The Recession

Causes and cures

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Contents

Executive Summary

- The recession was neither unforeseeable nor inexplicable. On the contrary, it was the direct and unavoidable result of the credit-fuelled boom that preceded it.

- Governments and their central banks contributed to the boom by: (1) keeping interest rates too low for too long, allowing asset-price bubbles to build; (2) giving implicit guarantees to the banks and other borrowers; (3) failing in their functions of prudential supervision and financial market regulation; and (4) encouraging borrowing by those least able to afford it.

- These mistakes originated in a misunderstanding by central bankers and Treasury officials on both sides of the Atlantic of the nature of the economic cycle, and in their consequent hubristic belief that they had solved the problem of how to prevent recessions.

- The only way to avoid a recession is to restrain the antecedent boom. However, once a recession is under way, there may be ways to mitigate its worst effects and bring it more quickly to an end. The key is to re-establish a climate of business confidence.

- The best way to do that is to set a long-term course for lower corporate and personal tax rates, and stick to it. In the medium term, higher taxes can only be limited by reducing government expenditure, not by borrowing. Large-scale borrowing does not inspire confidence, because it gives rise to an expectation of future tax rises, which discourages investment.

- In contrast, the three principal measures that have been adopted by the US and UK Governments to mitigate the recession are of marginal benefit and may prove harmful. These are: injecting taxpayers' money into the banks, artificially expanding the money supply, and attempting to provide a 'fiscal stimulus'.

- While one can understand why Governments felt the need to bail out certain institutions when they did, attempting to bail out all the banks is unwise. An orderly liquidation of the insolvent banks would have left sound banks in a stronger market position, allowing them to expand their lending to creditworthy borrowers more rapidly. No financial institution should be allowed to believe it is too big to fail.

- Expanding excessively the supply of money is unlikely to have a positive impact. In the long-term, it poses an inflationary threat, which may be difficult for central banks to counter.

- The prescription of an across-the-board fiscal stimulus as a remedy is equally misconceived. The present recession is not the result of a deficiency in aggregate demand which was growing steadily until the summer of 2007. Nor is the recession's impact evenly distributed across the economy. There may be a case for targeted assistance to alleviate hardship and ease adjustment, but government must be careful not to support unsuccessful firms at the expense of successful ones.

- A notable feature of the boom was the misalignment of incentives in financial markets, which encouraged excessive risk-taking. This is largely attributable to the persistent failure of institutional shareholders to hold directors and senior managers to account. This may be the biggest flaw in the operation of Western market economies at the present time, and needs to be addressed by legislation.

- The present crisis has cast into doubt the ability of national governments to control the supply of money and credit. In the short term, new monetary and fiscal policies will have to be formulated. If these don't work, then in the long term some form of commodity reserve system for currencies may need to be considered.

1 Introduction

There seems to be little agreement about remedies for the current recession. President Obama's statement that all economists were now agreed on the need for a substantial fiscal stimulus provoked a public letter of dissent signed by 200 leading US economists, including two Nobel laureates. Reports from this year's World Economic Forum at Davos suggested that the opinions of business leaders are equally divided. The actions of policymakers also suggest some uncertainty about what to do. The Federal Reserve's announcement in December 2007 of a plan to lend $40 billion to US banks was said to be the fourth high profile attempt to rescue the financial system in five months.[1] Former US Treasury Secretary Hank Paulson at first announced a plan to buy from the US banks their toxic assets, then cancelled the plan, then later reinstated it. A revised version, the Geithner-Summers plan, has been announced by his successor.

In the UK, Mervyn King, the Governor of the Bank of England, resisted further cuts in bank rate in Summer 2008, saying he expected output to be flat for the following twelve months. Six months later he was obliged to cut rates to unprecedented levels, acknowledging that the British economy was heading into recession. At about the same time, the Chancellor of the Exchequer gave a newspaper interview in which he disarmingly admitted that the first inkling he had had of the financial crisis was when he bought a newspaper in a supermarket. Having told us a year ago that the budget deficit in 2009-10 would be £38bn, in November Mr Darling revised this figure upwards to £118bn and then in April to £175bn. Three months ago, the UK Business Secretary, Lord Mandelson, said, "there are no manuals, no blueprints, no precedents to tell us what to do."[2] These and other episodes suggest that the understanding of the behaviour of the financial markets and of the economy on the

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* I am grateful to many friends for the stimulus of their thinking, but to none more than Jim Walker.
1 Paul Krugman, *New York Times* 14.12.07
2 Peter Mandelson, Speech to be delivered to the Council for Foreign Relations, New York, 17.2.09

part of the monetary and fiscal authorities in both the US and the UK is somewhat less than complete.

Lord Mandelson went on to suggest that anyone who thought they could predict the date of the recovery from the present recession was an 'idiot'. But while Mandelson was right to imply that there is no scientific basis for forecasting the precise timing of the recovery, it would be wrong to conclude that neither theory nor history has anything to teach us about the origins and course of the recession and what might be done about it. While predictions of detail in economic affairs are impossible, pattern predictions, as we shall see, can be made with some degree of confidence.

It may be that our Governments' lack of understanding of the situation in which we find ourselves can be explained by the attachment of their advisers – and of the academic establishment that interprets events and offers advice to the policymakers – to theories of economic behaviour that, while inappropriate in general, are particularly unhelpful in episodes of boom and bust. The conventional neoclassical model is especially unilluminating, because it has no theory about fluctuations in economic activity that arise from developments within the economy itself. Instead, it relies on a series of unexplained random external shocks that move the economy from one static equilibrium to another. The other pillar of orthodoxy, the Keynesian theory, does indeed have a theory of fluctuations, but its explanation for the occurrence of unemployed resources in an advanced market economy hardly appears to fit present circumstances. It would be difficult to maintain that the present recession has arisen as a result of a deficiency of aggregate demand in any of the leading economies. In most of these economies, aggregate demand (nominal GDP) had been growing steadily at an annual rate of around 5% for the past ten years.

Most economists nowadays seem to agree that the origins of the present recession and its associated financial crisis are to be found in the preceding boom. In order to find a remedy for our present difficulties that has a chance of success, we need to understand exactly how the recession came about. And to do that it is necessary to abandon both neoclassical and Keynesian orthodoxy, and turn to those theories, the classical, that do include sequences of prosperity and depression, or 'boom and bust', as an integral part of their thinking. Before turning to these theories, let us be clear what it is that we are trying to explain. The present boom and bust is not, as some would have us believe, a unique and unexpected event – a one-off. In fact, it follows a quite familiar pattern: in recent economic history there have been many financial crises, and quite a number of recessions.

Kindleberger identified no fewer than thirty major financial crises in various countries between 1720 and 1990.[3] Amongst the best known are the Dutch tulip mania of 1636/7, the South Sea Bubble of 1720, the Mississippi Scheme of the same year, the Great Wall Street Crash of 1929. Then there was the dot.com craze of 2001. If we confine ourselves to *purely* financial crises, there were 10 bear markets in US stocks in the 50 years from 1932 to 1982. Since then, there have been stock market crashes in 1987, 2001, and 2007/8.

Sometimes these financial crises have been followed by recessions in real economic activity, at other times they have not. In recent US history the financial crises of 1980/81, 1990/91 and 2001/2 were followed by recessions in real economic activity, each of less than a year's duration.[4] However, the stock market crash in 1987 and the global financial crisis of 1997/98 prompted by the Russian default were not followed by recessions in the United States.

When looked at closely, each of these crises can be seen to have differed from each another in several particulars. They were triggered by different events, and the assets whose prices rose and fell, and the industries principally affected, were different on each occasion. Each time, the expansion of credit took different forms. Nevertheless, a common pattern in each crisis is discernible. This report begins by identifying the features common to past and present crises, and then analyses the sequence of events that characterises the present one, the crisis of 2007/8. It then discusses the causes and possible cures, with particular emphasis on governmental responses.

3 C.P. Kindleberger, *Manias, Panics and Crashes*, 3rd edn, New York: John Wiley, 1996

4 A study by Barro and Ursua identified 148 occasions in different countries since 1870 where a country experienced a cumulative fall in output of at least 10 per cent. N. Ferguson, *The Ascent of Money*, London: Allen Lane 2008, p.396

2 The common pattern of booms and busts

We begin with a stylised version of the typical boom and bust cycle that draws heavily on the work of Kindleberger.

How the boom gets under way

There is first of all an event or series of events that triggers the process. It could be anything from the end of a war or a change in government policy to the widespread adoption of an innovation with pervasive effects, like the digital revolution at the beginning of this century. Whatever the cause might be, it has to be big enough to alter the economic outlook by changing perceived profit opportunities in at least one important part of the economy. Once that happens, investment and output pick up, and the boom is under way. A critical feature of the typical boom is that it is fuelled by an expansion of credit that enlarges the total money supply. Until quite recently, commercial banks were almost the only sources of credit, and their ability to expand its supply was limited by the central banks. Now, new means of payment to finance booms have emerged, including new credit instruments originating in the financial markets themselves, as well as the expansion of personal credit outside the banking system.[5]

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5 This means of course that it is now very difficult for the authorities to control the money supply by the traditional methods. The customary levers of central bank influence are the reserves of the commercial banks, currently amounting in the US to some $800 billion. The size of the total credit market has been estimated at around $50 trillion. (P. Krugman, *The Return of Depression Economics and The Crisis of 2008*, London: Penguin Books 2008, p.161)

After a while, increased demand funded by the expansion of credit presses against the supply of certain existing assets. Prices of these assets rise, creating new profit opportunities and attracting further investors. Euphoria sets in, and speculation in favour of further increases in prices is added to investment for production and sale. (Speculation can be defined as the purchase of real assets for resale rather than for use or for income.) As individuals see others making money out of speculative purchases and resales, they tend to follow their example. This speculative phase is usually marked by widespread examples of irrational behaviour, notably excessive risk-taking, incompetence, greed and downright fraud.[6] But the most important feature of the boom phase of the cycle is the monetary expansion in which credit is extended to speculators by banks and other institutions.

The bubble bursts

Eventually, when expectations of profit are overtaken by fear of loss, there is a flight from whatever assets have been the subject of speculation into more liquid assets. Once price trends are reversed in financial markets, participants are vulnerable to margin calls, and the consequent forced liquidation of collateral leads to a catastrophic and spreading acceleration of values downwards. In this phase, banks stop lending on the security of the assets that were the subject of the speculation. A period of credit contraction then sets in, accompanied by a remedial recession in real economic activity in which the losses of those who have made the least prudent investments are exposed. Note the adjective 'remedial': *it is the recession, however painful, which is the recovery phase of the economic cycle.* It is only in the recession that earlier wrong investments are exposed and corrected.

The credit contraction may lead to a phase of panic that, like the earlier speculation, feeds on itself. Confidence will not be fully restored until either: (a) prices of the assets fall so low that people are tempted to buy them again; or (b) a lender of last resort succeeds in convincing financial markets that money will be made available in sufficient volume to meet the demand for liquidity.

6 Perhaps in part explained by the observation that 'there is nothing so disturbing to one's well-being and judgement as to see a friend get rich', Kindleberger p.13

3 The recession of 2008-2010

It is not difficult to see in the present crisis many features that conform to the familiar pattern of boom and bust sketched above. More interesting perhaps are the details that distinguish the present crisis from others. The assets on which speculation has focused this time are not tulip bulbs, nor land nor share certificates, but houses and some of the new derivative financial securities that have greatly expanded in range and volume over the last two decades.

The background to the present crisis was provided by the conjunction of five historical factors that arose after 1982. They were: (1) A determination on the part of Western monetary policy makers and central bankers to create and maintain a low inflation environment, believing that to be a necessary condition for sustained economic growth. This was a policy introduced by President Reagan and Mrs Thatcher, and continued by their successors. (2) To achieve this objective, both Governments limited their spending and deficits, and de-regulated markets. (3) An extension of globalisation released onto world markets a greatly increased supply of cheap goods and services from China and other East Asian countries.[7] (4) The growing use of the internet strengthened competition in consumer markets, shifting pricing power from producers to people. (5) The internet also made it easier for companies to manage better their global supply chains.

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7 China's recycling of its dollar earnings into US Treasury bonds pushed down their yields and helped create the demand for the higher yielding securitised bonds.

These conditions resulted in a period of *disinflation* – a slowdown in the rate of increase of the prices of goods and services.[8] Disinflation helped to usher in a feeling of confidence, first amongst policymakers and later amongst financial market participants, that a new and permanent era of financial stability and economic wellbeing had been achieved. It was known to believers as the 'New Paradigm'. In his Presidential address to the 2003 meeting of the American Economic Association, Robert Lucas said that the *"central problem of depression prevention has been solved, for all practical purposes."* A year later, Ben Bernanke, soon to be appointed to succeed Alan Greenspan as Chairman of the Federal Reserve Board, gave a speech entitled 'The Great Moderation'. Like Lucas, he argued that modern macroeconomic policy had solved the problem of the business cycle, or at least had reduced it to the point that it was no longer a major concern.

The rationale for this belief seems to run as follows: A market economy may from time to time be subject to external shocks that produce disturbances in financial markets. A sudden loss of confidence can trigger a market panic that, like a 'run' on a bank, may become a self-fulfilling prophecy. Although such disturbances can have knock-on effects on the real economy, causing temporary declines in aggregate output and employment, they can be quickly corrected by the central bank making credit more easily available. If that should fail to work, then aggregate demand can be stimulated by the government increasing its expenditure or reducing taxation or both. According to this view, the Great Depression that afflicted the United States for seven years in the 1930s could have been avoided if the Federal Reserve had responded to the financial crisis of 1929 by expanding the money supply more vigorously.

This orthodox view, which is held by neoclassical monetarists and Keynesians alike, is unbalanced in two important respects. It does not acknowledge the significance of the 'boom' phase of the boom and bust cycle – indeed, it does not acknowledge its existence at all. And, secondly, it believes that the 'bust' phase is purely the result of a deficiency of aggregate demand. Nevertheless, it is a view that appeared to have been vindicated by recent events. The Fed had responded to the financial crises of 1987, 1991 and 2001 by flooding the financial markets with money, and the subsequent recessions in real activity were either short-lived or avoided altogether. These apparently successful policy responses added to the belief that the Western world had entered a New Paradigm of financial stability and economic prosperity. They also laid the foundations for later disaster by fixing in the minds of financial market players the belief that that no matter what you did, the central bank would bail you out.[9]

8 Not to be confused with deflation – a continuing fall in the level of prices.
9 On Wall Street in the early 2000s this came to be known as 'the Greenspan Put"

It was widely believed by central bankers, Treasury officials and their advisers on both sides of the Atlantic that this new era of financial stability, low inflation, steady growth and low unemployment would last forever, not appreciating that it was the result of transient historical forces that had already begun to disappear by the time the first tremor was felt in the financial markets in August 2007.[10]

The confidence of policymakers had been further boosted by a contemporaneous development in financial markets. The arrival of new forms of derivative products had seemed to provide an insurance function against changes in interest rates or defaults in traditional debt markets. The effect, it was believed, was to take risks off the balance sheets of commercial banks and pass them on to those more able to handle them, namely hedge funds and investment banks. And, indeed, at first the widespread adoption of these new instruments did contribute to an observed lower volatility in asset prices, and increased participants' confidence in the working of financial markets. It was believed that these new financial instruments had increased the 'shock absorption capacity' of markets by decreasing financial market volatility and spreading financial risk better. As Alan Greenspan said in 2004:

> *"Not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient."*[11]

Bankers, central bankers and policymakers persuaded themselves that this 'superlative financial engineering' had put an end to economic and financial cycles. Gordon Brown, then British Chancellor of the Exchequer, repeatedly asserted that under his stewardship there would be "No Return to Boom and Bust".[12] This was hubris on the grand scale. Nemesis swiftly followed.

As time passed, confidence in the stability of financial markets grew gradually and imperceptibly into overconfidence. When people grow to believe that the good times will never end, that their present level of profits will never fall and that the cost of borrowed money will never rise, they will borrow more and lend more than they would if they were less certain about economic conditions. A high level of confidence paves the way for excessive risk-taking, lending and borrowing.

10 This policymakers' error is analogous to that made by those market traders who persuade themselves that "it will be different this time: the price of the asset I'm buying really will go on rising for ever"

11 Greenspan 2004, cited in Krugman 2008 p.164

12 As late as March 2007, in his Budget speech, Brown said: "We will never return to boom and bust."

Banks and corporations felt comfortable in increasing their lending and leverage relative to their reserves and equity. Bank lending, traditionally secured against fixed assets, became increasingly secured against notional and less certain streams of future income. As fast as the risks disappeared off their balance sheets, the banks took new ones with the cash that they got from selling on their previous loans. Three weeks before the crisis broke, Chuck Prince, then CEO of the largest US bank Citigroup said that there was so much liquidity around that the financial markets could not be disrupted by the turmoil already beginning to be felt in the sub-prime market. At a time when defaults on junk bonds were running at their lowest rate since 1995, it seemed to make sense for Citigroup and the other banks to continue to make money while the going was good. To do otherwise would be to sacrifice market share and profitability to competitors.[13]

Two further factors contributed to the spiralling levels of risk-taking. In 2000, the major investment banks had altered their corporate forms of organisation from partnerships to become quoted companies. Henceforth, their management would be risking their shareholders' money, not their own. And the credit rating agencies, which were supposed to assess the risks of particular instruments and particular companies, completely failed to do their job. Bond ratings were negotiable with clients. Between 2002 and 2006, Moody's doubled their revenue and tripled their share price.[14]

Note that it was not the new derivative financial instruments that were at fault, but rather the behaviour of those who abused them. When they began to be used for speculation rather than for the management of risk, that is when things started to go wrong.[15]

The proliferation of excessive borrowing and lending facilitated by many of the new derivative instruments created an enormous bubble of credit within financial markets which not only dwarfed the supply of bank credit but lay outside the traditional measures of the money supply favoured by orthodox theory. Estimates vary,[16] but Roche and McKee estimate the global monetary base at $4trn, $53trn for broad money, $59trn for securitised debt, and $372trn for all derivatives.

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13 "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing" *The Guardian*, 16.2.09

14 C.R.Morris, *The Trillion Dollar Meltdown*, New York, Public Affairs 2008, p.77

15 For example, credit default swaps (CDSs) were created to allow an investor to be repaid if a company loan or bond defaulted. Speculators bought such contracts in the expectation of a default, meaning that they could claim the full value of a loan that they never made. The global CDS market eventually grew to more than $50 trillion, many times the value of the underlying assets.

16 D.Roche and B.McKee, *New Monetarism*, London: Independent Strategy p.33. See also Ferguson, pp. 4 & 5.

One of the results of excessive credit creation is that people feel unjustifiably rich. They are unable to distinguish between growth in the real value of productive assets and increased layers of debt on unchanged productive assets. In principle, one should try to distinguish between rising asset values that are the result of real increases in productivity and those that are simply due to speculative credit expansion. In practice, it may be difficult to do this. On aggregate data, one merges seamlessly into the other. The initial effect of securitisation and derivative creation in the financial markets was clearly beneficial. The only reliable danger signal that authorities should have spotted is the above-trend expansion of credit. But they do not seem to have counted the explosion of financial instruments as credit, because it was created within financial markets.

Furthermore, for symptoms of inflation the US and UK monetary authorities looked only at the rate of increases of prices of goods and services, as measured by the conventional indices of consumer prices. They ignored the evidence of the inflation of the price of houses and other assets, notably financial assets, despite the recognised importance of the housing market to the rest of the economy. There was some spin-off to the real economy. Banks' ability to sell on their mortgage debt meant that they had even more credit to lend to house purchases. And households' rising equity in the value of their houses led to consumers saving less and spending more than they otherwise would have done. But this expanding consumer debt and consumer expenditure did not translate into rising consumer goods prices because it took place at a time when the supply of goods was unusually elastic.[17]

At the same time that a credit bubble was building in the financial markets, a related bubble was building in housing markets on both sides of the Atlantic, as well as in some, but not all, other Western countries. This was far from being the first boom in house prices, but it was marked by one or two important differences from its predecessors. The expansion of credit by the banks and other mortgage lenders was fuelled by borrowing ('leveraging') and by lenders having extensive recourse to the wholesale money markets. But the really distinctive feature of the present crisis was the discovery by the lenders that they could release capital by securitising their loans and selling them on through the financial markets. The process of securitisation sparked an extraordinary degree of product specialisation. In this process, individual mortgages were bundled together, 'sliced' into various categories of supposed risk and repackaged for sale.

In a further stage of specialisation, contracts like interest rate swaps and credit default swaps were derived (hence 'derivatives') from these and other securities.

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17 The role of Chinese exports in keeping down the prices of traded manufactured goods was especially important.

Their ostensible purpose was to leverage credit still further and to manage risk, but it is evident from the volumes of these instruments traded that most of the trading activity has been speculative in nature.[18] Much of this speculative activity has been carried on by so-called hedge funds. Since the spectacular failure of one of their number, LTCM, in 1998, hedge funds have grown in number and in value of assets under management.[19] In fact, so opaque are most of the mortgage backed securities and the products derived from them that very few people, neither the rating agencies nor the regulators, understood the risks attached to these products, and those that did miscalculated them. The stage was therefore set so that, when the inevitable collapse eventually arrived in house prices, there would be an even bigger collapse in the financial markets.

Meanwhile, the expansion of lending to house owners was extended to reach more and more borrowers who were increasingly unlikely to be able to repay their loans – hence the euphemism 'sub-prime'. In order to attract them, increasingly soft terms had to be offered. Hence some lenders were offering 125% mortgages, others self-certification, and still others 'teaser' mortgages where the rates of repayment in the early years were low. Sub-prime lending in the US rose from an annual volume of $145 billion in 2001 to $625 billion in 2005, more than 20% of the total issuances.[20] If ever there was transparent evidence of the formation of a speculative bubble, this was it. Yet the regulators did nothing, nor did the lenders, despite the evidently deteriorating quality of their assets.

It may be asked, why did the lenders act in the way they did? There seem to be at least four reasons. First of all, their arms had been twisted, first by Clinton, later by Brown, to extend the benefits of home ownership to the 'socially excluded', i.e. people on low and uncertain incomes. Second, so long as house prices kept on rising, they could still make a profit in the event of foreclosure/repossession. Third, in any case, they had passed on the risks when they sold the securitised loans. Finally, competitive pressures demanded that they keep on making increasing profits for their shareholders.[21] So, as the banks kept on lending, house prices kept

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18 In 2006 the total annual issuance of mortgage-backed securities, asset-backed securities and CDOs exceeded $3 trillion. By the end of 2007 the notional value of all derivatives traded 'over-the-counter' was just under $600 trillion. Ferguson, pp. 4 and 5.

19 Originally set up in the 1980s to manage capital for investment banks and wealthy individuals, hedge funds have since attracted money from pension funds and endowments. In 1990 there were just over 600 hedge funds managing around $39 billion of assets. In the first quarter of 2008, there were 7,601 hedge funds with $1.9 trillion in assets. Ferguson, p.329

20 The positive effects of the housing boom should not be forgotten. The US rate of home ownership rose from 64% in the 1990s to 69% in 2005. The new entrants were disproportionately black and Latino households. Morris p. 69.

21 Those banks, like Lloyds, that seemed reluctant to join the dance were derided in the media for being staid and stuffy.

on rising. And rising prices meant that the same collateral could support a greater amount of credit. And the increasing amount of credit caused house prices to go on rising.[22]

The greatest real estate boom in US history came to an end in the summer of 2006. When a sufficient number of low-income borrowers reached the end of the 'teaser' period of their mortgages, and could not afford the higher repayments, this started a slide in house prices in some localities. At first it was thought that the problem was confined to only a small number of mortgages, and that the financial effects could be contained. However, it was eventually realised that the whole housing market had turned, and this precipitated a fall in the value of mortgage-backed securities as a class. Eventually, as a result of the housing market's decline, homeowners lost an estimated $7 trillion, and investors a further $1 trillion. It was that $1 trillion that caused the collapse of the financial sector.

On July 19th 2007, the Dow Jones Industrial Average rose above 14,000 for the first time. Less than a month later, on August 9th, the French bank BNP Paribas suspended withdrawals from its hedge funds. In the same month, the British bank Northern Rock collapsed, and it was revealed that there had been significant falls in asset values at hedge funds operated by Bear Sterns and Goldman Sachs. Once confidence changes, people rapidly lose their appetite for risk. When the downturn sets in, the credit creation process goes into reverse. De-leveraging is savage in both speed and extent. Loss of confidence quickly leads to panic, and there will be securities for which no buyer can be found at any price. Counterparties to deals go bust, and cannot meet their obligations. Banks become unwilling to lend, because they are being asked to meet increasing obligations while at the same time their assets are shrinking. The credit crunch has set in.

The banks' unwillingness to lend immediately affects the real economy. Thus the recession was not precipitated by an inadequacy of aggregate demand, but by a problem on the supply side of the economy, a sudden shortage of credit. Flooding the market with central bank money does not provide relief either, if the amount available is dwarfed by the shrinking volume of loans in the financial markets. Furthermore, fear of the recession makes banks feel uncertain which of their customers are still creditworthy.

It was not until March 2008 that Bear Sterns had to be rescued, but when Lehman Brothers failed six months later, panic set in. Panic causes irrational behaviour, unanticipated in the quantitative models used by so many hedge funds.[23] In the

22 This process resembles a Ponzi scheme.

typical financial crisis, confidence is finally restored only when asset prices have fallen to a realistic level. In the case of the present crisis, this probably means when a normal level of affordability of houses is reached. But the market itself will decide: when people start buying houses again that is usually the sign that normal conditions have been restored.

The effects of the financial crisis on the real economy

Faced with losses of capital, the banks started to contract their lending. This is the first, and most important, way in which the financial crisis has impacted on the real economy. The pattern was similar to that of 1929, where the proximate cause of the Depression was a shortage of bank credit because the banks had lost so much money lending to speculators. In 1929 the speculation was on stocks (equities), whereas this time it was on mortgages and other derivative securities. In both cases, the recession was preceded by a speculative boom in asset prices, fuelled by abundant credit. The more that assets rose, the more credit was attracted to the market.

The second main channel by which the present crisis has been transmitted is from the housing sector to the rest of the economy. When house prices are rising, homeowners are inclined to spend more on consumption, whether or not they formally refinance the loan on the rising value of their house. When house prices are falling, owners cut back on their current expenditure, especially on discretionary items, wishing to rebuild their savings and perhaps being wary of what the future might hold. Just as unease about the future causes businesses to postpone capital expenditure, so households postpone purchases of durable goods. Thus sales of cars and employment in car component manufacturing industries are particularly badly hit during a recession. Food processing industries and car repair services, on the other hand, are much less affected. Despite having had no housing boom, and only limited problems in their banking systems, both Germany and Japan have experienced severe reductions in demand because both countries are major exporters of capital and durable consumer goods to the rest of the world. Those two countries show that while the consequences of the present crisis are felt globally, its *origins* are not global at all. They are to be found in the housing and financial markets of a small number of countries, notably the US and the UK.

23 As Keynes famously observed, “markets can stay irrational longer than you can stay solvent”. For those who were wise enough or fortunate enough to be out of the market and in cash, then of course irrational behaviour on the part of others presented good buying opportunities, for example Warren Buffet’s purchase of shares in Goldman Sachs at distressed prices.

4 A theory of the recession

Economists in the classical tradition have always recognised that both monetary and real factors are involved in the cycle of prosperity and recession, or boom and bust, and that causality can run in both directions, from the monetary to the real and *vice versa*.

The most comprehensive theory of the economic cycle so far was put forward by Schumpeter.[24] Schumpeter believed that boom and bust was an unavoidable part of the progress of every market economy: it was the necessary price to be paid for capitalist economic development. It is not difficult to think of reasons why this should be so. The uncertainty associated with human behaviour means that things seldom turn out as planned. Our knowledge of the economic data that we need is fragmentary and incomplete, not least because the future is largely unknowable. Not only do individuals make mistakes and change their minds, most of us suffer from cognitive biases when we engage in economic activity. When operating in financial markets, we show a remarkable capacity to move quickly from bouts of unwarranted optimism (greed) to unwarranted pessimism (fear), and back again. That intangible but critical influence on investment decisions in market economies, the 'state of confidence', is equally volatile. And when they intervene collectively in markets, our policymakers and regulators turn out to be neither omniscient nor infallible.

Schumpeter, however, laid special emphasis on a particular source of disruption in market economies, namely the upheavals and disturbances caused by the introduction of new and improved ways of doing things, innovation for short. Innovations tend to arrive in clusters, and their appearance not only leads to an

24 The theory was first laid out in his '*Theory of Economic Development*' (1912), first English edition 1934, and expanded in '*Business Cycles*' (1939). In the latter, Schumpeter tried to show that there were discernible regularities of frequency and amplitude in economic cycles, but few economists nowadays find this convincing. See Spiethoff, *International Economic Papers* vol. 3, 1953.

increase in investment but often unleashes a wave of irrational exuberance. (Think of the 'dot.com' bubble of 2001, where the shares of new companies were floated at silly prices merely on the suggestion that the promoters might do something unspecified with the new digital technology). Innovations may also have disruptive as well as beneficial effects. To the extent that they are commercially successful, they destroy existing rival businesses, causing factories to close and putting people out of work.

So, according to Schumpeter, the boom phase of a cycle is generated by a cluster of innovations in some industry or industries, and fuelled by a related expansion in the supply of credit. The boom contains real beneficial elements that cannot be easily distinguished from the froth, the speculative and unwarranted price rises. The boom ends as the innovative investments exhaust themselves, and the resulting increase in output arrives on the market, undermining the sales of existing products and thus ushering in the recession. The recession phase of the cycle is a remedial one, in which those investments made during the boom that are subsequently revealed to have been unwarranted are liquidated. In the familiar parlance, a rising tide lifts all swimmers, while a falling tide reveals who was swimming naked. In other words, the recession helps to identify and eliminate unsuccessful businesses.

To this theory Paul Krugman, a leading standard-bearer of the orthodox Neoclassical/Keynesian view, responds: "...there is no obvious reason why bad investments made in the past require an actual slump in output in the present. Productive capacity may not have risen as much as anticipated, but it has not actually fallen: why not just print enough money to keep spending up so that the economy makes full use of the capacity it has?"[25]

To which Schumpeter would have replied:

> *"...any revival which is merely due to artificial stimulus leaves part of the work of depressions undone, and adds, to an undigested remnant of maladjustment, new maladjustment of its own which has to be liquidated in turn, thus threatening business with another (worse) crisis ahead."*[26]

A more recent version of classical cycle theory is provided by Minsky, who focuses on the changing relationship between the financial and the real factors in the economy. Firms borrow money to finance production based on uncertain expectations about future profitability. As output expands in the upswing of the cycle, these expectations become more positive, and more money is borrowed.

25 Krugman, p.68
26 Schumpeter, cited in Krugman p. 21

This process gradually undermines the quality of the liabilities firms have issued to borrow the money, because it becomes clear that it is increasingly unlikely that the profits that will be achieved will be sufficient to allow all the borrowing commitments to be met. Each firm tends to move towards thinner and thinner margins of equity in its financial position; firms that are unwilling to do so are punished by the competition.[27]

The gradual deterioration in the quality of the monetary liabilities provides the setting for a financial crisis in which many firms have difficulty in meeting their financial commitments. New lending is extended only on much tougher terms. The resulting collapse of the financial system has an impact on real economic activity as firms find it difficult to get finance for new production. Note that in Minsky's account the channels of influence run both ways: from economic activity to money, and from money to economic activity. But the central feature is the deteriorating quality of the monetary liabilities of firms as the upswing of the cycle proceeds.

27 H. Minsky, *Can It Happen Again?*, Armonk: Sharpe 1982

5 How governments have contributed to the crisis

For more than half a century, since the major trading nations abandoned the gold exchange standard, responsibility for the maintenance of *monetary and financial stability* has rested with national Governments. Governments have exercised this responsibility using three broad instruments of policy, namely control of the money supply through their central banks, fiscal (i.e. tax and spending) policies operated by their Treasuries, and prudential supervision of commercial banks and regulation of financial markets by various official agencies. Throughout this period it has been recognised that it is an important function of government to try to moderate the frequency and amplitude of financial crises and economic cycles, if not to eliminate them altogether.[28]

Monetary stability means first and foremost the maintenance of stability in the supply of money and credit. This is traditionally a responsibility exercised on behalf of governments by central banks. The proper role of central banks in moderating financial crises was well expressed by William McChesney Martin, Chairman of the Federal Reserve from 1951 to 1970. He said that the role of a central banker was "to take away the punch bowl just when the party gets going". It is now very clear that neither of his successors at the Fed, Alan Greenspan and Ben Bernanke, nor their counterpart at the Bank of England, Mervyn King, followed this advice. On the contrary, over the last ten years the punch bowl has been periodically and generously replenished. The consequent credit expansion led inevitably to a long-term inflation of asset prices, notably house prices. The corresponding explosion of borrowing and lending within the financial markets was simply ignored.

28 Because the British Treasury paid no attention to the risk of recession, Weale estimates that its fiscal rule of delivering current balance over the cycle was too slack by about 3% of GDP. M. Weale, *National Institute Economic Review*, April 2009, p.6

Monetary policy was too loose: interest rates were kept too low for too long, allowing asset price bubbles to build.

Once the cyclical nature of a recession is recognised, it follows that government policy should strive to avoid the creation of a boom, i.e. the formation of asset price bubbles, since it will inexorably lead to a consequent bust. But, under Greenspan, Bernanke and King, the central banks on both sides of the Atlantic have not concealed their view that it was not part of their job to be concerned about the formation of asset bubbles.

The case for inaction has been articulated by Alan Greenspan.[29] It boils down to saying (a) it is impossible to distinguish the formation of an asset bubble from healthy growth of the economy, (b) it would be dangerous to prick the bubble and risk precipitating a recession or at least stalling growth, and (c) it does not matter anyway, because once the bubble bursts we can quickly restore normality to the financial markets by flooding them with liquidity.

The classical theory of the economic cycle predicts that too great an expansion of credit will eventually be followed by a financial crisis and a possible recession. This prediction is supported by some recent research by Borio and Lowe at the Bank for International Settlements.[30] The researchers looked at the relationship between long-term credit growth in the G10 economies and the movement of asset prices. They found that there were 38 crisis episodes between 1970 and 1999 spread over 27 countries. When credit as a percentage of GDP grew at more than 4-5 percentage points above trend, some form of financial crisis followed within one year on nearly 80% of occasions.

The silence of the lambs

Had the credit boom of 2002-2007 not been tolerated, there would almost certainly have been a much less severe recession in 2008-9. Instead, the central banks in both the US and UK turned a blind eye to the credit boom and the speculative bubbles in the housing market and the financial markets, and kept interest rates too low for too long. The real Federal Funds interest rate was negative throughout 2002 and 2003, and for most of 2004. Only Arthur Burns as Chairman of the Fed presided over a longer period of negative interest rates than did Alan Greenspan.[31]

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29 A. Greenspan, The Age of Turbulence, New York: Penguin Books 2007, and The Wall Street Journal, March 11th 2009

30 Roche and McKee p.50

31 The 37 months between 1974 and 1977. Greenspan remains unrepentant: “I am increasingly persuaded that governments and central banks could not have importantly altered the course of the boom” Greenspan, p.523. However, Timothy Geithner, then Vice-Chairman of the Fed’s Open

Although Brown had in 1997 transferred responsibility for supervising individual banks from the Bank of England to the Financial Services Authority, the British central bank retained a share of responsibility for the performance of the financial system as a whole. However, it appears to have averted its eyes from the runaway credit, the housing bubble, the explosion of opaque financial instruments, and the rapid expansion of the balance sheets of the banks. In 2003, the Governor did voice his concern about escalating house prices, but he failed to return to the subject in subsequent speeches despite the fact that house prices continued to rise for a further three years.[32]

Instead, the Bank ran down its Financial Stability Department, distanced itself from the financial markets, and focused on achieving its statutory target of 2% for annual increases in the prices of consumer goods and services (as distinct from the prices of houses and other assets).[33]

But the central bankers cannot say they were not warned. As early as November 2003, Vincent Cable MP addressed the following question to then Chancellor, Gordon Brown, in the House of Commons:

> *"Is it not the brutal truth that... the growth of the British economy is sustained by consumer spending pinned against record levels of personal debt which is secured, if at all, against house prices that the Bank of England describes as well above equilibrium level?"*[34]

In 2004 *The Economist* wrote that:

> *"...the global financial system... has become a giant money press as America's easy money policy has spilled beyond its borders... This gush of global liquidity has not pushed up inflation. Instead, it has flowed into share prices and houses around the world, inflating a series of asset-price bubbles."*[35]

Market Committee that sets monetary policy, has confessed that "monetary policy around the world was too loose too long. And that created this just huge boom in asset prices, money chasing risk. People trying to get a higher return. That was just overwhelmingly powerful." *The Wall Street Journal Europe*, May 13 2009, p.11

32 It has been suggested that research within the Bank of England on the relationship between monetary conditions and asset prices, particularly house prices, was discontinued as the boom developed.

33 T. Congdon, *Central Banking in a Free Society*, London: IEA 2009

34 The Chancellor replied: "The Hon. Gentleman has been writing articles in the newspapers… that spread alarm, without substance, about the state of the British economy." Quoted in Vince Cable, *The Perfect Storm*, London: Penguin Books 2009, p.17

35 Cited in Morris p.63

And in 2005, the European Central Bank wrote:

> *"The close association between potentially disruptive asset price booms and excess credit and liquidity creation is particularly important for central banks… Indeed, certain historical episodes suggest that major asset-price escalations can be encouraged by lax monetary conditions which are not immediately reflected in an increase in consumer price inflation…*
>
> *[As] households are typically encouraged to spend out of their capital gains when asset prices advance, durable and sizable bubbles can boost consumer expenditure… In this respect, empirical evidence tends to suggest that a deflating bubble in the housing market is more costly than an equally sized crash in the stock market, as housing equity is more widespread and more intensely used as collateral for securing credit."*[36]

Although none of those responsible for monetary policy in the US and UK between 2002 and 2007 has yet apologised for their failure to even recognise that there was a problem, let alone to act, a confession of sorts has been made by Adair Turner, appointed Chairman of the FSA in September 2008. In a BBC television programme, he admitted that regulators had failed to see that by 2004 the banking system was moving in a direction that created a large systemic risk. "We didn't focus enough on that – the FSA, the Bank of England, the Treasury, and the Fed and the OCC in the US didn't focus enough on the issues. We have got to get that right in the future" He said that it was "a legitimate criticism" of the FSA that during the past decade it had focused on individual bank processes without recognising that the expansion of credit was "too risky" for the economy as a whole.[37]

The danger of giving guarantees to the banks

Banking regulation is supposed to prevent the banks from becoming insolvent. But that is its problem. Once the directors of banks begin to get the feeling that they are 'too big to be allowed to fail', then their lending and borrowing behaviour will reflect a willingness to take increasingly large risks. Observing that the Federal Reserve during the Greenspan years would cut interest rates at the least hint of a financial crisis, they came to accept such behaviour as normal, indeed as almost a responsibility of government. And they responded accordingly with increasingly imprudent behaviour.

36 "Asset Price Bubbles and Monetary Policy", ECB, Frankfurt, Spring 2005
37 *The Guardian* 16.2.09

Furthermore, their remuneration structure, with huge rewards for risk, and few apparent penalties for failure, encouraged them to 'bet the firm'. In the present crisis, the directors' belief that their bank would be bailed out turned out to be justified. When some banks appeared to be threatened with insolvency, both the US and UK governments rushed to their rescue.[38] In the words of the Chancellor of the Exchequer, "We shall do whatever it takes to maintain the stability of the banking system."[39]

But the effect of extending government guarantees, explicitly or implicitly, to the banks, is to weaken rather than to strengthen the stability of the financial system. This was the lesson of the Savings and Loans debacle in the US thirty years ago. Estimates of the total cost to the US taxpayer of that episode range from a quarter to a half trillion dollars in money of the day.

It is not difficult to see what these events and today's crisis have in common. Government guarantees of deposits, explicit in the case of the S&Ls and implicit in the present crisis, created perverse incentives that brought about the insolvency of most of the financial institutions concerned. More thoughtful regulation would have meant that banks and their customers would have been fully aware that their insolvency was the responsibility of the directors of the bank alone, and that the government would in no circumstances bail them out. This could have been expected to lead to an outcome where the financial strength of banks would once again become a competitive factor. Risk-averse customers would seek out those banks with the greatest financial strength.

Failures of prudential supervision of banks and of financial market regulation

Had the regulatory authorities taken a more restrictive approach to some of the excesses of the boom phase, the severity and extent of the subsequent recession might have been avoided. The excessive extent of imprudent lending for mortgages in both the US and UK was plain for all to see. In the UK, the evidence of the formation of a house price bubble was to be found in the offers of 125% mortgages, self-certification, relaxation of the criteria for lending, and the diminishing ratios of income to house prices.[40] As early as 2002 internal memoranda expressing concern

38 Lehman Bros was allowed to fail, but it was not a commercial bank. In the UK, not a single bank was allowed to fail, not even the Bradford & Bingley.
39 A. Darling, seriatim.
40 Between 1995 and 2007 house prices rose from four-and-a-half times earnings to more than nine times earnings. Mainly because of mortgages, but also because of personal borrowing,

at the risks being taken by Northern Rock and by HBOS were circulating within the FSA, but nothing was done. At the same time that the FSA, no doubt chastened by its humiliation in the Equitable Life affair, was imposing draconian capital requirements on British life assurance companies, it was allowing the commercial banks to run hugely risky positions financed by their depositors' money.

There appears to have been no attempt by the appropriate authorities in either London or New York to moderate the extravagant behaviour on the financial markets from 1998 onwards.[41] Greenspan is candid enough to explain that the Fed had no way of understanding, let alone measuring, the risks that were being taken by the banks and other financial institutions in these markets.[42] They left that job to the 'risk managers' of the banks concerned. This is an astonishing admission.

In the UK, the system of financial regulation, embodied in the Financial Services and Markets Act of 2000, left wholesale markets largely unregulated.[43]

So far as the attitudes of the central banks were concerned, it seems that both Greenspan and King accepted the conventional neoclassical theory that disturbances in financial markets are attributable to randomly occurring external shocks, and that the markets will quickly return to equilibrium thereafter.[44] In practice, imperfect information available to, and irrational behaviour on the part of, market traders means that financial markets can and do operate for long periods far from anything that could be construed as 'equilibrium'.

It is probable that controlling the money supply alone would not have been enough to prevent the formation of asset price bubbles. In addition, a gradual tightening of minimum margin requirements might have been needed. Of course, as Soros points out, such a process is never foolproof; as a result one should expect in practice an ongoing process of trial-and-error interaction between regulators and market traders.

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average household debt in Britain doubled over the same period to 160 percent of income, the highest ratio in the country's history and the highest of any developed country. Cable, pp.14 -17

41 Timothy Geithner, recently appointed Secretary of the US Treasury, was President of the Federal Reserve Bank of New York (i.e. the Fed's man in Wall Street) during the build up of the financial crisis

42 Greenspan, p.524

43 One of the architects of this Act was Alistair Darling, now Chancellor of the Exchequer.

44 G. Soros, The Crisis and What To Do About It, *The New York Review of Books*, November 2008

6 Government responses to the crisis

Among the factors that are different in every crisis is the response of the government authorities, including the central banks. The response of both US and UK Governments to the present economic crisis has been threefold: (i) 'save' the commercial banks; (ii) expand the supply of money; (iii) provide a 'fiscal stimulus'. Let us consider each of these in turn.

Saving the banks

The traditional approach to helping banks in difficulties that has evolved in Western countries over the years was for the central bank to act as the lender of last resort. This meant that the central bank should be ready to advance liquidity to a commercial bank when requested, against sound collateral and at a penal rate, provided that the bank was solvent. In the present crisis, the central banks and Treasuries of the US and UK and of many other countries have gone way beyond these limits.

Their intervention has taken broadly two forms; (a) the injection of additional capital in exchange for equity, and (b) arrangements for the government to acquire most or all of the doubtful securitised assets of the banks, sometimes known as 'toxic' or, more delicately, 'non-performing' assets.

In the British case, the equity stake has ranged from 100% (full nationalization) in the case of some of the smaller banks, to around 50% in the case of Lloyds-HBOS, with RBS coming in at around 70%. The estimated cost so far is some £37 billion. In the United States, the Federal Reserve and the Treasury have made available huge amounts of capital to Fannie Mae, Freddie Mac and AIG, effectively nationalizing these institutions, and have also made capital available to other, apparently solvent, banks.

The initial emphasis in the United States was on the Government buying the bad debt of the banks, the so-called TARP (Troubled Asset Relief Program) proposed by Hank Paulson, Secretary of the Treasury in 2008. Later, he announced that he would use most of the funds appropriated for this purpose to buy equity in the banks, implying that he thought undercapitalisation was at the root of the problem. A variant of his original proposal has been revived by the present Treasury Secretary, under a new name, PPIP (Public Private Investment Program). According to this scheme, private investors would receive federal loans to buy bad debts from the banks.

A number of similar schemes to relieve their banks of their bad debts have been proposed by other countries. In February 2009, the British Government introduced a scheme to insure their banks against the risks of the unknown losses on their portfolios of debt. For a 'premium' of £10 billion, risks of losses up to £585 billion were to be covered. In April, the Irish Government announced it was setting up a National Assets Management Agency to 'take over' an estimated Euros 80-90 billion of bad loans extended by Irish banks, mainly to local property developers. The hope is that the costs of servicing the consequent increase in the national debt will be met "as far as possible" from income accruing from the assets of the agency. Ireland is the first EU country to adopt this model.

TARP-type schemes have been heavily criticised by economists. As Krugman points out, rather than providing an infusion of capital where needed, they drive up the price of a single asset class. They are a taxpayer subsidy to anyone holding bad assets. In the case of the US, and probably the UK, it seems likely that the majority of such assets may be held by banks that are not insolvent.[45]

There may be a better alternative to TARP-type schemes for ridding the banking system of its bad debts. Under the existing schemes, if the Government pays the true price for the 'bad' assets, the banks are no better off. If they overpay, taxpayers take an unnecessary loss. If a government has decided to spend a certain amount of money to restore the flow of credit, it would surely be better to use the taxpayers' money to set up a wholly new 'clean' bank, whose capital could quickly be leveraged up with private borrowing to a substantial size.[46] This bank would have no reason

45 The slightly farcical situation has arisen whereby US banks are considering buying bad debts from each other with the help of the federal subsidy. (*Financial Times* 3.4.09)

46 The Government's equity in such a bank should of course be sold at the earliest commercial opportunity.

to restrict its lending to creditworthy customers, and every incentive to expand it. It should have no difficulty in attracting both deposits and private equity capital.

Despite these criticisms, the historical experience of both Sweden and Japan appears to support the proposition that *both* the infusion of fresh capital *and* the relief of bad debts are necessary for a restoration of the banking system to normal operation.[47]

The support offered by the US and UK governments to their banks has not been unconditional, and the response of the banks has been significant. While both governments have tried to behave as if all the banks were in the same situation, the banks' differential responses have revealed clearly which ones are solvent and which are not. In the UK, HSBC and Barclays have raised from private sources all the additional capital required of them by the regulator, and have declined to take part in the Government's bad debts insurance scheme. In the US, Goldman Sachs, JPMorgan Chase, Wells Fargo and Bank of America have all stated publicly that they intend to repay the capital they have received through the TARP scheme as quickly as possible to escape the restraints imposed by Washington on their dividend and pay policies.

There are more important grounds of public interest why these banks are right to try to avoid the Government's conditionality. In the UK, the Government has used these contractual obligations to put pressure on the banks it has 'rescued' to expand their aggregate lending.[48] There is an evident contradiction between requiring the banks to lend more while at the same time requiring them to observe higher capital ratios, imposing severe repayment conditions, and urging more prudent lending. What can be the justification for requiring the banks to lend more when the cause of their problem has been their recent excessive lending? This is a time when banks need to build up their capital as much as possible. It is true that the rather onerous terms initially imposed on the British banks have subsequently been moderated. But it is now too late: the demand for credit has diminished.

Despite the evidence of the destructive effect on confidence of Lehman's being allowed to fail, it is doubtful whether it is a good idea for governments to rescue every bank that is in danger of failing. If some of the insolvent banks of the US and UK had been allowed to fail, through an orderly liquidation, the better banks

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47 Kubayashi emphasises that, while every other policy had been tried and failed, Japan's recovery from 2003 to 2007 only began following the Government's introduction of its bad debt relief programme. (K. Kubayashi, *Shukan Bunshun* 26 March 2009)

48 There is also the danger that Government-controlled banks will be pressured to lend to politically desirable projects.

who survived would be in a much stronger position to expand their lending than they now are, since they would not have to compete against their less efficient but taxpayer-subsidized rivals. These profitable banks would have been able to increase their lending more rapidly, and thus the economy would have recovered more quickly. The Japanese experience in the 1990s of trying to support all their banks, including the failing ones, in response to a recession is a salutary one.[49]

The banking and financial industry has just experienced some serious systemic (i.e. system-wide) problems. But, while individual financial institutions have failed, there has been no failure of the system. To talk of 'global financial meltdown', and a risk of a 'return to barter', as some commentators do, is simply literary hyperbole. To speak of 'the banks' as if they were all at the same risk of insolvency simply undermines public confidence in the system as a whole, the very opposite of what is desirable in a crisis.

While one can understand why the US Government felt the need to rescue AIG, Fannie Mae, Freddie Mac and Bear Sterns because of the potential repercussions of their insolvency, the correct lesson to be drawn from this episode in banking history is that in future no financial institution must be allowed to believe that it is 'too big to fail'.

Expanding the money supply

In response to the recession, both the Fed and the Bank of England have flooded their money markets with liquidity, and reduced short-term interest rates close to zero. Whatever the immediate benefit of these measures, it has not yet brought about that resumption of normal medium-term commercial lending by the banks so anxiously desired by the authorities. Low rates of interest also discourage saving, at a time when saving is urgently required.

So the Bank of England has begun to create additional money by buying gilts and other bonds from financial institutions and other investors. It says it is prepared to spend up to £75 billion over three months on this exercise, known as "quantitative easing". The Swiss National Bank and the Federal Reserve have since followed suit. The announcement of the Fed's programme resulted in an immediate drop in the 10-year bond yield from 3% to 2.53%.

Will these unconventional measures 'work' in stimulating aggregate demand in the countries concerned? If they do not, the central banks have hinted that they will

49 It is a mistake that the Chinese as well as the British appear to be in danger of repeating.

go on expanding the money supply until it does work. The recession was initially precipitated by an interruption in the *supply* of credit. Now, one of the consequences of the recession has been a reduction in the *demand* for credit. Making it freely available may be in vain. In Keynes' metaphor: "you can take a horse to water, but you can't make it drink."

What about the risks of inflation? The official view from the Bank of England is that we do not have to worry about the long-term inflationary impact of monetary expansion or fiscal deficits, so long as there is 'credibility' in the Government's long-term commitment to monetary stability.[50] But when Alan Greenspan flooded the New York financial markets following 9/11, no one doubted his long-term commitment to monetary stability. The trouble was that that extra liquidity seems to have sown the seeds of future asset bubbles.

Proponents of quantitative easing argue that, at the first sign of inflation, the process can easily be reversed to mop up excess money. "If a central bank buys bonds, it can re-sell them" runs the argument. But surely this is not so. Who would want to buy back government bonds in a context in which inflation was anticipated?

A fiscal stimulus

Can a nation spend its way out of a recession by means of increased net Government spending? A generation ago, the question was posed and answered unequivocally in the negative by the then Labour Prime Minister James Callaghan. Addressing the 1976 Annual Conference of the Labour Party, he said:

> *"We used to think you could spend your way out of recession by boosting government spending. I tell you, in all candour, that option no longer exists. And in so far as it did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by higher unemployment as the next step..."*

Today there seems to be a widespread belief, represented by the declarations and actions not only of the current British Labour Prime Minister, but of President Barack Obama, and even of his predecessor George W Bush that 'Yes, We Can Spend our Way out of a Recession'.

On 24th November 2008, the UK Government announced a temporary 'fiscal stimulus' in the form of an immediate reduction in indirect taxes. On February

50 Martin Wolf, *Financial Times* 3.4.09

18th 2009 President Obama signed a $787bn fiscal stimulus package. Whereas the US stimulus amounts to some 4% of GDP, the UK stimulus amounts to only around 1% of its GDP. The disparity in the size of the two programmes reflects not so much a differential belief in the efficacy of a fiscal stimulus as its affordability. If overseas lenders are reluctant buy a Government's bonds (or lend to its banks), then that Government cannot borrow from abroad. The lack of success of a recent gilts auction suggests that the British Government may be near the limits of its borrowing ability.[51]

Other countries have taken a different view. The German Government has argued that a discretionary fiscal stimulus would be ineffective, since the increase in government spending would be offset by increased saving by households because they would anticipate higher taxes or higher inflation later. And indeed the announcement of the UK's fiscal stimulus was accompanied by a statement that it would be followed in eighteen months' time by an increase in both direct and indirect taxes as well as by a permanent and significant reduction in previously planned increases in public expenditure.[52]

The Irish Government has adopted a *negative* fiscal stimulus. A budget announced in early April 2009 raised a levy on higher income earners as well as other tax-raising and expenditure-reducing measures. The finance minister stated that these measures were intended to restore investor confidence in the government's finances.

In the discussion of these *discretionary* increases in government expenditure, it is often forgotten that they are usually significantly smaller than the increase in net government spending that takes place *automatically* in the course of a recession, as a result of the inbuilt stabilising functions of the tax and benefit system. When output, employment and profits fall, the corresponding tax revenues generated by these activities fall, while government spending on welfare benefits rises as unemployment rises.[53]

51 A significant part of British Government borrowing comes from abroad: 30 to 40 per cent of the national debt is held by overseas investors. Although Japan has a national debt that is more than three times as large as the British, (relative to GDP), it does not need to borrow from abroad. It has a large pool of apparently willing domestic lenders. The United States Government enjoys the privilege of being able to borrow in its own currency.

52 But not a reduction in the level of public expenditure. After April 2010, public expenditure is planned to increase at an annual rate of less than 1% in real terms.

53 The British fiscal deficit expected for 2009 is some 7% of GDP. Most of this can be attributed to the 'automatic' effects of the recession on the Government's revenues and expenditures. By contrast, the projected discretionary fiscal stimulus amounts to only around 1% of GDP.

Will these measures work? Proponents can point to Hitler's programme of road building and rearmament, which quickly succeeded in pulling Germany out of the Depression of the 1930s. On the other hand, the expenditure policies of Hoover and Roosevelt in the same period did not restore sustained growth to the US economy.

Advocates of a discretionary fiscal stimulus argue that if it does not work, it simply shows it was not big enough. This argument seems to betray a somewhat mechanistic view of how a market economy actually works. Such an impression is reinforced by the metaphors that are often deployed, such as 'kick-starting' the economy, as if it were an internal combustion engine. A more realistic view is that outcomes of government policies in market economies are in general context-specific. In other words, similar measures introduced in different places or at different times may have different consequences. Therefore one cannot dogmatically assert what will happen. Whether particular measures will 'work' frequently depends on their effect on the state of business confidence.

The prescription of a general across-the-board fiscal stimulus at the present time in any case represents a misconception of the nature of the current recession. The present recession is not a Keynesian recession, because it is not the consequence of a deficiency of aggregate demand. On the contrary, nominal aggregate demand had been rising steadily in the UK for more than ten years at an annual rate of around 5% until the summer of 2007.

The present recession is a phase of the cycle of economic activity with which economic historians are thoroughly familiar. It followed inexorably from the preceding boom in which an over-expansion of credit distorted the prices of residential and commercial properties, shares and other financial assets. Like its predecessors, the present recession is the remedial phase of the cycle in which the prices of these assets are returning to their normal relativities. The only way to avoid the recession is to limit the antecedent boom. Having failed to avoid the boom, the principal task of government policy should now be to facilitate this adjustment as quickly and smoothly as possible, and not to impede it.

There is a danger that a discretionary across-the-board fiscal stimulus might get in the way of the process of adjustment, either by combining with an expansionary monetary policy to revive inflation or by discouraging private productive investment. It is true that the risks of 'crowding out' private investment might seem small at a time when private investment is falling, but such investment might be discouraged by the prospect of future rises in business taxes to pay for the current 'stimulus'.

The aggregative view of the economy, held by Keynesians and monetarists alike, that underlies the notion of a fiscal stimulus, implies that the effects of a recession are felt equally in all parts of the economy. In fact, the impact of a recession is very unevenly distributed among industries, businesses and households. This diversity of industry experience can be illustrated by the fact the in the same year, 2008, that RBS made the greatest corporate loss in British business history, Shell made the greatest ever corporate profit.[54]

In addition to those industries that are the source of the boom – in the present case housing and banking – the industries likely to be hardest hit in a recession are the capital goods and consumer durable goods industries. The car industry provides a good example. Other industries experiencing a disproportionate fall in demand include those supplying the directly affected industries, construction and car components.

Even within the same industry there have been examples of some businesses doing much better during the recession than others. While RBS was losing £8bn, Barclays and HSBC each reported profits of around £6bn. In the retail industry, Morrisons and Amazon have flourished, while Woolworths and other retailers have gone bankrupt. Among British airlines, Flybe is prospering while others are languishing. In general, during a recession, weaker companies go out of business, while stronger companies, i.e. those with little debt and good cash flows, get stronger. As a result, control over resources passes into the hands of those whom experience reveals are better able to utilise them. This is all part of the continuing process of adjustment and development in a market economy.

Households have had equally diverse experiences in the recession. Hundreds of thousands of people have lost their jobs, and many of those are struggling to continue to repay their mortgages and other borrowings. Others have seen their retirement income reduced along with the value of their savings where these were invested in financial assets. On the other hand, many of those who are employed in the public sector, or who are repaying mortgages at variable rates of interest or whose savings have been largely in cash will have benefited from the recession.

Declining to accept the proposition that a country could or should try to spend its way out of a recession does not mean that one should oppose discretionary government spending in a recession to alleviate hardship, especially that which does not get in the way of the process of adjustment. The traditional response to a recession in economic activity included locally sponsored programmes of public

54 RBS lost £8bn, plus a further £20bn write-down of its assets. Shell made a profit of £20 bn.

works. Such programmes provided employment in the eighteenth and nineteenth centuries for those who would otherwise have been without an income.

Today, there is universal social security in the advanced economies. But there is also temporary excess capacity in the construction sector in various locations. There seems no reason why in these places particular infrastructural renewal projects should not be brought forward in time.[55] Likewise, where it is evident that potential buyers of new cars are merely postponing their purchasing decisions, there may be a case for offering incentives to bring these decisions forward. This type of assistance to the car industry should not be confused with schemes that give money to particular firms, thereby disadvantaging their domestic or foreign competitors.[56] Government policy in a recession needs to tread carefully to avoid directly or indirectly supporting unsuccessful firms at the expense of the successful ones. Nothing should be done which would prevent those firms that should go out of business from doing so.

55 Ironically, some government-sponsored infrastructure projects like the widening of the M25 have actually been postponed as a result of the recession, because they were dependent on private finance.

56 Car-scrapping schemes introduced in France and Germany appear to have been successful in stimulating the demand for new cars, although they have been criticised for allegedly switching demand from other durable consumer goods and from used cars.

7 Better options

Just as there is no medical way to escape a hangover other than to avoid becoming drunk, so the only way to avoid having a recession is to limit the antecedent boom. Once a recession has begun, however, there may be some ways to mitigate its worst effects and bring it more quickly to an end. The key principle must be to encourage the restoration of a climate of confidence in which businesspeople can seek and find profitable opportunities.

It is important to draw a distinction between short-term and long-term confidence. Certain measures, such as rescuing insolvent banks, may be deemed necessary by Governments to boost short-term confidence, and to avoid panic and runs on solvent banks. But if these measures are to be financed by means that undermine long-term business confidence then they are liable to be counterproductive. In other words, the increases in net government expenditure that are inevitable in a recession need to be seen to be funded other than by significant increases in future taxation, or more precisely, other than by increases in future *rates* of taxation.[57] Otherwise, they will simply discourage present as well as future business investment.

Higher future rates of taxation to pay for current increases in government expenditure can be avoided by commensurate reductions in unnecessary government expenditure in the future. In the United Kingdom, at least, there seems to be scope for this.[58]

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57 Inevitable, because the effect of a recession is to reduce tax revenues while at the same time increasing benefit claims. The effect on a government's budget of this inbuilt fiscal 'stabiliser' is normally larger than that of any discretionary fiscal 'stimulus'. See Footnote 52.

58 Following his recent experience as Minister for Business in the present Government, Lord Digby Jones observed that the work done by the British civil service could be carried out with half its present complement. Furthermore, given the relative advantages in terms of pensions and job security enjoyed by civil servants, there must also be scope for reducing their relative rates of pay.

The key to restoring long-term confidence for businesses and for individual savers and investors is for the Government to set a coherent policy direction and stick to it. A good example was provided by the incoming 1979 Conservative Government, which published a Medium Term Financial Strategy designed to squeeze out inflation, at that time a serious problem. It did not matter that the detailed monetary targets were misconceived and never realised: the Government's intentions were believed, and people's expectations and behaviour changed accordingly. The alternative of unveiling a new initiative every few days only encourages uncertainty amongst investors and savers.

Apart from seeking permanent reductions in their own unnecessary expenditure, governments need to address two other big issues, monetary policy and the alignment of incentives within businesses.

The experience of the last decade, to go back no further, has cast into doubt the ability of national governments, acting through their Treasuries and central banks, to control the supply of money and credit so as to avoid instability either in its supply or in the price level. It may be that this is an impossible task. However, before reverting to some form of commodity reserve system for currencies, it is likely that there will be at least one more attempt to make the existing system of managed money work.

If that attempt is to have any chance of success, it requires credibility. To have credibility, the framing and execution of a new monetary policy must be entrusted to those who are not associated with the failed policies of the recent past. No matter how honourable, able, intelligent and committed are the central bankers and Treasury officials on both sides of the Atlantic, recent events have clearly revealed that they lacked an adequate understanding of how the markets for which they were responsible operated.[59] They should therefore make way for others.

The third major issue is the widespread misalignment of managerial incentives in business. This problem was highlighted by the recent spectacular failures of some financial companies, where those in charge of the companies concerned faced systems of incentives that heavily rewarded them for success and barely penalised them for failure. Not surprisingly, they too often risked the future of their company. A significant increase in the capital requirements for banks, especially investment

59 Likewise, the former Chief Executive of General Motors, Rick Wagoner, is by all accounts an honourable and intelligent individual devoted to the company he served. But he demonstrably failed to understand and adjust to the forces at work in the markets in which the company operated, and therefore he had to resign.

banks, would help to correct these incentives. If banks can no longer leverage at 40:1 ratios, much of the incentive for irresponsible trading disappears.

Another much-cited example of misalignment of incentives in financial markets is the way in which mortgage brokers were rewarded solely for the quantity of the sales they made, and not for their quality. But the misalignment of incentives is a problem that extends well beyond financial markets, and is of much longer standing than the present crisis. In its general form, the problem can be expressed as the persistent failure of institutional shareholders to hold accountable their agents, namely the directors and senior managers of the companies they, the shareholders, own. It is not entirely clear why this should be so, but it evidently is so. It may not be an exaggeration to say that it is the single biggest weakness in the way that the market economy in the Western world operates at the present time.[60] The problem needs urgently to be addressed by government if the market economy is to function properly. Although self-regulation would be preferable, that seems unlikely to happen.

60 See also A. Sykes, *Capitalism For Tomorrow: Reuniting Ownership and Control*, London: Capstone 2000

8 Conclusions

At the beginning of the Great Depression of the 1930s John Maynard Keynes observed, "We have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand."[61] Seventy-five years later, official understanding of how the market economy works does not seem to have greatly improved. The conventional view remains that recessions are caused by shocks external to the system, and that any resulting recession can be avoided or mitigated by applying a fiscal or monetary stimulus, or both, to increase the level of aggregate demand. In his recent book, Paul Krugman, the Nobel Prize-winning proponent of the conventional view, has confessed that these policies are not working: "… the economy is stalling despite repeated efforts by policy-makers to get it going again. This policy helplessness is reminiscent of the 1930s…"

The alternative, classical, view is that boom and bust are an inseparable part of the growing market economy. From this perspective the recession is the remedial phase of the cycle in which relative prices, having been distorted by the boom, return to normal. In other words, the recession is a necessary period of adjustment to the distortions created by the boom. Therefore, the best way to diminish the severity of recessions is to moderate or avoid the excesses of the preceding boom. The bigger the boom, the bigger the following bust. During the bust there is no reason why governments should not step in to ease the pain of adjustment for individuals and businesses facing hardship, but attempts generally to inflate aggregate demand whether by expanding the supply of money, cutting taxes or increasing general

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61 Quoted by Krugman in *The Guardian Review* Dec 6 2008, p.31

62 This is not to deny the possibility that expansionary monetary and fiscal policies might be effective in circumstances of a prolonged deficiency of aggregate demand. But these are not the circumstances that exist at the present time, nor have they, generally speaking, existed in Western countries since the War.

government expenditure may hinder the natural processes of readjustment and eventually may prove inflationary.[62]

For more than seventy years the Federal Government has been wholly responsible for the supply of money and bank credit in the United States. In the United Kingdom, the British Government has exercised similar powers for slightly longer.[63] It is therefore impossible for either Government to escape responsibility for the recent events that have occurred in the financial markets of New York and London.

As we have seen in this report, the present recession is the direct consequence of first, the formation and then the bursting of speculative asset-price bubbles in the housing and financial markets, made possible by a combination of three factors. An excessive growth of liquidity in the financial markets in the first half of the present decade was tolerated by the central banks, notably the Federal Reserve and the Bank of England. The behaviour of these two bodies encouraged the development of two significant beliefs amongst financial market players. These were that debtors would always be bailed out by the increased availability of cheap money, and that many financial institutions were too big to be allowed to fail. The combined effect of these three factors was to encourage behaviour on the part of market participants that ranged from the reckless to the fraudulent. Lesser contributory factors included the failure of regulatory agencies to identify, let alone restrain, such behaviour, and the pressure exerted on the commercial banks by Governments in both countries to extend housing loans to households who were poor credit risks in the name of 'social inclusion'.

Those who were in charge of the commercial banks and other financial institutions that failed have mostly either resigned or been dismissed. No one would entrust them with the responsibility of leading the recovery of the institutions they made bankrupt. However, no such principles seem to apply to those policymakers who were responsible for the systems of monetary control and financial market regulation that failed so spectacularly in both London and New York. Their failures may be attributable to the fact that the policymakers concerned were relying on an inadequate understanding of how recessions come about, and how financial markets behave. Their variable and sometimes contradictory responses seem to bear this out.

63 One might quibble about the exact dates. The British Government finally abandoned the gold exchange standard in 1931, and the US, for domestic purposes, in 1933. The authorities in London today like to speak of 'the global financial crisis' as if it were some external happening whose origins had nothing to do with them.

Most Western economies are now in the middle of a painful but inevitable process of de-leveraging debt. Some of these economies are more resilient than others, but nowhere is it possible for an economist to predict exactly when this recession will end. If the present recession in the UK were to follow the pattern of the recession of the early 1980s, as it has done so far, it would take another year to bottom out, and a further two years before returning to pre-recession levels. But there is no reason why it should follow the earlier pattern.

What one can say with confidence is that it *will* come to an end, because recessions always do. They do so because the market economy is a continuously self-adjusting process of growth and change. There may be political constraints placed on this process, for good reasons and bad, but the satisfaction of both individual and collective wants in the future, as well as developments in technology, provides unbounded opportunities for investment and therefore for the resumption of growth in the aggregate as well as in the particular.

About the author

David Simpson received his Ph.D. in Economics from Harvard University in 1964. He was Professor of Economics at the University of Strathclyde from 1975 to 1988, and from then until 2001 he was Economic Adviser to Standard Life. He is the author of several books, and has published articles in periodicals ranging from *Econometrica* and *Scientific American* to *The Financial Times* and *The Spectator*.