The financial crisis in perspective.

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1. Are we heading towards a 1930s replay?

What is the likely impact of the financial crisis on the real economy?

University of Chicago economist Casey Mulligan publishes a new blog, Supply and Demand. He writes (September 28, 2008):

« Economic research over the last couple of decades rejects that belief (that Wall Street is the center of the entire economy). It has shown that the financial and non-financial sectors experience quite independent changes, especially over the short and medium term. Take for example the promised yield on the best commercial paper. Fluctuations in this yield are critically important to persons in the financial sector (such as money market traders), but have hardly anything to do with activity outside that sector. Since World War II, the correlation between the inflation-adjusted commercial paper yield and subsequent inflation-adjusted growth of GDP per capita is zero. That is, GDP growth has been high following high yields just as often as it has been low. It is equally hard to detect a correlation between stock returns, long term bond returns, or commodity returns and subsequent GDP growth. Quite simply, history has shown that the non-financial sector can do well when the financial sector does poorly, and vice versa. “

One predictor of the non-financial sector performance, according to him, is the “marginal product of capital” (profit net of variable cost and taxes).

“Since World War II, the marginal product of capital after-tax averaged between 7 and 8 percent per year. During 2007 and the first half of 2008 – exactly the time when financial markets had been spooked by oil price spikes and housing price crashes – the marginal product had been over 10 percent per year: far above the historical average. Compare this to the marginal product of capital in 1930-33 (the years of Depression-era bank panics): 0.5 percentage points per year less than the postwar years and significantly less than in 1929.

The marginal product of capital was also below average prior to the 1982 recession (in this case, far below average) and prior to the 2001 recession. Thus, the surprise was not that GDP continued to grow 2007-8 despite the bleak outlook from Wall Street corner of the world, but that GDP growth failed to be significantly above the average. More important from today's perspective is that much capital in America continues to be productive, and that this will likely permit Americans to advance their living standards as they have in years past. The non-financial sector today looks nothing like it did in 1930."

Another interesting viewpoint on the differences between then and now, is that of University of California at Berkeley Barry Eichengreen (available on Brad de Long's blog http://delong.typepad.com, September 28, 2008, "And Now the Great Depression"):

"In the 1930s the shock to the financial system came from a fall in the general price level by a third and the consequent collapse of economic activity. The solution was correspondingly straightforward. Stabilize the price level, as FDR did by pumping up the money supply, and it was possible to stabilize the economy, in turn righting the banking system.

… (Today) There has been a housing-market collapse, but in contrast to the 1930s there has been no general collapse of prices and economic activity. Corporate defaults have remained relatively low, which has been a much-needed source of comfort to the financial system. .. Since there has been no collapse of prices and economic activity, we are not now going to be able to grow or inflate our way out of the crisis, as we did after 1933."

Brad de Long answers on his blog (Grasping Reality with Both Hands, http://delong.typepad.com, September 28, 2008, "Analogies to the Great Depression"): yes we can, because we can inflate our way out of the housing prices collapse.

I add: Given the rather flat Phillips curve of the recent years (see below), we can inflate our way without much inflation by creating more money. This could also channel some buying power towards the assets markets, thus providing a much-needed boost to housing prices.

That's why, as Eichengreen claims for other reasons, "we are not going to see 25% unemployment rates like those of the Great Depression".

Brad de Long, however, warns: "Nevertheless, I said a year ago that if unemployment rate stays below ten percent then it is a win for monetary policy. And I think we have an 80% chance of achieving that…."

There is indeed, nowadays, a general agreement among economists to recognize – following the classical work of Milton Friedman and Anna Schwartz -- that the Great Depression was the result of the disastrous policy of the Federal Reserve that let the money stock contract by 30% or so in a few months, transforming a stock market crash in the worst economic contraction since the first “great depression”, that of 1873, sixty years earlier. The deflation ruined a large number of firms, their employees and their shareholders, even more than banking failures did.

In the present crisis, on the contrary, central banks in the US, Japan, and even Europe, pump up money supply, and governments recapitalize or nationalize failing banks and institutions. For the moment no cumulative bank failure (or “cascade”) materialized, in which one bank’s failure draws another one into bankruptcy, and so on and on. The failures will continue for some time however because all the housing losses have not been written down yet.

2. The causes: rogue traders and rogue institutions.

Do not mistake institutions for markets. John H. Makin very clearly explains in his September column for the American Entreprise Institute, « Risk and Systemic Risk » (Economic Outlook, http://www.aei.org) « why the frequency of financial crises has been increasing since the Asian crisis flared in 1997”. The economics of hedge fund organization are such that these funds can be seen as a collection of traders. But « an individual trader has the incentive to take too much risk because he or she captures all of the upside of large winning trades without a downside for net losses. » Traders do not personally share in losses, just gains. The downside for him (her) is limited to dismissal from the company. The management has the difficult task to keep control of the traders but faces similar incentives.

But then that is true also of the global financial and banking system. “Banks and other financial institutions assume the role of individual traders, while central banks and regulators take on the role of hedge fund management. The incentives for banks and individual financial institutions to assume too much risk are similar to those of traders, especially in institutions deemed « too big to fail ». This is especially true “when the « Greenspan Put » -- in which … central banks … contain the damage to financial markets after bubbles have burst … encourages a buildup of systemic risk ».

Finally, I suggest, what happened was a housing bubble that boosted these incentives. Such a bubble in asset prices happens when an innovation wave hits the economy, determining a huge creation of value for some corporations, but with increased uncertainty because these activities are new and consequently difficult to valuate. A technological (or financial) revolution) will necessarily be followed by a shakeout, letting only the best firms or instruments survive. But nobody knows which ones in advance. Quite the same thing happened in the 1920s with a booming economy and a stock market bubble. The extraordinary growth of the American economy and the wave of financial innovations in recent years fed several bubbles, paving the way for a later shakeout. It is a case of organizational failure, the organization of businesses lagging the technological progress of the services they were selling.

This evolution was sustained by the little noticed return to efficiency of monetary policy.

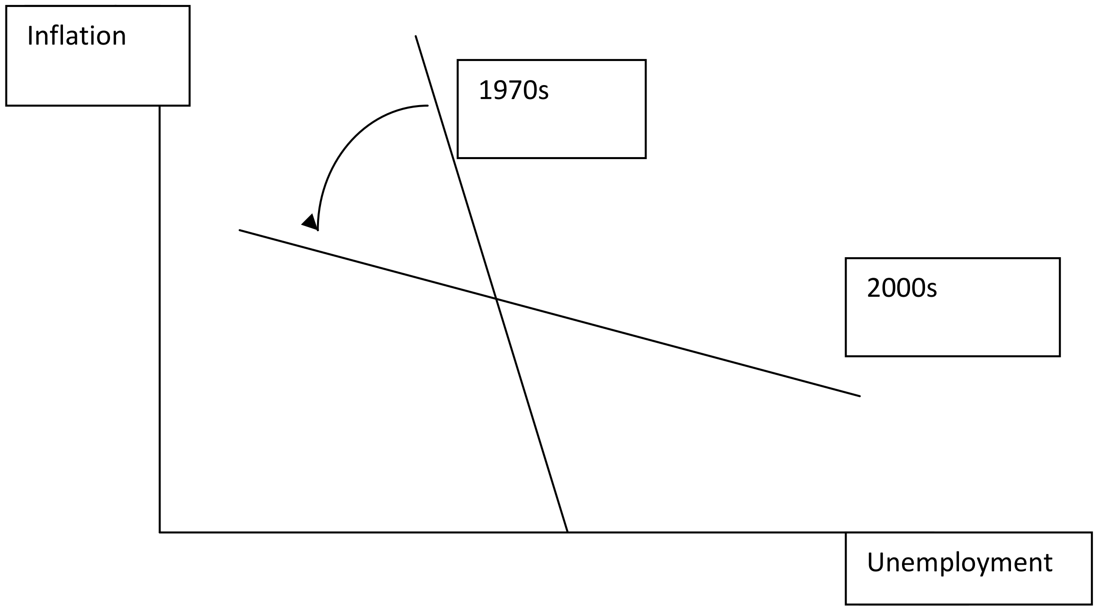
3. The return of monetary policy.

The conventional wisdom of recent decades (since the 1970s) was that an active or expansionist monetary policy was an unqualified “bad”. It could only create more inflation but no growth. This belief was linked to the alleged vanishing of the Phillips curve in the years of double-digit inflation. But it looked more in fact like a shift of the curve, rotating towards a quasi vertical position. In that case monetary policy had lost its power. More inflation could not buy more employment or growth.

As noticed by many scholars, however, a reverse shift took place, beginning in the 1990s: the flattening of the curve back to its position of the 1950s and 1960s. This flattening of the Phillips curve, was partly due to the globalization of markets that kept prices down through the competition exerted by imports, and partly due to the innovation (IT) revolution that led firms to change prices more often, thus reducing the slope of the curve (because it lessened price inertia, the very foundation of the existence and slope of the curve). In this new context, an increase in money supply does not lead so much to an increasing inflation than to an increase in growth and employment (contrary to what was the case when the slope was vertical in the 70s). This explains in particular the success of the Greenspan policy in stimulating growth without bringing back inflation. But the increase in monetary circulation also boosted asset prices … and the bubbles.

<u>The flattening Phillips curve</u>.

The 1970s versus the 2000s



While the 2000s flattened curve increased the moral risk in financial firms by making it easier to isolate the real economy from financial crises, it also allows monetary expansion to reduce unemployment and stimulate growth now, much more than the vertical Phillips relation of the 1970s. One percent inflation can “buy” much more growth now than it did in the 1970s. This is a main reason why we believe that active central banks interventions can mitigate efficiently the transmission of the crisis from the financial sector to the rest of the economy and reduce the risk of a severe downturn.

4. <u>Ideological consequences: the (temporary) triumph of colbertism</u>.

(He who pays the piper calls the tune)

Michael Skapinker writes, in the september 29, 2008, issue of the <u>Financial Times</u>:

"Do not write off New York and London".

"You can forgive Peer Steinbrück, Germany's finance minister, for his schadenfreude. You can understand French president Nicolas Sarkozy's triumphalism. … Laisser-faire was "as simplistic as it was dangerous", Mr. Steinbrück declared last week. "The all-powerful market which is always right is finished," Mr. Sarkozy said. Who could deny it when the US and UK nationalize one financial institution after another and a Republican administration throws $700bn at a problem? Three decades of untrammeled free markets and minimal government are over."

But wait a minute. Who ever said that markets are always right? Markets can be efficient but they are not omniscient, even though they use all the available information. And "Minimal government"? What "minimal government"? The decrease of government's role in the economy has not been that evident even in reform prone countries. Current public expenditures as a percentage of GDP are everywhere quite high compared to what they were in the 1970s. Modern capitalism is still mostly of the corporatist variety, rather than the competitive one. Finally the crisis is primarily a crisis of large firms or quasi governmental organizations (Fannie Mae for instance), rather than of markets proper.

We could say that this is the reason why Skapinker concludes, that despite the current anti-market sentiment:

"New York and London, exuberant, creative and open, sucked in the world's brightest, creating financial instruments so sophisticated that few outside Wall Street and the City could understand them. We now know that many of those inside the banks did not understand them either.

… But one day, with new regulations in place, companies will return to raising funds, banks to lending and financiers to making money. New York and London will remain the best places to do this because they retain the advantages they had before." These three advantages are language, law, and collective brain power.

Let us add to conclude that the companies that will return to the market will probably be much smaller than they are today. Note also that the conditions favoring the mercantilist trend in the 1930s (protectionism, state imperialism, collectivism) were totally different from the conditions of the early 21st century (those also of the "second twentieth century" as I explained in my book). We are still in the age of information abundance and decentralization and it is unlikely that States will regain much power and expand again on a broad front in the coming years. A return to socialism is even less credible. A crisis is not enough in itself to reverse such a deeply entrenched trend.

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