An imaginary retrospective of 2009

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It was the year when people finally gave up trying to predict the year ahead. It was the year when every forecast had to be revised - usually downwards - at least three times. It was the year when the paradox of globalisation was laid bare for all to see, if their eyes weren't tightly shut.

On the one hand, the increasing integration of markets for commodities, manufactures, labour and capital had led to great gains. As Adam Smith had foreseen in The Wealth of Nations, economic liberalisation had allowed the division of labour and comparative advantage to operate on a global scale. From the 1980s until 2007, the world economy had enjoyed higher, more widespread growth and fewer, less severe crises - hence Federal Reserve chairman Ben Bernanke's hubristic celebration of a "great moderation" in 2004.

On the other hand, the more the world came to resemble an intricate, multi-nodal network operating at maximum efficiency - with minimal inventories and just-in-time delivery - the more vulnerable it became to a massive systemic crash.

That was the true significance of the Great Repression which began in August 2007 and reached its nadir in 2009. It was clearly not a Great Depression on the scale of the 1930s, when output in the US declined by as much as a third and unemployment reached 25 per cent. Nor was it merely a Big Recession. As output in the developed world continued to decline throughout 2009 - despite the best efforts of central banks and finance ministries - the tag "Great Repression" seemed more and more apt: although this was the worst economic crisis in 70 years, many people remained in deep denial about it.

"We assumed that we economists had learned how to combat this kind of crisis," admitted one of President Barack Obama's "dream team" of economic advisers, shortly after his return to academic life in September 2009. "We thought that if the Fed injected enough liquidity into the financial system, we could avoid deflation. We thought if the government ran a big enough deficit, we could end a recession. It turned out we were wrong. So much for [John Maynard] Keynes. So much for [Milton] Friedman."

The root of the problem remained the US's property bubble, which continued to deflate throughout the year. Many people had assumed that by the end of 2008 the worst must be over. It was not. Economist Robert Shiller's real home price index in 2006 had stood at just under 206, nearly double its level just six years earlier. To return to its pre-bubble level, it therefore had to fall by 50 per cent. Barely half that decline had taken place by the end of 2008. So house prices continued to slide in the US. As they did, more and more families found themselves in negative equity, with debts exceeding the value of their homes. In turn, rising foreclosures translated into bigger losses on mortgage-backed securities and yet more red ink on banks' balance sheets.

With total debt above 350 per cent of US gross domestic product, the excesses of the age of leverage proved difficult to purge. Households reined in their consumption. Banks sought to restrict new lending. The recession deepened. Unemployment rose towards 10 per cent, and then higher. The economic downward spiral seemed unstoppable. No matter how hard they saved, Americans simply could not stabilise the ratio of their debts to their disposable incomes. The paradox of thrift meant that rising savings translated into falling consumer demand, which led to rising unemployment, falling incomes and so on, ever downwards.

"Necessity will be the mother of invention," Obama declared in his inaugural address on January 20. "By investing in innovation, we can restore our faith in American creativity. We need to build new schools, not new shopping malls. We need to produce clean energy, not dirty derivatives." Commentators agreed that the speech was on a par with Franklin Roosevelt's on his inauguration in 1933. Yet Roosevelt had spoken after the worst of the Depression was over, Obama in mid-tailspin. The rhetoric flew high. But the markets sank lower. The contagion spread inexorably from subprime to prime mortgages, to commercial real estate, to corporate bonds and back to the financial sector. By the end of June, Standard & Poor's 500 Index had sunk to 624, its lowest monthly close since January 1996, and about 60 per cent below its October 2007 peak.

The crux of the problem was the fundamental insolvency of the major banks, another reality that policymakers sought to repress. In 2008, the Bank of England had estimated total losses on toxic assets at about $2.8 trillion. Yet total bank writedowns by the end of 2008 were little more than $583bn, while total capital raised was just $435bn. Losses, in other words, were either being massively understated, or they had been incurred outside the banking system. Either way, the system of credit creation had broken down. The banks could not contract their balance sheets because of a host of pre-arranged credit lines, which their clients were now desperately drawing on, while their only source of new capital was the US Treasury, which had to contend with an increasingly sceptical Congress. The other credit-creating institutions - especially the markets for asset-backed securities - were all but paralysed.

There was uproar when Timothy Geithner, US Treasury secretary, requested an additional $300bn to provide further equity injections for Citigroup, Bank of America and the seven other big banks, just a week after

Bank of America and the seven other big banks, just a week after imposing an agonising "mega-merger" on the automobile industry. In Detroit, the Big Three had become just a Big One, on the formation of CGF (Chrysler-General Motors-Ford; inevitably, the press soon re-christened it "Can't Get Funding"). The banks, by contrast, seemed to enjoy an infinite claim on public funds. Yet no amount of money seemed enough to persuade them to make new loans at lower rates. As one indignant Michigan law-maker put it: "Nobody wants to face the fact that these institutions [the banks] are bust. Not only have they lost all of their capital. If we genuinely marked their assets to market, they would have lost it twice over. The Big Three were never so badly managed as these bankrupt banks."

In the first quarter, the Fed continued to do everything in its power to avert the slide into deflation. The effective federal funds rate had already hit zero by the end of 2008. In all but name, quantitative easing had begun in November 2008, with large-scale purchases of the debt and mortgage-backed securities of government-sponsored agencies (the renationalised mortgage giants Fannie Mae and Freddie Mac) and the promise of future purchases of government bonds. Yet the expansion of the monetary base was negated by the contraction of broader monetary measures such as M2 (the measurement of money and its "close substitutes", such as savings deposits, that is a key indicator of inflation). The ailing banks were eating liquidity almost as fast as the Fed could create it. The Fed increasingly resembled a government-owned hedge fund, leveraged at more than 75 to 1, its balance sheet composed of assets everyone else wanted to be rid of.

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The position of the US federal government was scarcely better. By the end of 2008, the total value of loans, investments and guarantees given by the Fed and the Treasury since the beginning of the financial crisis had already reached $7.8 trillion. In the year to November 30 2008, the total federal debt had increased by more than $1.5 trillion. Morgan Stanley estimated that the total federal deficit for the fiscal year 2009 could equal 12.5 per cent of GDP. The figure would have been even higher had President Obama not been persuaded by his chief economic adviser, Lawrence Summers, to postpone his planned healthcare reform and promised spending increases in education, research and foreign aid.

Obama had set out to construct an administration in which his rivals and allies were equally represented. But his rivals were a good deal more experienced than his allies. The result was an administration that talked like Barack Obama but thought like Bill Clinton. The Clinton-era veterans, not least Secretary of State Hillary Clinton, had vivid memories of the bond-market volatility that had plagued them in 1993 (prompting campaign manager James Carville to say that, if there was such a thing as reincarnation, he wanted to come back as the bond market). Terrified at the swelling size of the deficit, they urged Obama to defer any expenditure that was not specifically targeted on ending the financial crisis.

Yet the world had changed since the early 1990s. Despite the fears of the still-influential former Treasury secretary Robert Rubin, investors around the world were more than happy to buy new issues of US Treasuries, no matter how voluminous. Contrary to conventional wisdom, the quadrupling of the deficit did not lead to falling bond prices and rising yields. Instead, the flight to quality and the deflationary pressures unleashed by the crisis around the world drove long-term yields downwards. They remained at close to 3 per cent all year.

Nor was there a dollar rout, as many had feared. The foreign appetite for the US currency withstood the Fed's money-printing antics, and the trade weighted exchange rate actually appreciated during 2009.

Here was the irony at the heart of the crisis. In all kinds of ways, the Great Repression had "Made in America" stamped all over it. Yet its effects were more severe in the rest of the world than in the US. And, as a consequence, the US managed to retain its "safe haven" status. The worse things got in Europe, in Japan and in emerging markets, the more readily investors bought Treasuries and held dollars.

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For the rest of the world, 2009 proved to be an annus horribilis. Japan was plunged back into the deflationary nightmare of the 1990s by yen appreciation and a collapse of consumer confidence. Things were little better in Europe. There had been much anti-American finger-pointing by European leaders in 2008. The French president Nicolas Sarkozy had talked at the G-20 summit in Washington as if he alone could save the world economy. The British prime minister Gordon Brown had sought to give a similar impression, claiming authorship of the policy of bank recapitalisation. The German chancellor Angela Merkel, meanwhile, voiced stern disapproval of the excessively large American deficit.

By the first quarter of 2009, however, the mood in Europe had darkened. It became apparent that the problems of the European banks were just as serious as those of their American counterparts. Indeed, the short-term liabilities of the Belgian, Swiss, British and Italian banks were far larger in relation to those countries' economies, while the German, French and Danish banks were much more dangerously leveraged. Moreover, in the absence of a European-wide finance ministry, all talk of a European stimulus package was just that - mere talk. In practice, fiscal policy became a matter of sauve qui peut, with each European country improvising its own bailout and its own stimulus package. The result was a mess. Currencies outside the Euro area were afflicted by severe volatility. Inside the Euro area, the volatility was in the bond market, with spreads on Greek and Italian bonds exploding relative to German bunds.

The picture was even worse in most emerging markets. Especially hard hit in eastern Europe were Bulgaria, Romania, Ukraine and Hungary. Of the Brics (Brazil, Russia, India and China), Brazil had the best year, Russia the worst. It was a terrible year for oil and gas exporters, as prices plunged, taking currencies such as the rouble down with them. The Indian stock market, meanwhile, was battered by escalating tensions between New Delhi and Islamabad in the wake of the Mumbai terrorist attacks.

Political instability also struck China, where riots by newly redundant workers in Shenzhen and other export centres provoked a heavy-handed clampdown by the government, but also a renewed effort by the People's Bank of China to prevent the appreciation of the yuan by buying up yet more hundreds of billions of dollars of US Treasuries. "Chimerica" - the symbiotic relationship between China and America - not only survived the crisis, but gained from it. Although Obama's decision to attend the first G-2 summit in Beijing in April dismayed some liberals, most recognised that trade trumped Tibet at such a time of economic crisis.

This asymmetric character of the global crisis - the fact that the shocks were even bigger on the periphery than at the epicentre - had its disadvantages for the US, to be sure. Any hope that America could depreciate its way out from under its external debt burden faded as 10-year yields and the dollar held firm. Nor did American manufacturers get a second wind from reviving exports, as they would have done had the dollar sagged. The Fed's achievement was to keep inflation in positive territory - just. Those who had feared galloping inflation and the end of the dollar as a reserve currency were confounded.

On the other hand, the troubles of the rest of the world meant that in relative terms the US gained, politically as well as economically. Many commentators had warned in 2008 that the financial crisis would be the final nail in the coffin of American credibility around the world. First, neo-conservatism had been discredited in Iraq. Now the "Washington consensus" on free markets had collapsed. Yet this was to overlook two things. The first was that most other economic systems fared even worse than America's when the crisis struck: the country's fiercest critics - Russia, Venezuela - fell flattest. The second was the enormous boost to America's international reputation that followed Obama's inauguration.

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If proof were needed that the US constitution still worked, here it was. If proof were needed that America had expunged its original sin of racial discrimination, here it was. And if proof were needed that Americans were pragmatists, not ideologues, here it was. It was not that Obama's New New Deal - announced after the Labor Day purge of the Clintonites - produced an economic miracle. Nobody had expected it to do so. It was more that the federal takeover of the big banks and the conversion of all private mortgage debt into new 50-year Obamabonds signalled an impressive boldness on the part of the new president.

The same was true of Obama's decision to fly to Tehran in June - a decision that did more than anything else to sour relations with Hillary Clinton, whose supporters never quite recovered from the sight of the former presidential candidate shrouded in a veil. Not that the so-called "opening to Iran" produced a dramatic improvement in the Middle East region. Nobody had expected that either. It was more that, like Richard Nixon's visit to China in 1972, it symbolised a readiness on Obama's part to rethink the very fundamentals of American grand strategy. And the downfall of the Iranian president Mahmoud Ahmedinejad - followed soon after by the abandonment of the country's nuclear weapons programme - was a significant prize in its own right. With their economy prostrate, the pragmatists in Tehran were finally ready to make their peace with "the Great Satan", in return for desperately needed investment.

Meanwhile, al-Qaeda's bungled attempt to assassinate Obama - on the eve of Thanksgiving - only served to discredit radical Islamism and to reinforce Obama's public image as "The One". Another of the many ironies of 2009 was that the mood of religious reawakening triggered by the economic crisis benefited the Democrats rather than the deeply divided Republicans.

By year end, it was possible for the first time to detect - rather than just to hope for - the beginning of the end of the Great Repression. The downward spiral in America's real estate market and the banking system had finally been halted by radical steps that the administration had initially hesitated to take. At the same time, the far larger economic problems in the rest of the world had given Obama a unique opportunity to reassert American leadership, particularly in Asia and the Middle East.

The "unipolar moment" was over, no question. But power is a relative concept, as the president pointed out in his last press conference of the year: "They warned us that America was doomed to decline. And we certainly all got poorer this year. But they forgot that if everyone else declined even further, then America would still be out in front. After all, in the land of the blind, the one-eyed man is king."

And, with a wink, President Barack Obama wished the world a happy new year.

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