Thoughts about the Financial Crisis

Ed Tower
Visiting Professor: Chulalongkorn University
Professor: Duke University
tower@econ.duke.edu

I hope we can continue this discussion by email.

1. What caused it?

Much of the world was selling more than it was buying. The non-American demand for goods was far to the left of the supply.
Reasons:
Low wages in China
Oil exporters had not figured out how to spend their revenues from high oil prices.
Low population growth in Japan meant low housing demand.

In US
immigration kept demand for housing high.
Low taxes kept output demand high.
All this resulted in US increased demand for traded and nontraded goods. Traded goods came from China. Nontraded goods (housing) had a more vertical supply curve and rose in price.
Greenspan just kept interest rates low enough to keep the economy at full employment. There were regulatory failures.

2. Are there presidents for how to rescue a plunging housing market?

Tom Sargent tells a beautiful story in his little *Rational Exectations* paperback. When Britain agreed to return HK to China, property prices plunged. HK banks owed more in deposits than the value of their assets. HK could have had costly bankruptcy proceedings. Instead the authorities devalued the HK dollar by 50%. So prices in HK$ doubled. That raised the VMP of land in HK and raised house prices, sparing any need for bankruptcy.

3. Are there any presidents for how to avoid a bubble in the price of nontraded goods?

A lesson from Chile: After Pinochet's coup, investors were optimistic. They invested in Chile. This would have appreciated the peso, created a trade deficit and forced Chile to keep interest rates low, pushing up housing prices. But Chile taxed capital inflows to prevent this from happening. Consequently, exports stayed high and there was no need to lower interest rates and a bubble in the price of nontraded goods was averted.

4. Is the bailout of financial institutions the best way to stimulate the economy?

I am suspicious that any government give away is for the public good. I have a student who looked at congressional voting on the bailout package of Late October

2008. He found that every $100K a congressman received in campaign contributions from the financial industry increased the probability that he voted for the bailout by 7%.

5. The bailout of three big auto producers in the US, Ford, General Motors, and Chrysler, will this increase auto employment in the US auto industry. It will discourage foreign auto firms from investing in the US, and is unlikely to create an efficient auto industry.

6. What caused the problems. High relative wages in autos. Hard to be too sympathetic to auto unions. Second, the chicken tariff. When Europe raised the tariff on US chickens in 1962, the US imposed tariffs on light trucks. Meaning that Detroit specialized in heavy vehicles which got killed when gas prices rose. Thus we have some government failure here.

7. How to limit the damage to the auto industry: Make clear that any bailout is temporary. Refuse any bailout to an industry in which wages exceed the average for that skill group.

8. Do we need more regulation of the banking system? We need more efficient bankruptcy laws. As a bank finds its assets falling close to its liabilities it should automatically be pushed into partial bankruptcy. It should automatically be forced to convert some of its debt into equity. The whole process should be automatic. This was proposed in the Economist in late April.

9. Why do we need regulation of the banking system? We are unlikely to have an Asian crisis like that of 1997, because now bankers are aware that exchange rates change and if you borrow in dollars and lend in bhat or rupia that a depreciation of the local currency causes insolvency. Thus bankers will be more cautious.

10. Same with the US the problems with bad mortgage lending have been well publicized. We don’t need regulation there.

11. Lenders will plow money into risky banks only if they think they will be bailed out. We need to control risk only if we are unable to control the government’s tendency to bail out banks.

12. Why was the Swedish financial crisis of 1992’s not accompanied by large scale defaults and a huge cost to the government. The Sweds have a safety net so unemployment did not mean defaults on mortgages.

13. Ways the feds could have stimulated the economy in a nondistorting way: The AEA proposal: paid thee states to temporarily reduce their sales taxes. Folks would have had an incentive to accelerate purchases.

14. The Meade-Keynes-Singapore proposal: cut the payroll tax temporarily.

15. Hold back on scheduled minimum wage increases.

16. Cut the corporate income tax.

17. Age adjust the payroll tax, to keep folks in the labor market who are close to retirement.

18. Cut steel tariffs.

19. The cash for clunkers bill. Giving money to folks toward buying new cars for scrapping their old cars.

20. Allow folks to use their social security funds to buy houses, reducing the amount they need to borrow from banks.

21. What worries me: Edward Prescott's lecture: Prospertity and Depression. Depression in France caused by labor market restrictions, Depression in Japan caused by protectionism. Depression in Mexico caused by government direction of bank lending.

22. We should have used this crisis as a means to eliminate distortions, not as an excuse to increase them.

23. The Dracula Effect: Need for more transparency.

24. My hope is that you as trade economists will devote some effort to exposing the costs to countries themselves from adopting protectionism in the disguise of stimulus. I think the big gain is to point out the costs to the protecting countries of their own policies and in the process help the search for policies that benefit both the countries themselves and their trading partners.

Two quotes here:

Self-serving special interests will always fight to protect themselves. What can economists and political scientists do to limit protectionism? Bhagwati (1988, 85) in a marvelous rhetorical flourish articulates what he calls the Dracula effect. Just as Dracula shrivels into nothingness when the morning sunlight hits him, "exposing evil to sunlight helps to destroy it." Similarly, economists for a long time have been illuminating fallacies in protectionist reasoning and documenting the costs and unintended consequences of protectionism. It is only more recently that political economists have shed light on the role of the political process in generating protectionism. All of this analysis combines to convincingly demonstrate that protection is the costly product of a negative sum political game, rather than the product of a government benignly maximizing a social welfare function designed to put us somewhere on the maximal tradeoff between equity and efficiency.

F. Y. Edgeworth (1908), Keynes' predecessor as editor of the *Economic Journal*, anticipated much of the public choice response to various models that justify protection when he wrote in response to Bickerdike's exploration of the idea that the national advantage could be served by the optimum tariff :

Thus the direct use of the theory is likely to be small. But it is to be feared that its abuse will be considerable. It affords to unscrupulous advocates of vulgar Protection a particularly specious pretext for introducing the thin edge of the fiscal wedge. Mr. Bickerdike may be compared to a scientist who, by a new analysis, has discovered that strychnine may be administered in small doses with prospect of advantage in one or two more cases than was previously known; the result of this discovery may be to render the drug more easily procurable by those whose intention, or at least whose practice is not medicinal. … Let us admire the skill of the analyst, but label the subject of his investigation POISON.

Economic stimulus has been an excuse for vulgar protectionism. Your job as Asian trade economists is to point out to the US what the costs of its protectionist policies to the US is. Not to you but to the US to help fight the American protectionism that hurts both the US and you.

Reading list:

Barriers to Riches

Stephen L. Parente and Edward C. Prescott

Why isn't the whole world as rich as the United States? Conventional views holds that differences in the share of output invested by countries account for this disparity. Not so, say Stephen Parente and Edward Prescott. In *Barriers to Riches*, Parente and Prescott argue that differences in Total Factor Productivity (TFP) explain this phenomenon. These differences exist because some countries erect barriers to the efficient use of readily available technology. The purpose of these barriers is to protect industry insiders with vested interests in current production processes from outside competition. Were this protection stopped, rapid TFP growth would follow in the poor countries, and the whole world would soon be rich.

Barriers to Riches reflects a decade of research by the authors on this question. Like other books on the subject, it makes use of historical examples and industry studies to illuminate potential explanations for income differences. Unlike these other books, however, it uses aggregate data and general equilibrium models to evaluate the plausibility of alternative explanations. The result of this approach is the most complete and coherent treatment of the subject to date.

About the Authors

Stephen L. Parente is Associate Professor of Economics at the University of Illinois, Urbana-Champaign.

Edward C. Prescott is Regents' Professor at the University of Minnesota and Economic Advisor, Federal Reserve Bank of Minneapolis.

Prosperity and Depression:
2002 Richard T. Ely Lecture

Edward C. Prescott

Prosperity and depression are relative concepts. Today both France and Japan are depressed relative to the United States; equivalently, the United States is prosperous relative to these countries. I say these countries are depressed relative to the United States because their output per working-age person is 30 percent less than the U.S. level. An interesting and important policy question is, Why are these countries depressed? The answers for these two countries turn out to be very different.

The United States is prosperous relative to France because the U.S. intratemporal tax wedge that distorts the tradeoff between consumption and leisure is much smaller than the French wedge. I will show that if France modified its intratemporal tax wedge so that its value was the same as the U.S. value, French welfare in consumption equivalents would increase by 19 percent. Consumption would have to increase by 19 percent now and in all future periods to achieve as large a welfare gain as that resulting from this tax reform.

The United States is prosperous relative to Japan because production efficiency is higher in the United States. In the United States, total factor productivity is approximately 20 percent higher than in Japan. If Japan suddenly became as efficient in production as the United States, its welfare gain in consumption equivalents would be 39 percent.
Equally interesting and important are big changes over time in relative output (per working-age person) across countries. Why are New Zealand's and Switzerland's economies depressed by over 30 percent relative to their 1970 trend-corrected levels? Both of these countries have small populations, but depressions are not restricted to small countries. Japan, with its 125 million people, is now depressed by 20 percent relative to its 1991 trend-corrected level.

Conclusions

Depressions are not a thing of the past, even for rich industrial countries. Switzerland is currently depressed 30 percent relative to its trend-corrected 1970 level, and Japan is currently depressed 20 percent relative to its 1991 level and continues to become more depressed. On the prosperity side, Ireland is 60 percent more prosperous than in 1970, correcting for trend growth.

Growth theory is a powerful tool for studying depression and prosperity. French, Japanese, and U.S. workers all have similar preferences. The French are not better at enjoying leisure. The Japanese are not compulsive savers. In this lecture, I use this theory to develop a system of accounting for differences in output per working-age person. One factor is the exogenous level of technology. It is common across countries and grows smoothly over time. Another factor is the capital factor, which depends upon how capital is taxed and the nature of capital market distortions. This factor turned out not to be very important in accounting for differences across countries and time.

The labor factor, however, turned out to be important. The differences in the consumption and labor tax rates in France and the United States account for virtually all of the 30 percent difference in the labor input per working-age person. The welfare gains associated with France reducing its intratemporal tax wedge are large. Is the low labor supply in Germany, Italy, and Spain also due to a tax system that makes consumption expensive in terms of leisure?

Other labor policies also have large macro effects as evidenced by the Great U.K. Depression that began in 1920 and continued for nearly 20 years and the interwar German depression. The final factor, productivity, is the most important one. It accounts for the behavior of the Japanese economy in 1960-2000, a period during which both a growth miracle and a depression occurred. It accounts for much of the current differences in income across the OECD countries today and changes in relative incomes of these countries over time.

In this lecture I discuss three
polices that empirically appear to affect the productivity factor. Trading clubs, sound competitive mechanism for the allocation of saving to investment, and competitive arrangements all appear to foster production efficiency.

More industry studies with careful micro measurement, along with better theory, hopefully, will provide a better understanding of how policy determines productivity and this understanding will lead to better policy.

The politics of American Protectionism

http://www.econ.duke.edu/Papers/Other/Tower/Protectionism.pdf

If we had a situation where these [steel workers] were our constituents and someone was breaking in their house and raping and robbing and pillaging them, we would want to send in a policeman to do something. In this instance, they [importers of foreign steel] are just coming in and taking their future, they are taking their jobs, they are taking all of their dreams away. … We must stand up for the people of this nation. We must stand up with a force of steel and with a backbone of steel. (Mr. Klink, Pennsylvania, *Congressional Record*, 1999).

…the [steel import quota] bill before the Senate is a job killer, a trade war starter, and it is a bill that will destroy 40 jobs in steel-using industries for every one job it saves in steel producing. (Mr. Gramm, Texas, *Congressional Record*, 1999).

Clarifying the "Win": An Economic Review of the CARS Bill

By Daniel DeVougas[1]

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[1] Daniel DeVougas is a recent graduate of Duke University, where he obtained a minor in Economics; he will be attending law school in the fall. This paper was written in an introductory international economics course taught by Professor Ed Tower. daniel.devougas@gmail.com.

Abstract

This paper is a short, non-technical assessment of the 2009 “Consumer Assistance to Recycle and Save” (CARS) Act, a voucher program to incentivize US consumers to scrap old, highly pollutant autos in order to buy new American hybrid cars at a reduced price. Looking at the legislation from an economic perspective, this review explores the negative externalities that could arise from the bill’s protectionist provisions.

You can get a copy of the paper by emailing the author.

Two papers by Max Corden that are useful. I would be happy to email them to you.

The Global Imbalances: What is the Problem?

Max Corden

affiliation not provided to SSRN

Economic Affairs, Vol. 28, Issue 2, pp. 53-58, June 2008

Abstract:

In the 2007 Wincott Lecture the author argues that global current account imbalances are an indication of intertemporal trade. Savings and investment, both private and public, determine the imbalances. He expounds Richard Cooper's argument that it is perfectly natural for the USA to have a big deficit and suggests that the large Chinese surplus may be temporary.

The World Credit Crisis: Understanding It, and What To Do

W. Max Corden.

Abstract The origin of the world credit crisis has four stages: (1) too much credit - an international perspective; (2) too much risk - reaction to low real interest rate; (3) the fatal flaw - the new complex financial instruments; and (4) the panic - bank lending dries up. The paper also discusses how the crisis spread around the world from the US, whether the high credit expansion was the fault of Alan Greenspan, whether China is to blame, and how this crisis related to the often expected crisis of global imbalances. Some implications for long-term reform are discussed.