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Opinion

Why High School Musical is sadly misunderstood
Caitlin Moran, page 28

Darling's innovations may stave off depression

Two key planks of the Chancellor's plan may be enough to stabilise the banking system. But it will be only a small mercy

Anatole Kaletsky

There is more than one way to skin a cat. There might have been simpler and cheaper ways of preventing the collapse of Britain's financial system than that chosen yesterday by Gordon Brown and Alistair Darling. I have argued, for example, that the main requirements to stabilise the banking system would be to follow the Irish Republic and Denmark in offering unlimited deposit guarantees and to treat shareholders more generously when new capital has to be raised. But the announcements should achieve the same objectives — and could prove more effective, albeit at a higher cost.

So well designed was Mr Darling's package that Italy, Spain, Sweden and Denmark are expected to announce similar measures. Whether the plan can avert a serious recession is doubtful, especially with the Bank of England offering only tepid support with a half-point interest-rate cut, but at least Mr Darling has put in place the preconditions for some kind of stabilisation.

A broader question that my welcome for the plan is bound to raise is why anyone should take a British package seriously, given the failure of much bigger measures taken by the US Government? Aren't governments impotent against global markets? Shouldn't we just accept the inevitable hardships that follow the bursting of a credit and housing bubble, allowing market forces to clear up this mess in their own time?

This fatalistic argument, echoing the attitudes of 1930s America and 1990s Japan, is profoundly wrong. Banking crises have never been resolved purely by market forces.

Once a financial panic starts, government intervention is always required. Financial markets do not deal in physical commodities but in paper contracts that represent promises of future payments. Once faith in those promises is broken, only governments, with the right to print money and levy taxes, can offer truly credible financial guarantees.

That is why, amid all the lurches in sentiment I have suffered along with everyone else in this crisis, my analysis has focused on one point: sooner or later governments would have to take serious action to stabilise financial markets and the key question was when, and whether the government-led "Plan B" would be forceful and clever enough.

What has made this crisis so much worse than expected has not been the scale of the underlying problems but the inadequacy of the official response, led by the most incompetent US Administration since 1932. This brings us back to the Darling plan — and the possibility that it might catalyse some new thinking, not only in Britain but also around the world.

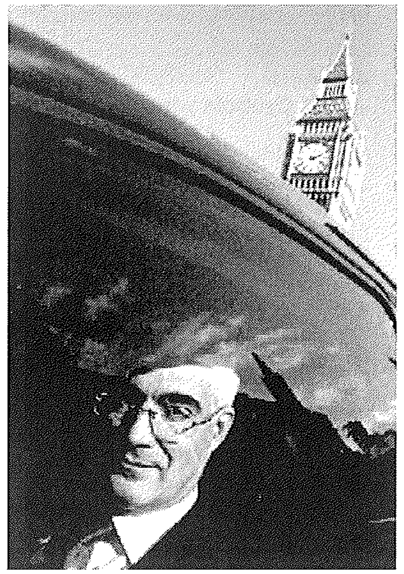
Two key elements in the package should help to stabilise conditions in British banking, and could end the chaos around the world.

The bigger and more surprising breakthrough was the £200 billion government lending facility that will ensure that British banks which agree to strengthen their capital positions to the level required by the Government will always be able to meet the repayment demands of depositors and creditors, no matter how suddenly they may wish to withdraw funds. This guarantee is four times bigger relative to the size of the economy than Henry Paulson's $700 billion US bailout — and the Treasury has agreed to increase it without limit if required.

This enormous commitment of public money, which will not require any of the collateral normally demanded by the Bank of England for emergency loans, has attracted fewer headlines than the smaller £50 billion fund to buy bank shares.

But it is the new credit line that deals with the genuine emergency in the banking system — the "silent bank run" in which nervous companies and financial institutions are withdrawing tens of billions of deposits from the wholesale money markets daily, thus jeopardising even the "soundest" banks.

The Government is effectively taking on to itself the risk of a bank run. To all intents and purposes, this is the temporary unlimited guarantee of all bank deposits that many commentators have identified as a precondition for stability. So why did Mr Darling provide it in such a roundabout manner, instead of simply stating, like the Irish and Danish governments, that the Treasury would back all deposits for 12 months? The answer is probably a market-fundamentalist belief in the Treasury that guaranteeing bank deposits is wicked and encourages irresponsible lending — a curious phobia when additional lending is exactly what the Government is trying to achieve. But the key point is that deposits in the big British banks in Mr Darling's recapitalisation programme are now 100 per cent guaranteed. Once this is recognised, conditions in the British money markets should return to normal, banks should resume lending to one another and the £200 billion credit line will probably never be drawn.



Model rescue: Darling's plan may catch on around the world

But how can we be sure that all British banks can strengthen their capital positions to be eligible for the guarantee? This brings us to the second innovative element in the package — the offer to buy up to £50 billion worth of bank shares. There is nothing new about buying bank shares or options with public money. That was what Mr Paulson did when he effectively expropriated Fannie Mae and AIG shareholders, with catastrophic results.

The key breakthrough lies in the relatively generous treatment of shareholders under the Darling plan.

While Mr Paulson seemed to take personal delight in wiping out the shareholders of any institution that dared to ask for his support, the British Treasury has realised that these scorched-earth tactics were disastrous. For shareholders in British banks, an offer of government help should not be the kiss of death that it has become in the US. British banks will offer their shareholders the right to participate in raising capital on the same terms as the Government. As a result, private investors may buy British bank shares and keep them as long-term holdings, instead of dumping them in terror, as they have since the Fannie Mae debacle, every time there is a rumour of government "support".

The upshot of these two key innovations — the effectively unlimited guarantee for bank deposits and the improved treatment of shareholders — is that the British banking system now has a decent chance of stabilising.

Restoring more normal banking conditions will not save the economy from recession; but paralysis of the banking system would have turned an unavoidable recession into a once-in-a-lifetime depression. Now just a common-or-garden recession is much more likely. For that small mercy, we should thank Mr Darling and Mr Brown.