Opinion

If all our bishops disappeared, would we miss them?

Theo Hobson, page 28

The real reason why bankers feel so gloomy

We could be on the verge on the greatest slump of all time ... if you ignore the encouraging economic figures

Anatole Kaletsky

According to the overwhelming majority of financial analysts in the City of London and Wall Street, the world is now in the worst economic crisis since the 1930s. Anyone who doubted this cataclysmic consensus — and I must admit that I played down the credit crunch, describing it initially as a "storm in a teacup" — must surely be eating humble pie after the events of last weekend, when the two largest financial institutions in the world — Fannie Mae and Freddie Mac — teetered on the brink of bankruptcy, despite the US Government effectively guaranteeing their debts. The debts of these two US mortgage insurers come to about $5 trillion, equivalent to the combined national incomes of Britain and France.

If the US Government can no longer be trusted to meet its financial obligations with dollars that it can print on its own printing presses at will, then there really is no place to hide. That seemed to be the predominant view in the markets, reflected in a doubling of the cost of insuring the US Treasury's own bonds against default. In such conditions, the only rational course for savers and investors is to pull their money out of all banks or investment funds, whether in New York, London, Frankfurt, Hong Kong or Tokyo, and to put every spare penny into oil, gold or other commodities that might have some lasting value after paper money is totally debased, along with all shares, bonds, mortgages and other financial obligations based ultimately on nothing more substantial than elaborately printed paper signed by politicians and central bankers.

This is more or less what happened on Monday and Tuesday when stock markets around the world plunged in response to the US Treasury's seemingly unsuccessful attempts to restore confidence in its mortgage insurers, while oil hit a record high and gold jumped to within a few points of the all-time high that it had reached just before the rescue of Bear Stearns and Northern Rock.

But before you conclude that the sky really is falling in and that relatively optimistic commentators (including me) have been confounded, consider the following. In the past few weeks, US industrial production, consumer spending and trade figures have all come in much stronger than expected and now point unambiguously to accelerating economic growth, rather than a further slowdown. On Tuesday the Federal Reserve Board published a sharply upgraded estimate of 2008 growth. The near-recession growth range of 0.3 to 1.2 per cent predicted in April is now seen as a much more respectable 1.0 to 1.6 per cent. Even the gloomiest private economists on Wall Street now expect second-quarter GDP figures to show a strong recovery to growth of around 3 per cent.

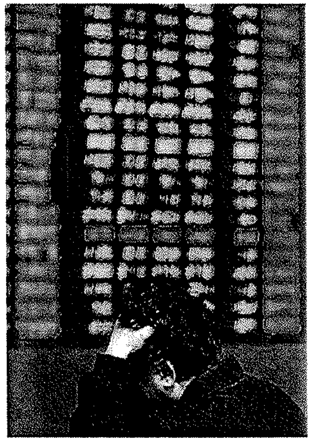
Looking at the recent indicators, the clouds are now much darker over Britain and the eurozone than the US. The correction in housing, which has now been running for almost two years in America, started in Europe only a few months ago. The main effects of the slowdown, in terms of falling house prices, lost jobs and weak consumer spending, are only just starting to be felt in Europe — while in America the worst has probably passed. For Britain, the outlook is arguably even worse than for the rest of Europe because its economy is so dependent on financial services and housing, the sectors suffering the biggest hits.

Meanwhile, government spending, the only other sector of the British economy growing strongly until a year ago, is also bound to suffer a severe squeeze as the public finances go from bad to worse.

Having said all this, however, there is nothing even in the British figures to suggest a disaster on the scale expected by most City economists — or implied by the recent collapse of shares in British banks.

What then is going on? There are two possible explanations for the total decoupling between the economic figures and the financial markets. The first is that investors are dispassionately analysing and forecasting the future, while economists such as myself and, more importantly, those at the Fed and the Bank of England, are indulging in wishful thinking, based on mechanistic projections from the recent past.

The second possibility is the polar opposite — that the financial markets are caught up in one of their periodic bouts of emotional, straight-line projections of recent losses. Looking at the perverse responses to economic news recently in the world's most important financial markets, it seems quite plausible that investors today are as blind to economic realities as they were in the dot-com bubble, the Enron panic and the sub-prime mortgage boom.



Just because life is hard for bankers, doesn't mean we're all doomed

But there is another, structural, reason why financial expectations may be out of tune with reality — the "hyper-finance" revolution in the banking system.

To see what I mean consider the following example. In the old world before the arrival of "hyper-finance", if a family wanted a £100,000 mortgage, they would simply go to the Halifax and borrow £100,000. Now consider what happens in the new financial world. The family would borrow £100,000 from Northern Rock, which would sell £100,000 of bonds to hedge funds, which buy these with £100,000 borrowed from Bear Stearns, their prime broker, which would raise this money by selling £100,000 of commercial paper to Citibank, which would then borrow £100,000 through the inter-bank market from Halifax.

So now the original £100,000 mortgage transaction has created £500,000 of new debts.

In principle, this entire chain of transactions could be squeezed, like a concertina, back to the original £100,000 transaction between the householder and Halifax, reducing the total amount of credit in the banking system by 80 per cent. This huge reduction in credit would do no great harm either to the homeowner or the ultimate lender, but eliminating all those intermediate transactions would devastate jobs and profits within the banks.

The upshot is that the main people suffering pay cuts and job losses in the present crisis are bankers, rather than industrial workers as in previous slowdowns.

Not surprisingly, this gives financiers a jaundiced view of the world. Nobody can say for sure whether financiers or economists will turn out to be right about the present crisis. Past experience suggests that financial market expectations are usually wrong at or near-cyclical turning points. It is always possible, of course, that the present financial panic really will be different from every other and will trigger the greatest economic crisis of all time.

But as they say in the markets, the four most expensive words in the English language are "this time is different".