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Opinion

Thanks to Petraeus, Iraq has pulled back from the abyss
Rosemary Righter, page 32

If this fails, it will take down all Britain's banks

If the Lloyd's-HBOS merger does not protect shareholders' interests, wholesale nationalisation of banks is inevitable

Anatole Kaletsky

The wonder of financial crises is how events can move straight from impossible to inevitable, without ever passing through improbable.

Two weeks ago nobody would have imagined that, before the end of the month, the Bush Administration would have nationalised the world's biggest insurance company, that two of the four biggest global investment banks would be out of business and that the US Government would take responsibility for three quarters of the country's new mortgage loans.

Sadly, the events of the past two weeks may be only the prelude, not the climax, of this amazing crisis. Even the apparent rescue of Halifax Bank of Scotland may result in a bigger crisis, if the drowning HBOS drags down its rescuer, Lloyds TSB. If this happens, every big bank in Britain, except possibly HSBC, will have to be nationalised, Northern Rock-style.

The same would become inevitable in the US if market speculators who have been richly rewarded by the US Government for taking down Fannie Mae, Lehman Brothers and AIG, turn their attention to the next group of stumbling financial institutions in the firing line: Washington Mutual, Wachovia, Bank of America, Morgan Stanley and Citibank. If any of these wounded giants collapses, the others will fall like dominoes and the entire US financial system will have to be nationalised. In a financial crisis, the impossible can become inevitable in one day, as we saw in Britain on Black Wednesday.

But the operative word here is "can". To understand what could still be done to prevent this crisis turning into a true disaster, we must look dispassionately at the unintended consequences on the markets of recent government actions. This means moving away from the moralistic slogans about "greed" or "bailing out reckless bankers".

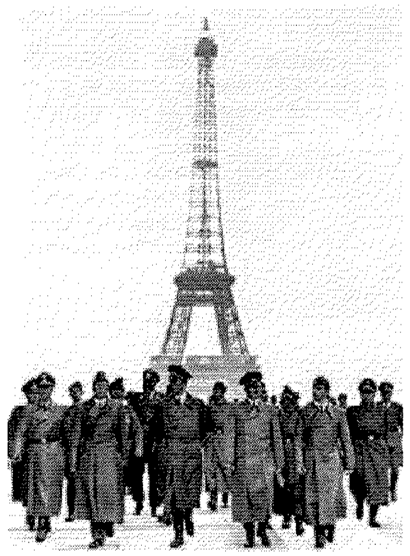
The main response to this crisis has been a furious argument over who allowed the banks to get into this mess in the first place and how such imprudence could be stopped. This is analogous to the heated debate among French politicians, as German Panzers rolled into Paris, over who had the stupid idea of building the Maginot Line. There will be a time for apportioning blame and inflicting punishments and reforming regulatory structures. But right now the only question is how to avoid a catastrophe in the next few weeks.

It is clear that most of the actions taken recently by regulators and governments have exacerbated the crisis. Instead of using his Government's unlimited financial firepower to defend the financial system, Henry Paulson, the US Treasury Secretary, turned his guns on his own side, wiping out long-term investors who tried to support leading financial institutions, while rewarding speculators who tried to bring them down.

Mr Paulson was activating a financial Doomsday Machine, driven by a chain reaction of actions by stock market speculators, regulators, credit-rating agencies and accountants. The details of this mechanism are complex, but the gist is simple — if a bank's share price falls below a critical level, its credit is downgraded; it has to sell assets at fire-sale prices; this further weakens its capital, leading regulators to question its solvency; this drives down its share price and the vicious circle takes another turn. What Mr Paulson did ten days ago was to hand to stock market speculators the key to this Doomsday machine.

This may seem an outlandish accusation — especially against a supposed financial mastermind who was a chairman of Goldman Sachs — but consider the event that triggered the market attacks on Lehman Brothers, AIG and HBOS. They all followed Mr Paulson's punitive decision on September 7 essentially to expropriate the $20 billion of capital injected into Fannie Mae and Freddie Mac by shareholders over the previous 12 months. Long-term shareholders made these investments, with the encouragement of the US Government, to stabilise Fannie and Freddie. Meanwhile, a host of short-term speculators were selling these same securities, convinced that the two companies would be driven into bankruptcy.

By rewarding short-sellers while wiping out investors who reckoned on a long-term recovery that would restore the mortgage giants to profitability, Mr Paulson sent the clearest possible message to financial markets around the world. Any investor who puts money into a US financial institution that might run short of capital would have it expropriated by the US Government. On the other hand, sellers of US bank and insurance shares would be richly rewarded if they could destabilise any financial institution sufficiently to force it to turn to the Government for help.



Were the banks reckless? Whose stupid idea was the Maginot Line? That's two pointless debates . . .

In the past few days the same pattern of perverse incentives has been repeated in the bankruptcy of Lehman and the "rescue" of AIG. In both cases, Mr Paulson decided to wipe out investors banking on a recovery while rewarding destabilising short-sellers.

The key question is whether this scorched-earth strategy will become a firm principle of Mr Paulson's responses to future attacks on US financial institutions. The alternative view is that Mr Paulson may have cunningly chosen the shareholders of Fannie, Lehman and AIG as sacrificial scapegoats, to make a point about his harshness to "greedy bankers" — and that having made this point, he will now be able to support more important institutions such as Bank of America and Citibank if they come under attack.

Events in next few days will reveal whether cunning or incompetence is the explanation for Mr Paulson's apparently self-defeating strategy, but in the meantime, financial mayhem has shifted from New York to London — and with it the responsibility for right and wrong policy responses.

As I write, the terms of the Lloyds-HBOS merger are unknown, but the key criterion for judging its effectiveness is clear enough — and it is exactly the opposite of the principle followed by Mr Paulson.

If the Lloyds-HBOS merger offers the enlarged bank some kind of firm government safety net — not just for depositors, but crucially also for shareholders — it will probably succeed and act as a firebreak against the financial crisis on this side of the Atlantic. If, however, the merger is presented as a "pure private sector solution", with no government support for shareholders, market attacks against HBOS will soon be revived and redirected against the merged bank.

This will leave only one solution — nationalisation of the entire British banking system. The impossible will suddenly become inevitable.