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The Ascent of Money: A Financial History of the World

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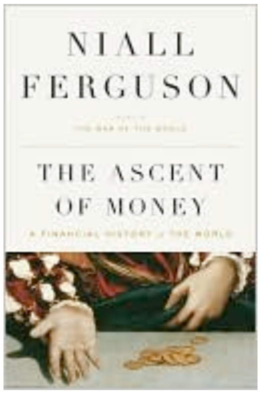

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Introduction

JOANNE MYERS: Good morning. I'm Joanne Myers. On behalf of the Carnegie Council, I'd like to thank you all for joining us.

During my tenure at the Carnegie Council, I have had the privilege of introducing many speakers. I know you will agree that most of them have been very stimulating, fascinating in what they have to say, and, for the most part, very smart. Even so, there are always a few who, in my opinion, stand out from all the rest. This morning it is my pleasure to welcome back one such individual, one of my favorite recidivists, Niall Ferguson.

In the past, Niall has spoken to us about empire, diplomacy, warfare, and globalization. Today he will be discussing a topic on everyone's mind, the financial crisis. His book, *The Ascent of Money: A Financial History of the World*, will provide a background and an understanding for many of the critical problems we are now facing on Wall Street and beyond.

For anyone who has read his earlier books or has taken the time to read his impressive bio that was handed out to you earlier, there is no denying that you have learned a great deal from this exceptionally formidable historian. The bottom line is that this morning you can bank on knowing that you will leave here with much more knowledge from someone who has never passed the buck in his talks here. Although he may not be made out of money, as you will see, he is worth his weight in gold.

When I began writing this introduction, it occurred to me how often the word "money" and references to it not only have entered our everyday vocabulary, but have permeated our culture as well. For example, over and over I kept seeing Joel Grey in *Cabaret* performing "Money, Money, Money Makes the World Go Around, Makes the World Go Around." When that stopped playing in my head, I heard the character Fagin in *Oliver!* singing, "In this life, one thing counts, in the bank, large amounts."

One thing led to another, and then I began thinking about the Watergate debacle, where the modus operandi was, "Follow the money."

Next I had visions of Cuba Gooding, who, in the movie *Jerry Maguire*, shouted, "Show me the money."

Finally, I had enough when I heard Michael Douglas, when playing Gordon Gekko in the movie *Wall Street*, speak the line that epitomized the late 1980s and has now once again become emblematic of our time: "Greed is good."

I could go on and on, but I think you have the idea. As I suspect, many of you in this time of financial crisis can conjure up your own associations to the power and fascination that the word "money" evokes. But before you do, I just wonder how many of you are familiar with this subject's complex history and have thought about the centrality of finance to all elements of human progress.

In *The Ascent of Money*, Niall takes us on a very special historical journey. Although his recent books have been mostly about the decline of empires, financial history is his specialty, as evidenced by his earlier writing, *The Cash Nexus* and *The House of Rothschild*. With his signature clarity, verve, and eloquence, this time around he shows us just how vital finance is to the history of the world. He asks, how did we come to live in a world where most money is invisible? Where did money come from, and where did it go?

As he charts the rise of money from 5,000 years ago to the numbers we see flickering on the big board on Wall Street, he engages and entertains, as he reminds us just how much money represents a relationship of trust and how the development of money has gone hand in hand with the development of modern societies. He explains the origin and growth of money, banks, stock markets, the exotic growth of the financial instruments and institutions that even bewilder those in the field. With his extraordinary ability to link the past with the present, Niall tells us, if we want money to serve us in the future, it is important to attend to the ways it has served us in the past.

I believe a reading of *The Ascent of Money* can do just that.

In these dire financial times, it should be self-evident that we need someone or something that can put today's crisis into context and suggest to us what can be done in the future. In my humblest opinion, that someone is here, with that something that can make all the difference, our speaker, the man with the Midas touch, Niall Ferguson.

Remarks

NIALL FERGUSON: The best things in life are free, ladies and gentlemen. Joanne, you're not free, but you're certainly one of the best things in life. Thank you so much for that very generous introduction.

It's a huge pleasure to be back here, I think some two years since my last visit. Two years ago, I talked about my book *The War of the World*, which was an explanation—I think an explanation—of mid-20th-century conflicts. One of the arguments that I made was that there are three things that determine the timing and location of extreme, organized, lethal violence in mid-20th century: empires in decline (that’s a subject I have written about in other places), ethnic disintegration, and economic volatility.

Two years ago, I was able to say we may have one and we may have two, but, fortunately, we don't have three yet. At that time, I was also quite regularly speaking at meetings organized by investment banks. You remember what they were, don't you? The theme of my talks in mid-2006 and early 2007 was the possibility, indeed the probability, of a liquidity crisis striking highly leveraged financial institutions and causing the kind of financial crisis that hadn't been seen in more than a generation. I wrote a number of pieces and gave a number of talks on this theme.

What most impressed me was the extreme reluctance of anybody in the financial world to take this scenario seriously. At that time, two years ago, the conventional wisdom on Wall Street and in the City of London was that we were living through what Ben Bernanke called the "Great Moderation," the death of volatility. Risk had been allocated to those best able to bear it. This time, it really was different.

My approach to the problem was to say, "Financial history will prove you wrong. You only believe this because you are basing your assessment on your own experience. And that is too small a data set. Even if you've had 25 years on Wall Street, you cannot imagine what it might be like if a really big liquidity crisis struck."

The Ascent of Money is an attempt to provide context for this crisis. It was written in anticipation of the crisis. I hope that, for those of you baffled or at least somewhat disconcerted by what is happening, it will offer some illumination. It is a lay person's guide to the international financial system, written on the assumption that you can't really understand something until you know where it came from. There's only one equation in the whole book, and it's there to be ridiculed.

What I want to do this morning is not talk through the argument of the book, but rather, because of the nature of this audience, to explore its geopolitical implications. What does it mean when a subprime mortgage crisis—that is to say, a crisis in the mortgage market for relatively poor Americans—precipitates a credit crunch—that is to say, a major breakdown in trust between financial institutions and a seizure within the credit market—which in turn begets a global financial crisis comparable in its magnitude to the worst recession of the postwar period, perhaps even comparable—who knows?—with the Great Depression? What does that mean?

There are a number of arguments out there that are relevant here. My friend Fareed Zakaria is riding high on the bestseller list with a book called *The Post-American World*. Does this accelerate the transition to a post-American world? Many people seem to think so. This, after all, is a financial crisis made in America.

"One thing seems probable to me"—and I'm quoting here Peer Steinbrück, the German finance minister, only a month or so ago—"the U.S. will lose its status as the superpower of the global financial system."

Here's a headline from *The New York Times* last month: "A Power That May Not Stay So Super," the United States.

"A Shattering Moment in America's Fall from Power." That was *The Guardian*.

"The End of Hubris," *Der Spiegel*.

It is fast becoming conventional wisdom in the Western media—and one also hears it argued in Asia, too (I have just returned from a trip to Singapore)—that this crisis implies an acceleration of the decline and fall of the American Empire. Richard Holbrooke only the other day published an article in *Foreign Affairs* in which he argued—and I quote—"There is one pattern that comes very close to being a law of history. In the long run, the rise and fall of great nations is driven primarily by their economic strength. Rome, Imperial China, Venice, France, the Netherlands, Portugal, the United Kingdom, all had their day, and their international decline followed inexorably from their economic decline."

This, of course, is the legacy of Paul Kennedy's great book, *The Rise and Fall of Great Powers*, a book that I very much admire but have had occasion to disagree with over the years.

Now, you might expect me to be attracted to this argument, particularly if you read my book *Colossus: The Rise and Fall of the American Empire*, the last chapter of which suggested—this was published back in 2004—that the principal vulnerability of the United States was not imperial overstretch, excessive military commitments abroad (which, you will recall, was Paul Kennedy's argument in 1987), but was internal indebtedness. The fiscal deficit, the current account deficit, I suggested in 2004, was among the three deficits that were likely to undermine the American Empire.

You will remember that the other deficits were the manpower deficit—the chronic inability of Americans to export people, which is a major problem if you are trying to run a global empire—and, of course, the attention deficit, which has plagued all American interventions overseas, with a very few exceptions.

However, I'm going to argue somewhat paradoxically this morning that the credit crunch, global financial crisis, or Great Depression—whatever you feel like calling it—this great economic shock does not necessarily reduce the power of the United States. It may, in fact, have the opposite effect, for the simple reason that power is relative. Let me explore this argument a little bit more closely.

The first point I want to make to you is that the wrong question is to ask if this represents a decline of the American Empire or of American superpower. What we should really ask is whether this crisis portends a decline of what I call "Chimerica." Chimerica is a fantasy country that I dreamt up a couple of years ago. It's the economy you get when you add together China plus America. Chimerica has been, in many ways, the key to the way in which the world economy has worked in the past ten years. Increasingly, the U.S. current account deficit, which peaked at around 1 percent of global output, has been financed by the People's Bank of China—not exclusively. The Bank of Japan has done some. So have the oil exporters. There have been a number of surplus countries that have helped to contribute to this financing of the American deficit. But China has become, in many ways, the key.

My argument is that you can't really understand what happened in the global economy in the last ten years if you don't understand Chimerica.

It seemed like the perfect marriage: One partner did the saving and the other partner did the spending. You may know couples like that. The Chinese saved; the Americans spent. For the Chinese, this was advantageous. They had an export market that they could rely upon. From the United States' point of view, this was a line of credit at remarkably low interest rates. When ten-year Treasuries were trading at 3.5 percent, the United States was able to borrow at historically low rates, despite the fact that its borrowings kept going up and up and up.

Call it the "age of leverage." We have lived through an age of leverage in which the ratio of debt to GDP in the United States, including all forms of debt, public and private, has risen from about 150 percent to 355 percent. You can't understand the consumption boom of the last six or seven years, and you certainly can't understand the great leveraging of the last decade or so, if you don't understand Chimerica. It was only possible because of what Ben Bernanke called "the Asian savings glut."

So the big question is whether the financial crisis that began in August of last year threatens Chimerica. If it disrupts the relationship between the United States and the great capital exporting economies—in particular, China—then we have a very serious problem indeed. But I'm not entirely sure that it will. Let me tell you why.

Before I explore this, let's reflect for a second on how this crisis unfolded. It's worth pondering. It began with the breakdown of a bubble, the deflation of a real estate bubble, in the United States. Property prices were rising at an annual rate, at the maximum point, of nearly 20 percent a year. This was a classic bubble, and the second bubble we have seen within a little more than a decade—the stock market bubble of the late 1990s, followed by the real estate bubble of the recent 2000s.

As property prices began to fall—and they are now falling at a faster rate than at any time since the early 1930s—monetary policy dived into action, diving downward in terms of the federal funds rate and leaping upwards in terms of the balance sheet of the Federal Reserve. Currently, the Fed's various liquidity operations total in excess of $1.7 trillion. Its balance sheet now exceeds $2 trillion. It may come as a surprise to you to know that, in effect, the Fed has become a hedge fund, leveraged at roughly 50 to 1. That's the ratio of its assets to its capital. So this is now one of the world's biggest and, it seems to me, riskiest hedge funds.

It wasn't enough. Not only did the United States slash interest rates and pump trillions of dollars into the financial system, it also has embarked on a public borrowing spree, as the U.S. Treasury has leapt into action with TARP, the Troubled Asset Recovery Program, and other stimulus packages no doubt to proliferate in the months ahead.

Where have we got to? I call it the "Great Repression." It's the Great Repression because we are repressing a banking crisis comparable in magnitude with that of the early 1930s. We are, in some measure, in denial about the magnitude of this crisis. I'm constantly meeting people who say, "The bottom of the market will be tomorrow."

It's very certain to be a big recession. I think we can anticipate an entire year of negative GDP growth in the United States, followed by a period of very slow growth, conceivably running for five years or more. Why do I think that? If the end of leverage is upon us, if the age of leverage is at an end, and debt is no longer going to be readily available to financial institutions and to households, then we are bound to have much lower growth. Deleveraging means precisely that.

If you take out mortgage equity withdrawal from the story of the period 2001 to 2007, take it out from the growth numbers, you find that growth under President George W. Bush would have averaged 1 percent a year. It was mortgage equity withdrawal that kept consumption going, and nothing else. So 1 percent per annum may, in fact, be the natural growth rate of the United States, in the absence of leverage.

But what does this mean geopolitically? Does this fundamentally alter the relationship between the United States and the rest of the world? That seems to me to be the big question. If the United States is turning Japanese, if it's about to experience what Japan experienced in the 1990s—zero interest rates, an explosion in public debt, but—oh dear, Keynesianism doesn't really work—very low growth, perhaps even no growth, over the decade—does that portend an acceleration of the decline of the United States?

There are three reasons why it's plausible to think that it does, three reasons that I hear people put forward when they are claiming that this is the end of American superpower.

One is just that this represents a loss of credibility. The Washington Consensus is dead. The American model of deregulated financial markets has been discredited, literally. This, I suppose, is an argument most commonly made in Western Europe.

The second argument that one hears is that this will accelerate what is sometimes called the "great reconvergence." That is to say, it will accelerate the closing of the gap between the United States and the big, rapidly industrializing countries, the BRICs—Brazil, Russia, India, and particularly China.

Goldman Sachs some years ago, under the direction of their excellent Mancunian economist, Jim O'Neill, produced a report, the BRICs report, that forecast that China's gross domestic product would equal that of the United States in around 2040. A few years ago—I think two years ago—O'Neill and his colleagues revised their projections of growth and concluded that the *sorpasso*, to use an Italian term, the moment at which China overtakes the United States, could come as soon as 2027.

Is it not reasonable, therefore, to assume that the credit crunch, that the financial crisis, will bring that date still nearer? If the United States is condemned to a decade of 1 percent per annum growth and China can still manage, let us say, conservatively, 6 or 7 percent per annum growth, could the *sorpasso* come as soon as 2020 or 2019, perhaps within a decade? It seems a reasonable probability, if you believe that growth rates can be projected forward in that kind of way.

A third possibility which is worth exploring, a third reason why the United States might be in serious trouble, is the idea that the dollar is going to lose its status as the reserve currency. It has been crucial for the United States that it has been able to borrow in the international reserve currency, because it has given it an advantage over other sovereign borrowers. But history tells us a very simple story, particularly British history. No reserve currency lasts forever. A hundred years ago, the pound was the principal international reserve currency. Its painful decline and fall from close to $5.00 at one time to the nadir of near-parity in the early 1980s—that is a story of the decline and fall of a reserve currency.

It could happen to a currency near you.

So these are the three arguments that I hear that have some substance to them:

(1) This is a crisis that discredits the United States as a purveyor of economic ideology.

(2) It's a crisis that accelerates the convergence of, particularly, Chinese and American GDP.

(3) It's a crisis that threatens the status of the dollar as a reserve currency.

Well, I want to suggest to you six reasons why this may not, in fact, work out the way the forecasts of decline anticipate—six arguments, if you like, against American suicide, or at least against American depression.

The first point to notice is that for the United States to contend with a financial crisis on this scale is fiscally possible. That is to say, even a $2-trillion deficit—let's assume the worst, the largest imaginable deficit in peacetime next year, to finance not only the bailout, but also an enormous stimulus package—this can be financed, it seems to me, because the debt-to-GDP ratio of the United States is by no means the highest in the world as things stand. If you include only that debt which is in public hands, as opposed to in the hands of government agencies, it's still less than 50 percent of GDP. An addition of another, let's say, ten percent of GDP is conceivably affordable.

It's affordable, but there is a caveat: Assuming the rest of the world is willing to absorb a continued, indeed accelerated, issuance of American government debt.

The second and, in many ways, crucial point is that it's all relative. It's relatively easier for the United States to finance this kind of a deficit than it is for European countries. What is not generally acknowledged here or in Europe is that the crisis is worse for Europe than for the United States. Why is that?

First, it's because the banking problems that we have seen in this country are mirrored on the other side of the Atlantic. Indeed, leverage is higher in many European countries' banking systems than it is here—much higher in the case, for example, of Germany. It comes as something of a surprise to realize the extent to which the Europeans currently pointing fingers at the United States have been guilty of exactly the same excesses in their financial markets as went on here. Indeed, in a country like Britain, the degree of imbalance between finance and the rest of the economy is far, far greater than here.

It has to be said—and I apologize to any of my countrymen and countrywomen here—that from a purely financial point of view, Great Britain is close to being "Great Iceland." The Icelandic story of an excessively large financial system in relation to an underlying economy is, in fact, quite closely paralleled but on a larger scale in the United Kingdom at this point.

Switzerland, too, has an Icelandic character—an enormous financial system relative to the underlying economy.

It's much harder for the Europeans to contend with this crisis because not only are these very large financial systems in, arguably, worse shape than the American banking system, there is also no European treasury that can finance a $700-billion bailout. Right now each European country is having to tackle its financial crisis on its own. National treasuries, national financial ministries are coping with this crisis—or, rather, not coping with this crisis.

So that's the second point. It's not really appreciated how big a problem this is for the Eurozone, and indeed for the wider European Union.

The third point is that those famous BRICs—Brazil, Russia, India, China—turn out to have been aptly named, because they are dropping like bricks. If you look at equity markets, although it's unquestionably the case that this is one of the worst bear markets in the United States in living memory, the stock exchanges of the BRICs have fallen twice as far as the S&P 500 in the year to date, with Russia the worst performer and China and India not far behind.

That's important, because it seems to me to cast fundamental doubt on the plausibility of the decoupling hypothesis. (I always find that word "decoupling" faintly obscene, but that's possibly because I have a puerile mind.) But let's simply assume the thesis that China can walk away from this financial crisis unscathed and continue to maintain a growth rate of at least 6 or 7 percent. That is the hypothesis of the great reconvergence.

I'm not persuaded. I'm not persuaded that China is so much less dependent on export markets than it was, say, 10 years ago. Many of the calculations that imply that seem to me to be based on official estimates of the importance of net exports that aren't wholly plausible.

The BRICs are dropping, in other words. It's by no means certain that they can avoid a kind of asymmetric shock as the export markets of the developed world suddenly contract.

My fourth point is that the great crisis is terrible news for the petro-powers. Remember, some of the biggest thorns in the side of the United States are energy exporters—Russia, Venezuela, and, of course, Iran. The great credit crunch spells the end of the commodity-price boom that peaked in the early part of this year. As the price of natural gas, and particularly of oil, zooms downward—I think quite likely to below $50 a barrel, maybe to as low as $25 a barrel—it's game-over for the petro-powers. It doesn't take much for Venezuela's financial system to teeter on the brink. In fact, as soon as oil fell below $95 a barrel, the finances of Venezuela began to look very problematic. For the other petro-powers, the price barrier is a little lower, but not that much lower.

Again, it's all relative. It's all relative. But in the end, the relative shock of a great recession, if not a great depression, is greater for energy exporters than for the energy importers, who, in fact, get a kind of stimulus, a kind of tax cut at the gasoline pump.

Let me make two more points and then conclude.

The penultimate is that, while our attention has been diverted to the financial crisis, so diverted that the economy became *the* issue, the one and only issue, in the presidential campaign that culminated on November 4, other problems that used to preoccupy us have become significantly less serious. The situation in the Middle East is significantly better, in my view, than it was two years ago, not least because of the success of the surge in Iraq in achieving some stabilization of that country's security and laying the foundation for an agreement between the Iraqi government and the United States on the future status of American forces in that country—a major breakthrough, which goes to show, of course, that in politics no good deed goes unpunished. His correctness about the surge did not help John McCain in the presidential election. He was right about it and his opponent was, in fact, wrong.

But success took Iraq off the electoral agenda. Indeed, the modest success, I would say, of the Annapolis process has also taken the Middle East off the political agenda.

But the success doesn't seem to me to be any the less, despite its lack of political salience.

I think the critical point, though, is the potential that now exists for some kind of breakthrough in relations between the United States and Iran. To me, the most significant part of those presidential debates by far came in the second debate, when the two candidates found themselves arguing about what Henry Kissinger had said on the subject of talks without preconditions with Iran. I found that fascinating, that a man who has been out of government for three decades should be still regarded as the fountainhead of wisdom on the front that we call the Middle Eastern peace process.

I foresee under the new president a breakthrough in relations with Iran, because the Iranians desperately need it and the United States has something it can offer. I foresee a Nixon-in-China moment, Obama-in-Tehran, that will fundamentally alter the situation in the Greater Middle East. This is a huge opportunity, there for the taking for the new administration.

In that sense, the geopolitical situation of the United States has been quietly improving in the most hot of all the hotspots in the world.

Which leaves me with just one final point: Is it all over for Chimerica? That's the key, really. Currently, the plans being implemented in Washington for a bailout and a stimulus package that will take the deficit well north of $1 trillion next year are predicated on the idea that the rest of the world, and particularly China, will continue to finance that deficit. It certainly can't be financed domestically, because the savings simply aren't there.

Now, will the Chinese do it or not? Will they continue to be buyers of U.S. Treasuries, as they have been for the past five or six years, or not? The possibility exists that they will switch their resources to domestic expansion, to domestic consumption. That seems to be one of the implications of their own stimulus package, which is around about $586 billion worth of stimulus, a very large proportion of Chinese GDP, about 15 percent. But I don't think it's absolutely certain. In fact, I have deep doubts that the Chinese are really able to walk away from their Chimerican relationship. That is because the export sector remains absolutely crucial to China's economy, and the Chinese themselves have been shocked at the damage that has already been done to that sector by the global slowdown.

It seems likely that they have reversed their policy of allowing the Chinese currency gently to appreciate relative to the dollar. In fact, I would anticipate an increase of intervention by the People's Bank of China to halt, and maybe even to reverse, renminbi appreciation. That is very crucial indeed, because it means they become committed to the accumulation of yet more dollar reserves.

News just in: Last month the Japanese were net sellers of Treasuries, to the tune of nearly $13 billion, but the Chinese were net buyers, to the tune of nearly $50 billion—just last month.

So their actions seem to me to be speaking rather louder than their words. I don't see the Chinese walking away from Chimerica. They have too much skin in this game. Did you realize that roughly a fifth of their currency reserves were in the form of the debt of Fannie Mae and Freddie Mac? If you want a reason for why those institutions were bailed out the way they were, look to Beijing, not to Washington.

The Chinese stand to lose more than anybody else from a dollar rout. If the dollar ceases to be a reserve currency and depreciates drastically against Asian currencies, the Chinese will be hurt more than anyone, which is why I think it's highly unlikely that they will let it go.

For all these reasons, it seems to me that, as Churchill, I think it was, once said, "God continues to look after not only fools and drunks, but also the United States." A crisis made in America is having greater repercussions and causing greater pain in the rest of the world than in the United States itself. Yes, the United States is heading for a decade of slow growth. But the pain may be greater in the rest of the world, including, my view, the BRICs. And since all power is relative, that may imply—and this is the supreme paradox—that this crisis enhances the power of the United States and indeed increases the demand in the rest of the world for American economic and geopolitical leadership.

This is the strange kind of opportunity that arises when a new and charismatic president is elected in the heat of a financial crisis. This is a little bit like getting Roosevelt in 1931 rather than 1933.

There is a catch. As I have said before, it all hinges on the bond market and China's commitment to it. As I have said, I think the Chinese will stay committed, but there's a possibility that they won't. There's a possibility that they will opt for what you might call market socialism in one country. On the 1930s model, we may yet see the last great Communist power going its own way and walking away from the great depression, having almost no involvement in it. That, after all, was the Soviet experience in the 1930s.

Watch the bond market, ladies and gentlemen, in the first 100 days of President Obama's administration, and remember the wise words of James Carville, campaign manager to Bill Clinton, back in February 1993—one of my favorite quotations from that era: "I used to think if there was reincarnation," Carville told *The Wall Street Journal*, "I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market: You can intimidate everybody."

Thank you very much indeed.

JOANNE MYERS: As anticipated, that was wonderful. I would say, don't invest in the stock market, but invest in *The Ascent of Money*.

NIALL FERGUSON: It will appreciate in value, I promise.

JOANNE MYERS: I would like to open the floor to questions.

Questions and Answers

QUESTION: Niall, after that global exposition, it's hard to think of a question that doesn't sound petty and nationalistic, but here I go. Would you give us your judgment on the deregulation-regulation argument in this country? How responsible, if at all, was deregulation for what happened? Can you imagine a new regulation kind of regime that would prevent it from happening again?

NIALL FERGUSON: I think one of the great fallacies of current debate is that there's somehow a choice between regulation and no regulation, and it was deregulation that caused the crisis, and if only we had kept the regulations, the crisis wouldn't have happened. I don't buy this at all. There's no such thing as a regulation-free financial market. All markets are regulated. The question is simply whether the regulations work or not.

The biggest case of deregulation in the past decade was the repeal of the Glass-Steagall Act, that act from the 1930s that divided investment banking from commercial banking. That has done absolutely nothing to cause this crisis. Not a single thing that happened that caused the crisis was made more likely by the repeal of that act. In effect, the separation of investment banks from commercial banks continued, regardless of the repeal.

What you can, I think, say is that there was negligence—and here I think I would shift the emphasis from regulation to monetary policy—there was negligence on the part of the Fed and there was negligence on the part of the SEC. Let me specify just what I mean by that.

First, I think the doctrine that the Fed should only look at core inflation when making decisions about monetary policy was a false doctrine. Alan Greenspan's argument that asset price bubbles were not his problem will, I think, go down in history as one of the great mistakes of modern financial history.

The other key issue, which seems to me to be crucial here, has to do with bank leverage. It was the decision to allow the investment banks a free run at expanding their balance sheets in relation to their capital—a decision that was taken quite informally at the SEC, with virtually no headlines—that paved the way to the excesses of the age of leverage. We have seen a basic failure in the way in which bank capital adequacy is regulated. Basel I, Basel II, those supposedly voluntary accords, failed to create discipline. They were not strict enough as regulations. They were not binding enough on national governments, both in Europe and in the United States. That was the great mistake, actually.

So I would emphasize more the way in which the regulations were enforced than the regulations themselves. There were regulations—Basel I and Basel II specified them—about bank capital adequacy, but they were not enforced. If anything has to change, it seems to me it's there. We do need some kind of more binding international regime to govern bank capital adequacy. If that emerges from the G-20 summit in April, I will be very pleased indeed.

QUESTION: Niall, thank you very much.

I want to ask you a question about the implications of your thesis for United States foreign policy. It seems to me that if you are right, everybody in the world actually has a very strong interest, in terms of stability, in the fact that China does continue its commitment to the U.S. bond market. But what does the United States need to do in order to encourage China to take that position? To what extent will the foreign policy options of the United States influence those Chinese decisions?

NIALL FERGUSON: Thank you. That's an excellent question.

It seemed to me for more than a year that a great deal more effort needed to be made by the U.S. Treasury to conciliate the Chinese and to encourage them to feel invested in American financial stability. About a year ago, I wrote a piece for the *Financial Times* in which I argued that a global bailout was conceivable in which the sovereign wealth funds, including that of China, and central banks of the great surplus countries could be mobilized to recapitalize the Western banking system. This was a lost opportunity. In fact, only very small amounts of money were invested, for example, in Morgan Stanley by the Chinese sovereign wealth fund. When those investments went bad, the Chinese and others, including the Gulf states, pulled back.

Given that it was obvious the banks needed to be recapitalized, that was a huge lost opportunity. Hank Paulson should have been down on bended knee in Beijing pressing the Chinese to make a much larger commitment to Western financial institutions and offering some kind of floor below which the stock price of Morgan Stanley would not fall. The global bailout could have happened, and it would have been a far more rational bailout than the one we are currently seeing.

But we are getting to a global bailout by a roundabout means. Instead of selling them bank equity, we are going to sell them bonds and use the proceeds to recapitalize the banks, as it were, indirectly.

What I don't know is whether it's appreciated sufficiently in Washington and in Beijing that this is the key. We have two ways out of the global imbalances the world currently faces. In one benign scenario, Chinese imports increase and American exports increase. That can be achieved through coordinated expansion. But it won't happen spontaneously. It won't happen if each national government narrowly pursues its own interests, which is what is happening now.

The other way it can happen is if Chinese exports collapse and American imports collapse. That's the painful way in which the imbalances disappear. That, it seems to me, is the Great Depression scenario.

So from an American diplomacy's point of view, it is crucial that there be a meeting, not of the G-20—far too many people around the table—but of the G-2. I've been urging that the G-2—that is to say, the Chimerican duo, China and America—get together and think of this in global terms. We shouldn't blow the dust off Keynes and think we can solve this problem in a narrowly national way. This requires a globally coordinated effort to reduce imbalances gradually, and it will only happen through diplomatic channels. Right now I don't see much traffic in those channels.

The nightmare, of course, is the headline which I have been imagining for some time: "China Calls Meeting of G-1 in Beijing."

QUESTION: Personal consumption has accounted for some 70 percent of the American GNP and it's evaporating. Would not a massive infrastructure program be the logical short- and intermediate-term response to jumpstarting the American economy and bringing it back on track?

NIALL FERGUSON: This, I think, is the Keynesian argument. Paul Krugman is one of those who currently makes it. With all due respect to the Nobel laureate—and indeed to you, sir—this is to overlook the fact of globalization.

Keynes's remedies in *The General Theory* (which I know, because I read it three times as an undergraduate trying to understand it) are very clear. It works best in a relatively closed economy. Keynes acknowledged this in the foreword to the German edition of *The General Theory*, in which he made the point that a totalitarian state would find it easier than a liberal state to implement his solutions.

If we embark on a grand infrastructure-building program, and thereby swell the deficit still further —remember, we already have $1 trillion in the pipeline from the bailout and associated measures already taken—we are essentially making a call on the global bond market. This is not a Keynesian solution at all. The stimulus will have repercussions internationally, not only in the bond market, but in the currency markets. That is why it is naive to imagine that we can simply do this.

As I've said, you need to think of this as one economy, Chimerica, and remember that any measures taken here will have knock-on effects in the wider world.

I'm not wholly against the idea of infrastructure investment. There's no doubt, as one walks around and drives around the United States, that one can see room for improvement. I'm also sympathetic to the idea that some of the investment be directed at renewable energy technologies, at weaning the United States off its dependence on fossil fuels. But we have to make sure that the deficit that we are running makes sense internationally. If it's not credible, if we overdo it and make too big a demand on the Chinese, then we risk unleashing a bond market rout and a dollar rout.

That seems to me to be insufficiently appreciated by the neo-Keynesians.

You know, one of the depressing things about all of this is the bankruptcy it reveals of economics as a discipline. The economists in this country are some of the cleverest people I know. I have huge admiration for them. It's one of the reasons I came here. But I was very struck by the fact that these great men—and they are nearly all men—failed entirely to anticipate this crisis. Some have written very eloquently about it since it began. But it has always made me nervous that it came as a surprise to them, and it makes me even more nervous that their response is to dig out theories from the 1930s, which seem to me almost not to have changed since the time of Keynes. I give them all a B+, if not a B-, for their performance.

QUESTION: Your analysis is so brilliant. But perhaps you could expand on the G-20. A lot of the books—you alluded to your friend at *Newsweek* and so forth—are predicting that the one superpower is gone and that there is going to be a real change in the balance of power. Certainly there are emerging nations who are sitting in the G-20 and saying, "This is the way the world has to be. We have to have a greater influence on world decisions."

How do you feel about this? It's so marvelous that you are giving us hope about America. But what is the world going to look like in the very near future?

NIALL FERGUSON: I have a certain skepticism that we can reengineer institutions like, let’s say, the International Monetary Fund or, for that matter, the United Nations Security Council, in such a way as to increase the representation of emerging markets without rendering those institutions paralyzed. What makes me nervous about something like the G-20 is the number 20. I don’t know about you, but I have been at very few meetings at which 20 people have sat around a table with equal bargaining power that have produced good results, as opposed to the kind of bland statement that we saw after the Washington summit last weekend.

I don’t know if any of you read that statement, but it was actually a classic product of an excessively large committee. What it said on the bottle was "Global Coordination." That indeed was the way the media played it. What it said on the bottle was "Bretton Woods II" and "New Financial Architecture." But when you actually opened the bottle and poured out the wine, there was nothing there. It was empty.

All the statement said was that the national regulators of the 20 countries represented at the summit should carry on doing what they are already supposed to do, only better, and we would meet again to discuss this further at the end of April.

You know, the Great Depression had its fair share of international financial conferences. There was one in 1933 in London that was notable for its complete failure. A great many countries were represented at that conference, but it all collapsed when the newly elected President Roosevelt sent a telegram from his yacht saying there would be no deal on exchange rates, which is what they were trying to arrive at. I have a sinking feeling that the G-20 meetings will have a kind of analogous role in our time. There will be great meetings that will get a lot of media coverage, but there will be no concrete results, because there are too many conflicting interests around the table.

The global financial architecture is changing. That's clear. But what really counts is the relationship between the United States and the surplus countries. Everybody else, it seems to me, might as well go home. If we can't get a deal on that key issue—the imbalance, the current account deficit—that manages its gradual reduction rather than its dramatic disappearance, then, frankly, there's simply no point holding these summits at all.

So if not a G-2, then something more like a G-2 plus three or four, bringing all the surplus countries into the room, is what we need. My sense is that the G-20 is unwieldy, and trying to remodel international institutions with that large a group of countries is a doomed venture.

QUESTION: If the crisis was indeed made in America, as you say, and through the subprime lending for housing, my question really is, the political decisions that were made in housing at the time were designed to achieve a certain kind of political goal. It was a certain kind of, perhaps, egalitarianism then run amok. Many in the banking industry knew about that. They knew that it was skating on thin ice.

What, in your mind, as a historian, as an analyst of all of these things, might have been done to avoid the kinds of results that occurred, while perhaps even still achieving the social goals that were the start of this whole thing?

NIALL FERGUSON: I entirely agree with the premise of your question. In Chapter 5 of this book, I talk about the idea of a property-owning democracy and ask the question, where did this come from? Why did we suddenly start to believe that it would be good for a majority of households to own their own homes? That certainly wasn't a 19th-century concept. In the 19th century, it was assumed that only an elite would own property and the majority of people would be tenants who paid rent.

This is a fundamental shift in the political economy of the Western world. It dates from the 1930s It's actually an absolutely crucial part of the New Deal that the Roosevelt Administration does not go down the road of building, as we would say in Britain, council housing, public-sector housing, for people to rent; it goes down the road of creating a very much wider and deeper mortgage market to encourage homeownership. As you say, this has a political goal.

The theory goes like this: If people own their own homes, they will be politically more conservative than if they don't. They will be less attracted to political radicalism. In many ways, the theory is an appealing one. If people are, in some measure, capitalists, if they own some stake in the country's capital, then they will be less attracted to the kind of political extremes that were so lethal a part of the 1930s crisis.

The question is, what proportion is the right proportion? Fifty percent? Fifty-five percent? Sixty percent? Sixty-five percent? Seventy percent? We have been trying to find this out by consistently increasing the proportion of households that own their own homes, using a number of inducements and institutional changes to make it easier.

The subprime crisis is the product of our discovery of the upper bound. We found it. It's somewhere in the mid-60-percent range. If you go above that, you essentially attract people into the mortgage market who have no business being there and can't sustain mortgage payments for more than a couple of years.

There are all kinds of technical problems associated with what went wrong in the subprime market, but that's the fundamental political problem. We created incentives that distorted people's investment decisions. We made it much, much easier to invest in real estate than to invest in anything else. The interest that you can deduct from your tax bill, the mortgage interest, is a huge distortion in the way that the American capital market works. It means you are nuts not to play the real estate market.

But think about what buying a house is. It is a one-way, highly leveraged, completely unhedged bet on a single asset class. From a purely financial point of view, it makes no sense at all to incentivize people to do this, to hold their wealth in this form. From a political perspective, it may make sense, but we have discovered that from a financial perspective, it's actually highly dangerous.

So my answer to the question is, we need to wean ourselves off the simplistic view that owning a home is the American dream. Ronald Reagan said this. That was why he opposed removing the tax relief for mortgage interest. I think this is an ideological distortion, a distortion of the financial market in pursuit of a somewhat illusory political goal of universal homeownership.

QUESTIONER: I'm going to digress a little bit. We know that in the last eight years, the United States has become exceedingly unpopular around the world as a result of many, many of the Bush-Cheney policies—apart from the war, how we have treated detainees, ignoring many aspects of the Geneva Convention, and so forth and so on. What you have described now—the fact that the world is suffering as a result of something that we have precipitated—would certainly exacerbate or increase the hostility that the world feels toward the United States.

What I'm asking you is, what do you see as the implications of this? Do you foresee some sort of retribution? There really is great, great anger toward us. I wonder if you do see implications of this.

NIALL FERGUSON: I think this is a very good question.

When people talk about the damage to the credibility of the United States caused by the financial crisis, my response is, "The credibility was already damaged. How much lower below zero can you go?" In that sense, this seems to me to be something of a misapprehension.

Yes, the neoconservative doctrine of the enforced democratization of the Middle East has been discredited. The intervention in Iraq and the associated abuses that you described have done enormous damage. We can see that from the Pew Global Attitudes surveys. But I don't think it follows that the discrediting of the neoliberal financial theory that the market should be free, as free as possible, somehow compounds the problem.

This is why there is a paradox at the heart of this crisis, because the United States can do with one bound a kind of makeover of its image. And it has just done it. The unpopularity that the Pew surveys capture, when one looks at it, decomposes quite nicely. It's the unpopularity of the Bush Administration, not the unpopularity of the United States, that is the phenomenon the polls are picking up. In many ways, what happened on November 4 provides an extraordinary opportunity for the United States to rebrand itself and transform its international standing. Simply by electing an extraordinarily charismatic young man who epitomizes a fundamental transformation in attitudes toward race in this country—this alone, it seems to me, negates a huge part of the damage done to American credibility by the eight years of the Bush Administration.

As I said, there is a kind of good luck that follows the United States through history. It's good luck that the election happened when it did. After all, the coincidence of the climax of the financial crisis and the election within the space of a few months was a remarkable historical conjuncture. As I said, it took two more years of depression before the Roosevelt Administration came into being. We have been lucky in the timing of this political change.

In the sense that Barack Obama has, above all, an extraordinary skill when it comes to changing the mood, his ability to speak with the kind of power that we can associate with only a very few politicians in our time creates a remarkable opportunity for changing the game and changing the mood, not only in the

United States but in the wider world. I would be very surprised if we didn't see a fundamental shift in those surveys of global attitudes towards the United States in the year ahead. Despite the financial crisis, perhaps even because of it, the world is going to look, far more than it has done in many years, to Washington, D.C., for leadership. That, I think, is the very paradox at the heart of my argument today.

You see, I’m an optimist, really.

QUESTION: I want to just ask you to say some more about the G-2—the G-1 here. Do you think that the people in the Obama Administration are thinking of China in the way that you are? On the other side—because you referred to the Bank of China—how much do you know or does anybody else know about what Chinese economists are analyzing? How close is their analysis to the gist of what you have said? Or are they really coming at this from some kind of immediate nationalistic perspective?

If you could maybe elaborate on that G-2 relationship, that would be great.

NIALL FERGUSON: I can't claim great expertise on the way in which policy is made in Beijing. I don't speak a word of Mandarin. But it is the question that I ask my friends, Chinese and Chinese-speaking friends. It is the question I asked people when I was out in Singapore last week at a conference attended by a great many people from the PRC, as well as from Hong Kong.

The answer I got, roughly, went like this: There is an argument going on between those who favor the prioritization of growing domestic consumption and those who see China as inextricably symbiotically linked to the United States. It is not clear who is going to win this argument.

I think those numbers I quoted earlier about Chinese purchases of Treasuries are very heartening. That suggests that, at least for the time being, the policy hasn't changed. If it had been a different story, if the Chinese had also followed the Japanese example and sold, I would have been very nervous.

My sense is that ultimately the proponents of globalization will prevail over the proponents of market socialism in one country, for the practical reasons I have given. But I don't think—and this is really the bottom line—I don’t think we can take that for granted. I think we should see as the paramount objective of the administration's foreign policy, when a secretary of state is finally nominated, to pursue the kind of Chimerican strategy that I'm talking about, to make the G-2 a reality rather than just a pet theory of mine.

So if there is a kind of clear policy recommendation to both Washington and Beijing, it's that: Don't turn away from globalization and don't be deluded into thinking you can solve this crisis with the old Keynesian nostrums that only worked in the closed economies of the Bretton Woods era, when capital controls were imposed and exchange rates were fixed. We're not in that world now, and it's an illusion to imagine that we can go back to it anytime soon.

With that, ladies and gentlemen, I think I'll fall silent. Thank you very much.