

**The Financial Crisis:
Economists Do Not Know Much,
But Politicians May Know Even Less
And They Should Learn Fast**

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Presentation at the
15th Regional Conference on
Social Insurance, Pensions and Provident Funds
Paphos, Cyprus
March 2-5, 2009

A Typical Balance Sheet circa 2008

LEFT
SIDE



RIGHT
SIDE



NOTHING
RIGHT

NOTHING
LEFT

- In the East Asia financial crisis the recipe was
 - Let banks fail
 - Increase interest rates
- In the current financial crisis the practice is
 - Rescue the banks
 - Reduce interest rates (to zero)

Do economists know anything after all?

At the Beginning of September 2008 No Country Admitted it was in a Recession

- In October 2008, global growth forecasts were reduced to 4.5% (WB)
- In November, this was reduced to 2.0% (IMF)
- In December 2008 ... to 0.9% (WB)
- In January 2009 ... to 0.5% (IMF)

- Now it is admitted the financial crisis will cause “a PROTRACTED recession” , “the DEEPEST GLOBAL recession in the post war era” ...

“Deep and Protracted Recession” or “Global Depression”?

- UK’s FTSE worse year on record -40%
- FTSEurofirst lost 45%
- Japan’s Nikkei 225 lost 42%
- Hong Kong’s Hang Seng lost 48%
- New York’s S&P 500 lost 39%
- China got the prize with a loss of 65%

What Went Wrong?

- Not the sub-prime mortgages – they were the result of other causes, they were just the trigger
- The real cause was that too many extreme ideological elements that have been into play for 30 or so years:
 - Too much faith in *free/unregulated* markets
 - Too much reliance on interest rates to manage the whole economy (*extreme* monetarism)
 - Too much political pressure to avoid short term recessions *with excessive borrowing* (and tax cuts for the highest income earners)

How Did the Story Evolve?

1. The Good Part (With Hindsight)

- In the 1950s and for some of the 1960s, planned economies were not doing badly, and in some cases they were doing better than market economies
- Planning was thought of in the West and was introduced in some cases (even in some “indicative” form) though Keynesianism was able to provide intellectual justification for many government interventions in the market
- By the early 1970s, Keynesian/fiscal policies reached their practical limit to tackle the advent of stagflation
- This gave rise to a new economic paradigm (monetarism) rightly that acknowledged the role of monetary policies especially with respect to controlling inflation
- **Controlling inflation became a success story since**
- At this point economics becomes less relevant and politics take over

The belief in free markets went a bit too far

- The Employee Retirement Income Security Act (ERISA, 1974) prohibited corporate pension funds from holding certain risky investments.
 - In 1978, the US Labor Department under the "prudent man rule" **allowed corporate pension funds to invest in riskier private equity. This created a major source of capital available to invest in venture capital and other private equity**
 - Fund raising increased from \$39 million in 1977 to \$570 million just one year later
 - Many corporate pension investors became active buyers of junk bonds that were necessary to complete leveraged buyout transactions.
- The Economic Recovery Tax Act of 1981 (ERTA) lowered the top capital gains tax rate from 28 percent to 20 percent
 - This made **high risk investments even more attractive.**
- The repeal in 1999 of the Glass-Steagall act that was introduced in 1933 during the Great Depression and **aimed to control speculation by separating investment and retail banking**
 - Before the repeal of the act sub-prime mortgages were negligible. When the financial crisis started, they were approaching 30% of all mortgage lending

How can this be accepted by sophisticated electorates in a democracy?

By appealing to:

- “Popular capitalism” (“everyone can now own a house and have shares” – some from the proceeds of privatization)
- Promise of higher pensions (through the funded pillar)
- “I am OK Jack” (e.g. the line of thinking that overspending of American consumers counters the thriftiness of the Chinese – and this is the right policy in an interconnected globalized and world)

How Did the Story Evolve?

2. The Bad Part (Anticipated)

- US and the UK led the pack ideologically on the grounds of ...
 - “Private good, public bad” (P. Krugman, October 2008)
- Fiscal policy was not really eliminated from the weaponry of Government but used in specific ways:
 - By raising consumption taxes (affected primarily the poorer), cutting income/estate taxes (primarily for the top income earners), and reducing public spending on social services
- Central banks relied “too much on interest rates to control the economy” (BoE, 22 Dec 2008)
 - Interest rates are OK for controlling inflation, less so for the *whole* economy
- Privately invested savings schemes (funded pillars) were seen as the solution to “the old age crisis” as well as for increasing savings, developing capital markets and so on
 - This forgets the prime objective of pensions is old age *security*, and pensions are paid once in a lifetime (kind of the “once in a lifetime tsunami” that hit Alan Greenspan, the Fed Chairman *aka* Maestro)
 - the Banking and financial activities were not only left largely unregulated but pension funds induced to invest in risky assets
- Many talked about the crisis but those in power did not listen (e.g. Peter Warburton’s book “Debt and Delusion” in 1999, Joseph Stiglitz’s paper at the Bank of Iceland 2001, Nuriel Roubini’s presentation at the IMF in 2006¹⁰ and so on)

10 Myths of Funded Pensions

(Peter R. Orszag and J. E. Stiglitz, 1999)

- **Macroeconomic myths**

#1: Individual accounts raise national saving

#2: Rates of return are higher under individual accounts

#3: Declining rates of return on pay-as-you-go systems reflect fundamental problems

#4: Investment of public trust funds in equities has no macroeconomic effects

- **Microeconomic myths**

#5: Labor market incentives are better under individual accounts

#6: Defined benefit plans necessarily provide more of an incentive to retire early

#7: Competition ensures low administrative costs under individual accounts

- **Political economy myths**

#8: Corrupt and inefficient governments provide a rationale for individual accounts

#9: Bailout politics are worse under public defined benefit plans

#10: Investment of public trust funds is always squandered and mismanaged

9 Myths of Funded Pensions

(N. Barr, 2001)

- Myth 1: Funding resolves adverse demographics.
- Myth 2: The only way to prefund is through pension accumulations.
- Myth 3: There is a direct (positive) link between funding and growth.
- Myth 4: Funding reduces public spending on pensions.
- Myth 5: Funded schemes offer better labor market incentives.
- Myth 6: Funded pensions diversify risk.
- Myth 7: Increased choice is welfare-improving.
- Myth 8: Funded schemes do better than PAYG systems
- Myth 9: Private pensions get government out of the pensions business.

Did we become rich? Yes, notionally

The trading volume of over-the-counter markets:

- Had reached \$700 trillion by June 2008
 - A ninefold increase in a decade, and 15% higher than in December 2007

The assets of the global fund management industry in 2007:

- reached a record \$74 trillion
 - An increase of 14% in 2007 and double from 2002

How much of the above is now a black hole compared to:

- Global GDP (2007): \$55 trillion
- US GDP \$14 trillion
- Value of troubled US bank assets \$ 5.7 trillion
- Sovereign wealth funds: \$ 3 trillion
- (BEFORE THE CRISIS)

And some became very rich

- According to Forbes magazine, there were:
 - 298 billionaires in the world in 1999
 - 1,125 in mid-2008
- Now there are fewer as, for example,
 - James Cayne, the Bear Stearns' chairman, lost one billion dollars in October
 - Some have, unfortunately, committed suicide

But some did not understand what was going on

Alan Greenspan (Oct 2008)

- I was "shocked" when the system broke down;
- I made a mistake in presuming that lenders themselves were more capable than regulators of protecting their finances
- My ideology and model that I always believed in proved me wrong.

Sir John Gieve, Dep. Governor, Bank of England (Dec 2008)

- The Bank knew "crazy borrowing" was taking place and the price of houses and other assets was rising unsustainably but the Bank did not understand the severity of economic problems before the current financial crisis.
- The Bank thought this problem was less serious than it turned out to be

And some others did not understand why Europe was falling behind the USA

A Member of the Executive Board of the ECB said in Liechtenstein on 28-10 2005:

- the financial sector will gain significantly in size and relevance on a global level and **will be subject to strong competitive forces;**
- The size and relevance of the financial sector will grow significantly ... The prospects for the financial sector are good ... as early as 2010 the global financial stock is expected to exceed the \$200 trillion mark, compared with around \$118 trillion at present (2005) ... private debt securities are the largest component of the global financial stock and the fastest growing ... **The depth of Europe's financial stock has also increased considerably, from 84% of GDP in 1980 to 306% in 2003; although this falls short of the US figure of 397%.**

A £ 4.2 billion Tragedy (Children)

In 1999 the UK Government pledged to decrease child poverty by half, from 3.4m to 1.7m children, by 2010 and to eradicate it completely by 2020

- The Joseph Rowntree Foundation (JRF) estimates (March 2009) that 2.3 million children will still be in poverty in 2010 (a discrepancy of 35%)
- Similarly, the Institute of Fiscal Studies estimated that the child element of the child tax credit would need to be raised by £12.50 a week to meet the target, adding up to £4.2bn a year.
- Child poverty could even rise to 3.1 million people by 2020, without any new policies to help low-income families, the report warned. This will not be dissimilar to the number of poor children in 1999.

Memo items

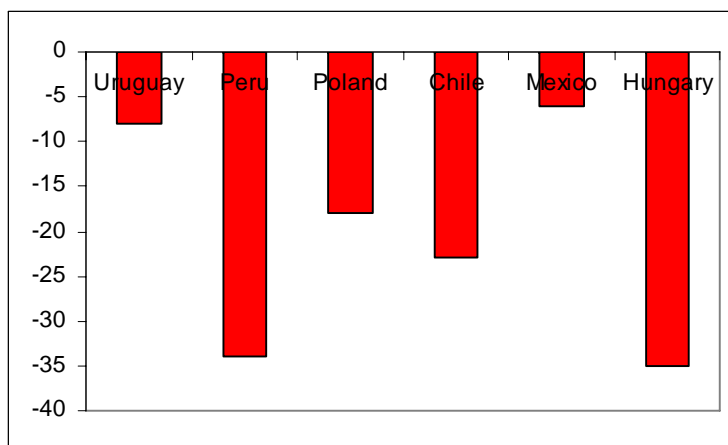
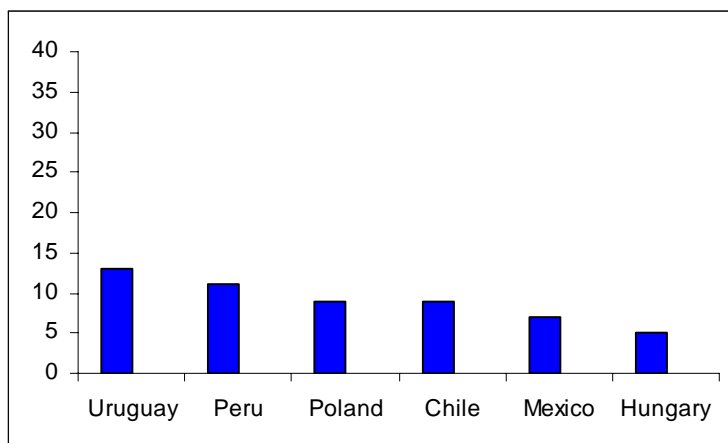
- The Royal Bank of Scotland paid \$5 billion in bonuses in 2007 and posted losses of £24 billion in 2008, the largest corporate loss in the history of the UK
- Net government debt in the UK to increase from 36% to 60-90% of GDP?
- The UK initial rescue of package of £...billion has now reached £...billion (fill in the blank)

A £157 billion tragedy (pensioners)

- The value of employees' defined contribution pensions dropped by nearly a third from £552bn to £395bn between October 2007 and October 2008
- The losses in mortgages come to \$ 2 trillion and in commercial deals \$200 billion - the sum of the two is equal to the UK's total GDP

(See, http://news.bbc.co.uk/go/em/1/hi/uk_politics/7749195.stm;
The Economist, Nov 29, 2008)

Real Returns of Mandatory Pension Funds – 2nd Pillar (balanced portfolio)



World Bank 2008 (beginning)

- Bebczuk Ricardo N. and Alberto R. Musalem 2008. "Can the Financial Markets Generate Sustained Returns on a Large Scale?". In Holzmann (ed). *"Aging Populations, Pension Funds, and Financial Markets: Regional Perspectives and Global Challenges for Central, Eastern, and Southern Europe."* World Bank. Washington DC.

World Bank 2008 (end)

- The Unfolding Crisis: Implications for Financial Systems and Their oversight

NOTE:

- The top diagram shows **return on capital** (flow).
- The bottom diagram shows **loss of capital** (stock).

=> Picking pennies in front of a steamroller?

The little that economists know (1)

- 33AD: Cornelius Tacitus on the link between credit crunch and real estate assets
- 1873-1897: The ~~Great~~ Long Depression
- 1929-?????: The Great Depression
- 1954: The Dow Jones regains its 1929 value
- 1990-?????: The Japanese Crisis (see next)

Nikkei 1970 – 2008 ...

18 long years and still going ...



The little that economists know (2)

Irving Fisher, the inventor of the famous $MV=PQ$ equation upon which monetarism is based:

- He said a few days before the Stock Market Crash of 1929, "Stock prices have reached what looks like a permanently high plateau"
- He still maintained a few days after the crash "the market is only shaking out of the lunatic fringe."
- And by 1933 he had lost his personal wealth and academic reputation
- But in 1933 he published "The Debt-Deflation Theory of Great Depressions" in *Econometrica* 1: 337-357 saying:
 - "Easy money is the great cause of over-borrowing. When an investor thinks he can make over 100 per cent per annum by borrowing at 6 per cent, he will be tempted to borrow, and to **invest or speculate with the borrowed money**. This was a prime cause leading to the over-indebtedness of 1929. **Inventions and technological improvements created wonderful investment opportunities, and so caused big debts**".

The little that economists know (3)

- Derivatives are financial contracts, or financial instruments, whose values are derived from the value of something else (known as the underlying).
- Derivatives can be used to mitigate the risk of economic **loss** arising from changes in the value of the “underlying”. This activity is known as **hedging**.
- Alternatively, derivatives can be used by investors to increase the **profit** arising if the value of the underlying moves in the direction they expect. This activity is known as **speculation**.

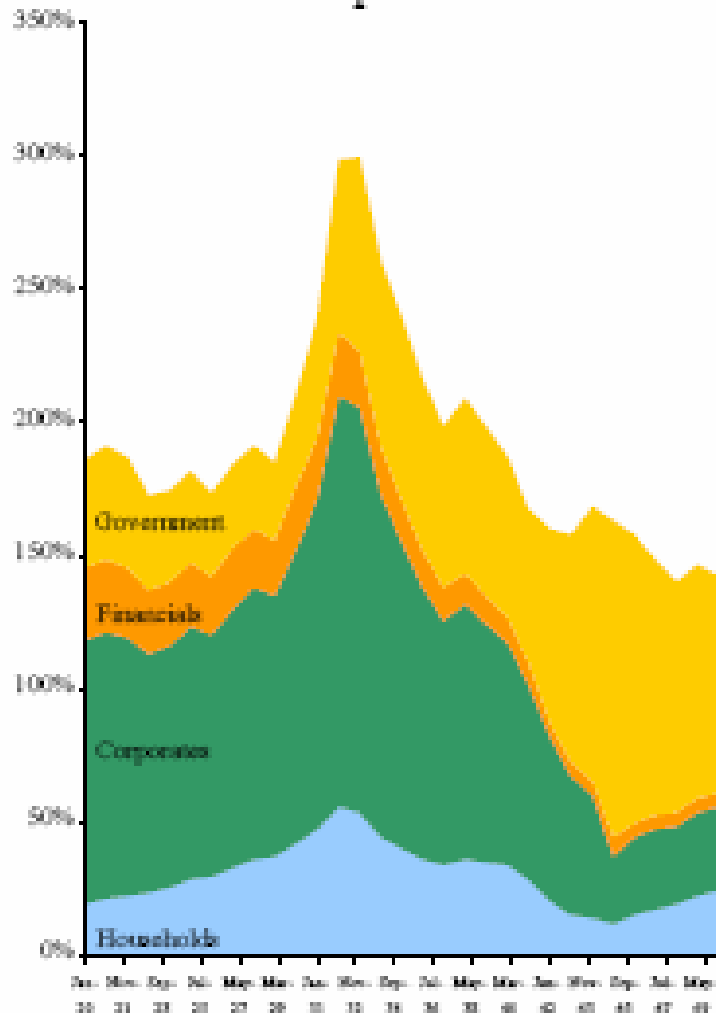
The little that economists know (4)

Someone Has to Pay for Deleveraging

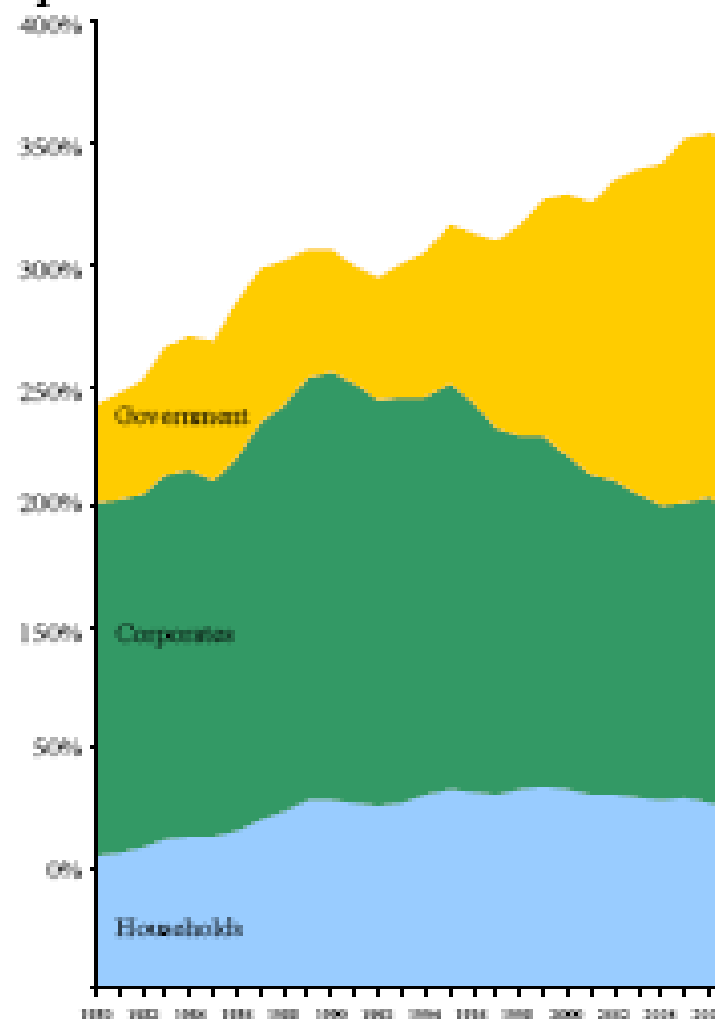
(The Fiscalization of Debt from Corporations to the Government/People)

(A. Bisat/ Traxis Partners)

US: The Great Depression



Japan: The Great Socialisation



Alan Greenspan (continued)

- (Oct 2008) The crisis will pass, and America will reemerge with a far sounder financial system ... **the \$700 billion program is adequate to serve the needs**
 - (One more trillion has been added to the rescue package and is growing)
- (Dec 2008) “the global stock market value wiped out this year was \$30 trillion ... Human nature being what it is, we can count on a **market reversal within 6 months to a year**”
 - (So, by June 2009 things should be getting better? if so, we are nearly there and everybody else has got it really wrong)

The little that economists know (5) (and Greenspan did not know)

Peak to Trough Changes of Crises

- House prices -36%, duration 6.0 years
 - Real equity prices -56%, duration 3.4 years
 - Unemployment +7%, duration 4.8 years
 - GDP -9%, duration 1.9 years
 - Public debt +86%
-
- Based on past and ongoing banking crises (so, if anything, the figures underestimate the effects)

C.M. Reinhart and K.S. Rogoff "The Aftermath of Financial Crises", AEA Meetings, 2009, Jan 3

The little that economists know (6)

- There is a difference between “markets” and “free markets”
- To have effective monetary policy you need two bullets:
 - Functioning banks (that are not currently available)
 - Effective interest rates (higher than the current near 0%)
- So what is left?
 - Fiscal
 - Financial support (liquidity, loan guarantees, capital injections, asset purchases, nationalization)

The little that economists know (7)

- The multiplier effects of spending (G) is greater than that of tax cuts (T)
- Among various forms of spending, infrastructure projects, especially maintenance, have the greatest impact
- Most of those opposing rescue packages favor tax cuts over increases in spending

What are politicians thinking?

"If we were to allow the free market to take its course now, it would almost certainly lead to disorderly bankruptcy and liquidation for the automakers"

- President Bush on Dec 19, 2008 after announcing that Automakers to get \$17.4 billion
- http://news.yahoo.com/s/ap/meltdown_autos

Deleveraging, Fiscalization or Socialism?

- **Is the Rescue Plan Socialism?**
 - Wall Street Journal, Oct 4, 2008
- **Barack Obama Is a Socialist!**
 - <http://news.aol.com/political-machine/2008/10/20/barack-obama-is-a-socialist/>
- **McCain Follows Obama Down the Same Socialist Road**
 - <http://www.newswithviews.com/Kincaid/cliff260.htm>
- **Bush Embraces Obama's Socialism**
 - http://www.familysecuritymatters.org/publications/id.1579/pub_detail.asp
- **“When I read the newspaper, I thought I woke up in France”**
 - Senator Jim Bunning, a Republican from Kentucky, after he read about the Fannie and Freddie rescue in July 2008. He went on to say “But no, it turned out it was socialism here in the United States of America.”

Will the rescue be successful?

- **You need 3 S's: size, speed and support**
 - Speed: so far the concepts are developed but no exact plans (trust requires solvency, not liquidity)
 - Size: has to be big in relationship to the black hole, whose size is not yet know
 - Support: Jolly opposition favors tax cuts over spending, less regulation, no nationalization
- **Moreover, the difference between depositors and investors is yet to be fully acknowledged and in most countries deposits are only partly, if not minimally, guaranteed**
 - Deposits should be fully guaranteed/insured as this helps the capitalization of the banks (practically) while, if deposits are lost, this is equivalent to theft (morally)
- **In the meantime, some things are working against the rescue packages:**
 - Private capital flows fell by 80% in 2008 to (\$165b)
 - Protectionism may creep back
 - Poverty will increase by 100 million people
 - Unemployment will increase by 50 million

SUMMARY

What economists know is that:

- Crises seem to be more the result of **wrong ideologies** held by a few influential people, **not houses** owned by many undistinguished people
- The costs of crises are **huge**
- The effects of the current crisis on the real economy may last for **more than a decade**
- The rescue packages **are far from being socialist** – at least so far
- Those who pay for the crisis are the current workers, the upcoming pensioners, the future workers and the children of today

What economists do not know:

- The crisis of 1873 ended the British empire – **can this crisis end a superpower?**

What Politicians Should Learn Is:

- Get the facts, or the facts will get you. And when you get them, get them right, or they will get you wrong.
 - Dr. Thomas Fuller
British physician, preacher and intellectual
Gnomologia 1732
- “If we don't succeed, we run the risk of failure”
 - George W. Bush
US President
2001-2009