When fortune frowned

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The worst financial crisis since the Depression is redrawing the boundaries between government and markets, says Zanny Minton Beddoes (interviewed here). Will they end up in the right place?

Illustration by Belle Mellor

AFTER the stockmarket crash of October 1929 it took over three years for America's government to launch a series of dramatic efforts to end the Depression, starting with Roosevelt's declaration of a four-day bank holiday in March 1933. In-between, America saw the worst economic collapse in its history. Thousands of banks failed, a devastating deflation set in, output plunged by a third and unemployment rose to 25%. The Depression wreaked enormous damage across the globe, but most of all on America's economic psyche. In its aftermath the boundaries between government and markets were redrawn.

During the past month, little more than a year after the financial storm first struck in August 2007, America's government made its most dramatic interventions in financial markets since the 1930s. At the time it was not even certain that the economy was in recession and unemployment stood at 6.1%. In two tumultuous weeks the Federal Reserve and the Treasury between them nationalised the country's two mortgage giants, Fannie Mae and Freddie Mac; took over AIG, the world's largest insurance company; in effect extended government deposit insurance to $3.4 trillion in money-market funds; temporarily banned short-selling in over 900 mostly financial stocks; and, most dramatic of all, pledged to take up to $700 billion of toxic mortgage-related assets on to its books. The Fed and the Treasury were determined to prevent the kind of banking catastrophe that precipitated the Depression. Shell-shocked lawmakers cavilled, but Congress and the administration eventually agreed.

The landscape of American finance has been radically changed. The independent investment bank—a quintessential Wall Street animal that relied on high leverage and wholesale funding—is now all but extinct. Lehman Brothers has gone bust; Bear Stearns and Merrill Lynch have been swallowed by commercial banks; and Goldman Sachs and Morgan Stanley have become commercial banks themselves. The "shadow banking system"—the money-market funds, securities dealers, hedge funds and the other non-bank financial institutions that defined deregulated American finance—is metamorphosing at lightning speed. And in little more than three weeks America's government, all told, expanded its gross liabilities by more than $1 trillion—almost twice as much as the cost so far of the Iraq war.

Beyond that, few things are certain. In late September the turmoil spread and intensified. Money markets seized up across the globe as banks refused to lend to each other. Five European banks failed and European governments fell over themselves to prop up their banking systems with rescues and guarantees. As this special report went to press, it was too soon to declare the crisis contained.

Anatomy of a collapse

That crisis has its roots in the biggest housing and credit bubble in history. America's house prices, on average, are down by almost a fifth. Many analysts expect another 10% drop across the country, which would bring the cumulative decline in nominal house prices close to that during the Depression. Other countries may fare even worse. In Britain, for instance, households are even more indebted than in America, house prices rose faster and have so far fallen by less. On a quarterly basis prices are now falling in at least half the 20 countries in *The Economist's* house-price index.

The credit losses on the mortgages that financed these houses and on the pyramids of complicated debt products built on top of them are still mounting. In its latest calculations the IMF reckons that worldwide losses on debt originated in America (primarily related to mortgages) will reach $1.4 trillion, up by almost half from its previous estimate of $945 billion in April. So far some $760 billion has been written down by the banks, insurance companies, hedge funds and others that own the debt.

Globally, banks alone have reported just under $600 billion of credit-related losses and have raised some $430 billion in new capital. It is already clear that many more write-downs lie ahead. The demise of the investment banks, with their far higher gearing, as well as deleveraging among hedge funds and others in the shadow-banking system will add to a global credit contraction of many trillions of dollars. The IMF’s “base case” is that American and European banks will shed some $10 trillion of assets, equivalent to 14.5% of their stock of bank credit in 2009. In America overall credit growth will slow to below 1%, down from a post-war annual average of 9%. That alone could drag Western economies’ growth rates down by 1.5 percentage points. Without government action along the lines of America’s $700 billion plan, the IMF reckons credit could shrink by 7.3% in America, 6.3% in Britain and 4.5% in the rest of Europe.

Much of the rich world is already in recession, partly because of tighter credit and partly because of the surge in oil prices earlier this year. Output is falling in Britain, France, Germany and Japan. Judging by the pace of job losses and the weakness of consumer spending, America’s economy is also shrinking.

The average downturn after recent banking crises in rich countries lasted four years as banks retrenched and debt-laden households and firms were forced to save more. This time firms are in relatively good shape, but households, particularly in Britain and America, have piled up unprecedented debts. And because the asset and credit bubbles formed in many countries simultaneously, the hangover this time may well be worse.

But history teaches an important lesson: that big banking crises are ultimately solved by throwing in large dollops of public money, and that early and decisive government action, whether to recapitalise banks or take on troubled debts, can minimise the cost to the taxpayer and the damage to the economy. For example, Sweden quickly took over its failed banks after a property bust in the early 1990s and recovered relatively fast. By contrast, Japan took a decade to recover from a financial bust that ultimately cost its taxpayers a sum equivalent to 24% of GDP.

All in all, America’s government has put some 7% of GDP on the line, a vast amount of money but well below the 16% of GDP that the average systemic banking crisis (if there is such a thing) ultimately costs the public purse. Just how America’s proposed Troubled Asset Relief Programme (TARP) will work is still unclear. The Treasury plans to buy huge amounts of distressed debt using a reverse auction process, where banks offer to sell at a price and the government buys from the lowest price upwards. The complexities of thousands of different mortgage-backed assets will make this hard. If direct bank recapitalisation is still needed, the Treasury can do that too. The main point is that America is prepared to act, and act decisively.

For the time being, that offers a reason for optimism. So, too, does the relative strength of the biggest emerging markets, particularly China. These economies are not as “decoupled” from the rich world’s travails as they once seemed. Their stockmarkets have plunged and many currencies have fallen sharply. Domestic demand in much of the emerging world is slowing but not collapsing. The IMF expects emerging economies, led by China, to grow by 6.9% in 2008 and 6.1% in 2009. That will cushion the world economy but may not save it from recession.

Another short-term fillip comes from the recent plunge in commodity prices, particularly oil. During the first year of the financial crisis the boom in commodities that had been building up for five years became a headlong surge. In the year to July the price of oil almost doubled. *The*

Economist's food-price index jumped by nearly 55% (see chart 1). These enormous increases pushed up consumer prices across the globe. In July average headline inflation was over 4% in rich countries and almost 9% in emerging economies, far higher than central bankers' targets (see chart 2).

High and rising inflation coupled with financial weakness left central bankers with perplexing and poisonous trade-offs. They could tighten monetary policy to prevent higher inflation becoming entrenched (as the European Central Bank did), or they could cut interest rates to cushion financial weakness (as the Fed did). That dilemma is now disappearing. Thanks to the sharp fall in commodity prices, headline consumer prices seem to have peaked and the immediate inflation risk has abated, particularly in weak and financially stressed rich economies. If oil prices stay at today's levels, headline consumer-price inflation in America may fall below 1% by the middle of next year. Rather than fretting about inflation, policymakers may soon be worrying about deflation.

The trouble is that because of its large current-account deficit America is heavily reliant on foreign funding. It has the advantage that the dollar is the world's reserve currency, and as the financial turmoil has spread the dollar has strengthened. But today's crisis is also testing many of the foundations on which foreigners' faith in the dollar is based, such as limited government and stable capital markets. If foreigners ever flee the dollar, America will face the twin nightmares that haunt emerging countries in a financial collapse: simultaneous banking and currency crises. America's debts, unlike those in many emerging economies, are denominated in its own currency, but a collapse of the dollar would still be a catastrophe.

Tipping point

What will be the long-term effect of this mess on the global economy? Predicting the consequences of an unfinished crisis is perilous. But it is already clear that, even in the absence of a calamity, the direction of globalisation will change. For the past two decades the growing integration of the world economy has coincided with the intellectual ascent of the Anglo-Saxon brand of free-market capitalism, with America as its cheerleader. The freeing of trade and capital flows and the deregulation of domestic industry and finance have both spurred globalisation and come to symbolise it. Global integration, in large part, has been about the triumph of markets over governments. That process is now being reversed in three important ways.

First, Western finance will be re-regulated. At a minimum, the most freewheeling areas of modern finance, such as the $55 trillion market for credit derivatives, will be brought into the regulatory orbit. Rules on capital will be overhauled to reduce leverage and enhance the system's resilience. America's labyrinth of overlapping regulators will be reordered. How much control will be imposed will depend less on ideology (both of America's presidential candidates have promised reform) than on the severity of the economic downturn. The 1980s savings-and-loan crisis amounted to a sizeable banking bust, but because it did not result in an economic catastrophe, the regulatory consequences were modest. The Depression, in contrast, not only refashioned the structure of American finance but brought regulation to whole swathes of the economy.

That leads to the second point: the balance between state and market is changing in areas other than finance. For many countries a more momentous shock over the past couple of years has been the soaring price of commodities, which politicians have also blamed on financial speculation. The food-price spike in late 2007 and early 2008 caused riots in some 30 countries. In response, governments across the emerging world extended their reach, increasing subsidies, fixing prices, banning exports of key commodities and, in India's case, restricting futures trading. Concern about food security, particularly in India and China, was one of the main reasons why the Doha round of trade negotiations collapsed this summer.

Third, America is losing economic clout and intellectual authority. Just as emerging economies are shaping the direction of global trade, so they will increasingly shape the future of finance. That is particularly true of capital-rich creditor countries such as China. Deleveraging in Western economies will be less painful if savings-rich Asian countries and oil-exporters inject more capital. Influence will increase along with economic heft. China's vice-premier, Wang Qishan, reportedly told his American counterparts at a recent Sino-American summit that "the teachers now have some problems."

The enduring attraction of markets

The big question is what lessons the emerging students—and the disgraced teacher—should learn from recent events. How far should the balance between governments and markets shift? This special report will argue that although some rebalancing is needed, particularly in financial regulation, where innovation outpaced a sclerotic supervisory regime, it would be a mistake to blame today's mess only, or even mainly, on modern finance and "free-market fundamentalism". Speculative excesses existed centuries before securitisation was invented, and governments bear direct responsibility for some of today's troubles. Misguided subsidies, on everything from biofuels to mortgage interest, have distorted markets. Loose monetary policy helped to inflate a global credit bubble. Provocative as it may sound in today's febrile and dangerous climate, freer and more flexible markets will still do more for the world economy than the heavy hand of government.