Credit Crunch

The anatomy of a crisis

Rt Hon John Redwood MP

The Adam Smith Institute has an open access policy. Copyright remains with the copyright holder, but users may download, save and distribute this work in any format provided: (1) that the Adam Smith Institute is cited; (2) that the web address adamsmith.org is published together with a prominent copy of this notice; (3) the text is used in full without amendment [extracts may be used for criticism or review]; (4) the work is not re–sold; (5) the link for any online use is sent to info@adamsmith.org.

The views expressed in this report are those of the author and do not necessarily reflect any views held by the publisher or copyright owner. They are published as a contribution to public debate.

© Adam Smith Research Trust 2009
Published in the UK by ASI (Research) Ltd.
ISBN: 1–902737–64–4
Some rights reserved
Printed in England

Contents

Executive Summary

- In the period 1997-2001, the British economy functioned well. Although some mistakes were made, Gordon Brown largely stuck to his self-imposed doctrine of prudence.

- The period 2001-2006 was characterised by ultra-loose money, reinforced by a sloppy fiscal stance, as Brown prioritised building up his political power base over the stability of the public finances.

- Throughout these boom years, banks such as Northern Rock, Bradford & Bingley and Alliance & Leicester adopted aggressive business models based on selling securitised mortgages and borrowing short-term from the money markets to finance new lending. The easy credit this approach engendered is what drove Britain's house price bubble.

- By 2007, it was clear to the authorities that they had overdone the cheap credit binge. From January to July that year, the Bank of England raised interest rates from 4.75% to 5.75%. However, market rates soon diverged substantially from the base rate, reaching 6.9% in early September, as the money markets ran dangerously short on cash.

- Instead of doing anything to reverse this severe and sudden monetary tightening, the government and the Bank of England decided to publicly lecture the banks on moral hazard. Rumours began to circulate that those banks which depended on short-term borrowing from the money markets were in trouble – but the government continued to grandstand.

- Northern Rock was in the worst position, and required emergency help from the Bank of England. The Bank should have extended a loan to Northern

Rock quickly and privately, while simultaneously instructing them to sort themselves out. Instead, news of Northern Rock's difficulties leaked to the press, triggering the first run on a British bank in more than a century.

- At this point, the authorities flip-flopped. The government announced it would stand behind deposits, and the Bank of England made £10bn available to the money markets. Unfortunately this was too little, too late. In the months that followed, Alliance & Leicester, Bradford & Bingley and HBOS had to be rescued. Northern Rock was nationalised.

- At the time, many claimed that the UK's problems were imported from the US. This was not the case. The UK banking casualties lost money on UK mortgages, not US ones. They were lending UK money to UK customers, under the not-very-watchful eye of a UK regulator. While Britain's crisis may have had much in common with America's, it was very much home grown.

- In the year that followed the run on Northern Rock, interest rates remained relatively high, as if nothing serious had happened. Then, in autumn 2008, things started to move rapidly again. This time the British financial sector faced not just disaster, but catastrophe.

- As crisis struck Ireland and Iceland, and the US stunned the world by announcing a $700bn bailout package for its stricken banks, the Bank of England finally started to cut interest rates – a year later than they should have done. Yet despite serious strain in world markets, the British government now decided they wanted banks to hold more capital than they had required during the boom years. This was the worst possible moment to make such a request.

- News of the UK regulators demanding more cash and capital leaked, putting all negotiations under an intense media spotlight. Once a bank was identified by the regulator as having too little capital, they would find it very difficult to raise money on the market. Nevertheless, the Lloyds/HBOS, RBS and Barclays were given a stark choice: either raise the necessary sums immediately, or take government capital and offer shares to the taxpayer.

- As autumn turned to winter in 2008, there were few left who continued to believe the crash was little more than an important lesson to hubristic banks. For every banker losing a bonus, several manufacturing workers lost their jobs. Factories lay idle, orders plummeted, export credit and exports seized up. Britain had entered the worst slump since the 1930s.

- As the smoke cleared, it became obvious that much of the preceding boom had been false, based on low interest rates, lax credit controls and an explosion of lending, rather than on real, sustainable growth. But instead of accepting that Britain had to undergo a period of adjustment, in which debts would be paid off and spending brought under control, the authorities opted for one more dose of the old medicine.

- The result is that the next government will face enormous debts, a broken regulatory system, and the worst budget position Britain has ever faced in peacetime. It will also have to deal with a part-nationalised banking sector, with too few competitors and too many weak balance sheets.

- The next government's prime task will be to remodel the state owned banks and return them to the private sector as quickly as possible. To encourage more domestic competition, they should be split up into a number of smaller institutions. Banking regulation should be returned to the Bank of England, who would in future set counter-cyclical cash and capital reserve requirements for banks.

- The next government will also have to tackle the budget deficit by reducing public spending. The efficiency of the public sector must be increased, both by removing waste and unnecessary activities altogether, and by selling on those activities like post, banking and some transport that could be better run in the private sector. The overall size of the public sector should be reduced by natural wastage, and by the cancellation of projects and activities like ID cards and regional government.

1 Background

This is the story of one man, Gordon Brown, who set out to suspend the economic cycle. It is the story of one cobbled together party, New Labour, which thought that if you said something often enough it would be true. This is the story of one style of politics, based on soundbites issued by all powerful spin doctors, which fell apart in the Credit Crunch.

It is a poignant tale of hubris and nemesis. It shows the triumph of hope over experience, only to be followed by the triumph of experience over hope. It is a gripping tale of greedy bankers and incompetent regulators, a narrative of politicians who were casual with the truth aided and abetted by a British establishment that should have known better. It is a fable of mind the gap: the gap between what they said and what they did, between what they told you was happening and what was in practice happening. That gap grew too wide for the story to remain credible.

The losers were the 3 million unemployed, the businesses that went under, the people who lost their pension funds, the taxpayers who ended up paying the bill and future generations who will be saddled with unbelievable amounts of debt. The winners were the people who got rich in the well paid public sector jobs they created, the New Labour politicians who gained fame and riches beyond their imaginings and all those who make a living out of lending to the state.

Boom, bust and attempted boom again

Gordon Brown said he had married Prudence. In his first couple of years he more or less kept to Conservative spending plans. He even got to the point where he repaid some debt. The economy functioned well, continuing to grow as it was doing when he took over in 1997. Errors were made, with the decision to tax pension funds, the changes made to the regulatory structure of the financial services industry and the money markets, and the sale of gold at the bottom of the market. Some of us warned in 1997 that the changes to the Bank of England could prove dangerous if a banking crisis developed. We warned that taxing pension funds would lead to funds closing and people denied access to final salary schemes.

After the 2001 election Gordon Brown divorced Prudence, and started the remorseless increases in public spending which characterised the second and third Labour dominated Parliaments. The budget deficit started to rise, despite stealth tax rises and the growth in the economy. This period represented an era of ultra loose money, reinforced by an increasingly sloppy fiscal stance. It was an era of off-balance-sheet financing for governments and of the multiplication of wild instruments for gearing in the private sector. It was as if driving a car at breakneck speed could suddenly become safe because they were for the moment on a straight and empty piece of road.

By 2007 it was becoming obvious even to the authorities that they had overdone the easy credit binge. We were pushed into a new era of austerity, with higher interest rates, monetary tightness and rough regulatory intervention against the banks, forcing them suddenly to be cautious. In the period 2007-8 the authorities induced the worst collapse in money supply, share prices, and economic output since the 1930s. Using the driver analogy, they saw the bends and traffic too late and slammed on the brakes. We crashed and the driver was hurled against the windscreen.

From the end of 2008 until the present the authorities have lurched back to a very accommodating stance. They have slashed official interest rates, printed large sums of new money and run up enormous budget deficits. They have been desperate to reverse the damage they did in the preceding two years through their monetary stringency. They have, however, perversely continued with tough and tight regulation of the banks, making it difficult for the new money to reach borrowers through the intermediation of the commercial banks. Their conduct has been similar to seeking to drive a car that slowed and crashed by putting your foot flat to the floor on the accelerator whilst still keeping the other foot hard on the brake. They have put huge sums into the banking system, only to force the banks to lend it back to the government to fund the growing deficit.

Why did the government do it?

Gordon Brown and Alastair Darling were the drivers when the economy went wrong. Gordon Brown is a complex and solitary character, who intended it to be so different. A clever boy at school and university, he allowed his intelligence, academic and early political success to isolate him from robust criticism and in the end from reality. He was best as a leading opposition MP. Dedicated to politics, he spent many an evening going over all the detailed figures of the UK economy under Conservative management seeking to find the weaknesses, disappointments and failures. He would seize on the balance of payments or the unemployment numbers, and crusade strongly against them. He created an image of “Thatcherism” which was a distortion, marketed this image, and used it to explain every problem in British society. It gave him credibility and admirers within the Labour party, and fuelled his rise to Shadow cabinet and from Shadow Secretary of State for Trade and Industry to Shadow Chancellor.

So often people become prisoners of their best days. His failure to wrestle the leadership on the untimely death of John Smith left him in opposition to the new Leader, Tony Blair. His opposition mode of thought survived the transition to government. His small coterie of advisers and supporters would turn their talents in private to criticising the Leader. In public he continued to treat the Conservatives as if they were still in government, holding up their every statement or past policy to withering criticism.

Like some other clever and powerful people, he surrounded himself with people who agreed with him or fuelled his prejudices. His main advisers appeared to think government was just like opposition politics with proper access to government information, and use of government facilities to shape or close down debates. Much of his time as Chancellor when he started the large increase in public spending was about building an overwhelming body of support for his transition to the Prime Ministership once Tony Blair could be persuaded to go.

Mr Brown knew the Labour party well. He knew that many Labour MPs believed that more public spending was good, and even more was better. He encouraged bread and circuses as his approach to politics, personally associating himself with “generous settlements” for spending in each Labour MP’s constituency. Question times often appeared well rehearsed, with Labour MPs asking about their last generous settlement or seeking their next one. They contrasted this with “Tory cuts” or alleged past Tory meanness. The careful Gordon Brown of 1997-2001, who recognised there were limits to how much the public sector could spend tax and borrow was gradually replaced by the spend more spin more Gordon Brown. He was determined to spend whatever it took. He wanted to improve public services and to create the good will he needed to gain the highest office of all. Maybe he began to believe his own rhetoric, that he had solved the past problem of high-spending governments and could now borrow what it took.

After one botched coup and much dithering he gained the top job. According to media opinion he started very well, performing to their satisfaction in interviews about the diseases and floods which hit the troubled UK. His early speeches implied a break from the Blairite past, a change to a more honest more serious era where real problems would be solved by a government which cared about people. If only he had meant it, or knew how to deliver it, all would have been so much better. Unfortunately the promises to restore Parliament to a central role, to banish spin, to give people an honest account of their government and to concentrate on solving the problems of poverty and worklessness turned out to be hollow.

In September of 2007 with the Credit Crunch and banking crisis beginning to bite, the Prime Minister was still surprisingly popular. Many thought he was the man with the experience to tackle such a problem. We were primed to expect an autumn election. Instead he walked away from it, and saw his opinion ratings plummet, partly as a result.

Since that fateful autumn the Prime Minister has been mainly a long way behind David Cameron and the Conservatives in the polls. He lost by elections in Crewe and Nantwich, Glasgow and Norwich to his main rivals. He had one brief rally in popularity as he dashed around the world posing as an international statesman who knew about banking crises in the autumn of 2008. His failure to prevent the crisis in the UK, or his inability to limit the damage to the same scale downturn as the USA, soon reversed the temporary blip in popularity.

The sad irony of Gordon Brown is summed up by the giddy rises in the unemployment numbers. He has always stood in politics for the morality of the Manse. He believes in the need for people to work hard to pay their way and look after their families. He has been espousing the cause of “Get on your bike” to get a job, whilst pretending that such sentiments shocked him when expressed by others.

Instead of leaving a Britain richer and stronger thanks to the healing power of paid work, he will leave a ruptured Britain, damaged by mass unemployment and by a deeper recession than under any other UK post-1945 government.

2 The boom years

Borrowing takes the waiting out of wanting

Between 1979 and 1997, public spending (measured by Total Managed Expenditure) rose by 30% after allowing for price increases. In the eleven years that followed managed expenditure shot up by 42%, a more than doubling in the growth rate. In the first three Labour years it grew by just 2%, when the economy performed well.

Much of this money went on a combination of wage increases for existing public sector workers, and recruitment of a new large army of officials and advisers within the core civil service, and to staff the growing number of quangos the government created to tackle every problem and launch every major initiative. In the NHS new European controls on working hours led to the need for many more people to do the same amount of work. The GPs negotiated a new contract, which boosted their earnings substantially.

The government did not just want to expand the rate of growth of most of the major departments. It also wanted to expand its capital programme, to build new schools, hospitals and other public buildings. To do so it took, developed and expanded the idea of the Private Finance Initiative (PFI).

The origins of the PFI lay in the last Conservative government. We were looking for a way of financing what would traditionally have been a public sector project using private finance. In order to keep it off the public balance sheet, we believed the project needed to be designed, built and owned by a new private operator, who should be on risk for the revenue from it. The ideal project for such treatment would be a toll-financed bridge or new road. The first major example of such a scheme was the Dartford crossing for the M25, where a toll bridge was designed and built using private money. The private operator owned and ran the bridge at their own risk until they reached a specified return, and then gave the facility to the taxpayers.

The new government thought they could adapt this idea and make much more use of it. They were less worried about the need for proper risk transfer before counting any such scheme as a PFI one outside the public accounts. They thought they could promise grants and revenue from the public sector to the private operator for a facility like a new school or hospital which was properly part of a public service paid for out of the national budget. It was increasingly difficult to see that much risk had been transferred. The private projector would raise the money, build and operate the building. If something went wrong they would doubtless expect more public money to bail them out.

The government ploughed on with these projects, which were often dearer for taxpayers than if they had been bought and paid for in the normal way in the public sector. They did not include them in the borrowing figures, so they felt they could do as many of them as they liked.

They decided to extend this principle, by developing even larger projects or by creating public sector companies. New Public Private Partnerships (PPP), as they became known, were another way of extending the reach of the public sector and raising more money to spend on political priorities without having to include them in the official figures for borrowing. The government forced Railtrack, the privatised railway business, into administration. They replaced it with Network Rail, a public interest company, which was one of the dearest of this range of schemes. This was followed by a PPP to run the London Underground. One of the private companies involved failed, and left the taxpayer picking up the costs of restoring the service.

Why did they go to all this trouble to disguise their borrowings? They did so for a couple of reasons. The first is Gordon Brown remained notionally wedded to rules of prudence over his total level of spending and borrowing long after he in practice divorced Prudence and determined on a high spending course. He claimed he was following a couple of fiscal rules. One stated that over the lifetime of an economic cycle he would only borrow for investment, not for day to day expenditures. He used the vagueness of the word cycle to allow himself flexibility to decide as he went along what constituted a cycle. The second rule stated that he would not borrow more than 40% of our national income. Keeping the borrowings of Network Rail and much of the capital programme for schools and hospitals out of the figures for government borrowing made hitting these targets much easier.

All this book-cookery at the Treasury made the perfect backdrop for what was going on in the banks and the City at the same time. Government can set the tone. There were big fees to be made out of serving up complex lending packages to arms and branches of government to disguise their true indebtedness. The fees on lending more money to the government through the bond market were small in comparison to the fees that could be charged for a complicated PFI or PPP package. If off-balance-sheet financing was the order of the day for the state itself, why not try it for companies as well? The noughties became the decade of off-balance-sheet fun and excess.

On both sides of the Atlantic government was keen on promoting home ownership to people who previously could not afford it. President Clinton had a dream of getting people out of trailer parks into new suburban owner-occupied property. Even Gordon Brown, a more traditional socialist in a party which favoured council rented property, recognised how popular ownership was and was keen to see more people buy their own place.

Northern Rock – the dream castle of New Labour

The rise and rise of Northern Rock summed up what New Labour wanted for their monument. Even Gordon Brown, ambiguous as he was, favoured its development. Gordon was New Labour because in the 1990s he was fed up with losing with Old Labour. As the noughties ran their course he became more Old Labour again, both to pursue his opposition to Blair and his New Labour gang, and to curry favour with the majority of the Labour Parliamentary party who remained Old Labour in instinct.

Both Old and New Labour could agree that the south had got rich through its accent on service sector business in general and financial services in particular. There was resentment at the success and wealth of the south, and resentment that Northerners had to pay fees to fancy southern businesses if they wanted a mortgage or a financial product. Northern Rock seemed to be the way to harness the ideas of the south to the cause of the North. Two birds could be killed with the one stone. A successful Northern Rock could lend more money to people in the North East to buy their homes. A successful Northern Rock would bring the income and wealth of a large financial business to the North East, by keeping its headquarters in Newcastle.

In 1997 Northern Rock was a provincial, conservatively run institution. It had a balance sheet with total assets of £18 billion. It had cautious levels of capital. In the years which followed, it was transformed by aggressive management, driving it to 25% annual growth in loans on a regular basis. By 2001 it had £31 billion of assets. This had risen to £52 billion by 2003 and to £65 billion a year later. In 2005 it reached £83 billion, and exceeded £100 billion by 2007. It became a star performer, regularly taking a much bigger share of the growing mortgage market as it sustained its high growth rates.

Northern Rock Directors believed they had come up with a clever model for growth. Though it now looks racy, at the time the regulators and many investors were impressed by what they were doing and saying. They decided to specialise in mortgage finance, concentrating on what they knew best. They gained a bigger market share by being more flexible over whom they lent to and how much they lent. They added personal loans to the mortgage, allowing total advances to hit 125% of the value of the property in some cases. They correctly reasoned that people buying a home often needed more than its purchase price to pay stamp duty, purchase expenses, and have some money to do the place up or buy some new furniture. House prices usually went up, so the lack of cover for the loan package would soon be removed.

Raising enough money in deposits was going to constrain their growth, as there was only so much money they could attract from savers through their branch network and by advertising without giving away very high rates. They decided they could grow more quickly and spread their risk better if they drew on three different sources of money. They would continue to finance some of their loans from savers deposits. They would borrow in the liquid and low cost money markets, rolling this short term money over regularly. They would every now and then sell off bundles of mortgages that they had written to other investors. They could structure packages of mortgages as bonds which hedge funds, pension funds and banks might like to buy. It enabled them to power up from £18 billion of assets to over £100 billion of assets in ten years.

Suddenly the North East had its own flagship large financial company. Residents of Newcastle, Gateshead and the other leading Northern towns could obtain mortgages more easily. The Board and senior executives started to pay themselves London-style remuneration with bonuses to match their growth. In recognition of their origins and to keep the goodwill of those who backed them in the local communities of Tyneside and Wearside they set up a trust fund which paid out for local projects from the profits of Northern Rock. The business of making money out of money was being given a human and social face. Here was capitalism with a difference, capitalism with a Northern accent, capitalism with a socialist conscience.

It was not just Northern Rock which was growing this way. Alliance and Leicester was doing something similar. Bradford and Bingley had been fuelling the mortgage market for buy-to-let properties, as many people responded to the surge in house prices by becoming mini landlords themselves, borrowing more money to own an additional home. The easy credit of the early noughties was bound to push property prices up. Too much money was chasing too few homes. The government knew this and was always urging the construction industry to build more. They incorrectly assessed the situation of house prices through the wrong-headed Barker review. This ignored the fuel of the house price flames coming from the likes of Bradford and Bingley and Northern Rock, lending large percentages of rapidly rising values. Instead the report – and government ministers – stated that the price rises were the result of too few new homes being built. They turned a blind eye to the obvious overheating, to the easy credit in the markets, to the high degree of liquidity in the money markets which the mortgage banks drew on, and to the ballooning of their balance sheets. The regulators smiled benignly on Northern Rock's apparent success. They did not query the giddy growth, the values of the homes used as collateral or the reliance on money market funds. They assumed, as did the directors of the company, that the authorities would continue to keep the money markets liquid allowing Northern Rock to carry on borrowing.

On the eve of the Northern Rock crisis the world's regulators met to create a new set of rules for banking capital at Basel in Switzerland. When the Northern Rock Directors took advice on what this meant for their business, they discovered to their delight that they were keeping too much capital for the strict needs of the new rules. The regulators were so impressed by world markets and their apparent capacity to handle risk, that they were busily lowering the standards near the dangerous market peak.

The buy-to-let game was bound to work, people thought, responding to Bradford and Bingley's offers. If they could arrange a mortgage so that the rent the tenants paid met the running costs of the mortgage, they could in due course pocket the large capital gain they expected to make from the rising market. Some even budgeted to lose money in the early years when comparing running costs and mortgage costs with the rental income, confident that they would make a packet on resale.

In the summer of 2007 the UK authorities lurched from being accommodating of this freewheeling model of financial growth to putting it under a severe and ultimately terminal test. They decided on a course of action which was bound to make the likes of Northern Rock suffer badly. They had been raising interest rates. They now allowed the money markets to run short of funds.

Higher interest rates spelt death to these aggressive business models. As mortgage interest costs soared, so the people on low incomes with the largest mortgages struggled to meet their payments. Some had to abandon the task and allow the mortgage company to repossess and sell the property off. People owning more than one home and letting the other out found their sums did not add up anymore, and they needed to sell in a hurry to stop the running losses. The banks realised they could not go on making so many new advances at ever rising property values. Valuers started to become more cautious about how much a property was worth when asked to assess its mortgage potential. The authorities who had done so much to allow and fuel the growth in property prices and the mortgage market brought it to a screaming halt.

3 Bust replaces boom

Hiking interest rates and keeping them higher will bring a credit bubble to an end. If you add to that keeping the money markets short of funds, and refusing open market operations to ease the squeeze, then you can bring a boom to a shuddering halt. In the UK the so-called independent Monetary Policy Committee of the Bank of England kept interest rates below 4.75 throughout most of 2003, 2004, 2005 and 2006. On 11 January 2007 they hiked them to 5.25%. On 10th May they raised them again to 5.5%, and raised them to 5.75% in July 2007. By September 7th market rates in the UK had risen to 6.9%, well above the usual level you would expect with a 5.75% base rate. The authorities kept the markets very short of cash. This led the market rates to be well above the recommended rate, and meant the MPC had lost control of the situation.

Several of us were urging the authorities to make more money available and to try to get market rates down. We were well aware of the damage that would be done to the banking sector and to the wider economy if the monetary tightness remained as severe as we could see it was. Instead the Chancellor of the Exchequer and the Governor of the Bank of England decided to lecture the banks on the subject of moral hazard, telling them they needed to get better at doing their jobs and that there would be no bailouts if things went wrong. The Chancellor's notorious interview on 13 September was a classic. He opined that "Institutions have, in some cases, been prepared to lend to people without checking if they're ever going to repay it. Institutions themselves need to open their eyes and be more honest."

There were already market rumours that the mortgage banks which depended on borrowing short-term money from the money markets were in serious trouble, struggling to raise the sums they needed. The Chancellor, as chairman of the tripartite regulatory group (the Treasury, the Bank of England and the Financial Services Authority), should have known this. Northern Rock, Alliance and Leicester and Bradford and Bingley were all the topics of market gossip and speculation.

Instead of convening the tripartite committee and contacting all possible banks at risk to discuss with them how they would see themselves through the crisis, they were sent a public moral lecture. Instead of the Bank being told to make money available in the money markets so there was money around for Northern Rock to borrow short term, the markets were kept short of money. Instead of telling the banks privately to lend less, to think of raising more capital, and to sell some more loans on, we had the silliest and shortest lived grandstanding on the issue of the whole crisis. Within forty-eight hours the authorities were forced into a humiliating U-turn. The biggest ever public bail-out of the British banking industry was about to begin.

Northern Rock was the most exposed of the problem banks. It had been the most aggressive and successful on the way up. As mentioned above, it relied on three main sources for the funds it needed to conduct its business. Around 25% came in the conventional way, from retail deposits placed in branches and over the web by individual savers. Another quarter came from money market funds, where Northern Rock relied on the plentiful and cheap credit of the 2003-6 period to finance part of its activities. The remaining 50% came from securitised vehicles and funds buying its mortgages, taking them off the Northern Rock direct balance sheet and providing long term funding for them. This turned out to be the only stable part of the arrangement from Northern Rock's point of view. Typically the securitised lending was blamed by many for the problem, when in this case it worked well for the sponsor company.

In those early September days Northern Rock found it more and more difficult to get the money it needed from the money markets. It was clear it needed to borrow short term money from its banker, the Bank of England. One of the prime functions of a central bank is to act as lender of last resort to other banks. Surely this was such a case? The Central Bank should do it quickly, privately, and take security against the loan. It should also privately read the riot act and demand that the offending bank sorts itself out rapidly – by selling assets, raising new share capital, arranging longer term loans, cuttings its business or whatever means it wishes – so it does not come to rely on Central Bank support.

Instead, in this case, the news leaked out that Northern Rock was in need of emergency help from the Bank of England. This triggered a run on the Rock. Many small savers, fearing the bank would not be able to repay their savings when asked, decided to turn up at its branches and demand their money back. Queues formed outside the branches. TV cameras arrived to follow such a drama, fuelling more doubts amongst Northern Rock savers. The more the media followed the story, the more people felt they needed to take their money out. The shortage of funds in the money markets, which the Bank of England could have prevented, started the problem. The leaks about the bank and its need for lender of last resort money compounded the problem. The demands of individual depositors for their cash threatened to bring the bank down.

The government did its flip-flop, and announced it would stand behind the deposits, to take the pressure off. On September 19th the Bank of England made £10 billion available to the money markets. It was too little too late. The authorities actions and inactions had ensured the wreck of the UK mortgage banking business. In the months that followed rescues had to be devised for Alliance and Leicester, Bradford and Bingley, and Halifax Bank of Scotland.

Some tried to claim at the time that the UK was a strong and well-run economy. Our problems, we heard, were imported from the US where their sub prime mortgage crisis was doing so much damage. The interesting thing about the main UK banking casualties was that they lost money on UK mortgages, not on US ones. They were British banks, lending UK mortgage money to UK customers, under the not-very-watchful eye of a UK regulator. This was in every sense a banking crisis made in Britain. It had things in common with the US crisis, but it was very much home grown.

Nor was the drying up of the money markets simply the result of the US sub-prime crisis. It is true that the atmosphere of doubt and unwillingness of banks to trust each other's paper was fuelled by US events as well as by UK events. But the UK authorities could have made money available to Northern Rock through general money market operations or via a traditional last resort loan. The collapse of Northern Rock was the direct result of the UK authorities' failure to regulate it tightly enough on the way up, and their actions helped to bring it down in 2007.

The lull before the second storm

A year passed from the run on the Rock. During that year extraordinary comings and goings over Northern Rock ended up with the full nationalisation of the bank, announced on 17th February 2008 after abortive attempts to sell it to a private sector buyer. Subsequently the government acted as midwife or nodded through shotgun mergers, giving Abbey Santander control of Bradford and Bingley's branches and deposits and of Alliance and Leicester. It gave Lloyds Bank control over HBOS.

For a whole year the authorities kept interest rates quite high, as if nothing serious had happened. They ignored the pleas and warnings that interest rates needed to be slashed to prevent a serious recession. They did not enter detailed discussions with all the banks to try to find out how bad their balance sheets were, to try to map out a way to recapitalise them and get them into profit after allowing for past losses. Months went by, with the UK government setting out future changes to prevent a future crisis, as if the present one had already been cured. They asked Northern Rock to wind down its business, so some of the huge taxpayer sums committed could be repaid. Around half the staff were to go and the business was to shrink rapidly. In April 2008 the authorities made £50 billion available to markets, a sum which would easily have prevented the run on the Rock half a year earlier. Some of the banks decided themselves to raise more cash and capital, and presumably continued to meet with the regulators approval for the state of their balance sheets.

It was not until the autumn of 2008 that things started to move rapidly again. This time instead of a disaster we experienced a catastrophe. The UK authorities suddenly decided that they did after all want to insist on more cash and capital than they had required in the good times, just as there were signs of serious strain in world markets. It was the worst possible moment to make such a request, and the worst possible thing to do when markets needed reassurance from the authorities that the banks would survive, not an undermining exercise of the most inappropriate kind. This time it was not just the UK that faced trouble.

The bust – second phase

On October 2nd the Irish banks were under pressure, so the Irish authorities gave a state guarantee for all deposits. Other EU countries complained that this was giving their banks an unfair advantage. On October 3rd the US authorities astonished the world by offering a $700 billion package for their ailing banks. On October 8th the leading central banks and governments of the world announced a co-ordinated reduction in interest rates, to signal to frightened markets that they were aware of the seriousness of the problem and would do whatever it took to sort it out. On October 9th the whirlwind in Iceland forced the Icelandic government to nationalise Kaupthing Bank. On October 13th the UK government produced a stunning £487 billion package, many times the size of the US one relative to the size of the economy. On October 14th the Japanese went to the aid of their regional banks and on October 19th South Korea announced $130 billion of support for its banks. By October 27th the run on Icelandic banks and assets was so great they had to hoist their interest rates to 18% to stop the run, whilst on October 29th the IMF went to the aid of Hungary which was also being buffeted by the markets. On November 6th the UK cut rates by a large 150 basis points (1.5%), taking them down to 3%. On November 23rd the US had to mount a bail out for Citigroup and on November 25th the US offered an additional $800 billion of support to banks in general.

All the main jurisdictions in the West announced the biggest ever shift in policy. They slashed interest rates, about a year later than they should have done. They increased their budget deficits. They offered unprecedented support for banks. They nationalised banks on a massive scale.

In the UK the regulatory exercise to demand more cash and capital backfired in a spectacular, predictable and costly way. News of it leaked, as all the negotiations were put under a media spotlight. These most sensitive of issues, which always before had been sorted out behind closed doors, suddenly became public property. Once a bank was fingered in public for having too little capital, it would find it very difficult to raise it from the market. There was always the possibility that the word of the regulator would work as a black spot for the offending bank. It could trigger a run on the deposits. The government presented its newly merged Lloyds/HBOS, Barclays and RBS with a simple choice – either raise the money the regulator now said they needed immediately, or take government capital and offer shares to the taxpayer. Barclays went abroad and found some money, arguing that it was a strong bank and was not in trouble. RBS and Lloyds accepted the government's offer, and became largely owned by the state.

In the USA Bear Stearns was bailed out and taken over. Lehmans was allowed to go under, which in the short term spooked markets more and led to a further sell off in assets as people worked out how many assets the bankruptcy would release onto the market. The two large US mortgage banks, Freddie Mac and Fannie Mae, were brought into state ownership.

By the end of the bust the world economy looked very different. More commentators came to appreciate that the old model, based on countries like the USA, UK, Spain and others borrowing too much to spend beyond their means, was coming to an end. This had sustained Chinese factories, German exporters and Japanese corporations for years, but it was passing. The collapse of banks left people short of credit. The plunging markets made more and more businesses and people willing or needing to sell assets at depressed prices to reduce their risks and repay some of their debts. The financial crisis was going to become a major economic crisis, hitting output and jobs as well as city fortunes.

In the early days of the financial crash there had been some scarcely concealed glee by non-financial onlookers that the banks were at last getting their retribution for all those years of apparently effortless profit and super-bonuses. It was no bad thing, some thought, that they would have to rein back. There were friends of the UK Chancellor who thought it an important lesson in moral hazard. As autumn turned to winter in 2008, few remained with this naïve opinion. For every banker losing a bonus there were several manufacturing workers losing their jobs. The car factories were idle, machine tool orders plummeted, export credit and exports seized up. We were in for the worst slump since the 1930s.

4 Getting over the slump

One more boom?

It was Gordon Brown who had famously parroted on many occasions his slogan, "No more boom and bust". He thought in the heady days of credit expansion in 2003-6 that he had done it, achieved the impossible, abolished the trade cycle, created the nirvana of economic stability. As the smoke started to clear the full dreadful reality of the crash became apparent. It emerged that the whole boom he had presided over was a false boom based on ultra low interest rates, lax credit controls and an explosion of lending. The Monetary Policy Committee in the UK, far from being smart and cautious, had just allowed more and more credit to chase too few assets. It had presided over a crazy boom in asset prices.

Instead of apologising, telling people the truth, and explaining we now had to have a period of paying off our debts and spending less, the authorities decided to embark on one more course of the same medicine, on a new and altogether electrifying scale. They decided to follow their large bailouts of the biggest banks with quantitative easing in both the USA and the UK. This was on top of the very large and increased public deficits both the US and the UK proposed.

Loads of money

Gordon Brown will go down history as the biggest spender, the biggest borrower and the biggest money printer the UK has ever known. The man who set out faithfully wedded to Prudence in 1997 became in 2009 the most profligate Prime Minister the country has ever witnessed. Going into the recession there were still more than five million people of working age living on benefits, putting the social welfare costs sky high. The recession itself may add more than a million to this total, as unemployment surges after the collapse of demand and factory output. Mr Brown decided understandably to treat the costs of rising unemployment as a necessary increase in the public budgets – the so called automatic stabiliser which prevents the loss of employment income leading to such a large loss of spending power.

He also decided at the same time to add a "Keynesian" stimulus to the already large public deficit. He selected a cut in Value Added Tax from 17.5% to 15%, hoping this would at one and the same time cut the Consumer Price Index and lead people to buy more discretionary items. He added selected increases in spending in areas he favoured.

He determined on a politically motivated strategy towards public spending and borrowing. He decided to pledge to increase spending in all sorts of areas. It was a kind of scorched earth policy. Fearing electoral defeat, he wanted to make sure that the electorate was given every opportunity to vote for a government which was promising to meet all their spending wishes. More importantly, were they to lose, the Conservative successors would have to spend the first year removing many of these unaffordable "promises" from the budget. Were he to win he would doubtless announce that many of these schemes could not be afforded for the time being. For example, he announced a commitment to rail electrification, yet his capital spending plans for after the election according to Treasury figures reveal substantial cuts.

The misdescribed reflationary packages might prove to do little to help. Council tax, fuel duty and other taxes are going up. If extra spending is financed by tax increases then there may be no increase in demand. Every penny the public sector spends, the private sector has to give, so the private sector can afford less. If the extra spending is borrowed in the first instance then the private sector has to lend the money and is no longer able to spend that money. In due course taxes have to rise to pay the interest and repay the capital. "Reflationary" packages may have more impact on the distribution of income and assets and less on the overall level of spending.

The Bank of England flipped from being tough on inflation and worrying about price increases, to being worried about undershoot of price increases and in effect mainly preoccupied about the plunge in activity. For much of 2008 the Monetary Policy Committee was keeping interest rates up, claiming inflation remained a problem, and denying the views of Mr Blanchflower, the one member of the Committee who predicted a big recession and called for rate cuts. From the end of 2008 a very different outlook prevailed. They acquiesced in the concerted reduction of international rates on October 8th and ended the year at low levels. They then began their plans to print more money.

Money printing

Early in 2009 the authorities agonised over research which indicated that they needed to buy up government and corporate bonds, to push more cash into the markets and banks. They decided they needed to give it a try. They appeared to panic over the severity of the downturn they had helped to create, and did not seem to appreciate that the lower interest rates they set around the turn of the year would take perhaps a year to have any real impact. They had been slow to cut rates. They felt instead that cutting rates was no longer working, so they needed to do something else.

Respectable monetarists advised them correctly that the results of their actions to date had been to restrict the money supply, leading to lower activity. These monetarists recommended buying bonds to increase the amount of money in use, as the bondholders received cash for their bonds. The Bank of England's original justification for quantitative easing was somewhat different. They drew attention to the "failure of the banks to lend more", and felt that buying bonds would increase the banks capacity to offer credit.

The Chancellor of the Exchequer signed off a programme of up to £150 billion of bond buying. The Bank decided on a programme that originally stretched to £125 billion. In August 2009 it decided that more was needed, and applied for permission to do another £50 billion on top, to take the total to £175 billion.

Some of this money has gone abroad, helping to lower the sterling exchange rate. Some foreign holders of government bonds have become nervous and sold, selling the currency at the same time. Much of this money has gone to portfolio holders of bonds – pension and other investment funds. Some of this has been deposited in the banks. They have tended to lend the money straight back to the government, which has at the same time as buying up bonds been issuing substantial quantities of new ones. Some of the cash has been spent by the investment funds on buying new gilts from the government, or subscribing for the new equity and corporate bond issues coming from a private sector still needing new cash to survive. The arrival of substantial sums in this way has helped financial asset prices rise generally – as has the same process in the USA.

The government's gross borrowing requirement in the years 2008-2010 is a record-breaking £417 billion. That is more than the total national debt this government inherited in 1997, a debt built up over the preceding centuries and including the remains of the debt needed to fight two world wars. Some cynics think the arrival of quantitative easing was a necessary device to ensure the government could raise these huge sums prior to the general election.

Why didn't the early days of quantitative easing lead to substantial increases in bank lending, given that some of the cash was deposited in banks as investors sold their bonds to the government? The answer is partly because the investors reinvested the money, and partly because the banks were in no position to re-lend any cash they did accumulate. The new tough regulatory atmosphere made them keep bigger reserves of cash and capital, so instead of allowing an expansion of lending it just allowed them to hit the new and more taxing targets. One of the conundrums of this phase of policy is the way that the monetary policy was seeking to be very accommodating, flooding the markets with huge sums to buy bonds, whilst the banking policy was very tough, seeking to prevent banks lending so much. One possible explanation is it suited the authorities that the banks effectively had to lend the money to the government to kept their cash and safe securities ratios high.

5 Conclusions

Gordon Brown has been on a curious journey. The man who helped Tony Blair design and market new Labour was apparently happy that it tore up Labour's commitment to more nationalisation. Ten years on he embarked on the needless and expensive policy of bank nationalisation, when he could have saved banks much more cheaply by lender of last resort actions and more intelligent regulation. The banks were thought to be a frontier too far by the nationalisers of the 1940s and 1960s Labour governments. Suddenly Mr Brown seized the chance to nationalise some of the commanding heights. The taxpayer is losing a fortune, and bank restructuring has been delayed as a result.

He has moved from backing tight Conservative spending plans, to proposing the most enormous increases in ill judged spending the country has ever witnessed. He has done this in the name of reflating an economy which has collapsed on his watch after a period of credit excess.

He has changed from believing their should be tight limits to how much the country can borrow, to saying that he will borrow whatever it takes, whatever bills that may leave to future governments and future generations of taxpayers.

He has changed from accepting the Conservative personal tax reforms – and lowering tax rates a bit more in some cases – to imposing a new much higher rate of tax on people on higher incomes.

He has changed from thinking the Monetary Policy Committee of the bank should be free to make its own judgements, to backing a Chancellor who has played an important role in changing the MPC's interest rate and money supply stance. Gordon Brown himself changed the target of the MPC at a crucial time in the run up to the 2005 election, a change which had the felicitous political consequence that the MPC kept rates lower.

The end game

Far from abolishing boom and bust, the conduct of monetary policy and the big build-up in public spending and debt has put our economy through the most violent cycle of the last 70 years.

This government will bequeath to the next the worst budget position this country has experienced in peacetime. It will leave a huge amount of public debt to be sold, and a large burden on future generations to repay it. It will leave a broken system of banking regulation. It will pass on nationalised banks that need sorting out and returning to the private sector. It will leave a banking industry with too few competitors and too many weak balance sheets. It will, in sum, leave a mess. It will take years to restore health to the banks, stability to the money supply and proper growth to the economy.

Postscript – what should government do now?

Government has done too much in recent years. It has specialised in doing too much too late. Sorting it out will be a long and arduous task.

It is likely quantitative easing will have ended before the next election. If not, it will be important to stop it, to allow sanity to return to the government bond market. We need to know the true price of borrowing the large sums being sought, without the artificial and temporary intervention of Bank of England buying. The present policy does not cancel the reckoning, merely delays it. The Bank's chosen interest rate of 0.5% is now notional for most people and companies, with effective rates for savers and borrowers being several times the MPC level. The MPC interest rate will need to be brought into line with reality.

We need better banking regulation, not more regulation. As the power to regulate banks is transferred back to the Bank of England, it should be made clear that we need big picture regulation, controlling the cash and capital of the banks. This should be done counter-cyclically. As credit builds up and the good times roll, the authorities should demand more cash and capital. As the bad times emerge and credit is restrained, they should relax as much as they can.

The prime task will be to remodel the state owned banks and return them to the private sector as quickly as possible. Without properly functioning banks it will be difficult for the economy to recover on a sustainable basis. The state banks should be split up into more manageable sized institutions, creating more competition in the domestic market than we currently enjoy. HBOS should be separated from Lloyds, NatWest from RBS, and new banks formed around Northern Rock and the remnants of Bradford and Bingley. They need to be established, capitalised and sold in a form which allows them to trade sensibly from sale. The taxpayers' interest needs to be protected by packaging the more dubious assets with the more attractive ones to effect the maximum disposal and reduction of taxpayer risk.

The government also needs to start tackling the deficit. The problem is one of overspending. The UK is not undertaxed. Indeed, penal increases in income and company taxation could make our economic problems worse by driving away enterprise and entrepreneurs that are needed to grow the economy again. The deficit needs to be brought down by raising the efficiency and quality of the core public services, by removing waste and less desirable activities altogether, and by selling on those activities like post, banking and some transport that could be better run in the private sector. The size of the public sector has to be reduced, through sensible use of natural wastage, and the cancellation of projects and activities like ID cards and regional government. These are luxuries for some that will have to be forgone, and evils to others who will cheer as the axe falls.

About the author

John Redwood has been the Member of Parliament for Wokingham since 1987, and is chairman of the Conservatives' Economic Competitiveness policy group. First attending Kent College, Canterbury, he graduated from Magdalen College, and has a DPhil from All Souls, Oxford. A businessman by background, he has been a director of NM Rothschild merchant bank and chairman of a quoted industrial PLC.

John was an Oxfordshire County Councillor in the 1970s. In the mid-1980s he was Chief Policy Advisor to Margaret Thatcher. He urged her to begin a great privatisation programme, and then took privatisation around the world as one if its first advocates before being elected to parliament. He was soon made a minister, joining the front bench in 1989 as Parliamentary Under-Secretary in the Department of Trade and Industry. He supervised the liberalisation of the telecoms industry in the early 1990s and became Minister for Local Government and Inner Cities after the 1992 General Election.

Shortly afterwards, John joined the Cabinet and served as Secretary of State for Wales from 1993 to 1995. In opposition he has acted as Shadow Secretary of State for Trade and Industry, Shadow Secretary of State for the Environment, Transport and the Regions, and Shadow Secretary of State for Deregulation. He stood for the leadership of the Conservative Party in 1995 and again in 1997.

John was a fellow of All Souls from 1972 to 1987 and again from 2003 to 2005. He is currently a Visiting Professor for Middlesex University Business School and has published a number of books including *Superpower Struggles*, *Just Say No*, and *Singing the Blues*. His most recent publications are *I Want to Make a Difference, But I Don't Like Politics*, which examines the reason for the decline in membership of political parties and those voting in local and General Elections, and *After the Credit Crunch: No More Boom and Bust*, which considers the reasons behind the global recession and why Britain has been hit especially hard.