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What happened?

Nationalised banks. The very thought conjures up visions of Labour's election manifesto in 1945 and the demands of street sellers of socialist newspapers. It just was not supposed to happen in the freewheeling world of globalised finance. After all, there is a consensus across political parties that free markets deliver continually rising prosperity and benign outcomes. Rocking the capitalist boat went out of fashion in mainstream politics some time ago.

But it *has* happened, and in the 21st century too. Of all the astonishing developments in the credit crisis which began in August 2007, perhaps the most astonishing is that governments, professing faith in the supremacy of markets, have had to take share stakes in major banks to ensure their survival.

And these were not governments elected on hard left tickets. Who would have believed that Hank Paulson, a Wall Street banker who became George Bush's US Treasury Secretary, would venture to invest state money in such giants as J. P. Morgan and Bank of America? It may have stuck in his craw but he clutched at the idea like a drowning man. And where did the idea come from? New Labour's Gordon Brown who in the recent past had gone out of his way to praise the wealth-generating capabilities of the City of London.

Who would have believed that Royal Bank of Scotland would have the British government as a majority

shareholder, and Lloyds-TSB and HBOS would have to tolerate the state as significant minority holders? Bradford and Bingley, carved up by the Treasury and regulators leaving a £40 billion mortgage book on the list of state assets, appears almost a footnote. Northern Rock, which seemed at the time of its rescue by the Bank of England in September 2007 to be one bad apple in an otherwise wholesome basket, is now a distant memory.

Capitalism wobbled. The banking system nearly fell apart. You have to pinch yourself to remember that this was not some sort of bad dream. The financial crisis of 2008 was beyond anyone's worst expectation. You could not have made it up.

'Credit crunch' became a household phrase. People were anxious for knowledge. They fretted over their savings and wondered which banks were safe. Students of early 20th century history scratched their heads and wondered how something which looked and smelt like the Wall Street Crash of 1929 could have developed again. To the average hard-working saver it seemed inconceivable that all the great brains in banks and governments could not prevent the events of the 1920s and 30s being replayed. What about the lessons which had supposedly been learned after the Great Depression?

Penguin rushed out a reprint of the late J. K. Galbraith's classic *The Great Crash 1929*. Writing about Wall Street in 1970, Galbraith describes how people had forgotten the lessons of 1929, fuelling another stock market boom and

bust: 'There is merit in keeping alive the memory of those days. For it is neither public regulation nor the improving moral tone of corporate promoters, brokers, bankers, and mutual fund managers which prevents these recurrent outbreaks. It is the recollection of how, on some past occasion, illusion replaced reality and people got rimmed.'

Galbraith was deeply aware of the dangers of unbridled capitalism, but even he might have been surprised if he had survived to see the events of 2007 and 2008 unfold. Once again illusion had replaced reality and people had got rimmed.

Sales of *Das Kapital* by Karl Marx were said to have risen noticeably in Germany. 'Marx is fashionable again,' declared a Berlin publisher, who went on to argue that a new generation of readers had been rattled by the financial crisis and become disillusioned with liberalism. In the *Communist Manifesto*, Marx and his co-author Engels had said one of the essential steps to communism was 'centralisation of credit in the hands of the state'. The bearded guru might have relished capitalism's 21st century crisis.

The events of the credit crisis of the early 21st century were shocking even to those who thought they understood financial markets. The run on Northern Rock and the queues outside branches rocked the confidence of the British financial elite. But they convinced themselves this was an isolated case of bad management. Lessons would be learned, they said.

But a year on, Bear Stearns had been bailed out,

Lehman Brothers had collapsed and Halifax Bank of Scotland had been forced into the arms of Lloyds-TSB. A 40% slump in the Royal Bank of Scotland share price one morning had provoked fears that even the giants of High Street banking might topple. The Governor of the Bank of England, Mervyn King, later admitted the system had been close to collapse. What odds would you have got on that astonishing sequence of events?

Sovereign governments creaked. It emerged that Iceland was on the brink of bankruptcy. How many people understood that this country with 300,000 inhabitants had unleashed a banking leviathan with overseas borrowings five times the nation's economic output? It seemed clever for local authorities and savvy individual savers to chase higher returns with the Icelandic banks. Rather less clever it looked when those banks were reined back in by a despairing Icelandic government, leaving liabilities strewn around the UK.

So how did it happen and could it have been halted in its tracks before the damage got out of hand? These are big questions without simple answers.

The roots of the crisis go some way back into the mists of time. Apportioning blame is hard. Banks, regulators and governments all had a hand in the mistakes. Consumers must also take the stand in the court of expert opinion. They must share responsibility insofar as they were willing buyers of the cheap mortgages and loans that became financial weapons of mass destruction.

More pertinently, could it happen again? People in authority say banking will never be the same. The days of big bonuses and excessive risk-taking are over, they say. Banks must be regulated more vigilantly. But did they not say that in the 1930s and the 1970s? And it still happened again. Maybe fear and greed are built into the DNA of markets – and those who participate in them. Galbraith urges us to keep alive the memory. We can try to do that by telling the story.

Where does the story begin? Perhaps as far back as the 1980s. When Big Bang hit the London stock market, the City was transformed from a cosy club into an international financial centre. London's stockbroking firms had been run as partnerships for generations. They placed orders on behalf of clients. Jobbers, as they were known, were the people on the floor of the Stock Exchange who did the buying and selling. Corporate advisory firms were another distinctive profession in the old City.

Big Bang's reforms, in 1986, abolished the old distinction between broker and jobber. The market went electronic and big financial conglomerates evolved. These brought stock-broking, market-making and corporate finance under one roof. And those conglomerates were predominantly foreign-owned. They could trade across time zones and markets and in almost any financial instrument you would care to name. Globalisation had arrived. London was transformed into a global financial power player, the old-boy network of the City cast aside and forgotten.

As London came into line with New York, international investment banking was propelled to new heights. Major players on the world financial stage could take positions in whatever markets they chose. There were no boundaries for these new powerhouses. Debt could be taken on but then repackaged and sold to others. Risk was spread around the system.

The dot-com bubble saw the international banks at the top of their game. Confident, brash and clever, they traded in as many stocks, bonds and more exotic instruments as they could, as well as advising new internet companies coming to the stock market. Trade in derivatives – that is tradeable securities linked to underlying assets such as mortgages – increased and flourished.

The abolition of the Glass-Steagall Act in 1999 was the symbolic official blessing of these new banking titans. Glass-Steagall had been passed in the aftermath of the Wall Street Crash. It insisted that commercial banks, which took deposits from savers, should be kept insulated from more risky forms of banking. The Act's abolition gave the green light, if one were needed, for giant financial supermarkets to come of age.

As the banks burgeoned, the public appetite for home ownership grew and grew. For bankers this was a market which was too good to miss.

Mrs Thatcher's government in the UK had encouraged people to fulfil their dreams of owning the roof over their heads. Sales of council houses to tenants became a

trademark policy of her early years in power.

This policy was supported by Labour after its election victory in 1997. The new government set out its own targets for expanding the percentage of homeowners relative to the total population. This was seen as both politically and economically sound. It was typical of the sort of aspirational Thatcherite policy which Tony Blair and Gordon Brown were disinclined to drop.

Home ownership became part of the American dream too. Significant political support for expanding property ownership evolved in Congress.

But to a much greater extent than in the UK, there was a drive to bring millions of Americans who had never been in a position to afford a mortgage into the housing market. These customers were known in the delicate jargon of the lending industry as ‘sub-prime’. Wherever they lived, in trailer parks or rented apartments, and whatever their credit histories, they were ripe to be sold mortgages.

Congress decreed low-income Americans to be a priority market. In 1992, legislators passed laws requiring the government-backed mortgage providers Fannie Mae and Freddie Mac to develop more sub-prime lending. Fannie and Freddie were the pillars of the US housing market. If they indicated they were willing to take more such loans onto their books, banks and other lenders would be incentivised to seek out new customers, safe in the knowledge that the debt could be sold on. By 2008, the two giants had amassed more than half of all the nation’s home loans.

The Clinton administration set aggressive targets, with nearly half of all mortgages to be targeted at households with low incomes. The target number for sub-prime loans, defined as loans to borrowers on 60% or less of average earnings, was set at 20% in 2000 to rise to 28% by 2008. It seems strange now that such an ambitious series of goals was set. Why would a government so vigorously promote the idea of owning a home, in effect encouraging low-income families to take on risky levels of debt? But this was the late 1990s and the prospect of another house price crash seemed remote.

Extolling the virtues of owning a house seemed a responsible stance for the administration to take, as well as a politically attractive one. It had its roots in moves by President Jimmy Carter in the late 1970s to open up the mortgage market to ethnic minorities. It is easy with hindsight to ridicule the government's push to expand homeownership, but to many people it seemed to fly in the face of natural justice that those with no credit histories should have to pay higher borrowing costs to get on the housing ladder.

The political drive into sub-prime markets intensified with a row over Fannie and Freddie. In 2004 and 2005, Republicans called for the two giants to be cut down to size and for their dominance of the market to be ended. Fannie and Freddie's management lobbied hard against change. Democrat legislators blocked reform legislation in Congress. They backed Fannie and Freddie's drive to provide yet more funding of the sub-prime market to

make home ownership attainable for another swathe of low-income American families.

This persuasive line of argument has been set out by Professor Russell Roberts of George Mason University. He suggests that politicians, both Democrat and Republican, were keen to promote home ownership without using government money. They put pressure on banks and the mortgage providers to ease lending policies in pursuit of social goals. Presidents Clinton and Bush both trumpeted the increase in home ownership levels to record highs. Professor Roberts concludes: 'Beware of trying to do good with other people's money.'

While American politicians demanded more housing-market funding and put pressure on banks and mortgage providers, a new source of cheap finance for the developed economies was on tap. The Chinese economic miracle was throwing off cash at an astonishing rate. The Chinese authorities pegged their currency to the dollar at a conveniently low rate, so their exports swept all before them in North American and European markets. With exports running so far ahead of imports, China ran up huge trade surpluses and more piles of dollars than they knew what to do with. The Chinese authorities looked to reinvest that cash in overseas markets.

Other Asian economies had also piled up savings mountains and needed to disperse them. Local consumers had been scarred by the economic crises of the late 1990s, and were reluctant to spend their cash.