The perfect storm: Lack of international cooperation and flawed policies will prolong the recession

Laurence A. Tisch Professor of History at Harvard University and William Ziegler Professor of Business Administration at Harvard Business School

The Brazilian Economy: In your recent book, *The Ascent of Money*, you point out that financial systems deliver immense benefits but they are inherently crisis-prone, and this has to do partly with human emotional volatility. However, a question that begs an answer is why central banks that have long institutional memories have not been able to create incentives to limit the damage done by foolish human nature.

Niall Ferguson: I think there are two answers to this question. One is that we have stopped reading Walter Bagehot. Bagehot’s *Lombard Street* provides a wonderful account of how central banks should deal with speculative excesses and liquidity crises in a financial market. His view was that an insolvent bank should not be helped, but banks having merely a liquidity problem should be lent generously, at a penalty rate. I think the theory of central banking has suffered a serious deformation in the last 10 years.

I would single out the Jackson Hole Conference of 1999, in which a series of papers were presented arguing it was not the business of central banks to anticipate or prevent asset bubbles but merely to mop up after the bubbles had burst. The corollary of this view was that central banks should target or closely monitor consumer price inflation. This idea that you could somehow turn monetary policy into a very simple game in which you anchor expectations by targeting a particular inflation rate was adopted in...
various degrees by central banks around the world, and I think it was a gross oversimplification of what central banks are supposed to do. Why should consumer price inflation be more important than asset price inflation? Why does the price of a house not concern a central bank, but the price of a computer does? That was a big mistake, because it meant central banks, particularly the Federal Reserve Bank (the Fed), stopped caring about the dangers of asset price bubbles.

Here is the second problem: Regulators did not pay enough attention to bank balance sheets or turned a blind eye to their excessively leveraged character. When you come to think of it, that was the big vulnerability.

Banks were downloading their risk off their balance sheets. Now they are forced to bring the risks back onto the balance sheets. And the leverage is now exploding. Banks were following the same off-balance-sheet-vehicles techniques that were pioneered by the Enron Corporation — hardly a model for good accounting practices. Particularly in Europe even more than in the US, but certainly in Wall Street, leverage (the ratio between borrowed funds and equity) kept going up. Now if your leverage is 25 to 1, assets do not need to go down terribly far to have a bank’s lending capacity wiped out. That seems to have escaped regulators in the US as well as in Europe.

It seems unbelievable that so many people got it wrong.

I think it was overconfidence in the theory of efficient markets and the theory of monetary policy. In 2002 Ben Bernanke published The Great Moderation, arguing that effectively central banks had solved the problem of economic volatility by clever improvements in monetary policy. With hindsight that was incredible hubris. Even at the time, I did not believe it, and I wrote skeptically about the death of volatility. The notion that volatility somehow was experiencing a decline because of improved monetary policy always struck me as complete nonsense.

In your view, is the current crisis the end of global financial markets as we know them? It is certainly the end of the age of excessive debt. It is not possible to base consumption growth on debt growth for a long time. It is also the end of the Basel II vision of bank regulation with a very generous measure of capital adequacy. We will have to adopt something much stricter, as some countries have done — as Canada did. It is certainly the end of the Asian export-led growth model. The collapse of exports Asian economies are suffering is spectacular, and since these economies rely heavily on exports, economic growth is falling. That is the most alarming development. Whether all this means the global financial system is going to collapse we do not yet know, but it is certainly going to contract.

Beyond the current financial mess, your point on Asian export-led growth underlines a more fundamental problem facing the world economy. How do we rebalance global demand and support global growth? As Americans try to restructure their debts, they will be forced to save more, and Asians are apparently now willing to consume more.

Getting the IMF and the G20 to agree on a global bailout is going to be really difficult. The political obstacles to a global bailout are really quite big. A much more likely scenario is going to be an outbreak of sovereign defaults.
This will certainly prolong the recession. It is a global paradox of thrift. If it seems likely that US households continue to raise the savings rate from 0 to 5% of GDP very fast (it may even rise to 10% of GDP), then the engine of world economy growth has just stalled, because it was essentially fuelled by American consumption, and that is over. There has been a fundamental shift in the American psychology; you can detect it and you can see it in the statistics. I do not think we will have a Great Depression, but we will certainly have a protracted period of very low growth.

So although I do not believe the global financial system is dead in the way it was in the early 1930s, when by 1933 the entire system had basically frozen. What is going to happen is that planet finance, as I call it, is going to shrink. It is going to be a lot smaller and it is going to be dominated by public institutions, whether national governments, national central banks, or the International Monetary Fund. That is going to be the big transition. We are also heading toward some big defaults in Eastern Europe, and it is not clear whether there are resources to bail them out. It is big, actually bigger by some measures than the Latin American debt crisis or the Asian crisis of previous decades.

But getting the IMF and the G20 to agree on a global bailout is going to be really difficult. And actually we don’t have much time, the G20 meeting is going to be on April 2nd. Ukraine could have collapsed by that time.

Perhaps under pressure the G20 could pull its act together.

American policies are sucking all international capital into the US. The effect of that on currencies depreciating against the dollar and on almost any asset market except the US bond market is really quite dramatic. That has been what happened in the US. There has been a policy response whenever things have taken a further step down. The Lehman bankruptcy forced the Troubled Asset Relief Program, the TARP bill, to be passed and AIG to be bailed out. But I doubt it is going to work quite so easily at the international level because the crisis is very asymmetric. It is not evenly distributed. Some countries are getting much more pain than others. The US is not taking most of the pain by any means, and in some ways it is better placed than anybody else to ride it out because of the “safe-haven” status of the dollar and the fact that the Fed, the Treasury, and the Federal Insurance Deposit Corporation (FDIC) can respond with enormous stimulus to the crisis.

The problem with the G20, I foresee, is that at some point people are going to say, and I bet the Russians will be the first, you Americans started this crisis, it is your fault, but we in the rest of the world are suffering more, what are you going to do about it? And President Obama is going to reply that Americans have their hands pretty full dealing with their own economy. That is when cooperation to fight the global crisis will break down. Imagine if the US administration goes to Congress and says that in addition to the US$1.7 trillion budget, it has to rescue Ukraine. The Republicans will have a field day. So the political obstacles to a global bailout are really quite big. A much more likely scenario is going to be an outbreak of sovereign defaults.

You have been critical of the delusion that creating more debt and spending can solve
a crisis that resulted from excessive debt in the first place. Why is a Keynesian approach of government profligacy not likely to take us out of the crisis?

I am a great admirer of Keynes, but I am not a believer in a crude application of a caricature of Keynes' General Theory of Unemployment, which is what is currently going on. We are already making an enormous monetary effort. The Fed has already done a large amount and will do more to inject liquidity. I do not think Fed monetary policy has failed, I think it is succeeding. The big question is what happens if you compound a problem of excess leverage with an explosion of public debt. If the US budget is right, the debt-to-GDP ratio will rise from 70% to 100% in less than 10 years. Although having that additional government expenditure financed by borrowing may in some measure compensate for reduced consumer demand, the expenditure multiplier is almost certainly very small, so it is not going to have a tremendously positive impact, and there are lots of negative side effects.

For example, American policies are sucking all international capital into the US. It is really extraordinary, and the effect of that on currencies depreciating against the dollar and on almost any asset market except the US bond market is really quite dramatic. So I think we have to think about the crisis globally. When you think of it as a global problem, Keynesian solutions do not actually make a lot of sense. Governments all over the world simultaneously flooding bond markets with their bonds is clearly a no-win situation. Investors would prefer the US safe haven to other sovereign bonds.

This could create a lot of volatility. It’s the volatility I’m worried about. We’re already seeing it because people are thinking, wait a minute, the US is a safe haven but the US deficit is 12% of GDP and its debt-to-GDP ratio is going to double. What should I do? What am I more worried about? Should I be worried about everybody else defaulting, or should I be worried about the US dollar depreciating sharply?

US expansionary policies are going the same way Brazil and Argentina went in the 1980s.

This is the big intellectual challenge. For years economists like Ken RogoH have been warning us about the US dollar. One thing economic theory tells us is that at some point huge external current account deficits will weaken the dollar, but it hasn’t happened because the financial crisis had the opposite effect: It strengthened the dollar as people desperately tried to scramble for dollar liquidity and also for a safe haven. This tension between worrying about the potentially inflationary downside to American expansionary policy and worrying about everything else being more dangerous than US assets is going to create a tug of war between expectations and cause a lot of volatility. Because of this sort of thing the current US policy approach makes the crisis worse.

It seems to me that if you think the crisis is fundamentally a problem of excessive debt, the policy is more straightforward than that. You don’t need an enormous expansion of the public deficit if households are behaving this way because they are underwater — basically
their debts are in excess of the value of their properties. Then you have to address that issue directly, and everything else is going to be a Band-aid. Similarly, if banks are essentially paralyzed by excessive leverage, you cannot drip-feed them bailouts. That is not solving the problem. We need one great big restructuring, in which bondholders of insolvent institutions will receive equity. Some of the insolvent institutions will just have to be taken under government administration. I do not see a problem with that. That is much more likely to change the game, send a positive signal to households and financial markets, and make credit flow again through the economy than just an explosion of public debt predicated on a flawed Keynesian policy.

How would you rate the Obama administration with regard with addressing the banking crisis and the real estate downturn? The economic team is supposed to include the smartest people on the planet. Larry Summers is very smart. I wonder if in the end there is a kind of intellectual gridlock, where the mindset of the Harvard economists, which turns out to be Keynesian during a crisis, bumps up against the mindset of the US Congress, where the Democratic Party is overwhelmingly dominant, to produce a suboptimal policy mix. The stimulus package is a mistake because it looks like essentially Obama said to Congress, you decide what we spend the money on. That is not the rational way to decide the bill to get the optimal effect.

As Robert Samuelson pointed out, Obama’s package is too focused on political goals and projects and will do little to boost domestic demand because a large part of public investment spending will take place in 2011 or latter.

In a way the stimulus package became sort of a dog’s breakfast, a kind of mess of competing political priorities. The other big issue I think is that Treasury Secretary Timothy Geithner was part of the previous administration, and there is therefore real continuity in the way in which the banking crisis has been dealt with. Geithner’s most significant action has been to say that the Fed should make more use of the term asset-backed securities loan facility (TALF). In fact, this is much more important than the stimulus bill. It is much more money and is targeted at the asset-backed securities market, which Bernanke wants to revive. That is real continuity in policy, and the decision has been clearly taken to postpone the nationalization of insolvent banks. I consider this policy highly questionable. So we are stuck on a course of improvisation that dates back all the way to 2007. We have not had a real paradigm shift in thinking about the banking crisis.

I guess what the Obama administration fears most is that they might do something that has even bigger unintended consequences than Paulson’s decision to let Lehman fail. They fear that if they say something that suggests bank nationalization, there will be a meltdown of the stock market. The only way you can pull off bank nationalization is if you do it dramatically, overnight, without warning. You do not achieve that psychological shift in confidence without a more dramatic step. That is a key point. At the end, it all comes down to dealing with the problem of excessive debt.

You have to bring the debt down to a sustainable level that you can pay. The lesson of emerging markets is that when debt restructuring happens, it is all very unfortunate and painful but it is amazing how quickly people get over it once they see the country is on a sustainable path again. The
The degree to which sovereign defaults had not been punished by increases in risk premium is one of the striking findings of financial history. Right now people’s nightmare scenario is that there will be a vast number of foreclosures and Lehman’s bankruptcy will repeat itself with Citigroup and Bank of America. This nightmare scenario could be eliminated by simply imposing a general debt restructuring.

In the case of the US during the Great Depression, the Home Owners Loan Corporation was set up to restructure mortgages and it was relatively successful. Yes, that was one of the important things the New Deal did. The New Deal really did transform mortgages into long-term financial instruments. Before that only short-term loans were available to buy houses. This illustrates why it is worth looking at financial history, because you suddenly realize, Gosh, this was something they tried and it worked, and we could do the same.

You and some economists have argued in favor of giving support to households to restructure their mortgages. Does the US Treasury housing rescue plan address the problem? The current Treasury policy takes a large group of people who have Fannie Mae and Freddie Mac mortgages and hopes that lenders will give people lower interest payments, and it subsidizes that by reducing interest payments further. But that does not address the issue of negative equity at all, and it is negative equity that makes people walk away and causes foreclosures. So it seems to me that the Obama administration is missing a fundamental analytical point here. I think it will become painfully apparent in the course of this year that this is not working, and a change in the economic team is possible.

Is Paul Volcker involved in the policy making? He plays the role of figurehead, he is not involved in the decision making, and I was told he is not very happy about that. He would have handled the crisis very differently. I interviewed him for my book The Ascent of Money a year ago. He made clear to me the extent to which he thinks we need structural reforms of the financial system rather than just fresh injections of cash to keep banks in operation. If you had appointed him as Treasury Secretary the impact on confidence would have been psychologically huge.

Fresh injections of cash are dangerous because you keep dead banks going, making it very difficult to recover confidence. That is my point. You have to deal with insolvent banks because they are standing in the way of financial recovery. They are also standing in the way of new banks. We need new banks well-capitalized to have credit flowing again through the economy. Let Canadian banks come into the US. Basically what we are doing is taking taxpayers’ money and putting it on the line for bank equity and bondholders. I do not think that is justified in a systemic banking crisis. It is not achieving enough results to justify these huge risks that have been taken on the taxpayers’ money.

---

1 English journalist, closely associated with the English institutionalist-historicist tradition, He stressed the need for more institutional content, especially cultural and social factors. He was one of the first economists to discuss the concept of the business cycle, and developed a distinct theory of central banking.

2 Conference organized by Federal Reserve Bank of Kansas.