Some reflections on the responses of governments to the global financial crisis

(Written in response to a question from an ANZ customer, who sent me a copy of an 'open letter' to Dominique Strauss-Kahn, Managing Director of the IMF, from Martin Weiss, Chairman of the 'Sound Dollar Committee', urging him to resist government interventions in the financial system in response to the current global financial crisis. The full text of the open letter can be found at www.moneyandmarkets.com).

Martin Weiss' advice - especially his apparent endorsement of a 'deflationary debt collapse' as the 'mechanism' by which the necessary atonement for the 'financial sins' which have been committed can be attained, and by which 'millions of people' can be compelled 'to make great sacrifices' - is rather reminiscent of the advice which President Herbert Hoover received after the October 1929 sharemarket crash, from his Treasury Secretary Andrew Mellon, to "liquidate stocks, liquidate the farmers, liquidate labour" etc.

Hoover largely followed that advice, and the result was the economic and social calamity which the world has come to know as 'the Great Depression'.

By what has turned out to be an extremely fortuitous co-incidence, the current Chairman of the US Federal Reserve, Ben Bernanke, spent his academic career studying the mistakes which the Fed made during this period. There is no-one better equipped than him to ensure that the Fed doesn't repeat those mistakes - and thus far, for the most part, it hasn't. In particular, unlike the period between 1929 and 1933, when thousands of banks collapsed, and millions of Americans lost their life savings, no depositor in an American bank has as yet lost a cent.

It's true, as Weiss suggests, that the partial rescue of Bear Stearns (in which, it should be noted, Bear Stearns' shareholders lost almost all of their money, and Bear Stearns employees lost their jobs) prompted other financial institutions in some difficulty (including Lehman Brothers, AIG and Washington Mutual) to raise additional equity and 'senior' debt capital.

But in September, the Treasury and the Fed followed the advice of the sort proferred by Weiss, and allowed Lehman Brothers to fail. Not only did those who had subscribed fresh capital after the Bear Stearns 'rescue' lose their entire investment; but money market funds who had bought Lehmans' short-term paper had their investments largely wiped out and in one notable case had to mark down the value of their assets to less than par, something which is not supposed to happen to a money market fund (cash management trust).

Similarly when the Treasury effectively nationalized Fannie Mae and Freddie Mac, and AIG, it extinguished the capital which had been recently subscribed to it, as well as that of much longer-standing equity- and debt-holders; the same result ensued when the Federal Deposit Insurance Corporation (with the blessing of the US Treasury) delivered Washington Mutual into the hands of JP Morgan Chase.

As a result, since mid-September, whatever willingness there was on the part of investors to supply additional capital to banks, or on the part of investors and banks to lend short-term funds to other banks, was totally eliminated.

On the other side of the Atlantic, confidence in the financial system was eroded by the ongoing state of denial on the part of European governments about the extent to which European banks were embroiled in the crisis, the inability of the European Central Bank to comprehend the impact which the crisis was having on the outlook for the European economy, and the inability – until this past weekend – of European governments to co-ordinate their actions, preferring instead to look after their own national financial systems oblivious of the effects of their actions on the options available to other governments.

Hence the juncture at which the global financial system arrived last Friday.

The melt-down over the past month was thus caused not by 'government intervention' *per se*, but rather by inconsistent and *ad hoc* government intervention which compounded the erosion of trust which had been caused by the revelations of massive losses arising from the previously-existing sub-prime mortgage crisis.

One of the unambiguous lessons of the history of financial crises is that they do not get resolved until the only entity with sufficient resources to supply the capital required to end them - namely, the government - puts its balance sheet "on the line" to do so.

And the history also shows that the more quickly and comprehensively this is done, the less it costs, the less will be the damage done to the broader economy, and the greater the chance that the taxpayers will eventually come out of it with a profit: contrast, eg, Sweden's rapid response and subsequent experience in the early 1990s with that of Japan in the second half of the 1990s.

The original Paulson plan (to spend US$700bn buying ‘toxic’ assets from banks and other financial institutions with very little Congressional oversight or accountability) was poorly conceived. It was too easily portrayed as a request to hand over mind-boggling sums of money to the people who caused the problem in the first place, among whom Henry Paulson himself used to work prior to becoming Treasury Secretary, and with no means by which taxpayers could share in any upside resulting from the success of the plan, if it indeed were to succeed. No wonder it was initially voted down, wasting valuable time and causing a further erosion of confidence.

By contrast, the plan conceived by British Prime Minister Gordon Brown, which involves subscribing sufficient capital to banks to allow them to write down the value of 'toxic' assets to something realistic (which may well be zero in many cases) without in so doing destroying their capacity to lend, and thereby giving the taxpayers a stake in any upside, whilst at the same time guaranteeing inter-bank loans and customer deposits (thereby stemming the 'investor run' on banks and forestalling a 'depositor run' on them) is much more soundly conceived and would appear to address the critical elements of the problem.

Indeed if it doesn't work, I struggle to think of what might.

It is of course true that governments in both the US and Europe will take on considerable volumes of additional debt in order to fund the capital injections - although the guarantees of inter-bank loans and customer deposits are contingent liabilities which, if the plans work, will not actually be crystallized.

Even so, the resulting levels of debt will not be at all unprecedented. US Federal debt held outside of federal agencies will likely increase from about 38% of US GDP at present to around 46% of GDP within six months. But that is actually less than the US had a decade ago, before the surpluses recorded in the Clinton Administration's second term began to push it down; and substantially less than the US had for around two decades after the end of World War II (indeed at the end of World War II US Federal debt was over 100% of GDP).

It is also less than the debt-to-GDP ratio of many European countries (recall that in order to get into the euro zone, under the Maastricht Treaty countries were supposed to have public debt-GDP ratios of less than 60%).

Yes it's true that there are unresolved, and potentially major, problems in relation to derivatives, credit default swaps and the like. But these problems will be easier to sort out now that governments have both such a large stake in the outcome and the capacity (where they have large ownership stakes) to be more directly involved in the processes by which those outcomes are sought.

Perhaps governments and politicians needed to catch a glimpse of the abyss into which the world financial system and economy were in danger of falling before they could be persuaded of the need to undertake such extraordinary actions as have been announced over the past few days. But I shudder to think of what the outlook might have been had they been unwilling to. This was not a choice between "good policy" and "bad policy". It was a choice between the unpalatable and the unthinkable.

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