UNITED STATES AND GLOBAL FINANCIAL CRISIS

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The Suggestion: *Cherchez l'Etat*!

When men quarrel for no apparent reason, Frenchmen are saying "*Cherchez la femme!*", or: "Search for a women!", who is an object of that subterranean rivalry. My suggestion is that when you see aberrations in the performance of the economy on a grand scale: "*Cherchez l'Etat!*", or: "Search for a state!". Business cycles, accelerations and decelerations, expansions and recessions, even exuberant, irrational optimism in expansions and no less irrational pessimism in recessions – all are a n o r m in a capitalist market economy.

However, a b e r r a t i o n s are another matter. Nine times out of ten they are the end result of state intrusions into the functioning of the economy. The present US and – by transmission – global financial crisis is not different as far as its causes are concerned. And, as an aside only, because I have no space to devote to this issue, so was an Asian financial crisis that took place roughly a decade earlier than the present crisis [see, *i.a.*, Winiecki, 1999].

"Flooding the Economy with Money" Or An Attempt at Banishing the Business Cycle

In 2002 Robert Barro noted the propensity of Chairman Greenspan to cut, again and again, interest rates: "*The pattern of accelerated rate cuts is worrisome because it might signal that the FED has become less committed to maintaining low inflation and more interested in attempting to forestall an economic downturn*." [Barro, 2002, p.157] and added that "... *it would be better if Greenspan remained focused on his central mission of monetary policy*" [*ibid.*, p.158].

Unfortunately, Chairman Greenspan did not. His recipe was straightforward: Russian crisis? Let's cut interest rates. Dot.com's bubble? The same. Terrorist attack on 9/11? The same. Housing bubble? The same! No matter what the cause, the cure was the same. Cutting interest rates was the answer, regardless of the question.

Alan Greenspan was not alone. There were many economists of interventionist persuasion, who were delighted by such approach to business cycle. Some of them fervently wished the recessions to be banished forever. One of the Nobel Prize winners said some years ago that inflation in the US will be at the level wished by Alan Greenspan... Consequences of drowning the economy with money to forestall a n y economic downturn were disastrous in the end.

Risk Was Not Eliminated; It Was Only Shifted on to the Economy as a Whole

What it means for the economy to be "flooded with money"? It means to have nearly unlimited access to inexpensive credit. We all remember the basic diagram from the capital theory on investment projects' selection (see Fig. 1). The level of interest rate offers a cut-off

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point, indicating which projects look profitable and may be selected for financing and which are not.
But what if the interest rate tends down to zero as a result of subsequent interest rate cuts by the central bank (here: FED)? It means that nearly all projects look (artificially) profitable; and the foregoing applies to housing as well. And, yet, interest rate cannot be kept forever near the zero level and, consequently, the quality of assets may turn out to be much lower than estimated at the beginning (that is, in the era of cheap money). Pretensions of risk elimination cannot maintained forever, either. Therefore, with rising inflation and interest rate, many investments were revealed to be failures. The risk returned with a vengeance.
Ever-expansionary monetary policy allowed investors to buy assets at low prices with the cheaply borrowed money, but did not free them from risk. Normally, businesses and households can either reduce risk (as with insuring themselves, *e.g.*, against fire and theft) or can shift risk on to those, who are better able to cope with it (as when farmers sign a forward contract with grain or corn dealer [a "speculator"]).
But such monetary policies aimed at preventing any economic slowdown not only distort the real profitability of assets. They also generate the climate of excessive propensity to risk-taking. As *The Economist* [9.08.2008] suggested, the "*speculative mentality in financial markets ...*" has emerged. *"Why not take risks if you know that central banks will intervene only in falling, not rising, markets?*" [p.12]. A moral hazard was created on a gigantic scale.
Inevitably, near-zero interest rates could not have been kept forever. With inflation, and consequently also interest rates rising, it was only a matter of time when and where the bubble will burst. For both general and specific reasons it was the housing sector and the financial assets related to that sector.

Why Housing? Why Mortgage-backed Assets? Or *Cherchez l'Etat* again ...

Before turning to the bursting of housing bubble and looking at mortgage-backed assets, let's look at banks behavior first. Were they "greedy" or were forced to lower standards in the face of the money flooding the financial markets? After all, these money flowed to banks and other financial institutions and they were supposed to earn some revenue to depositors. Therefrom came the (often frantic) search for assets. They took the risks, *i.a.*, of buying assets untested yet by the market and of unknown (varying, as it turned out) quality, and paid dearly as a result...
The most recent housing super-boom was supported not only by monetary policy flooding the economy with money. It was also an outcome of the deliberate regulatory policies of subsequent American governments, which pressured private financial firms, primarily banks, to spend a part of their money on a variety of projects benefiting "disadvantaged members of the community". To take an example, the famous (or *in*famous) Community Reinvestment Act warned banks in no uncertain terms about negative consequences of not spending a part of their money in that manner. And spending they did, at times up to 20% of their money allocated to substandard mortgages.
Consequences were, expectedly, negative, some more negative than other. Clearly with part of the money tied in low profitability/higher risk mortgage loans for low and irregular income customers (sometimes called *ninja*, from: no income, no job, no assets), other clients had to pay more or bank had to look for more profitable and therefore more risky other assets.
But the worst consequence has been a sheer volume of substandard, or even junk, assets, created in as a result of legal/political pressure. The degree of their low quality – as stressed already - remained largely unknown since the composition of mortgages backing a given security was revealed only with the dramatic increase in defaults on what has been euphemistically called *sub-prime* mortgages. This is – to a large extent – the root cause of the crisis. With banks realizing they hold assets of unknown quality, their willingness to lend to

each other declined sharply. No amount of liquidity supplied to the system by monetary and other authorities could remedy the emerging sharp deficit of trust and perception of higher risk.
The story, however, does not there. When private banks resisted further spending on substandard mortgages, politicians pressured the two "government-sponsored enterprises" (a strange beast, unknown even in welfaristic Western Europe!). Congressman Barney Frank made himself famous the world over for criticizing sharply Alan Greenspan for believing too much in the market forces. But he himself clearly believed too much in political intervention. For he was pushing Fannie Mae and Freddie Mac not only to keep insuring the lousy sub-prime mortgages, but also to increase direct mortgage lending. On top of all the mortgage mess, Fannie and Freddie bought the mortgage-backed securities as part of their portfolio...
The rest is too well known, to be repeated here. Their sudden collapse and government takeover of both became necessary – with the prospect of further enormous loan losses still to come [0.7-1.0 trillion acording to Wallison and Calomiris, 2008]. Strangely enough, the disaster took place in spite of earlier assessments that the risk of default and such takeover is "*effectively zero*" [see Stiglitz, Orszag, and Orszag, 2002].
Under normal circumstances – I submit – securities backed by the steady stream of revenues coming from the payment of mortgage installments should be seen as a very secure paper (in spite of its novelty). But these were n o t normal circumstances. In consequence, assets backed by *sub-primes* infected the portfolios of financial institutions holding those assets not only in the US but throughout the world.
One more question is worth exploring, namely: Why the world caught "American disease" so fast? In trying to answer the question, we should, I am afraid, turn again to the "search for a state" suggested by the present writer. Fannie Mae and Freddie Mac were "government-sponsored enterprises". When they needed money, the pricing of their bonds had been almost at the level of the US Treasury bonds. Eager buyers perceived there the existence of the i m p l i c i t g o v e r n m e n t g u a r a n t e e. (In that, at least, they turned out to be right – to the chagrin of American taxpayers...).

From Keynesianism to "Greenspanism": The Forgotten Lesson of 1950s-to-1970s' Period

Policies aimed at preventing recessions (or even any slowdowns) were not invented by Alan Greenspan and his circle of admirers. At this point it is worth reminding what politicians did with the original idea of John Maynard Keynes, who stressed in 1930s that capitalist market economies have problems with returning to full employment equilibrium from a deep recession. And recommended fiscal expansion as an instrument to be used in this respect.
However, politicians transformed – from 1950s onward – fiscal policy into an instrument aiming at the p r e v e n t i o n of recessions. Sounds familiar? It worked at the beginning, but the gradual disappearance of monetary illusion following an ever growing inflation made the instrument decreasingly effective. It all ended in the period of stagflation in 1970s. (or, to be more precise, in 1973-82).
Chief of the German general staff, Heinrich von Moltke, said in late XIX century that war is politics pursued by other means. Following that line of thought, "Greenspanism" is Keynesianism followed by other (monetary) means. The only difference is much weaker theoretical foundations of the former. Moreover, "Greenspanism" did not draw any lesson from the failure of unrestrained fiscalism of 1950s and 1960s. It, again, tried to banish recessions – and business cycle in consequence.
Preliminary reactions of politicians in both periods have been quite similar. In each case the reaction to failure was m o r e of t h e s a m e. Injections of the medicine had to be larger and larger. But it did not help much in 1970s and does not look promising at present.

And all the more so, since anti-recessionary measures are in conflict with the measures needed to clean the books of financial institutions. Regardless of means applied to that end, one thing is certain. Banks have to deleverage, or reduce the ratios of their credit and other engagements relative to their own capital. And that requires the reduction of the growth rate or absolute reduction of credit. But policy-makers pressure banks to increase the flow of credit to the non-financial enterprise sector and to households!

Toward Stagflation: Unpromising Prospects for the Next 5-7 Years

This author is convinced that extremely lax monetary policies and gigantic fiscal deficits will inevitably generate inflation. And inflation is always a deterrent to investment. Therefore, economic growth will be relatively low in the US and elsewhere in the West (and, in consequence, beyond).

A combination of low growth and high inflation will get reinforcement from yet another factor, little discussed in a systematic manner. Namely, from what I call mineral resource cycle. It is a long term cycle (up to 30-40 years long), which entered its high prices' phase – lasting some 8-10 years – around 2005. Before supply catches up with new, greater, demand, prices will continue to be high. A recession does not change the basic pattern; even a mild recovery brings about rapid increase in prices.

Interestingly, the combination of expansionary macroeconomic policies and additional inflationary pressures resulting from excess demand for resources (relatively to stagnant supply) is a repetition of 1970s. Incidentally, the depth of recession seems to be similar as well.

Where the 1970s and the present period differ is in the observed thrust of economic policies. Then, the Margaret Thatcher and Ronald Reagan victories augured the new era. Both were ready to wring out inflation from their respective economies and both applied strongly restrictive macroeconomic policies. Recessions ensued and inflation subsided sharply. Stability returned: economic growth accelerated, while inflation stabilized at low levels (helped, undoubtedly, by the phase of low mineral resource prices).

Now, politicians ready to use traditional stabilization measures are nowhere to be seen. Some (the Germans or the Swiss) are relatively more cautious than others (especially the Americans and the British). But most are in the Keynesian expansionary mood. What may be the consequences?

Not very pleasant, I am afraid. Then, applied restrictive measures, combined later with deregulation and lower taxes, resulted in a quarter of a century of a faster economic growth than that of other major Western economies. Now, with the dominant expansionary mood, as well as demand for more regulation and higher taxes, US and Britain may actually face – by contrast – a long period of a slower economic growth than that of other Western economies that chose to pursue more restrained policies.

A Dangerous Mood

The picture of the present financial crisis presented earlier stands in a sharp contrast with the prevalent thinking of its causes and – consequently – remedies. In the rush to criticize greedy bankers and other institutions of the financial system the prevailing mood seems to be unable to differentiate between enabling and restrictive institutions. The former help the markets to perform better, while the latter throttle initiative, entrepreneurship, and innovation. Innovations generally increase the ability to create wealth – and financial innovations are not different in this respect. Thus, necessary restraints should be applied judiciously.

Reformers (or should I have said: tinkerers?) should keep in mind the fundamentals. The capitalist market economy, based on private ownership, is the foundation of Western civilization. Its civic and political freedoms are resting on the autonomy of the economic activity *vis-a-vis* the state. Tinkering with the fundamentals to obtain short term gains may bring about unintended – but highly undesirable – consequences.

The foregoing look at the big picture reminds me of George Shultz, businessman and politician, who has been known for saying that if things get bad enough people will do even the most obvious and sensible things. Following his reasoning I draw two tentative conclusions.

The first conclusion is that may be things did not get bad enough because we do not see the obvious and sensible things being done. The most important in the face of the financial crisis is to clean the books of the banks to reduce the risk and raise the level of trust within the global banking (and, more widely, financial) sector. And, yet, more is being said and done about politically palatable measures such as, *e.g.*, helping those who (not unexpectedly!) face problems with paying their mortgage installments.

The second conclusion is more pessimistic. Perhaps, things got bad enough, but the beliefs and, accordingly, expectations have changed and our societies and polities are psychologically unable to do the most obvious and sensible things. For example, to accept the inevitability of downturns and often absolute output decline, that is recessions. If the latter conclusion is true, then the only thing to do is to hope that the change in question is reversible.

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