New president inherits a sea change in policy

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Some of history's greatest economic shifts are closely associated with politicians and big political swings.

In Britain, "Thatcherism" introduced monetarism, defeated inflation and ended an era of heavy government spending. The last decade of non-inflationary expansion is identified with New Labour and Gordon Brown.

In the US, the Reagan revolution ushered out stagflation, and Bill Clinton brought down the US deficit and delivered growth.

Thus many reckon the upcoming US presidential election could be critical for the world economy. It comes with the US economy in crisis, and pits two candidates with different economic philosophies against each other.

But in practice the link with politics is muddier than at first appears. Epic changes of economic policy do not come when voters dismiss one bunch of politicians and ask a new lot to do things differently. Rather, they tend to happen by force when the previous policies collapse under their own weight. It is politicians on their way out who are forced to change their own policies, once it becomes clear they have failed.

Thus monetarism in the UK dates from the Labour government's acceptance of a loan from the International Monetary Fund in the 1976, with all its monetarist conditions, rather than from the election of Margaret Thatcher three years later. Brownite expansion dates to Black Wednesday in 1992 when the Conservatives were forced to abandon the policy of pegging the pound to the Deutschemark.

In the US, supply side economics started with President Jimmy Carter's decision to appoint Paul Volcker as chairman of the Federal Reserve, while the Clinton attack on the deficit dates from President George H. W. Bush's decision to raise taxes - and arguably seal his political destiny.

The chances are that much the same thing has happened once more. In the last few months, the lame duck Bush administration has had to preside over a huge expansion of the government's role in the financial system. The Bear Stearns crisis prompted a big change in policy as investment banks, not only commercial banks, were allowed to borrow directly from the Federal Reserve.

Last weekend brought another move in this direction, as it was announced the Fed would lend to Fannie Mae and Freddie Mac, the independent agencies that between them guarantee or own half the mortgages in the US. The Treasury also said it would intervene to buy the agencies' stock if it stayed under pressure from short-sellers.

The agencies' debt in recent years has been more popular with non-US investors than either US stocks or US government bonds. They are the keystone of the entire US mortgage market. And now, almost explicitly, it appears they are agents of the US government.

Tuesday's announcement of a crackdown on "naked short-selling" - the already illegal practice of selling a stock without owning or even borrowing it first - was another instance of a shift away from the logic of free markets.

If this is not quite another New Deal, it does signal a sea change in economic policy. And like other great changes, it has come under pressure, not at the behest of voters.

This will now be presented to president McCain or president Obama as a *fait accompli* .

Events in the US markets this week need to be interpreted in this light: traders are reacting to the kind of shift which in the public mind only comes with important elections. Put this on top of an aggressive trade that had already been overdone - buying oil and selling short financials - and you get chaos.

By Tuesday, the KBW commercial banks index was trading at two-thirds of book value, with many big names trading for much less than this. This only made sense if a collapse was imminent. Bad but not apocalyptic results from regional banks were enough to trigger a bounce.

The KBW has gained 37 per cent since Tuesday; but it is still 47 per cent (or about $750bn in market cap) below last year's high.

The same pattern came in oil. Reports of demand slightly weaker and supply slightly stronger than expected were enough to push the crude price down by an eighth in 48 hours.

Traders were egged on by the close resemblance of the oil market to recent stock market bubbles. The chart compares crude in the last six months with the top six months for the Shanghai stock bubble last year.

In financials as in oil the common factors were an overdone market, and an emphatic signal from the government the world had changed.

This may explain why political risk is low on traders' priorities. There will be big decisions for the next president, but they are technical.

For example, the latest framework for Fannie and Freddie is untenable in the long-term. Should they be nationalised, split or closed for new business, or hit with regulations to force them steadily to cut back?

Much money will be made and lost on these decisions, but this is the stuff of technical arguments by policy wonks - not the deciding issues of a political campaign.