

# Financing Speculation and

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THE Labour Party still insists that banks should be nationalised. To support their ideological commitment, they cite in evidence to the committee investigating the operations of the City (chairman: Sir Harold Wilson) the fact that the banks have failed to meet the investment needs of British industry. During 1973/4 all the big financial institutions—banks, insurance companies and pension funds—channelled large sums of money into property speculation instead of wealth-creating forms of fixed capital formation, and did indeed seriously affect the workings of the economy. Notorious among these were the so-called “fringe” banks, which were heavily implicated in the land boom five years ago. They accepted money from small savers and borrowed from big institutions—and then lent the cash at higher interest rates to the speculators.

The first crash came in late 1974 when London & Counties hit the rocks. Millions were lost by people who thought they were on to a good thing; unrealistic land values were forced higher and higher until the inevitable happened: the bottom fell out of the market. Meanwhile, industrialists who needed capital to extend their businesses were deterred from borrowing by the interest rates which were forced up by those who were willing to pay practically any price for money with which to speculate in land.

This was a shaky foundation for an industrial economy, but not all of the edifice collapsed. The Bank of England stepped in with a “lifeboat” operation of £1,300m. Twenty-six deposit-taking companies were helped, of which eight subsequently went into liquidation. The Bank of England was anxious to protect the reputation of the British banking system, for if confidence had been destroyed, the depression which threatened the system would have been even greater. Requests for help from property companies were turned down.

But the naive socialist belief that only individuals—or privately-owned institutions—are capable of speculating is contradicted by the case of the Crown Agents. The Government has recently announced a further grant of £90m. to help the rescue of the Agents, whose deficit on property investment and secondary banking operations is estimated at £236m. The latest grant is to be used to sort out the Agents’ disastrous Australian property ventures.

The Crown Agents pumped enormous sums of money into secondary banks and property companies during the boom years, and often accepted as securities for loans properties which had been over-valued. One of the benefactors was William Stern, who had lost the Agents over £41m. by 1974. Stern turned the Freshwater Group into Britain’s biggest private landlord, at one point worth £200m. When the bubble burst, it left Stern with debts of £110m.

The Crown Agents’ activities have been scrutinised by the Fay Committee, and the House of Commons—despite strong opposition from Prime Minister James Callaghan—has now succeeded in securing a

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further official investigation into the affair. This new enquiry is likely to throw more light on the complicity of Whitehall, which helped to cover up the unsound decisions which were being taken by the Crown Agents during those heady days of the land boom.<sup>1</sup>

Direct management of the land market by public sector institutions as an alternative to controlling the sources of funds is no guarantee against problems, however. The Land Authority for Wales, which was set up under the Community Land Act, is a good example of the bureaucratic solution. It buys development land, releases it to those who need it, and recoups some of the profits for the public. In its first two years the Authority bought, or is buying, 465 acres at a net cost of £2.6m., and has disposed (or is under contract to dispose) of 198 acres for almost the same sum. So the Authority is left with 267 acres, and according to its chief executive, Mr. E. W. G. C. Howell: “After less than two years of actual trading the estimated value of land and other assets held exceeds the cumulative deficit of the authority by more than £2m.”<sup>2</sup>

This may be a cause of much satisfaction to civil servants who measure their success and power by size or numbers. But a major result of this kind of public sector intervention is that owners hold on to their land rather than sell it willingly under the existing tax arrangements; and the presence of a buyer with taxpayers’ money to spend deters others from competing for land. A rise in land prices could have been predicted, and this has come to pass. Builders have been forced to pay prices not far from those reached during the boom four years ago, and some firms have now withdrawn altogether from the house construction business.

That there will be legislative action to tighten control over banks there can now be no doubt, and after the behaviour of some of the “fringe” bank operations this will be welcome. A licensed and regulated banking system is required under the Second Banking Directive approved by the EEC Council of Ministers late last year. This will give the public some protection—a business calling itself a “bank” will have to be one, as commonly understood, rather than a slick vehicle for switching funds around in the interests of wheeler-dealers pursuing speculative profits. But the more urgent need is for

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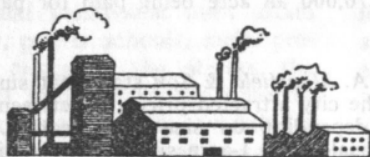
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existing financial institutions to make themselves more accommodating to the small entrepreneurs who want loans with which to establish new businesses. Instead of waiting for the big - safe - corporate borrowers to knock on their doors, bank managers should be promoting their lending facilities among the businessmen who are in a position to quickly establish the wealth-creating operations which meet immediate consumer needs, and can open up the job opportunities needed by the 1.5m. people who are currently unemployed.

There is, however, a danger in inviting a more aggressive involvement of the banks in industry. The historical example of German creditbanks is worth recalling as a reminder that, unless the basic principles of the economy are sound, the system is just as likely to be destabilized by decisions taken in the private sector as by public institutions.

Germany's infant industries were ill-served by the banks up to the 1870s. It was in this period that the conditions were apparently ripe for a rapid transformation of the economy from an agrarian to an industrial character. The creditbanks emerged



to provide the finance needed to set up new companies. There were some fundamental differences between the British and German systems. German companies relied more heavily on cash from the banks, many of whose directors consequently secured places on the supervisory boards of the firms which they financed. The relationship, in other words, was a very close one, with the entrepreneurial decisions shaped to a considerable extent by the wishes of the banks.<sup>3</sup> Furthermore, while the UK banks were conservative and mainly concerned with deposit business, the creditbanks were more enterprising. Two important consequences followed from this.

First, the creditbanks were disposed to limit competition. When profit margins narrowed and less competitive firms were threatened with bankruptcy, the creditbanks either initiated or supported moves to carve up the market in order to protect every-

one's interests. Cartels were developed to the highest degree in Germany. These involved agreements on quotas, territories and price-fixing designed to protect all participating firms. The banks also encouraged fusions of firms into conglomerates, thereby creating oligopolistic structures. And some governmental attempts to curb the power of certain organisations were successfully resisted by the creditbanks, which used their combined financial strength to thwart the politicians. From the point of view of the creditbanks all of this was admirable, for it minimised the risk to their money. So far as the economy and the consumer were concerned, however, it entailed high prices—and to that extent reduced living standards—and a sub-optimal allocation of resources. New firms which might have emerged were still-born for want of capital or market opportunities.

Secondly, the creditbanks were disposed towards participating in risky speculative ventures, particularly those involving land. In addition, their general philosophy (the pursuit of large capital gains) made them more amenable to lending money to others who wanted to speculate. Some of the most sensational bankruptcies among creditbanks followed unsound speculation in land. Their collapse sent out shock waves which had disastrous effects on the rest of the economy at critical times in Germany's—and, as it transpired, the world's—history.

German history cautions us against assuming that our problems can be resolved by the design of some grand plan. Yet this is not a good reason for complete inaction. For industry does need finance with which to expand capital investment if it is to grow at a faster rate. *Something* needs to be done. But what? For while the prospect of making an unearned profit out of land speculation continues to exist, funds will be diverted away from capital formation whether the banks are nationalised or not.

The only sound method of preventing speculation in land is to remove unearned profits *without* simultaneously causing new problems of the sort now being created by the Development Land Tax. Only one technique accomplishes the desired effect, and that is an *ad valorem* tax on all land values. This has the advantage of acquiring for the public's benefit, land values created by the community without the need for a bureaucratic apparatus which inhibits the operations of the free market. Within such a framework, people are free to make the personal decisions which are right for them and therefore the system as a whole. And it is out of the aggregation of these many individual decisions that the appropriate plans and institutions emerge, rather than the other way round.

1. Patience Wheatcroft, "Too much cash, too few ethics, too little sense", and Insight, "Whitehall's Cover-up", *The Sunday Times*, Dec. 4, 1977.
2. Letter from Howell, 'Land logic in Wales', *The Sunday Times*, February 19, 1978.
3. For an excellent review of the history of creditbanks up to 1930, see P. B. Whale, *Joint Stock Banking in Germany*, Frank Cass (1968).