The Financial and Economic Crisis of 2008-2009 Fiscal and Monetary Effects*

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- This presentation will have three parts. First, the road to the Financial Crisis. Second, the policy reaction to that crisis. Third, the transformation of the Financial Crisis into a Fiscal Crisis.

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- Banking or financial crises are not rare and have become less rare in recent decades. At times they become fiscal or even sovereign debt crises. This happened to the 2008-2009 crisis. It started as a financial crisis and evolved into a fiscal crisis. In a paper that I wrote at the end of 2008, I warned that “relying too much on fiscal tools may change the financial crisis into a fiscal crisis”. See Tanzi, 2009, p. 7. The prediction came to be true.

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- Crises often affect single countries. They may spread to whole regions; or even to much of the world. The 2001-2002 Argentine crisis was limited to Argentina. The 1997-98 crisis involved the South-East Asia region. The “Great Depression” of the 1930s and the current crisis are examples of global crises.

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- Crises have rarely single causes. They have often multiple causes. The current crisis is no exemption. Several factors contributed to it.

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- The main causes that led to the crisis can be identified as the following:

a) Large and unsustainable macro-economic imbalances.
b) Misguided macro-economic policies that allowed and sustained those imbalances;
c) the prevailing ideology "market fundamentalism" that argued that the market is always right and self-correcting.
d) Misguided regulations and ineffective regulations and regulators; and
e) Financial incentives that guided the actions of market operators toward short-term profits.

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- Many books have been written about these causes. Many more are being published.Only some of the main elements will be presented here. The details are much more complex.

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- The last decade was characterized by large and growing macro-economic imbalances that were clearly unsustainable over the long run. These imbalances were particularly large between the United States, on one side, and several creditor countries, on the other side. The U.S. trade deficit reached almost 7 percent of its GNP, an extraordinary level.Some other smaller countries had equally large imbalances.Investments in housing were often the cause.

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- Americans stopped saving and lived well beyond their means. The saving rate of the USA fell to zero.The trade deficit of the USA and the financing connected with it financed two wars (Iraq and Afghanistan), huge investments in housing, high consumption levels, and even a tax cut that lowered the level of US taxation, under President Bush, to what it had been 50 years earlier.

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- Given these macro-economic developments, the logical, orthodox policies for the United States should have been (a) an increase in the level of interest rates, to encourage people to save, and (b) a tighten fiscal policy. The American policymakers (both at the FED and at the Bush Administration) did the opposite. They reduced both the interest rates and the tax level, thus encouraging people to spend and the country to borrow.

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- Low interest rates were maintained over several years. When they were increased after 2004, they were increased slowly and predictably. This (a) encouraged investment in housing, because houses are bought with borrowed money. And (b) it encouraged financial institutions to increase their leverage that soon reached 30 or, in some cases, even 60 times the available capital. The low interest rates and the predictability of the pace at which they were raised created a strong incentive to this high leverage. Booms tend to follow periods of stabilitybecause ” irrational exuberance” sets in

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- This (assumed) low-risk situation encouraged the development and the use of various exotic new financial instruments (various forms of derivatives, credit default swaps, collaterized debt obligations, etc.).They were used to bet against sub-prime mortgages. The assumption was that the present and the recent past were good predictor for the future. The cross financial obligations reached astronomical levels. The obligations they created were less and less connected with the real economy.

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- More and more individuals were attracted by the investments in housing. Low interest rates and fast growing prices for houses made these good investments. The standards for qualifying for loans to buy houses were significantly lowered. Many individuals bought houses assuming that they could sell them a short time later at a higher price. Huge real resources were invested in building new houses, leading to a housing “bubble” and to huge investments of financial resources in sub-prime mortgages.

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- The process that led to the crisis was helped by the prevailing ideology, strongly shared by the Bush Administration and by Alan Greenspan, that (a) markets are self- enforcing and (b) that prices are always right. Thus, the market does not need any particular monitoring and regulation. It regulates itself. Greenspan declared himself astonished when the market failed.

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- "Market fundamentalism" and the "efficient market hypothesis", that argues that prices are always right, encouraged the development of quantitative models that predicted <u>future developments</u> on the basis of past developments. Stable recent developments inevitably predicted stable and well-behaved future developments. No "black swans" (i.e., extreme developments) were expected. This led to the taking of excessive risks on the part of insurance institutions, such as AIG.They guaranteed credits that were likely to fail.

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- Misguided or ineffective regulations contributed to the crisis. There are several elements to this issue. First, there were government regulations that directly contributed to the "housing bubble" and to the so-called "sub-prime crisis" in the United States. At least two of these regulations need to be mentioned. Both have to do with the American obsession to own the house where one lives.

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- The first was the creation of Fannie Mae and Freddie Mac in the 1960s. These two "quasi-governmental" institutions were created to buy mortgages, using revenue from the sale of bonds, so as to reduce the interest rates that house buyers paid when they bought new houses. The quasi-public status of these institutions led people to assume that the debt of these institution was guaranteed by the government thus creating an indirect subsidy to home buying and increasing the supply of funds to housing. These institutions exposed themselves to enormous risks.

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- The second was a regulation that reduced the power of banks to discriminate between borrowers, on the basis of geographical areas or ethnic and economic characteristics, when they applied for a house loan. Banks became less careful in the selection of borrowers. This led to higher rates of delinquency in the servicing of the sub-prime loans.
- Both of these legally -imposed regulations could be considered governmental interference in the working of the market. They were thus government and not market failures

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- The role of ineffective regulators. In an environment guided by the belief that markets are always right and self-enforcing, :

a) Needed regulations on the actions of operators in the financial market were not introduced;

b) Existing regulations were ignored or watered down;

c) Resources needed by regulators were cut;

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d) Potentially disastrous outcomes, expected with low probability, were ignored;

e) There was inevitable “regulatory capture”. See Madoff etc.; and

f) There was a revolving door. The same individuals went from the regulating agencies to the regulate industry, and vice-versa.

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- Various disasters – in the financial market, the mining industry, the oil industry, and in other sectors can be traced directly to these developments.

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- Other causes leading to the financial crisis can be connected with:

a) The increasing complexity of the financial market;

b) Its increasing global scope that made global and not just national regulation necessary;

c) The financial incentives (bonuses etc.) that had been created in financial institutions.

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- The financial market had become enormously complex. See Tanzi, 2007. It had also become global, when policy obstacles to cross-countries capital movements had been removed in the 1990s. New computer-based technology had made cross-countries transfer of funds very easy. Soon daily transfer of funds, from one to other currencies, reached trillions (1000 billion) of US dollars. Speculative movements were also encouraged.

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- At the same time, technical innovation in the financial market was developing very fast partly stimulated by “financial engineers” and “rocket scientists”. They had found a new area in which to apply their advanced mathematical skills. Their models were intended to spread risks and to make the financial market more flexible. The objective was to lower risk and to develop instruments that made it possible for individuals and enterprises to fit closely their lending or borrowing to their needs in terms of risk.

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- In the process, the share of total incomes absorbed by operators in the financial market grew enormously. In the United States, where after World War Two the financial market had received about five (5) per cent of total profits, that share rose to over 40 percent of the total in the decade of 2000s. Thus financial intermediation was absorbing close to half of total profits. Those operating in it saw their incomes rise enormously. Multimillion dollars incomes became common.

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- The complexity of some of the financial instruments developed in recent years, combined with increasingly frequent “asymmetry in information” between the financial operators and their clients, created a “casino capitalism” where the search for immediate, large profits became the norm. The incentive structure that developed assigned large shares of profit to the financial operators while it tended to pass losses on clients and (in the case of systemic losses) on society.

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- Banks that, in the past, had been either “commercial banks” or “investment banks” were allowed to be both. Allowing them to trade with their own money, while at the same time trading with their clients’ money, created conflicts of interest that have led to sharp criticism of actions by Goldman Sachs and other institutions. Often banks tried to unload instruments expected to fall in value by urging their clients to buy those instruments.Ethical and legal rules often were not correlated.

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- In many instances, financial institutions followed a behavior that was clearly unethical but not illegal. For example, bad mortgage loans were bundled together, securitized, and sold to unwary buyers around the world carrying a AAA rating. This helped to export to other countries the American housing crisis. The asymmetry in information between those who sold these instruments and those who bought them could not have been greater.

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- The financial crisis reached its apex in the last quarter of 2008 when:

a) The prices of houses started to fall fast;
b) Interest rates had gone up;
c) Credit had dried up; and
d) Many of those who had bought new houses stopped servicing their mortgages, creating difficulties for the financial instruments often rated AAA that had been backed by mortgage payments.

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- Financial institutions that had bought securities backed by the mortgage payments faced disaster. Some large ones, Lehman Brothers, Bear Stern, Northern Rock went broke or had to be taken over by governments or by other institutions. Institutions that had guaranteed mortgages (Fannie Mae and Freddie Mac) or had insured the payment of the debts (AID) suffered enormous losses and had to be rescued.

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- Some insurance companies, and especially AIG, were in serious trouble because they had insured financial assets that had lost value. AIG had to be helped by the government because it was considered “too big to fail”. Its failure could have created a financial catastrophe. The government had to intervene with hundreds of billions of dollars in “loans”. The government was also forced to nationalize the quasi-governmental institutions that had guaranteed mortgages, Fanny Mae and Freddy Mac, assuming trillions in “gross” liabilities.

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- The crisis led to a sharp reduction in trust among financial institutions, a fundamental asset for the financial market. Banks stopped lending to each other and to other financial or even non-financial institutions. Export credit was also affected.At this point the financial crisis became a crisis of the real economy. Through its effect on trade and on investment, it became a global crisis bringing fear that it might become an other Great Depression.

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- Both the financial crisis and the crisis in the real economy soon started to have an impact on the public finances and on the behavior of central banks. The immediate impact of the crisis on the public finance came from the "automatic stabilizers". Tax revenue went down and some public spending, such as unemployment compensation, went up. Even before governments intervened with stimulus packages, fiscal deficits and public debts, as percentages of GDP, started rising fast.

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- The automatic deterioration of the public finances was made worse by governmental interventions, stimulated by the fear of another Great Depression. Some international institutions (IMF and OECD), and some vocal economists, urged governments to enact large “stimulus packages”,i.e., discretionary policy changes (mainly involving higher spending). These packages aimed at preventing a larger fall in GDP or a larger unemployment. Fiscal deficits and public debts rose very fast in many countries.

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- Worried about the collapse, or potential collapse, of important financial institutions, and about fears of “deflation”, central banks abandoned their traditional prudence and started on a very unorthodox road. They sharply reduced their lending rates, bringing them close to zero, and started on a policy called “quantitative easing”. The latter meant that they would buy “bad”, “toxic”,or worthless assets from financial institutions. This operation was ridiculed by Joe Stiglitz as “cash for trash”.It was obviously very valuable to banks.

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- As the result of the fiscal and monetary actions the financial crisis was arrested. Some banks disappeared. Others were taken over by other banks. Some that had been "too big to fail" became even bigger. The financial sector became again profitable. It could borrow money cheaply and buy government securities that paid higher interest rates.While the financial sector improved the government sector worsened.

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- By the time of the June 2010 meeting of the G20 in Toronto (June 26-27) most countries were growing again and banks had returned to make profits. Fiscal deficits had remained very high and public debts were growing fast in most countries. A lot of liquidity had been created in the economies by the actions of central banks. However, unemployment remained high in many countries.Some economists and the Obama administration was calling for further fiscal stimulus.

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- Two important questions remain. debated in First, is it time to begin an “exit strategy” from high fiscal deficits and growing public debt? Second, when should interest rates begin to rise?The first was discussed at length in Toronto.

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- Several countries (Germany, Great Britain, Italy, Spain, Ireland, and others) have recently announced policies aimed at reducing fiscal deficits over the medium run. They have reacted to the threat of a creditors' strike, that could sharply increase the cost of servicing the public debts, or even make credit unavailable to governments. The danger of such a market reaction had appeared in a striking fashion recently in Greece.

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- The European “exit strategy” has been challenged by the Obama Administration, because of fear that it might damage the ongoing recovery from the crisis. Countries face two dangers: exiting too soon, thus potentially creating a delayed recovery or even a double dip in the crisis; or risking a fiscal crisis by waiting too long to take action. Both are serious dangers.Economics does not prescribe a clear alternative.

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- The view that (more) public debt and (more) fiscal deficits would help sustain the economy is the classic Keynesian recipe. It is still believed by many economists, including some prominent ones. However, it ignores (a) the structural elements of the crisis, and (b) the psychological and possibly financial costs of high and increasing public debts. These costs can raise the rates at which governments can borrow (see Greece). They can discourage individuals from spending and companies from investing.They can also perpetuate

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- The monetary policy that was followed in the past couple of years (very low interest rates and "quantitative easing") has injected a lot of liquidity in the economies. So far there has not been much of a positive effect on consumer prices. However, in the past (see Latin America in the 1980s and Germany in the 1920s) this policy led to high inflation. Will it do it again (with a lag) this time? We shall have to wait. Current price behavior can provide wrong signals. Fears that new bubbles will be created, continue to be expressed.

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- The fact that inflation has so far been contained has led some observers (such as Martin Wolf of the Financial times) to suggest that governments should borrow directly from central banks. This policy used to be called inflationary financing and often led to disastrous results. It might seem a good policy in the short run but it might become a very bad policy over the longer run.

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- There is now a lot of discussion in both Europe and the United States about reforming the financial market. The United States is trying to pass a new law that would attempt to prevent some of the abuses of the past. The proposed law is being progressively watered down by the work of lobbyists. There is also a clear need for coordination of regulations among countries. Major difference in vies remain between the Untied States and some European countries and little coordination has so far taken place.

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- Hopefully, reasonable rules will in time be introduced and coordinated. And hopefully these rules will not fight the last war but will be able to cope with future developments that may be different from the past.However, it is not easy to remain optimistic.It will take a long time before the countries come out of the fiscal crisis.The next few years will not be easy years for many countries.

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- By next year, when ASIP meets again, we shall have a better picture of what has happened and of how well the exit strategy has worked. The G20 Toronto meeting has asked the countries to cut in half the fiscal deficits by 2013.However, even if this were achieved, public debts will keep going up.

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