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Crisis may make 1929 look a 'walk in the park'

http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/12/23/cccrisis123.xml

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As central banks continue to splash their cash over the system, so far to little effect, Ambrose Evans-Pritchard argues things are rapidly spiralling out of their control

Twenty billion dollars here, $20bn there, and a lush half-trillion from the European Central Bank at give-away rates for Christmas. Buckets of liquidity are being splashed over the North Atlantic banking system, so far with meagre or fleeting effects.

As the credit paralysis stretches through its fifth month, a chorus of economists has begun to warn that the world's central banks are fighting the wrong war, and perhaps risk a policy error of epochal proportions.

Faces of power: The Fed's Ben Bernanke, the BoE's Mervyn King, the ECB's Jean-Claude Trichet

"Liquidity doesn't do anything in this situation," says Anna Schwartz, the doyenne of US monetarism and life-time student (with Milton Friedman) of the Great Depression.

"It cannot deal with the underlying fear that lots of firms are going bankrupt. The banks and the hedge funds have not fully acknowledged who is in trouble. That is the critical issue," she adds.

Lenders are hoarding the cash, shunning peers as if all were sub-prime lepers. Spreads on three-month Euribor and Libor - the interbank rates used to price contracts and Club Med mortgages - are stuck at 80 basis points even after the latest blitz. The monetary screw has tightened by default.

York professor Peter Spencer, chief economist for the ITEM Club, says the global authorities have just weeks to get this right, or trigger disaster.

"The central banks are rapidly losing control. By not cutting interest rates nearly far enough or fast enough, they are allowing the money markets to dictate policy. We are long past worrying about moral hazard," he says.

"They still have another couple of months before this starts imploding. Things are very unstable and can move incredibly fast. I don't think the central banks are going to make a major policy error, but if they do, this could make 1929 look like a walk in the park," he adds.

The Bank of England knows the risk. Markets director Paul Tucker says the crisis has moved beyond the collapse of mortgage securities, and is now eating into the bedrock of banking capital. "We must try to avoid the vicious circle in which tighter liquidity conditions, lower asset values, impaired capital resources, reduced credit supply, and slower aggregate demand feed back on each other," he says.

New York's Federal Reserve chief Tim Geithner echoed the words, warning of an "adverse self-reinforcing dynamic", banker-speak for a downward spiral. The Fed has broken decades of practice by inviting all US depositary banks to its lending window, bringing dodgy mortgage securities as collateral.

Quietly, insiders are perusing an obscure paper by Fed staffers David Small and Jim Clouse. It explores what can be done under the Federal Reserve Act when all else fails.

Section 13 (3) allows the Fed to take emergency action when banks become "unwilling or very reluctant to provide credit". A vote by five governors can - in "exigent circumstances" - authorise the bank to lend money to anybody, and take upon itself the credit risk. This clause has not been evoked since the Slump.

Yet still the central banks shrink from seriously grasping the rate-cut nettle. Understandably so. They are caught between the Scylla of the debt crunch and the Charybdis of inflation. It is not yet certain which is the more powerful force.

America's headline CPI screamed to 4.3 per cent in November. This may be a rogue figure, the tail effects of an oil, commodity, and food price spike. If so, the Fed missed its chance months ago to prepare the markets for such a case. It is now stymied.

This has eerie echoes of Japan in late-1990, when inflation rose to 4 per cent on a mini price-surge across Asia. As the Bank of Japan fretted about an inflation scare, the country's financial system tipped into the abyss.

In theory, Japan had ample ammo to fight a bust. Interest rates were 6 per cent in February 1990. In reality, the country was engulfed by the tsunami of debt deflation quicker than the bank dared to cut rates. In the end, rates fell to zero. Still it was not enough.

When a credit system implodes, it can feed on itself with lightning speed. Current rates in America (4.25 per cent), Britain (5.5 per cent), and the eurozone (4 per cent) have scope to fall a long way, but this may prove less of a panacea than often assumed. The risk is a Japanese denouement across the Anglo-Saxon world and half Europe.

Bernard Connolly, global strategist at Banque AIG, said the Fed and allies had scripted a Greek tragedy by under-pricing credit long ago and seem paralysed as post-bubble chickens now come home to roost. "The central banks are trying to dissociate financial problems from the real economy. They are pushing the world nearer and nearer to the edge of depression. We hope they will eventually be dragged kicking and screaming to do enough, but time is running out," he said.

Glance at the more or less healthy stock markets in New York, London, and Frankfurt, and you might never know that this debate is raging. Hopes that Middle Eastern and Asian wealth funds will plug every hole lifts spirits.

Glance at the debt markets and you hear a different tale. Not a single junk bond has been issued in Europe since August. Every attempt failed.

Europe's corporate bond issuance fell 66pc in the third quarter to $396bn (BIS data). Emerging market bonds plummeted 75pc.

"The kind of upheaval observed in the international money markets over the past few months has never been witnessed in history," says Thomas Jordan, a Swiss central bank governor.

"The sub-prime mortgage crisis hit a vital nerve of the international financial system," he says.

The market for asset-backed commercial paper - where Europe's lenders from IKB to the German Doctors and Dentists borrowed through Irish-based "conduits" to play US housing debt - has shrunk for 18 weeks in a row. It has shed $404bn or 36pc. As lenders refuse to roll over credit, banks must take these wrecks back on their books. There lies the rub.

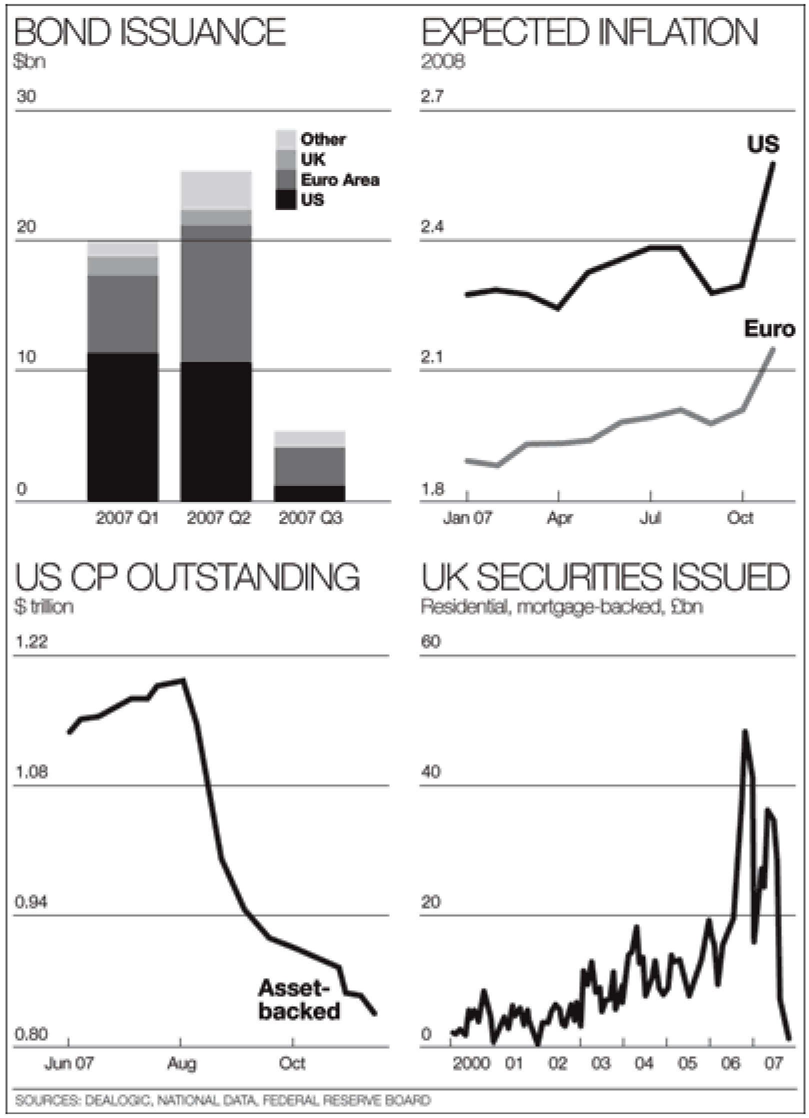
Professor Spencer says capital ratios have fallen far below the 8 per cent minimum under Basel rules. "If they can't raise capital, they will have to shrink balance sheets," he said.

Tim Congdon, a banking historian at the London School of Economics, said the rot had seeped through the foundations of British lending.

Average equity capital has fallen to 3.2 per cent (nearer 2.5 per cent sans "goodwill"), compared with 5 per cent seven years ago. "How on earth did the Financial Services Authority let this happen?" he asks.

Worse, changes pushed through by Gordon Brown in 1998 have caused the de facto cash and liquid assets ratio to collapse from post-war levels above 30 per cent to near zero. "Brown hadn't got a clue what he was doing," he says.

The risk for Britain - as property buckles - is a twin banking and fiscal squeeze. The UK budget deficit is already 3 per cent of GDP at the peak of the economic cycle, shockingly out of line with its peers. America looks frugal by comparison.



Maastricht rules may force the Government to raise taxes or slash spending into a recession. This way lies crucifixion. The UK current account deficit was 5.7 per cent of GDP in the second quarter, the highest in half a century. Gordon Brown has disarmed us on every front.

In Europe, the ECB has its own distinct headache. Inflation is 3.1 per cent, the highest since monetary union. This is already enough to set off a political storm in Germany. A Dresdner poll found that 71 per cent of German women want the Deutschmark restored.

With Brünhilde fuming about Brot prices, the ECB has to watch its step. Frankfurt cannot easily cut rates to cushion the blow as housing bubbles pop across southern Europe. It must resort to tricks instead. Hence the half trillion gush last week at rates of 70bp below Euribor, a camouflaged move to help Spain.

The ECB's little secret is that it must never allow a Northern Rock failure in the eurozone because this would expose the reality that there is no EU treasury and no EU lender of last resort behind the system. Would German taxpayers foot the bill for a Spanish bail-out in the way that Kentish men and maids must foot the bill for Newcastle's Rock? Nobody knows. This is where eurozone solidarity stretches to snapping point. It is why the ECB has showered the system with liquidity from day one of this crisis.

Citigroup, Merrill Lynch, UBS, HSBC and others have stepped forward to reveal their losses. At some point, enough of the dirty linen will be on the line to let markets discern the shape of the debacle. We are not there yet.

Goldman Sachs caused shock last month when it predicted that total crunch losses would reach $500bn, leading to a $2 trillion contraction in lending as bank multiples kick into reverse. This already seems humdrum.

"Our counterparties are telling us that losses may reach $700bn," says Rob McAdie, head of credit at Barclays Capital. Where will it end? The big banks face a further $200bn of defaults in commercial property. On it goes.

The International Monetary Fund still predicts blistering global growth of 5 per cent next year. If so, markets should roar back to life in January, as though the crunch were but a nightmare. There again, the credit soufflé may be hard to raise a second time.