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Strategic Analysis

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A "People First" Strategy: Credit Cannot Flow When There Are No Creditworthy Borrowers or Profitable Projects

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In 1930, John Maynard Keynes wrote: "The world has been slow to realise that we are living this year in the shadow of one of the greatest economic catastrophes of modern history." Today, as then, we are in the shadow of catastrophe. Today, as then, our thinking is slow. We need to come to grips with the crisis itself.

Two ingrained habits are leading to failure. The first is to assume that economies will eventually return to normal on their own. In London in January, U.S. Federal Reserve Chairman Ben Bernanke said, "The global economy will recover." He did not say how he knows. The fact that for months the news has been consistently worse than expected shows that the forecasts are wrong. Their basic failure is that they do not take account of the massive pay-down of household debt, everywhere under way, resulting from the collapse of the banks.

The second bad habit is to believe that recovery runs through the banks rather than around them. This idea holds that credit is "blocked"; it must be made to "flow." The metaphor is fallacious. Credit cannot flow when there are no creditworthy borrowers, no profitable projects. Banks have failed, and the failure to recognize this is a recipe for wild speculation and control fraud, compounding taxpayer losses. Thus, the following measures, though far from exclusive, are needed now.

Make Economic Forecasts Realistic

Economic forecasts should be consistent and realistic, with their point of departure being the consequences of debt deflation. Fiscal expansion programs should therefore be geared to the actual scale of the crisis, not limited by the arbitrary thought that it will be shallow and short.

Audit Banks More Honestly

Competent regulators should take charge of troubled banks, install new management, and obtain an honest audit. A review of U.S. loan files will show that fraud and misrepresentation were pervasive, that the market for bad assets cannot be re-created. Therefore, the condition of many major banks (U.S. and foreign) holding subprime securities in quantity cannot be repaired without a pass-through receivership, reorganization, and recapitalization. In Europe, the same conclusion will be drawn from fair examination of foreign-currency-linked residential loans in Central Europe, whether the individual credits were fraudulent or not. Audits will force action and restore confidence in the remaining healthy banks—nothing else can.

Introduce Effective Financial Regulation

Financial regulation going forward should abolish tax havens, eliminate shell corporations and other forms of regulation evasion, and restrict the carry trades and foreign-currency-linked debt instruments that fatally infected Iceland and Central Europe in recent years.

Keep People in Their Homes

As this is a housing crisis, a critical need is for measures to forestall evictions and keep people in their homes, limiting chronic oversupply and collapsing values. This means measures to stop foreclosures or to permit foreclosed homeowners to convert to rentals under public management, with options to repurchase their homes when conditions improve. Measures adopted in the United States may be adapted to meet conditions in other affected countries.

Increase Public Retirement Benefits

Finally, an overlooked arena is a major opportunity. The crisis is dealing a major blow to the elderly in every aspect of their private wealth. Home values, stock market values, and interest income are all being hit hard. This is surely the moment to increase public retirement benefits. In the United States and in developing countries, a strong increase in social security benefits is called for. The European Union should start a European Pension Union, leveling up pension payments in the poorer member states until a common minimum standard for Europe as a whole has been reached. This would have good effects on employment, and help to ease the mortgage crisis.

Some of these issues are long term, but the time to start work on them is now. We are not in a temporary economic lull, an ordinary recession, from which we will emerge to return to business as usual. We are at the beginning of a long, profound, painful, and irreversible process of change. We need to start thinking and acting accordingly.

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