SPECIALFX

BROWN BROTHERS HARRIMAN

10 October 2008 www.bbh.com/fx

Anatomy of Crises

Over the least several decades, economists have generally focused on growth. It became unfashionable to study crises. This will likely change going forward.

There are two main schools of thought about modern crises. The first camp, the more orthodox one, sees the causes of crises being exogenous to the market itself. Some external force interrupts the expansion that capitalism will naturally produce. You know the suspects. The Federal Reserve tightens too much. Workers resist downward pressure on real wages, which cannot then find a clearing price. Politicians sometimes propose policies that retard growth. There are also wars and natural disasters that could throw an economy off its growth trajectory.

The second camp suggests that business cycles are like people. They don't have to be murdered. They can die of old age. That is to say that the causes of the end of a business cycle, which is when crises materialize, are planted during the upswing. Crises are thus endogenous to the market economies.

The second camp itself has two factions. The most popular faction now is represented by Hyman Minsky. He argued that in democracies, politicians seek to deliver prosperity: full employment, rising equity markets, rising asset prices. But a prolonged period of that fosters what Minsky called "balance sheet engineering" and speculative euphoria.

Sustained low volatility in and of itself encourages increased risk taking that often leads to unacceptable levels. Minsky located the source of crisis within a self-reinforcing dynamic of speculative finance, with decreasing debt quality leads to economic instability and crisis (an acute form of instability). "Periods of stability (or tranquility)", he wrote, "of a modern capitalist economy are transitory." Stability leads to instability. It may not be Aristotelian logic, but there is logic to it nonetheless.

The other faction of endogenous causes of capitalist crisis views the key problem as one of surplus capital. The economic elite are so successful at accumulating capital that it leads to excess investment. It leads to redundant investment; over-production and downward pressure on prices as the supply of goods exceed demand, which threaten to drive prices below the cost of production. Owing to the high ratio of fixed (to variable) costs in the modern enterprise, businesses face little choice but to produce at a loss, which in turn exacerbates over-production and eventually produces failures, concentration, and consolidation that gets rid of the excess capacity.

As a result, this faction (although of course it is not nearly as homogenous as it is being depicted here for explanatory purposes) sees capitalism as permanently in crisis. It is constantly transforming the labor process and revolutionizing production. Even though there is much interest in "sustainable development", this faction argues that capitalism itself (not just finance) is unsustainable by its very nature. There is a nearly constant oscillation between booms and busts. There is a profound supply and demand disequilibrium that is bridged by debt. It is here that this second faction can make room for Minsky's minions.

While there is plenty of blame to go around for the current financial crisis, the point is that financial crises or the threat thereof, happens too frequently to be simply attributed to moral defects in a few of the culprits. It needs to be understood from a deeper systemic level.

Where We are Now

The current crisis is about 14 months old and only in the past couple of weeks has the situation become sufficiently dire to impress upon officials a sense of urgency that until now was most notable in its absence. Policy makers in the US, but increasingly elsewhere, are moving to deal with the crisis as a crisis and not simply as this or that bank failure.

Marc Chandler	212-493-8800
Win Thin	212 493-8361
Meg Browne	212-493-8744
Audrey Childe-Freeman	44 207 614 8791

This crisis poses four major challenges. The first is insulating the real economy from the chaos in the financial markets. This can be achieved by a combination of fiscal and monetary policy. The coordinated rate cuts and the additional cuts that are likely to be delivered will help in this regard, but don't forget about the lagged effects. Direct fiscal policy to support aggregate demand may also be increasingly employed. Although some of the deregulation of the last 20 years has undermined some New Deal-type of institutions, a few programs, like unemployment insurances and social security, may help support aggregate demand.

The second challenge is getting the bad assets off the banks' balance sheets. In addition to the US TARP, some other countries are also moving in a similar direction. Essentially, the government will warehouse the distressed assets on the idea (and hope) that many of these assets have value if they can be held to maturity. The government is the only agent that has the luxury and cost of capital to allow it to perform this function.

The third challenge is to recapitalize the banks. The UK's purchase of preferred shares is one way to do this. Another way that has been proposed by former US Treasury Secretary Paul O'Neill (an early casualty of the Bush Administration) is for the US to issue non-marketable Treasuries to the banks. The interest rate on these bonds might be set a little above the prevailing rate on marketable securities to induce an early pre-payment. But in the meantime, the bonds would be counted as part of the bank's core capital.

The fourth challenge and the one that ultimately may prove the most difficult and that is rekindling the "animal spirits" of risk taking. The excess capacity in the global financial industry had been masked in recent years by the mis-pricing of risk. The financial wreckage has triggered a violent swing in the pendulum and has soured the appetite for risk. Of the four challenges, this one is the hardest to get one's hands around. Even if the other challenges can be addressed, which is no mean feat, it is not clear what steps are needed to spur on more healthy and prudent risk-taking. Perhaps it is like getting one's heart broken. What it takes to heal the scars is not obvious.

Broken Cash Register

There still seems to be a tendency to blame the United States for this financial crisis, much in the same way that it was blamed for the Great Depression. Yet if the students of crises are right, it is better to understand that capitalism is a global system and no one, regardless of the regulatory environment or level of disdain for hedonistic consumer-oriented immediate gratification behavior patterns, is immune from the downside of the cycle.

If banking and finance was the cash register or the engine of capital accumulation for the past decade or two, it is not clear that the outcome of this crisis will simply repair that broken cash register. It is not clear what the new cash register will look like.

Despite the financial loses everyone is experiencing; one of the most disturbing features of crises is the political fallout. The Great Depression brought us fascism, Stalinism, and of course WW II. This financial crisis is of sufficient proportions that we should expect some political repercussions. Let's hope there are some lessons we have all learned.

Marc Chandler
Global Head of Currency Strategy