

Where Are We Now?

This past year has been without parallel since the Great Crash and the Great Depression. It seems that no market has remained untouched. The world's publicly traded companies and partnerships have lost almost half of their value, from a peak of almost \$60 trillion, to a little over \$30 trillion now. If we look at the value of the world's stock markets and housing markets, almost half of the wealth evaporated. We now talk in tens of trillions of dollars of international losses, and we don't know if the bleeding has finished.

Perhaps the most reassuring aspect of the global economic response to the financial meltdown is the shared leadership worldwide. How did we find ourselves on this path of unprecedented global market intervention?

We are very much a victim of our own success. The rapid wealth creation of the 1990s and 2000s inevitably found its way into rising housing values. At the same time, a push to increase the rate of home ownership in the United States and elsewhere added fuel to the fire. There were exorbitant profits to be had by all and, in such an economic culture, nobody asks questions that would bring the party to an end.

And party we did. Mortgage companies like Countrywide in the U.S. and Northern Rock in the U.K. made it too easy for anybody to realize the dream of home ownership. Many that could not afford home ownership were lulled into the home buying contagion, with the confidence that they could always sell for a handsome profit if they ever found themselves on the ropes. But once the bubble popped, the home ownership dream became a nightmare. It is this nightmare that still haunts us today and portends to a severe global recession.

The rapid decline of Countrywide and Northern Rock in the face of mounting mortgage defaults is a tale of two different market philosophies. The U.S. response to the bankruptcy of Countrywide was to have it absorbed by Bank of America. The U.K. took a more multidimensional approach. When building society Bradford and Bingley's subprime mortgage exposure forced it into illiquidity, Spain's Grupo Santander bought some of its operations for less than ten cents on the dollar. However, other parts of its business, and of the Northern Rock building society, were nationalized by the British government through a new arms-length government-owned corporation U.K. Financial Investments Limited.

The British Government was quick to step in and protect retail accounts of these leading banking entities, as early as the Fall of 2007. This is contrary to the actions of the U.S. monetary authorities, which took a hands-off approach until March of 2008. A greater willingness of the British government to explore nationalization, while their U.S. counterparts adhered to free market principles, allowed the U.K. to gain early experience with private-public partnerships as a solution to the private market failures.

The shoes continued to drop though. The Wall Street brokerage house Lehman Brothers

was parcelled out to the major British bank Barclays. American International Group, a major underwriter of the notorious credit default swaps that created huge liabilities for investment houses and investors alike, was eventually bailed out to the tune of \$143 billion by the U.S. Treasury, while the mounting losses of Icesave, the online banking wing of the Icelandic bank Landsbanki, were bailed out by the Dutch and United Kingdom finance ministers.

Even the International Monetary Fund, long considered the last resort lender to developing countries, responded to pleas from Argentina, Estonia, Iceland, Hungary, Latvia, Lithuania, Pakistan, Russia, South Africa, Turkey, and the Ukraine. It seems that no country was immune to the threat of bankruptcy in an environment where credit became nonexistent.

These examples of British, European, and international public interventions catapulted U.K. Prime Minister (and former finance minister) Gordon Brown as the emerging global economic leader. The U.S. was eventually forced to adopt a similar interventionist strategy to preserve the integrity to the U.S. banking industry and free up what had by the fall of 2008 become an almost complete freezing-up of U.S. and worldwide credit.

The U.S. responses began well after the first European interventions. In the week of March 16, 2008, the Federal Reserve Board facilitated the bailout of Bear Stearns, one of the world's most revered investment banks. By making an unprecedented foray into the investment banking sector, the Fed departed from its traditional role of limiting its efforts to commercial banking. The next day, the Fed again decreased the interest rate it charges for short-term loans to commercial banks to 2-1/4%, with another quarter percentage point cut a month later.

The Fed was responding to an already alarming crisis in credit markets that by January of 2008 was wreaking havoc in world stock markets. Dramatic declines in the Hang Seng Index of China and the Nikkei in Japan reverberated through Europe and onto Wall Street. Investors worldwide hung on every word and gesture from the as-yet untested Chairman of the U.S. Federal Reserve Board, Ben Bernanke. His willingness to broker a buyout of Bear Stearns and his announcement of a reduced federal funds rate caused the stock market soared in a day by more than it had any day in five years. The next day, with no quick Fed fix to ward off the market pall, the Dow Jones Industrial Average again slumped by 300 points, wiping out much of the enthusiasm generated just a day before. Predictably, markets the world over had fits. We ushered in an era when any reprieve from a market decline was short-lived, and market volatility ruled the day.

Since then though, the Bear Stearns bailout and the 300 point drop seem like minor bumps on a pothole strewn road. The severe global stock market meltdown in October of 2008 induced the U.S. Federal Reserve Open Market Committee to implement an emergency .5% rate cut, followed three weeks later with a further .5% rate cut at its regular October meeting. The short term interest rate fell to just 1%, with the promise of more rate cuts as necessary. This places the Federal Funds Rate at a historically low level, lower than the rate in the Great Depression and World War II. The Fed has almost

used up its ability to encourage banks to borrow, and is perilously near a Keynesian liquidity trap.

The U.S. Congress also approved an unprecedented \$700 Billion bailout package designed to re-establish integrity and confidence in U.S. financial markets, in return for government ownership of newly issued preferred shares in U.S. banks. These funds are being used to create liquidity in first and second tier U.S. banks, and to encourage some buyouts of weaker tier three and tier four banks. This public encouragement in economic Darwinism is also unprecedented, and has inspired the likes of free-marketeters like former Fed Chairman Alan Greenspan to indicate we are all interventionists now.

The Fed and the U.S. Treasury have bought stakes in, and brokered shot-gun marriages of, many more multi-billion dollar corporations. And it has injected, or shall soon inject, about a trillion dollars into the U.S. economy. Regulators and Central Banks around the world have done likewise, in a spirit of international monetary economic coordination not seen since Bretton Woods. Still, the Dow Jones Industrial Average has declined as much in a year as it did in the first year of the Great Crash of 1929. But while the market continued to fall for a couple more years in the Great Depression, we remain unsure how much further it will fall this time.

It is understandable that markets have become unnerved and people are scared. These numbers now bandied around are unprecedented in size. People have a difficult time absorbing figures that bear little relation to their own world. In the U.S. alone, stimulus packages total about a trillion dollars. Nations the world over, from China to the European Economic Community, and international lending organizations like the International Monetary Fund, are working in concert to lower interest rates and provide for fiscal stimuli. The world has never before seen such a concerted and expensive rescue package.

And yet, the challenge remains daunting and the outcome uncertain.

Export oriented countries like China, Japan, and Korea have suffered dramatically on the news of reduced U.S. consumption. The Hang Seng Index in China has dropped precipitously, and Japan's Nikkei 225 index reached its lowest level on record. These losses exceed even the losses on Wall Street, and represent vanishing nest eggs of middle class workers the world over. Once the economic security of the Consumer-Investor is threatened, we respond emotionally, motivated by fear of loss rather than logic. It is natural for us to wonder what is going on, what might happen next, and how it might affect us.

It is now clear that we are entering into a global recession that is likely to be deep and prolonged, compared to the short and mild recessions of the past quarter century. We have discovered that dramatic drops in housing values, in combination with the decline in wealth in the stock markets, have an effect on consumption. For instance, U.S. consumers decrease their consumption by about \$60 for every \$1,000 fall in housing value, and another \$40 for each \$1,000 fall in stock value. The decline in consumption alone in the

U.S. may account for a 5% drop in spending. This drop is much greater than the stopgap efforts that offered U.S. taxpayers tax rebates in the Spring of 2008 and the initiatives being implemented worldwide. While unprecedented and massive, fiscal efforts to now have filled only a small share of the spending gap.

As a consequence, nations worldwide have begun reporting their first quarter of negative growth. Most economists now agree we are currently in our second quarter of negative growth, which meets the common definition of a recession. However, few economists believe we will pull out before 2010.

The Fed and central banks the world over have not needed to cope with the current decline in financial market confidence since the Great Depression. While many now realize that the failure of regulation to keep up with new fangled financial products is largely responsible for this current mess, spending too much time on blame doesn't get us any further toward solving it. Perhaps history can give us some insights. Confidence in financial markets was shaken with the Great Crash of 1929. The immediate effects of that crash on market performance and confidence were only a little larger than what we are seeing today.

What we perhaps ought to understand is why things continued to deteriorate between 1929 and 1932. First, we did not have a well-functioning Federal Reserve System that viewed the maintenance of financial stability as perhaps their primary objective. We also had a prevailing philosophy in the President Herbert Hoover administration that the market should be left to its own devices. Hoover was monitoring the situation but did not believe the turmoil could last as long as it did.

Modern Keynesian macroeconomics has since taught us that the economy is well capable of long periods of persistent and dramatic recession or depression, but these studies were in their infancy in 1930. Finally, there was a tradition of lack of government involvement in economic affairs that prevailed throughout the Roaring Twenties. But, while the Fed tried to do whatever it could, without the support and reinforcement by the Economic Commander in Chief, the Fed's actions were deemed not credible.

Will things get as bad this time around? I don't think so. While perhaps we have done far too little far too late, the cries are getting louder and louder. And it has not taken four years for these clarion calls to be heard. My only fear is that the Fed has used almost all their monetary arrows in their quiver somewhat futilely, given the lack of a concerted fiscal policy response. There is not much more the Fed will be able to do at this point. We do have the attention of policymakers the world over though, and they are injecting unprecedented amounts of cash in concert into the banking system to thaw the lending freeze brought on by banker caution and pessimism.

There is a broad acceptance though that the unfettered deregulation of the last decades has put too much blind faith in complex markets. There is now broader worldwide appreciation for the need to reform regulatory oversight and encourage a much greater degree of transparency in markets. Only then can we demonstrate to the marketplace that nothing is as important as securing our collective economic future. If we can lend that

confidence to financial markets and the economic citizens, it is likely that we will have to do little more. Markets and citizens are incredibly resilient if the financial environment is sound, reasonably optimistic, and well regulated. At least for this moment in history, we recognize that private markets operate in the public trust. We may be witnessing the end of the era in which we turn a blind eye when profits are lucrative because we now know the public coffers must indemnify markets from the most severe losses.