Yale Class of 1959 - 50th Reunion – Sprague Memorial Hall – June 6, 2009

Panel on the Economy: Charles D. Ellis, '59, founder of Greenwich Associates and noted expert on investing; Arthur L. Kelly, '59, private equity investor; J. Paul Horne, '59, independent market economist and retired International Economist of Smith Barney/Citigroup; Prof. William Goetzmann, Edwin J. Beinecke Professor of Finance and Management Studies at Yale; Prof. John Geanakoplos, James Tobin Professor of Economics at Yale; and Dr. Henry A. Kissinger, former Secretary of State, Nobel Peace Prize, head of Kissinger Associates and honorary member of the Yale Class of 1959.

International Aspects of the Financial-Economic Crisis

Comments by Paul Horne '59

It is ironic that this week, 50 years after we graduated, **GM** goes into bankruptcy with the U.S. government taking control in exchange for $50 billion of our, taxpayers', money. When we were in school, Charlie Wilson, Ike's Secretary of Defense and former CEO of GM said: "What's good for GM, is good for the U.S.A." I certainly hope not.

Also this week, **Chrysler** is about to emerge from bankruptcy thanks to its private equity owners (who bought it from a disillusioned Daimler Benz for a bargain price) who will merge it into Fiat. Yes, this is the Italian carmaker that for decades led the list of European carmakers expected to disappear. During our 14 years in Rome, Italian friends joked that Fiat meant: ***Fix It Again, Tony***. If Fiat can solve Chrysler's problems, it will be the second "miracolo Italiano".

Not only has the U.S. car manufacturing industry failed, but, more importantly, the **U.S. financial establishment** has been destabilized by the crisis resulting from years of unbridled risk-taking, often incompetent management, ideologically-driven supervisory failures and ballooning financial complexity.

The implications of this unholy set of circumstances were so badly understood that the **global financial system** nearly collapsed in early August 2007, after our Paris bank, the BNP Paribas, triggered the crisis when it refused to redeem its mutual funds invested in sub-prime mortgage-related securities bought from their U.S. investment banks which could not price those securities. The global financial situation was so precariously interconnected, within several days of the BNP's action, global equity, money market, commercial paper, bond, inter-bank and derivatives markets became dysfunctional.

Subsequently, we learned that despite the catastrophic insouciance of our financial managers, including the much vaunted and **unregulated shadow banking industry** of hedge funds and private equity groups, most major banks and institutions were **"too big to fail".** They required immense tax-payer bailouts just to keep the U.S. and international financial system functioning. The **one** case in

which a major U.S. investment bank, **Lehman Brothers**, was allowed to fail last September, proved so catastrophic, the world financial system nearly foundered again.

The resulting **credit crunch** spread through world markets afraid of the "priceless" **toxic assets** that our U.S. financial products marketing machine had sold, most profitably, into **most international portfolios.** This insured the **crisis was a global one**. The credit drought and consequent deleveraging of individual and corporate debt triggered the **economic recession.** I would emphasize that the global economic downturn **did not result from the usual cyclical pressures or from central banks tightening monetary policy**. It was, simply, our fault.

Fortunately, the extraordinary efforts by the **Federal Reserve**, guided by Ben **Bernanke** – far more pragmatic than his predecessor whose ***laissez faire*** attitude toward regulation, bubbles and monetary policy was a root cause of the crisis; and the **Treasury** under both Hank Paulson and Tim Geithner, appear to have headed off a collapse of the financial system. But the cost, in terms of a tsunami of new money, Treasury debt and government guarantees, is trillions of dollars, and today equivalent to over 50% of GDP.

This crisis means, in my view, that the **American business model**, as it has functioned since the mid-1980s, including the dominant theory that **rational expectations** and instant information insured **efficient financial markets**; **was flawed**. Even Bill Gross, PIMCO's co-founder and investment officer and one of the first to caution about the systemic risks of the "shadow banking system", said the unthinkable recently: **The U.S.' AAA credit rating may be at risk.**

Although the **U.S. equity market is up nearly 40% from its low on March 9**, just when and how we finally recover from the financial crisis and the economic recession is anybody's guess. But it's safe to say that **things will be quite different** from the way they were when the crisis began nearly two years ago … not to mention in June 1959.

As GM, Chrysler and our banking industry have learned, **ending the crisis will depend on international cooperation** to resolve what my French economist friends call **"fundamental economic imbalances"** that led to this systemic disaster.

The most important may be U.S. excess consumption and inadequate savings. Private consumption represented 60-65% of U.S. GDP between World War II and the early 1990s. The **personal savings rate** during this time was 7%-to-8% of (after-tax) disposable income. Since then, however, **consumption rose to 71% of GDP and the saving rate dropped to zero.**

Contributing to this basic disequilibrium were: low real interest rates, promoted by the Greenspan Fed; **increasingly plentiful credit** and **sharply rising debt**. **Financial and real estate bubbles** contributed to a huge **wealth effect** despite a few hiccups such as the dot.com bust, 9/11, the 2001-2002 mini-recession and the "**Enronitis**" epidemic of corporate scandals. **Regulatory supervision was neutered** as the our politicians embraced the **leave-it-to-the-market mantra**.

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Skyrocketing home values, and a powerful equity market rally between October 2002 and October 2007 generated extraordinary wealth that stimulated consumption and apparently offset the absence of saving. The Federal Reserve reported that **household net worth** (net of all types of debt) peaked at **$64.3 trillion in the 2Q2007,** four times the GDP, **just as the crisis was about to detonate**. By December 2008, household net worth was down to $51 trillion, a decline nearly equivalent to this year's GDP.

A less visible but critical problem also resulted from the scissors movement between consumption and savings: a growing **balance of payments deficit**, t**he best measure of which is the current account** (**C/A**). As we **persistently imported more than we exported**, the C/A deficit began in 1981 and grew steadily to the equivalent of **nearly 6% of GDP by end-2007**.

A C/A deficit must be financed by borrowing abroad if are to invest more in our economy and avoid a decline in the dollar's exchange rate. **Indeed, we have borrowed more and more from foreigners for the last 28 years**.

We have been lucky, however, because **foreign investors have been willing to lend us more – usually because they perceive the risk-reward relationship in the U.S. to be better than at home** in Europe, Japan or China. Foreign direct investment thus flooded into the U.S., as well as into financial assets, **more than financing our C/A deficit**.

Even when times are tough, the **U.S. appears to many foreign investors be a refuge for international capital**. Or when foreign trade partners accumulate too many IOUs issued by the U.S., call them dollars, they are willing to park them in AAA-rated U.S. Treasury securities. **This was the case with Japan in the 1980s; as it is with China, the No. 1 creditor of the U.S., today**. But Japanese investors lost as the yen appreciated dramatically against the dollar. And China worries about its dollars today.

It is important to understand that foreigners do not finance our deficit because they love us. They invest their savings here, hoping for a competitive real rate of return and, above all, a long-term store of value, **as measured by the dollar's purchasing power in their own currency**.

China's dollar-denominated foreign exchange reserves, notably Treasury securities bought with the dollars we pay for Chinese exports, today amount to around $1.6 trillion. Their Prime Minister and other officials have publicly worried that their national savings parked in dollars could be devalued by **imprudent U.S. policies causing the dollar to depreciate against the yuan.**

They have reason to worry about a country whose **net international balance sheet** has eroded from a **net creditor position** of $346 billion in 1981, 10% of our GDP**; to a net debtor position** of over $2.4 trillion today, 17% of our GDP**.** The new debt we are incurring means this ratio will rise rapidly.

Moreover, **the dollar's value has declined markedly** since we began running an external deficit in 1981. Measured against the major currencies, it is down 22% in nominal terms since 1981. **In real terms, the dollar is down 22% from its recent high in February 2002**.

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Seen from Beijing, or the Euro zone, there are few reasons to be optimistic about the future**.** Although the recession is slowing U.S. consumption and reducing debt, boosting the personal saving rate to 5.7%, **underlying American attitudes remain a question**.

Do we really intend to tighten our belts, reducing consumption and saving more ? Do we really want to buy the Prius instead of the Yukon ? Do we really want three-bedroom green houses instead of McMansions ? Do we really want to put aside enough money to pay for our retirement, health care and the kids' college ? All of which are needed to improve our fundamental consumption – saving imbalance enough to reduce the external deficit and dependence on foreign capital.

Another fundamental question: **Do we really want to repay that foreign debt with real money in 2010 or 2015** ? Wouldn't it be easier to let the dollar depreciate and accept a bit of inflation ? Far better to send Steve Adams' "currency of music" to the rest of the world ! 1)

Just as worrying, the crisis has forced us **to rescue the economy with measures so drastic** that they may threaten long-term **economic equilibrium and the dollar**. Mountains of money created by the Fed and new Treasury debt, plus direct government involvement in the banking system, insurance (AIG), residential mortgages (Fannie and Freddie) and the automotive industry (GM and Chrysler), point to difficult years ahead, fending off **inflationary pressures and political manipulation of the economy.**

Foreigner investors may well question their long-held faith in the credibility and even the honesty of American stewardship of their savings. The ineptitude of public and private management that got us into the crisis; the cavalier attitude toward risk; the neutering of sensible regulation and the numerous business mega-scandals from the Enronitis epidemic to Madoff, **do not comfort foreign savers**.

Perhaps I am too harsh on the U.S., having lived and worked virtually all adult my life in Europe since graduation. After retiring from Smith Barney/Citigroup in 2001, we returned to a United States very different from the one we left four decades before. But, like Rip Van Winkle, our memory of the U.S. was that of 1959. **Things and thinking have grown far bigger and more complicated since then.**

Our population is now 304 million vs. 177 million in 1959; cities, highways and other things are huge; diversity – ethnic and linguistic – is extraordinary; battles intensify over legal and cultural differences; tax evasion is rampant; income disparities widen; the role of government and national industrial policy burgeons (under both parties); the battle for power grows between states and the federal government; the struggle over executive privilege in the White House intensifies; etc., etc.

Such issues, aggravated by today's crisis, are similar to those which make **European unification** so difficult. Having watched Europe struggle to overcome these divisions during the last 50 years, I worry that **the U.S. may be "Europeanizing"**, with all of its attendant problems. If so, the national unity and sense of common purposes and values that made us unique in 1959 could be at risk.
This is important because **severe economic and political crises can disrupt world peace**. We must never forget that the Great Depression of the 1930s, born of financial excesses in the 1920s, led to World War II.

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This is a particularly sober thought today, **the 65th anniversary of D-Day**, when the Allies landed on the Normandy beaches, the bloody start to retaking Europe from the Nazis. We must hope that international cooperation will prevent such terrible strife from happening again.

J. Paul Horne '59

"The Awakening" by J. Seward Johnson at National Harbor, MD
(An apt symbol, perhaps, for the U.S. consumer drowning in debt)

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1) Stephen, '59, and Denise Adams gave $100 million to the Yale School of Music to ensure that no student at Yale's School of Music would have to pay tuition. Noting that this had helped the School become a world class institution attracting the best musical talent, Dean Robert Blocker, commented at a musical tribute during the Reunion, that the Adams had enabled the School of Music "to send its currency of music to all corners of the world."