

# What Went Wrong?

## Alternative approaches to explain the global economic crisis

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2. Proximate causes: financial sector analyses
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## 2. What went wrong? Overview on alternative interpretations

**Causes of the systemic crisis – different layers: market and state failures, basic underlying structural distortions, ideas & ideology**

**Popular views:**  
“Blaming the guilty” – who? It is a system of failures, but which system failed?

**Market failure I:**  
Banks -- > information asymmetry, adverse selection, moral hazard

**Market failure IV- financial instruments, financial innovations**

**Market failure II:**  
monopoly/oligopoly; too big to fail, too big to rescue

**Market failure III - Rating Agencies**

**Market failure V - asset market performance, bubbles**

**State failure I - national governments and supranational institutions**

**State failure II: supervision of banks and non-banks – micro- and macro-prudential supervisions**

**State failure III – central banks – monetary policy**

**Crisis of global imbalances in trade and capital flows**

**Crisis of „finance-led capitalism“, evolved since 1980s**

**Crisis of income distribution**

**Ideas and ideology - toxic economics**

**Political economy – political power of Wall Street-industry, supported by government**

**Structural long-standing distortions and aberrations**

## 2. Proximate causes: financial sector analyses

1. All features of a classical asset price crisis but on a huge scale with enormous spillover mechanisms
2. Multiple securitization, CDO + CDS, shadow banks without capital, opacity, over-complexity
3. Flaws in risk models, trust in financial engineers, mass-scale irrationality among market leaders, short-termism
4. Failure of microprudential regulation; lack of „macroprudential regulation“
5. Accelerators/magnifiers of crisis underestimated
6. Fed: Jackson Hole Consensus -> Inflation Targeting
7. Alerters were shunned, like Cassandra

## Focus on macroprudential regulation (MPR)?

Proposals from BIS, FSB, Geneva Report, G20, include

- Control-hierarchy of financial instruments (from free use ... to bans)
- Ban OTC derivatives markets, establish central counterparties, clearing house
- Extra capital requirement: systemic risk charges, according to individual systemic risk contribution
- Countercyclical capital buffers
- MPR assigned to CBs
- Explicit mandate for CBs to secure financial stability
- Additional countercyclical tools to fight credit and asset price bubbles
- Revision of Basel II

## Some comments and questions

- Increased capital-asset-ratio -> higher interest rates!? Can harm real economy.
- Countercyclical capital requirements: impacts on monetary policy?
- International coordination? Regulation arbitrage?
- How to assess systemic risks? Indicators?
- Based on assumption that banks inevitably undertake procyclical risk assessment
- If supervisors see risks, and banks not?
- Fundamental change of role of central banks; uncharted territory!

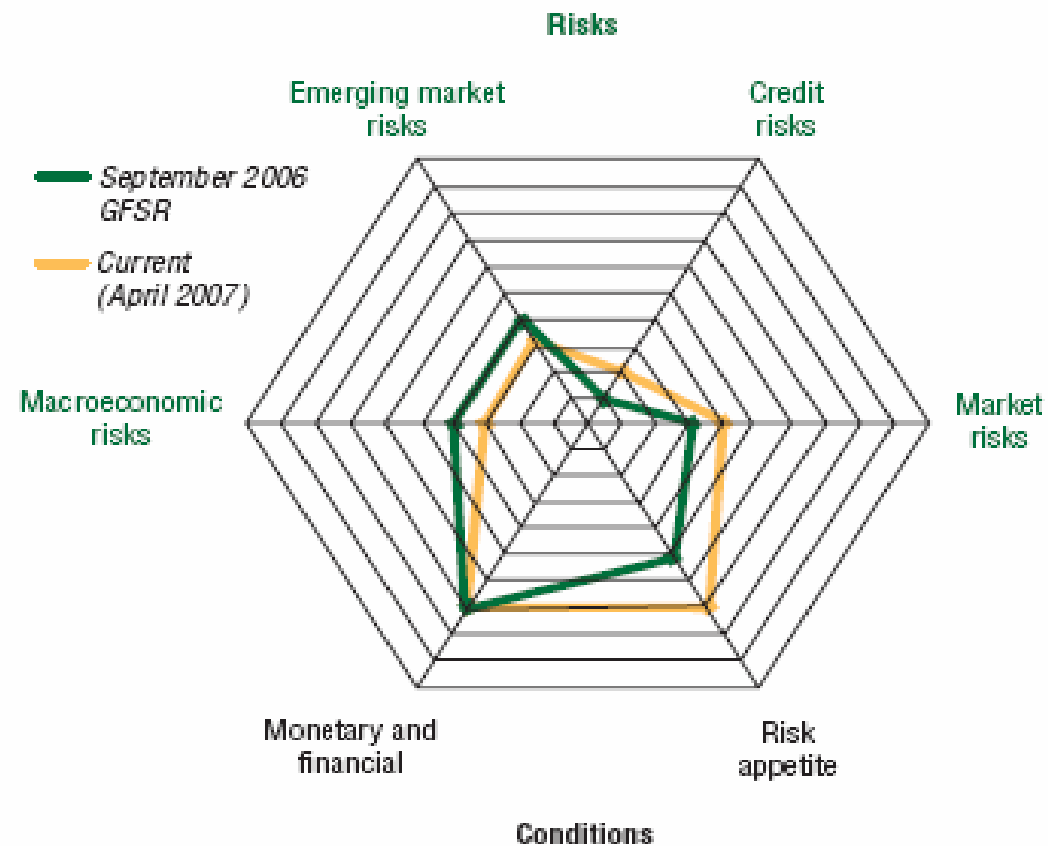
## Cont.

Check also other instruments, eg

- Required reserves on selected assets instead of liabilities?
- require risk models that include systemic risk accounting
- Special charges on excessive maturity mismatch
- Guidelines for rating agencies: leverage, maturity mismatch, quality of capital etc. should be included
- Special corporate bank tax atuned progressively to excessive return on equity or value added, to deter risk taking and absorb excessive profits
- Reform of corporate governance of banks/non-banks

# IMF: Global Financial Stability Reports April 2007-October 2008

Figure 1.1. Global Financial Stability Map

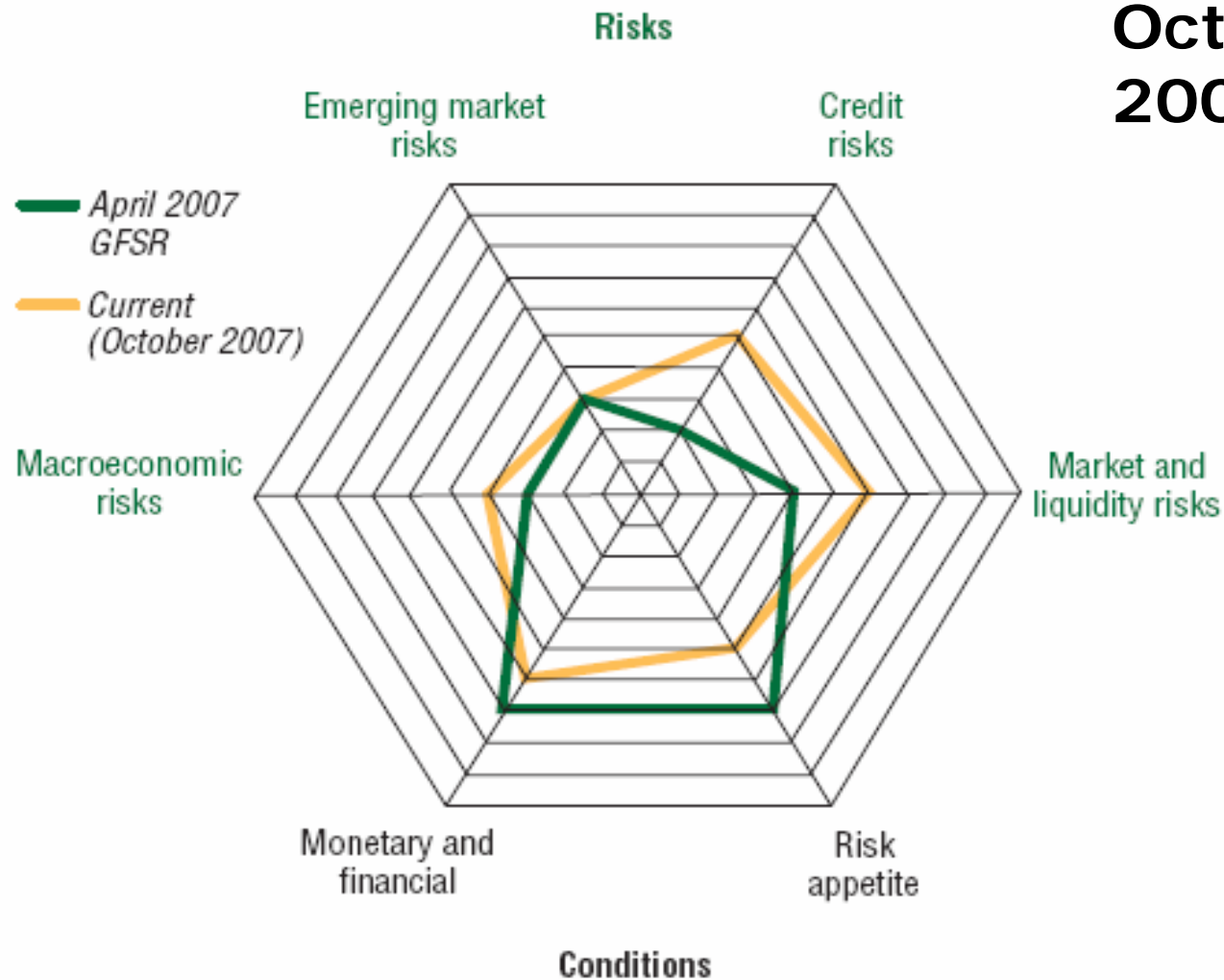


April  
2007

Source: IMF staff estimates.  
Note: Closer to center signifies less risk or tighter conditions.

# Figure 1.1. Global Financial Stability Map

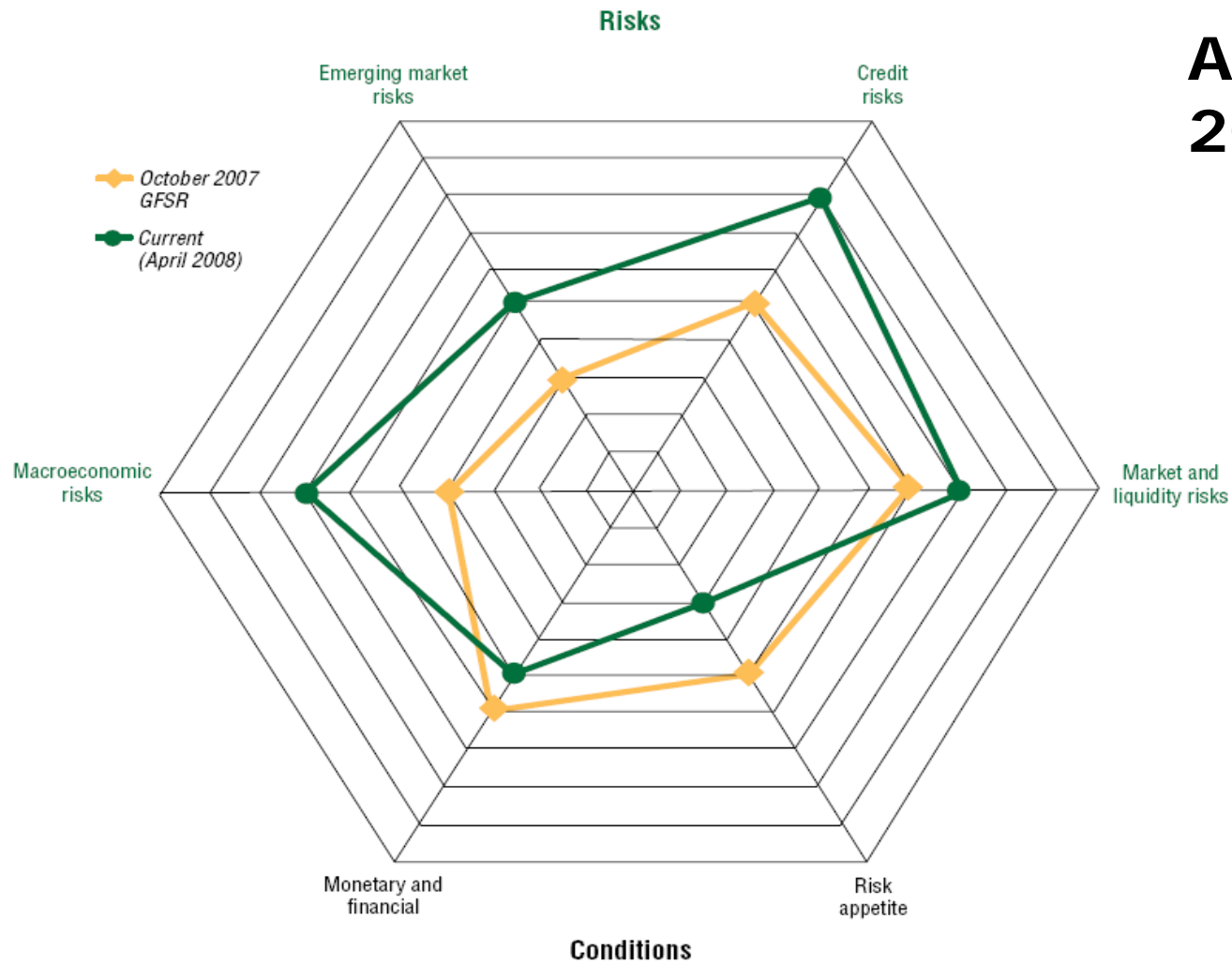
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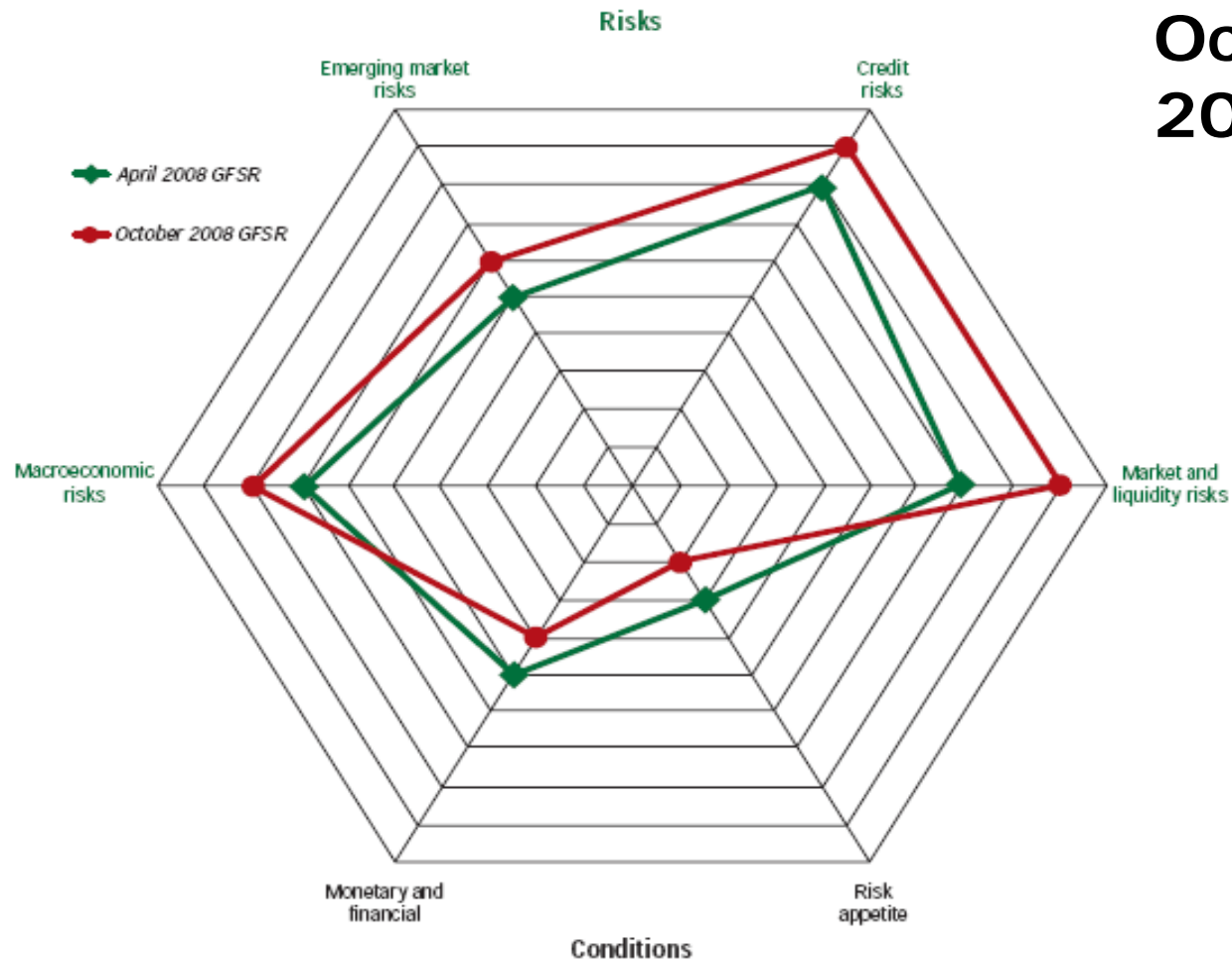


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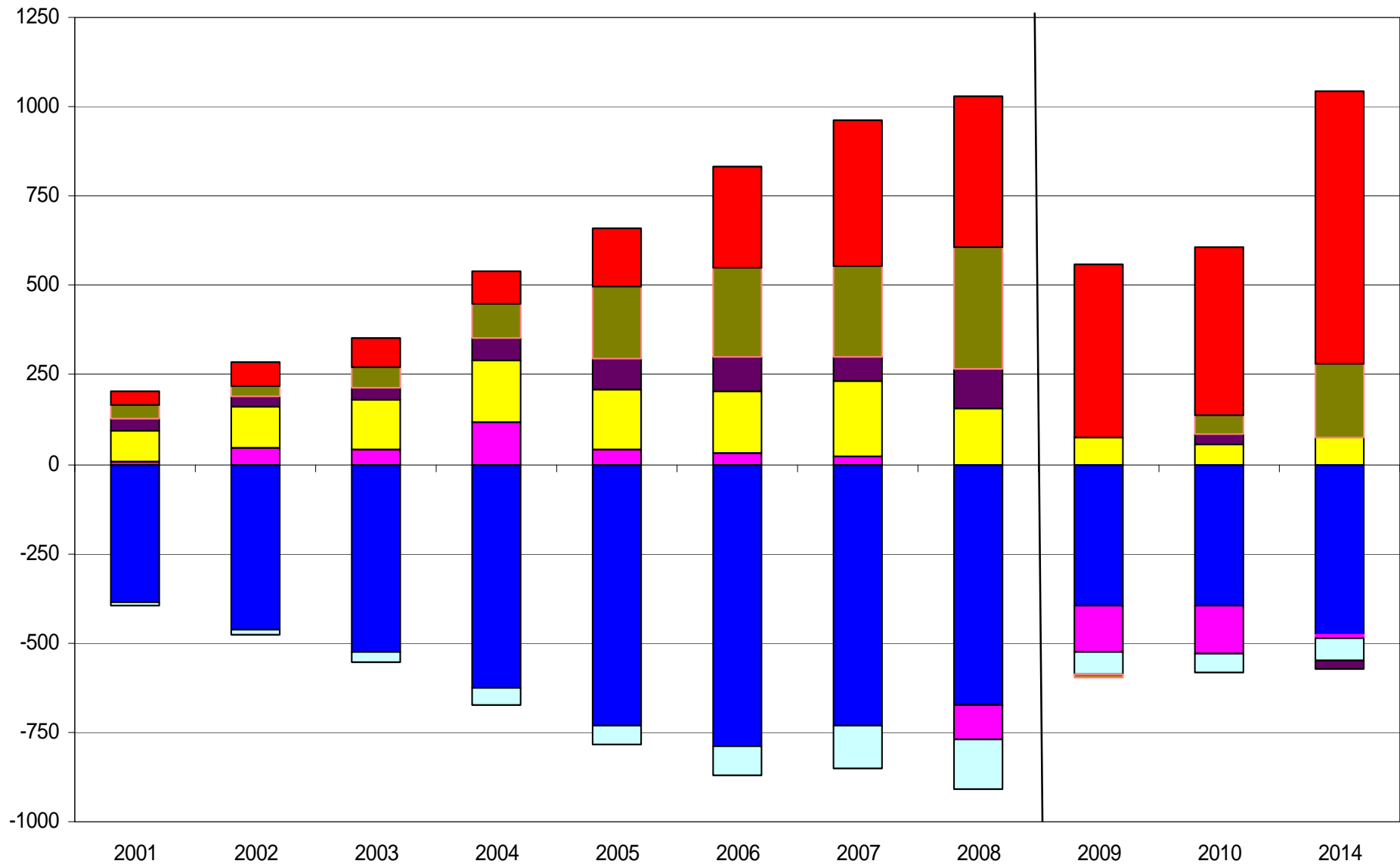
Source: IMF staff estimates.  
Note: Closer to center signifies less risk, tighter monetary and financial conditions, or reduced risk appetite.

## 3. Ultimate causes: long-standing structural distortions

### 3.1 Impact of global imbalances (GI)

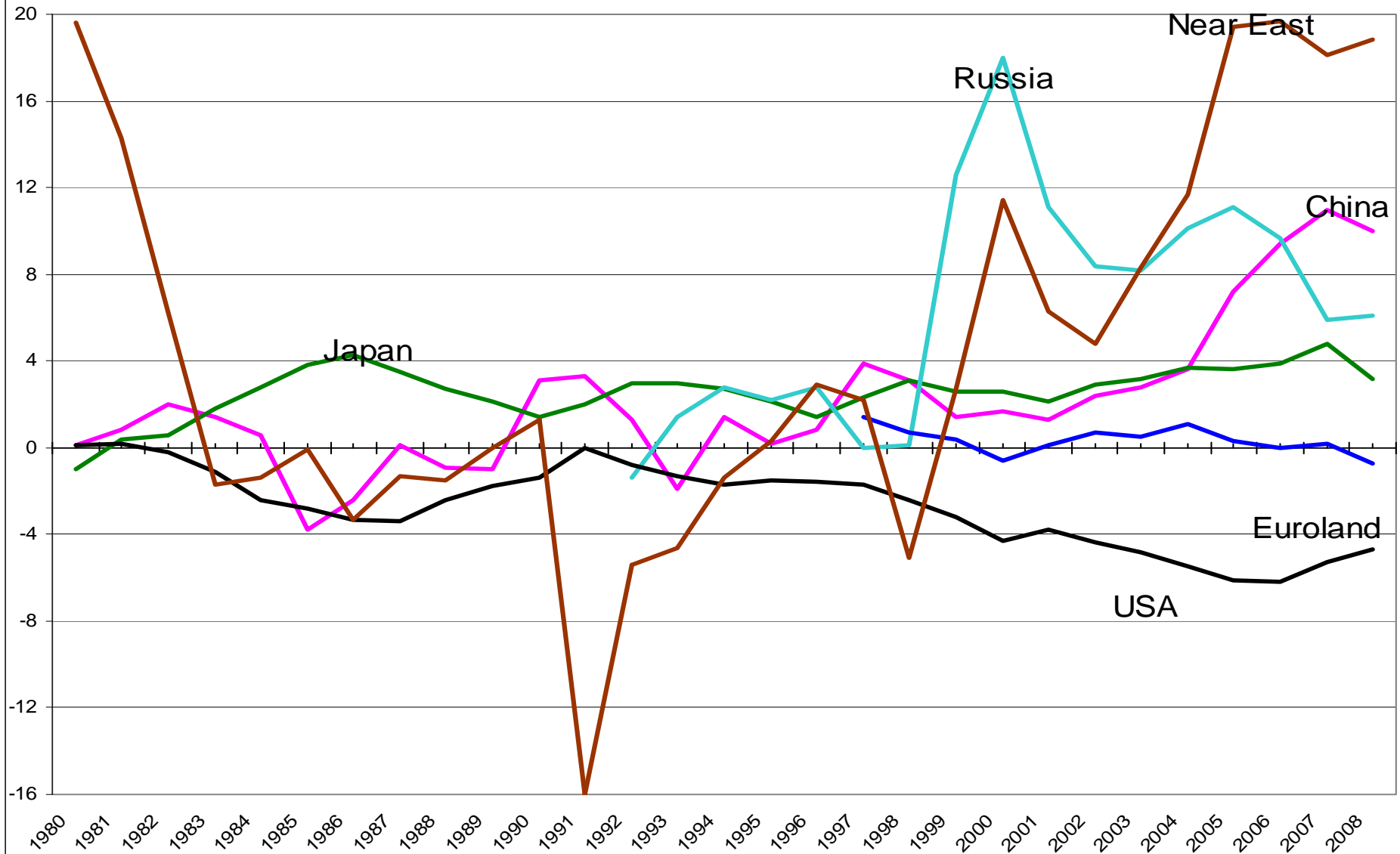
- Some facts

## Current Account Balances, bn USD



■ US ■ Euro area ■ Japan ■ CEE ■ CIS ■ Middle East ■ Devel. Asia

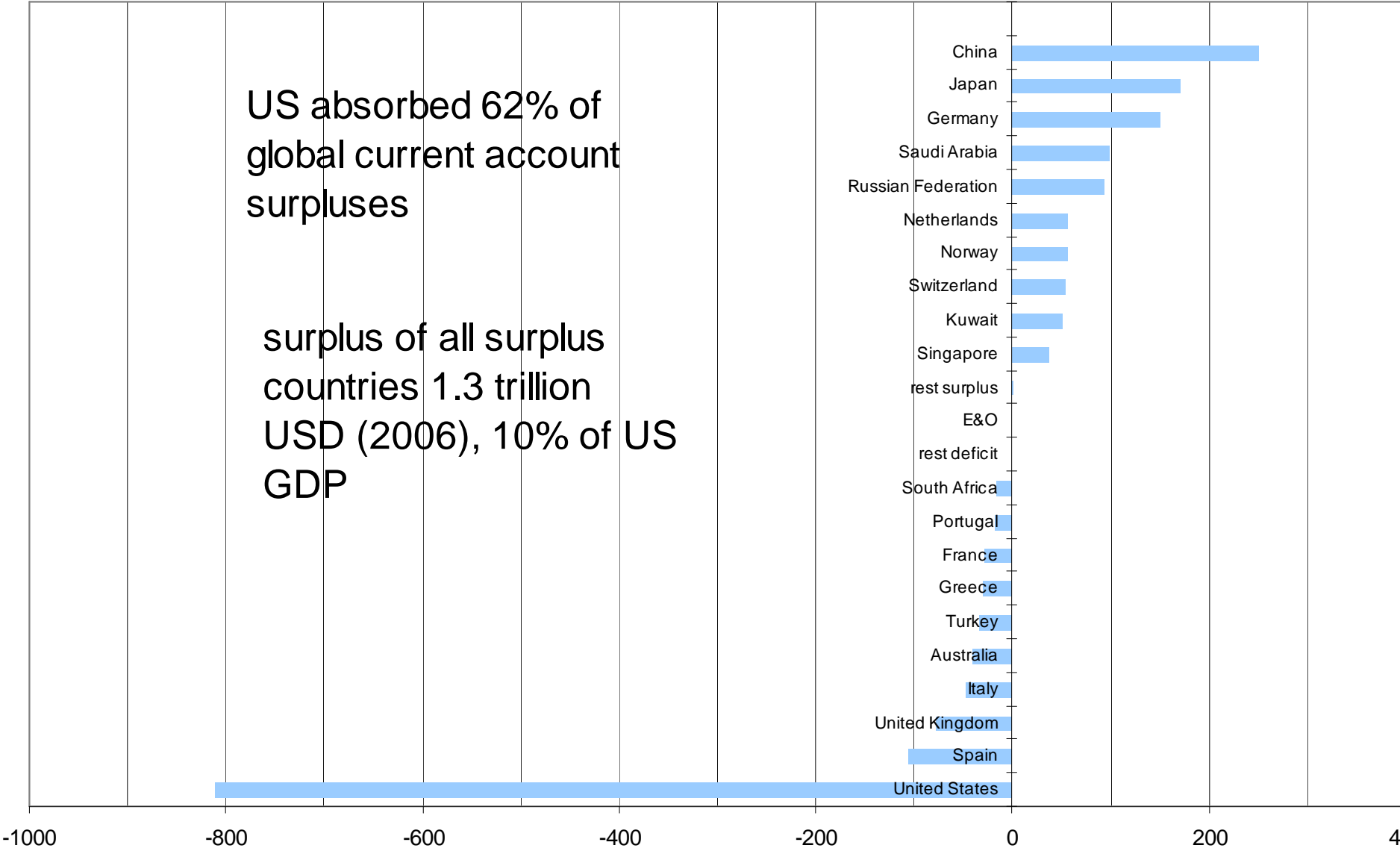
# Current account balance in % of GDP



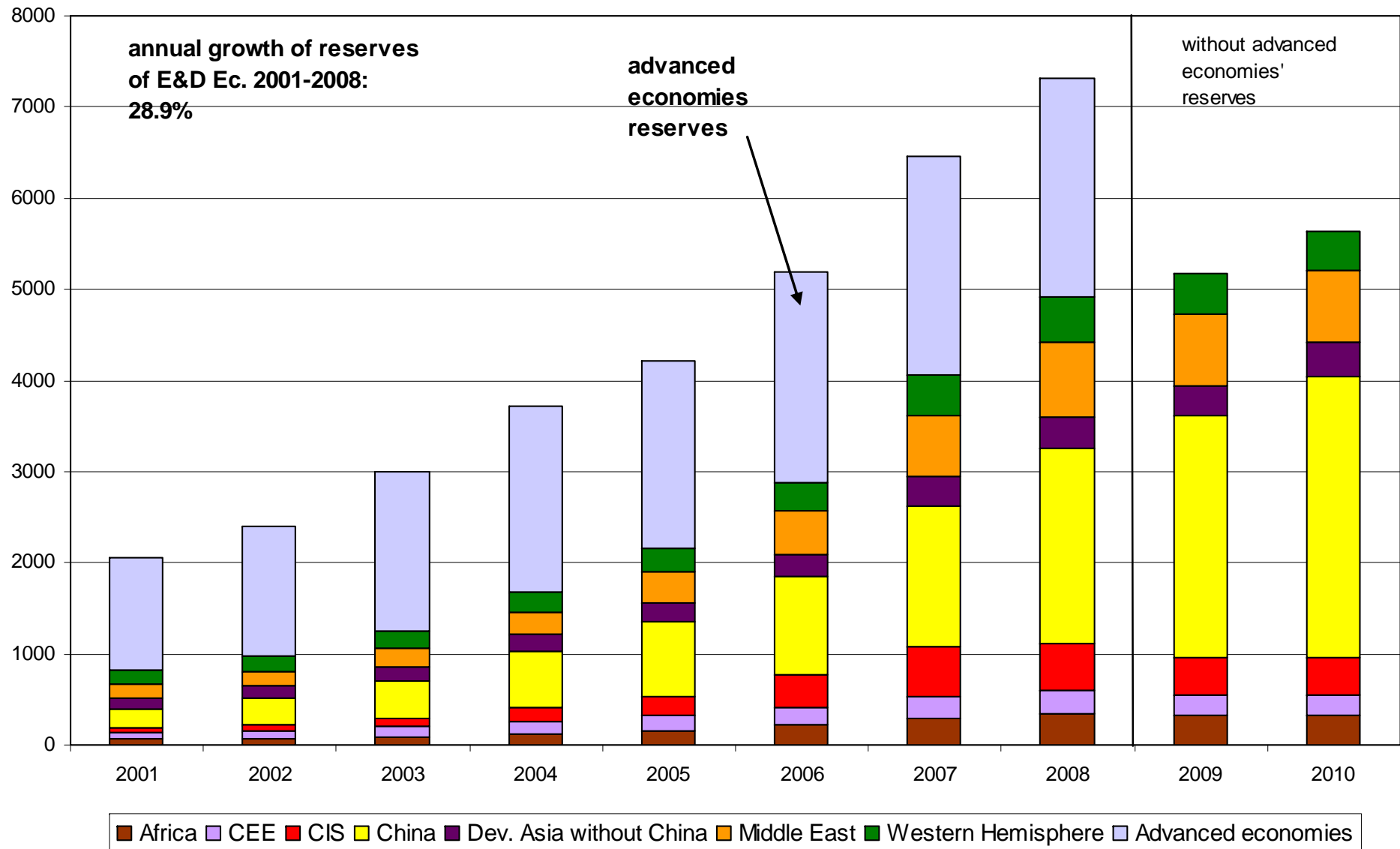
# Current Account Balance in bn USD 2006

US absorbed 62% of global current account surpluses

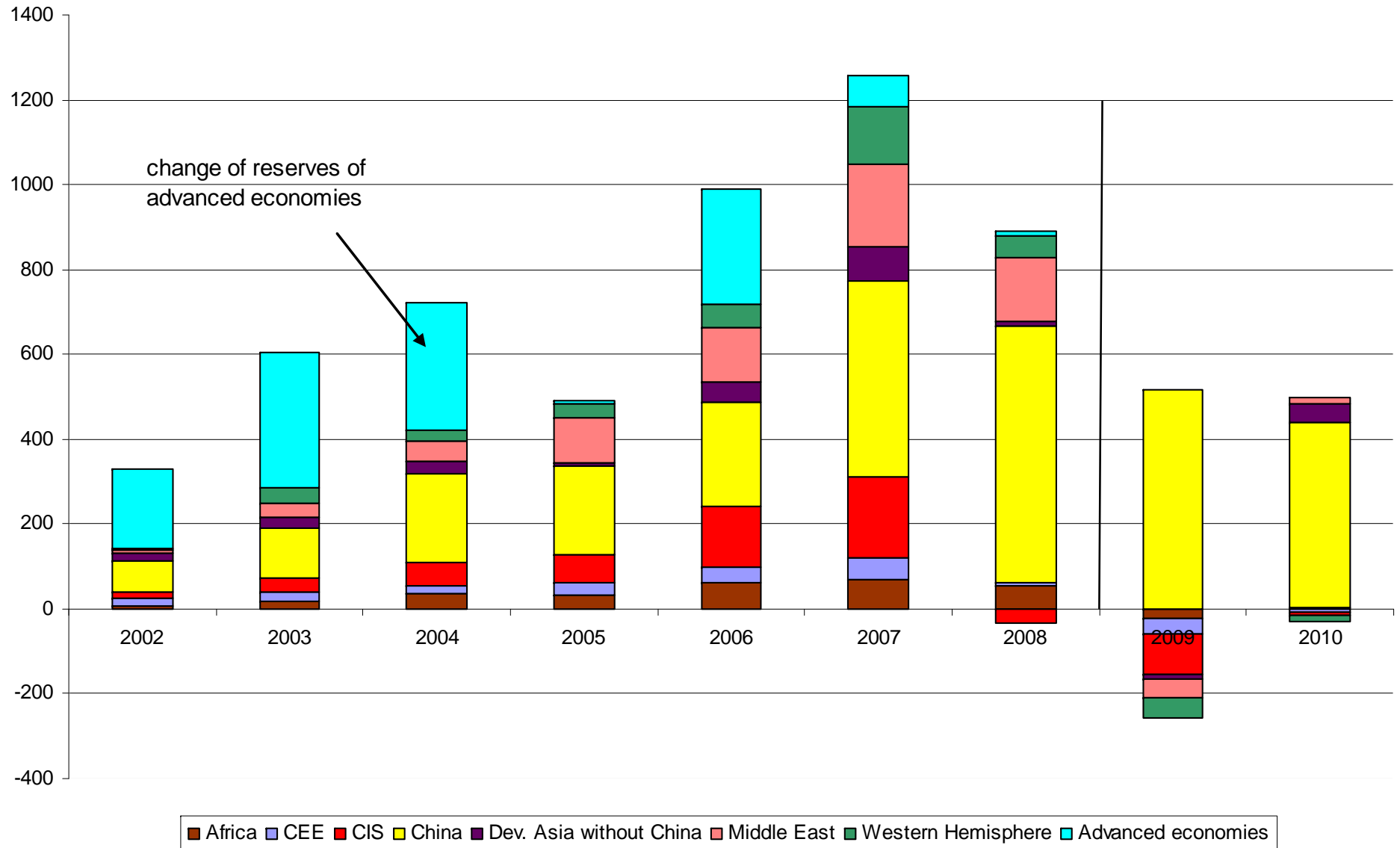
surplus of all surplus countries 1.3 trillion USD (2006), 10% of US GDP



## Reserves of Emerging and Developing and Advanced Economies in bn USD



Change in reserves of emerging & developing countries and advanced economies



## GI contributed to boom & bust

- Focus on capital flows rather than trade, flows increase stocks of assets
- Capital flows determine XR and trade flows
- 1 big deficit country hosts risk-averse and risk-loving capital inflows (official/private inflows = ~50/50)
- Global imbalance was key source of high growth of world economy 1998-2007, but unsustainable – „Bretton Woods II“
- Weakest chain link – absorption capacity of U.S. for capital inflows, especially risk-oriented inflows
- Risk seems to fall with scale, but deceptive
- **GI explain scale of demand for US securities, supply adjusts**

- U.S.: rich households invested in risky assets, poorer ones consumed more than they earned, based on rising asset and home prices
- official inflows dampened interest rates on bonds, made risky investment comparatively more attractive to private financial investors
- Private capital inflows attracted by high yields, low exchange rate risk (reserve currency premium), size of financial markets
- pull and push factors: over-borrowing in U.S., over-lending of surplus countries due to lack of aggregate demand and comparatively lower returns

## Unstable „Bretton Woods II“

- Official capital inflows from EME/OPEC (pegs, managed float) stabilize US-\$, ie prevent depreciation
- Private capital from Eurozone/Japan etc. with floating exchange rates flows in and out, US-\$ fluctuates with wide band to € and Yen and others
- Regime unstable: **New Triffin Dilemma**, Triffin-dilemma caused breakdown of Bretton Woods, Gold-dollar parity was no longer accepted
- BW II – „Dollar Standard“ undermined, leading either to dollar crisis or over-borrowing of US incl. over-valuation of USD
- Crisis moderates imbalances only temporarily

## Old and New Triffin Dilemma

Triffin on BW-dilemma:

- gold-pegged \$ needed increasingly as global money, but gold supply is limited
- requires US CurrAcc deficit to provide dollars to RoW -> over-valuation of \$ -> CurrAcc surplus needed to guarantee credibility of \$ -> gold-peg unsustainable -> erosion of BW

New Triffin Dilemma under BW II:

- BW II tends to increase imbalances in trade and capital flows  
-> US CurrAccDef  $\uparrow$  -> \$ over-valued -> fuel for asset price bubble
- Some countries exploit „export-led growth“, US financial industry exploits premier currency status
- -> currency crisis or recession/financial crisis

## Consequences

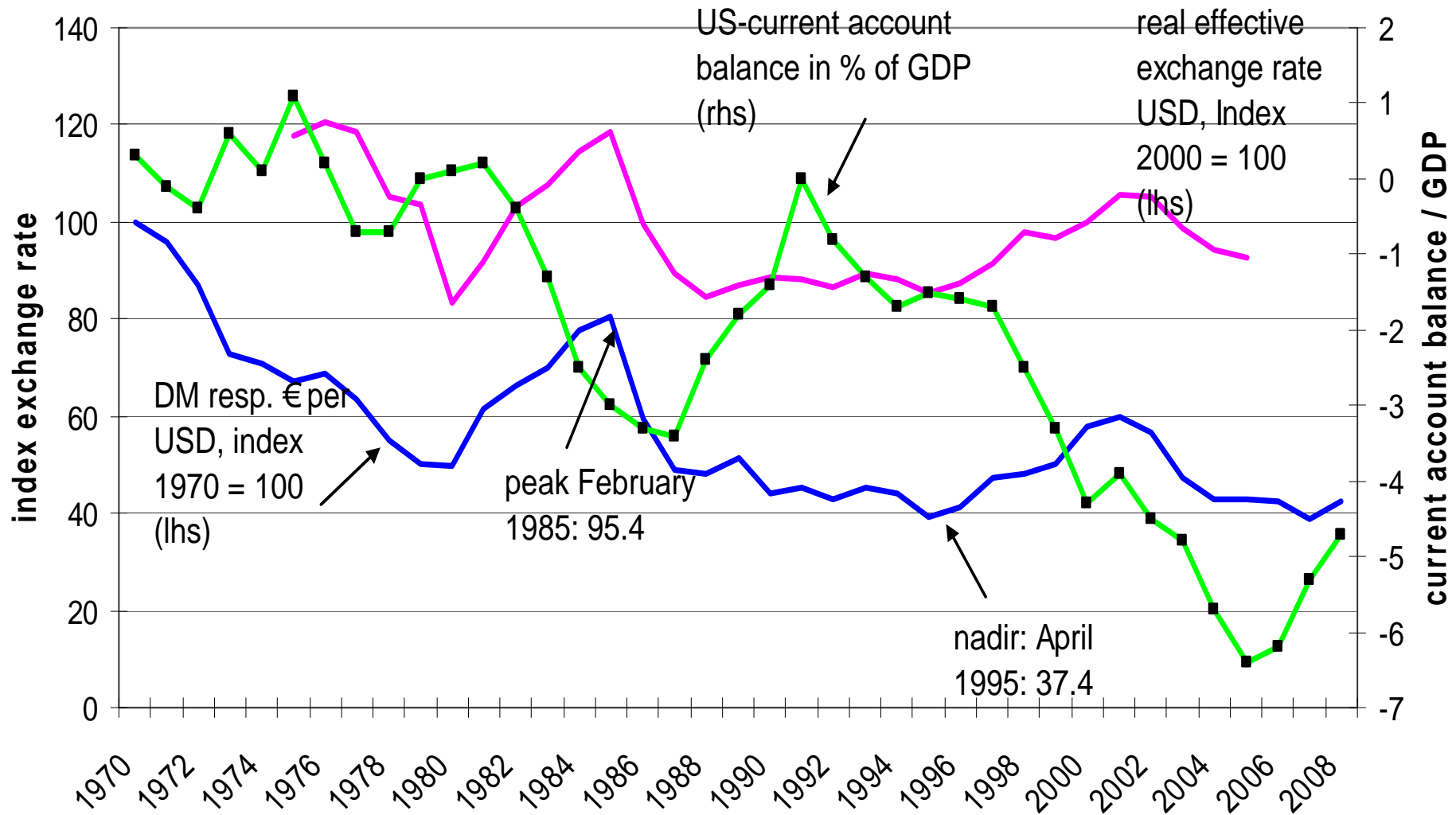
- High and unsustainable current account deficit in US
- over-valued real effective exchange rate (REER) of U.S.-dollar
- REER of USD appreciated 1995-2002 -> deindustrialization
- Financial sector growth substitutes for weakened manufacturing base -> „export of securities instead of goods“
- Superior financial market profitability hampers real economy
- GI has undermined US competitiveness gradually, since the 1980s -> „living beyond the country's means“

- Re-industrialisation, adjusted to REER, failed -> dot-com-failure
- GI made U.S. economy particularly susceptible to bubbles and over-borrowing

## **Conclusions**

- GI have contributed to financial crisis and have magnified global crisis of real economy
- re-balancing of capital flows and exchange rates necessary, trade flows will adjust

# US-current account balance, real effective exchange rate of the US-\$ and DM/€ per US-\$ 1970-2008 (annual averages)



## Avoiding risky conclusions from GI

- Unilateral resolution in US by austerity? -> global recession
- Unilateral resolution by expansionary policy and appreciation in surplus countries?
- Or multilateral orderly and sequenced unwinding? -> Keynes „justice scenario“ in his 1945 memorandum “Overseas Financial Policy in Stage III” (CW XXIV 256-295)
- Mutual dependency requires coordinated actions -> global macroeconomic policy

## 3.2 Role of „Finance-led Capitalism“ (FLC)

FLC – rough features

- **Financial sector** growth above average, „**strategic sector**“, lax regulation, boosts financial innovations
- Financial sector perceived as if it were part of real economy, financial innovation ~ technical progress
- Superior profitability, **hollows out real sector**
- Tends towards asset price bubbles, inflating financial wealth, boom-bust-cycles
- Financial innovations, often bypassing regulation and laws
- Wage share in national income falls

- Profit rate in financial industry benchmark for real economy
- **„shareholder value“-orientation** of corporations, ie maxim is **rise in stock market value**; CEO participation; change in corporate governance; pressure for takeovers/mergers+acquisitions
- Real economy growth in tandem with financial sector, but slower: **finance *leads* real economy**, temporarily; distortions of real economy
- Rise in value of stock of financial assets more important than flow of saving
- **Money & credit supply increasingly used for financial rather than real transactions**

### 3.3 Role of changing income distribution

- Loss of productivity-led real wage patterns
- Falling share of labour-income, increased profit margins, rising personal income distribution inequality
- Dampens domestic demand unless offset by reduced saving or increased net exports or gov't spending
- US: consumption-led growth model, incl. Residential construction, supported by monetary and fiscal policy

- Rising income inequality does not automatically lead to financial/economic crisis
- In part result of other causes mentioned, enclosed in „finance-led economy“
- Consumption-based US-economy unsustainable -> „endogenous shock“ inevitable if bubble bursts, foreseen by many

## 4. Ultra ultimate causes: ideas and ideology – toxic economics and distribution of powers

- Efficient market hypothesis
- Rational expectations theory
- Microeconomic asset risk models
- Dynamic general equilibrium models – exclude crisis
- New consensus macroeconomic theory over-estimates capacity of monetary policy, excludes the possibility of liquidity crises
- Lack of theory of systemic financial risks
- Lack of stock-flow consistent macroeconomic models that incorporate the financial sector
- Ignoring uncertainty, liquidity preference, financial instability, non-neutrality of money & finance

- -> outright failure of mainstream macroeconomics
- Toxic economics reduced to simple guidelines: belief in stabilising capacity of free markets: „it cannot happen again“
- Backed and enforced by predominating distribution of political power, warnings disregarded
- „The party goes on as long as the music plays – let’s play the music!“

## 5. Conclusions

- Most explanations focus narrowly on financial market failures, particularly on lack of macroprudential banking regulation
- Macroprudential regulation is uncharted new territory, many issues open
- new authorities needed to avoid asset price bubbles
- Proximate causes alone cannot fully explain crisis, global imbalances had been an important precondition -> scale of demand for assets
- New Triffin dilemma undermines dollar standard and BW II

- CurrAcc surpluses /  $\Delta$ reserves accumulate, unsustainable, absorption capacity of financial sector at risk
- exchange rate alignments necessary
- multilateral unwinding of GI necessary, includes more stability among multiple reserve currencies, or global basket currency
- features of finance-led capitalism have favoured emergence of crisis
- toxic economics mindset and vested interests paved the road to disaster
- All factors together – mine field for cumulative explosions