The 2010 view from Harvard

At the beginning of 2009, Harvard professor Niall Ferguson told Financial News that fixing the banking crisis was key to putting the world economy back on an even keel.

A year on, and he has seen little evidence that governments have done enough on that front. He remains deeply concerned about the banks and the astronomical debt that the US is piling up. Indeed the focus on fixing the symptoms of the financial crisis, rather than the illness itself, has left the world as vulnerable as it was a year ago.

Interview by Eric Uhlfelder

‘The system is not only unreformed, but actually worse than before’

The Financial Crisis

How does the world look to you as we start a new year?
I guess we sort of avoided Great Depression 2.0 but I wouldn’t say we are out of danger. We’ve applied the theories of Milton Friedman and John Maynard Keynes, but they’ve only addressed the symptoms of the financial crisis, such as bank failures and credit contraction.

The structural causes of the crisis remain in place. They are excessive bank leverage; bond markets contaminated with AAA-rated toxic assets; the reckless insurance of financial risk; excessive economic incentives to increase home ownership; and China’s huge credit line to the US and its currency policies.

Change in US behaviour could potentially mitigate the impacts of these structural weaknesses. But has it?
Households have begun to deleverage, and there are signs of increased savings. But financial sector behaviour seems to have scarcely changed. In London and New York everybody now comments that it’s not only business as usual for the survivors, but business that’s better than usual, thanks to money that is essentially free when you borrow from the Fed.

Thanks to the Troubled Asset Relief Program, you got bailed out when the going got really tough, and could then repay that money and be free of special government stipulations. And the show goes on. So the system is not only unreformed but actually worse than before, and I think that is a major cause for concern. In not having addressed the underlying issues, the same problems will happen again.

Is it too late for the government to take a different approach to the crisis?
It’s getting hard to think of doing now what should have been exacted from the banks when governments on both side of the Atlantic were handing out money. We missed the opportunity to say to them: “You get bailed out now, but after this crisis there will be a different set of rules.”

Politicians are still looking at the symptoms: bonuses, executive compensation, and incentives. I think this focus misses the point completely.

How well have quantitative easing, the stimulus package, Tarp and the Public-Private Investment Program worked?
With monetary policy, one must give credit to Ben Bernanke for responding boldly and swiftly to the prospects of a major financial system collapse. I think future historians may say that perhaps he went too far. But he would likely counter that it was better to go too far than not to go far enough, which was the case with the Bank of Japan after 1989.

The benefits of this fiscal stimulus might very well be outweighed by the costs, especially now that people are asking whether it is indeed credible for the US to be borrowing $1 trillion annually for nine years and never run a balance budget again as far as the eye can see, out to 2079.

I think Keynes would have said, “you guys are already in a big fiscal hole, and digging it even deeper might not help you”.

Tarp had to mutate into a recapitalisation programme because banks weren’t willing to sell their troubled assets at credible prices. Rather than reveal these assets were insolvent, the banks just decided that they simply wouldn’t sell. That’s also why the Public Private Investment Program died an ignominious death. That tells us that something is still badly wrong with the balance sheets of some of these banks.

How should we deal with the debt problem?
I’m enough of a supply-sider to believe radical US tax reform will encourage growth. We need to make the system more efficient, less cumbersome, and less distortionary. A flat-rate income tax of around 25%, a significantly lower corporation tax, and a value-added tax of 7.5% to 10% would seem the best ways to achieve that.

We need to shift the burden of taxation away from income, away from profits, and more onto consumption. This can speed fiscal recovery. But I fear we are adopting precisely the wrong measures to achieve that end.

Will the US see meaningful regulatory reform?
At the moment, I’m quite pessimistic. There doesn’t seem to be any stomach for radical reform of too-big-to-fail institutions and the rating agencies seem to be getting a pretty easy ride as well. I hope the Fed will not only retain its relative independence from Congress, but will also have a clear responsibility to maintain systemic stability and powers over issues and institutions that threaten US economic stability. I’m in favour of a return to powerful central banks rather than the creation of some new super agency that can say to institutions: “You must stop doing what you’re doing or else you’re going to get penalised.”

However I don’t buy the argument that more regulation will fix the problem. It may be forgotten that it was the most highly regulated institutions that caused most of the trouble: commercial banks and Fannie Mae and Freddie Mac.

The most important thing is to understand what went wrong, identify what were the major regulatory failures, and then fix them. But that kind of clarity of thought is not, it seems to me, much in evidence in the moment.

There are some honourable exceptions. I think Lord Turner, chairman of the UK’s Financial Services Authority, has done a very good job in analysing the crisis and proposing remedies. However, there is a lot less quality in the publications that have emerged from the US government since the crisis began. That’s interesting, because of all the economies, the US needs to be the one that thinks hardest about this.

To windfall tax or not to windfall tax, that is the question

Should the US consider taxing excess profits and bonuses of financials [like the French and British are doing]?
I have no problems with temporary windfall taxes of this sort. Banks benefited from the bailout. But enacting such policy is largely a populist measure.

The possible amounts realisable are trivial in relation to trillion-plus dollar deficits. It is a way of penalising the too-big-to-fail institutions so that they know that they can’t do this again with impunity.

But if there isn’t similar treatment internationally, we could end up seeing major financial centres competing to see who can offer bankers the best deal.

The next crisis?

Could a serious decline in the commercial real estate market create a second banking crisis again requiring major government intervention?
A good chunk of dodgy commercial real estate debt in the US is due over the next six to 12 months creating two kinds of problems: the debt itself, and the impact on public finance.

Abroad, if governments have essentially said that we will bail out our big financial institutions, then the former will start to lose financial credibility.

Dubai is first, Greece is next, Spain is not far behind. Iceland showed the way. People are now asking questions about the UK. This could very well be a key part of the financial story that evolves in 2010. On a slightly more positive note, the market, which had been living in cloud cuckoo land about where residential real estate prices could go, will not be caught off guard with the next round of real estate defaults.


Warning sign: real estate is key to recovery

Who would get most hurt in the US?
US regional banks are likely to be the institutions most exposed to a commercial real estate collapse.

The fate of these too-small-to-save banks will be a key indicator of future economic conditions. It's quite likely that up to 1,000 banks will fail over the next six to 12 months because of commercial real estate loans going bad.

That's really ugly because local and regional banks are the sources of credit to small businesses, without which we can't expect much of a recovery next year.

Is moral hazard more of a problem than before?
A big concern is that moral hazard, which was a problem before the crisis, is now absolutely systemic and endemic, and the too-big-to-fail institutions that survived the crisis now have a licence to print money since they have an implicit, well actually explicit, government guarantee that if anything goes wrong, they will get bailed out.

And all they really have to do is be contrite in public. They can pay whatever bonuses they like in the US, as long as they do it in a way that's ostensibly self-effacing.

How well or poorly has Europe done responding to the crisis?
I think the Bank of England has shown great intellectual clarity but less political savvy. The Financial Services Authority has done an extremely good job. And in Lord Turner it has found a very articulate spokesman for quite radical reform.

I think the European Central Bank has done a reasonably good job after initially misreading the situation. I think the problem of enormous fiscal imbalances is very clear.

Countries like Greece, Spain, and Ireland, which are running enormous deficits, are going to struggle because they have no monetary room to manoeuvre. Europe's problem is that it doesn't have an integrated fiscal policy. And I think we are going to see more difficulties arising from that in the year ahead.

The ECB's budget is too small to prop up troubled countries. The Europeans simply don't have a mechanism for dealing with the problems that emanate from having an integrated monetary system but not an integrated fiscal system. There isn't a way to transfer resources fiscally from one state to another. This is going to cause real difficulties.

What are your thoughts on what's happening in Dubai?
Dubai was always the most leveraged play on real estate. Other parts of the Gulf are less reliant on real estate, deriving a much greater percentage of their wealth from oil.

With oil prices relatively higher than most people would have expected a year ago, the situation in the region as a whole is not too catastrophic. And if political risks increase, so should the price of a barrel of oil.

You would like to see the relationship between China and America, which you label Chimerica, to be altered because of imbalances it has produced. Are there any reasons why the Chinese would be willing to change the status quo?
Contrary to some popular sentiment, the continuing decline of the dollar will not sway China's currency policies. China's vast US Treasury assets represent only about 5% of the government's total wealth. So the loss on its dollar reserves through any subsequent revaluation of its currency would be completely overshadowed by the gain in the value of China's renminbi-based assets.

Currently, China's currency peg to the dollar makes the country's exports the cheapest in the world, helping it to generate 10% growth. So the government will continue accumulating treasuries to sustain that peg for some time to come. For China, the system works.

For the rest of the world's exporters, it's a very painful state of affairs. That's why there is a need to seriously alter the present relationship. With the peg to the dollar keeping Chinese exports ridiculously cheap, and with China providing vast amounts of liquidity to the US, I don't think that it's desirable for Chimerica to persist as it's presently constituted.

I think the Chinese will keep the peg until they feel confident that they can risk an upward move in the value of the Renminbi. Then the currency's value would be likely to shift to a basket of currencies.

Are you concerned about any particular geo-political strains that are being felt from the crisis?
Yes. First, economic crises tend to intensify existing geo-political problems because they throw young men out of work, and the devil makes work for idle hands. Don't expect radical Islam to decline in 2010; it will probably gain new adherents.

Second, the pressing need for co-ordinated international response to Iran's nuclear programme is not likely to be met because odds are China and Russia won't sign off on really tough sanctions. And I think the Israelis will continue to plan their own unilateral action, which will be very difficult indeed for the US to ignore.

So I think 12 months from now, the geopolitical problems are probably going to be near the top of our agenda, far more so than they currently are.

Are you concerned that the markets are still vulnerable to another massive selloff?
Using an historical analogy, we are in late 1931, having avoided the summer of 1931 banking crisis. But I wouldn't be surprised to see a downward move in equities as we get more stories about bad debt, more defaults, and when consumers sleepwalk their way through the holidays.

However, with the way Fed policy is set up and with the administration flailing around trying to think of new ways to stimulate the economy, I'm expecting both growth and equity prices in 2010 to remain basically flat.

What is the outlook for the major western currencies?
The dollar is an interesting sawtooth story. I think we'll see it continue to weaken over the medium term, but there will also be periodic rallies over the short term, depending on investor sentiment as people scramble for liquidity every time there is a bit of bad news. I think it would be reasonable to think that by the end of 2010, the euro-dollar will be closer to $1.60.

Given the volume and the depth of the euro zone market and the European Central Bank being a relatively independent institution, I think the euro will hold up well against the dollar. It may do even better against the pound over the near term.

I think the problems in the UK are extremely disturbing. There will be an election next year that will add more uncertainty to the picture.

If there isn't a clear Conservative victory, then I don't feel happy at all about the prospects for the pound. If the Tories get in and stick to what they say, then the pound may strengthen.

But there will be a lot pain along the way because the UK fiscal crisis is very bad. If we end up with a hung parliament or even a narrow Labour victory, then I'll be selling all my pounds.

What are your current thoughts on investment allocation in terms of asset class and geographical exposure?
I think the old rules of diversification still apply. I don't think you want to be too long the dollar or the US equity market. I think there are lots of other opportunities out there. Right now, I prefer Australia and Canada to the US. You would want indirect, not direct, plays on China. So discern which of its trading partners are doing the best.

Since the spring, we have probably seen the top of the commodities boom. Gold, I guess, is kind of over as a story right now.

Overall, I am nervous about the prospects of bad economic news in the US or from places like Dubai. I wouldn't want to be holding Treasuries because of the fear of upward rate moves or have too much exposure to the S&P 500 because I don't see fundamentals driving greater upside. There is the possibility that a string of negative news could cause quite a number of markets to take a hit.

I can't over emphasise the need for being cautious right now. I would be underweight both equities and debt, and shift to a 50% cash strategy held in multiple currencies, including the Canadian and Australian dollars.

I think Brazil will continue to offer good news. It's still in an early stage of transition into being a major economy.

I'm getting more excited about India, which has many of the advantages the Chinese don't have. It's not the most streamline legal system in the world. But the rule of law prevails, and there are private property rights.

As India's infrastructure continues to improve, I think there is a lot of upside in the next few years. Plus, India is much more of a domestic demand story. It's less reliant on exports than China, and it's an easier market for foreigners to get into.

As mentioned, I like Australia and Canada, where in both cases you don't have the public debt risks that you're seeing in a number of other developed markets. And its banks have escaped the crisis largely unscathed.

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Obama, one year on

Has Obama's economic team of Tim Geithner, Larry Summers and Christina Romer lived up to your expectations?
These are some of the best qualified and smartest people in the business. We've seen a very intelligent assessment of macroeconomic problems in terms of the big picture and a successful effort to learn from the mistakes of the 1930s to avoid another depression.

But there has been an almost laissez-faire attitude toward the too-big-to-fail problem. I find that puzzling because I'm quite sure these people are intelligent enough to know there is something amiss with the system. It's seems they are very reluctant, for reasons that aren't entirely clear, to tackle these problems.

If you had Obama's ear, what two points you would want to whisper into it?
One, bring the federal budget back into balance over the next 10 years. To do so, you should be seriously considering a value-added tax on the sale of goods and services [at a lower rate that is common in Europe] to avoid increasing income and corporation taxes.

Two, get ahead of the debate on banking reform. It's too important to be treated as a minor issue, which it appears to be at this point.