exposed to the risk of individual

people defaulting on their mortgages than if I own just one mortgage.¹

Of course, I have not eliminated *all* uncertainty, *all* volatility in the stream of payments I will receive from mortgage holders. What if there is some event that affects the whole mortgage market, so that many more people than is normal default at the same time? Perhaps even the risk of *that* is reduced – perhaps financial innovation means that the economy as a whole will be less volatile in the future.

The counter-argument is that if the risk is just sliced up and moved around by these products, it is only diversified, not reduced. For each person that gives up a little bit of risk, the argument goes, there must be someone else that takes the risk on. True enough. But there are discontinuities here. As a bank becomes more and more distressed, it may lend less and less and charge higher and higher interest rates, thereby incrementally adding to the burdens of its customers. At some point, however, the straw of losses breaks the camel's bank, the bank defaults, and the burdens on its customers rise dramatically. Things that happen to *me* have spillover effects upon *you*. So if we can spread out the risk better, moving it from those less able to bear it to those more able to bear it, it may be that the aggregate risk in the system is actually reduced. The important words here are “more able to bear it”: in the event that there are losses, those more able to bear risk are less likely to default and thus less likely to impose spillover costs on those they deal with.

¹ For the technically minded: the *expected value* of one one millionth of one million mortgages (on the hypothesis of identical credit quality) is the same as that of one such mortgage (the average level of default is, *ex hypothesi*, the same), but the *variance* is dramatically reduced.

The question, of course, is whether, in fact, we *do* spread out the risk better, moving it from those less able to bear it to those “more able to bear it”. If, in practice, we spread out the risk “worse”, moving it from those more able to those less able to bear it, then aggregate risk will have increased. A lesser variant of this problem would be if we have the same amount of risk but now spread it around in such a way that it becomes more concentrated at certain times (so, even if, on average, over the cycle, there is no more risk, there might be more volatility because the bad cases will all turn up at the same time). Some studies suggest that, in fact, one of these two “bad” scenarios is what actually happened.²

So did we end up with an innovation that allows people to diversify their individual risks but might either increase the total amount of risk about or concentrate it all in walloping great busts? Is this one of those “individually advantageous but collectively disastrous” things? Maybe markets aren’t such great ways to organise things after all?

Markets, of course, can never be perfectly efficient allocation mechanisms. The challenge, of course, is working out whether, with regulation or state intervention, one can actually improve upon the market’s “natural” outcome rather than wasting one’s time or making things worse.

² For an example of a study concluding the former “bad” case (those less able to bear risk end up with it), see K Alexander, J Eatwell, A Persaud & R Reoch, “Financial supervision and crisis management in the EU”, *European Parliament Committee on Economic and Monetary Affairs*, December 2007.

For an example of the latter (increased correlation of risk) see p26 of R Ricol, “Report on the Financial Crisis”, *Mission entrusted by the President of the Republic In the context of the 2008 French Presidency of the European Union*, September 2008.

It is often the case with major innovations, of all sorts (not just financial), that when they first arrive people aren't sure how best to use them, and sometimes over-estimate how much difference they will make in the short term. The uncertainties associated with these innovations frequently lead people to over-pay for innovations initially. Most people think this was the case with the railways, with the light bulb, with radio, with dotcom companies.

This is the key: the relationship between the price charged and the price people were willing to pay. If people on average were willing to pay too much for their one millionth share in a million mortgages, then the market might well allocate the risk such that the aggregate system-wide risk increased. In the long run, once the risk-return features of these products became clearer, then individual risk should fall and system-wide risk should at least be no higher. Unfortunately, we are still in the short run.

So people in financial markets did over-estimate how much risk had been reduced by these new products; and consequently paid too much for them. This led to unanticipated losses, and a market correction once people better reassessed the true value of these products.

That's capitalism. Mistakes happen. But seeing this aspect of the problem is crucial. For the right response to the railways mania was not to ban or restrict the building of railways; nor was the right response to the dotcom crash to ban or restrict internet-based companies. So why should we think that the right response to the CDO crash might be to ban or restrict the use of CDOs?

Lots of people have long thought they could improve upon this innovation-drives-volatility aspect of capitalism. Perhaps there

are ways to do that.³ But there are *definitely* ways to make things worse, and the other four causes in our list will be the sorry tale of how regulators and financial/monetary authorities have made this boom-and-bust much worse than it needed to have been.

Each of these policy errors, by itself, would have been more than adequate to create a calamity. Together, their effect has been to make a catastrophe out of a disaster.

Over confidence in the regulatory badging

In most markets, if you decide to buy something, it is generally thought to be your problem to work out how much to pay for it. If it turns out to be worth less – tough! You shouldn't have bought it at all, or at least shouldn't have paid that much for it. *Caveat emptor*.

The erosion of caveat emptor

Over the past 20 and more years, the concept of *caveat emptor* has been eroded in financial services. Instead of their own analysis, people have become almost totally reliant on the stated opinion of appointed experts – the regulators and the ratings agencies – who create confidence through provision of their regulatory badge.

This has been most obvious at the retail level, particularly for retail products such as pensions and retail banking activities such as the accepting of deposits. Here are some of the justifications made for this behaviour:

- Many consumers are not able even to understand compound interest, let alone the more sophisticated aspects of many

³ It is certainly worth trying to alleviate some of the symptoms of this, and various suggestions are made later that may have a positive effect. But maybe all we can do is to clean up efficiently afterwards and make sure we have enough saved away to make post-innovation busts a little less uncomfortable.

retail financial products with their collars, redemption penalties, payment holiday clauses, and so on. People also buy too few financial products: they have too little pensions provision or not enough liquid cash savings. So consumers of financial products came to be seen as naïve victims, ever vulnerable to exploitation and mis-selling.

- Many financial products are highly complex, and their value cannot easily be observed by consumers. Hence instead of direct information consumers may rely on the reputation of a financial firm, in general, for the quality of its products. However, some financial service products are experienced only once (eg pensions), sometimes long after purchase. Hence reputational disciplining mechanisms may be weak.
- Firms may know more about the value of their products than consumers. Firms (or their salesmen) may have incentives to exploit their informational advantages to the detriment of consumers. Markets may have mechanisms to address these problems. However, market punishment mechanisms are not always effective, and even where they are may operate over a sufficiently long-run timescale that failures can arise. For example, in the long term, companies that do not exploit their customers may gain a good reputation. But a company that already has a good reputation may exploit that reputation in the short term, and while in the long term that will lead to its losing its reputation, in the short term its customers may suffer.
- The managers of depositing institutions (eg banks) face limited liability (even bankruptcy is a limited form of punishment). Therefore they have incentives to engage in risky activities that might return high rewards but also might lead to large losses – or alternatively to engage in many different very risky activities, each of which has only a

relatively small chance of success. This means that such managers need monitoring by those whose money they invest. However, many depositors are small. So each depositor faces incentives to free-ride on the monitoring of other depositors. Hence markets may under-monitor banks to the detriment of some depositors. (Similar arguments apply to small shareholders.) Hence it is argued that there is a need for private or public “representatives” of depositors, necessitating regulation.⁴

So instead of it being up to the pension-purchaser or the depositor to work out how much it was worth paying for their products, how much risk there was, how much interest needed to be paid to compensate for the risk of depositing, and so on, the regulator did all the work. The regulator investigated banks and decided whether they were acting prudently. The regulator investigated pension funds and decided how likely they were to go bust before paying out. The regulator checked whether the financial advisers were appropriately trained and qualified, whether they were properly monitored by their bosses to make sure they were not telling lies or just plain incorrect information. The regulator checked that consumers were given “best advice” instead of being sold the products that made the company or the salesman the most commission.

Even though some regulators tried to urge that it was not their job to protect people from downside risk (and the FSA certainly did try this), no one really believed it. The impression entered the public mind that whenever a product went down in value or didn't rise by as much as they had expected, there had been “mis-selling” rather than bad luck. Almost no one seemed to

⁴ This is the famous Dewatripont and Tirole “representation hypothesis”. See M Dewatripont and J Tirole, *The prudential regulation of banks*, MIT, 1994.

think that, if they bought a retail financial product and the company supplying it collapsed so they lost their money, it was the purchaser's fault.

Even if a regulator would like to offer a “we don't insure against downside risk” message, the politics was such that this lacked any real credibility. If the regulator wouldn't act, the politicians would. Note how, when push came to shove, it did not matter that deposit insurance was supposed only to be at 100% for the first £2,000, 90% for the next £33,000, and nothing beyond that. If people's money was going to be lost, the politicians felt they must act. The rules meant nothing.

Caveat emptor was gone. The consumer was infantilised.

Once we take *caveat emptor* away from those actually supplying their own money in such a system, it will become highly dependent on the value of the regulatory badge and the robustness of the incentives structures within the industry. Employees operating with other people's money have incentives given by the nature of their jobs and their remuneration structures. The incentives to strive to fully understand the products they are trading – with other people's money – are intrinsically restricted.

How ratings agencies intensified the problem

In this case, however, matters were much worse than there simply being some problem with remuneration structures. For even the highly expert people who dealt with complex financial products every day weren't expected to assess them. Instead, the system involved a second kind of regulatory badge – that provided by ratings agencies. Just as retail consumers relied on the regulator to inform them of the risks of products and the institutions in which they invested, those in the finance industry relied upon the ratings agencies to tell them how risky were the

products *they* purchased and the institutions in which *they* invested. *Caveat emptor* didn't even apply properly to the expert traders.

So, everything relied upon those two classes of regulatory badge – the regulators and the ratings agencies. This added to the credit crunch in two connected ways. First, because it reduced the incentive to analyse new and poorly-understood innovations. It wasn't the job of retail consumers or depositors to understand whether the institutions they were investing in were taking too much risk or paying too much for these products – that was the regulator. And it wasn't the job of the trader to decide how risky these products were – that was the job of the ratings agencies. But, of course, the regulators and rating agencies had no robust way to work out how much should be paid, no way to gainsay the optimistic analysis of those that had designed the new products and hoped to sell them. They were as impotent in the face of innovation as anyone else. But because everyone relied upon them, that created the second problem. For it meant that when the regulatory badgers got it wrong, *everyone* got it wrong, so there was a system-wide problem instead of problems for just a few people making bad mistakes.

There has been much discussion about the detailed failings of the regulators and about whether ratings agencies faced conflicts of interest. But it is a mistake to focus on these matters of detail.⁵ For in the presence of rapid and significant financial

⁵ The notion that financial regulation become too "light touch" is wrong. The burden of regulation increased significantly after the creation of the FSA and in the period leading up to the beginning of the bonds market madness. Let's take 2003. The FSA itself admits that, relative to operating costs, the cost of complying with financial regulation rose just under 50% between the creation of the FSA in 2000 and 2003 (from 1.1% of operating costs to 1.6% of operating costs). See : http://www.fsa.gov.uk/pubs/other/cost_compliance.pdf

innovation, it will always be beyond the reach of any regulator to state, definitively, what are the risks involved and how much the product is worth. It is a mistake to believe that the state can create a regulator who knows the risks and value of massive financial sector innovations of the sort we have seen in recent years.

Indeed, if we pay regulators even more, and if we hire all the best minds to work as regulators, all that would be achieved would be to increase even more false confidence in regulatory badges. Then, when a problem finally did defeat them (which would be inevitable) it would not be spotted until even later. The ensuing crash would be even worse.

The answer is not ever more invasive regulation, chasing *caveat emptor* even further away; infantilising consumers even more; forcing everyone to rely even more upon regulatory badges that cannot, in the most dangerous cases, be relied upon. If people become ever more reliant upon these regulators, even fewer people will do their own individual analysis of anything, and when matters go wrong, things would be even more coordinated – making the crash even bigger. Coordination of analysis increases systemic risk. Individual, idiosyncratic analysis diversifies decision-making and so diversifies risk. This key insight was overlooked.

Why calls for boring banks are wrong

Many people now say that what they really want is a “boring bank”. But in a system without *caveat emptor*, and in which politics demands that ordinary investors (eg pension purchasers, depositors) are insured against downside risk, there is no market reward for being boring. Boring institutions may be lower risk, but if no one experiences personal loss in the event of risks going bad, who would want that? Everyone will want to participate in high-risk ventures, so that they get the high upside

when things go well and are insured by the politicians against the downside. And boring banks would have to pay depositors lower rates of interest, so wouldn't attract deposits, so would become more dependent on other funding sources, so would become higher risk. Boring banks would pay shareholders lower dividends and so their senior management would be fired. Why, in the absence of *caveat emptor*, would anyone want to run a boring bank?

The only way to deliver boring banking in such a system would be to forbid exciting banking – ie to forbid the growth-generating innovations which drive growth in the economy and make us all wealthier most of the time, but which do lead to occasional significant crashes. Is that what we want?

Can caveat emptor really be feasible?

The four arguments against *caveat emptor* outlined above do have some merit. But do you conclude from them that various regulations may be required to assist *caveat emptor* in operating properly? Or do you conclude that *caveat emptor* can't operate at all and we need something else?

Let us put that same message another way. There was a powerful case offered for replacing *caveat emptor* with regulatory badging. But if everyone depends on the same regulatory badgers, then when the badgers get it wrong (as will inevitably happen from time to time) the whole system's errors will occur at the same time – there will be systemic risk. *Caveat emptor* may have its drawbacks, but the drawback of regulatory badging in terms of greatly coordinated risk turns out to be disastrous, and should at the very least lead us to revisit whether *caveat emptor* might be a better basis for the system after all.

What might that mean? Is there any way past the problems of limited financial literacy or the dangers of being exploited by commission salesmen? Can *caveat emptor* be revived?

When people don't understand things they often seek advice. The fact that they don't understand a product well themselves matters less if their adviser does understand them. Take buying a car. If you weren't sure which second-hand car in the yard would best suit you, would you consider the "advice" provided by the second-hand car salesman to be really "advice" in this sense? Obviously not, because the salesman has a financial interest in your decision. But does that mean he should be banned from talking to you? Obviously not. So long as it is clear that he is a salesman and not a provider of independent advice, you can filter his arguments.

In contrast, suppose that you went to a company selling advice on which cars were best – something like *Which? Car* magazine – and took their advice, but then it later turned out that they were paid commission. Would you think that *Which? Car* were really an "adviser" under these circumstances, or would you feel that you had been misled – defrauded, even?

Oddly, this situation has been allowed in the financial services industry. People who had a financial interest in what products you purchased were permitted to present themselves as providers of advice, even of independent advice. A great deal of fuss was made over whether people advised on financial products from just one or many companies (whether they were single-tied or multi-tied). But that does not change the fundamental issue. The fact that you have a financial interest in what I buy that runs across multiple companies does not change your having a *financial interest*.

If you have a financial interest in what I buy, you should not be able to pretend to be able to offer me disinterested advice. We see calls now for the banning of commission selling. But that is absurd. Commissions are useful incentives for salesmen. There is nothing wrong with being a salesman. We don't object to second-hand car salesmen provided that we know that that is what they are. The problem arises only if they are pretending not to be salesmen.

Regulators tried to provide countervailing incentives. Duties to provide "best advice" to consumers were imposed on financial products salesmen ("financial advisers"). If they failed to do so, they might be found guilty of mis-selling. But that is an exercise in futility. For are we really supposed to believe that salesmen who have a financial interest in my buying one product over another, when the difference to me is rather small, are going to advise me to buy the product against their interests? Even if they always offered what they considered "best advice", in the absence of *caveat emptor*, over time those advisers who honestly believed that the products that happened to deliver them personally the largest commissions would flourish. Those who honestly believed that products delivering them lower commissions were the best would not flourish. So competition would drive out the "honest and good" advisers.

This approach is simply a mistake. What is necessary is:

- If you are a salesman, that's fine. You can be paid commission and you can try to convince consumers to buy the products yielding you the greatest commissions.
- If you are a salesman you must, however, inform consumers that you are a salesman.

- Only those that have no financial interest in the products about which they provide (they are not employed by the product providers concerned, do not work for companies part-owned by the product providers concerned, do not receive commissions from the product providers concerned) can call themselves “financial advisers”. They must be paid by the consumer seeking the advice.⁶
- Let *caveat emptor* apply.

Some will object that almost no one will pay for financial advice. Instead, they will all just back themselves to see through the sales pitches of the salesmen. So almost no true advice will occur, and so all this system will achieve is the freeing of commission salesmen to offer “misleading” advice.

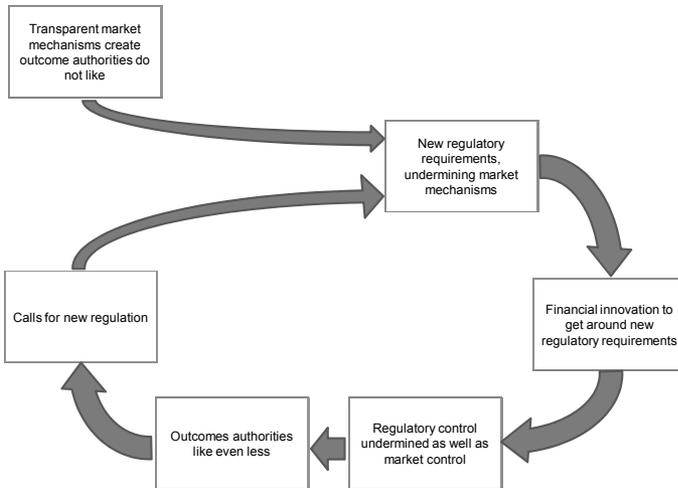
But if people don’t want to pay for advice, then they don’t want it. It isn’t worth anything to them. And if the consequence of that is that they purchase fewer financial products (cf car repairs), then they will purchase fewer financial products. Is that a Bad Thing? Is it really worse than the disastrous results from the *caveat-emptor*-eliminating strategy of the past 20 years?

Use of novel products to by-pass regulatory requirements

Financial markets respond to restrictions on activities that are frowned upon by devising clever new techniques that fall outside the regulatory net. Financial companies only need not do what they are forbidden from doing. New financial products have enabled institutions to by-pass prudential banking requirements and other kinds of regulation.

⁶ Let’s ignore complications such as your mother or your employer paying for you to receive financial advice.

It is not feasible to prevent the finance industry responding to regulatory restrictions by seeking regulatory get-arounds. To do so would undermine financial innovation and the workings of financial markets. So a vicious cycle of events was created:



And the cycle starts again. The proper response is to be more modest in one's initial expectations of what regulation can really achieve; to trust in and value market mechanisms; and to accept failure.

Extreme moral hazard in respect of housing

House prices have come to be closely associated with political fortunes in recent decades. Governments have been seen to take political responsibility for house prices, boasting when they rose and suffering when they fell.

As a consequence, financial markets anticipated that governments would intervene in the event that house prices fell, to limit defaults and foreclosures. Because of this, lending associated with housing

was seen as a lower risk than would be its natural status in a market in which governments would not intervene.

As a consequence, it was appropriate for lenders to take far greater risks in lending on housing. This increased the pool of potential purchasers and drove up house prices to extreme levels until the point at which the Government bailout feasibilities were tested.

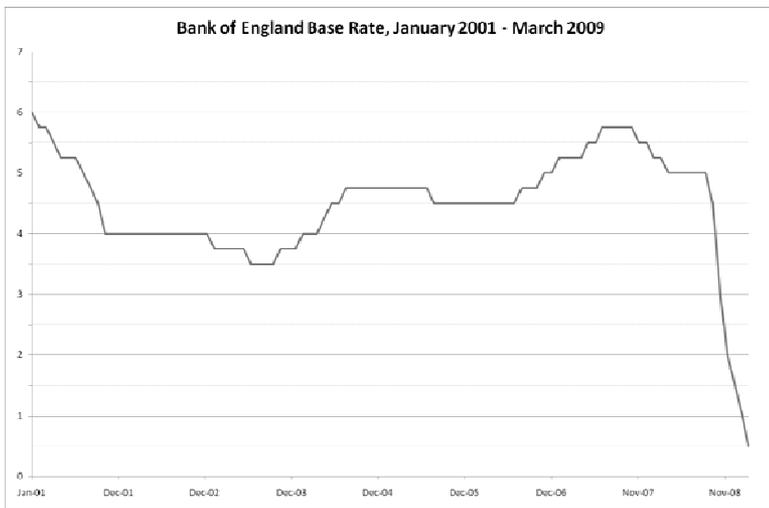
The answer is not for governments to validate moral hazard expectations of the past by intervening today. Otherwise housing will continue to be subject to wild cycles of this sort. Instead, governments must find ways to eschew responsibility for house prices, and to give this credibility by enacting monetary policy mechanisms that will minimise house price effects.

Overdependence on annual inflation targets

A monetary policy regime based on annual inflation targets has a technical flaw: because of something called the "base drift problem", interest rates will tend to be raised too late in response to scenarios in which excess liquidity enters into asset markets rather than consumer goods markets. Such scenarios do not necessarily lead to consumer price inflation over the two- to three-year timescales relevant for annual inflation targeting, and hence are not a policy concern in terms of the meeting of the target. So excess liquidity, which perhaps the monetary authority initially creates in response to a negative shock, can end up driving up asset prices, creating exaggerated asset price cycles.

In response to the dotcom crash, 9/11, the Enron affair, and then the Iraq War bear market, interest rates were kept very low, creating excess liquidity. There was an opportunity to mop up this excess liquidity in 2004 and 2005, but because it was not

issuing in inflation at that point, and because there was understood to be a risk that aggressive tightening would threaten already-over-inflated housing markets, the mopping up was not done (indeed, under inflation targeting it was not strictly necessary, and in the UK rates were actually cut in August 2005). This exacerbated the problems: too much liquidity was available seeking a return from poorly-understood (but well-badged) novel products.



To be fair, inflation targeting may have been unlucky in facing two significant capitalist innovation busts in short succession, without time for the economy to recover properly in between. But be that as it may, the reality is that inflation targeting was not merely impotent in the face of the credit crunch: it actually contributed to bringing it about.

Of course, inflation targeting in the UK had an even worse feature. For from 2003 the effects of house price changes on housing costs were eliminated from the inflation target with the switch from RPIX targeting to CPI targeting. The CPI target was introduced when Gordon Brown announced that his five tests for euro membership had not been met. It was explicitly introduced

in order to promote convergence between the UK and Eurozone economies – they use the same consumer prices index (usually called the "Harmonised Index of Consumer Prices" (HICP)).

At the time of the switch, about one fifth of household costs in the UK were housing costs, but the CPI had (and still has) no housing costs component. This is not because there is some argument against having a housing costs component. It is simply because there are technical statistical difficulties in formulating a common way to account for housing costs that will work across the whole Eurozone. These would not apply to a UK-only measure.

Why asset pricing isn't the answer

Some have argued that policymakers should not care only about retail or consumer price inflation, but also about inflation in asset prices – particularly in the prices of houses or of shares. They advocate a regime in which monetary policy decisions (eg whether interest rates go up or down) should take asset price movements into account. The idea is that policymakers might spot bubbles developing in asset markets and raise rates so as to prick these bubbles so they would deflate in a controlled manner.

Probably the best-known opponent of the asset price targeting concept was Alan Greenspan, Chairman of the Federal Reserve. His view was that, although central banks might be able to note that asset markets were behaving with "irrational exuberance", the proper role for central banks was to place themselves well to "mop up afterwards" when the bust occurred.

There are a couple of often underestimated distinctions to take into account. First we need to distinguish between the monetary policy regime called "inflation targeting" (the regime in the UK);

and the monetary policy regime called "discretion" (what Greenspan is sometimes alleged to have done in the US).

Under inflation targeting, the central bank is set a target for the annual inflation rate. The central bank's performance can therefore be assessed by comparing the actual outturn for inflation versus the target. In contrast, a central bank like the Federal Reserve, operating under "discretion", has no formal target. It just sets policy as it sees fit. If, for a time, it happens to think the most interesting feature of the economy is consumer price inflation, that is just an exercise of its discretion. It does not make it an inflation targeter.

The second distinction is between three things: (a) the central bank being set a formal target for asset prices; (b) the central bank taking close account of asset prices in attempting to meet an inflation target; (c) the central bank taking close account of asset prices when exercising discretion.

Once we see that (a), (b) and (c) are separate, we should see that arguments for doing (c) – for example, that the Federal Reserve, as a central bank with discretion, ought to take account of asset price movements – are not necessarily good arguments for (a).

As it stands, the Greenspan doctrine is simply not applicable to the Bank of England's own policy setting, for the Bank of England does not have discretion. The closest we could come would be a claim relating to (b) – the question of whether the Bank of England ought to take close account of asset prices in attempting to meet an inflation target. To make the claim that the Bank of England ought to have taken more account of asset price movements, we would need to argue either that significant asset price movements will lead inflation to stray away from its target, or that pricking an asset price bubble will not affect

inflation materially but would promote growth (thereby meeting the second part of the Bank of England's mandate).

Asset price movements do not necessarily affect inflation rates within the timescales relevant to an inflation target. But bursting asset price bubbles would be likely to have a short-term impact on inflation. If an inflation targeting central bank were to burst a bubble that was not causing inflation, and that resulted in inflation going under target, that would be a straightforward violation of its mandate.

The introduction of a formal asset price target is not desirable. Could the central bank really know better than the market what was the correct as opposed to bubble price for the asset? A standard line of thought is that the central bank could not possibly know enough to set any useful target. Even if it thought that prices were probably too high, it could have no accurate concept of how much they should fall.

A further problem is better-known and perhaps easier to see than some of the above. If the central bank is targeting the price of an asset, then the price of the asset today will embody the market's expectations about how the central bank will react to today's price. In other words, prices of assets cease to reflect some underlying value of the asset, and start instead to be distorted by expectations of policy response. In this way we replace occasional distortions of asset prices (during bubbles) – which *might* create economic inefficiency – with permanent distortions of their prices (by the policy) – which *definitely* create economic inefficiency.

Inflation targeting allows the central bank to focus on stabilising growth and employment in the economy, subject to meeting the target for inflation. It is thus essentially a growth- and stability-promoting framework. The target acts as a focus for

inflation and interest rate expectations, reducing policy uncertainty considerably and granting the central bank sufficient discretion to react to events so as to smooth out growth. It is an elegant solution, because it is exact and simple. Politicians can debate what is the appropriate inflation rate to target each year. Consumers and businesses can understand well what is being targeted.

So while inflation targeting has failed, its strengths should not be under-estimated. However, its tendency to create asset price bubbles and then act against them too late is a weakness which needs to be overcome.

Price-level targeting

Fortunately there is a simple alternative to inflation targeting that eliminates many of its problems. This is price-level targeting.

The difference between the two is that, under inflation targeting, the monetary authority (eg the Bank of England) targets an annual percentage change in the price-level (currently, in the UK the price-level is defined as the level of the Consumer Prices Index (CPI) and the annual inflation target for 2008 is 2%). In contrast, under price-level targeting, the target is a trend change in the price level. So, instead of there being a target of 2% inflation, then if the CPI were 100 at the start of 2008, the target would be 102 at the end of 2008.

So far, there is no practical difference. But now consider later years. Suppose that inflation were only 1% in 2008, so that at the end of the year the price-level were 101. Then, with inflation targeting, a 2% inflation target for 2009 would imply that the price-level targeted at the end of the year would be 103.02, whilst under price-level targeting the target would remain at a 2% rise on the 102 end-2008 target – so, 104.04. Under inflation targeting, the price-level is “reset” in the event of policy misses –

bygones are left as bygones – whilst under price-level targeting there is an attempt to remedy past failures.

The crucial point is that under inflation targeting the price-level implied by the target for more than a few years ahead is subject to wide uncertainty. For price-level targeting, it is completely certain.

Let us assume that the inflation targeting regime has high credibility but there is also a considerable rise in the stock of money. Because of the high credibility of the inflation target, under some circumstances, it could be attractive to place that money into assets (say, the stock market, or houses) instead of buying goods. Now, the rise in the value of these assets (eg rising house prices) may tend to make people feel wealthier, and thence spend more, and thence create some inflationary pressure. But if inflationary expectations are extremely well anchored, this inflationary effect may be dampened in the short term – or just appear as above-trend growth. Now, one day, off in the future, this extra wealth must either imply greater spending and hence greater prices, or the value of these assets must depreciate. For dynamic equilibrium, if the stock of money is to stay large indefinitely then prices must rise (so that the value of these assets falls in real, though not nominal terms). Alternatively, the implied stock of money must fall at some point (implying something like a credit crunch or a period of very high interest rates).

The short-termism of inflation targeting

But if credibility is sufficiently high, it might happen that the timescales here were rather long. So, if we take the case where matters are resolved through rising inflation, it could potentially be a number of years before rising asset values (driven by monetary expansion) turned into rising inflation. Essentially, this would only happen once people ceased to believe that the Bank

of England could plausibly raise interest rates high enough for long enough to at some point have a sufficiently sustained period of very low monetary growth (or even monetary contraction).

Of course, when this happened, that would mean rising inflation, which would imply a policy response – much higher interest rates. So one might think that, earlier on in the process, the Bank would be able to look ahead and understand that if it did not act early enough, then it would eventually lose credibility and have to raise rates very high. Unfortunately, under an inflation targeting regime this isn't so. Remember, under inflation targeting the implied price-level that the Bank would be targeting off far into the future is highly uncertain. Hence, early on in the process, when that money is turning into rising asset prices, the Bank doesn't know whether it should care. Shocks in the meantime might offset the effects created by these rising asset prices, so that at the end of the day it did not prove necessary to raise rates very high in the end. Of course, such shocks would be possible under any regime (including price-level targeting), but because of the by-gones-are-by-gones nature of inflation targeting, the correct thing to do is only to care about policy over a relatively short timescale (two or three years).

So, an inflation targeting central bank will not care about asset price “bubbles” unless they are going to turn into inflation (or, if they burst, into deflation) over a timescale of a few years.

The same is not true of a price-level targeting central bank. The reason is that a price-level targeter cares about the entire future pathway of prices – off forever into the future. The policy objective is well-anchored into the future, as well as in the present. Consequently, any current development that might

affect the future path of prices will enter into consideration under the rule.

This means that if we had a price-level target, it would be unnecessary to have additional explicit targeting of asset prices. Of course there would be uncertainties over the implications of asset price developments for future price levels, and hence over how interest rates should respond, but these would be precisely the uncertainties over what is the appropriate target for asset prices. By using a price-level target, the effects of current asset price developments on future inflation and output would be embodied into one simple rule, rather than (as presently) using a complicated proliferation of rules.

Price-level targeting is therefore greatly preferable to more complicated asset-price targeting rules. These would be hard to devise, would probably result in policy-makers second-guessing financial innovations and forecasting “appropriate” stock market movements (creating serious price endogeneity problems), and would represent a large change from current regimes.

Greed: a non-explanation

In a market economy, a basic underpinning ethical framework is needed if the market is to function well – specifically, a general commitment to truthfulness, promise-keeping, law-abiding, and a desire that agreements should be to mutual benefit rather than the harm of one party. But that is pretty much it, and that is one of the great unsung strengths of a market economy – namely that it works with the grain of human imperfection and diverse motivations and turns all to the common good.

Markets do not deny that people are greedy, impatient, selfish, covetous and avaricious. But they do not depend for their success upon the virtue of economic agents. They do not require that we all adhere to the same religion, that we all have

the same political beliefs, that our interpretation of history or science is the same, that our goals for ourselves and society are similar. Markets are celebrations of diversity.

The alternative is a world in which commerce only flourishes if people are virtuous. Then it will suddenly be central to collective economic success that we are all good and all similar. Toleration of differences in ethical outlook, in religion, in attitude to history, in personal motivations and goals – these things must pass in such a system.

Bonuses

Many companies offer annual bonuses, bonuses attached to particular projects or milestones, commissions, and other incentive schemes. They do so in order to:

- create loyalty. In many companies a component of total salary is paid in the form of a six-monthly or annual lump-sum for which staff are only eligible if they continue to work for the company past a specified date. This gives staff an incentive not to change jobs prior to that date;
- manage cash-flow. By paying staff only at the end of the year, companies ensure that they have earned profits before paying out cash. A clear example would be a start-up company with limited initial resources that promises to pay its Managing Director a lump sum at the end of the year;
- transfer risk. If you have a start-up company or a company undergoing rapid growth there may be uncertainty about how much you could pay staff and yet still be profitable. By having a pay structure with a limited base salary and a bonus paid at the end of the year, the Chairman is in a position, when considering bonuses, to decide on total remuneration with less risk to the company;

- To reward staff more precisely according to their individual output. Two staff members that on the surface appear similar may, in any one year, differ considerably in their contribution to the company. It is economically efficient for staff to be paid according to their individual productivity. Bonuses allow this to be done more accurately. This also allows companies to pay enough to keep their highest quality staff whilst not over-paying for lower quality staff;
- To direct the efforts of the company to specific objectives. If the shareholders desire that the company should achieve certain strategic goals – eg establish a new branch in some country, or establish a certain market share in a new sector;
- To direct the efforts of individual employee or teams towards certain strategic objectives. For example, a sales team might be instructed primarily to focus on selling to older consumers, and be given a bonus calculated on the basis of how many sales are made to older consumers;
- To create incentives to put in effort. In many jobs it is much more efficient to provide people with bonuses based on their output than to monitor them with personal managers.
- To create incentives to deliver quality. For example, someone selling pensions might be paid a commission based not on the number of sales or on the value of those sales but, rather, on the amount actually paid in to the pension each year.
- To build *esprit de corps* by having employees participate in the profitability of the company as a whole.

Some of these functions of bonuses are related to the profitability of the company as a whole. Others are related to individual performance. Others are simply a reflection of working at the company past a certain date. It would, for example, be

perfectly possible to be legally entitled to a pre-committed bonus if one has worked past the qualifying date, or if one has met one's sales target, or if the section one manages has met its profitability target, even if the company as a whole makes very large losses. Why should an individual employee feel under any obligation to forego his or her bonus just because the company as a whole has made a loss if the bonus is in no way related to the company's overall profitability? The employee wouldn't have received any more money if the company had done well – so why should he or she receive less if it does badly?

Incentive schemes can of course produce perverse incentives as well as useful ones. For example, bonus schemes might produce incentives to deliver high long-term returns to the company when what it really needs is more short-term cash. Similarly, they might produce incentives to deliver short-term cash when what the company really needs is more long-term profits. Either kind of perverse incentive is possible.

RBS made a huge loss in 2008. It had done lots of things wrong. Amongst those things might be that it paid its staff too much and/or that some of its staff have perverse bonus schemes. That is plausible. Indeed it is almost certain that future contracts need to be different. The question is what to do about what is already in place (if anything). Some suggest that the government shouldn't care about contractual obligations but should just tell employees that they aren't getting their bonuses. Others have suggested that bankers should feel under a moral obligation not to take their bonuses.

Both these ideas are dangerous nonsense. Non-discretionary bonuses are attached to the delivering of specific goals. If people have delivered those goals then they have done their jobs and are entitled to their pay. The fact that other people in the company were incompetent and lost money is neither here nor

there. Further, if we are going to start violating people's contracts, why are we starting with employees? Why not start with the bondholders who participated in the wholesale funding gap of banks and thereby were the proximate cause of the credit crunch, telling them that they aren't getting their money back unless they accept equity-debt swaps? Why should the workers suffer while the providers of capital are spared?

Even for the senior executives, if their contracts say they are entitled to be paid a certain amount of money then that's what they should receive. The Government could have allowed these companies to go into administration or it could have taken them over without promising to honour existing contracts. But instead it nationalised them intact.

Bonus and incentive schemes are useful devices, particularly well-suited to the nature of work in the financial sector. The idea that we need to "end the bonus culture" is base political posturing and scapegoating of an easy target.

3. THE ESCALATION

The Escalation of the crisis is defined here as the nationalisation of Fannie Mae and Freddie Mae, the bankruptcy of Lehman Brothers, and the subsequent wave of nationalisations, part-nationalisation and other interventions that swept the world from September 2008.

While the credit crunch was partly a consequence of capitalism and partly a regulatory failure, the Escalation is squarely and directly the result of inept policy. Three key policy errors were made:

- the disastrous decision to remove prudential supervision of the banks from the Bank of England, the connected failure properly to employ the lender-of-last-resort function of the Bank of England, and the perverse impact of formulaic prudential rules;
- the perverse consequences of deposit insurance;
- the unwillingness to see any significant institution failing, even when insolvent, undermining the market's mechanisms for healing itself.

One of the worst economic decisions in the last 75 years

There are two schools of prudential regulation through banks: the "monarchical" system and the "written constitution" system. The old Bank of England regulatory framework applied the monarchical system. The Bank was that monarch, empowered to do whatever it took to deliver its mission. If a bank were solvent but faced a temporary liquidity problem arising from a systemic issue, then the Bank would provide liquidity. If a bank were insolvent or were going to become insolvent, then the Governor of the Bank would take the controllers of another bank down to his club and explain to them that they were going to take over the insolvent bank – and like it. Then he would explain to the insolvent bank that it was going to be taken over – and like it. And then the next day it would be announced publicly that the insolvent institution were being taken over by the other institution – and everyone would like it.

Earlier than that, the monarch Bank would inspect the banks under its care, and if something didn't seem quite ship-shape then there would be a quiet word in the ear and the bank would sort itself out. The monarch Bank had the tools and the authority to do what was necessary. Note that prudential supervision, in this monarchical model, is simply the counterpart of the lender-of-last-resort function.

An alternative regulatory model, the "written constitution" model, involves the setting out of a set of rules specifying how much of this or that sort of thing banks are allowed or required to do on this or that occasion. Of course, one cannot write down a rule that tells you the best thing to do in all circumstances – there is the problem of unforeseen circumstances. Consequently, under any rules-based system it is possible that a bank that actually has a sound business model is inadvertently shut down as a result of the rules. Similarly, there is always the possibility that

something comes along that no one thought of, so that rules that worked perfectly well on most occasions fail in exceptional times. Either way, sound institutions might occasionally go bust as a by-product of, or through inadequacy of, the rules.

Partly because of this, under the written constitution model it is necessary to set out what happens when sound institutions fail. Depositors need to know how their deposits are protected. In contrast, under the monarchical model, the question of compensating depositors in solvent institutions doesn't arise – the flexibility of the monarchical system allows the Bank to prevent solvent institutions from failing.

Indeed, there would have been considerable advantages in having a monarchical Bank of England in the current crisis – such an arrangement allowed the UK to navigate many an international financial crisis over decades with relatively little financial turmoil here and this stability was an important reason for the strong presence of financial services in the UK.

Some of the weakness of the rules-based system are evident in the current crisis. The conditions today were simply not envisaged in the Basel II framework or the risk-assessment models arising from it. Employing hindsight, some suggest we should now include liquidity provisions in Basel II. Fine, but that won't allow the rules to deal with next-time's unforeseen contingency.

The worst aspect of the current system in the UK was the removal of prudential supervision from the Bank of England by Gordon Brown. This was one of the worst economic policy errors of the past 75 years.

The failure of capital adequacy rules

The rot, however, had begun earlier. Deposit insurance came in under an EU directive in 1979. And the Basel I framework was agreed in 1988 and came into full effect in 1992. With the benefit of hindsight, the UK should not have belonged to this system at all – for formulaic capital adequacy rules of this sort belong to a written constitution-type model, and undermine the ability of a monarchical model to fine-tune its supervision to an institution's specific circumstances. When market circumstances change quickly, an international accord of this sort makes it difficult for the monarch to intervene forcefully – eg by suspending all formulaic capital adequacy rules.

And that is what ought to have happened some time in late 2007 or early 2008: the suspension of all formulaic capital adequacy rules. Formulaic rules are supposed to ensure that banks have sufficient capital so that financial sector crises do not arise. Once we are in the midst of a crisis, however, formulaic rules cease to be useful. Indeed, their effect is probably perverse.

For example, suppose that something happens that means the banking sector will halve in size, but we aren't sure which banks will disappear and which will survive to the new regime. Under such a scenario the market values of the assets held by all the banks might drop dramatically. This might be sufficient to take them all below formulaic capital adequacy requirements. But do they really all have inadequate capital? Clearly not. Their capital is only properly regarded as inadequate with reference to the old regime (where the banking system was large). An attempt to force all the banks to restore their capital to above regulatory thresholds is an exercise in denial. What the market would do would be to eliminate half the sector, with the surviving banks being more profitable, because they face fewer competitors, and hence their assets being more valuable and their capital adequate.

The problem is that without the process of market adjustment – without some banks going into administration and being restructured or liquidated or sold on or having their debts renegotiated – it may not be possible to identify which are the banks with adequate assets and which are the banks whose assets wouldn't be adequate even with considerable capital injections (because they are going to disappear in the new regime).

Formulaic capital adequacy requirements don't help to identify what is going on, and they don't help the process of market adjustment. Indeed, they impede it because:

- they force banks that don't need capital injections to acquire additional capital under difficult market circumstances, potentially either threatening their regulatory permission to trade or even threatening their future profitability because they are forced to acquire very expensive capital with ongoing commitments.
- they drive companies to seek capital injections in market environments where the total amount of capital seeking investments of this sort might be limited. This drives up the price of that capital further, making the problem worse.
- they create regulatory flaws in the system against which people might trade. For example, hedge funds might short sell shares of a company close to capital adequacy thresholds on the basis that the regulatory authorities might panic in response to falling share prices and intervene. This in turn would stop the company from continuing to trade, thereby driving its share price down even further.

This was not inevitable. A proper monarchical central bank would have been able to rapidly suspend any formulaic

guidance it had previously offered, and instead determine on an institution-by-institution basis what it considered an appropriate level of capital. Market healing would also have been facilitated, because the central bank (being well-informed and intimately involved in the businesses concerned) would have been able to exercise last resort lending much more aggressively than was practical for the Bank of England in this crisis. Solvent institutions could have been saved with lending and insolvent institutions either permitted to go into administration, recapitalised privately (if private capital injections were forthcoming), driven to renegotiate loans (eg by swapping debt for equity), sold on to other banks, or perhaps driven to engage in sufficient self-originated restructuring that the Bank of England decided that future profitability would be sufficient to permit the bank to trade out of temporary insolvency and so last resort lending was appropriate.

That of course is not what happened.

Deposit insurance

Deposit insurance was particularly damaging in the early stages of the credit crunch.

The standard way that banks work is called "fractional reserve banking". What this means is that banks take deposits and lend out large multiples of those deposits held at any one time, keeping only a small reserve of funds available to pay out to people withdrawing deposits. The consequence is that banks owe their depositors ten times, 50 times, perhaps 100 or more times as much money as the bank has available for instant withdrawal. If all depositors attempt to take out their money at the same time, then the bank will fail, even if it is a profitable and otherwise solvent business. Thus, fractional reserve banking is an intrinsically and ineliminably risky activity.

People depositing their funds in banks are providers of capital to the bank, like shareholders or bondholders. Banks pay depositors deposit interest rates higher than the amount depositors would receive if, instead of lending their money to the bank, they put their money into government bonds (the closest thing to risk-free lending that there is).

So, people lend money to intrinsically and ineliminably risky institutions that then use that money to engage in risky activities. Deposit insurance appears, perhaps, to remove some of that risk by saying that if everyone attempts to take out their money at the same time and the bank fails, then they will still get their money back. But if depositing in risky institutions is insured by the state and treated by as if it were risk-free, surely this introduces a form of instability right at the heart of the capitalist system?

There are two problems with deposit insurance. First, it necessitates invasive and restrictive regulation of financial innovation. Suppose that all banks have low-risk business models and that we have only light regulation. Then someone produces an innovation – a new bank that engages in slightly riskier activities than other banks and consequently has slightly higher expected returns. Because the returns to its activities are higher, this bank can afford to pay slightly higher deposit interest rates. The depositor doesn't care whether the money is in the low-risk or higher-risk bank, because it is insured by the state. So the depositor takes advantage of the higher interest rate by switching deposits to the higher-risk bank. Consequently the low-risk banks become insolvent and disappear (no one deposits there any more), leaving only the higher-risk banks. Then there is another innovation – a yet more risky bank, paying yet higher deposit rates. And so it goes on with the banks becoming riskier and riskier, until eventually there is a system-wide shock and the banks become insolvent at once.

This happened in Britain during 2007-8. Icelandic banks were known to be in difficulty from late 2007. So they tried hard to attract additional deposits. So they offered high deposit rates. Since British savers thought of themselves as insured – particularly following the lavish undertakings of the British Government from September 2007 – they put money into these high-interest-rate Icelandic institutions, without a care for their risk of collapse. This made the crisis worse when these institutions failed, and it also sucked deposits out of lower-risk British banks.

The second problem is that deposit insurance undermines the monarchical system of prudential supervision. This is because the regulator will adjust for the presence of deposit insurance, in a process akin to cyclists adjusting to the presence of a helmet by taking more risks or cigarette smokers compensating for lower tar levels by smoking more and inhaling more deeply. Deposit insurance allows a monarchical regulator to be laxer, allowing a few extra firms to collapse rather than be provided with liquidity or taken over, with activities monitored that little bit less – because the public is protected in the end. Deposit insurance leads to more bank failures under a monarchical system, not fewer.

The counter-argument is that people depositing their funds in a bank don't want to work out how risky its activities are. So whether there is deposit insurance or not, there will be the risk-escalation process described above. And is it politically feasible to allow ordinary depositors to lose all their life savings when their bank down the road fails just because the depositors didn't adequately monitor its activities? And what about people who just have their pay put into their accounts electronically? Of what interest is it to them what other activities the bank engages in?

If not deposit insurance, what?

Some form of consumer protection must be reluctantly conceded. This would include:

- making depositors “preferred” or “preferential” creditors. This means that if a bank is liquidated, and the assets sold off, the first chunk of money released by this goes to the preferred creditors. At the top of this list must go creditors such as salaried employees (for their wages) and HMRC (for taxes). Depositors should be placed just below these very highest preferred creditors. So in order for depositors to lose anything, not only would shareholders need to lose all their money, but also the bondholders would lose all of theirs. At the most fundamental level, this means that depositors cease to be investors of the same nature as bondholders – just as bondholders are different from shareholders at present, depositors would be different from bondholders. Obviously this would restrict the ability of banks to obtain (at least private sector) loans – they would find it impractical to offer any collateral. That would mean they would be less likely to face the kind of wholesale funding gap that is one of the key features of the credit crunch.
- insurance of one chequing account into which salary payments are made. A ceiling of £10,000 should be adequate, and would impose the regulatory requirement that zero interest be paid on insured accounts.⁷
- a requirement on all banks licensed to engage in fractional reserve banking that they provide a special sort of deposit account that I shall term a “gilt aggregator account” (GAA).

⁷ One could imagine having other higher-threshold variants of this concept, such as a special account that would remain insured for a few hours and could be used to hold money during the settlement of house purchases.

Such an account is effectively the purchase of a share in a government gilt fund, and each pound deposited in the account must be fully backed by one additional pound of government gilt purchase. Banks would pay the government gilt rate they themselves receive minus an administration fee. They would make their money on this business through the economies of scale in transactions costs versus someone buying their own personal gilts. Funds deposited into GAAs would be excluded from regulatory requirements in respect of fractional reserve banking – they could not be offered as capital reserves – and the gilt fund backing would be legally ring-fenced from the other assets of the bank in the event of bank failure. Since these funds are, as near as can be, risk-free, the government insurance really addresses situations such as fraud or gross incompetence when the gilt backing does not work.

Under such a system, people would be able to engage in electronic payments and risk-free storage of their money. Of course, gilt aggregator accounts would pay very low interest, so banks would be able to offer attractive time deposit accounts paying much higher rates of interest, but would have to warn depositors that if they switched their monies out of the GAA then they would no longer be insured by the state. In this event, with clear warnings, people would understand that monies on bank deposits outside GAAs are lending-at-risk, and that depositors are investors like bondholders or shareholders. Of course, it is likely that, with state insurance totally eliminated, banks would seek to obtain private insurance of their deposits, and would be at liberty to quote their private insurance to potential depositors.

This scheme could not be introduced immediately. Under current circumstances it would imply a dramatic contraction in banks since monies moved into GAA deposits would be

excluded from regulatory prudential capital. But over the longer term, this is preferable to the high-regulation path of conventional deposit insurance.

Fear: the unwillingness to see any significant institution fail

Uncertainty is a hallmark of the crisis. With everyone terribly unsure about who is broke and who isn't, people and companies become much less willing to lend to anyone, in case they don't pay back. Hence loans might become very expensive.

Certain institutions, because of poor decisions or bad luck, would be most exposed to this scenario. They would fail, because they would either not be able to source enough cash to pay their debts or because the cost of capital acquired would be so high as to render them unprofitable. As these failed institutions' assets were liquidated or they were taken over by other companies, we would learn something about what losses they had made. This would tell us something about what losses are yet to be identified and how likely other companies are to fail. This might enable us to say "Now I know that companies A, B, and C are probably safe to lend to, and companies X, Y, and Z are probably *really* bad risks. I'm still not sure about companies D to W, but maybe I'll learn more."

After we've learned a bit about companies A, B, C, X, Y, and Z, matters evolve. A, B, and C who previously had to pay very high prices for their loans now have rates that fall back a bit. Meanwhile no one lends to X, Y, and Z at all, and X and Y fail while Z, surprisingly, survives. Observing the unwinding or selling on of X and Y, and reflecting upon the survival of Z lets us work out that companies U, V, and W are probably going to fail next. And so it goes on and the uncertainty is largely resolved.

In this way the process of institutions failing is a crucial part of the way in which uncertainty is resolved and the market heals

itself. If we forbid any institution from failing, then we impede this process of market healing.

Toxic assets

There has been much confused criticism about undisclosed losses, with demands from politicians that banks should “confess all”. But it isn’t the case that the banks know what their losses are. When banks have bad debts, they are often rather uncertain about how bad things are going to be. The classic strategy is to imagine a worst case scenario, announce this to the market, then later write back as matters don’t turn out as bad as the worst case.

In this case, however, that isn’t really viable. First, the set of assets over which there might be bad debts moves very rapidly. This makes analysis of worst-case scenarios intrinsically problematic. So perhaps the banks should just imagine an overall worst-case scenario and disclose that? But the overall worst-case scenario is so bad that it might plausibly render almost every financial institution in the developed world insolvent and subsequently forbidden to trade. How is that supposed to help?

When matters need to change as much as they do in this scenario, uncertainty is very high. This gets even more complicated when the scenario is liable to expose huge scams such as the Madoff affair. How are firms supposed to make provision for unknown losses of this sort?

To make matters worse, the sense that no institution is allowed to fail may (and in this case did) spill over into a belief that the state will not merely bail out failing institutions but also, perhaps, purchase bad assets or otherwise act so as to make up accumulated losses.

The longer no institution fails and everyone becomes ever more confident that losses will be made good by the state, the longer the sector as a whole stays too large, and the longer those institutions that ought to survive in a market scenario have their profitability undermined by having to compete with zombie institutions. Meanwhile hidden losses (not maliciously hidden, but hidden by the uncertainty inherent in the scenario) at zombie institutions mount ever greater. At some point this process must lead to a significant escalation of the crisis – and it did.

4. THE RESPONSE TO THE ESCALATION

On 8 October 2008 the British Government announced a £500bn bailout scheme, in response to the Escalation and the risk that certain UK banks might fail. The bail-outs in the US as well as in the UK, were wrong for two reasons:

- they signalled the end of private capitalism.
- they will not work, even on their own terms. They will not return the financial system to smooth functioning.

The end of private capitalism?

Private capitalism, as it operated in the UK for about 300 years until late 2008, was a system in which private sector banks were central. Private people provided capital, and private agents decided where that capital should be employed. When banks were key conduits of private capital, the fundamental consideration was whether the likely private return on capital justified the risk taken in supplying it.

With a nationalised banking system, the government becomes the key director of capital in the economy. Instead of private capitalism we have a system more like that in Dubai or China – a form of state capitalism.

The British Government, supported by the Conservative opposition, chose the path of nationalisation of the banks, the path of state capitalism. Here are a few of the casualties of this decision:

- **Much of the academic theory of financial markets and of corporate finance is finished.** There will now follow an intense academic race to develop an alternative finance theory in which we can estimate efficient pricing in an environment in which the government steps in to nationalise the system at the point of system-wide failure.
- **All the standard economic theorems that tell us that markets are efficient allocation mechanisms are open to question.** If the government is going to create from nowhere 10% or more of GDP to bail out lenders when their decisions go bad, then markets are not going to be seen as good ways to organize the economy. Arguments in favour of the government deciding directly which businesses should exist and which should not, of where investment should go and where it should not, will prosper.
- **The free market argument against bailing out other failing companies is difficult to make.** Once the argument was offered in the US that banks had to be bailed out because of their systemic significance, it became inevitable that car companies would also be bailed out. Since then we have already seen arguments for bailing out newspapers and other claimants. And there seems much justice in these calls. Why should rich workers at, and rich lenders to, banks be bailed out while much poorer workers suffer?
- **A wider belief in the use of market mechanisms to solve problems is at risk.** Once market efficiency theorems are gone, why would we assume markets are good allocation

mechanisms in other settings, such as public service delivery? To put it differently, if markets don't even deliver efficiency in areas such as financial markets in which many of the assumptions of market theories hold good, why should people be interested in their use in areas such as health, education or the environment in which the setting has always been acknowledged more problematic for markets?

- **The sense of global leadership of the US social model is at risk.** The US model of capitalism is now seen to have failed. The sense of the failure of capitalism at the end of the 1920s was important to the rise of alternatives in the 1930s and thereafter.

Loss of growth: the hidden cost of the bail outs

One reason why the bailouts have made the recession worse, even in the moderately short term, is because they will reduce growth. Private capitalist economies experience volatility, but because they promote innovation they grow, on average, rather fast. A state capitalist economy, an economy in which the government controls the banks, must grow more slowly. Even if the government returns the banks to the private sector within a few years, it is certain that government regulation will limit lending in the future. The consequence will inevitably be slower growth.

The UK Government, in its pre-Budget Report's predictions of Autumn 2008, suggested that the British economy's sustainable growth rate had been unaffected by the credit crunch and Escalation, and remained at 2.75%. This is preposterous. A more plausible figure would be 2.2%. To give a sense of what that difference means, after two decades of growing at 2.2% the economy would be about 10% smaller than if it had grown at 2.75%. That's an enormous difference.

Suppose that were right. The consequence would be the a huge number of perfectly prudent long-term deals entered into in 2005 and 2006 will now go bad – the profit and wage growth just won't be there over the long-term to sustain them. This suggests that a fall in sustainable growth rate of this order would induce an additional GDP loss of between 5% and 6%. In other words, by itself, the Government's intervention has created an additional recession of the same order as the recession of the early 1980s or the 1930s.

There was an alternative. If the Government really had £500bn to throw around, was this truly the best way to spend it? Or was it throwing good money after bad? Might it not have been better to let the fools and the unlucky go bust, and to spend these gargantuan sums on tax cuts to provide relief to the real economy? Indeed, might not tax cuts have turned some of these bad debts good?

And how bad would the recession have been without the Government's interventions? Could it have been worse than creating a 5%-6% add-on to the recession, spending hundreds of billions of pounds in the process, destroying private capitalism, and forcing the bailing out of other types of company and the enactment of wealth taxes. Was this a better strategy than using the money to cut our taxes or provide other sorts of comfort? And how bad will it have to be for them to accept that the bank bailout strategy was flawed?

And they won't work anyway

Companies – in any industry – can face three forms of crisis:

- liquidity crises;
- solvency crises arising from past losses;
- future profitability crises.

A liquidity crisis is a lack of available cash to pay bills that are now (or will shortly become) due for payment. If a firm has assets greater than its liabilities and likely to remain greater than liabilities if the firm continues trading, then a liquidity crisis can be resolved straightforwardly by borrowing money.

A solvency crisis arising from past losses is less easy to resolve by just borrowing money – though that may be a solution. When a firm has assets less than its liabilities, there is a risk to its continuing trading, because perfectly normal business practices – like paying bills at the end of the month – will impose risks on the firm's suppliers (if it were to cease trading there would not be sufficient money to pay all those to whom the firm owes money). If a firm's future profitability is secure, it might trade its way out of problems – future profits will restore solvency eventually. In some industries, however, the risks imposed by insolvent firms continuing to trade will be high. Indeed, in some industries it is considered sufficiently risky for insolvent firms to continue trading that it is not normally permitted – banking would be an example. An alternative way through would be an injection of new capital – "recapitalisation". This restores solvency, and if future profitability is secure, then this may be sufficient.

A future profitability crisis is when there will either be future losses rather than profits or, at best, future profits will be insufficient to pay off future interest on current debts. In other

words, the company is no longer viable over the medium term in its current form. In such a situation, unless the company is liquidated quickly or action is taken to raise future profitability expectations, equity capital will disappear and the company will become insolvent. In this kind of situation neither lending nor recapitalisation will be adequate, unless accompanied by a credible plan to restore profitability. An attempt to address such a situation by recapitalising will simply throw good money after bad, because future losses will, over time, eliminate the new capital injection – all recapitalisation will achieve is to lose more money; and to put off, a little, the day at which the company becomes terminally insolvent.

Initially, many people thought that the current financial crisis was just a liquidity crisis, and so could be addressed by lending – perhaps involving clever lending tricks like the Bank of England's Special Liquidity Scheme.

Later, people thought that it was a solvency crisis associated with past losses, and proposed recapitalising the banks.

But is the problem a future profitability crisis? If so, the sector must shrink, so that the remaining players can be restored to adequate profitability. With fewer, more profitable players, the equity value of the remaining players will increase and their capital will prove adequate.

Recapitalising the banks: an exercise in denial

The attempt to recapitalise the UK's banks is an exercise in denial – it is an attempt to convince us that the sector can carry on, much the size that it was before, without radical shrinkage. Of course, it might be politically painful to accept that one of our most important sectors must decline – far easier to spend tens of billions putting back the evil day, hopefully until political times are more favourable. But if it is a problem of future profitability,

this denial will ultimately prove futile, and good money will have been thrown after bad.

Many politicians have asked where the £37bn of taxpayers money for recapitalisation has gone, and why it didn't lead to additional lending.⁸ The answer is that it will eventually all go in ongoing bank losses unless the banks are restructured (ie unless they undergo the kind of process that would occur if they went into administration).

We can get a sense of the scale of ongoing losses from the US. At the time of writing, Merrill Lynch has lost \$39bn in the past six quarters, including \$15bn in the quarter since it was saved last autumn by Bank of America. Citigroup has lost \$19bn over the past year, including \$8bn since the bailouts process began. The bailouts money is vanishing rapidly in the gaping hole of insufficiently restructured loss-making businesses, the business models of which will either not generate profits in the future at all, or if profits are generated they will not be sufficient to pay off loans the financial institutions have taken out.

This is not, as some believe, all to do with the complex derivatives arms of businesses that can be quickly shut down. Even in 2004 (ie well before the top of the bubble), mortgages were the single most important source of income for retail banks in the EU. They generated 30% of the gross income to retail banks from personal customers.⁹ Even before the madness of bond markets and derivatives, the retail banks were heavily dependent on mortgages. But the numbers of mortgage

⁸ Subsequent recapitalisation has seen this figure rise to £72.5bn with a further £25.5bn going to RBS in February 2009, and £10bn going to Lloyds in March 2009.

⁹ See: http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/sec_2007_1683_en.pdf

transactions are now falling – half or even less. And even when numbers pick up, the value of mortgages will only be a half to two thirds of what it was (because of the falls in house prices). That 30% of gross income is going to shrink dramatically – and that is before all the other problems. Everyone knows the banks can't go back to where they were in 2007. But in fact they can't even go back to where they were in 2004.

It is tempting, in these situations, for politicians to imagine that if only they can find the correct lever to pull then all will be well. And when that proves hard, the temptation is to blame economic downturn principally on the financial institutions – even better if that blame can be attributed to perhaps half a dozen individuals. It is also easier for financial journalists to offer their readers a narrative according to which the banks are in financial trouble somehow *randomly*, by some external cause, and that therefore the banks aren't lending and therefore we have house price falls, business failures and individual bankruptcies.

But the truth is this: overwhelmingly, causality runs from the real economy to the financial sector. That is to say, overwhelmingly the banks are in trouble because house prices are falling, businesses are failing and individuals are going bankrupt, meaning that the banks make losses and have few attractive new loans to offer. In the main, the recession caused the banking crisis, rather than the other way around.

So, the banks have made mistakes and some are no longer viable. They didn't anticipate the recession, they overpaid for financial innovations, and they lent far too much for mortgages. Many of the business models in the sector are finished as profit-making enterprises in their current forms. The only way these business could continue without significant restructuring of the sort that would occur under administration is for

governments to provide an ongoing stream of subsidies (perhaps by nationalising the entire sector, or at least all the loss-making enterprises within it).

Is there a global solution?

Much has been said about how this is a global crisis, about the need for a globally-coordinated solution, and about how the G20 can collectively put forward policies to alleviate the problems. But there's only any point in coordinating policy when we have a good idea about what the best thing to do is. 18 months of endless policy initiatives, which have made things worse rather than better, demonstrates that the Government does not know what the best thing to do is. Coordination is a device for everyone getting things wrong in the same way.

It would be better for each of us to try our own thing. Then we can look around at what others have tried and what seemed to be working better or worse, and gradually move towards some kind of solution. It is obviously politically attractive to all herd together – that way who can blame you if you get it wrong? Herding is what everyone tends to do in conditions of great uncertainty – hence wild stock market fluctuations, the lending policies of banks, business decisions in the wider economy. But we should not let our politicians get away with that. Herding is nothing more than political cover. It isn't a constructive policy.

5. WHAT SHOULD HAVE BEEN DONE INSTEAD?

If the Government has got things so wrong since last autumn, what should it have done instead?

Make bondholders suffer the consequence of their mistakes

The key weakness of the Government's response has been the sparing of bondholders. The banks became overly dependent on bond finance while paying out large dividends, thereby changing their effective capital structure. They did this believing that bonds were very low risk. What ought to have happened, therefore, is that the bondholders should have suffered for their error – since over-gearing was one driver of excessive risk, the market would have punished that over-gearing by making those that supplied the debts (the bondholders) lose their money.

Instead, by bailing out these institutions with the bondholders intact the Government has validated this capital restructuring decision: the bondholders thought the bonds very low risk and the Government has proved them right, for even in the extreme case the bondholders did not lose out. This means that in the future these institutions will have even stronger incentives to acquire bond finance unless invasive regulation is used to prevent this.

Instead, the bondholders should have suffered. There are two politically feasible ways in which this might be achieved:

- impose a temporary or permanent “depositors as preferred creditors” regime; then permit or force administration, so that bondholders suffered ahead of depositors, and depositors only suffered at all if bondholders were wiped out entirely;
- provide government assistance, but make a condition of such assistance that bondholders suffered in some way – eg by being forced to accept debt-equity swaps or by having bonds devalued.

The extreme nature of the scenario of October 2008 means that the property rights of bondholders should have been over-ridden. It is vital to the functioning of a capitalist economy that errors and bad luck be punished by market processes. Without that punishment the overall argument for markets as allocation mechanisms becomes weak. It is wrong that the the poor are forced to pay taxes to bail out the rich.

Focus government money on tax cuts for the real economy

At the time of writing, Goldman Sachs estimates that the net cost of the UK bank bailouts stands at £120bn (8% of GDP). The IMF estimates £200bn (13% of GDP). Figures upwards of £300bn are plausible and probably all that stops the number going above £400bn is that the Government would choose to permit default before then.

The Government claims that this incredible expenditure was justified because otherwise the recession would have been much worse. Is this plausible? And would it not have been better to cut taxes to the tune of 13% of GDP (or less)? And is the Government seriously claiming that keeping rich people rich

was really a better use of 13% of GDP than tax cuts to boost the real economy?

Tax cuts might not have been spent. In which case they would have either recapitalized the salvageable bits of the existing banking sector or capitalized a new banking sector through deposits. In this way, a well-functioning banking sector could have returned relatively rapidly. In contrast, the attempt to focus money on keeping dead banks as walking zombies defers the cleansing process and delays new startups.

The road not taken

To date, few credible alternatives to the Government's response to the crisis have been proffered. As such a subconscious consensus has formed around the notion that the Government took the only viable course of action available.

If we concede that the action taken to bail out the system was necessary, we are conceding that a capitalist order cannot heal itself in a way society could accept. We would accept that government action on an epic scale would be required, every generation or two, to save the system. This would have profound implications.

However, there was an alternative, even given that (as I have argued) we should not have been starting from there. Set out below are the steps which should have been taken last Autumn. These steps may not have avoided a recession, but they would have left the UK economy on a much surer footing to come out of the recession.

- Suspend all formulaic capital adequacy requirements, placing the Bank of England as intimate prudential overseer. For banks that could prove to the Bank of England that they

were solvent, lend them unlimited funds, newly printed with no early repayment date.

- Announce an average inflation target over the next five years of 3%, including a housing depreciation component (so it would be brought down by house price falls). Explain that this means that if inflation falls below 3% then inflation above 3% will be accepted later.
- Announce an income tax rebate of £20bn, to be paid on the basis of 2007/8 tax year earnings, by lump sum cheque delivered in December 2008. Announce a corporation tax rebate of £10bn, to be paid on the basis of the previous financial year, again delivered in December 2008. Announce that PAYE and VAT payments could be made late for the next two months (at the end of the third month) though subject to an interest charge at Bank Rate plus 3% (so not all firms would want to take this up). Say that consideration of significant further income tax and corporation tax rebates for May 2009 would be made at the end of November 2008.
- Establish a deposit access fund. This would pay withdrawals by people that had deposited in banks that entered administration (see below). Announce that all deposit insurance would cease after two weeks from the announcement date. For ease of reference, assume that the announcement is made on 18 October 2008, so the insurance would cease on 31 October. Apply this at previously-agreed statutory levels to any institution entering administration before that date. So, after that date, if, upon liquidation, it turned out that the depositor was entitled to fewer funds than had been withdrawn from the deposit access fund, the depositor would owe these monies back to HMG.

- Establish a special insolvency regime for banks. Make depositors preferred creditors in any bank not entering administration after two weeks from the date of the announcement – all bondholder collateral would lapse after that date. Administration prior to that date could only be forced through inability to service loans. Banks would continue to offer depository and payment functions during administration – these could not be discontinued and payment systems could be seized by the state if it were judged that their functions were not being discharged adequately.
- For the forthcoming two weeks, offer last-resort lending to those institutions rendered insolvent by past losses but with a future profitability outlook adequate to convince the Bank of England that they could trade out of insolvency without significant structural change. This last-resort lending would be withdrawn beginning from 1 November 2008 (from that date a penal interest rate would start to apply to Bank of England loans, higher than the rate for more robustly solvent institutions).
- Invite bondholders, in any institution that the Bank of England regards as justifying the provision of last-resort lending, but which would require such lending during the forthcoming two week to accept debt-for-equity swaps.
- Place institutions that could not achieve future profitability adequate to restore solvency without significant restructuring and renegotiation of their debts into special administration. The administrators should aim, in the first instance, to renegotiate their loans, restructure their operations, sell off units and other assets, and achieve private equity capital injections to refloat any surviving parts. No Bank of England last-resort lending should be available during special

administration. No special promises should be made to provide loans to external banks taking over new units. No promises should be offered to set aside competition law. Deposit insurance would apply at previous statutory levels.

- In the event that administration takes a form in which branches are shut, make the branches of the previously-nationalised banks (eg Northern Rock) available for the distribution of deposits from the deposit access fund.
- Stand ready, but without announcing any such readiness, to fold the previously-nationalised institutions, along with any branch or payments networks seized during administration, into a new clean state bank in the extreme event that the entire industry is liquidated and there are no buyers. (ie. rather than hint at a willingness to nationalise the industry, instead prepare to abandon the “old” industry and establish a “new” financial sector – new in the sense of new capital, though employing the old branch network and payments system architecture).

The key defining features of the above scheme are that bondholders would suffer and depositors not be guaranteed (not beyond statutory limits in the first two weeks, not at all after that date). That mirrors the single most important flaw in the recapitalization programme: that bondholders have been spared.

Should the above steps have been taken, it is probable that only two or three UK institutions would have had to enter administration, and it is perfectly plausible that there would have been none. Obviously the US experience of the early 1930s is not one to seek to emulate, but even there only 40% of the banks disappeared. There is no credibility in the Doomsday scenarios in which permitting administration of a few institutions would

have resulted, without government bailouts, in the collapse of the entire financial system. The Government has not demonstrated that any of the banks it nationalised or part-nationalised was, in fact, insolvent at the point of nationalisation. Furthermore, banks such as Barclays which were given the space to seek private sector solutions rather than having the help of the state (in equity terms) forced upon them, have identified private sector funds. If it is true that Lloyds and RBS are solvent, then private sector funds might very well have been available – at the right price.

These proposals would have created significant disruption in the economy and the financial services sector in the very short term. There would certainly have been panic in bonds markets. The Bank of England would probably have had to stand ready to replace the entirety of wholesale interbank funding – at around £600bn, three times the amount supplied under the Special Liquidity Scheme – as well as providing additional funds to replace deposits withdrawn during resulting runs on banks. It would also have had international ramifications, since we would have withdrawn from international agreements (such as the Basel Accords) and many of the bondholders upon whose rights this procedure would have trampled might be foreign who would cry “Foul!” to their governments. A recession would still have followed.

However, after the initial two weeks of crisis, the system would have started to heal itself. Unviable institutions would have been eliminated, leaving the survivors more opportunity to make future profits and thus more secure long-term viability. Debts that could not be serviced would be renegotiated, swapped for equity, or defaulted upon – whichever, the burden of them upon the sector would be reduced.

The sector would understand that solvent and potentially solvent institutions would be supported but terminally insolvent institutions would be allowed to collapse. Depositors would understand that the surviving institutions were the viable ones, and so gradually return their deposits, allowing the Bank of England gradually to withdraw its loans. Any administrations would be largely complete within a few months.

Businesses would have been able to use their tax deferrals to help them through difficulties in obtaining overdraft facilities in the immediate crisis period. The payments system would be preserved.

Looking further ahead, if the operations of the financial system were seriously impaired, so private lending availability continued to be limited for a while, the income tax rebates would constitute a form of lending mediated by the state (it would be lending, because these tax rebates would generate debt that would have to be paid back in the form of higher taxes later) in place of lending mediated by the banks. That might mean that these tax cuts would stimulate additional real economy activity. Alternatively, these income tax rebates might be saved, in which case they would be deposited in the surviving banks helping them to rebuild their capital.

The period of disruption created might well have created a crisis for certain firms already weakened by recession and we may have suffered a sharper shock to GDP growth in the last three months of 2008. However, whilst the above prescription would not have necessarily lessened the duration of the recession, it would have maintained capitalism and helped the economy grow faster over the longer term.

6. RECOMMENDATIONS

What should we do *now*, bearing in mind where we are?

For the short term:

- Stop the bleeding. In the final quarter of 2008 Merrill Lynch lost \$16bn; Citigroup lost \$8bn; AIG lost \$60bn – all in one quarter. Governments around the world must stop pouring good money after bad into these companies. The scale of the problem is not being faced by companies – and why should they face it as a matter of urgency, when the taxpayer is prepared to provide more and more money so they can keep on with their loss-making ways for month after month.
- Do not interfere with any more institutions – stay away from Barclays and HSBC. Rely on the preferred creditors regime for depositors.
- If a major institution fails, employ a deposit access fund as described above.
- Don't pretend you can pin the recession on three or four individuals, as if it were the personal responsibility of the former senior executives of a few banks.

- For institutions in which the government has a controlling stake, accept the role of shareholders. Force operational restructuring – no one else is going to. Force financial restructuring: make bondholders accept debt-equity swaps. Only honour bonds to the extent that this can be done with the company profitable after restructuring. If it can't be done, cut your losses and let the bank fail.
- Don't restrict above-100% mortgages or sub-prime lending. Above-100% mortgages got going in the UK in the 1990s off the back of negative equity – without an above-100% mortgage, people in negative equity would not be able to move house to change job or to get a job if unemployed. The time to consider such restrictions will be once house prices have recovered – (probably some time in the 2020s). British sub-prime mortgages will become necessary in future, because so many people will have damaged credit records by the end of this recession. It is important that they should nonetheless be able to borrow at an appropriately raised interest rate.
- Focus funds on the real economy. Cut taxes. Reduce expenditure growth (total managed expenditure is, on current paths, expected to exceed 50% of GDP). A reduction of at least £100bn in the 2010/11 projected total managed expenditure is required. Further spending cuts can be considered after that.
- Insofar as financial sector funds must be employed, they should be focused on loans to solvent institutions and on capital for new lending institutions.
- Introduce a price-level target for 2014 at 15.9% above the current price-level (ie target 3% annual average inflation over the period).

For the longer-term:

- Have no nationalised banks.
- Focus financial regulation on assisting *caveat emptor* rather than replacing it. Investors in intrinsically risky activities should be encouraged – in general, not as a matter of the individual product – to understand and accept that they can lose money as well as make it. This spirit of responsibility should seek to pervade the system.
- Allow salesmen to be paid commissions, but ban them from calling themselves advisers. Anyone providing advice must have no financial interest (either direct or indirect) in the products on which he or she is advising.
- Introduce gilt aggregator accounts. Require heavy warnings for anyone switching out of a gilt aggregator account into time deposits.
- Restrict deposit insurance to gilt aggregator accounts (unlimited) and current accounts (modest ceiling).
- Ensure that (uninsured) time depositors are always preferred creditors.
- Set the Bank of England the task of prudential regulation, which should be explicitly paired with its role as the lender-of-last-resort. No institution should be able to accept retail time deposits without a lender-of-last-resort clearance from the Bank of England. Last-resort lending might be made available to non-retail-banks, also.
- Leave the Basel system (ideally), and instead focus on the Bank of England as specified above. However, if international prudential standards really must be employed, then there should be a three-part-system: First a prudential requirement

that is a function of an international early-warning system (the IMF sets a kind of coarse-grained “DEFCON” rating for the world economy – say red, dark amber, light amber, or green, and there is a prudential capital requirement that satisfies this). Second, a prudential requirement that is a counter-cyclical instrument of monetary policy, employed by the Bank of England. Third, an individual-firm prudential requirement, set by its prudential supervisor (hopefully the Bank of England).

- There should be a price-level target for the UK. The price index employed should include housing costs but no asset prices. Close attention should be paid to signals in monetary data, but no explicit monetary target should be set.



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