Paradoxes of the Global Financial Meltdown

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Three years ago, I wrote a paper called "Paradoxes of Globalization". I made a long list of paradoxes. In the list below, I have reproduced the “paradoxes” particularly relevant to the major recession that is now affecting almost every country in the world, including Thailand. These phenomena are paradoxical because they are precisely the opposite of what we might expect to happen in a world that in the last 30 years has become more globalized than ever before in human history.

Before listing the paradoxes, let me make one thing clear: I personally, and I might add most economists worldwide, are convinced that globalization on balance has created unprecedented wealth and well-being world-wide. To blame our present problems on the globalization of trade in products, capital, technology and ideas would be gravely wrong. In fact the greatest danger that the “global meltdown” poses is that it will lead to protectionism and a freezing up of global trade and capital flows , as happened in the 1930s.

And now here is the list of some “paradoxes of globalization”:

Less equitable income and wealth distribution both within most ‘globalized’ countries, and between most countries.

Poor countries lending much more money to rich countries than vice-versa.

Developing countries that borrow capital from the rest of the world growing more slowly than those that lend to the rest of the world.

No consensus even among democratic, capitalist countries about optimal government involvement in their economies.

Many people in ex-communist or socialist countries claiming to be worse off under capitalism.

Increasing awareness among economists that other disciplines, particularly psychology, can shed light on human behavior. Accumulating evidence that even economic and financial behavior is sometimes systematically non-rational.

Since the onset of "global financial meltdown" we are witnessing yet another paradox:

A crisis that originated in the U.S. is hurting most other countries much more. "Virtuous" countries - those that saved and ran export surpluses - are suffering more than "venal" countries - those that borrowed and ran export deficits.

The big "virtuous" countries were Germany, Japan, Republic of Korea and China. Together with some smaller Asian economies like Taiwan Province of China and Singapore, they saved internally, exported externally and (together with oil exporters) became lenders to the rest of the world. The big oil exporters – Russian Federation, the Middle East, Nigeria and Venezula - are not as deserving of the epithet "virtuous" since their export surpluses resulted simply from the good fortune of high oil prices.

"Venal" countries - notably the U.S. and the U.K. - became the world's biggest borrowers. Over the decade ending 2008, U.S. household saving was zero or negative, and government borrowing mushroomed. U.S. government spending and investment was nevertheless sustained because of borrowing from abroad: government borrowing financed largely non-investment spending like the Iraq war, and corporate borrowing (added to retained earnings) financed productive capital. Foreign funds flowed into the U.S. stock and bond markets. Ominously, however, inward flows of Foreign *Direct* Investment (FDI) dried up.

The fundamental, root cause of the current "global financial meltdown" was this huge imbalance between the world's savers and the world's borrowers. Many observers, including some economists, are prone to lay blame: indeed I have implicitly done so by labeling the savers "virtuous" and the borrowers "venal". But this is wrong. The savers acted in their own perceived self interest just as did the borrowers. China, Germany and Japan were not motivated by altruistic urges to sell products and lend money cheaply to the U.S. Nor was the U.S. motivated by greedy urges to cheat the Chinese by buying cheap clothing stitched by low wage workers. U.S. homeowners were not motivated maliciously to take advantage of the low interest rates that lending by China, Germany and Japan made possible.

But of course both savers and lenders were indeed motivated by incentives that have proved misguided. Economists like to believe that decisions taken for self interest are guided by the market's "invisible hand" , and that they result in outcomes that simultaneously benefit buyers and sellers, and lenders and borrowers. The prices of products and interest rates on financial contracts should settle at levels that leave 'producer and consumer surpluses' for all market participants. What went wrong?

I want to dismiss the idea that the crisis was caused by vulgar, greedy consumers, or ruthless, rapacious bankers. Of course there were lots of those kinds of people involved, but greed and rapacity is always with us.

I want also to dismiss the idea that sinister Chinese mandarins conspired to manipulate their currency so that rich countries would be forced to import more than they export. Or that these same Chinese conspired to buy up U.S. Treasury bonds and keep U.S. interest rates low so that they could seduce naive Americans into buying homes they couldn't afford and hence be able to buy up big chunks of America's banks. That too is nonsense.

Yes the Chinese effectively subsidized their exports by keeping their currency artificially low but they did this in order to employ their own underemployed workers. And yes they bought American Treasury bonds but only because their own banks and financial instruments were not yet well developed enough to absorb the capital that pored into China from exports and from inward FDI.

In short, both borrowers and lenders acted in their own self-interest. But this self interest was distorted by global financial markets: so distorted, in fact, that the lending/borrowing imbalances led to global "meltdown" on a scale the world has never known.

Market or government failure?

The central controversy that is now raging among economists is this: did the markets themselves cause this disastrous distortion because they were unregulated, and left to their own devices? Or were the markets in fact *not* left to their own devices because they were distorted by government regulation? Bluntly put, have we witnessed what some economists call "market failure", or have we witnessed what other economists call "government failure"?

I believe that this is the most consequential
issue that divides economists today. It is consequential because it is the issue that must be acted on by governments. Governments must and will decide whether to increase regulation of financial markets or, by contrast, remove distortions that are already in place.

Fear of Keynesianism in present circumstances is misguided

I will return to regulatory issues shortly, but first let me dismiss what I see as an irrelevant "red herring". For as long as I can remember, professional economists have identified themselves as either "Keynesian" or "Classical". In the 1970s, these terms morphed into "New Keynesian" and "New Classical". The issue at stake was very simple: whether or not *macroeconomic* intervention by government is necessary and sufficient to prevent recessions and inflation. The Keynesian view is that counter-cyclical fiscal policy - surpluses in times of incipient inflation, and deficits in times of incipient recession - are necessary to smooth the business cycle. The Classical view is that as long as prices and particularly wages are flexible enough, the business cycle will smooth itself, though admittedly it may not go away because it has “real” sources: technical booms and busts, terms of trade reversals and so on.

Furthermore, according to the Classical view, counter-cyclical ‘fine-tuning’ via taxes and government spending will often have unintended consequences and prove counter-productive.

A sub-controversy, that peaked in the 1970s, was “monetarism” versus Keynesianism: whether increases in the money supply should or even could spur higher real growth. This argument was mislabeled since Keynes himself espoused sound money as vigorously as most monetarists, but the latter did us a service by forcing post-Keynesian acolytes of the time to tone down their advocacy of loose money as a tool to raise growth and lower unemployment.

The irony of course is that Alan Greenspan, who was never accused of Keynesianism, took over a post-monetarist Federal Reserve System and convinced it to use loose money to maintain growth. But the difference between Greenspan and both naive Keynesianism and naive monetarism was this: he understood that the long run equilibrium rate of unemployment (sometimes called the ‘structural’ rate or ‘natural’ rate) was shifting down in the U.S. due to productivity increases in the New Economy of the late 1990s, and that to raise interest rates would have underutilized U.S. productive capacity.

Back to the red herring: the traditional debate about whether or not to ‘fine-tune’ business cycles via fiscal and monetary policy, (New) Keynesian-style, is *not* the salient issue in the face of today’s global meltdown. For the first time since the 1930s, the context in which Keynes was writing, we are facing a massive collapse of private sector aggregate demand: consumer demand, investment demand, and export demand have all collapsed. The *only* source of demand available is government. Otherwise resources - labor, capital and natural resources, like minerals - will remain unemployed or underutilized on a massive scale, world wide. The only sensible disagreement about the need for government fiscal deficits is whether they should take the form of lower taxes or increased government spending.

And the massive deficit being engineered by the U.S. government is the only hope that the entire world will recover quickly from this recession.

What caused the crisis? Markets? Globalization? Regulators? Alan Greenspan?

How much of the current crisis was caused by too much regulation and how much by too little? This is really part of a much grander question: has free market capitalism failed, and what should replace it? Has globalization failed? My judgment about these grander questions is “No. Neither markets nor globalization have failed. Financial markets have faltered and globalized capital markets have frozen up, but they have not failed. We must be very careful not to kill the golden goose that has laid golden eggs for so long just because it has fallen ill. It is ill, but not terminally ill unless we overreact with remedies”.

Regulatory mistakes

First let’s look at what regulatory mistakes triggered the financial crisis in the U.S., and allowed it to spread world-wide. There were two major mistakes: over-regulation of the housing market and under-regulation of nonbank credit, and credit derivatives.

Over-regulation of the housing market began during the Clinton administration with legislation to increase home ownership among poor Americans. This was inspired by noble intentions but it had unintended consequences. Banks were encouraged to lend on easier terms to low income borrowers. Fannie Mae and Freddie Mac - the two huge semi-government institutions created in the 1930s and 1970s to buy mortgages from commercial banks - were encouraged to buy lower quality mortgages, freeing up the banks to lend more.

Paradoxically low interest lending to high risk home buyers really took off under Bush, not Clinton. Between 2001 and 2008, Alan Greenspan lowered interest rates in the aftermath of the burst of the high-tech bubble and subsequent recession of 2000-01. He kept interest rates low throughout the Bush years, despite huge government borrowing to pay for the Iraq war. He was greatly helped in this effort by the almost limitless willingness of surplus countries - Japan, China, Germany and the Middle East - to lend to the US by buying Treasury bonds.

Greenspan’s low interest rates and monetary expansion meant that more money than ever was available for mortgage lending, and banks, encouraged by the Clinton-era legislation, began seeking out borrowers with poor credit risks more aggressively than ever before. The Clinton legislation encouraged lending quotas: banks strived to meet minimum percentages of lending to poor people. To encourage more borrowing, banks invented sub-prime “teaser” interest rates, with “escalator” clauses in fine print whereby the rates would rise after a year or two. Housing prices boomed, and a “bubble” was created.

The housing bubble began to burst in mid-2007. Millions of Americans had borrowed almost the entire value of their homes, and when that value collapsed, they could no longer borrow more to continue their payments. At the same time the escalator clauses in sub-prime mortgages began to kick in , and interest payments became unaffordable. This led to foreclosures of homes by banks, followed by more price declines, followed by more payment delinquencies, and so on.

But why did this housing problem, that began in the U.S. almost two years ago, lead to a *world-wide* financial meltdown? The answer brings us to the globalization of housing finance via innovative financial engineering. The banks that originated the questionable mortgage loans were able to sell these loans to investment banks and other large institutions that packaged them together with thousands of other loans and then transformed them into bonds. These bonds are called “securitized mortgages” or “mortgage-backed securities.” The investment banks then sold these bonds to banks, insurance companies, pension funds and other large financial institutions, not just in the US, but around the world. They also sold them to Fannie Mae and Freddie Mac, who then sold their own bonds to commercial banks and also to central banks around the world.

When these securitized mortgage bonds, as well as similar securities backed by car loans, credit card loans and much more, began to fall rapidly in value, they became known as “toxic assets”. Beginning in August 2008, big banks in the US and then world-wide began to mistrust one another because they did not know how exposed other banks were to these toxic assets. In fact they did not even know how exposed they themselves were. The problem was compounded by an accounting convention that had been imposed a decade earlier: “marked-to-market” pricing of financial assets. Pricing according to the day to day market has become very problematic because the market for toxic assets has almost collapsed.

Once big banks stopped trusting one another, they stopped lending to one another, or at least they greatly increased the interest rates at which they were willing to lend to one another. The best indicator of this is the interest rate spread between the rates that central banks lend, which is very low, and the rate at which banks lend to each other: the international benchmark rate for interbank lending is the London Interbank Offer Rate or LIBOR. Since late 2008, central banks in the US and Europe have been engaged in a desperate effort to bring down the spread between LIBOR and central bank lending rates. Simply lowering the latter has not proved enough.

The reason that interbank lending is so important is that if the cost of loans from one bank to another is high and the availability low, they won’t lend to nonbank borrowers in the so called “real” sector. There’s a “credit crunch” that extends from home buyers and consumers to auto makers and construction projects.

However this credit crunch to the real sector - cars and construction - did not really begin to bite until late 2009. It was preceded by spectacular failures in the financial sector: Lehman Brothers went bankrupt, AIG was bailed out, and most big American banks as well as some huge foreign banks like Royal Bank of Scotland and Switzerland’s UBS , were kept afloat by massive injections of capital from governments. Citibank, which until a year ago was the biggest bank in the world, is now 33% owned by the US government.

Who is to blame and how should it be fixed? Here are some favorite villains:

*The Clinton administration, which enacted legislation encouraging home loans to poor people.

*The Bush administration, which ran huge fiscal deficits and financed them by borrowing from the Chinese, Japanese, Germans and Middle Eastern oil producers.

*Chinese, Japanese and Germans who “saved and exported too much” and, in the case of Middle Eastern oil producers, conspired to keep the price of oil high.

*American and also British financial regulators, who not only deregulated banks and financial markets but failed to keep pace with the mushrooming growth of complex financial derivatives, of which mortgage-backed securities are just one example. “Credit default swaps” are another notorious example: these provide insurance against collapsing credit, but can bring down the insurers (like AIG) if credit collapses systemically, across many industries and many countries and at the same time.

*American accounting regulators, embodied by the Financial Accounting Standards Board (FASB), who imposed “mark - to - market” requirements on financial assets, rather than allowing “future cash flow” evaluation, which takes a longer view.

*The Bank for International Settlements (BIS) in Basle, which ten years ago imposed “Basle 2” capital requirements on the world’s large banks. Basle 2 requires more capital when assets become riskier. Hence “toxic” assets (undervalued by mark-to-market accounting) require banks to raise more capital at the very time that capital is hard to raise. Capital requirements rise when times are bad: they are (unintentionally) “counter-cyclical”.

*Alan Greenspan, who refused to raise interest rates in the late 1990s, allowing the high tech stock market bubble to expand until it burst, and then refused to raise interest rates in 2002-07 allowing the housing market bubble to expand until it burst.

Was Greenspan right to hold interest rates low?

Last Friday I had an excellent discussion with Professor Salomon Kalmanovitz about whether Greenspan should be held to account for holding interest rates so low for so long. As a “devil’s advocate”, and in order to trigger a good argument with Salomon, I suggested that if Greenspan had tried to prick the equity and housing bubbles by raising interest rates in the late 90s, and again in the mid 2000s, he would have slowed American growth and raised unemployment, thereby imposing several years of unnecessary underutilization of production capacity. That lost production must be weighed against the lost production we now face with this massive world-wide recession.

In other words, would the world have been better off if Greenspan had slowed down the US economy in the late 1990s and mid 2000s and avoided the global recession we have now?

Of course this question is unanswerable until we know how long the present recession lasts. And we don't really know, and never will know, the "counter-factual" : would the current meltdown have happened even if Greenspan had raised rates earlier.

I tend to think it would have because of all the other distortions to global markets I've just listed, most of which had nothing to do with Greenspan. The worst that can be said about Greenspan is that he neglected to impose regulatory oversight on all the sources of credit and credit derivatives that mushroomed under his watch: for example the complex "structured financing vehicles" that made so much money for hedge funds and then lost so much money for the financial system as a whole when credit defaults became systemic.

What should be done?

I will close by listing six measures that should take priority in US policy making, and to a lesser extent in most countries around the world.

Major macroeconomic stimulus in the form of government fiscal deficits (or reduced surpluses) that combine increased government spending with lower taxes. The balance between the two depends in part on various countries' tastes for government versus the private sector, and also on how large a deficit or surplus the country started with. But even in the US, which in normal times preaches private sector over public, the bias will be toward increased government spending, both because it is likely to enter the spending stream faster, and because the US is direly in need of new public infrastructure, ranging from highways to health care.

The fiscal stimulus should be accompanied by monetary expansion. Both fiscal and monetary stimuli should have "exit strategies" built into them; they should be reduced and reversed rapidly as aggregate demand and the real economy recover.

International coordination of macroeconomic stimulus. This is a message that President Obama will push at the G20 meetings in London and one that many countries, notably Germany, will find hard to endorse. Without such coordination, the golden goose of globalization is in peril: countries will be lured by their electorates into mutually impoverishing trade protectionism, as they were to the enormous detriment of the world during the 1930s.

Financial regulatory reform. This will involve overhauling some regulation such as marked-to-market accounting and the counter-cyclical bias built in to Basle 2, and introducing other, such as major broadening of disclosure, supervision and regulation of financial lending, borrowing and trading of derivative instruments that are currently beyond the jurisdiction of central banks and bank supervisors.

International coordination of financial regulatory reform, without which financial institutions will escape to the least regulated jurisdictions.

Encouragement and financial funding of the international financial institutions - IMF, World Bank, regional development banks and the like - to enable them to come to the aid of emerging markets that have been sharply cut off from capital inflows. This applies not least to the emerging markets of Central and Eastern Europe, for which the European Union and its budget bear primary responsibility. A meltdown in Hungary, for example, could do major damage to Western Europe.

Forceful but reversible plans to revive banks and the credit markets, including equity injections and even temporary nationalization if necessary. A compliment to such injections should be the purchase of "toxic" assets by a government agency in order to remove them from the banks and encourage them to start lending anew. Only a government agency can, in the present fearful private sector environment, afford to take the longer view on these assets, which are undoubtedly worth more than the market currently prices them at, but paradoxically will only be worth more if temporary but forceful government intervention along the lines of 1. - 6. above is undertaken now.

Footnote
On April 1, 2009, FASB decided to modify marked to market rules to allow consideration of longer term values, and the G-20 committed $1 trillion for the IMF and funding short term trade finances.