XXIV "Conferenza Fulvio Guerrini"

The Great Crash of 2008: Causes and Consequences.

A Classical Liberal Perspective

Relatore

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Introduce **Angelo M. Petroni**

Le "Conferenze Fulvio Guerrini" sono state inaugurate dal Centro Einaudi nel 1984 per onorare la memoria del fondatore.

Il loro tema generale è la libertà nelle società industriali avanzate.

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INTRODUCTION

GLOBAL IMBALANCES

• Global imbalances in 1980s -> Plaza Accord.

• Spillover effects of domestic policies on global economy.

• Integrated global economy, diverse economic agents actions coordinated through international markets for goods and assets.

• Reflected in changing macroeconomic variables.

• Spillover effects ‘pecuniary externalities, eg D for shoes rises -> rise p shoes -> rise p of leather -> rise p of handbags. No need for any public action

CHANGING FINANCIAL STRUCTURES

• 1980s crisis similar.

• Difference in outcomes due to changed Western financial structure- universal banks.

• Commercial banks can create money, Non bank financial firms cannot.

• Deposit insurance and Glass- Steagall Act

POLICY ERRORS

- LTCM Bailout
- Greenspan Put
- Affordable Housing-> subprime mortgages
- Basle II capital adequacy->SIV’s
- Bear Sterns Bailout
- Lehman bankruptcy->changed expectations
- TARP

THEORETICAL REMEDIES

• Inappropriate Keynesian lens

• Wicksell origin of all macro economic perspectives

• Wicksell asked: in a pure credit economy how can price stability be maintained?

• Answer: Bank rate set at *natural* rate balancing productivity and thrift

• Taylor Rule and Greenspan Put

• Hayek's Austrian theory": market interest rate< natural rate -> boom-> low return capital intensive production -> bust and liquidation of 'maladjustment'.

• "injection effects" with stable prices -> false inter-temporal prices. US housing boom with stable prices an example.

• Hayek’s prescription let slump run till maladjustment end, wrong.

• Keynes correct to emphasis effective demand failures in crash, and deficit spending but not through counter cyclical public works. Keynes unlike Hayek no explanation for boom preceding slump.

• Friedman closer to Wicksell in concentrating on *general* price level, unlike Hayek on *relative* prices.

• Natural rate of unemployment corresponding to natural rate of interest. Monetary policy only transient deviations from natural rates.

• New Classical, Real Business Cycle, New Neo Classical theories no money or finance.

• Fisher and ‘balance sheet recession’

• Hayekian recession with Fisherian consequences.

MONETARY POLICY

• Two objectives: monetary stability, financial stability

• Monetary stability- independent central banks, inflation targeting

• Financial stability- Bagehot’s lender of last resort (LLR) rules for a panic

• In panic lend unlimited cash to *solvent* but *illiquid* banks at penalty rate against good collateral

• Century of UK financial stability till Northern Rock run

• Meltzer shows US Fed never developed and announced LLR policy->market uncertainty as in 2007-08 crisis.

• Insolvent banks to be shut down.

• US can now be done through FDIC

• Avoiding Fisherian deflation

• Liquidity traps

• Monetary policy transmitted through changes in real broad money balances . Meltzer evidence

• Japanese decade long slump due to not increasing broad money balance through joint debt market operations with fisc, but relying on narrow money expansion through money market operations. Congdon evidence.

• Ben Bernanke’s ‘quantitative easing’ and ECB and Bank of England right policy.

• Problem timely exit. But no liquidity trap.

FISCAL POLICY

• Low or no structural fiscal deficit- raise aggregate demand through temporary deficit- China and India etc.

• US structural deficit- stimulus package ‘tax cuts worked’ not rest of dogs breakfast

• Needed a large across the board temporary tax cut to allow deleveraging without cutting other spending.

• Health care bill worsened structural deficit. No further room for fiscal or monetary policy -> further QE and inflation fears.

• UK right to create more fiscal space for QE by rolling back welfare spending.

• Keeping 50% income tax rate and VAT rise wrong.

• Eurozone: ECB right to QE whilst asking for fiscal tightening -> German success

• Greek debt problem- ECK IMF program: no devaluation or debt restructuring makes large internal devaluation politically unlikely.

FINANCIAL ENGINEERING

• Complex financial instruments created and spread crisis.

• Public promotion of US home ownership created sub prime crisis.

• Moral hazard created by Greenspan Put and bailouts led to mispricing of risk.

• Crisis internationalized by opaque asset backed securities.

• Sausages with infected meat -> closing of interbank lending and crisis.

• Bail outs of AIG and others, ‘too big to fail’ banks, investment banks becoming bank holding companies, have accentuates moral hazard.

• Dodd Frank Wall Street Reform bill, will create a corporatist banking sector beholden to Fed.- Wallison

ENTITLEMENT ECONOMIES

• Past dirigisme caused crisis as in many developing countries -> entitlements to politically determined income stream -> tax resistance and fiscal cum debt crisis.

• US explicit subsidy through mortgage interest tax deduction + implicit subsidies through GSE’s.

• Put implicit housing subsidy on the budget.

• European welfare state entitlements explicit. Becoming unsustainable eg. Greece U.K.

• US in denial with expansion of health entitlements.

• David Walker and unsustainable structural deficit due to health care subsidies.

• Current crisis likely to be followed by even more serious future crises.

CONCLUSIONS

- Classical liberal prescriptions for dealing with financial crises

    1. Tame or dismantle entitlement economies

    2. Separate commercial banking from investment banks

    3. Allow investment banks to be unregulated and take whatever risks they want without being bailed out.

    4. Failing financial institutions to be closed down- by the FDIC in the US.

    5. Establish the Bagehot LLR rules formally for deposit taking commercial banks.

    6. Maintain monetary stability by controlling broad money.