Here we are again — at the brink of global financial and economic meltdown — and the question of the hour is: In whom should we place our trust? And make no mistake: This is a crisis of faith and confidence. Whom should we believe? The banks and investment banks that most immediately brought the financial system to its knees? Sleepy regulators who cast a half-blind eye over the market? Politicians who have done the bidding of interest groups? The market itself, whatever that may be or become?

It is surely a confusing time. Words themselves fail us. If this is a "liquidity" shortage, why do we need a "bailout"? American voters are assured that the rescue crafted by the Federal Reserve Board and Treasury is not for Wall Street but Main Street. In truth, too many of us lived for too long on Easy Street, with nary a care or complaint about where our overblown sense of prosperity came from. Dedicated government officials like Henry Paulson Jr. and Ben Bernanke may be working hard to prevent complete collapse, but they must overcome the legacy of predecessors whose loose regulation and easy money fueled this crisis, and their solutions have felt maddeningly impromptu and vague. Yes, they must be flexible, but hurly-burly and hasty promises don't inspire most folks —in the markets or not. To solve a crisis brought on by excessive borrowing, the government now must itself borrow excessively. The $700 billion seems like a lot until you consider that, with Fannie Mae, Freddie Mac, AIG and Bear Stearns tucked under its wing, the government is already supporting bailouts that could climb well over $300 billion — and that's without the authority of Congress or the explicit support, or understanding, of the taxpayer.

Trust us, the Fed and Treasury seem to be saying. We'll buy damaged assets, though we don't know yet at what price, or quite exactly how we will value them, but if we don't buy them things will get a lot worse. So in for a penny, in for a pound.

My oh my, from Ed McMahon's house to the House of Lehman, this has been one strange year. In March, long ago and in another era, while Bear Stearns collapsed and the erstwhile corruption crusader New York Governor Eliot Spitzer was discovered with his pants down but socks still on, we learned that veteran TV pitchman McMahon faced foreclosure on his multimillion-dollar home. How could this be? we wondered, followed shortly by: Am I next? No, but 158-year-old Lehman, which could not get a bailout, as McMahon did from Donald Trump, was. Then the doors of Armageddon swung open.

Lehman's bankruptcy, some say, was the thread that, once pulled, unraveled the financial system, helping to take down AIG, send Merrill Lynch into the arms of Bank of America, and put Goldman Sachs and Morgan Stanley up against the wall, before they succumbed to the inevitable and, presto chango, became commercial banks one magical Sunday night, while the children of Wall Street's centurions prayed there'd be no school the next day and their parents wondered if they could continue to pay tuition.

What can be stranger than this sequence? Before embracing its inner commercial bank Morgan Stanley briefly turned to Wachovia as its savior. Hardly a week later, a suddenly barely breathing Wachovia agreed to sell itself to Citigroup, previously thought to be at the brink but now proclaimed by its leadership to be a bastion of safety and strength. Not long ago, the overstretched Citi was prohibited by federal authorities from buying any more companies — and that was before it posted the first of what will soon be four consecutive multibillion-dollar quarterly losses. But, then, before the ink could dry on that $2.2 billion deal — arranged by the FDIC, with Citi agreeing to absorb the first $42 billion in losses! — Wells Fargo swooped in to buy Wachovia in a stock swap valued at $15 billion, in which Wells says it will need no government assistance at all.

How can an institution like Wachovia be valued in such wildly different ways over such a short period of time? How can anyone be confident of a market where such things are taking place?

And yet trust and confidence are the underpinnings of any market system, and they must be restored, which is why, like it or not, government — in the U.S. and around the globe — must intervene one way or another. That alone will not be enough, though. Systems that seem preordained, like governments or markets, are not: They depend on the continued willed consent of their participants. The test of faith for markets now comes, in America anyway, at a time when faith in government is also at a low ebb. This means, in effect, we have lost faith in ourselves.

How to restore faith and confidence? Perhaps we should first acknowledge that we have all — from Wall Street titan to government bureaucrat to homeowning citizen — had a hand in the madness that led to this crisis. Now, of course, we want to blame anyone but ourselves, our firm, our political party. But if we want to build a system in the future based on openness, we should be honest; if we want accountability, we should accept our own. A friend, who happens to be a Buddhist, says that to truly forgive another is to know and accept that that person will commit the same offense again. It is our nature, after all. We should think of ways to manage our worst impulses in the future, but we should start now with forgiveness — and not just of our debts. — *Michael Carroll*

1. Entering a "Contained Depression"

THE ECONOMY HAS REACHED THE END OF AN ERA — NOT just the end of a business cycle — and it faces challenges even more profound than a recession and financial crisis.

During the past quarter century, bloated private sector balance sheets have become ever larger relative to incomes, but the era of

the big-balance-sheet economy is now over. A transitional period of debt reduction and asset deflation has begun — a period that will last at least several years and perhaps a decade. It will bring financially severe recessions, spotty recoveries, poor profits and chronically high unemployment as the economy undergoes a painful healing process. Massive government intervention in the financial markets will prevent a crippling breakdown of the financial system, but it will not prevent enduring economic difficulties. This new period is a depression, but fortunately, it will be a contained depression.

A depression can be defined as an extended period — five years, ten years or longer — of chronically weak economic performance and financial instability caused by such long-term imbalances as chronic overcapacity, severely overpriced assets and grossly excessive debt levels. By contrast, a recession is a shorter period, usually a year or so, of contracting economic activity typically caused by short-term imbalances reflecting overproduction or temporary demand disruptions. The imbalances that cause a depression result from many years of overinvestment and unsound behavior, and it takes years to resolve them. The economy must reduce debt-to-income ratios, eliminate excess capacity and bring the prices of assets back into line with their earning power — tasks made more difficult by paltry income growth, stagnant production and depressed earnings. A depression is not a continuous recession, and it may span multiple business cycles (the Great Depression had two).

I coined the term “contained depression” in July 1990 to describe our economic outlook for the coming years. The 1990–1991 recession and subsequent 30-month malaise were caused not by rising interest rates or an inventory buildup, but by enduring balance-sheet problems, which included widespread industrial overcapacity, deflating bubbles in residential and commercial real estate and related crises in the financial sector.

However, unlike in 1929, the economy had two critical containment mechanisms: (1) an effective lender of last resort, embodied in the Federal Reserve Board, the Federal Deposit Insurance Corp., the Treasury and other government agencies, which prevented massive 1930s-style bank failures, and (2) a larger federal government budget relative to the size of the economy (roughly 20 percent of GDP, compared with 3 percent of GDP in 1929), making the government a much larger automatic fiscal stabilizer.

The economy did indeed enter into a comparatively mild contained depression from 1990 to 1993, and again from 2000 to 2003. However, both of these episodes were cut short by new bubble expansions, which interrupted the cleaning up of long-term balance-sheet excesses and ultimately exacerbated them. In both cases, the only way the Federal Reserve could reignite the economy was by lowering interest rates substantially, to below where they had been in decades, thereby providing vast debt service relief, stabilizing credit markets, justifying higher asset valuations and stimulating new bubbles that powered the economy. Today, however, the Fed will not be able to lower rates far enough to provide sufficient refinancing opportunities, having held the federal funds rate at 1 percent just a few years ago. Thus the chances of once again escaping a much longer correction period are small this time around.

Balance sheets have been getting bigger relative to incomes over the course of the post–World War II period, with the process accelerating dramatically from 1980 on. This has been true for the household, nonfinancial corporate and financial sectors alike. However, these trends cannot persist indefinitely. Debt cannot grow faster

than incomes forever because it must be serviced out of incomes, and assets must ultimately be justified by the incomes they generate. Thus there is a limit to how large balance sheets can become relative to incomes.

Reaching that limit creates an enormous problem for the economy: Balance-sheet expansion is directly tied to the processes through which a private economy generates profits. As balance-sheet expansion shifts from rapid to sluggish, profits weaken dramatically, debt performance worsens, asset prices are undermined by poor returns and investment falls faster. In other words, the economy's bloated balance sheets cannot simply remain bloated; either they must continue to expand rapidly or else profits will fall and trigger a vicious cycle that causes balance sheets to contract.

Our economy appears to have reached the point where balance sheets cannot continue to expand and are beginning to contract. Household debt growth virtually halted in the second quarter and may be negative for the first time in the postwar era in the third quarter. The value of household holdings of real estate and corporate equities is deflating. Prices of some corporate assets are beginning to decline, including some commercial real estate, and business equipment investment is falling.

“Massive government intervention in the financial markets will prevent a crippling breakdown of the financial system, but it will not prevent enduring economic difficulties.”

What makes these trends so serious is their interaction with crumbling debt performance in a vicious cycle of financial breakdowns and economic decline. Like the period we are entering, the early 1990s and the early 2000s were characterized by vicious cycles of asset deflation, credit crises and plunging investment in various parts of the economy. This time, however, the severity of the balance-sheet contraction will be greater, with dramatic contraction in household balance sheets and what may well be the mother of all postwar consumer retrenchments. Moreover, the financial sector, which was largely unscathed during the corporate credit problems of 2001–2003, will continue to undergo profound balance-sheet contraction.

Without the government's containment the economy would indeed face another Great Depression, but fortunately, nothing so dire will occur. The government will prevent a collapse of the financial system and partially buffer the damage to the economy, containing the depression. The government will succeed not because it is wise about economic affairs or because it won't make mistakes. Rather, it will have no choice but to keep patching holes in the financial sector, and its sheer size and presence guarantee a sizable fiscal stabilization. The government has virtually unlimited power to intervene to protect the basic functioning of the financial system, and in an emergency can spend whatever is necessary. Although government solutions will not fix the fundamental problems that will cause the depression, they will limit the financial fallout. By the end of the contained depression, the government will likely have committed trillions between rescue operations and running huge deficits. And although some may complain about the price tag, it will be a bargain for enabling us to avoid another Great Depression.

Although the economy's exact path is uncertain, we expect the economic and financial decline to intensify in the final months of 2008 and in 2009. The present recession, which is only the beginning of the contained depression, is likely to continue until near, if not past, the end of 2009. Even when the housing market has bottomed out, the effect of home depreciation on consumer spending will keep worsening. We have advised our institutional clients that this is a time to put top priority on the protection of capital and to expect unusually severe, widespread asset price deflation and credit market tightness.

Nevertheless, the contained depression will bring opportunities long before it is over. One opportunity is to capitalize on falling interest rates. The Fed will ultimately cut rates to the floor in an effort to mitigate the economic and financial debacle as inflation rapidly diminishes and deflation threatens. As in the past two recessions, Treasury yields will fall to record lows, although spreads will remain wide.

A good defense for investors now will provide for a good offense later. The contained depression will create great long-term buying opportunities by reducing asset prices, depressing returns, making credit scarce and darkening investor expectations. Once the present recession hits bottom, when fear and financial chaos still cloud the markets, it will be time to start looking for long-run opportunities. (The best time to buy stocks during the 1930s was in 1932, long before the depression ended.) However, we have urged our clients to be patient, both by holding out for extreme “fire sale” bargains and by lowering their short- and medium-term expectations when they do consider buying because prices may remain depressed for several years.

The coming years will be difficult and frightening, but the world is not coming to an end. The contained depression will create lean balance sheets, pent-up investment demand and growing pressure to employ rapidly changing technology and to address society's changing needs. For now, however, do not underestimate the financial storm, and be glad that the government, no matter what mistakes it may make, will ultimately succeed in preventing the breakdown of the U.S. financial system. *— David A. Levy*

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Growing Risks to U.S. Credit Rating and the Dollar

AS THE FINANCIAL CRISIS HAS SPIRALED DOWNWARD over the past year, events that were once virtually unthinkable have now become almost commonplace: U.S. housing prices falling