There is nothing magic about this Keynesian fad

Last week, The Spectator said that 'Keynesianism is not the answer'. Here, **Tim Congdon** says the government's economic recovery strategy is a sham based on outmoded leftist thinking

Mr Brown's bank recapitalisation exercise has been portrayed in the British media as a financial and political coup. The *Financial Times* has been particularly enthusiastic, describing it as 'a global template'. Mr Brown's admirers apparently believe that the British government's programme is both intellectually original and a real-world success, and is therefore being copied in other leading nations.

The truth is very different. The government's policy is not intellectually original, it will not be fully implemented in practice and, to the extent that it is implemented, it will be a disaster. Further, no other country is copying Brown's plan or behaving as vindictively as Britain towards its financial system.

Admittedly, the Treasury has acted over the last month with a decisiveness that was sadly lacking in the Northern Rock affair. This may explain — although it does not excuse — the widespread readiness to applaud the plan as new and clever. The key elements have been widely reported. They include two types of money-raising, a requirement that banks issue preference shares to which the government would subscribe and a government offer to underwrite new equity issuance by the banks. An open threat was used to enforce the money-raising. If a particular bank did not issue the amount of capital suggested and agree in certain circumstances to sell much of it to the government, the Bank of England would stop lending to that bank and so force its nationalisation.

We live in a world of bounded rationality, in which more than 99 per cent of the population are as unfamiliar with modern corporate finance as they are with quantum mechanics. To news desks and political hacks, the idea of preference capital must have seemed a brilliant wheeze. Banks can remedy their shortage of risk capital not just by issuing ordinary equities, which receive ordinary dividends, but by issuing a special type of security. This security is really a bond, since it carries no votes and is repaid at par, but it is called 'capital' and receives preference dividends (i.e., dividends paid before any ordinary dividends are allowed and in that sense are preferred).

Preference capital from the government is best seen as a form of long-term loan, which gives the banks time to improve the quality of their assets and to make profits from their good customers as they write off losses arising from business with bad customers. Although ingenious, the use of preference shares in this way is not in the slightest bit new. Indeed, preference shares played a vital role in the recapitalisation of the American banking system in the 1930s.

Like the Bank of England in the Northern Rock affair, the Federal Reserve failed to act as an efficient lender of last resort after the Great Crash in 1929. With corporate bankruptcies numbering in the tens of thousands, the Hoover administration founded the Reconstruction Finance Corporation in January 1932. Its purpose was to provide finance to companies, including banks, which could not borrow elsewhere.

At the time US banks could issue only common stock, but this was changed by legislation in March 1933 which allowed them also to issue preference shares. From then until the end of 1935 the RFC bought $833 million of preference shares, typically paying very low interest rates, from 4,134 banks. The RFC's work was central to the rehabilitation of the American financial system in the later 1930s. ($833 million may not sound like much, but it was about 1.5 per cent of the USA's national income in the mid-1930s; 1.5 per cent of our own national income today would be just over £20 billion, remarkably similar to the sum envisaged in the Brown programme.)

What about government underwriting of the rights issues of ordinary shares? A shocking aspect of the current crisis is the multiplicity of media references to the 'nationalisation' of the UK's banking system. Journalists are wonderful people, but they are not known for close attention to detail in the 23 minutes before the next deadline. They have been sloppy in reporting the 'deal', insofar as there was a deal, between the British government and the banks.

It has to be emphasised that the underwriting of a share issue is not the same thing as subscription to a share issue. What the Brown plan proposes is that if the banks' current shareholders do not wish to take up the shares offered in the rights issue, the government will take their place. However, if the banks' current shareholders do subscribe in full to the rights issue, the government has no equity stake and the banks are not nationalised. End of story, full stop. (One does not need to be a great financial genius to see that the banks' sale of preference shares to the government is not nationalisation, since the shares are non-voting and will be repaid within a few years.)

This is not to deny that two British banks — Royal Bank of Scotland and HBOS — may be unable to drum up enough support from private shareholders. If so, they may become partly or even wholly owned by the government. In that event everyone will know that the passage of these institutions into public ownership occurred, to a large extent, because they were intimidated by the British government in October 2008.

What will then happen? Internationally mobile parts of British banking will relocate to other jurisdictions and possible foreign entrants into British banking will hesitate to invest here. HSBC, which includes the old Midland Bank in its worldwide portfolio, will become even more definitely a Hong Kong/Chinese bank. Barclays must already be considering shifting capital and operations to New York and other centres.

Contrary to press reports, the British government's treatment of the banking industry is not being copied elsewhere. Yes, the American government is following the lead set by Hoover and Roosevelt over 70 years ago, and issuing preference capital to US banks. But the interest rate charged by the US government will be 5 per cent, much less than the 12 per cent imposed by Mr Brown. Germany's banks have already kicked up a fuss about being charged more on their preference capital than American competitors. The German government has responded by adjusting the cost downwards to the American level, not upwards to the British.

Most fundamentally, as far as possible bank nationalisation is being avoided everywhere, except in the UK. The correct principles of public policy here are simple in conception, even if complex in application. First, the state — ideally through a strong and independent central bank, but if necessary through the finance ministry — should provide lender-of-last-resort loans to solvent banks if they have difficulty in financing their assets. These loans should be on a generous scale, but at an above-market rate. Secondly, the state should not nationalise solvent and profitable banks, but only insolvent banks which have no hope of recovery.

The British government's breach of these principles over the last few weeks has been unique in the industrial world. Brown and Darling have said that despite a sharp rise in the budget deficit, they plan to boost spending on public sector capital projects to compensate for the shrinkage in the banking system. Commentators have characterised this as the return of Keynesianism, as if the invocation of Keynes's name could cure any economic ailment by sympathetic magic. Brown and Darling, notorious left-wingers in their early political careers, may indeed have a taste for 'isms'. Far from setting an example to the rest of the world, they have inaugurated a policy of economic and financial sado-masochism in one country.