Any 'gift' of public money to Rock is pure myth

Tim Congdon

Misrepresentation in the media has been a curse on policymakers' attempts to resolve the Northern Rock affair. A particularly disturbing illustration has been the recurrent use of the phrase "taxpayers' money" to describe the Bank of England's financial involvement with Northern Rock.

In the more extreme versions the government is said to have directed "money" to "City bankers" at the expense of resources that could have been used in education or health. Northern Rock is stigmatised as a private sector black hole into which public sector expenditure is being poured. The throwaway line is: "If the state can give £25bn to Northern Rock shareholders, why can't it afford a pay rise for teachers of more than 2.3 per cent?"

There are two mistakes here. The first is not recognising that via its 100 per cent-owned bank, the Bank of England, the state is making a loan to Northern Rock. A loan is not a grant and must be repaid. No money has been given to anyone.

An element of subsidy might arise in either of two circumstances. The loan might be at an artificially low interest rate or might not be repaid. But neither ought to apply here. The loan is at a penal rate, while guarantee fees must be paid to the Treasury on the bonds that are to replace the loan. Northern Rock will therefore be charged a higher rate than other banks for its funds, not an artificially low one.

It is conceivable that Northern Rock will not repay the loan, because loan losses will exceed its capital and the shareholders will be wiped out. But the propositions that "the state has thrown money at the City" or that "the City has misused public subsidy for its own ends" would then be preposterous. Shareholders – equated with "the City"

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in the demonology of the commentariat – would be the big losers. (The shareholders in this case include large numbers of people of modest means, originally Northern Rock depositors and predominantly in north-east England.)

The second mistake is to assume that, whenever a sum of money is mentioned, an identical flow of resources is implied. In due course the allocation of money to a task does indeed often result in a flow of resources, but not always. Loans can be extended to acquire existing capital assets and repaid from the sale of those assets, and the only resources involved are the time and energies of a handful of bankers, lawyers, surveyors and so on.

Contrary to the headlines in the newspapers, almost no resources have been used in the Northern Rock rescue. The relevant transactions have so far led to no more than a large number of book entries in various accounts. Some resources have been deployed in a cottage industry that might be called "Northern Rock anxiety-making", including the time and energies of a chancellor of the exchequer, a governor of the Bank of England, a bevy of private equity and corporate finance executives and other worthies.

Whether resources have been usefully deployed and appropriately paid in this cottage industry is moot. In particular, it is difficult to see what value is added by the Goldman Sachs scheme. The key has always been to give Northern Rock time to wind down its assets, so that these could be sold or run off for at least book value, and the lender-of-last-resort loan repaid.

All that was necessary was for the original loan – from the Bank of England, but with a Treasury indemnity to the Bank – to be of sufficiently long-term duration, although, of course, at a penal rate. The trouble arose from the Bank's foolish imposition of a February deadline for the loan's repayment, on the spurious grounds that the loan breached European Union rules on state support for financial institutions.

The Goldman Sachs scheme replaces the Bank's loan and Treasury indemnity, to be repaid by cash flows from Northern Rock, with a bond issue with a Treasury guarantee, to be repaid by cash flows from Northern Rock. The relabelling matters not a jot in terms of economic substance. What does matter is that Northern Rock now has more time to run down its assets and will get a better price for them.

The Northern Rock affair has been a reminder of how dismally Britain's institutions can perform if they have poor leadership. In effect, the European Commission has been granted a veto on the future use of lender-of-last-resort facilities by the Bank of England, while the Treasury regards its own expertise as so inadequate that it must pay American investment bankers for guidance and counselling.

The writer's latest book is Keynes, the Keynesians and Monetarism (Edward Elgar). He has shares in Northern Rock