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News Analysis: A lesson rooted in the Great Depression

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FRANKFURT: Will future historians write about the Great Depression of the 2000s as they did about the one in the 1930s? The world's central bankers sought to answer "no" Thursday – resoundingly, though not definitively.

With a huge infusion of cash, the U.S. Federal Reserve, joined by its fellow central banks around the globe, unleashed their most forceful volley of financial firepower yet. The goal was to persuade a convulsing banking system that there will be no shortage of money to meet essential obligations, now or in the future.

The \$180 billion in additional funds they committed Wednesday was only the start.

That is in sharp contrast to what happened in the 1930s when the Fed stood idly by as waves of defaults drained money from the banking system, starved the American economy of credit and eventually dragged Europe down as well.

This time around, central bankers are purposefully searching for strategies to avoid that chain of events. And unlike the approach in the 1930s, it is a global effort, driven by a close-knit community of central bankers who are aware that the mistakes of the Depression era erased their credibility for years afterward.

"The need to avoid that next depression plays a big role in U.S. policy making," said Paul de Grauwe, a professor of international economics at the Catholic University of Leuven in Belgium. "But it is also present in Europe because we have experiences with bank crises in a number of countries. It may not be as intense, but it is not absent."

The chairman of the Fed in the 1920s, Benjamin Strong, foresaw the potential for a banking crisis that would interrupt lending and he was one

of the few Americans to understand that financial ties between the United States and Europe made the problem a global one.

The solution, in his words, was for central banks to "flood the street with money."

Strong died in 1928, too early to experience the monetary dystopia that followed when the Fed reined in lending in response to the stock market crash of 1929. The other half of Strong's scenario came true in 1931, when a run on the Austrian bank Creditanstalt grew into a European banking crisis that U.S. banks then amplified by calling in loans to Germany and other countries.

The banking system today is deleveraging, the inelegant term for what happened with catastrophic effects in the 1930s. Banks have to shed losses linked to the lifeless U.S. housing market and recapitalize, either by attracting new investors or by selling themselves to stronger institutions, so they can resume lending.

This process sometimes turns out badly: Lehman Brothers is a recent addition to the list, and Washington Mutual, the largest savings and loan in the United States and once among the most successful financial institutions in the country, is talking about selling itself to a stronger bank. That is why even healthy banks hoard cash in a crisis.

Events took an ominous turn Wednesday when it became clear that even money market funds, repositories for savings of as much as \$3.5 trillion, were scaling back their lending to be sure they could meet any demands from customers for their money.

That approached the 21st century equivalent of stuffing cash under mattresses for safekeeping – exactly what President Franklin D. Roosevelt urged Americans not to do during the Depression. The credit ecosystem functions today by channeling savings from individuals and into securities issued by, among others, precisely the same banks whose future seems so dark.

Every barometer that measures the willingness to lend went haywire by midweek, notably Libor, a benchmark borrowing cost that influences lending around the world. Returns on ultrasafe U.S. Treasury notes plunged as money sought a haven, an experience that left even seasoned professionals grasping to comprehend the magnitude of distrust.

"There is a complete lack of confidence," said Jim O'Neill, chief economist at Goldman Sachs in London. "It's the most extreme since the credit crisis began."

The cash infusion announced Thursday will function via an exchange of various currencies for as much as \$180 billion from the Fed, with most of the share taken by the European Central Bank. That money will then course through the banking system, allowing commercial banks to borrow more easily from each other and their central banks.

Most crucially, and unlike what happened in previous coordinated cash injections, the Fed, the ECB and other central banks explicitly promised to continue the infusions as long as money markets were in turmoil.

After the terrorist attacks on Sept. 11, 2001, the Fed lowered its benchmark rate to 1 percent and promised in advance to keep it there indefinitely to create a security blanket of continuous credit. The strategist behind that step – Alan Greenspan, then the Fed chairman – is now widely blamed for keeping money too cheap for too long, inflating the real estate bubbles whose bursting is now wreaking so much havoc in the United States and elsewhere.

The current corps of central bankers wants to avoid a similar permanent expansion of the money supply, while keeping cash flowing through banks and into the rest of the economy.

The move Thursday creates a globally administered line of rolling credit whose terms can be slowly tightened, via higher interest rates and lower lending volumes, as banks recapitalize themselves and confidence returns among lenders and borrowers. That prospect preserves a stick for central bankers to use on banks that do not heal themselves.

"They are playing a very delicate game of chicken," O'Neill said. "And they are doing a pretty good job, under very difficult circumstances."

Will it work?

One lesson of the past year has been that the crisis of tomorrow stems from risks that were unseen today. That is one reason why O'Neill and other analysts expect further unorthodox moves from central banks and other officials who know what they want to do – keep credit flowing – but have proved flexible about how to do it.

But their success rests with the banks themselves.

Raising money to rebuild a capital cushion requires issuing new stock, merging or selling big stakes, moves that are rarely popular with existing shareholders even in the best of times. And chief executives often lose their jobs taking such painful steps.

Yet they are necessary before financiers can return to their normal job of lending money to grease the wheels of commerce.

"They are not acting like banks these days," said Charles Wyplosz, director of the International Center of Money and Banking Studies at the Graduate Institute of International Studies in Geneva. "They are acting like besieged fortresses."