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Michael Farrell, Chairman of Annaly, delivered opening remarks to the company's 2007 fourth quarter earnings call. We reprint those remarks below:

Welcome to the Keynesian Nightmare

British economist John Maynard Keynes was an advisor to the American government in the 1930s when it was struggling to restart the domestic economy. The Depression was tragic but, to put it in historical context, Keynes and his client were dealing with a cyclical problem that, by the 1930's, had already happened regularly during US history.

Before World War II, the US had had many serious recessions or depressions, including 1807, 1837, 1873, 1882, 1893, 1907, 1920, 1933, and 1937. During the 1930s Depression, Keynes' interpretation of the economic problem was that the US, indeed the world, was caught in what he described as a liquidity trap. A liquidity trap is defined as a time when institutions and consumers hoard money and refuse to spend, protecting their own financial assets for fear of losing them. He argued mightily for his solution to the problem, what we now call Keynesianism. To simplify, he wanted FDR to 'prime the pump' of the economy, to put so much money in people's hands that the increased consumption would lead the way out of the liquidity trap, that the resulting improvement in consumer confidence and normalization of lending habits would reestablish the footing of the economy. The Roosevelt Administration and the economic community initially dismissed his ideas as too simplistic, but the New Deal came to look a lot like the Keynesian construct. Ultimately, the US was dragged out of the Depression by the deficit spending of World War II, but Keynesianism got the credit, thus setting the course of economic policy for much of the post-war Western world. Keynes, who died in 1946, didn't live to see the implementation of his theory in the real world.

Since WWII there have been ten recessions in the US, but unlike the pre-war recessions, none of them turned into a depression. I think this is because the Keynesian prescription of deficit spending and heavy government pump-priming has been engineered on a massive scale. Or, as Richard Nixon famously claimed in 1971, "I guess we are all Keynesians now." Keynesianism had triumphed, and the result is that Keynesian spending provided the foundation for the greatest economic boom that the world had ever experienced. Capitalists throughout the world piled into the example of the US, and in the process turned Keynes' dream into a nightmare: The nightmare of economies powered by huge amounts of debt and inescapable liquidity traps.

So here we are sixty years past America's emergence as the world's dominant superpower, and the perversity of Keynesian theory has grown like a weed. I think it is fair to say that the world we are in today is not the world Keynes foresaw when he wrote his General Theory of Employment, Interest and Money in 1936. The most pronounced change, to me, is to the amount of debt capital issued in the US and its changing composition. The US grew during the Cold War economic boom thanks to the issuance of the US Treasury's full faith and credit notes and bonds,, and since then the rest of the US economy has followed suit as society has gotten more and more comfortable with credit risk—first corporate debt, then consumer debt, then junk bonds, then mortgage debt, then structured debt. As a result, today the dominant part of the total debt structure in the US, the part that has played the largest role in driving GDP growth over the last decade, has occurred outside of the government's purview.

It is no secret that the US is a country driven by debt. It now takes approximately $3.25 of total debt in the US to generate $1 of GDP, a significant increase from 1952, when it took just $1.30 in debt to generate $1 of GDP. However, in 1952, government debt—federal, state and local— was $244 billion and accounted for **55.1%** of the $443.6 billion in total debt outstanding in the US. Today, government debt stands at $7.2 trillion but accounts for just **15.7%** of the $45 trillion in total debt. Household debt today has a much larger impact on economic growth than government debt— at $13.6 trillion, it is almost twice as much as government debt, while in 1952 it was just one-third of government debt.

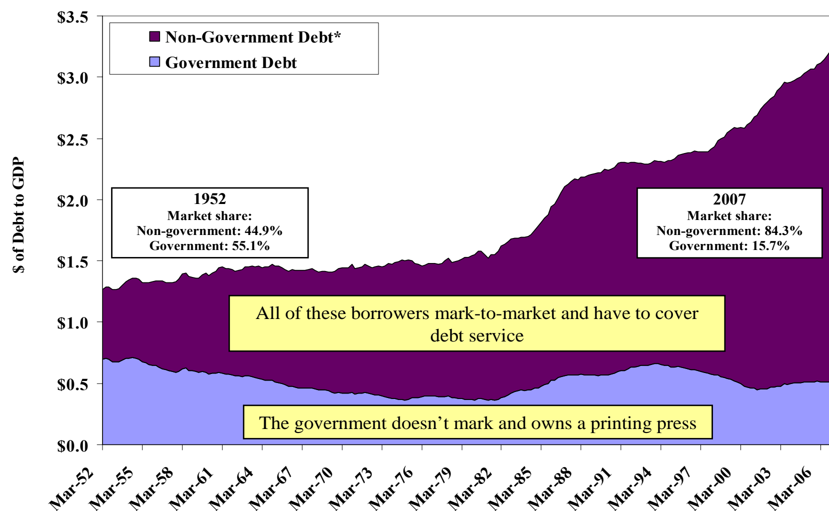
The first part of the Keynesian nightmare is related to this change in the composition of debt in the US. If we are counting on deficit spending and the resulting debt capital creation to pull the economy out of recession, the non-

governmental borrower who has driven economic growth over the last half decade won't be there. Don't count on him. That borrower marks to market and has to cover debt service out of earnings. His ability to borrow today is severely restricted by the asset deflation in house prices and on bank balance sheets. The government, on the other hand, doesn't mark to market and owns a printing press. So we would be on the watch for much, much deeper government deficits and a surge in government debt issuance going forward.

The second part of the Keynesian nightmare is that we might be in the middle of one of the worst liquidity traps ever. Banks are hoarding liquidity not so much because they are afraid to lend to weak credits but because they are protecting their own capital ratios. Their massive writedowns and equally massive capital infusions—neither of which are done—aren't working. So while the ECB and the Fed are trying to break the excess liquidity preference of financial institutions through extraordinary measures, the market is doing the opposite: While the Fed may be accommodative, the widening of credit spreads is restrictive. I suggest that this should offset the inflationary potential of the Fed's actions.

The struggling consumer will also likely start to pull in his horns and spend less and save more. We'll see whether those election-year fiscal stimulus checks change consumer confidence, but my guess is that $600 or $800 or whatever the package provides to consumers will be a transient event for the economy.

In short, the Keynesian nightmare is that it won't work. Maybe that's why the Fed cut 125 basis points in just eight days. And maybe that's why they have more to do.



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