The Banks – Too Big To Fail

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Government ministers, bankers, businessmen and women and the media have begun to talk hopefully about the ending of the current recession, and 'the green shoots' of recovery already showing when economic growth will start again. Ludicrous as such a suggestion must be of further growth of the kind we have been enjoying being sustained within the limits of the planet's capacity, talk of an early recovery is a profound misjudgement of the real situation. This has been clearly revealed in two recent authoritative publications. The first on 'Green shoots or yellow reeds' – mainly about the United States economy – appeared in Nouriel Roubini's *Global EconoMonitor* for May 19th. The second – mainly about the UK banks – was written by John Lanchester, entitled 'It's Finished', taking up eight full pages of the *London Review of Books* issue of May 28th. Any reader of these two papers must be left with profound doubts about our economic future.

Despite the failure of earlier promises of recovery by mid-2009, a research group at Goldman Sachs bank in the United States was still predicting, in March 2009, an early bottoming out of the recession on the basis of four improving trends – employment, retail sales, industrial production, and housing conditions. In each of these areas Roubini shows that improvement is quite simply not occurring. Unemployment is likely to rise to 11% by 2011. Retail sales and consumption have been falling sharply since April, and are hardly likely to recover as employment falls and savings have to be rebuilt. Industrial production, of motor vehicles, for example, is still declining as home demand, especially in China, shows no sign of replacing falling exports. Housing starts and building permits are still falling with a huge inventory of unsold homes and unpaid mortgages. This is the immediate picture for the United States, but worldwide and in the longer term the picture, which Roubini paints, is no brighter.

The risks and vulnerabilities

Roubini identifies ten risks and vulnerabilities for the world economy in the medium-term future. The first, and the one that influences all the others, is that the cause of the crisis has been misunderstood. Wrong remedies have been applied. Instead of recognising excessive over-borrowing and over-spending as the problem, it has been treated as a crisis of financial confidence. Debts have been transferred by Government intervention from private banks and households to the state. But they still hang over the whole world economy.

The second is that the response to debt by households and businesses and by the state is to reduce spending and increase savings. But this only has the effect of deepening the depression. The debt overhang has not been reduced, so that spending, preferably on investment goods, can be resumed and the productive cycle restarted.

The third is that, with banks weighed down by the burden of bad loans and toxic securities and by trillions of expected losses, and with hedge funds closing, the current credit crunch is likely to persist for a long time. Again, the cycle of demand led production is held back.

The fourth is that the big corporations – the motor car industry as a prime example – are equally under financial stress, with outstanding debts and vast excess capacity, partly as a result of massive over investment by China.

The fifth is that the socialisation of private losses and debts implies a sharp rise in public debt, which will rise from about 40% of gross domestic product (national income) to 80%. Interest rates are bound to rise, crowding out private spending.

The sixth is that government monetisation of fiscal deficits must lead to inflationary pressures and an end to the years of price stability, which have been sustaining growth, misplaced as it has been in excessive consumption at the expense of investment.

The seventh is that rising unemployment is likely to continue beyond 2010, with the threat for the United States and Europe of over two billion more Chinese and Indians in the global labour force.

The eighth is that the economic balance will end whereby up till now countries running deficits, consuming more than they produced – the

United States, United Kingdom, Australia and New Zealand – have been absorbing the surplus output of countries producing more than they consume – China, Japan, East Asia, and also Germany, unless they begin to expand their internal consumption. Such a change in consumption patterns, with a switch to more investment, is likely to take many years.

The ninth is that mistaken government policies in future – protection of markets for goods and capital, heavy taxation and state intervention – could easily result in sub-par development.

'It's pretty clear by now that this is the worst financial crisis, economic crisis and recession since the Great Depression. A number of us were worrying about it a while ago. At this point it's becoming conventional wisdom.

The good news is probably that six months ago there was a risk of a near depression, but we have seen very aggressive actions by US policymakers, and around the world. I think the policymakers finally looked into the abyss: they saw that the economy was contracting at a rate of 6 per cent-plus in the United States and around the world, and decided to use almost all of the weapons in their arsenals. Because of that I think that the risk of a near depression has been somewhat reduced. I don't think that there is zero probability, but most likely we are not going to end up in a near depression.

However, the consensus is now becoming optimistic again and says that we are going to go from minus 6 per cent growth to positive growth in the second half of this year, meaning that the recession is going to be over by June. By the fourth quarter of 2009, the consensus estimates that growth is going to be positive, by 2 per cent, and next year more than 2 per cent. Now, compared to that new consensus among macro forecasters, who got it wrong in the past, my views are much more bearish.

I would agree that the rate of economic contraction is slowing down. But we're still contracting at a pretty fast rate. I see the economy contracting all the way through the end of the year, going from minus 6 to minus 2, not plus 2. And next year the growth of the economy is going to be very slow, 0.5 per cent as opposed to the 2 per cent-plus predicted by the consensus. Also, the unemployment rate this year is going to be above 10 per cent, and is likely to be close to 11 per cent next year. Thus, next year is still going to feel like a recession, even if we're technically out of the recession.

The outlook for Europe and Japan, both this year and next year, is even worse. Most of the advanced economies are going to do worse than the United States for a number of reasons, including structural factors in Japan and weak policy response in the case of the Eurozone.

The problems of the financial system are severe. Many banks are still insolvent. If you don't want to end up like Japan with zombie banks, it's better

The tenth is that, in addition to all the risks already described, a long period of recession will lead to the loss of skills and innovation and, though Roubini does not mention this, the necessary adaptation of consumption and production to the results of climate change.

After presenting this list of risks and vulnerabilities likely to delay global economic recovery, Roubini warns that a temporary recovery might be followed by a further recession – what is called a W-shaped recession, not just his expected U-shaped one. This could be caused by commodity

… to do what Sweden did: take over the insolvent banks, clean them up, separate good and bad assets, and sell them back in short order to the private sector.

Now, on the question of policy responses, there is no inconsistency between monetary easing and fiscal easing. Both of them should be stimulating demand, and the monetary easing should be leading also to restoration of credit. Of course, in a situation in which the economy is suffering not just from a lack of liquidity but also problems of solvency and a lack of credit, traditional monetary policy doesn't work as well. You also have to take unconventional monetary actions, and you have to fix the banks. And we need a fiscal stimulus because every component of our economy is sharply falling: consumption, residential investment, non-residential construction, capital spending, inventories, exports. The only thing that can go up and sustain the economy for the time being is the fiscal spending of the government.

However, fiscal policy cannot resolve problems of credit, and it is not without cost. Over the next few years it's going to add about $9 trillion to the US public debt. Niall Ferguson said it's the end of the age of leverage. It's not really. There is not de-leveraging. We have all the liabilities of the household sector, of the banks and financial institutions, of the corporate sectors; and now we've decided to socialize these bad debts and to put them on the balance sheet of the government. That's why the public debt is rising. Instead, when you have an excessive debt problem, you have to convert such debt into equity. That's what you do with corporate restructuring–it converts unsecured debt into equity. That's what you should do with the banks: induce the unsecured creditors to convert their claims into equity. You could do the same thing with the housing market. But we're not doing the debt-into-equity conversion. What we're doing is piling public debt on top of private debt to socialize the losses; and at some point the back of some government's balance sheet is going to break, and if that happens, it's going to be a disaster. So we need fiscal stimulus in the short run, but we have to worry about the long-run fiscal sustainability, too.'

Nouriel Roubini, New York Review of Books, 11 June 2009

price increases, government tax increases, and/or inflationary pressures.

The dangers of corporate size

The sheer size of banks and industrial corporations has exacerbated the problems of financial and economic instability. John Lanchester in his article supplies some history of this growth in corporate size. The Royal Bank of Scotland (RBS), now since its takeover of NatWest, by asset size the biggest company in the world (with the ex-chief executive Sir Fred Goodwin enjoying one of the largest pensions), is the chief object of Lanchester's very detailed company accounts examination. Assets of RBS in 2007 are shown as amounting to £1.9 trillion when the whole UK gross domestic product amounted to £1.672 trillion. RBS as a bank arose from the failed Scottish Darien (Panama) trading speculation in 1695, the subsequent massive Scottish losses and the bail-out of compensation organised as part of the Act of Union of England and Scotland in 1707. But RBS is not the only giant of British banking. In the United States there are still many banks in the different states, though the failed Lehmans and the American Insurance Group (AIG) were very large. By contrast, there are now just four joint stock banks in Britain's high streets – RBS-NatWest (once National Provincial), Lloyds-HBOS (once Halifax Building Society and the Bank of Scotland), Barclays and Midland-HSBC (Hong Kong and Shanghai Bank of China). All had manufacturing and trading origins with overseas Empire connexions. The Co-operative Bank and Nationwide are mutual societies owned by their depositors.

What, it may well be asked, has been the advantage of size that has led to this succession of bank mergers and takeovers? It is not difficult to understand in terms of monopoly positions and economies of scale why size has been increasing in manufacturing, mining and retailing, but why in banking? Lanchester offers a convincing explanation. Shareholder value, that is the value of shares on the Stock Exchange, does not depend so much on productive efficiency as on confidence in survival. Size is reassuring and great size means 'too big to fail'. State support can be relied upon to rescue failing banks, and this has proved only too true in the current crisis. But the next question is why the tell-tale signs of over spending, over lending and 'toxic assets' did not show up in the banks' accounts. Sir Fred Goodwin, in 2008, promised his RBS share holders that great caution had been exercised to avoid any failure like that of Northern Rock, yet within a few days RBS had to be bailed out by the government. Lanchester's detailed examination of RBS's accounts (in itself a beautiful model for a business school exercise in the study of company balance sheets) shows in the relevant footnotes that mortgage-backed securities rose in 2007 to £68.302 billion from £32.19 billion in the previous year. Derivatives insurances had risen to £377 billions of assets, compared to £116 billions the year before. Surely, he suggests, these were warning signs that were not picked up, but resulted in the meltdown of confidence that forced government to step in.

With the exception of Barclays and HSBC, the largest British banks were all in serious trouble in 2008.

> ‘The fact is,’ Lanchester concludes, ‘that nobody knows which banks are solvent. Because banks are crucial to the creation and operation of credit, a bank crisis leads directly to a credit crunch. It is also the reason the huge amounts of money being pumped into the banking sector by governments are tending not to do the thing they are supposed to do, i.e. restart lending to businesses and consumers. That’s because – and here we can have that very rare thing, a brief moment of sympathy for the banksters – the banks are being given two totally incompatible goals. One is to rebuild their balance sheet and recapitalise themselves so that they’re no longer at risk of being broke. The second is to keep lending money. They’re being told to save and keep spending at the same time.’

Banks which are kept in business when they are insolvent become what may be called ‘zombie banks’. Their managers need either to be forced to admit what their assets are worth. If they are proved to be insolvent, then they need either to be nationalised or broken up into viable bits and put on sale on the market. No one in government or in the banking system wants to do either. So the government pumps huge sums of money into the banks to keep them solvent, at least £500 billion in the United Kingdom and much more in the United States. This does not rid the system of its toxic assets. It is being assumed that there is a crisis of liquidity that can be met with funds, and not a crisis of solvency, which needs radical action.

Why the banks are not being nationalised

In the end, short of nationalisation, what happened? The debts and losses of RBS amounted to at least £100 billions, plus the unaccounted debts of companies taken over by RBS. Similar enormous sums were involved in the losses of most of the other UK banks, and even larger sums in the United States. Government action taken is described as ‘bailing out’. This means a number of quite different actions by governments, ranging from the supply of capital and loans to various forms of insurance against future losses. The most common of the latter is an asset protection scheme called a Credit Default Swap or CDS. This, rather than capital provision or nationalisation, has been the main instrument employed both by US and British governments, to bail out the bankrupt companies. The sums involved are enormous, and their impact on future economic development very serious, as Roubini has shown. It is not being suggested here that nationalisation of the banks would be a simple solution to the problem, but it is interesting to note that Lanchester lists four major reasons for governments' reluctance to take over the banks.

Once upon a time, in the 1930s, Harold Macmillan, in his address to the electors of Stockton, proposed as the National Conservative candidate, a number of forms of nationalisation – railways and mines – but also the Bank of England and the joint stock banks. It so happened that Macmillan was the Treasurer of the 1930s think-tank, the Next Five Years Group, of which my father was the Secretary. As a very young student, I was rather honoured to be shown Macmillan's address and asked for my comments. I rather cheekily replied that I understood the 'National' bit , but where was the 'Conservative' bit? Macmillan's reply was immediate, 'It depends, young man, on what you intend to conserve'. I had to ask my father what Harold meant, and was told 'the capitalist system'. It seems unlikely, some 75 years later, that the same answer could be given with the same confidence in the current crisis. But the reasons for governments' continued reluctance to nationalise are perhaps stronger than ever.

These are the arguments quoted by Lanchester as grounds for this reluctance:

1. Governments would be bad at the job. 'What?' asks Lanchester, 'worse than the bankers who broke capitalism?'
2. Every banking decision made by governments would be blamed on the government – refused mortgages, refused loans to business. These would all carry a high political cost.
3. Paying off the banks' debts is going to mean tax rises, a near freeze on government expenditure, public sector job cuts, school and hospital building delayed, rising unemployment in the private sector, higher rates of inflation, reduced imports. Governments would think it better to blame the bankers than take the blame on themselves.
4. Above all, abandoning the whole Washington-London 'Anglo-Saxon' capitalist model and admitting that it had failed would be acutely embarrassing, as well as political suicide. So it won't happen.

As events have unfolded since the financial crisis broke in 2007, media interest has been directed at the obscene bonuses and pensions of the bankers and then at the fiddled expense accounts of Members of Parliament. It might almost seem as if these were intended to divert attention from massive malfeasance of the banking system, and government involvement in it. Combined with these events, there is the desperately underestimated impact of climate change. The fact is that the whole situation puts into question the very survival of our parliamentary capitalist system. As popular anger grows, it can hardly be assuaged by voting within the current political structures for the candidates of a plethora of dissident political parties. Something of a revolution in political thought and action will emerge, as systemic political and economic failure, and the very real threats to the survival of the planet and of human existence on it, come to be recognised.