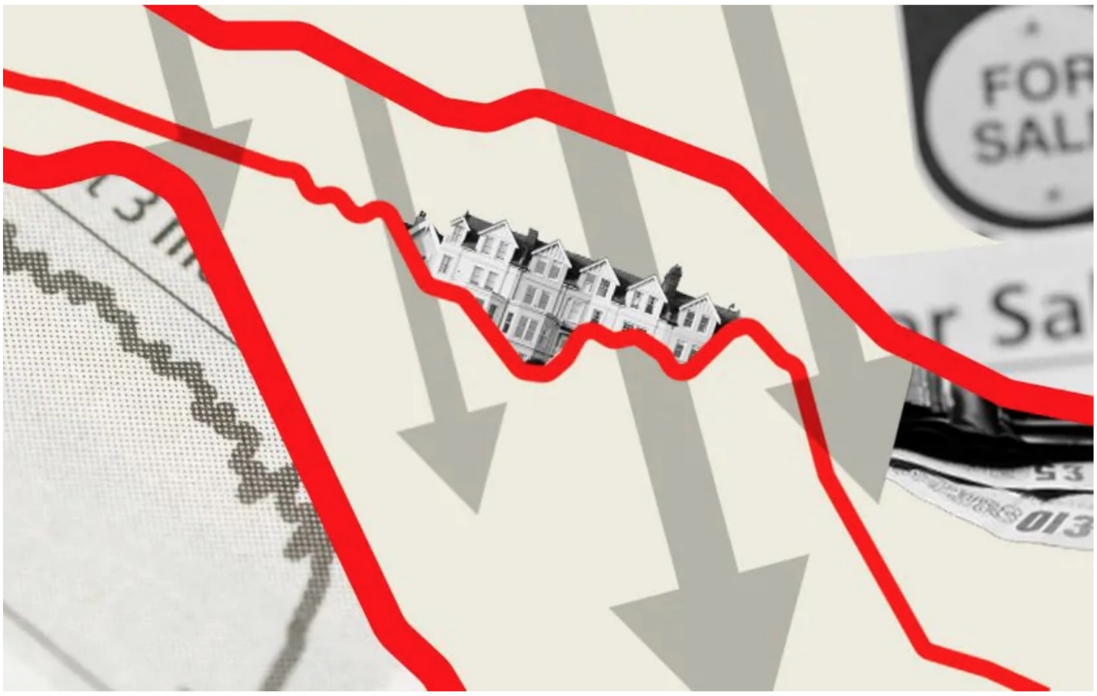
The next downturn could rival the Great Depression and wipe $10 trillion off US household assets



The banks may be safer today but the debt-drenched world economy is even more fragile than it was in 2008, and political solidarity has collapsed

By **Ambrose Evans-Pritchard**

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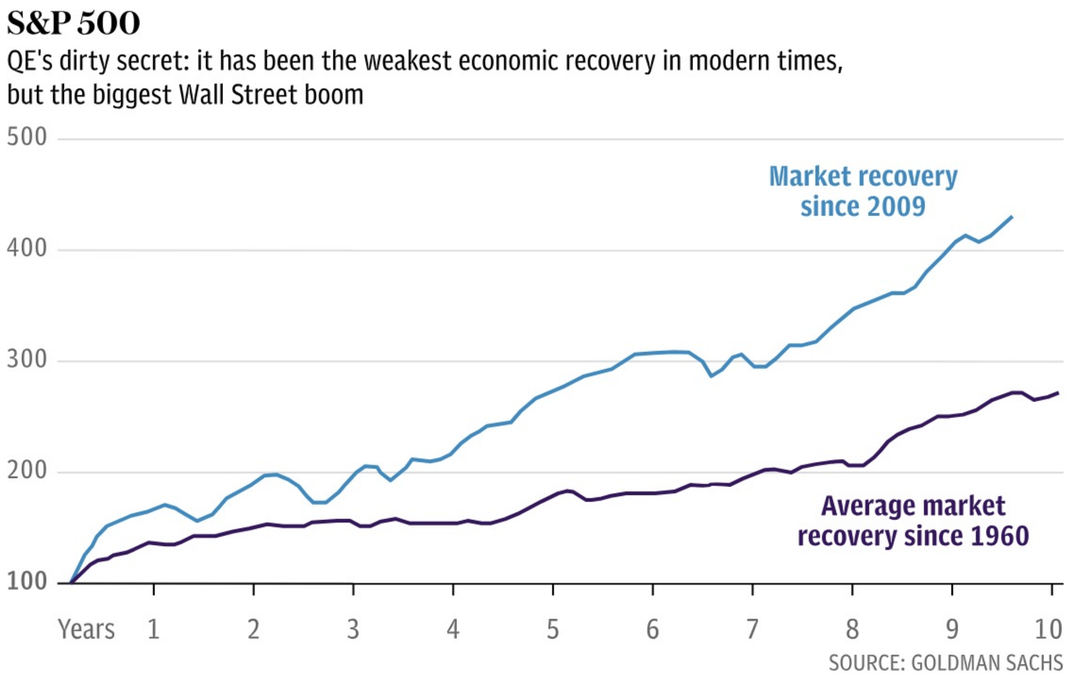
The world's major economies are skating on dangerously thin ice and lack the fiscal, monetary, and emergency tools to fight the next downturn.

A roster of top crisis veterans fear an even more intractable slump than the Lehman recession when the current ageing expansion rolls over. The implications for liberal democracy are sobering.

"We have no ability to turn the economy around," said Martin Feldstein, President of the US National Bureau of Economic Research.

"When the next recession comes, it is going to be deeper and last longer than in the past. We don't have any strategy to deal with it," he told The Daily Telegraph.

Professor Feldstein, a former chairman of the White House Council of Economic Advisors, described a bleak scenario more akin to the depressions of the 1870s or the 1930s than anything experienced in the post-War era.
He warned that a decade of super-low interest rates and monetary stimulus by the US Federal Reserve has pushed Wall Street equities to nose-bleed levels that no longer bear any relation to historic fundamentals. Stock prices will inevitably come plummeting back down to earth.

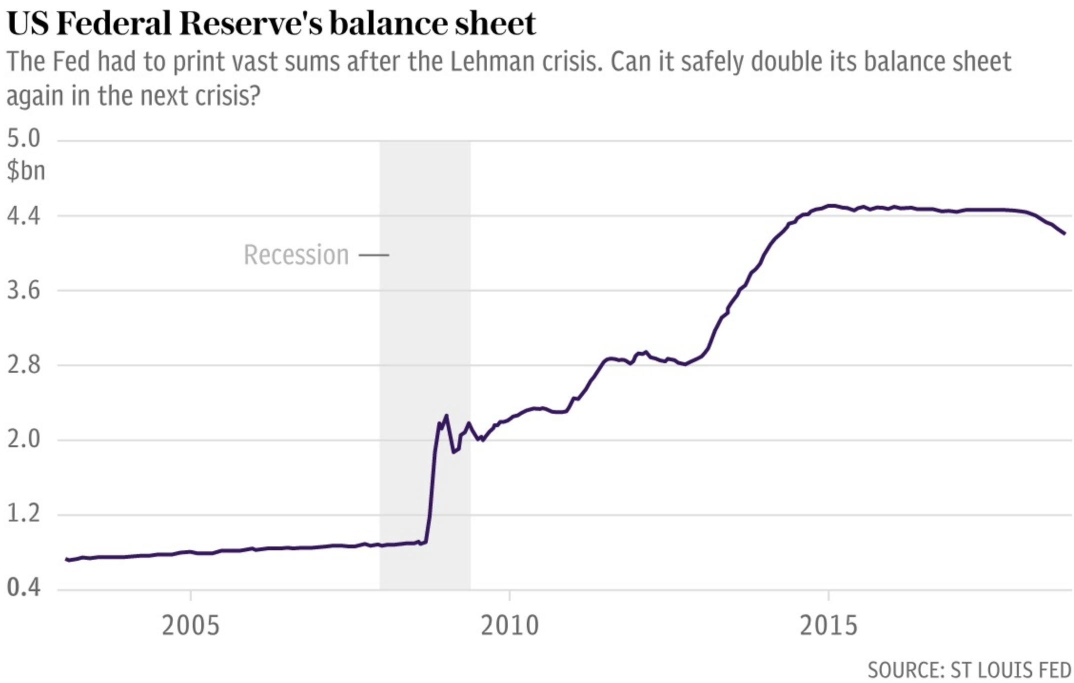


Prof Feldstein said the next bear market - most likely triggered by a spike in 10-year Treasury yields - risks setting off a $10 trillion crash in US household assets. The cascading 'wealth effects' will drain the retail economy of $300bn to $400bn a year, causing recessionary forces to mestasasize.

"Fiscal deficits are heading for $1 trillion dollars and the debt ratio is already twice as high as a decade ago, so there is little room for fiscal expansion," he said, speaking earlier on the sidelines of the Ambrosetti forum on world affairs at Lake Como.
The eurozone faces an even worse fate when the global cycle turns since the European Central Bank has yet to build up safety buffers against a deflationary shock. The half-constructed edifice of monetary union almost guarantees than any response will be too little, too late.

"The Europeans don't have a fiscal back-up. They don't have anything. At least you have your own central bank and treasury in Britain, so you will be happier," he said.

“Mario Draghi is going to be very happy when he has left the ECB because it is not clear how they are going to get out of this when they still have zero rates. They can’t play the trick of the cheap euro again,” he said.
It is striking that bond yields are still negative on maturities of five years or more in Austria, Belgium, Finland, Germany, Ireland, and the Netherlands (though not in France any longer, interestingly). This is evidence of a profound structural malaise.



The ECB has already pre-committed to holding its reference rate at minus 0.4pc until late 2019. By then the global economy will be acutely vulnerable since the sugar rush from Donald Trump’s tax cuts and infrastructure spending will have faded.
The US is entering uncharted and perilous waters. The jury is out over whether it can - in extremis - follow the example of Japan and push the public debt ratio to stratospheric levels (245pc of GDP).

The difference is that the Japanese are the world’s biggest savers and external creditors. The Americans must import capital to finance their twin deficits.
Foreign investors own half the stock of US Treasury bonds. They will not fund ballooning deficits indefinitely. Prof Feldstein said Americans will have to cover a bigger share of the burden themselves and this will “crowd out” the US bond markets, with knock-on effects for equities.

Olivier Blanchard, ex-chief economist of the International Monetary Fund, said the US has big enough buffers to cope with a "run-off-the-mill" recession but would need to Error! Hyperlink reference not valid. altogether in a deep downturn.

While the Fed's balance sheet is already "scary" at $4.2 trillion after previous rounds of quantitative easing, it could go a lot higher. "If we need it, we could clearly double it and nothing terrible would happen," he told a Boston Fed forum on how to fight the next slump.

Prof Blanchard, now at the Peterson Institute, said the Fed could buy equities. The Bank of Japan already does this. It is the biggest holder of exchange traded funds on the Tokyo bourse. "This could do the trick and could work even better than buying long bonds," he said.

The Fed could even print 'helicopter money' to fund the fiscal deficit directly, an idea floated by academics after the last crisis but deemed too radical for the political system.

This variant of 'people's money' injects stimulus directly into the veins of the economy rather than channeling it through asset markets, the post-Lehman trickle down mechanism that has greatly benefited the rich and entrenched wealth inequality. But it is difficult to reverse later when the time comes to drain excess liquidity.

While the US could in theory experiment with helicopter money, Congress would be hostile to any such form of monetary adventurism. It would be a last resort. In the eurozone it would be completely impossible under EU treaty law and the restrictive fiscal rules of the Stability Pact.

Mr Blanchard said it took at least 850 basis points of rate cuts to fight the post-Lehman recession - directly or synthetically through bond purchases under the Wu-Xia model - and this is clearly not available now. His advice is to delay monetary tightening and run the US economy hot until it is safely out of the deflationary doldrums.

A fresh crisis would expose another huge problem. Capitol Hill has tied the hands of the US Treasury and the Fed, raising serious doubts over whether the authorities could legally repeat the crisis measures that rescued the financial system in 2008.

The Three Musketeers of the Lehman Crisis: Hank Paulson, Ben Bernanke, and Tim Geithner. They are worried again CREDIT: WSJ

The fire-fighting trio of the day - Ben Bernanke, Hank Paulson, and Tim Geithner - wrote a joint article in the New York Times last week lamenting that Congress had stripped the watchdog bodies of "powerful tools".

The tougher rules constrain the Fed's ability to halt fire-sale liquidation. The Dodd-Frank Act stops it rescuing individual companies in trouble (there must be at least five, and they must be solvent) or lending to non-banks. The Fed cannot issue blanket guarantees of bank debt and money market funds. It can lend only to 'insured depository institutions'.

What saved capitalism in 2008 were lightning-fast moves by the Fed and the US Treasury to shore up the markets for commercial paper and the asset-backed securities markets, and to stop a run on the money market industry. It took $1.5 trillion of emergency loans to halt the vicious cycle. "These powers were critical in stopping the 2008 panic," they said.

It is often forgotten that the Fed also saved the European financial system when the global dollar funding markets seized up in the days after the Lehman and AIG crashes. It became nigh impossible to roll over three-month dollar credits. The ECB and its peers could not create the dollars desperately needed to buttress Europe's interbank markets.
The Fed responded with liquidity swap lines in US dollars to central bank peers, removing all limits over the wild weekend of October 14 2008. Total swaps surged to $580bn.

The problem today is that Fed no longer has the authority to do this. It needs the approval of the US Treasury Secretary, and therefore the Trump White House.

The worrying question is whether Mr Trump would refuse to “bail out” Europe in a crisis - deeming it their own problem - or might try to use this enormous power as leverage for political or trade policy objectives.

In short, it is no longer clear that there is a lender-of-last resort standing full square behind the dollarized global financial system and able to act instantly in a crisis.
Gordon Brown warned last week that lack of global solidarity threatens to leave a poisonous situation when the next storm hits. Almost all the policy survivors of the last crisis agree with him.