

## 8 INTERVIEW NIALL FERGUSON

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## The view from Harvard

Massive deleveraging, a full year or more of recession followed by years of slow growth, high unemployment and wartime-like federal deficits.

It's hardly a cheerful outlook from Harvard academic Niall Ferguson, who presents a UK television series called *The Ascent of Money*.



And that's his best-case scenario. His forecasts do not bode well for most investments over the near term.

Ferguson is a professor of history at Harvard University and the William Ziegler Professor at Harvard Business School.  
*Interview by Eric Uhlfelder*



# Fixing the banking system is key to

**What element of the crisis has most surprised you?**

The scale of leverage and underpriced risk on banks' balance sheets. I was more conscious of household and government debt in thinking about possible problems, and not aware how vulnerable the banks were. Simply put, the world got lazy about balance sheets and more attention was being paid two years ago to hedge funds and private equity. There was an assumption that banks and investment banks must know what they were doing. I don't think I was aware how their leverage was creeping up. Did I say creeping? – racing up, and I don't think I was aware how they were juicing their returns through leverage.

**Describe what is most likely to happen to the US economy over the next five years**

The most probable scenario is a fairly bleak 2009, with unemployment reaching double digits and a full year of recession. This is likely to be followed by four years of slow growth as deleveraging works itself through the economy. But this scenario assumes the US can continue to finance a substantial part of its expanding deficits with the help of foreign investors.

If Chinese or Middle Eastern investors balk at increasing their purchases of treasury bonds, we could end up with a much more serious trough. This could

lead to my worst-case scenario involving the rapid decline of the dollar and rising long-term interest rates necessary to attract foreign capital. Higher rates are likely to choke off recovery.

At the same time, deflationary worries could then be replaced by inflationary fears, as the Fed's expansionary policies exceed its ability to contract credit.

Unfortunately, in either scenario, there is still the risk of a complete seizure of the banking system, suspension of new credit creation, an increase in corporate failures, rising unemployment and fresh waves of financial panic spreading across global markets.

But on a positive note, a big difference between the 1930s and today lies in policy, especially in the US where monetary and fiscal policies are aggressively expansionary. This wasn't the case in the 1930s.

**Is inflation inevitable given the exploding monetary base?**

It's not likely over the near term because the banking system is essentially absorbing this expansion, not widening the broader money supply, since there isn't much new credit being created. And there is a strong deflationary pressure coming from the recession.

**Can we expect lower employment?**

I certainly anticipate unemployment

above 10% over the year ahead. And if growth starting in 2010 is only about 1% for the next five years, it's hard to imagine how the US economy can create jobs the way it did in the past.

So we can certainly expect average unemployment over the next five years to be substantially higher than what we've been used to, something closer to European levels of around 8%.

**Does the potential scale of a stimulus package concern you?**

Yes. The current size of the federal deficit is at wartime levels. Without passage of any additional spending packages, Morgan Stanley estimates it to be about 12.5% of GDP. Under normal circumstances, such as the years leading up to the crisis, the US shouldn't have been running much of a deficit. This would've provided the fiscal space to better accommodate expansionary policies that wouldn't have threatened the overall integrity of the federal budget.

But now we must be mindful of how this deficit is perceived by foreign investors buying treasuries. We are running the risk that one day soon these folks may conclude, "hey, wait a second, the US Government is behaving like Argentina or Mexico, and the dollar is looking like some kind of peso".

If you get to that kind of sentiment, it can begin to eat away at your status as the world's reserve currency. Then your

government bonds lose the perception of risk-free assets, and the cost of funding your deficits is likely to grow much larger.

**Where should one be investing in this kind of market?**

Broadly speaking, I like Baron Rothschild's model portfolio weighting: one third securities, one third real estate, and one third art (personally, I'm nowhere near that allocation). But effective asset allocation is getting harder because it's difficult to find assets that are uncorrelated, which is the key to better portfolio and risk management.

Therefore, especially in today's challenging market, it's more essential than ever to be thinking at least a bit outside the box to achieve real diversification.

For a more specific look, it may be easier to start off by saying where I would not invest. It may seem counter-intuitive, but the prudent investor doesn't want to be too exposed to longer-term US Government bonds. At some point, there's going to be a shift in sentiment against these securities, and it could be that right now we are very close to the top in demand and price for the 10-year treasuries, which are yielding less than 3%.

I'm also bearish about European government bonds because I believe there is going to be a widening of

spreads, especially in the euro area.

Real estate will continue being a minefield, especially commercial property, which is just starting to get hit. This is not going to be a period in which I buy my Manhattan apartment. And I don't expect US real estate to bottom out much before the middle of the year.

As for commodities, I would be short rather than long. And longer term I believe the dollar is a horror show with a lot of currency volatility next year as US bond prices and currencies are repriced.

This in part makes a case for foreign exposure. The most compelling segments of the global economy at this moment are some of the emerging equity markets where valuations appear to be very cheap.

If there is going to be any meaningful growth at all over the next four or five years, it will be in China, its neighbours, and certain Latin American economies such as Chile and Brazil. I like these markets now. But I would avoid eastern Europe, along with markets that are exposed to above average political risk.

I also like some corporate bonds in fiscally prudent markets.

But whether it's stocks or debt, investors need to differentiate between various submarkets. Don't expect broad-based index exposure to work.

**Why is interbank lending still troubled?**

If the Bank of England estimates global toxic assets at \$2.8 trillion and recognised writedowns are only about \$500bn, everybody knows there's a lot more trouble to come.

And this makes the banks very wary of one another. It's as if the banks were men nursing very grave wounds, looking at one another wondering, "who's going to be the first to die". Not a great basis for long-term relationships or trust.

We will only see a return to healthy interbank lending when there has been a full and credible disclosure of losses.

We are a long way from that. And that's a very difficult conversation to have because such full and frank disclosure of market losses at this point is likely to destroy a very large number of institutions, I suspect.

So we are in a twilight world where

## The eurozone

**Until recently, the euro seemed poised to take its place as a reserve currency. What happened, and what is the outlook for the eurozone?**

With respect to common currency, there are two issues here. The first is the euro's strength over the past five-plus years was largely a mirror image of the dollar's weakness, more than superior underlying fundamentals of the eurozone.

The dollar's recent rally has been based on technical factors. But the second factor driving the dollar is the belief that the US still retains its status as a safe haven during this crisis, hence the flight into treasuries and surging demand for dollars to pay for them.

The euro's failure to compete with the dollar as a safe haven currency during the crisis doesn't really surprise me because there's no European fiscal union or common treasury. National governments are coming up with their own stimulus packages. So it's much harder for Europe (compared to the US) to co-ordinate a comprehensive response to problems caused by this crisis.

Regarding the outlook for Europe, I think early on Europeans were exaggerating how the crisis was primarily American. Now they are seeing a wide range of really ugly problems coming their way, and not all are being imported. Moreover, I think the banking crisis is actually worse in Europe than it is in the US. It's just not as widely recognised yet. But it will be. Europeans don't have the policy levers, like those that exist in the US, to respond as rapidly or as effectively. In the long term, Europe may suffer worse than the US during this crisis.



# INTERVIEW WALL FERGUSON

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## global recovery

the full scale of the damage on balance sheets is being repressed.

**Do you think extraordinary bailouts will harm our business system over the long run?**

In normal circumstances, the US bankruptcy system works effectively to allow insolvent firms to restructure and get back on their feet. But now that would be very hard to do. So temporary extension of credit is understandable. You don't want major industries to collapse on the cusp of a major recession.

But over the long term I worry about the suppression of the evolutionary process with government assistance preventing failure and consolidations from taking place to clear out the debris and pave the way to healthier markets. Intervention could delay the inevitable, protracting the suffering.

Creative destruction has its place. But if everyone but Lehman Brothers is too big to fail, then we aren't in a good place.

I'm not happy with the terms of the Citigroup deal. It's too open and more guarantees may be needed. Someone described it as one of the biggest option trades in history.

The Government is writing blank cheques based on the belief that bank management knows what they are doing. Unfortunately, I'm not certain of that. The conglomerate financial model Sandy Weill conceived hasn't worked. And I would be amazed and seriously depressed if Citigroup remains in its present form 12 months from now.

We need a serious restructuring in the US financial sector. So one of the most important jobs of the incoming administration is to come up with an approach that's different from the blank cheque model.

The good news is that there are a number of up and coming banks that are smaller and not so leveraged and which can step up and start filling in the spaces vacated by the larger, more troubled institutions. I still have some faith in the powers of the US to renew itself.

But ultimately, what we can achieve from the money being injected into the system is only the avoidance of massive bank failures and monetary implosion.

Broadly speaking, we can't breathe life back into the dinosaurs. But we are trying to make their death as painless as possible.

**Should governments be thinking about a global approach to saving global companies?**

That's an interesting question. Co-ordination would be the key. And towards that end we would need a world finance organisation, something akin to the World Trade Organization, which could make independent decisions that its members had to honour.

Presently, the International Monetary Fund can only help at a country level.

The big problem is that the more parties involved, the more challenging are the negotiations.

Any one nation already has to balance many interests, such as investors, bondholders and employees. Just imagine multiplying these concerns across various borders.

Look at the Lehman collapse. There was a wide perception in London that the UK operations were simply "screwed" by the firm's US executives in the scramble to recoup what was left. Every last dollar ended up in New York, leaving London dented.

But in early December, we saw General Motors and Ford approach

Sweden for aid for their Saab and Volvo divisions, respectively. Perhaps corporations will start this globalised approach on their own.

Big picture: despite what may seem logical as a way to deal with global problems, the quickest action for the time being is likely to evolve from corporate home markets.

**What benefits may come from the crisis?**

The silver lining may be that we are given the opportunity to rethink the US monetary system – both monetary policy and bank supervision – along with the basis of growth. The theory that the Fed exists purely to control consumer price inflation and to prevent the stock market from cratering, which I would call the Greenspan Doctrine, has shown its limitations. So has the belief that banks are best off if left alone to do what they like.

It's also time to reconsider if the role of the patriotic American is first and foremost to shop. I remember that was Bush's message after 9/11, and I thought it was kind of kooky back then.

The ultimate soundness of any economy is rooted in the productivity of its human capital, not a function of citizens leveraging themselves to unsupportable levels of consumption.

## The Obama effect

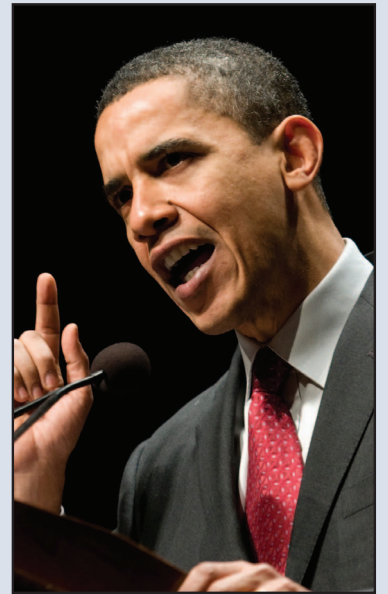
**In broad terms, what should President-elect Barack Obama do?**

Popular sentiment is that he will launch another huge fiscal stimulus. But there's a danger in this strategy because the Federal Government already took on \$8 trillion in investments, loans and guarantees issued over the past year.

It won't be long before we are looking at the potential doubling of the federal debt. And I'm concerned that we are underestimating the international ramifications of this trend. National markets are far more open and interrelated than they were just decades ago. Therefore, we need to pursue policies that are globally co-ordinated, especially between Beijing and Washington.

As for a traditional stimulus package that involves issuing cheques to households, that may not work because I'm not sure if people will spend this additional income. They are most likely to save it. We should be mindful that there is stimulus occurring from the sharp decline in commodity prices and nominal wage growth.

Most important, we must forget about trying to restart the formerly high levels of consumer-driven growth, because so much of it over the past seven years was based on credit. If you take away mortgage-equity withdrawal from 2001 to 2006, growth would have averaged only 1%. Households must first improve their balance sheets, as it were, before



**Obama: danger in strategy**

we can expect consumer demand to again contribute substantially to economic growth.

This suggests that Obama may be more successful if he targets government resources less on trying to stimulate consumer spending and more on infrastructure improvement that would enhance productivity and broader-based economic growth. It may be that Obama needs to focus more on the medium term rather than the short term.

The age of leverage is over. The race will go to the productive, and investments in education, technology and clean energy will pay more attractive returns than endless Wal-Marts. Hopefully, the crisis will drive home this point to policymakers.

**Looking ahead, what concerns you most?**

The banks, the Fed and the dollar. When the discussion in the US shifted to the automobile industry, I started laughing because it was such a distraction from the main issue.

We've got a financial crisis, and everything else that's happening is a consequence of that. Every company in the country is going to have problems if our banking system collapses. Until we fix the banking industry, anything else we focus on are symptoms.

The balance sheets of the very biggest banks in the US and Europe have been a nightmare for a year and only recently have people woken up to that. There's still denial about how big the problem is. And here's what makes

things surreal: we are seeing the monetary base explode, but with very little to show for it, as banks seem to be just swallowing up all this capital.

Now about the Fed. As long as global markets continue to treat the dollar as the world's reserve currency, the Fed will have room to manoeuvre. That room, however, is not limitless.

There will come a point when the credibility of the Fed's policies will be called into question, along with the dollar itself.

As I mentioned at the beginning of the interview, any significant move away from the dollar before this crisis is resolved could then lead to a very unpleasant scenario where foreign lenders, seeing their investments rapidly diminish in value, sharply curtail their lending.

This would force interest rates up to attract deficit financing, which in turn would choke off recovery.

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## The price of gold

**Should we consider returning to the gold standard?**

For some folks there is a certain nostalgia in considering this during a major crisis. I have trouble imagining how the world economy with \$50 trillion could be put back into gold given the relatively modest amount of the metal available to central banks.

Gold is just a commodity. It's good for jewellery and it's a relatively good hedge against inflation and bank panics. But the notion we can re-engineer a gold standard is based on a naïve reading of history. The gold standard was not a Garden of Eden. Its supposed heyday, between the mid-1870s and mid-1890s, was a time of global deflation. There was an even more deflationary period during the 1929 and 1931 when the standard basically broke down.

The last thing we need during a time of high deleveraging is a deflationary global monetary system. That would be suicidal.

