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Wall St trembles but it's not the Big One

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This time around, some economic Elastoplast will do the trick in stemming a total financial collapse. -------------------- There has been a huge amount of naivete in our responses so far to the world financial crisis.

While it's probably not going to be a repeat of the Great Depression of the early 1930s there are many lessons we can learn from that time. One is that it was a full year after the financial crash on Wall St before the Great Depression really hit New Zealand. But when it hit, it hit with a vengeance.

Despite the mass of American literature that treats the Great Depression as a peculiarly American event, the 1930s crisis was truly international, largely precipitated by international economic and financial imbalances in the 1920s which, among other things, led in 1927 to a reversal of foreign investment flows, resulting in fast-growing asset bubbles within the United States.

In the US and many other western countries, including New Zealand, financial activity in the mid-2000s (at all levels of the financial sector) created unusually large numbers of loans. These loans represent (to creditors) future claims on domestic goods and services, and were spent by debtors in large part either in secondary financial markets (eg, buying existing shares or real estate) or on imports mainly from non-western countries (especially China).

Thus we have a situation in which residents of western nations (through inflated claims) and eastern nations (through current account surpluses) have massive outstanding claims on the outputs of western economies.

The problem is western economies are growing more slowly than eastern economies, and too much of the outputs of western economies are non-tradeable services which will not be the products that many of those holding future claims will want to purchase.

In New Zealand it is still possible to sell financial assets and buy a substantial amount of Asian-made goods with the proceeds, so long as not too many of us try to do that. But declining asset prices mean our assets buy significantly fewer imports than they could last year, and the diminution of the purchasing power of our assets will continue.

Lending in New Zealand and Australia in the mid-2000s has been at least as unsustainable as was lending in the US; witness the collapse of the finance company sector in New Zealand.

The good news for New Zealand (and Australia) is it has the opportunity to trade its way out of trouble by selling food and other primary products to Asian countries wishing to exercise their claims on western economies' outputs.

This export-led recovery for our region will gather speed if the New Zealand and

Australian exchange rates continue to fall. The exchange rate fall is being driven by New Zealand and foreign holders of New Zealand dollar assets wishing to exchange those assets for assets denominated in currencies of countries with economies that are more productive than ours.

The US and the United Kingdom face a longer crisis, comparable to that faced by Japan throughout the 1990s. (New Zealand's experience may prove to be more like that of Thailand in 1997.)

A weak US dollar or a weak sterling will not in itself be able to restore those large economies that have become highly specialised in non-tradeable services. Their recoveries will require a rebalancing of the value of outstanding financial claims with the capacities of their economies to meet those claims.

Whether the US and UK experience inflation or deflation in the rebalancing process will depend critically on the monetary policies adopted. By creating more money, as the US Fed is doing, holders of financial assets will more easily be able to trade their bonds, shares and real estate for money. But, taken to excess, too much new money could be chasing too few goods and services; a period of inflation would occur as holders of money attempt to spend it before it loses too much of its purchasing power.

Tighter monetary policies, on the other hand, would lead to much larger falls in the values of bonds, shares, mortgages and real estate. Scarce money would then become a premium asset, to be held in preference to other assets. Deflation would take hold, leading to failures of major banks, and large-scale closures of non- financial businesses. Debt-deflation is the "black hole" of economics.

My guess is the problems will be patched up this time with some very large economic Elastoplast. Western economies may muddle on for another decade or so before the real problems are addressed.

Ultimately, a one-in-a-100-years meltdown (such as the Great Depression) is a result of a substantial disconnect between prevailing economic thought and actual economic reality. As in the 1930s, a long-term recovery from the next one-in-a- 100-years crisis will also be accompanied by a revolution within capitalist economic thought.

We might note that, in the 1930s, the Keynesian economics revolution saved capitalism. The only other politically viable alternatives that were on the books at the time were fascism and Marxian socialism.

The next one-in-a-century crisis, when it comes (and I'm sure it's not now), will see a radical revision of market economics, not a replacement. Now is the time for academic economists to challenge the orthodox interpretations of economic phenomena to a greater extent than they have done in recent decades.

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CAPTION:

Wall St is shaking on its foundations but the worst may be yet to come.