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The Economic Crisis as of December 2008: The *Global Economy Journal* Weighs In

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Abstract

The present crisis is too raw to have a catchy title, but while previous work of members of the International Trade and Finance Association and readers of the *Global Economy Journal* already helps us understand it, I anticipate many future contributions to the *GEJ* on the subject as well.

KEYWORDS: crisis

We are students of the economy. We get it: real economic growth depends on improvements in technology and their commercialization, on education, on investments in hardware and tractors—and on well-functioning financial markets. Regardless of their particular specialties, members of the International Trade and Finance Association and readers of the *Global Economy Journal* could not be unaware of the pragmatic corollary—that cause and effect go both ways between the real and financial markets—the global evidence is too overwhelming: Japan's housing bubble in the late 1980s, stock market crash, and the subsequent lost decade; Sweden's experience with a housing bubble and financial crisis in the early 1990s; the lost decade in Latin America of 1980s with its debt and depression; the Asian contagion of 1997-1998; Mexico, 1994-1995; Russia, 1998; Argentina, 2001, Iceland 2008; not to mention the U.S. Savings and Loan debacle in the latter 1980s.

The present crisis is too raw to have a catchy title, but the fact of its existence is all too apparent. Too many countries are in recession or nearly so; too many countries have banking and financial systems in utter disarray; financial asset prices have crashed, and in some places real asset prices as well. The governmental responses are perhaps the best signal of the scale of the crisis—the September $700 billion bailout package in the U.S.; the October packages, 50 billion pounds in the U.K., 500 billion Euros in Germany, 360 billion Euros in France; and November's four trillion Yuan package in China—although the numbers are by no means certain and other examples could be mentioned.

Whether this particular crisis started in the financial markets or the real economy will be debated for years. A global savings glut in China, Japan, Germany, and the oil exporting countries (Mizen, 533) is the same as a consumption glut in the destination countries, perhaps chiefly the U.S. Ironically, the long period of prosperity and stability in the U.S. and at least parts of Europe were a force in keeping interest rates low, which in turn contributed greatly to the innovations in the financial markets in search of higher returns, for example, the invention of mortgage backed securities and collateralized debt obligations. These financial assets may have originated largely in a few countries, first the U.S., then the Netherlands, Spain, and Italy (Mizen, 537), but they were purchased globally as the investment community is truly global.

And while the innovations in the financial markets have played a key role in the crisis, certain long-standing problems there certainly contributed. Many of my colleagues and I have been telling students for years that incentives for financial intermediaries do not align with good decision-making, that the compensation from top to bottom in the financial markets is incommensurate with their contributions to the economy, and that there was a systematic misunderstanding of risk. The notion that it is possible to insure against a decline in the value of one financial asset by buying another financial asset should always

be treated with a fair degree of skepticism. Remember the time-honored saw about diversification: If one firm or industry or country is in decline the only "insurance" for the investor is to have an equal holding in some other firm or industry or country which is prospering.

These factors could hardly have helped when the financial markets ran into trouble dealing with the problems that arose with the new financial products. Although the bursting of the housing bubbles in various countries seems to have triggered the crisis, it is by no means obvious that a crisis could have been avoided if the housing markets had never imploded. A challenge to any of the new high-valued assets whose risk was insufficiently recognized would have done the trick.

Members of the International Trade and Finance Association and readers of the *Global Economy Journal* in particular have had an excellent explanation of the forces at play in the article by Gallegati, Greenwald, Richiardi, and Stiglitz in the most recent issue of this journal. I'll let them speak for themselves, giving the abstract of the article here; the citation is in the reference list. The division into paragraphs is not in the original.

> In this paper we provide a general characterization of diffusion processes, allowing us to analyze both risk-sharing and contagion effects at the same time.
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> We illustrate the relevance of our theory with reference to the subprime mortgage crisis and more in general to the processes of securitization and interbank linkages.
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> We show that interdependencies in real and financial assets are beneficial from a social point of view when the economic environment is favorable and detrimental when the economic environment deteriorates. In the latter case, private incentives are such that too many linkages are formed, with respect to what is socially desirable. The risk of contagion increases the volatility of the outcome and thus reduces the ability of the financial networks to provide risk-sharing.
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> Our analysis suggests that a likely major explanation of the subprime mortgage crisis is the process of securitization itself, in addition to the absence of transparency about the characteristics of the underlying assets that the multiple layers of financial intermediation fostered, as commonly claimed.

> This may call for a different emphasis on the role of public intervention. While a goal to stabilize the economy in good times should be to disrupt the channels that bring contagion, that is a positive correlation in the returns, in a period of worsening economic conditions our analysis suggests regulatory intervention aimed at disconnecting the economy at crucial nodes.
>
> Moreover, we show that policy interventions should be aimed at rescuing institutions, but not their managers. Diminishing the cost of default actually increases the inefficiency due to the divergence between the social and the individual optimum.

Theoretical possibilities notwithstanding, the crisis was in fact triggered by the implosion of housing bubbles. That a bubble was possible in at least Europe and North America is pretty old news, see Shelburne and Palacin (2006) of this journal, Esteban (2008), Roed Larsen, and Weum (2008), and for the U.S. Shiller's 2008 Presidential Address to the Eastern Economic Association. Fixing the current problems in the housing market is a political blackhole—someone must decide how those who were not harmed by the bubble should help those that were, exactly which homeowners deserve help, and on what scale. But putting the regulations in place to avoid a repetition of the housing debacle is not impossible. Mizen (2008) does a good job covering this ground. More difficult, but necessary I would argue, is to remind homeowners that they are responsible for their investment decisions in housing, just as they are, for example, in education.

Consider the homeowner living in the median value home in a given market. It was not unheard of for the annual appreciation of that home to be two or three times the median annual income of the market. If this situation were normal then nobody would work. Instead, one would simply buy the most luxurious house available and use a home-equity loan to live handsomely on the house's appreciation. (And everyone would be a subprime borrower.) Of course, in the real world, that's clearly a bubble about to burst, and I would argue that the level of basic economic reasoning required to understand that is commensurate with what we expect of residents of market economies.

But if I am not in favor of widespread relief to homeowners, the fall 2008 bailout money so far has completely missed anyone but major banks or bank like institutions. Major writedowns have been done by Citigroup (U.S.A.), Merrill Lynch (U.S.A.), UBS (Switzerland), AIG (U.S.A.), HSBC (North America), RBS (U.K.), IKB Deutsche (Germany), Bank of America (U.S.A.), Morgan Stanley (U.S.A.), Deutsche Bank (Germany), Ambac (U.S.A.), Barclays (U.K.), Wachovia (U.S.A.), MBIA (U.S.A.), Credit Suisse (Switzerland),Washington

Mutual (U.S.A.), and HBOS (U.K.) all of which have been involved in takeover or bailout schemes except for the Deutsche Bank which has rejected bailout money and MBIA for whom bailout seems more chatter than real. To focus just on Wall Street for a moment, there have been particularly noteworthy bailouts for Bear Stearns, Goldman Sachs, JPMorgan Chase, Wells Fargo, Fannie Mae and Freddie Mac.

So what about the little guys in the market, those who save for some worthy goal, say retirement, who have taken such a beating? Does there seem to be any plan afoot to rescue them? Well, at best only indirectly—if the bailouts restore that chimera called investor confidence then perhaps the asset prices and particularly stock prices might recover.

What about the responsibility of members of the International Trade and Finance Association and readers of the *Global Economy Journal* to give good advice? To be truthful, how many of us—say, sometime in the spring—would have put a higher probability on inflation than on a crash? And in a world where both are possible, it is not, in general, easy to hedge against both wealth destroyers at the same time. Park your funds in cash, and inflation will kill you; put them in equities and a crash will do the same.

The standard advice, never invest in anything you do not understand, is not realistic for a good part of the saving population, however well educated. To pick on only those I love best; try explaining a hedge fund to a poet. Most people must rely on financial intermediaries of one type or another for help with their portfolios—and pay a hefty fee for the privilege. Which is to say, of course, there will always be people who make a living gambling with other peoples' money. I am not of the view that the fund managers, to mention one example, are the proverbial fox guarding the chicken house, but such a view is commonly held. With the recent trends in asset prices, and the headlines that go with them, it is asking a lot of human nature for savers to entrust their money to markets that have so conspicuously failed to conserve it. I have no idea what combination of policies will reignite the virtuous circle, persuade savers to trust the financial markets to get their funds to those firms best able to make good use of them, earn profits, pay dividends and interest, and not at all incidentally, facilitate economic growth. I just hope it happens soon.

In an economic crisis the members of the International Trade and Finance Association and readers of the *Global Economy Journal* have the responsibility to be thinking long and hard about causes and remedies. As recently as May 2008, in my survey of journal contents, Highfill (2008), there is not as much as a hint of the crisis well underway. As for possible policy responses, the recent article by Paul Mizen (2008) of the St. Louis Fed which I have drawn from several times for this article has been particularly helpful in my own thinking. But it is not the time to just round up the usual suspects. Those inclined to advocate markets should be

thinking about market failures. Those inclined to advocate regulation and/or government intervention need to be thinking about the failed aspirations and achievements of such policies. Those who advocate a judicious mix of markets and government intervention should be thinking how to improve the fit between them, and about the moral hazard problems that will inevitably be created. I expect that the results of this hard thinking will be reflected in *GEJ* contributions for some time to come.

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