A long shadow
Niall Ferguson

Low interest rates and finance through deficits may have been right for the Depression and have since been used to counter economic weakness. But techniques such as those look unsustainable in the face of the current crisis, writes Niall Ferguson

Alan Greenspan, that grandmaster of good timing, last week described the current financial crisis as "probably a once-in-a-century event". The Great Depression began less than 80 years ago but, then again, we are in a different century. Whether or not this will be the worst such upheaval the world has to face between now and 2099, the fact that nothing as bad as the Depression occurred between the 1930s and now is in itself remarkable.

It was Hyman Minsky, one of the few economists of his generation to think seriously about financial crises, who observed in 1982 that the most significant economic event since the second world war "is something that has not happened: there has not been a deep and long-lasting depression". Could it now, at long last, be happening?

it is no wonder that Wall Street's finest have been caught out so completely. After all, the average bank chief executive's career has spanned little more than 25 years. Nothing that happened between 1983 and 2007 remotely prepared today's masters of the universe for this.

The widely read newsletter published by the Bridgewater hedge fund put it bluntly last week. "With interest rates heading toward 0 per cent, financial intermediaries broken and the delever-aging well under way, it appears that we are headed into a new domain in which the classic monetary tools won't work." This domain is likely to have a "1930s dynamic".

There has certainly been a 1930s feel to this month's events. The nationalization or "conservatorship" - of Fannie Mae and Freddie Mac (the former a creation of the Depression era), the bankruptcy of Lehman Brothers (which traces its history back even further), the takeover by Bank of America of Merrill Lynch and the US government rescue of AIG, the country's largest insurer: a single one of these would have constituted a big financial crisis in the 1980s or 1990s.

Ken Lewis, Bank of America's chief executive, was asked last week how many of the nation's 8,500 banks he thought would survive the credit crunch. "About half," he replied. The failure of more than 4,000 banks would surely amount to Depression 2.0 (though, for the record, the total number of national and state banks to disappear between 1928 and 1933 was over 11,000).

Except that this is clearly not depression - at least not yet. For a start, the federal government is vastly larger than it was when the Great Depression struck and has been throwing money at the economy in a way that Herbert Hoover would have abhorred and John Maynard Keynes applauded. The federal budget deficit will be just shy of $490 bn (£268bn, €340bn) in fiscal 2009. Yes: half a trillion dollars of new federal debt.

From first to last, the Federal Reserve has meanwhile sought to do precisely the opposite of what it did during the Depression: fighting the contraction of credit by cutting rates and targeting shots of liquidity at the banking system, extending to investment banks facilities that were previously the preserve of commercial banks and relaxing its rules on collateral.

On top of that, Hank Paulson, Treasury secretary, last Friday proposed the creation of an institution that would use taxpayers' money to buy distressed assets from financial groups. According to Mr Paulson, this could involve up to $700bn of additional government expenditure. Others such as Ken Rogoff, the Harvard economist, estimate a price tag closer to $1,000bn.

This last measure owes more to the 1980s than the 1930s. The template is the Resolution Trust Corporation, created in 1989 to acquire bad loans from insolvent savings and loans

institutions, the local mortgage lenders at the heart of the last great crisis in the US real estate market. The final cost of the S&L crisis between 1986 and 1995 was $153bn, or about 3 per cent of 1989 gross domestic product, of which taxpayers had to pay $124bn. Given the much larger volume and complexity of the distressed assets today and the much greater difficulty of valuing them, the RTC bill this time is almost certain to be larger, perhaps as much as 7 per cent of GDP.

Cheap money and deficit finance were the techniques recommended by Keynes and others in the 1930s as solutions to the problem of the Depression. They were used and abused in the 1960s and 1970s when there was no depression, with ultimately disastrous inflationary results. But can these techniques work now? So far, what they have achieved is what might be called a Great Repression. They have in effect repressed, but not cured, a depression. The question is whether, as some psychological theories would suggest, repression is a sustainable strategy or whether, at some point, the patient will come out of denial, break down and admit the terrible truth.

Although nothing is more uncertain than the course of a crisis as rare as this, I shall hazard six guesses as to why repression could ultimately fail.

First, there will he more bank deaths, whether in the nice form of takeovers or the nasty shape of bankruptcies. True, a consortium of 10 big banks last week formed a $70bn bail-out pool, but meanwhile the London interbank offered rate - which financial institutions charge each other to borrow - more than doubled.

At one point last week, credit default swap spreads widened to 39 per cent for debt issued by Washington Mutual, which some fear will be the next shoe to drop. In spite of posting better-than-expected quarterly results, even Morgan Stanley and Goldman Sachs saw their share prices slide prior to the announcement of Mr Paulson's RTC Mark II. It remains to be seen whether the broker-dealer business model can survive in any form without a deposit-taking sugar-daddy of the sort Merrill found in the nick of time.

Second, the credit default swaps market will enter crisis. This was foreshadowed when the bail-out of Fannie and Freddie forced 13 Wall Street groups to settle $1,400bn of related derivatives. But the consequences of Lehman's failure are more serious - and raise the question whether those active in the market have left it too late to set up a clearing mechanism. True, most derivative contracts are based on standard documents, but the fact that they are essentially financial insurance policies sold over-the-counter from insurer to insured militates against smooth "netting" of positions in a crisis like this. The whole system could seize up - a bonanza for lawyers, no doubt, but another kind of reduction in liquidity. Third, what William Gross of Pimco, the bond fund manager, called the "financial tsunami" will sweep onwards into hitherto neglected parts of the financial system. Last week the $62bn Reserve Primary Fund became the first money market fund in 14 years to expose investors to losses, after writing off $785m of Lehman debt, "breaking the buck" as its net asset value fell below a dollar a share. There will be more such stories. There are hundreds of billions of dollars in losses looming on corporate debt - almost as much as has already been lost on mortgage-backed securities.

Fourth, there will, finally, be a US recession, beginning in the last quarter of this year and continuing into 2009. On an annualised basis, retail sales and industrial production are already negative. Automotive vehicle sales are far below their level in 2001. Unemployment is rising faster than at any time since the early 1980s. The only reason GDP growth is still positive is that there has been a surge in exports, due mainly to a depreciation of the dollar that began in 2006 and has been only partly reversed in recent weeks.

The dollar is likely to weaken again, especially if - as seems likely - the Fed funds rate is cut in stages to zero and federal debt leaps upward (the 1990s Japanese policy mix) and especially if as also seems likely - China starts to reduce the proportion of its vast currency reserves that is held in dollar-denominated debt. The trouble is that even a weak dollar will not generate tremendous export growth if the rest of the world slows down.

Fifth, unfortunately the rest of the world will slow down. Indeed, parts of the world are already ahead of the US in the race to recession, including the next largest developed economies: the eurozone and Japan, not to mention Britain. Growth has also sagged in a number of emerging markets: Hungary, Malaysia, Mexico, Singapore, South Africa and Thailand are all facing zero if not negative growth.

The good news is that this global slowdown has reduced the inflationary pressures that were mounting, especially through energy and food prices. The bad news is that emerging markets tend to experience more violent financial reactions to reductions in growth. Overall, the MSCI emerging market index is down 30 per cent from its peak last October. Emerging Asia is down 45 per cent. Russia, having shot itself in the foot with its 1930s-style escapade in Georgia, is bottom of the heap - with its stock markets forced to close temporarily last week in order to avoid a complete collapse. (So much for "the return of history". Memo to Vladimir Putin, Russian prime minister: when Hitler invaded neighbouring countries, he had capital controls in place.)

Sixth, the US presidential election will cease to be the soap opera it became during the party conventions and will become a contest between two brands of economic populism. Compare and contrast these two quotations:

1. "Decisions made in boardrooms, on trading floors and in Washington ... rewarded financial manipulation instead of productivity and sound business practices. We let the special interests put their thumbs on the economic scales. The result has been a distorted market that... favours Wall Street over Main Street... an ethic of greed, corner cutting and inside dealing that has always threatened the long-term stability of our economic system."

2. "The excess, the greed and the corruption of Wall Street have caused us to have a situation which is going to affect every American... We need to fix... the inside-the-Beltway, old-boy network."

The first is from Barack Obama, in a speech he made in March. The second is from John McCain last week. Wall Street is going to take a bigger political pounding in the next month and a half than at any time in the past 25 years.

There will of course be differences of emphasis between the two candidates. To the Democratic nominee, the blame for the current crisis should be laid on "deregulation". He can point, if he wants, to the privatisation of Fannie Mae, the savings and loans debacle or the repeal of the Glass-Steagall Act as examples of how the deregulation of financial services since the 1960s led us down this primrose path to hell.

Mr Obama's Republican opponent will blame Washington more for its sins of commission than of omission. After all, it was the federal government that exhorted mortgage lenders to widen home ownership with scant regard for creditworthiness; it was the Federal Reserve that stoked the fires of speculation with the Greenspan "put" -the perception that the Fed would cut rates if stocks fell too far.

It was the Securities and Exchange Commission that slumbered while Wall Street's biggest players danced on a volcano of leverage; it was Congress that allowed itself to be suborned by lavish campaign contributions from the likes of Fannie and Freddie. Asking Congress to establish a "21st-century regulatory framework" (in Mr Obama's phrase) may be like asking a gang of inveterate rustlers to mind the ranch.

If that is the line Mr McCain takes, American voters might end up with a choice between Franklin Roosevelt and Theodore Roosevelt: between a reheated New Deal in the rhetorically high-faluting style of 1933 and a rather feistier kind of economic populism that appeals more to the self-reliant individual than to the federal bureaucracy. The bottom line, however, is that neither candidate is going to be saying kind words about finance. This may be the right way to go about winning votes. It is unlikely to do much for confidence on Wall Street.

Nor is this the only political threat to the great bail-out envisaged by Mr Paulson at the Treasury. Half of the current members of Congress also need to get themselves re-elected in November. Judging by their initial reactions, they will not all meekly rubber-stamp the Paulson plan. It looks too much like an open-ended commitment by Joe Public to Wall Street's erstwhile masters of the universe. Didn't those guys make enough money in the good times? Isn't it about time they lost some?

Yet the slightest sign of political delay will unleash a fresh wave of financial uncertainty. At the same time, crude bans on short-selling, of the sort introduced in New York and London last week, will not prevent fresh declines in asset-backed securities and financial stocks.

The Great Repression is upon us. On one side can be seen the chain reaction of deleveraging as banks, other companies and households all battle to stabilise balance sheets that became much too highly geared in the days of easy money; as the resulting credit contraction and forced asset sales create a vicious downward spiral; as the slowdown spreads to Main Street and from Main Street to the world. On the other side are the Fed and the Treasury, desperately manning the monetary and fiscal pumps while trying to decide who is too big to fail and who is not.

Will the authorities succeed in keeping a depression repressed? Among the above six reasons why they might not succeed, politics may hold the key. It is scant consolation to think that the world will not have to go through this again for another century.

Fonte: Financial Times, London, September 22 2008, Primeiro Caderno, p. 15.