Niall Ferguson – Economic Historian with a view on the Global Financial Crisis

Australian Broadcasting Corporation
Broadcast: 26/02/2009
Reporter: Leigh Sales

World renowned Scottish historian Niall Ferguson joins Lateline to discuss the unpredictable patterns of financial markets throughout history and the lessons that can be learnt from the past.

Transcript

LEIGH SALES, PRESENTER: In the last few minutes, the Reuters news agency has published leaked reports on US President Barack Obama's first budget proposal.

The figures are remarkable, including a $1.7 trillion deficit, which at more than 12 per cent of GDP, is the biggest since World War II.

But how remarkable are these financial times?

Economic history is a rollercoaster ride of booms and busts. From the days of the powerful Medici family in Renaissance Florence, to the modern day 'masters of the universe' on Wall Street, crises like the one we're currently in have been unavoidable.

History also teaches us that the markets unpredictability reflects human emotions like euphoria, greed, panic and fear - they all come into play.

Niall Ferguson is a world-renowned Scottish historian who's currently a Professor at Harvard University. He's an expert on financial and economic history, and the author of the best-selling books 'Empire' and 'Colossus'.

He spoke to me earlier today from Boston.

Professor Ferguson, you've recently written a book called 'The Ascent of Money' which traces the history of finance from Ancient Mesopotamia to the present day. So you're obviously someone who just goes in for the very small projects.

NIALL FERGUSON, AUTHOR & HISTORIAN, HARVARD BUSINESS SCHOOL: That's right, it was a modest ambition to write an entire financial history of the world inside one cover, but it seemed to me a worthwhile undertaking. When I set about writing this in 2006, most people thought that all the financial problems in the world had been solved, and I was regarded as an outlier for suggesting that a huge liquidity crisis was imminent. I'm glad I wrote the book, 'cause I think it helps people get a sense of perspective when they try to understand this extraordinary upheaval in the financial world that they're living through. And part of the point of the book is to set this crisis that we're now in a broader historical perspective, going back, as you say, 4,000 years.

LEIGH SALES: You believe that looking at the history of finance is the best way to understand the current financial crisis. Given the modern complexities and technology, why is looking at history, even hundreds of years ago, still applicable?

NIALL FERGUSON: Well, you know, there have been financial crises for a very long time indeed. I tell the story of the first stockmarket bubble back in 1719-20. Now, the early 18th Century may seem almost a completely irrelevant subject to your viewers, but you have to bear in mind that, in many ways, stockmarket bubbles usually have the same cause, whether it's in 1719 or in 2000, when the last great stockmarket crash happened before the one we're in now. Nearly always, it's the role of monetary policy that's decisive. Excessively lax credit by the central bank was as much to blame in 1719 as it was in the 1990s and in the early 2000's in the United States. The other key point to remember is that we haven't seen a financial crisis like this in a very long time indeed. In fact, not many people now have first-hand memories of the early 1930s, which was the last time the global financial system was hit by a shock this large. You really do financial history if you're gonna understand what's going on now. People who just rely on their own experience may be able to remember the 1970s, and they may well remember the crises of the early '80s or 1987. But, frankly, those are really small beer compared with what we're living through now. And that I think is the strongest argument of all for taking financial history seriously - perhaps more seriously than the economic theories that got us into this mess.

LEIGH SALES: Given that the lessons of history always dictate that bubbles will burst, why in 2007 were people thinking, "Ah, but this one will be different. This one's not going to burst."

NIALL FERGUSON: It's very easy to believe this kind of thing if you've drunk enough of the coolade on offer. And there was a lot of coolade on offer on Wall Street and in the city of London in 2006. I knew people who were willing to bet really large sums of money in early 2007 that there would never be another recession in United States. Now when I heard things like that, I was vividly reminded of the sort of euphoria that prevailed in the late '20s on Wall Street, and indeed the euphoria that prevailed in 1719-20 period, when the South Sea Bubble blew up in London.

LEIGH SALES: I recently interviewed the economist Robert Shiller, and he believes that the inflated optimism that surrounded the markets in recent years has been due to an almost wilful ignorance in indifference on the part of people about how financial products and systems work. What do you think of that?

NIALL FERGUSON: Well, I very much admire Robert Shiller's recent work and indeed his new book 'Animal Spirits', is I think an indispensible companion to my book 'The Ascent of Money'. Robert Shiller is somebody who's come to realise the limits of the traditional way of thinking about economics, in which we imagine that human beings are rational actors who have perfect information about the economy around them. The reality is that we're very often irrational actors, operating in almost complete ignorance of the economy around us. If you do surveys in the Unites States, or in Europe, and I suspect the same would be true in Australia, you find people are really quite staggeringly ignorant of the financial system. They don't know the difference between a share and a bond, they can't calculate a real interest rate. Indeed, it's quite extraordinary to me that all over the English speaking world, we expect people to make quite complex decisions about, say, taking out a mortgage, without there actually being equipped to make even the most basic financial calculation and get it right. So we have a problem of ingrained financial ignorance. We don't teach people in school or in university anything like enough about the way the financial system works. And we teach virtually now financial history. People know a lot more about the kings and queens of England, it seems to me, than they know about the way the financial world has evolved. And that I think helps explain why so many people made so many bad decisions in the last few years. It was a collective delusion that gripped almost the entire English speaking world that property prices could only go up. And this was in defiance of the evidence that they very frequently go down. And when they do go down, well, it's really quite a problem, especially if you've bought the house with a very large mortgage.

LEIGH SALES: In your latest book, you write that a financial revolution preceded the Industrial Revolution of the late 18th and early 19th Centuries, and that, indeed, changes in the financial sector often precede major cultural, social and political changes. Do you believe that this financial revolution that we're witnessing now will precede any sort of other revolution?

NIALL FERGUSON: I think it's almost certain. Although it's conventional to refer to this as the 'global financial crisis', it's more than that. You know, it's a crisis of globalisation. What we're seeing is a breakdown of the system of international trade. The latest figures for exporters out of the major Asian economies are truly terrifying. We haven't seen a collapse of global trade like this since the early 1930s. And you don't need to know a whole lost history to know that the Great Depression of the '30s was very quickly followed by enormous political upheavals. Democracies failed all over Europe, central and Eastern Europe in particular, and those democracies that failed wee very quickly failed by dictatorships that were bent on aggression. And I think one of the most troubling symptoms of this crisis right now is the combination of breakdown in Eastern Europe, economies falling off cliffs, and really quite aggressive rhetoric from the Russian leader, although he's supposed to just be the Prime Minister, but in fact he's the leader, Vladimir Putin. I was extremely unnerved by Mr Putin's speech at the recent Davos World Economic Forum which I attended, because he said quite explicitly that in times of crisis, you should expect certain countries to engage in aggressive foreign policy as a way of distracting populations from their economic troubles. Well, if he's thinking that way, it seems to me only a matter of time before Russian foreign policy takes another turn for the worse.

LEIGH SALES: What about China? There's a school of thought that this financial crisis will mark the start of China setting the global financial tempo, rather than the US.

NIALL FERGUSON: Well, there was an argument doing the rounds not so long ago that China was growing so rapidly that it could in effect decouple itself from the United States and rely much less on American demand or Western demand generally. I never believed that argument, and it's proved to be quite false. The effect of a contraction of US consumption - indeed, the effect of a recession in all the major developed economies, has been devastating for China. The export sector is contracting drastically, and say, 20 million people, migrant workers, are returning to the cities and finding that there are no jobs for them. This is a huge shock for China. And the Chinese authorities really seem to me in something of a bind as to know what to do. In an ideal world, they would be able to shift to domestic consumption, boosting Chinese demand and getting ordinary Chinese households to go out there and shop until they drop. But in the real world, it's very hard to get people to change their behaviour that quickly. And Chinese households have an established habit of saving a really large proportion of what they earn. The Chinese economy has been focused on exports, like most of the Asian economies over the last 10 years, and indeed the reliance on exports has been growing. This sudden decline of demand in the developed world is creating really problems for China. And I for one don't really believe their claim that they're gonna be able to achieve a growth rate of close to seven per cent this year. I'll be very surprised if it's half that.

LEIGH SALES: Many governments around the world are trying to spend their way out of this crisis by going into debt, like Australia, or going further into debt, like the United States. What do you think of that strategy?

NIALL FERGUSON: Well, I can see the argument for substituting public demand for private demand at a time when consumption is contracting. The economic textbooks make it clear that it's a good idea for the government to step in. But I don't think we should expect too much of these various stimulus packages. John Maynard Keynes has been dead a long time, and it's extraordinary the devotion that economists still feel towards him. In a crisis, they pick up his 1936 'General Theory' like a comfort blanket. The trouble is that Keynes' theory was that if you had a large government deficit, if you increased government spending, you get a really quite big bang for your buck. You'd get significantly more in terms of increased output than you had to spend in terms of increased government spending. That's the so-called "multiplier effect" - you multiply every dollar that you spend in terms of the increased output that you get. Unfortunately, I think the multiplier in most economies today is really very low, and we're not going to get the kind of results from these various stimulus packages and deficits that most economists are hoping for. In that sense, it seems to me it's gonna be a - it's gonna become clear before the year is out that you can't borrow your way out of a crisis of excessive leverage. And that's what this is: this crisis has come about because of excessive debt, not only in Australia, in the United Kingdom and of course above all in the United States. The English speaking peoples have been consuming by borrowing, and that game is over. The idea that you could somehow keep it going by having governments step in and do the borrowing I think is highly implausible. We're gonna have a rethink before too many months are out as it becomes clear that these deficits are causing almost as many problems as they're likely to solve.

LEIGH SALES: So you're making the argument that the way out of a crisis created by excessive debt is not to create more debt.

NIALL FERGUSON: I think that's right. After all, if every major economy in the world rushes to the bond market issuing enormous quantities of new government debt. In the case of the United States alone could involve sums in excess of $1 trillion this year, possibly closer to $2 trillion - it's a little hard to predict. That's a huge amount of new borrowing. That compares with the kind of the deficits the US ran in 1942 during World War II. And I'm not sure quite who's going to buy all of this stuff. Because although it's clear that there is some appetite around the world for US government bonds, that appetite is not limitless. And even the Chinese, who've been loyally buying the stuff in recent years, partly in order to keep their own currency relatively stable against the dollar, even they must be cringing at the prospect of a veritable flood of government debt. And that's the US alone: if every other major country's doing the same thing, there's gonna be the most almighty glut. Now, supply and demand is simple stuff that everybody could understand. If you increase the supply of government bonds at a time when the demand for them is contracting, the price of them is going to fall. And that means that long-term interest rates are very likely to start heading upwards. Well, that, of course, is gonna choke off any recovery that we're hoping to generate by fiscal or monetary means. And I think that's going to reveal itself pretty soon to be a major problem for the recovery strategies of governments round the world.

LEIGH SALES: Are there enough assets in the world to cover all the debt accumulated by individuals and corporations and governments?

NIALL FERGUSON: Well, notionally, the world has a balance sheet and on that balance sheet there are all the assets, and on the other side all the liabilities. But I don't think anybody's ever attempted to draw this balance sheet up. And if they did, they'd find it very difficult. It's very hard to value assets right now. And that is one of the key problems. We don't really know what the right price for the housing stock of the United States is, for example. It's declining in price at an annual rate of around 19 per cent. We haven't seen declines in property prices like that since the early 1930s. But as the asset prices fall, the bad news is that the debt prices stay the same. The debt is essentially what it was when you took out the loan. And until we find ways of adjusting that process, other than through the painful route of bankruptcy or foreclosure the world is going to be in the grip of a really very, very painful crisis. That's really the way to understand this. A crisis of excessive debt has caused a fundamental revaluation of the assets on which the debt was secured. And as the collateral declines in price, the debt burdens become unbearable - that's the story in the United States, it's the story in many parts of Europe, and I have no doubt that it's the story increasingly in Australia too.

LEIGH SALES: Do you believe that market forces should be allowed to play out during this crisis of debt without government intervention? So that, for example, banks that have overreached should be allowed to fail.

NIALL FERGUSON: Well, of course, government intervention is preferable to a great depression. And one of the lessons of the early 1930s is that if governments merely stand by and allow banks to fail in their hundreds or even thousands, the result can be an absolutely appalling contraction. That, I think, is one of the most important lessons to come out of the study of the Great Depression. And I think that's why central banks in particular around the world have been trying furiously to minimise the number of bank failures. But there's a limit beyond which you can't go. Simply propping up insolvent banks and drip feeding them taxpayers money isn't really a solution to the problem. It's simply a postponement of a solution to the problem. That's why I've been talking recently about a great repression in which we sort of are in denial about the extent of the insolvency in the financial sector. My own preference would be in the case of insolvent banks in the United States and Europe for a swift nationalisation that not only wipes out the shareholders but also gives those people who hold bonds, who have lent money to banks a significant haircut. We've got to adjust the debt downward if we're to stabilise these institutions. And at the moment, I don't see many governments ready to take that kind of radical step, despite the fact that, for example, Sweden in the early 1990s did this and was able to solve a major banking crisis that way.

LEIGH SALES: Let's say an historian writes a book like the 'The Ascent of Money' 50 years from now; what do you think will be the lessons of this financial crisis when they're put in the context of all the crises that have come before?

NIALL FERGUSON: Well, I hope that my successor is able to say that rumours of the death of capitalism were greatly exaggerated in 2009 by over-excited commentators, and that what in fact had gone wrong was something relatively technical - that the regulation of bank capital had gone completely askew and that it had to be fundamentally changed. The various accords - Basel I and Basel II- designed to regulate bank capital adequacy failed. And only those countries that had their own relatively strict regulations - like, for example, Canada - have come out of this crisis with their banking systems relatively unscathed. Where banks were able to become leveraged at ratios up to 60:1 - in other words, their assets were 60 times the size of their capital, the financial disaster was only a matter of time. And I think that's one of the key lessons of history. The other lesson that I'd expect historians to draw 50 years from now, perhaps even sooner than that, is that monetary policy went fundamentally off the rails in the late 1990s. When central bankers started to say, "We don't need to worry about asset prices. We don't need to worry about the stockmarket. We don't need to worry about house prices. All we need to worry about is something called core consumer price inflation. We can even ignore house prices. We can even ignore energy. Let's just focus on that one thing." Some believed if they targeted that price, that inflation rate, they would solve all our problems. That was a delusion. The more the central bankers ignored the asset bubbles that were going on around them, the bigger the bubbles got and the more painful the subsequent adjustment. So those are the two lessons that I think future historians will draw from this crisis. It's not the end of capitalism; it's not the death of the free market, but it is a signal that we got two things badly wrong: the regulation of banks, and particularly bank capital, and the way in which monetary policy is formulated.

LEIGH SALES: Niall Ferguson, thanks so much for making the time to talk to us.

NIALL FERGUSON: It's been a great pleasure.