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CHAPTER FIVE

How the bubble was inflated in Britain – and elsewhere – and the trouble it caused

Homely capitalism

The core of the capitalist system is the market where goods are bought and sold and money is earned and spent. There is a basic, homely view about how it works. Agreement is reached about price through the interaction of supply and demand. Banks issue money in the form of currency which is guaranteed by real assets such as gold, or a promise, underwritten by the government, to protect its value. Trades and professions emerge to repair the goods when they break down, to offer them for resale, to find ways of resolving disputes between producers or customers and to make sure that the skills needed to produce them are preserved and handed down. There is a kind of homeliness to the system which suggests that good and honest work will be rewarded. A good working economy will be conducive to general prosperity and kindness, and only the idle or unfortunate will not benefit from this enterprise. Overall this view has prevailed. The other major economic model, communism, failed: we are all capitalists now.

It follows that business organizations like companies are necessary, even though their habits often need critical examination. What is needed is a much clearer account of what a good company looks like, what they should be doing, rather than what they should not.

This is not a peculiar exercise. The books of Charles Dickens and of Anthony Trollope, amongst many others, are full of descriptions of bad and good practice, of bad bosses, and good ones. In the current economic crisis a recurrent complaint is that there has been too much concern with shareholder value and too much short-termism. In other words, too many companies have been concerned with getting rich quick and making their chief executive officers very rich indeed as quickly as possible. The opposite is better – thinking of nurturing the company for the long term, of rewarding investors reliably and of keeping the incomes of CEOs at a reasonable multiple of those of the least well rewarded. A good company also looks after its staff by

making sure their facilities are comfortable, their health is protected and their pensions adequate. Companies in general should make sure that redundancy packages are sufficiently generous to allow a comfortable transition to new employment. The list is long and need not be repeated here. There can be such a thing as a good company – this is clear. There is also such a thing as a bad company – these have become more common.

Yet this homely view of capitalism was always flawed. There have always been speculators who took the market for a ride, such as those involved in the South Sea bubble, and people like Mr Mellmotte in Anthony Trollope's *The Way We Live Now*. Traditionally, cheating the market involved lying about the value of assets owned and profits to be made or manipulating the price of shares. The hero of Patrick O'Brian's novels about the Royal Navy during the Napoleonic wars, Captain Jack Aubrey, was wrongly found guilty of the latter. After the Second World War the range of ingenious ways of getting rich in Britain which were critically reported in the press, while still formally within the law, increased to include Rachmanism, unscrupulous property development, the selling off of state assets at knock-down prices by governments to favoured individuals and various new ways of exploiting what are called market inefficiencies.

How to get rich quick

Rachmanism, named after its chief perpetrator Peter Rachman, involved the exploitation of those who rented property by unscrupulous landlords. It afflicted the inner city areas of Britain, especially London, in the 1950s and 1960s. It was eventually suppressed by changes in the law. Property development remained a favourite way by which the less scrupulous could get rich quickly by shoddy building and shady deals. The selling of state-owned assets by the Conservative governments of Mrs Thatcher and John Major, called privatization, usually led to some individuals getting seriously rich. The worst case was probably that of the privatization of the railways. They were broken up in haste in the dying days of Major's government into a complex system of operators, maintenance companies and rolling stock owners, and sold at a price well below their market value.

There are also a number of international and secret conduits of private wealth. In the modern world, it has been alleged, one of the quickest ways of getting rich quick was to be involved in the financial arrangements of the international oil trade. Almost all the world's financial centres, including

the City of London, were involved in 'the secretive world of tax havens, shell companies, pricing schemes and shielded trusts', through which oil money was filtered for the benefit of bankers and the political elites of oil producing countries.¹ These schemes led one commentator to label the world's financial centres as 'Dracula Zones'.² They sucked out money and brought little or no benefit for local populations. Nigeria earned oil revenues of \$350 billion per annum, but more than 90 million Nigerians lived below the poverty line.³

The arrangement after the privatization of the railways in Britain required that the rolling stock was owned by three companies (ROSCOs) which turned out to be massively profitable. These companies then leased carriages and locomotives to the operating companies which were denied ownership of their own stock. Before transfer to the ROSCOs rolling stock value was quite artificially inflated by Treasury officials to literally twice the amount first thought of. Ownership of the ROSCOs was acquired by three of the major high street banks which were able to make about 30 per cent profit per annum on their investment. The track maintenance companies proved dangerously inefficient and had to be taken back into the public sector. The result was that railway travel in Britain became the most expensive in Europe and public subsidy continued at a level higher than that which had been enjoyed by the nationalized system. Each of the privatizations led to a flow of large fees for the selling of the assets to the friends of the government in the city. Several of the ministers involved joined these same companies for fat salaries shortly after leaving office. The whole saga looked like just another of the scandals that marked the period.

The privatization of public assets in the United Kingdom, described by an earlier Prime Minister, Harold Macmillan, as selling the family silver, was not quite as badly managed as that in the ex-Soviet Union. The rapid transfer to the private sector of Russian state assets in the 1990s was a tragic consequence of a coincidence of political events, the fall of the Iron Curtain and the intellectual dominance of right wing economists, particularly from the Chicago School. This led to the selling off of Russian industry, including production of oil and other raw materials, at breakneck speed and knock-down prices to individuals who in consequence became massively rich. The process was driven by the mistaken belief that any form of privatization was preferable to state ownership. Many of the new super-rich 'oligarchs' then moved their new wealth out of Russia into countries such as the United Kingdom, and, of course, Switzerland, where it was used to buy city

mansions and football clubs. The privatization of Russia also contributed to the emergence of a Russian mafia. The government of Vladimir Putin had genuine cause to be angry about how the assets of the Russian state were squandered under the tutelage of neoliberal, largely American, economists, disciples of the ideologue Milton Friedman. It was a sobering thought that the malevolent touch of Western neoliberal economists contributed to the re-emergence of a more intransigent and illiberal Russia.

Not all of the new wealth emerged as the result of such misdeeds. London also acquired a range of successful businessmen from the emerging economies, especially India. These included the Mittals and the Hinduja. There were also a number of oil rich individuals from the Middle East who bought property in Western cities and invested in assets in the developed world. These often used their new found wealth to purchase British and other Western assets, as described in Chapter 4. Added to them of course were the new rich from the world of pop music and sport. Footballers and singers of popular music from the 1960s onwards now earned super-salaries. The market for their product was international. Their earning capacity was expanded by the setting up of highly profitable deals in advertising and the branding of goods such as clothing. Their reputation could be exploited in a large number of ways in the world of commerce, and their rare and popular skills probably justified their share of earnings.

Other ways were found by which individuals became massively wealthy, and some of them were thought up by clever people in the universities. There had been super-rich before, but not so many, and not so rich, and not by so many routes. The social science known as economics followed a path similar to that in other areas of knowledge: developing understanding, increasing control and discovering opportunities for exploitation. In a first phase, scholars such as Adam Smith in the late eighteenth century struggled to understand how the economy worked. As knowledge improved there was a greater awareness of ways of controlling the system, and disagreements between specialists about how best to do it. After the Second World War some followed the ideas of Maynard Keynes and favoured the management of demand, while others later followed Milton Friedman and argued for controlling the money supply. Some inventive individuals in the new field of Financial Economics then realized that a range of new devices could be added to homely capitalism by which they could extract profit. This development was a natural product of increasing understanding of the economy on the part

of a few gifted specialists. The defining characteristic of these new devices was that they exploited the inefficiencies of the market and were designed to generate targeted returns and absolute performance. They did not rely on marginal improvement in the value of invested funds to derive profit, but exploited market failure, such as the collapse of stock prices or the value of currencies. Generally they relied on the exploitation of volatility, the word used to describe the spread, or gap, between the values of assets; they assumed that the spread would narrow and prices converge. They could also increase the amount available for investment by borrowing amazing multiples of the original sum from banks and investment companies.

The techniques used by the actors to generate and protect profits – the new devices – may be reduced to four:

- Futures trading.

The futures market. Trading in futures took various forms, but the most regulated involved a standardized, transferable contract in which the trader agreed to buy a named asset, a commodity, bond, currency or stock, at a specified price at a specified future date. They were applied to products such as coffee, cocoa and the wide range of raw materials. The idea was that an option would be agreed now to buy a future harvest or commodity at an agreed price. Futures became important in Chicago in the later nineteenth century as a way of stabilizing the market price of agricultural products such as corn or pigs. The farmer would have an assurance about the future price of what he grew.

Such contracts were traded in a futures market under an overseeing agency and were subject to various rules. Only registered members could trade directly. The contracts were guaranteed in a clearing house, and there were interim accounts which had to be settled on a daily basis. For the buyer, winning depended on the market price of the asset increasing above that specified in the contract. For the seller it depended on the price declining below that specified. The gain of the one was matched by the loss of the other. The seller of the asset and the buyer gained or lost equally.

Traded Options. These were agreements between individual traders which typically involved selling short or selling long. In the case of selling short the owner of an asset agreed in return for a fee that a trader should sell that asset. The trader gambled that the price of the shares would fall and in this event bought back the shares at the lower price for return to the owner. The trader thus made a profit without the risk of directly investing

his/her own capital. If they rose however the trader would lose. The trader might also use the mechanism of selling long if he/she believed the value of a share would go up. A contract would be made to purchase shares at today's price at a future date. If the shares increased in value they could be sold at that price and a profit taken. On the other hand if the future price collapsed the gambler would lose. Any asset such as financial instruments like stocks and bonds, or commodities such as the classic pork-bellies, could be dealt with in this way.

Derivatives. Futures trading created an instrument that dominated the international financial market in the early twenty-first century – the derivative. The options thus agreed, which became known as derivatives, also became a kind of product in themselves and could be bought and sold. They were derivatives because they were derived from a selection of assets put together in a single envelope, which could be bought or sold. The price of the derivatives depended on complex calculations of risk, interest rates and price volatility. A breakthrough in understanding this complexity was made in an article published in 1973 by Fischer Black and Myron Scholes.⁴ They used advanced mathematical techniques to develop formulae for calculating the price of derivatives, and movements in the market. Even more complex derivatives, and even more refined ways of calculating their price, were invented, so that by 2003 the total value of derivatives was much greater than the total value of the planet's economic product. Almost any asset, including, as we learned to our cost, sub-prime mortgages, could be the root of derivatives, making up such esoteric products as Securitized Investment Vehicles and Consolidated Debt Obligations. As pointed out, it became more and more difficult for non-specialists to understand how they were made up and how their value was calculated. The world's leading stock market investor Warren Buffet strongly warned against them on the grounds that even he could not understand them and that they were a risk to the whole capitalist system.⁵

Spread Betting. This was also a form of futures trading. One of its forms was a bet on the future movement of a share index, and might be a bet on daily, weekly or quarterly movements. There might also be rolling bets which were let to run until such a time as the better quit because of the scale of losses or gains. A bet could be made on the index offer price – related to the value of all the shares on a list, like the 100 shares on the Financial Times index of 100 selected shares. If the index then increased so

that the bid price exceeded the original offer price, a profit had been made and the share of the index could be sold. If the gambler calculated that the index would fall he/she would sell now at the bid price and buy back after the fall at the offer price.

In all of these forms of futures trading the gains and losses could be very high depending on the movement of the market. Winning depended on detailed understanding of the market in the kind of asset which was bought or sold, and the ability to predict accurately future movements in the price of that asset. The latter became the object of study of clever mathematical economists, such as Black and Scholes, and later, Robert C. Merton.⁶ Obviously a trader was constantly faced with the risk of disastrous losses. But he/she might also make enormous gains for herself/himself, his/her fund and the client. Much of this depended on the ability of traders to greatly increase the scale of their bets by enormous borrowing on the collateral they held, a practice known as leverage. This was easy because no money actually changed hands. The reckoning would come later.

- *Arbitrage*. This was a method by which complex formulae were used to generate profits from buying and selling assets such as currencies to take advantage of movements in their value against each other (cross rates) in the relevant market, and the short delay between one movement and the other. The trick was to spot the profit to be made by buying and rapidly selling, say, up to 5 currencies, moving from one to the other, ending up with greater holdings of the original. It could involve simply buying or selling a single currency, say the pound, values against another, say the dollar. This could be done on a very large scale operating through contracts to buy rather than actual currencies bought and sold and could generate massive profits. The speed and scale of the purchases and sales was determined by formulae which were often highly complex algorithms.

Currency arbitrage was much the same as short selling when it involved the large scale selling of a particular currency as happened when George Soros sold sterling in September 1992, calculating that the pound was overvalued. In this case the amount of currency sold was so great that those holding it forced the British government to lower its value – to devalue – so that profits could be taken when it was repurchased. Soros judged that the currency was overvalued when it joined the Exchange Rate Mechanism of the European Union in 1992, and that the government lacked the resources to defend it in the market place. But there was also a powerful self-fulfilling prophecy

in that if enough selling took place – and this was the feat of organization managed by Soros – a devaluation could be forced. Success depended on whether the calculation was correct that the currency was overvalued and that it could not be defended at a particular exchange rate value.

- *Leverage; gearing.* This was when money was borrowed against the security of assets held to purchase some other asset such as a company or a futures option. At a time of low interest rates and massive system liquidity, which, because of a massive weight of derivatives, was the case in the first years of the early twenty-first century, leverage could hugely increase the available investment funds so that the quoted shares of even the biggest companies could be bought. This was a method particularly favoured by hedge funds and private equity companies. The investment company took the risk that the assets on which the leverage rested would be shown to be worthless than was supposed, and the money borrowed might have to be repaid, as was the case in 2007 with debt based on consolidated debt obligations. But if they succeeded in buying a majority of the shares of the target company the debt used to purchase the company could be transferred to its books. The company was thereby forced to pay for its own takeover. But this would lead to high gearing for the company, meaning a poor ratio of its debt to assets. The debt would have to be reduced out of profits or by selling the company's assets. Eventually what was left of the company could be sold on and the investors take their profit.

Leverage – essentially borrowing – was a way of gaining the finance necessary to force the takeover of a company, usually so that the new entity would dominate the market and extract higher profit. With companies such as Lazards in pole position, aggressive investment banking became a key feature of capitalism in the United States and the United Kingdom, and beginning in the 1960s Lazards emerged to position themselves at the centre of the capitalist system in the United States and the United Kingdom.⁷ The narrowing of the number of significant shareholders in the world's major stock markets made it easier to set up deals, as there were fewer players to persuade, by a relaxed attitude towards extravagant deal making especially in the United Kingdom, and by the energy of a small number of ruthless and inventive individuals. No more than 50 insurance companies and mutual fund groups were important holders of shares in New York. In Lazards there were three key individuals who became fabulously wealthy. According to Hutton the deals left the purchased companies worse off but the merger makers extremely wealthy.

- *Swaps; hedging.* These two methods were similar only in that they were both methods of reducing the risk of massive losses inherent in the other techniques. Swaps involved the arrangement of an exchange of obligations, say to pay interest on a loan. A private equity company might find it prudent to do this if it found it had borrowed extensively – it had leveraged its assets – in order to take over a company. The effect was to spread the risk of losses arising from increases in such interest rates. In effect deals could be made between those who took a positive and those who took a negative view of future movements in interest rates or other values. Hedging was also a way of reducing the chance of massive loss if, say, a deal in futures options went wrong. Such a loss could indeed be massive and could bankrupt a large bank. Further deals were therefore made – the hedge – which bet on the opposite outcome to the one predicted. If the deal went wrong this would reduce the scale of the disaster. It should be remembered that often the bets were not made with the gamblers own money but with money borrowed, or contracts on future deals.

In the modern system three new kinds of actor emerged as important players, in addition to the traditional range of investment banks and dealers. They were hedge funds and private equity companies, though the line between the two was sometimes hard to draw, and a new kind of bank. Hedge funds appeared soon after the Second World War and were typically managed by a small group of specialists under the leadership of a dominant partner. They had the great advantage from the point of view of their partners of being very lightly regulated compared with normal banks. They built up a pot of funds from financial institutions or wealthy individuals that were rich enough to risk substantial losses in order to make substantial gains. They became skilled in getting money to breed money. The funds' investments could be hedged in the way described. They made gains which were described as *absolute* because they were not dependent on marginal accrual of asset value in the market. For this the fund was able to charge substantial fees, as high as 25 per cent of the gain.

The second new player, private equity funds, had access to the wealth of individuals, financial institutions and, more commonly in the early twenty-first century, governments such as those of Qatar, Dubai and China. At the time of writing the EU was considering limiting the ownership of public utilities by such funds in member countries, a natural response since such ownership could be an effective lever of political power as explained in

Chapter 4. Unlike hedge funds, private equity groups aimed to use their wealth to purchase established companies. Money was made by increasing efficiency in the companies, by such practices as reducing staff, paying them less and trimming services, by selling off parts of the company and eventually reselling the company at a profit. Such takeovers were often financed by highly leveraged borrowing, as is explained below. The private equity partners could exploit the tax law in the United Kingdom by taking their returns in the form of capital gains which were only taxed at 10 per cent per annum, as opposed to 40 per cent payable on earned income. In the autumn of 2007 the new British Chancellor of the Exchequer promised to do something about this, but struggled to find a way which would continue to help small start-up companies, as well as preventing exploitation by the super-rich. He proposed that the tax on capital gains be increased from 10 to 18 per cent.

A third type of actor emerged out of the existing banks. The latter had concentrated on taking assets from depositors and lending this money to other customers. The banking formula allowed the banks to lend more money than they took but they were required to keep, as it were, in their cellars, enough money to pay back the money of depositors. They gambled that not all depositors would want it back at the same time, so only kept in house about 8 per cent of their liabilities. The rules governing these traditional institutions were however changed in the 1990s: they were deregulated. The result was that all banks became investment banks – they could borrow much more from derivatives, and act more like the traditional specialist investment banks, with fewer assets kept in the cellar. Building societies, which had taken money from savers to finance house purchase mortgages, increasingly went down the same route. They became massive investment banks, borrowing on the basis of derivatives and investing speculatively in the various games mentioned above. There was a sense in which in Britain all banks, and most building societies, took on the colouring of investment banks. As will be seen there were great risks in this, but the process of deregulation went on regardless, and was even a cause for boasting in good times by the British government.

Finding fault with the new ways

The above description of the ways in which modern capitalism departed from its homely form implies criticisms of the new ways which some thought were unfounded. Gordon Brown, the British Prime Minister, described them in 2007 as a reflection of the inventiveness of businessmen, which was a

welcome and productive thing, part of the dynamic quality of capitalism. By the autumn of 2008 after the crisis in the financial markets, and the beginning of recession in the economy, he had changed his mind. Others pointed out that as long as business activities were within the law it was unreasonable to find them objectionable. Pride should be taken in facing economic realities and exploiting every opportunity for gain: capitalism implied that there would be winners and losers. The game had to be played hard, using whatever weapons came to hand, and winners must have characteristics such as foresight, ruthlessness, determination and be prepared to take high risks. It was objectionable to frustrate such ambition.

There were points to be made on the other side. Certainly towards the end of the first decade of the twenty-first century a large number of people felt uncomfortable about the appearance of Über-capitalists, the new capitalist devices, and the clear evidence of the weakness of national and international regulation of the system. This feeling proved well justified by the unprecedented failure of the credit market and the banking system in 2008. Indeed what was now believed was that those who were responsible for regulation often did not understand the changes, or their dangers. Forms of exploitation were being invented so quickly that they always escaped from the net of control. The personality type of the Über-capitalists, together with their enormous wealth, also made them hard to pin down. Their ruthlessness and their cunning, as well as their wealth, meant that they were likely to break loose. One of the essential parts of any critique of modern capitalism had to deal with the character of the dominant individuals and their impact upon the modern society and economy. In Chapter 6 the question of whether we were now being led by a group of deeply flawed individuals is discussed.

Criticisms of the new ways of capitalism boiled down to the following:

- Investors benefited from falling prices as much as from increasing prices, e.g. in shares and currency values, through short selling and arbitrage. In Britain hedge fund traders were severely criticized for engineering falls in the shares of HBOS by aggressive short selling. They had borrowed and sold a large number of HBOS shares, then started rumours that the bank was in trouble, so that the shares could be brought back more cheaply and the originals returned to their owners.⁸ (Such are the mysteries of the financial markets: why would any bank lend shares to traders in this way?) Improvement in the economy was increasingly irrelevant to the

interests of the most successful capitalists. There was a value in crisis and declining values – as long as they were not catastrophic – and there was now an incentive to take actions which risked system failure. Indeed greater profits could be made in periods of economic turbulence, though the risks of catastrophic failure and system collapse were also greater. The Über-capitalists often preferred disorder to order, damage to damage limitation, regardless of the number of losers. In April 2008 a group of hedge fund traders tried to land an even bigger fish. They attempted to engineer a collapse of the banking system in Iceland in order to benefit from the resulting opportunities for short selling. Again the method used was to start rumours that Icelandic banks, like ING, were in trouble. They did not succeed mainly because the Icelandic authorities were told about this scam in time to act.⁹ In the autumn of 2008 the Icelandic banking system did indeed collapse, and it remained to be seen how much of this had been engineered by short sellers. The fear that short selling could be damaging led the British government to ban it for a while in 2008.

- If the gambles went wrong, the general interest also favoured the gamblers, as government was pushed to shore up the very system which was exploited by the gamblers. This is seen in the case studies below. Otherwise the damage to the general interest could be even greater. After all if a bank moved towards bankruptcy it was a good idea to guarantee the deposits of its investors to avoid what was called a “run on the bank” and tipping it over the edge. If the banking system itself failed everyone would be in deep financial trouble – with the possible exception of the super-rich. The failure of banks such as Lehmans in the autumn of 2008 did not prevent its managers from picking up considerable sums in the form of bonuses and forms of compensation.
- Effective regulation became increasingly difficult as the methods of gambling become harder to understand and monitor. Some economists were motivated to invent more and more complex and opaque ways of exploiting the system, such as the complex algorithms applied in futures trading or spread betting.
- The players in the gambling games were faced with pressure to conceal weaknesses rather like doctors who ignored each others’ mistakes. For instance those who held a flawed asset were unlikely to broadcast this, hence the sub-prime problems in 2007–8. Auditing companies also had an incentive to conceal asset weakness when they had themselves supported

its purchase. This was not a new problem. In the 1990s the accountants Arthur Andersen had been found out in this practice in the case of Enron. Institutions that were part of the regulatory process, such as auditing firms, actually made great profits out of the suspect practices. ‘They often treat the regulated institutions as constituents to be protected.’ (*International Herald Tribune*, Tuesday, 18 December 2007, p. 14) In casino capitalism, malfunctions were concealed until a stage of system crisis was reached. The specialist companies responsible for rating as Triple A what became known as toxic securities – meaning that they were completely secure – such as Standard & Poor and Moodys, were also under attack. They seemed to have completely failed to detect the toxicity in the securities they examined. So much for the expertise of the insiders!

- The *International Herald Tribune* provided convincing evidence that the US authorities had been warned well in advance about the risks in the sub-prime market, but failed to act. (Front page article, 18 December 2007) This is discussed further below. The Bush regime actually intervened to prevent Georgia and North Carolina from passing tougher laws against abusive lending practices and stopped investigation of local subsidiaries of nationally chartered banks. By 2003–4 increasing numbers of people were defaulting on their mortgage payments and having their houses repossessed. The inflow of foreign funds, especially from China and Japan, as well as the slashing of US interest rates from 2000 to 2004, created a ‘global savings glut’ which encouraged more and more risky lending to mortgage applicants (hence the expression sub-prime lending). Banks began to accept applications for mortgages without verifying the borrower’s credit status, encouraging purchase without deposit and the taking of repayments holidays. Yet Alan Greenspan, then Chair of the Federal Reserve, and other top officials were impervious to appeals to act from housing advocacy groups, from staff in the prestigious Federal Deposit Insurance Corporation and even from individuals on the staff of the Federal Reserve itself. There was a wilful neglect of the approaching storm.

One reason was probably the lack of understanding of the world of derivatives and its most recent form, sub-prime instruments, though Greenspan is on record as saying that he could see there was a problem. Greenspan also claimed that his people were not qualified to understand and prevent bad practice as against illegal practice. There was probably a degree of wishful thinking: maybe the ingenuous new ways would indeed

work, and sub-prime lending helped the less well off onto the property ladder, despite the evidence of huge profit taking in the form of high start-up fees and transfer to high interest rates after an initial teaser rate. This was a wonderful opportunity for the financial whiz-kids, who could masquerade as social benefactors while raking in profits. This was not an unforeseen crisis, an unexpected breakdown in the financial machinery, a kind of accident. It was rather an example of incompetence, reinforced by a paralysis of the regulatory authorities, both in the United States and in Britain. The underlying cause was probably that the authorities were too close to the practitioners. They were part of the same community, and likely to be taken in by assurances that all was well. Thus the authorities were taken in, given the sucker punch, conned.

To add insult to injury, they failed to understand a simple economic lesson that greatly increasing the quantity of money available to purchase a relatively fixed supply of housing was bound to force up house prices. In the United States there was a savings glut. In Britain mutual building societies, which traditionally borrowed from individual savers to lend to mortgage investors, were translated, for short-term profit, into banks which increased funds by borrowing wherever they could. The result was that more money was lent to less reliable customers for increasing profits.

- The rules of the game as played by the Bank of England, the Treasury, and the Financial Services Authority (FSA) in Britain were astonishingly imprecise. No one seemed to be sure about the correct move to any play made by the other side – the investors and bankers. It was like a football game, played in mist and rain. New rules were made up by the players as the game went on but the referee, peering through the mist, did not take the trouble to discover what they were or consider their implications. At the same time there was an astonishing degree of insider hubris. It was assumed that the game was between insiders, including the referee, and that outsiders need not bother themselves with it. There was also a structural problem in the system of oversight. In Britain it was tripartite in that the Bank of England, the Treasury and the FSA shared responsibility. But it was not clear who was responsible for what and very quickly the buck was passed from one to the other.

The case of the crisis in the British Mortgage Bank, Northern Rock, in 2007 illustrated some of these difficulties.

- There was an astonishing lack of foresight about what could go wrong. Economics analysts promptly traced the failure of Northern Rock back to the problems which affected South East Asian countries in the early 1990s. The IMF then imposed such hard conditions, it was reported, that the authorities in the affected states decided that in future they would avoid putting their fate in the hands of outsiders. They would save internally and buy dollar or Euro bonds. In consequence global interest rates were reduced, and domestic authorities in the United States and Europe reduced them further to encourage domestic demand. The amount of available credit hugely increased. This set in train a vicious circle of increasing borrowing by financial institutions, at low rates, for investment in ever riskier projects generating ever higher returns. Eventually the borrowing got to the point of drawing debt from the sub-prime market in the United States. Lending to people who could not pay back the debt seemed a good way of using up some of the surplus money sloshing around in the cellars of the investment companies. The rest is history.

What was amazing was that this story suddenly became the obvious account in 2007 but had not occurred to any of the financial wizards previously. At least they were not prepared to shout about it. Suddenly it appeared that there was a direction of movement in the financial markets which had led directly to the precipice. The story was simple and obvious. Why was it not noted by the financial authorities? One reason was that the calculations of those concerned with economics, either in the universities or the banks, often had no regard for history. Hence brilliant minds were applied to the solving of problems without historical context. No one bothered with historical trends leading from then to now, or the lessons to be learned from previous economic cycles, until too late.

- In the United Kingdom a problem arose which some might say – including the present writer – was a typical error of the English. The financial authorities, the FSA and the Bank of England and the Treasury were conscientious in their oversight of staff in the financial and banking industries but paid little attention to the numbers, the amount of debt, the assets on which it was based and the ratio of lending to assets. They concluded that the chaps were decent sorts and well qualified so the sums would look after themselves. No one, as far as they knew, had been in prison. No one bothered to check what games they were playing. There was astonishment when it was discovered that ‘Northern Rock was itself

a gigantic Securitized Investment Vehicle (SIV).’ (*The Independent*, 6 November 2007). Its mortgage lending was derived not from the deposits of savers, but from massive short-term borrowing from the credit markets for onward lending. The heart of its problem was its so-called business model¹⁰: its borrowings were repayable in the short term, but what it had lent was repayable in the long term. In late November the bank HSBC had to bail out two of its SIVs to the tune of \$35 billion when lenders demanded the return of their money (*The Times*, 27 November 2007). Northern Rock was not so fortunate: when its creditors demanded repayment it simply could not repay what it owed. It was a relief at least that the British regulatory authorities now saw they should get a better understanding of the banks’ business and that the monitoring of liquidity should be upgraded!¹¹ But it was astonishing that this penny should have taken so long to drop. In matters of such grave importance such *sang froid* was unbelievable.

- As the Northern Rock crisis unfolded in 2007 the authorities eventually accepted – since Northern Rock reported that it was bankrupt – that something would have to be done to help out. The discussions about this were disastrously protracted and public. Eventually after much discussion of the various ways of providing support, including abortive early discussions with LloydsTSB about a possible takeover of Northern Rock, the Bank of England agreed to provide the necessary resources as the lender of last resort. It found itself ‘on the hook for more than £23 billion of rescue money to bail out the small, regional mortgage bank.’¹² It was predictable that individuals with money with Northern Rock were likely to decide to try to extract their funds. This was partly a result of the low level of liability of the Bank of England for the losses of investors. In the United Kingdom little cover was provided then over a loss of £2000 in a failing bank (this was later increased to £50,000); in the United States changes in the 1990s meant that the Federal Authorities backed deposits up to the sum of \$100,000. The result was the first run on a British Bank for 150 years, meaning that there were queues round the block of customers wanting to get their money back. There were subsequently several offers from various consortia of investors, including private equity groups, to buy Northern Rock.

The IMF lending to help the SE Asian countries in the early 1990s largely went to bailing out the Wall Street bankers that had recklessly lent money to the countries in the first place. Similarly it might be assumed that the

Bank of England's rescue at that stage of Northern Rock was more to do with the damage its collapse would do to the authorities' associates in the City of London than with concern for the small investors. Northern Rock was put up for sale in November 2007 and there were several private bidders, including private equity groups. It appeared that a private sale was likely to release great profits for the new owners, since it was likely that the debt would be transferred to what was called a zombie fund, to be run down slowly over a number of years. The remaining profitable parts of the company, thus insulated from the debt, would fall into the pockets of the new owners. Once again the Über-capitalists stood to gain from an economic failure. (Later the Government was forced to make further significant investments of public money in Northern Rock: the company was technically not taken over by the state, but relied on state support. It was quasi-nationalized.)

The authorities, in the United Kingdom, the United States and by 2008, France, seemed incapable of learning from past errors. The case of LTCM was described by one commentator as a case of *When genius failed*.¹³ The history of LTCM was essentially the same as that of the events leading to the later great crisis, but, of course, the economists failed to learn and shout. LTCM appeared in the early 1990s, made massive profits in the mid-1990s, and folded disastrously in 1998. It was astonishing that the dangerous games played by financial traders then were still tolerated by the authorities in 2007–8. Then, as later, politicians, often the friends of the traders, appeared to be mesmerized by the magic formulae for making money and were unable to understand how these new devices took the capitalist system closer and closer to disaster. They were like the rabbits who became afflicted by 'big eye' in the face of the headlights of the oncoming car and found it impossible to move out of the way.

The sheer mad greed of the traders at LTCM was extraordinary, and their financial failure was catastrophic. Their intellectual sins were obvious. The underlying assumption was that the value of assets such as bonds tended to converge. All bets were based on this assumption. The trick was to spot matched pairs of assets which had a spread, in the sense that there was a current difference in their value, and then to bet short and long on the assumption that they would converge. Volatility was the spread over a period. If volatility reduced – there was convergence – the trader would win, but if it increased

the trader would lose. It was assumed that although markets were random they followed patterns which were mathematically predictable according to the Scholes–Black formula, as further refined by Robert C. Merton. The most probable outcomes were around the centre, in the same way that the most frequent outcome of throwing pairs of dice is any outcome between 5 and 7. The traders could hedge by betting long on one asset and short on the other. The formula was all that was needed: no real world evidence was necessary. In its first two years of operation LTCM produced a 43 per cent and 41 per cent return on equity and had amassed an investment capital of \$7 billion.

The confidence of the traders in their own suspect formulae was psychotic. They took enormous gambles with massive amounts of borrowed money, but they felt they were sure to win. As already pointed out, being largely unregulated, hedge funds could pile up massive leverage in the sense of borrowing massively to make their trades. LTCM borrowed fifty times its underlying assets and had several additional multiples of derivatives which were not recorded in their accounts. The various trades were all interrelated and there were many thousands of them so, as with the later crisis, it was virtually impossible for outsiders to grasp what was going on. LTCM made a point of making this more difficult by keeping their bets and sundry operations to themselves.

It was extraordinary that the banks that gave them capital, like Merrill Lynch and Goldmans – both later in much trouble – did not check LTCM's exposure to possible losses and tolerated its refusal to reveal the underlying financial position. There were huge gains to be made and other banks were investing: they did not want to be left out. So persuasive was the promise of gain that even the Chair of the Federal Reserve, Alan Greenspan, opposed increased regulation in 1996–7 and deliberately avoided a situation in which the regulatory authorities in the United States actually checked the numbers. He argued that the banks would do this without the intervention of the authorities. They didn't! Hence no one knew the extent of the exposure and the risks that were being taken until too late. Even other insiders did not necessarily understand what was being done by the brighter sparks among them. There was magic about financial success, and the enormous gains made, that led financial chums to simply have faith.

The area where LTCM traders had the greatest empirical knowledge was that of bonds trading. But they expanded into betting in areas, such as merger risk volatility, the spread on bank rate (the rate charged on lending from the

Central Bank) and Libor (the interest charged on money lent between banks), and most dangerous of all, equity spreads where they had little practical expertise. They relied on the magic of the formula and their belief that values always converged and all markets were subject to the same rules. The Russian default on currency convertibility in 1998 started the rot as did the sub-prime mortgage failure in 2008. As confidence fell the bonds moved in ways that defied the Black–Scholes formula. The margins between Treasury bonds and other (company) bonds widened to a level which the formula had not predicted, and continued to widen. The values of other assets, especially the equity markets, similarly defied the formula. The declining confidence in the financial markets led the banks to move into more secure and less profitable assets such as Treasury bonds, rather than company bonds.

The question was whether the banks were prepared to lend enough to LTCM to cover their possible debts until confidence returned. They were not. The falling away of the banks' confidence meant they became less willing to borrow from each other, and eventually determined to call in their loans to LTCM and other traders to reduce their exposure to risk. In consequence LTCM went from triumph, in the sense of making massive profits – showing genius – to disaster, facing bankruptcy, in 5 weeks. Greenspan mistakenly judged that the problem was just a matter of not enough credit and lowered the federal reserve rate. All that happened was that more credit led to LTCM further increasing its leverage in an attempt to recover the losses. The Federal Reserve eventually stepped in to put pressure on other investment banks to bail out LTCM with new lending conditional upon disclosure of the extent of LTCM exposure. This was a further dangerous step as it raised the spectre of moral hazard.

The traders were encouraged to think that as long as the risks they took were truly massive they would be safe as the authorities dared not risk the collapse of the system. The traders did not face the discipline of ultimate failure. Indeed a number of them emerged from the bankruptcy of their firm with large personal fortunes intact.

What happened later?

All this took place in 1998. It was remarkable that at the time of writing ten years later effective regulation was still not in place and the monitoring of trading activities remained entirely inadequate.¹⁴ In February 2008 the most recent of a long list of failed trading gambles was that of the French

bank Société Général, involving one of its traders Jérôme Kerviel who allegedly gambled and lost more than 4.9 billion Euros. He was described as a rogue trader. The unfortunate truth – as admitted ex post facto by the French authorities – was that, as with LTCM, the responsible authorities and the Bank did not have in place adequate systems for monitoring his performance. He was no more a rogue than his colleagues who had won their bets rather than losing them.

In early 2008 a hedge fund failed in a manner much like that of LTCM. The *Financial Times* reported that ‘one of London’s most successful hedge funds imploded when Peloton Partners put the assets of its \$2 billion flagship fund up for sale ... after geared mortgage bets left it unable to meet lender’s demands.’ Shortly after, the hedge fund Carlyle Capital Corporation, one of the biggest players, found itself in trouble because of failing asset values and calls for the repayment of debt. The US Federal Bank released up to \$200 billion of emergency finance as ‘the global credit crisis plunged to new depths’ (*The Times*, Saturday, 8 March 2008). Once more the authorities had learned nothing. In October 2008 it was reported that as a result of the banking crisis some hedge funds were now in trouble. *The Times* reported that investors were withdrawing their money on an unprecedented scale; there had been ‘a twenty five percent cull’. In the three months up to the September 2008 \$210 billion had been withdrawn from hedge funds, which had assets which topped \$2 trillion a year ago.¹⁵

These figures should not be understood to mean the end of hedge funds. Of their nature they are vehicles for a quick buck for footloose funds – if the going is good they move in, if it is bad – unless it is too late – they move out. The fact that some hedge funds have gone bust does not mean that more will not appear when things get easier. And most of the money is still around, waiting only for the storm to pass before it returns to the managements of another group of whiz-kids. The point is that this is turbulence but not a tsunami – hedge funds as a generic type are not under threat. They will still make a few people very rich, still cause instability for the rest and still need regulation. The lessons of LTCM are still to be learned and applied.

Up to the time of writing the most serious failure of an investment bank was that of Bear Stearns, America’s fifth largest, which announced in March 2008 that it was unable to cover its debts. (Later there were a series of failures including the two massive US mortgage security institutions, Fannie Mae and Freddie Mac.) What was astonishing – again – was that

the pattern of failure was exactly the same as that of LTCM over a decade earlier. The bank had indulged in excessive leverage, meaning that it had £11.8 billion of capital and \$395 billion of debt helpfully provided by other Wall Street banks, without due diligence. Some of its debt – how much was not known – was in the form of sub-prime mortgages. Even the dimmest of economics undergraduates could have predicted what then happened: the increasing mistrust of the market, fuelled rather than mitigated, by the Federal Reserve's unprecedented decision a week earlier to release massive credit, led the banks which had lent money to Bear Stearns to demand its return. This it could not do. Bear Stearns turned again to an obliging Federal Reserve for special support. Since the danger was to the system, as well as individual bankers, the Fed obliged. Once again it was the managers of Bear Stearns, and their friends in the other banks, who survived with most of their personal fortunes intact courtesy of the general taxpayer. One of the few commentators who saw through the incompetence and selfish deceit explaining this series of bank failures, Will Hutton, wrote: 'the United States is about to be trashed by perhaps the greediest, most arrogant, self-deluding financial class in the country's history.'¹⁶ This damning criticism also applied to their counterparts in the City of London, and the world's other financial centres. It was striking however that the specialist financial press failed to place blame in this way, and reported the failure as if it was just the result of inclement weather. The reason for this was, of course, so as not to offend their friends in the city.

The Black–Scholes–Merton formula fell into a pattern of assumptions about social phenomena which assumed that past behaviour could be reduced to neat formulae and accurate predictions made about the future. There had been other illustrations of this fallacy in recent US history. There seems to have been an oscillation between being overly confident in the capacity of scientists to predict everything, and simply denying, as President Bush on climate change, clear scientific truth. For instance 'scientific' strategists in the United States had reasoned in the late 1960s that if the Vietnamese body count was increased to level X, the United States would be assured of victory since no society could tolerate a kill level above a certain rate. Robert McNamara, the US defence secretary, was persuaded by this, but afterwards expressed great regrets about the complete underestimation of the Vietnamese will to win. As always the rational approach to understanding society and economics failed completely because of a false understanding of

human nature. The madness was that economists were awarded the Nobel Prize for this kind of thing, even though their theories were not merely wrong but actually pernicious. Then other economists were awarded Nobel prizes for proving them wrong. In the case of Black, Scholes and Robert C. Merton the one who put them right, also getting a Nobel Prize, was Merton H. Miller.¹⁷

There were therefore a set of drivers of instability. These seemed to be gaining greater power and leading the system to take on ever greater gambles, in declining transparency and a weakening capacity for regulation. A key development was that the new players had discovered a way round the problem of moral hazard. The gambles they took had now increased to the point at which the risks of losing were transferred to the government and ultimately the public. Gambling losses were now to be paid for out of general taxation. For the gamblers it was a wonderful arrangement.

In the short term the odds were in their favour. It often happened that though they might ruin the companies for which they worked they themselves emerged with great wealth from their own failure. In the fall of 2007 the boss of Merrill Lynch, Stan O'Neill, resigned when it emerged that his firm would lose \$7.9 billion in the sub-prime market. His parting gift for this failure was a golden goodbye of \$161.5 million. The head of Citigroup, Chuck Prince, similarly falling short, was given \$90.00 million (Editorial and Opinion, *The Independent*, 6 November 2007). On 18 November bankers at Goldman Sachs shared bonuses of \$18 billion, despite the general turmoil in the credit markets (*The Observer*, 18 November 2007). *The Times* business commentary said that past bonuses paid to top performers were also not repaid when they turned out to be failing moves. The wan hope was that such payments for failure should cease. 'Otherwise it will continue to be perfectly rational for self-interested future Chucks and Stans to take unacceptable bets with their shareholders' money.' (*The Times*, Saturday, 10 November 2007, p. 61). In Britain the attitude of the public towards such rewards for failure became increasingly hostile. The government made some sympathetic noises but seemed curiously reluctant to step in firmly to stop rewarding the executives of failed banks.

It was hard to understand how the head of the failing bank Northern Rock could have been awarded a bonus of £750,000 on departure and a share of £2.5 million in the bank's pension fund (*The Observer*, 30 March 2008). What could possibly explain such a travesty?

Conclusions

At the time of writing the crisis was still unfolding. Massive amounts had been spent by the government to bail out an increasing number of failing banks and to encourage them to start lending again. There was evidence of a wider collapse of the economy, with a decline in Gross Domestic Product – a very unusual event – and an increasing number of business bankruptcies. People became more reluctant to spend, and although the business of some retailers held up, such as the food supermarkets, others were worried about declining sales. There was also an increase in the number of unemployed, with the figures at just under 8 per cent in the worst hit areas. These included the City of London, though it is doubtful that they referred to the bankers – more likely to be their cleaners. In this book no prescription is attempted. In the final chapter the reasons for this are mentioned.

This was a world of sorcerers' apprentice capitalism. The inexperienced magicians had found some new tricks which conjured up heaps of money for the favoured few. The regulators stood by mesmerized until the crisis had reached catastrophic proportions. They claimed that the sorcerers knew what they were doing and that they would check each other for any practice of the dark arts. They neither understood what was going on, nor particularly cared to find out until it looked as if the place would be flooded or burned down.

The community of the regulators, the FSA, the Treasury, the Bank of England, as well as the responsible politicians had to carry most of the blame. Indeed a feature of their response was doing too little too late, and always having to try again. In the last week of March 2009 a significant point was reached when the Governor of the Bank of England, Mervyn King, declared that there was no more money for bailing out the system. There were two further desperate measures: increasing the amount of money released into the system, which was at the risk of inflation and, finally, calling in the International Monetary Fund.¹⁸ If history was to be believed this would bring further misery for the worse off, as the Fund's usual habit was to cut government borrowing at the expense of welfare. So not only was the public asked to pay for the gross gambles of the bankers, but beyond that they were to have their welfare assets stripped.

The government decision in 2009 to inject money into the system by buying gilts made things worse for both final salary and personal pensions. The yield on gilts was reduced as a result and this had the effect of cutting the returns on annuities which personal pension holders were required to buy.

It also reduced returns to the funds which paid final salary pensions. This was a double whammy for the less well off: their taxes were being used to bail out failing banks and their pensions were reduced as a side effect of the medicine. The irony was that much of the money released was deposited in off shore accounts and did little or nothing to help the British economy.¹⁹

The British Financial Services Authority, the Bank of England and the US Federal Reserve belatedly admitted that they should get more familiar with the magic spells and start counting the numbers. Then they stepped in to help out the wrongdoers and to set them up for another session. The sorcerers learned that they would always be bailed out and continued to take the same old risks. The potion known as the Black–Scholes formula was still applied, even though responsible investors like Warren Buffet and, later, George Soros, warned loudly about the dangers involved in this. The investment banks could still not be bothered to keep a firm check on their traders. Each time something went wrong a major plank in the structure of capitalism collapsed.

The losers in this game were the general public, the taxpayers. The sorcerers themselves did not invariably emerge unscathed when things went wrong, but they usually did. In the mad magical world of derivatives and futures trading the price of failure was often high reward. The sorcerers became figures of envy, and models for how to succeed. As will be shown in the next chapter their ways were introduced into a whole range of other areas of social life. The modest claim was that the market should be applied everywhere. The new criterion was not success in dealing with failing humanity but rather success according to the magical formula of business quality assessment. Hence patients could be left to die as long as performance targets were met. And there were managers who saw this simply as harsh necessity. These points are explored in the next chapter.