

**« POUVOIR ET FINANCE :
Éclairage historique sur les conséquences
politiques des crises financières »**

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KEYNOTE ADDRESS

PRIX LATSIS UNIVERSITAIRES 2010



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Niall Ferguson
Power and Finance: The Political Consequences of Financial Crises in Historical Perspective

[Slide 1] I'd like to tell you a story, and it must be said that compared with the academic work that has been honored tonight my story is, in fact, not very complicated at all, at least not in English. I want to try to explore the connection between financial crisis and political populism, and if you are wondering why my first slide this evening depicts the Mad Hatter's tea party from *Alice in Wonderland*, then stay tuned.

[Slide 2] In the wake of what has been the biggest financial crisis since the Depression, we have lived through and continue to witness a succession of backlashes. Let me begin with the backlash against finance itself. This curious object is a model of a giant vampire squid. Those of you who are regular readers of that august journal, *Rolling Stone*, will be aware that last year one of its writers, Matt Taibbi, described the investment bank Goldman Sachs (yes, you'll be relieved to hear that it was Goldman Sachs and not UBS) as 'a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money'. Disappointingly, *Rolling Stone* did not illustrate the piece with a giant vampire squid, for which I must say I have a very low opinion of the editor. However, in an anti-Goldman Sachs protest that was staged in New York shortly after the publication of the piece, some of the protesters had the wit to make this giant vampire squid, which as you can see is playing with a small planet, Planet Earth, in its tentacles. Incidentally, those of us who study the history of finance recognize this image only too well. More than a hundred years ago, populist critics of the financial system, about whom I will say more presently, depicted the house of Rothschild as a giant octopus once again playing with the world as if it were a mere ball. So part one of the backlash that follows any financial crisis is a backlash against finance itself. But that's not all. We are also witnessing a backlash against political incumbents, against those politicians unfortunate enough to be in office when the financial storm broke. I'm sure you're all avid readers of that other august journal, *The Sun* newspaper [Slide 3] and if you are you will remember well the decisive moment in the recent election in my own country, the United Kingdom. This occurred when the Prime Minister, Gordon Brown, had the bad luck to leave a microphone on after an encounter with a member of the public. Now you all know, ladies and gentlemen, that after an encounter with a member of the public, you should take the microphone off before you say words to the effect that she was 'just a bigoted woman'. She was described that way by Mr. Brown because Gillian Duffy had had the temerity to raise the issue of East European immigration to the United Kingdom, an issue which the Prime Minister was very resolved not to talk about during the election campaign. Those words, 'just a bigoted woman', almost certainly ensured Mr. Brown's election defeat and departure from office. And soon he will be able to form a club with other leaders swept from power by the financial crisis as well as their own ill-judged words. The former prime minister of the Netherlands, for example, Mr. Balkenende, could buy him a drink and they could discuss why it was that the financial crisis had to happen on their watch. Mr. Brown must wonder, as he sees his former partner Mr. Tony Blair's memoirs soar up the bestseller list, why it couldn't have happened to Tony.

[Slide 4] There are those political incumbents who seek to dodge the flying bullet of financial crisis by directing the bullet away from themselves towards others. It is, I think, no coincidence that the French President Monsieur Sarkozy chose this past year to raise the issue of the full female veil, the burka, and turn it into a major political objective of his government to prohibit that article of clothing. Only a few days ago this passed into French Law: it is now illegal to wear a burka in France. I, ladies and gentlemen, do not propose to enter into the rights and wrongs of that question, merely to point out that it is a not uncommon historical strategy when faced with a major financial crisis to bash people who are originally of immigrant stock and to direct fire at their culture. Nor does the backlash end there.

[Slide 5] Yesterday, as I'm sure you will have seen on your television news, there were demonstrations in numerous European countries, mainly organized by trade-union movements, again so called 'austerity' budgets. This picture is of a demonstration in Valencia, in Spain; I could show you many more. And believe me, you will see many and probably bigger demonstrations in the months ahead, as the austerity measures introduced by governments like the Spanish government take their toll, particularly take their toll on public sector trade unions and their rather comfortable pension packages. So, we are already in the midst of a political backlash following a great financial crisis. What I want to do this evening is to try to explain the nature of the connection by using historical context, by showing you that we have in some ways seen this movie before.

[Slide 6] Let's just get this crisis into perspective, shall we? It's been described in a recent *New York Times* column by Paul Krugman as a 'Third Great Depression', which rather confused some people who had only ever heard of one before. It's good that he did that, in fact, because I want you to learn a bit more this evening about the original Great Depression that began in 1873. But before we get to that, let me just clarify why this is not as bad as the Great Depression of 1929 to 1932. Right now, the biggest economy in the world is said to be out of recession, in the sense that the National Bureau of Economic Research pronounced the end of the recession to have come in June of last year, a pronouncement that elicited incredulity from the many Americans who have lost their homes, their jobs or their savings and see very little sign of recovery in the United States today. Accepting, however, this official definition, which says that the recession is over when the downturn stops and the economy begins to recover, it has been without question the longest recession since World War Two, measuring fully eighteen months, which is longer than the recessions of the early 1970s and early 1980s, but as you can see from this slide, it's still a lot shorter than the Great Depression of 1929 to 1932/33 which lasted fully 43 months, and shorter still than the original Great Depression of 1873-79 which lasted, according to the NBER definition, 65 months. So it's a long or great recession or if you prefer, and I do prefer, a *slight* depression. Real gross domestic product growth has been negative for five out of the last ten quarters, the recovery is clearly slackening in the United States right now, and the reason that Americans do not feel any real sense of recovery is that long-term unemployment has reached a record high in post-war terms, though not anything like what was seen during the Depression.

[Slide 7] So here we can see if we look at quarterly numbers for the change in Gross Domestic Product adjusted for inflation, that this was a longer (though not actually especially deep) recession than anything since the war. [Slide 8] We can also see that the long-term unemployed rate is really very strikingly high indeed. What this chart does is it shows you the percentage of the unemployed who have been out of work in America for 27 weeks or more, and it's now at 45% and still rising. And that is why the perception in the American public that this is more like a depression than a recession, and that it's not over, is so deeply rooted. [Slide 9] However, I want to emphasize that if it's a slight depression, that does mean something different from a great depression. If it was a great depression, ladies and gentlemen, your investments in developed-market stock markets (and I'm sure you all collectively have vast sums invested in stock markets as this is, after all, Switzerland) your investments would be down 85% rather than just 30%, because at this stage in the Great Depression, this many months in, that was where the U.S. stock market was: 85% below its peak. If (and I'm sure some of you were wise enough to do this) you'd invested in emerging markets, and particularly in Latin American markets, you wouldn't be complaining at all, because actually you would have seen a real annual return of something like 6.75% throughout this crisis. Colombia was the best buy (and you can ponder why that might be...and perhaps you can tell me the answer). If you were properly diversified as an investor, and had a significant portfolio of bonds, government or corporate, you were actually 20% or so up. So this was not anything like as big an economic shock as the Great Depression that began in 1929. [Slide 10] Let me show you some charts which explain the difference between the Great Depression of 1929-33 and our time. These charts are the work of my old friends Barry Eichengreen and Kevin O'Rourke, who did the great service of regularly updating their comparisons in an article that they published online. What this chart shows you is that global industrial output did fall at a depression-like rate up until the summer of 2009. Essentially, if you follow the red line, and compare it with the blue line, which is the crisis that began in 1929, they match perfectly for a very significant period, and then they diverge, and they diverged just as the NBER says for the U.S. economy, in around June 2009. [Slide 11] Same story when you look at world trade. In fact, world trade fell more sharply in our crisis than in the beginning phase of the Depression, but then, unlike in the Depression, trade recovered, and the recovery was once again from mid-2009 onwards.

[Slide 12] If you look at global stock markets, you see just how steep the crisis was, how severe the losses were in 2008/2009, but then you see the bounce. You can see that as in every other indicator I've shown you so far, the initial depression trend ended in mid-2009. [Slide 13] And if you take the U.S. stock market it is very clear: something happened in the summer of 2009 to pull the U.S. economy out of a tailspin which, had it continued, would have replicated the Great Depression, and this is a very important thing to understand. I want you to see that we came very close indeed to a re-run of the Great Depression, but avoided it. And part of what I want to do this evening is to reflect on why that was, and then to proceed to discuss the political consequences. [Slide 14] There are, I think, three reasons why we are not in a great depression, why we are only in a slight depression or a great recession, and the first is in fact China. Unlike in the early 1930s, one important economy continued to grow at an impressively rapid rate despite the near-collapse of the western financial system, and that economy was China's, now the second largest in the world,

overtaking Japan this year. And what is impressive about this chart is that you can see that nothing remotely approaching a recession happened in China in this crisis, and that the International Monetary Fund expects China's growth to remain remarkably close to 10% per annum going forward to 2015. So one reason we are not in a great depression is that a new engine of growth kicked in, and that engine was China. Other Asian economies also grew, India's performed impressively, but most of the other Asian economies grew because China's grew, and China's stimulus was really the crucial reason why global trade recovered in the second half of 2009 and continues to recover reasonably today.

[Slide 15] The second reason we are not in a great depression is that one person at least learnt from history, and that person was Ben Bernanke. The chairman of the Federal Reserve fortunately was a financial historian when the chips were down. This really was very lucky indeed. The number of people in the United States who have studied the finances and particularly the banking aspects of the Great Depression is really very small. I routinely ask American audiences, and these are audiences of financial experts, 'who has read Milton Friedman's and Anna Schwartz's *A Monetary History of the United States*, the single most important work of financial history written about the United States?' Generally, in a room this size, I get three hands at most, because financial history, ladies and gentlemen, is not studied the way, for example, quantitative methods in finance are studied. Luckily, as I say, the man who was running U.S. monetary policy had read Friedman and Schwartz, and indeed had read a few books on the subject besides, and had contributed his own scholarly papers on the banking crisis of the early 1930s. So we know that at least one person in control knew what to do, and what he did was very simple. He did the exact opposite of what the Fed did in the Depression. The exact opposite. In fact, Ben Bernanke fulfilled a pledge that he made to Milton Friedman shortly before Friedman's death, when he said, 'We promise you, we've learnt and we won't let it happen again. We won't do it again. We won't allow the economy to contract by failing to expand the monetary base in the face of a banking crisis.' What you see here is the balance sheet of the Federal Reserve System, which is another way of describing the monetary base of the U.S. Economy. Ben Bernanke multiplied the size of that monetary base by a factor of 2.6, mostly in the aftermath of the Lehman brothers' bankruptcy, and that, ladies and gentlemen, is the second reason why we are not in a great depression. Had he not done that, many more financial institutions would have failed than did fail after Lehman went bust.

[Slide 16] The third reason, it is commonly argued (though I'm not sure I entirely believe this), that we are not in a great depression has to do with fiscal policy and the very large deficits that have been run by the United States and by other governments. These should not be described simply as fiscal stimulus because most of the deficits in the U.S. and elsewhere in fact arose because of collapsing tax revenues and rising welfare payments, what economists call 'automatic stabilizers'. Nobody had to make a decision; it just happened, because that's the way the fiscal system works in a developed economy. But part of it in the United States – 787 billion dollars or so – was undoubtedly due to a discretionary fiscal stimulus, and believe me, economic historians will argue for years about whether that stimulus had any significant effect. Let's just say, it probably did no harm; it may even have

done some good, and it certainly helped Bernanke's monetary policy by providing additional sources that he could turn into liquidity, additional government bonds.

[Slide 17] There has of course been a debate in this country, as there has been a debate in my country, about the wisdom of fiscal stimulus. One of the nice things about this chart is that it allows you to compare fiscal stimuli the world over. What's striking is that when you look at fiscal stimulus in relation to gross domestic product and rank the stimuli, the United States has been without question the biggest of the Keynesians. I've circled Switzerland because as you can see, there was almost no Keynesian fiscal response in this country by American standards – the deficit was really very small indeed internationally. Korea, Australia, one can go down the list – all were not far behind the United States in the scale of their borrowing. Now, I'll leave aside the question of whether these great fiscal injections were as important as Keynesian economists like Paul Krugman and Martin Wolf claim. That is not my subject for tonight.

[Slide 18] My subject for tonight is what happens next. Since not every country has been as restrained as Switzerland, since most developed countries have pursued Keynesian policies or have at least allowed their deficits to balloon willy-nilly, we face a situation in which the world has turned upside down. It used to be emerging markets that had debt crises, that ended up with really large debts in relation to gross domestic product. Now, in the wake of the crisis, it is the developed economies that have a debt crisis. As you can see if you look at advanced economies in the G20, we are heading for a situation within just the next few years in which on average they will have a debt-to-GDP ratio significantly above 100% and in fact closer to 120%. [Slide 19] The trouble is, as we are now seeing, if you go on a debt binge it is a bit like going on an alcohol binge, you get a hangover, and the interesting thing is to find out who got the hangover first. This chart shows you the latest trends in ten-year bond yields for Greece, for Ireland, for Portugal and for Spain. Greece is up top: it has seen a massive increase in bond yields since this crisis of European sovereign debt began. Ireland and Portugal are in second place and third place, and Spain is doing relatively well still. The point is that governments that borrow consistently in the range of 10% of gross domestic product sooner or later suffer a loss of credibility, and when they suffer that loss of credibility in the eyes of bond investors, a terrible tailspin begins. As the markets lose faith, they sell the bonds; as the bonds fall in price, so the interest rate – the yield – for new borrowing goes up; as that goes up, the cost of financing new borrowing goes up, and so the deficit becomes larger, and the larger the deficit becomes, the less confidence there is in the market, and so on, down and down and down. The Greek tragedy, now the Irish tragedy, pretty soon the Portuguese tragedy; we must hope, but it is only a hope, that it does not soon become a Spanish tragedy. That is the process that is underway, and it has begun in peripheral Europe, in Southern Europe and Ireland but I do not believe that it will stop there. And the fact that it will not stop there is really tremendously important for the argument I want to make this evening.

[Slide 21] You will frequently hear the bailout that happened earlier this year described as a Greek bailout. This is a complete misnomer, because what in fact happened was that funds were made available to Greece and also to Ireland and Portugal and Spain to prevent a major crisis in North

European banking. What this table shows you is the exposure of the German, French, Belgian and Dutch banks to the so-called PIIGS. Now PIIGS is an ugly acronym for Portugal, Ireland, Italy, Greece and Spain, but you'll see why I don't mind using it in just a little minute. The point is (and I want to emphasize this because we're not so very far away from Germany) that when one hears German economists and politicians lecturing South Europeans for their wickedness and their profligacy, we are hearing what can only be described as hypocrisy, because the bailout was a bailout of German banks more than it was a bailout of the Greek government. [Slide 20] Let's revert to the PIGS. Let me show you why the market has lost confidence in those PIGS. I want you to look here at four charts: one for Portugal, one for Ireland, one for Greece and one for Spain. These charts come from a study published earlier this year by your own Bank for International Settlements, a wonderful institution that produces some of the best analysis of the financial world that there is, and indeed it was one of the few institutions to anticipate the financial crisis before it happened. It's just too bad that the BIS has no power. What they showed in their study was that these four countries were on course for fiscal crisis. If they did not correct their policies at all, their debt-to-GDP ratios would rise to either 300%, or in the case of Greece 400%, by 2040. Even if they corrected policy in one of two ways (and I won't bore you with the details), even with significant policy correction, they all still ended up above 100% of GDP. And since those policy corrections seemed rather a remote prospect earlier this year, it's not surprising that people concluded they really were 'pigs'. It's just that when you look at the same study a little more closely, and look at the charts for the United Kingdom and the United States, it turns out that they are not the only 'pigs' out there. [Slide 22] Prior to the election of the new government and the stern budget introduced by my friend George Osborne, Britain was on course to be a record-breaker, heading for a debt-GDP ratio of 500% without policy correction. And not far behind was the United States which, *nota bene*, has not introduced any kind of fiscal retrenchment measure since this study. In other words, nothing alters the picture presented here that the United States is on course to have a debt-GDP ratio in excess of 400% by 2040. This inspired a headline which I was not allowed to use in the *Financial Times* thanks to the extreme meanness of the editor, Lionel Barber, but I want to share it with you [slide 23]. I want to share it with you because this sums up, in essence, the situation, that the problems of the so-called PIGS are in fact somewhat less, in a long-term perspective, than the problems of the United States.

[Slide 24] Let me show you once again, from a slightly different source, why that is so. Imagine a calculation which leaves out gross domestic product but only looks at tax revenues, and calculate the relationship between debt and tax revenues. Expressed as a percentage, the figure for Greece is indeed a shocking 312%, and that is notably worse than any other European country. But if you go down the right-hand column, you will find that the United States is even worse, with a ratio of 3.6 - 358%. That is why the slogan 'PIGS 'R' US' is no facile joke, ladies and gentlemen. The United States, without a significant change in its fiscal policy, is on course for a major fiscal crisis. The only reason that this crisis has not already begun is that the United States, as a superpower that issues the world's Number 1 reserve currency, has a cushion, some room for manoeuvre that Greece, Ireland and Portugal don't have. [Slide 25] The Congressional Budget Office produces its own projections, and they show very clearly the scale of the problem. The CBO, which I think uses more optimistic

assumptions than the Bank for International Settlements, still says that its more likely scenario propels the debt-GDP ratio up towards 180% by 2035. That is their more likely scenario; they have a less likely baseline scenario which assumes that nothing will change. The alternative scenario, the higher one, assumes that American politicians will act the way they usually act, which is why it's the more likely scenario.

[Slide 26] Having set the scene economically, let me now turn to the political implications, and for those of you who dislike economics, it is time to breathe a sigh of relief. [Slide 27] I want to focus on two dimensions: the international and the domestic. I want to begin with the international, and to begin in particular with the fear, on the part of America's creditors, of inflation. About half of the federal debt in public hands is held by foreigners, and of that a very large proportion indeed is held by the Chinese Monetary Authorities. The Chinese for over a year have been fretting that U.S. policy is on course for a dollar devaluation, and they understandably fear that they will be the ones who pick up the tab, since they hold around 2 trillion dollars of dollar-denominated reserves at the present time. 'The U.S. government has strong incentives to reduce its real burden of debt through inflation and dollar devaluation', according, this is, to Zhang Ming, deputy chief of the International Finance Research Office at the Chinese Academy of Social Sciences. 'Whichever way it is, the yuan-recorded market value of Treasuries will fall, causing huge capital losses to China's central bank'. That is what the Chinese fear, and I could supply you with ten other quotations to the same effect all from this year. Now, you can understand why the Chinese feel this way. As the biggest importer of commodities in the world, they are acutely aware that commodity price inflation has taken off since the global economy came out of its tailspin. [Slide 28] You can see here that the principal commodity indices all ticked up from the middle of 2009. [Slide 29] And with gold (and I'm sure you're all great hoarders of gold) now above 1300 dollars an ounce, most people would see that as a strong signal of future inflation. [Slide 30] That is why, ladies and gentlemen, without anybody really noticing, the Chinese have significantly reduced their holdings of U.S. treasuries since the summer of last year, down by around 10%, I calculate, so they now hold only 10%, rather than previously 13%, of the entire federal debt in public hands.

So that is one view of the world, and it is one reason why what I have described as 'Chimerica', the fusion of at least economic interest between the United States and China, is unraveling before our very eyes. [Slide 31] But, I want to suggest to you (and it's an extremely important point, so if you were feeling remotely sleepy, this is the moment to suddenly jolt awake) that the Chinese fears may be misplaced, and that at least for the foreseeable future, deflation is a more likely scenario in the United States. Why do I think this? One, because the maturity - the term structure - of the U.S. federal debt, is relatively short and because U.S. bond investors are highly vigilant, to the extent of being vigilantes, any sign of an increase in future inflation is likely to be responded to with a rise in nominal yields, in nominal interest rates. If that happens before inflation happens, we may actually see a rise in real interest rates, and that is a much more serious concern for such a highly-leveraged economy with both huge public debt and even huger private debt, mostly on household balance sheets. What I want to suggest to you, the point I want to make to you tonight, is that under those circumstances, the distributional conflicts will be more painful politically than would be the case if

there were inflation. In fact, secretly, subconsciously, Americans want and need inflation. It's just that they can't admit it, and in any case they are not going to get it. [Slide 32] Here are the latest U.S. inflation numbers for core consumer price inflation. You can see it's heading for zero [Slide 33]. And if you look at other indicators, the Producer Price Index or the Philadelphia Fed's Prices Received Index, it is actually already in negative territory, which is really quite a sobering thought. [Slide 34] Even more startling to me is that measures of borrowed money in the United States, including the now unofficial M3 statistic, are contracting quite sharply, at an annualized rate of -5%, which is in no way an inflationary scenario. [Slide 35] That is a deflation signal if ever I saw one. If you take all the projections and all the forecasts by all the banks, which I've done, and you look at what they say about 10-year yields and inflation in 2011, you cannot get a negative number. There is absolute, 100% agreement that real rates will stay positive into next year. And let me reiterate. Positive real interest rates, nominal rates minus inflation, still in positive territory is extremely bad news for an economy which has an aggregate debt burden of public and private debt of the order of 375% of gross domestic product.

[Slide 36] We're in a two-speed world. In one world, China's world, inflation is an issue. China is growing at full tilt. They are growing because they massively expanded their credit system. Commodities are spiking because the Chinese are buying them in vast quantities. India has to worry, it always has to worry, about the price of food. In the emerging Asian world, inflation is a concern. But in the other world, the world we live in, the developed world, the issue is *deflation*. And, ladies and gentlemen, the nightmare scenario is very real that Japan already showed us the future and that both in the United States and in the European Union the next few years may be characterized by a Japanese-style combination of exploding public debt, very low nominal rates, positive real rates and pathetically slow growth.

Now comes the history: this has happened before. A period of prolonged deflation and sub-prime growth happened after the first great financial crisis of 1875, the first Great Depression that began in that year. Economic performance in the most mature economy in the world – Britain – was feeble in the 1870s and 1880s. The U.S., which was more an emerging market in those days, had one year of negative growth, and then a period of prolonged but slower growth and falling prices. Falling prices, positive real rates: that's the key concept, because under those circumstances, the conflicts between creditors and debtors become intense, and they dominate the domestic political scene. [Slide 37] Here's the U.S. Consumer Price Index from 1872 through to 1901, and you can see that prices fell quite steeply, by more than 20% peak to trough, and the deflationary trend continued right down to the beginning of the twentieth century. [Slide 38] Now let me show you a slide I have already shown you but with a third line added. Remember I pointed out how different the stock market's performance was in this crisis and in the crisis of 1929? Now look at the blue line. That's how the U.S. stock market performed after the peak of May 1872, and I think, if you see the green line moving in that direction, almost towards a meeting, that we may find ourselves in *that* kind of a depression. Not a 1929 kind of depression, an 1873 kind of depression. It lasts a long time, but it isn't so severe, and it's characterized not by a collapse in asset prices but by a slow downward slide accompanied by a downward slide in prices. [Slide 39] We can learn from that period, ladies and

gentlemen, a little bit about what lies ahead, because that period was associated with the rise of a movement generally known to historians as the populist movement. Populism, ladies and gentlemen, is the politics of the losers and the aspirants, the debtors and those whose earnings are stagnating when they thought they were going to grow. Populism has certain characteristic features familiar to those who have studied the late nineteenth century: hostility to bankers, to political incumbents, to foreigners. And, one consequence of populism is very often international conflict, because governments that come under pressure from populists are more likely to raise tariffs, to adopt isolationist foreign policies, to engage in currency wars, competitive devaluations, and to get into arguments about debt default. We have, as I said, seen this movie before.

[Slide 40] The People's Party never produced a President, but it did produce 10 state governors, 6 Senators, 39 Representatives and, although it lost one argument which was the argument to re-monetize silver, to go off the gold standard onto a bimetallic standard, the Populists successfully pushed the Republicans to raise tariffs and to bust trusts, to bust cartels, and they secured ultimate victory on one of their key issues, Prohibition, in 1920, with the prohibition of alcoholic drinks in the United States. [Slide 41] This man became the personification of the Populist movement: three-time Presidential loser William Jennings Bryan. Anti-gold, anti-alcohol, anti-Empire and famously anti-Darwin, he was one of the most important and, I believe, disruptive figures in the politics of the late nineteenth- and early twentieth-century United States. Part of what I want you to imagine this evening is the advent of someone like him. Someone like Bryan.

[Slide 42] If you look at the electoral statistics for the United States, it is very interesting how many votes were cast for candidates that were not from the two major parties. If you just look at the votes for President, it went up from just 1% in 1876, close to 5%, then by 1892 to 12%. If you look at votes for the House, 10% in 1896, above 20% in 1912 and indeed in the presidential election of 1912, non-Democrat, non-Republican candidates together polled 35% of the popular vote. You think the two-party system is kind of God-given in the United States, but no. In fact, in a time of Populist backlash, the two-party system is the thing most likely to come under pressure, because that hostility to incumbents applies to both parties. 'Throw the rascals out' is a slogan that applies to Republicans and Democrats alike.

[Slide 43] What's going to happen in November? Here's what I am told by those who know more about it than I do. Likely gains in the Senate for the Republicans: 8 or 9 seats. Gains in the House: probably 40, maybe 50. They will get a majority in the House, that's for sure. They could also gain 6 governorships, and end up with the majority of governorships. Most commentators, if you read the press, expect that Obama will react to this by tacking to the centre the way Bill Clinton did after Newt Gingrich burst onto the scene in the midterm elections of 1994. I think that's wrong. The last point I want to make to you this evening is that populism changes the political game as surely as a financial crisis changes the economic game. Let me say a few words about the Tea Party and then open this to discussion.

[Slide 44] Over half of the U.S. electorate today say they favor the Tea Party Movement, 35% say they positively support it and up to a quarter say they are in fact members of it – a quarter. 71% of

all Republicans say they support the Tea Party. What is the Tea Party? Well, the Tea Party is an allusion to the Boston Tea Party, and its defining characteristic is a kind of constitutional, early-Republic fundamentalism, combined with strong fiscal hawkishness, anti-deficit, anti-Keynesian policy, and just a little tiny hint of xenophobia. That's the Tea Party defined in what I would say was the most positive way.

[Slide 45] There are two kinds of tea party in this world, ladies and gentlemen. There's the Boston Tea Party, and there's the Mad Hatter's tea party. Let me introduce the man who might just be the William Jennings Bryan of our age. His name is Glenn Beck, he's a television host with the fastest growing audience in America, and if you haven't heard of Glenn Beck, you need to go to YouTube tonight and watch some. He's a former alcoholic, he's a convert to Mormonism, and he's a pathological hater of Woodrow Wilson – notice, Woodrow Wilson, the progressive who put the Democrats back in power in 1912 by breaking with the populist tradition. He's a Populist, that's what Glenn Beck is. And here's Glenn Beck in an interview he gave the *New York Times* which will be published in this Sunday's *New York Times Magazine*. 'Everything that is getting pushed through Congress, including this health care bill [is] driven by President Obama's thinking on ... reparations [and his desire to] settle old racial scores ... [his] deep-seated hatred for white people.' Now that's not the Boston Tea Party as I understand it. That, I think, is another kind of tea party.

[Slide 46] Ladies and gentlemen, could populism make a comeback? Yes. It's making it now. The collapse of Barack Obama's popularity since his election two years ago, the realization that he was not in fact the Messiah, that he was just another Chicago politician with all that that implies, has opened the gate for a major shift in American politics comparable in its nature and scale to the populist backlash of the nineteenth century, of the first Great Depression. [Slide 47] It's interesting that President Obama's only response seems to be to shift to protectionism. He seems to have read the script and he knows that's what you do as an incumbent in the United States. So watch out: the China-bashing season is upon us. President Obama spoke forthrightly on this subject just last week, and the Congress today has passed legislation essentially authorizing the imposition of punitive tariffs if the Chinese do not change their currency policy.

[Slide 48] I'm telling you, we have seen this movie before. So ladies and gentlemen [Slide 49], do get ready for 2012. Thank you very much indeed.