The Great Crash: Past and Present: The Great Malaise

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The Great Malaise

ALAN GREENSPAN

Another stock market crash is not likely. But the speculative imbalances in the housing market, the tremendous increase in mortgage debt, and the large dollar overhang abroad make our present situation precarious.

October 29, 1929 marked the beginning of the greatest economic upheaval in modern history. The contractions and financial panics that took place in the United States prior to the Great Depression were contemporaneously perceived as deep and prolonged, as indeed they were. All fell far short, however, of the devastation that took hold beginning with the collapse of stock prices fifty years ago. Today's conventional view is that the legislative response to that trauma—deposit insurance to avoid runs on banks, securities legislation to stem stock market speculation, and sophisticated monetary tools to prevent credit panics—will prevent such a disaster from confronting us again. In any event, let us not forget that the crash of 1929 and the despair that followed was, in itself, a rare event, one which would have been unlikely to be replicated, even with the institutional structure that prevailed in the 1920s and earlier. The danger currently confronting us, in my judgment, is not a deflation of the 1930s type; rather it is the consequence of excessively inflationary policies which are being rushed into place in response to a credit crisis which is perceived as a replay of the Great Depression.

While there is no fully satisfactory explanation of the sequence of events which began a half century ago, there can be little doubt that the heavy speculation in the stock market, followed by its collapse, was a key, perhaps *the* key, factor undercutting investment incentives and business outlays in the period that followed. Indeed, the fact that we chose a specific day to commemorate the beginning of the Great Depression presupposed a consensus on its cause. Even today we look at stock market values as a measure of the marginal cost of equity capital or, more important, in combination with other measures, as a proxy for investment incentives. But, unlike the period of mid-1929, equity prices relative to earnings are now low, great caution prevails, and few, if any, observers would ascribe speculative excesses to the current stock market.

Speculation in housing

The excesses lie elsewhere, particularly in the housing market. It's there, if anywhere, that speculative

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imbalances have surfaced which could threaten the stability of the American economy. Financed by elephantine advances in mortgage debt, residential real estate values have soared. The market value of the average home has nearly tripled in little more than a decade. Those currently selling homes are averaging capital gains of approximately $20,000.

Increasingly, the demand for homes is being spurred as a sure way of achieving price appreciation from an asset, that is, as a hedge against inflation. As might be expected, the rate of existing home sales has soared and mortgage debt growth has accelerated as home turnovers at successively higher prices inevitably increase the debt on each house. The annual increase in one-to-four family home mortgage debt did not top $20 billion until 1971 and remained under $50 billion annually until 1976. However, it has been running in excess of $100 billion a year in each of the past three years.

The housing capital gains, whether realized or unrealized, have encouraged households to take on other consumer debt and have enabled them to expand purchases of all kinds of goods and services. Meanwhile, the acceleration in inflation has imbued debt with an apparent attractiveness which has caused households to have recourse to it more readily than they did in the past, but in the process has greatly increased the debt service burden households are now carrying.

As a result, the total of interest and scheduled amortization payments on both mortgage and installment debt currently accounts for 28 percent of cash disposable personal income—up from 19 percent twenty years ago. Moreover, nearly one-fifth of all American families owe no debt at all at this time. Consequently, the four-fifths of families who are debtors must be allocating roughly 35 percent of their cash disposable income for debt service payments. If the average for all debtors is that high, a substantial portion of households must surely be committing closer to 50 percent of their monthly paychecks to debt service.

A sizable number of home purchasers have taken on this inordinately large debt in the expectation that in a few years inflation, in general, and constantly skyrocketing housing prices, in particular, would bail them out of their temporarily precarious debt burden. That has indeed been the experience of many home purchasers over the past decade and its continuance in the future is now widely assumed. However, this could create serious problems for the economy if the continued surge in home prices fails to materialize.

Monthly carrying charges on new mortgages already have reached levels which are beyond the means of many prospective home purchasers, even those with two incomes. Mortgage lenders are disqualifying a rising number of loan applicants as a result. As the recent softness in home sales continues, the upward pressure on home prices should weaken. A modest decline in home prices would probably have only a small impact on the overall economy. However, while the probability is surely quite low, housing prices could slip 20 percent, 30 percent, or more in response to sliding home sales and rising interest rates. Such a plunge in prices would wipe out much of the unrealized capital gains which homeowners currently assume are available in case of difficulties.

Moreover, such a massive wiping out of paper profits and reduction in equity would catch many recent buyers with net losses and excessive debt burdens. Loan delinquencies and foreclosures undoubtedly would rise, creating financial difficulties for both lenders and borrowers. In addition, homeowners probably would be forced to accept a sharp retrenchment in their day-to-day expenditures as they tried to pay off part of their existing debt burden. Certainly the wealth effect which has been a stimulus to consumer spending would turn negative. The cumulative impact of such problems would be far deeper than any envisioned recession.

The world scene

But even that, as disturbing as it would be, could not approach the worldwide disaster which occurred in the 1930s. In order for such a debacle to recur, it would have to be brought on by circumstances which were international in scope.

The most probable scenarios for such an upheaval, should it ever occur, involve a breakdown of a world financial system unable any longer to finance mounting oil-related balance of payment deficits. Prior to the 1973 oil price increase, international payments were rarely out of balance. Some nations had surpluses and others had deficits, but these shifted around. Beginning in 1974, however, two distinct groups emerged: those nations with continuous surpluses (the Organization of Petroleum Exporting Countries—OPEC) and those with persistent deficits (non-OPEC less developed countries). At present world price relationships, non-OPEC less developed countries are running annual current ac-

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count deficits, on balance, of $50 billion or more; that is, they must as a group borrow, net, at least $50 billion each year, cumulatively, year after year, with no way of shunting the cumulative debt onto someone else. As real oil prices stabilized after 1974, the industrial nations as a group were largely able to balance their accounts. However, with real oil prices again on the rise, chronic deficits among nations of the Organization for Economic Co-operation and Development (OECD) may again emerge as well.

Initially, the oil-importing countries did not have much difficulty borrowing in world financial markets to cover their deficits, because they had borrowed relatively little previously and had substantial unused lines of credit. It soon became evident that the major oil financing problem was not recycling, about which almost everyone had been concerned five years ago. The financial institutions have been able to channel funds as required. The difficulty in financing the deficits has centered increasingly on the question of the creditworthiness of the borrowers, whether governments, private firms, or citizens.

Today, it is clear that the deterioration in the borrowing capabilities of much of the world cannot go on indefinitely. Deficits, accumulating year after year and jumping periodically as the real price of oil rises, eventually will create such a huge debt structure that most borrowers will find it difficult to meet the interest and amortization charges on the loans. The world economic system is not in balance with average oil prices in excess of $20 per barrel. Under these conditions, the risk that the least creditworthy of the world's oil-importing nations will be forced into default on their loans is troublesome.

The major central banks, of course, have contingency plans which would be immediately implemented in the event of a cascading series of financial failures in the Eurocurrency markets. We have every reason to hope that such emergency measures would be sufficient to stem the collapse before it ruptured the world's financial fabric and destroyed the confidence underlying the international economic system. But, can we really be certain? Unfortunately, the answer is no, for several reasons.

Despite the extraordinarily complex development of international finance since the end of World War II, our theoretical understanding of how the Eurocurrency system functions—its impact on inflation, investment, real growth, and even interest rates—is remarkably sparse. There are very likely to be unimagined structural inadequacies in these new financial innovations which the standard bail-out procedures of the central banks do not fully address. There is evidently a significant amount of interbank depositing in the Eurocurrency system and how this might complicate any problems that developed is not fully clear. Moreover, the spread between the cost of funds and the rates received on relending is exceptionally narrow—too narrow in the eyes of many bankers fully to fund the risks involved in such lending. Finally, the inflationary expansion of the world's credit base has reduced capital-asset ratios of banks in the United States and abroad to a point where they no longer provide protection should a bank get into trouble; it would have to be bailed out by its central bank or

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international agencies, or be absorbed by institutions not yet in difficulty.

Dollar dangers

But a cascading set of bankruptcies in the Eurocurrency markets, brought on by defaults on loans to the less developed countries, is by no means the only threat. A related danger is the evident excess of dollar-denominated assets in government and private portfolios throughout the world. Dollars currently account for approximately three-fourths of net Eurocurrency liabilities—and to whatever extent one can infer from stated preferences and market performance—a considerable diversification of assets into other currencies is desired. The support for the Dollar Substitution Account within the International Monetary Fund is the most recent manifestation of displeasure over the excess of dollar liabilities in the world.

If inflation in the United States should continue (relative to rates in Europe and Japan) to a point where a cumulative disaffection with the dollar as a store of purchasing power erupts into an attempt at massive diversification, either the dollar will fall abruptly, or worse, central bank support will create inflationary excesses of the support currencies.

A collapse in dollar exchange rates could create severe international financial uncertainty and retrenchment—and could trigger the bankruptcy scenario outlined above. The problem is that a shift in portfolio preference for, say, marks or francs for dollars does not simply delete dollars from the world currency system.

We know, of course, that only if the loans denominated in dollars are liquidated concurrently with the liquidation of the deposits can a major reduction in outstanding Eurodollar balances occur. But what exactly does that mean? Put simply, there is no way to wave a magic wand and eliminate the more than $700 billion in external liabilities of American residents and the Eurodollar market. Behind these dollar claims is an equivalent sum in loans outstanding also denominated in dollars. When the treasurer of a multinational corporation sells a million U.S. dollars for marks, the million dollars do not disappear. Unless the offsetting asset is liquidated, the dollars merely change hands. Hence, short of a massive worldwide credit contraction, the aggregate level of liabilities cannot be significantly reduced in the near future.

The effects are similar to those seen when the price of the stock of a company declines. Heavy selling of shares, for example, of General Motors, may sharply reduce their price, that is, their exchange rate against dollars, without altering the number of shares outstanding. The aggregate value of the shares will decline until progressively lower prices finally unearth willing holders for the stock, but the total number of shares does not change in the process. In the same way, the total number of dollars in the Eurocurrency market does not change as a result of a decline in the exchange rate of the dollar, although their value in terms, for example, of Deutsche marks, may fall. Short of a massive credit contraction worldwide, there is no way to make outstanding dollar balances disappear or turn into Deutsche marks or Swiss francs.

With the world's central banks standing ready to flood the world's economies with paper claims at the first sign of a problem, a full-fledged credit deflation reminiscent of the 1930s seems out of the question. The real threat to the Western industrial economies is the inflation which would be triggered by an attempt to fend off the kind of deflation we had in 1929-1932.

The overriding mandate of the world's monetary authorities to prevent a credit deflation almost assures policy overkill at the first sign of credit stringency and falling prices. Deflation would be quickly aborted—to be followed shortly by accelerating inflation and economic stagnation. In despair, policy-makers, I fear, are likely to retreat to increased symptom-fighting—price, wage, and credit controls—and a broad expansion of economic regimentation. Such a response would reinforce the stagnation and economic malaise.

Thus, in today's political and institutional environment, a replay of the Great Depression is the Great Malaise. It would not be a period of falling prices and double-digit unemployment, but rather, an economy racked with inflation, excessive unemployment (8 to 9 percent), falling productivity, and little hope for a more benevolent future.

I should like to emphasize that a breakdown of the world financial and economic systems is still a low-probability outcome. There is a remarkable resiliency in the basic capitalist institutions which support most Western societies. Extraordinary shocks are required to undermine them. While I do not want to appear the protagonist for Pollyanna, I trust that in a hundred years Black Friday will *still* be regarded as the beginning of the greatest economic upheaval in modern history.

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