

I've watched the economy for 30 years. Now I'm truly scared

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Will Hutton If more people understood what has happened in the British and American banking system, the financial crisis would only be containable by the immediate partial nationalisation of every bank in Britain and America. There was not a run on the banks by depositors queuing in the streets to withdraw their savings. Rather, it was an escalating and terrifying run on the banks in effect by themselves, which, if it spread to millions of small savers, would reproduce the events of 1929.

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In Britain, the money markets that the banks organise between themselves completely froze. Such was the break down in trust and sense of panic that some of the most familiar names in British high street banking would not lend to each other at all or, at best, just overnight. Instead, the Bank of England had to supply tens of billions to banks who found the normal sources of funds blocked.

I have been writing on the financial markets for nearly 30 years. I have known the system was becoming increasingly fragile, but for all the ferocity of my criticisms, I never expected the scale of today's events. Or that I would begin to wonder whether my own bank would survive without nationalisation. The negotiations in Washington over this weekend to finalise the \$700bn Paulson financial bail-out plan, and the expected vote on Sunday, are all that stands between the Anglo-American banking system and a first-order disaster. The scheme had better work.

This is not the end of capitalism, as some wildly claim; there is no intellectual, social or political challenge to a market system based on respect for private property rights, even by the Chinese Communist party. Rather, it is a crisis of a particular capitalism that has set aside respect for trust, integrity and fairness as fuddy-duddy obstacles to 'wealth generation'. What we are relearning is that without trust and fairness, capitalism risks its own sustainability, even while it unleashes forces that undermine those self-same values. London's money markets froze because of a trust collapse; banks simply don't believe each other when they say their businesses are sound and will not default on their obligations. Trust matters.

And although some conservatives in Britain and America continue to make the ideological case against any government action as a response to the recent turmoil - governments necessarily do everything worse than the market - they have no alternative proposal about how to restore trust once it has gone. Trust is a reciprocal relationship, dependent upon a desire to be considered decent and honourable. Even in the dog-eat-dog financial markets, trust and integrity are matters of self-interest. However amoral you may be, it is in your interest to care about your reputation, because if you behave badly you will not do business with me - or others - on favourable terms again.

But the scale of the personal rewards now available in London and Wall Street - £15m-£20m at the top is the norm - along with the greed-is-good doctrine associated with extreme laissez-faire economics, has trashed the need for individuals to worry about integrity. They don't need to be concerned about their reputations; they just need one deal or one year at the top and they need never work again. The incentive structure has so departed from one of the principal norms of fairness - proportionality between value added and reward - that it has eviscerated trust relationships and integrity.

Everybody tries to 'game' the system on their route to vast personal fortunes - whether short-selling, packaging up dud mortgages as prime mortgages or telling lies about their financial viability - and the result is that the system is getting wise. The best course today in any financial transaction is to presume zero integrity. Credit is drying up and with it the very lifeblood of the economy.

Worse, now that the system is in trouble, financiers are turning to taxpayers in the US and Britain for help without understanding the other key principal of fairness - that we will consider helping those who for no fault of their own get into trouble, but not those who freely created their own bad circumstances.

Hank Paulson certainly acted decisively in launching his plan, but the former Goldman Sachs CEO, who negotiated a special exemption from tax when he took the job, like his former Wall Street colleagues is not well endowed with the fairness gene. It polluted the very design of the scheme.

He knows that unless the US government does something comprehensive, the entire financial system is at stake, but his

original plan was designed to bail out the system intact. It made no demands that any financial executives sacrifice pay or bonuses despite having driven their firms and wider economy to the point of bankruptcy. He does not want the government to provide new bank capital to help recapitalise a bust banking system. Instead, he wants the government to buy their toxic debt and so leave the banks unreformed. On top he wanted complete discretion to act as he chose without any oversight.

American economists of every persuasion signed a joint letter complaining not at the aim of the bail out, which is plainly vital, but for its lack of fairness. Conservative papers and politicians echoed the complaint. Suddenly, Wall Street is coming back to earth. The transactions from which it skims such riches are built on the savings of ordinary Americans to whom it has obligations, as it has to other Wall Street firms. What we know now about the yet to be agreed compromise is that Paulson has accepted Congressional oversight, will offer direct help to distressed US homeowners as well as banks, and will accept some constraints on the worst excesses of executive pay.

But the core proposal remains. The government will buy toxic debt rather than inject government funds into the banks' capital base, in other words, reject even partially nationalising the entire US banking system as the Swedes had to in 1992. I don't know - nobody does - whether the Paulson plan would be sufficient or whether ultimately the Americans will have to go for nationalisation. What I do know is that unless there is a radical and government-led change in ownership, structure, regulation and incentives so that the principles of fairness are put at the heart of the Anglo American financial system - proportionality of reward and fair distribution of risk - there is no chance of the return of trust and integrity upon which long-term recovery depends.

The political debate in Britain and America so far little reflects this need - but it will. Barack Obama's election as President is much more likely. And the discourse in Britain will follow. Brown may be crampingly cautious but, unlike Cameron, he does understand that without government action the restoration of trust and fairness may never happen. This week, I expect the nationalisation of the stricken Bradford & Bingley to join Northern Rock. It is but another in a long sequence of interventions that are imperative to save the system from its own proclivities. Once again, the left is coming to capitalism's rescue.

Will Hutton has written a weekly column for more than 15 years: six years at the Guardian and nine years at the Observer