When a flow becomes a flood

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The deep causes of the financial crisis lie in global imbalances—mainly, America's huge current-account deficit and China's huge surplus

ASK people what caused the financial and economic crisis and most are likely to plump for some mix of greed and incompetence. Bank bosses have been castigated for fee-seeking gluttony, reckless lending and failure to heed the risks to their institutions. Regulators have been accused of sleeping on watch. Central bankers once lionised for mastering inflation and the business cycle are feted no longer.

Few among the public would be likely to pin the blame on "global imbalances": the pattern of large, persistent current-account deficits in America and, to a lesser extent, Britain and some other rich economies, matched by surpluses in emerging markets, notably China. The damage done to the financial system by lax controls, rotten incentives and passive regulation is plain. Yet underlying the whole mess was the deeper problem of imbalances. A growing number of policymakers and academics believe that these lay at the root of the financial crisis.

Economists had long feared that America would ruin itself on foreign borrowing. The current account, which measures the balance of investment and saving, has been in the red every year since 1992. Until 1997, the annual saving shortfall was modest but it grew steadily thereafter, reaching a peak of $788 billion, or 6% of GDP, in 2006. America needed to borrow from abroad or to sell assets—shares, bonds, property—to pay for the string of deficits. Deficits need not be ruinous, especially if they finance profitable investment. But economists worried that as America's consumption boom took it deeper into hock, foreigners would become less willing to lend to it. That could lead to an abrupt halt to financing and a plunge in the dollar.

Puzzles and explanations

The deficits reflected a falling saving rate rather than a rising investment rate. To finance this, America was sucking in savings from abroad that could not be relied on for ever. The dollar started to decline gradually from 2002 but the current-account deficit only got bigger. There were other puzzles: long-term interest rates ought to have picked up to reflect the scarcity of American savings and the concern about the dollar. But even when the Federal Reserve started to raise short-term rates from the middle of 2004, long rates declined. The chairman of the Fed, Alan Greenspan, told Congress in February 2005 that this was a "conundrum".

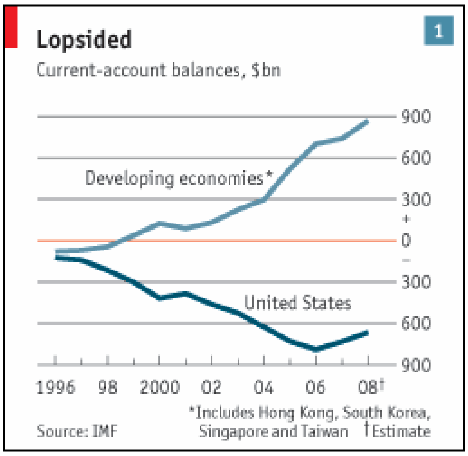
This spurred new thinking on global imbalances, which sought to rationalise why poor countries were so willing to send their savings to rich countries such as America and Britain. Ben Bernanke, now the Fed's chairman, then a governor, argued in 2005 that America's low saving was a passive response to a global "saving glut" washing onto its shores. It was not that America had lapped up foreign capital; rather capital had been thrust upon it. The money flooding in from willing foreign savers had bid up government-bond prices, lowering interest rates and lifting house prices. That encouraged Americans to run down savings and to keep spending.

As academics found fresh theories to explain the saving glut, they became less anxious about the imbalances it produced. The most developed financial markets were found in America, so it was the natural destination for foreign savers seeking safe returns. It could not run deficits for ever but the day of reckoning might be years away. Americans earned far higher returns on their investments abroad than foreigners did on their American assets. That and a weaker dollar helped to slow the increase in foreign indebtedness.

Both the old-school worrywarts and the new-school optimists got some elements of the story right and others wrong. "The dollar crisis that was predicted by the central view is the only one that hasn't happened," says Pierre-Olivier Gourinchas of the University of California, Berkeley. In the depths of the financial crisis in October, the dollar rallied against most currencies. America was not cut off from external funding. But equally there was a crisis—as the pessimists foresaw—and one that has undermined a pillar of the optimists' thinking on imbalances: that America is a beacon of financial stability.

There are signs of a consensus emerging from these two schools. A growing band of economists agree that the forces behind the saving flows from emerging markets are likely to persist. The continuing thirst for dollar assets, albeit of the right sort, suggests that America remains a magnet for global capital. But the belief that its financial system can handle huge saving flows indefinitely has been punctured. Kenneth Rogoff of Harvard University, who had given warning of an eventual reckoning, believes that with $800 billion of net capital flows pouring into the United States in a year, some slippage of regulatory and lending standards was perhaps inevitable. The worry now is that if imbalances are not tackled, they may in time breed another calamity.

The size of the saving glut is staggering. In 1996, the year before the Asian financial crisis began, economies designated by the IMF as emerging, developing and newly industrialised ran a collective current-account deficit of $78 billion. Over the next decade this turned into a surplus of several hundred billion dollars (see chart 1), with China and oil exporters accounting for almost all of the increase in the past three or four years. Much of the turnaround is mirrored in a widening American deficit. (The world's sums do not add up. Statisticians are unable to offset the recent burgeoning surpluses with deficits elsewhere: according to the IMF, in 2007 the surpluses exceeded the deficits by $265 billion.)



The glut and the gap

What persuades developing countries to export capital to the rich world that might be better used at home? Influences on saving vary from region to region. The income of oil-exporting countries, for instance, has ballooned since 2004 because of higher prices for crude. It would have been neither feasible nor wise for oil-rich nations to spend this windfall at home, so much of it was saved and sent abroad. Economists who have looked for something that unifies the saving behaviour of a disparate group of countries, from oil-exporters to metal-bashers, have converged on one important motive: the need to acquire reliable stores of value that can be sold easily when trouble strikes.

This idea has been developed in a series of papers by Ricardo Caballero of the Massachusetts Institute of Technology (MIT), Emmanuel Farhi of Harvard University and Berkeley's Mr Gourinchas. Their thesis is that emerging countries cannot create enough trustworthy saving vehicles to keep up with the pace of economic growth, because their financial markets are immature. Householders cannot rely on a ready supply of credit—or on government safety nets—so must save hard for a rainy day. But the domestic supply of financial assets is unreliable so the thrifty plump for foreign assets instead. America is the favoured place because it has broad and liquid markets for securities.

That interpretation sits awkwardly with another: that excess saving, particularly in China, is the result of exchange-rate policy. Emerging-market central banks have bought dollars to weaken their own currencies. That encourages exports and depresses spending at home. The result is a high level of net national saving, much of which ends up in central banks' foreign-exchange reserves. These rainy-day funds have swollen since 2004, mostly because of increased hoarding by oil-exporters and by China (see chart 2). How can this reflect private saving?

Mr Gourinchas doubts that depressing the exchange rate could sustain a high rate of saving for long. By flooding the foreign-exchange market with their own money, central banks risk driving up inflation which would erode the gain in competitiveness from a cheap currency. China has avoided that fate because it has been able to "sterilise" its currency interventions by selling bonds to banks, companies and households. That would be an expensive operation, says Mr Gourinchas, were it not for demand for savings. The reserves are collateral for the bonds held privately.

That may be too neat an explanation. In China's tightly controlled financial system, savers have little choice. And firms, not households, account for the recent rise in net national saving. There is another puzzle: why have emerging-market currency reserves grown so large? This was largely a reaction to the painful memory of the Asian crisis: Asian countries wanted to insure themselves against another sudden flight of capital. Reserves need to be large enough to draw upon if foreign-currency financing suddenly dries up, and to ensure that trade flows smoothly. But reserve holdings in some emerging markets have gone way beyond levels suggested by prudential rules of thumb—enough to pay for three months of imports, say, or to cover short-term foreign-currency debt.

Research by Maurice Obstfeld of Berkeley, Alan Taylor of the University of California, Davis, and Jay Shambaugh of Dartmouth College views these "excess" reserves as insurance for the domestic banking system. They argue that in economies with managed exchange rates and fast-growing bank deposits, there is increased risk of a "double drain". When crisis hits, fear of devaluation could spark a rush out of bank deposits into cash, and from cash into hard currency. Reserves are not only a prudent safeguard against a "sudden stop" in foreign finance. They are also needed as insurance against the risk of "sudden flight" by domestic savers.

The authors found that a measure of financial depth—the ratio of broad money to GDP—helped to explain the size of reserves. In a more recent study they found that countries with insufficient reserves to insure their financial systems suffered bigger currency crashes during last year's turmoil. The currencies of countries with full war chests did not depreciate; some rose. If economies draw the lesson that their reserves were not big enough, global imbalances will be even harder to tackle.

Mr Taylor reckons the policy of accumulating reserves accounts for a significant and growing fraction of global surpluses—enough (in the early years of this decade) to finance as much as a third of America's current-account deficit. The self-insurance against financial fragility is part of a more general bent towards precautionary saving in the developing world. If it persists, as seems likely, it will throw the problem of deficient global demand back to America.

An unsatisfying implication of the literature on the saving glut is that it paints America as a tragic victim of forces beyond its control (though some of the authors insist this is not their belief). The emerging markets' need for insurance, in its many guises, drives them to export capital to America (and to similar places, such as Britain). America, by implication, has no choice but to make room for it.

In fact, Asian savings may have provided the rope; but America hanged itself. The macroeconomic forces that drove the capital flows were hard to reverse. But what made them so devastating was that they were met by microeconomic failures—described in the special report in this issue.

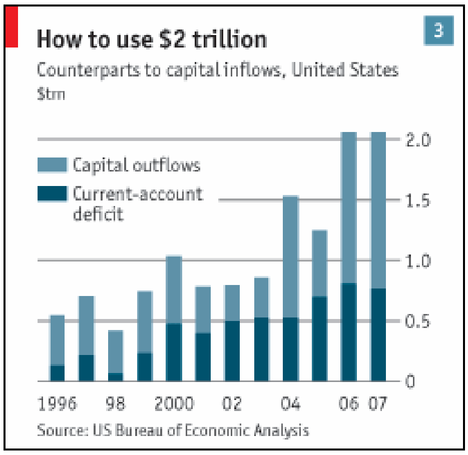
The interaction between the two was fatal. After the dotcom bust, American firms turned cautious and investment spending was weak. That ruled out a natural home for foreign capital. Faced with strong external demand for AAA-rated assets, the financial system got creative. Marginal home loans were packaged into supposedly safe securities. That supply of credit lifted house prices and spurred a boom in residential construction, which filled the gap in demand left by sluggish business investment.

As these loans turned bad and losses mounted, it became clear that banks had set aside too little capital to protect themselves against unexpected losses. That left the banks crippled and the economy on its knees. The villains in this story are the banks for making silly loans and regulators for not insisting on more precautions. But what would a well-regulated financial system have done with the money?

The bait for capital inflows is that America provides reliable and liquid assets, which cannot be found at home. Ideally its financial system might have provided an intermediary service—funnelling emerging-market savings into emerging-market projects. That would have lowered deficits in America and surpluses abroad. Only a fraction of the capital that flows into America is swallowed by the current-account deficit. Much of it finances capital outflows—the purchase of foreign assets by American residents (see chart 3).

In a world of perfect regulation, the likely outcome would be fewer new assets, such as securities backed by subprime mortgages, and higher prices (and lower returns) on the best assets. That implies long-term interest rates would have dropped even further. That might have given more life to business investment but it might also have fuelled a bigger housing boom, at least in prime real-estate.

Could macroeconomic policy have better addressed the global imbalances? One option would have been to keep an eye on the current-account balance when setting monetary and fiscal policy. Tighter policy might then have dampened consumer spending and curbed imports.



The trouble is that the much tighter policy needed to make a meaningful dent in the trade deficit would have led to recession in America and perhaps in emerging markets too. It would have been hard to justify with inflation so low (and it would also rule out low interest rates and fiscal stimulus now). Mr Caballero at MIT, for one, is sceptical: "I know from my experience in emerging markets that it is very hard to fight capital when it is flooding in. Policy mistakes may have been made at the margin but no more than that." Yet America's loose monetary policy after the dotcom bust does bear some blame. After all, a lot of subprime mortgages with variable interest rates were originated when the federal funds rate was very low.

An alternative would be to try to tackle imbalances from all sides. That would require co-ordinated action by surplus and deficit countries. Such attempts failed in the past because everyone had something to gain from sticking with the status quo. China might think Americans should save more but only as long as that did not curb their spending on Chinese imports. America would ask China to revalue its currency and boost its domestic demand. But it was also keen for China to keep buying its public debt.
Policymakers blithely assumed they would avoid a dollar crisis and that America would export its way out of any trouble. And that was how things were starting to play out before a quite different crisis, in the financial system, blew up.

With luck and good judgment some of the worst excesses of the financial system will now be reined in. The danger is that by focusing on regulatory reform and less clumsy ways to deal with bank failures, policymakers fail to tackle the underlying causes of the crisis. The anxieties that prompt emerging markets to run big current-account surpluses have not been assuaged. Indeed, the crisis may have spurred some countries to seek even more self-insurance in reserves and other forms of prudential saving.

It's good to talk
Earnest editorials often call for international talking shops to co-ordinate global demand. Alas, Sino-American exchanges on international economic affairs are often heated: when America's treasury secretary, Hank Paulson, said recently that imbalances played a role in the run-up to the crisis, he provoked an outcry in China. Past failures of co-ordination initiatives do not offer much hope either. Yet as Raghuram Rajan of Chicago University's Booth School of Business points out, the crisis has lasted a long time and there is no end in sight: so the situation may soon be ripe for a cooler exchange between surplus and deficit countries. The two big surplus countries in the rich world, Germany and Japan, are suffering deep recessions, which may bring them to the table. The problem of imbalances goes much wider than America and China.

One necessary task is to assure emerging-market countries that they will not be caught out if they run short of liquidity. The IMF might have to be prepared to offer funds more quickly and with fewer strings. Another option would be for emerging markets themselves to pool reserves. The politics of that would be messy at best. As Hélène Rey of London Business School points out, the devaluations within Europe's exchange-rate mechanism in the early 1990s showed that risk-sharing is far from perfect even where countries have well-established political ties.

The IMF's resources are puny in comparison with the amounts in the vaults of emerging-market central banks. That is why the swap lines offered by the Fed to four emerging economies in October were a welcome innovation (even if the recipients were flush with their own reserves). But countries will not be persuaded to stop accumulating reserves unless such credit lines can be relied upon in future. The Fed cannot be asked to vet potential recipients: that may be a job for the fund.

America, Britain and other deficit countries have drowned themselves in cheap credit from abroad. Because the structural forces behind the global saving glut are unlikely to abate quickly, there is a real risk that the dangerous imbalances will persist—with America's public sector as the new consumer of last resort. It would be foolish to focus on fixing the financial industry only to find that the public finances are left in ruins.
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Greed—and fear
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The golden age of finance collapsed under its own contradictions.

THE monument to Soviet central planning was supposed to have been a heap of surplus left boots without any right ones to match them. The great bull market of the past quarter century is commemorated by millions of empty houses without anyone to buy them. Gosplan drafted workers into grim factories even if their talents would have been better suited elsewhere. Finance beguiled the bright and ambitious and put them to work in the trading rooms of Wall Street and the City of London. Much of their effort was wasted. You can only guess at what else they might have achieved.

When the financial system fails, everyone suffers. Over the past 22 months the shock has spread from American housing, sector by sector, economy by economy. Some markets have seized up; others are being pounded by volatility. Everywhere good businesses are going bankrupt and jobs are being destroyed. For the first time since 1991 global average income per head is falling. Even as growth in emerging markets has come to a halt, the rich economies look set to shrink. Alan Greenspan, who as chairman of America's Federal Reserve oversaw the boom, calls the collapse "a once-in-a-half-century, probably once-in-a-century type of event". Financial markets promised prosperity; instead they have brought hardship.

Financial services are in ruins. Perhaps half of all hedge funds will go out of business. Without government aid, so would many banks. Britain has suffered its first bank-run since Disraeli was prime minister in the 1870s. America has stumbled from one rescue to the next. The Wall Street grandees have been humbled. Hundreds of thousands of people in financial services will lose their jobs; many millions of their clients have lost their savings.

For a quarter of a century finance basked in a golden age. Financial globalisation spread capital more widely, markets evolved, businesses were able to finance new ventures and ordinary people had unprecedented access to borrowing and foreign exchange. Modern finance improved countless lives.

But more recently something went awry. Through insurance and saving, financial services are supposed to offer shelter from life's reverses. Instead, financiers grew rich even as their industry put everyone's prosperity in danger. Financial services are supposed to bring together borrowers and savers. But as lending markets have retreated, borrowers have been stranded without credit and savers have seen their pensions and investments melt away. Financial markets are supposed to be a machine for amassing capital and determining who gets to use it and for what. How could they have been so wrong?

Finance is increasingly fragile. Barry Eichengreen of the University of California at Berkeley and Michael Bordo of Rutgers University identify 139 financial crises between 1973 and 1997 (of which 44 took place in high-income countries), compared with a total of only 38 between 1945 and 1971. Crises are twice as common as they were before 1914, the authors conclude.

The paradox is that financial markets can function again only if this lesson is partly forgotten. **Financial transactions are a series of promises**. You hand your money to a bank, which promises to pay it back when you ask; you invest in a company, which promises you a share of its future profits. Money itself is just a collective agreement that a piece of paper can always be exchanged for goods or services.

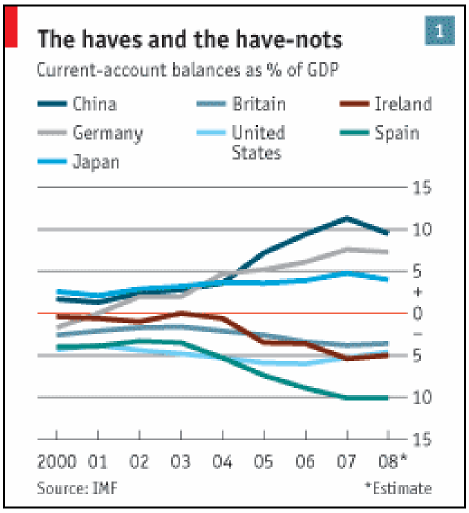
Imagine, for a second, how finance began, with small loans within families and between trusted friends. As the circle of lenders and borrowers grew, financial transactions were able to muster larger sums and to spread risk, even as promises became harder to enforce. Paul Seabright, an economist at the University of Toulouse in France, observes that trust in a modern economy has evolved to the miraculous point where people give complete strangers sums of money they would not dream of entrusting to their next-door neighbours. From that a further miracle follows, for trust is what raises the billions of dollars that fund modern industry.

Trust's slow accumulation pushes financial markets forward; its shattering betrayal batters them back. Sometimes this is through bad faith, as when Bernie Madoff, a grand fund manager, allegedly made his investors $50 billion poorer, or mortgage-sellers tempted naive borrowers. But promises made in good faith can be broken too. Indeed, honest failure is even more corrosive of trust than outright criminality. Everyone understands that now.

New order

The failure of finance will affect ideology, too. Many people find capitalism's central planner hard to put up with at the best of times. Free markets shun seemingly worthy causes, whereas the frivolous or apparently undeserving are rewarded. Look at the financial-services industry itself. In America middle-class pay has stalled in recent years but financiers have figured prominently among the tiny number of people who have captured much of the extra income. For as long as the world economy was growing fast, financial markets commanded grudging allegiance. Yet the same financiers who preached the necessity of free markets on the way up have since depended on taxpayers to save their industry at a cost of trillions of dollars.

Financiers will find the arguments for free markets harder to make now that they have lost the benefit of the doubt. Charles Kindleberger's classic study, "Manias, Panics and Crashes: A History of Financial Crises", updated by Robert Aliber in 2005, suggests that financial instability feeds on itself. Japanese savings fled their own bust and sloshed first into the Nordic countries and then into Asia, which suffered contagion in 1997.



The haves and the have-nots

Current-account balances as % of GDP

Source: IMF

Some see today's disaster as a result of that Asian crash. Asian nations—especially China—have been determined to be part of global capital markets but not to run current-account deficits which would leave them vulnerable to sudden currency outflows. So they have been happy to see their money go abroad. In the phrase of Martin Wolf, an economic columnist at the *Financial Times*, they "smoke but do not inhale".

In 2006 America's current-account deficit peaked at 6% of its GDP (see chart 1). Between 2000 and 2008 the country received over $5.7 trillion from abroad to invest, equivalent to over 40% of its 2007 GDP. Over the same period Britain and Ireland absorbed around a fifth of their 2007 GDPs and Spain a vast 50%. The financial system had the job of recycling the money to borrowers. Inevitably, credit became cheaper and savings declined. In America savings fell from around 10% of disposable income in the 1970s to 1% after 2005.

Not everyone agrees about the cause of this torrent of foreign capital. Although some blame Asian saving, others point to Western extravagance. But there is little doubt about the consequences. All four of the debtor countries in the chart enjoyed housing booms. Jeffry Frieden, a political economist at Harvard University, says about three-quarters of credit booms financed from abroad end up in crashes.

And yet financial services were not so much a victim of the inflows of foreign capital as an eager accomplice. The question is why financial systems are so liable to turn foreign credit into ruinous busts. In particular, why did America, home to the world's most advanced financial system, turn foreign credit into the world's most serious post-war bust?

The suspicion is that American know-how and talent made the disaster worse. Of all the financial instruments to have failed, newfangled collateralised-debt obligations (CDOs) have turned out to be among the most devastating. One way of thinking about CDOs, says Raghuram Rajan, a professor at the University of Chicago, is as a mechanism for converting mortgage securities and corporate bonds from huge, illiquid assets owned by local investors into liquid financial instruments that could be flogged across the world. Philip Lane, of Trinity College Dublin, thinks that sophisticated American financial services combined dangerously with relatively unsophisticated financial services elsewhere.

Never again, etc

If the price of sophistication is instability, something is wrong. You might conclude that the thing to do is to shackle finance as it was shackled in the 1950s and 60s. If ever there were a moment for this, it would be now. It takes a big upheaval to open the way for radical reform. The structure of financial regulation in America still bears the mark of ideas forged in the Depression.

Reform is certainly needed, yet, for all the excesses and instability of finance, a complete clampdown would be a mistake. For one thing, remember the remarkable prosperity of the past 25 years. Finance deserves some of the credit for that. Note, too, that finance has always been plagued by crises, whether the system is open or closed, simple or sophisticated. Attempts to regulate finance to make it safe often lead to dangerous distortions as clever financiers work around the rules. If there were a simple way to prevent crises altogether, it would already be the foundation stone of financial regulation.

In fact, the aim should be neither to banish finance nor to punish it, but to create a system that supports economic growth through the best mix of state-imposed stability and private initiative. Modern finance is flawed, unstable and prone to excess. But think of those boots and those wasted lives: planned markets are flawed, unstable and excessive too.

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28 gener 2009

Diagnosing depression

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What is the difference between a recession and a depression?

THE word "depression" is popping up more often than at any time in the past 60 years, but what exactly does it mean? The popular rule of thumb for a recession is two consecutive quarters of falling GDP. America's National Bureau of Economic Research has officially declared a recession based on a more rigorous analysis of a range of economic indicators. But there is no widely accepted definition of depression. So how severe does this current slump have to get before it warrants the "D" word?

A search on the internet suggests two principal criteria for distinguishing a depression from a recession: a decline in real GDP that exceeds 10%, or one that lasts more than three years. America's Great Depression qualifies on both counts, with GDP falling by around 30% between 1929 and 1933. Output also fell by 13% during 1937 and 1938. The Great Depression was America's deepest economic slump (excluding those related to wars), but at 43 months it was not the longest: that dubious honour goes to the one in 1873-79, which lasted 65 months.

Japan's "lost decade" in the 1990s was not a depression, according to these criteria, because the largest peak-to-trough decline in real GDP was only 3.4%, over the two years to March 1999. Since the second world war, only one developed economy has suffered a drop in GDP of more than 10%: Finland's contracted by 11% during the three years to 1993, mainly thanks to the collapse of the Soviet Union, then its biggest trading partner.

Emerging economies, however, have been much more depression-prone. Among the 25 emerging economies covered each week in the back pages of *The Economist*, there have been no fewer than 13 instances in the past 30 years of a decline in real GDP of more than 10%. Argentina and Poland were afflicted twice. Indonesia, Malaysia and Thailand all suffered double-digit drops in output during the Asian crisis of 1997-98, and Russia's GDP shrank by a shocking 45% between 1990 and 1998.

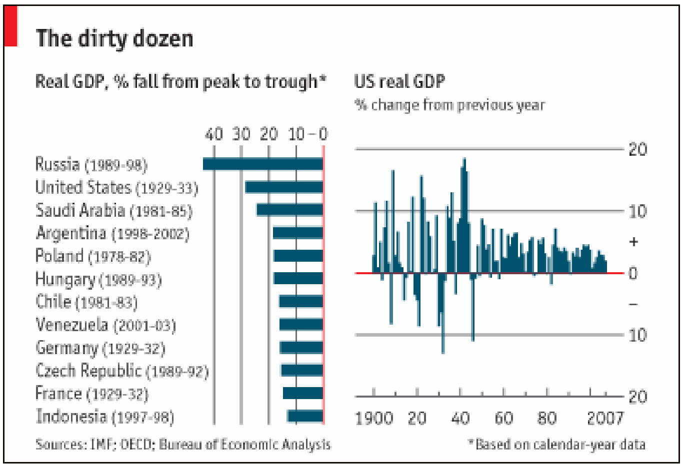
The left-hand chart shows *The Economist*'s ranking of slumps in developed and emerging economies over the past century. It excludes those during wartime (both Germany and Japan, for example, saw output plunge by 50% or more after 1944). The depressions in Germany and France in the 1930s make it into the top 12, but not that in Britain, where GDP fell by a relatively modest 6%.

Before the 1930s all economic downturns were commonly called depressions. The term "recession" was coined later to avoid stirring up nasty memories. Even before the Great Depression, downturns were typically much deeper and longer than they are today (see right-hand chart). One reason why recessions have become milder is higher government spending. In recessions governments, unlike firms, do not slash spending and jobs, so they help to stabilise the economy; and income taxes automatically fall and unemployment benefits rise, helping to support incomes. Another reason is that in the late 19th and early 20th centuries, when countries were on the gold standard, the money supply usually shrank during recessions, exacerbating the downturn. Waves of bank failures also often made things worse.

But a recent analysis by Saul Eslake, chief economist at ANZ bank, concludes that the difference between a recession and a depression is more than simply one of size or duration. The cause of the downturn also matters. A standard recession usually follows a period of tight monetary policy, but a depression is the result of a bursting asset and credit bubble, a contraction in credit, and a decline in the general price level. In the Great Depression average prices in America fell by one-quarter, and nominal GDP ended up shrinking by almost half. America's worst recessions before the second world war were all associated with financial panics and falling prices: in both 1893-94 and 1907-08 real GDP declined by almost 10%; in 1919-21, it fell by 13%.

The economic slumps that followed the collapse of the Soviet Union and those during the Asian crisis were not really depressions, argues Mr Eslake, because inflation increased sharply. On the other hand, Japan's experience in the late 1990s, when nominal GDP shrank for several years, may qualify. A depression, suggests Mr Eslake, does not have to be "Great" in the 1930s sense. On his definition, depressions, like recessions, can be mild or severe.

Another important implication of this distinction between a recession and a depression is that they call for different policy responses. A recession triggered by tight monetary policy can be cured by lower interest rates, but fiscal policy tends to be less effective because of the lags involved. By contrast, in a depression caused by falling asset prices, a credit crunch and deflation, conventional monetary policy is much less potent than fiscal policy.



Yes, we have no bananas

Where does that leave us today? America's GDP may have fallen by an annualised 6% in the fourth quarter of 2008, but most economists dismiss the likelihood of a 1930s-style depression or a repeat of Japan in the 1990s, because policymakers are unlikely to repeat the mistakes of the past. In the Great Depression, the Fed let hundreds of banks fail and the money supply shrink by one-third, while the government tried to balance its budget by cutting spending and raising taxes. America's monetary and fiscal easing this time has been more aggressive than Japan's in the 1990s.

However, these reassurances come from many of the same economists who said that a nationwide fall in American house prices was impossible and that financial innovation had made the financial system more resilient. Hopefully, they will be right this time. But this crisis was caused by the largest asset-price and credit bubble in history—even bigger than that in Japan in the late 1980s or America in the late 1920s. Policymakers will not make the same mistakes as in the 1930s, but they may make new ones.

In 1978 Alfred Kahn, one of Jimmy Carter's economic advisers, was chided by the president for scaring people by warning of a looming depression. Mr Kahn, in his next speech, simply replaced the offending word, saying "We're in danger of having the worst banana in 45 years." America's economy once again has a distinct whiff of bananas.

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