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"Anatomy of Crisis- the Living History of the Last Thirty Y ears:

Economic Theory, Politics and Policy?"

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A. Introduction

The current economic and financial crisis, and it is both, has already imposed great costs on the global economy. Nor is there any guarantee that we have seen the worst and that recovery is now assured. The obvious question, and the topic of this session, is how we got into this mess. Answering this question is crucial if we are to move on to the next set of questions. What policies would help us get out of this mess, and would help us avoid similar problems in the future?

Reference is made in the title of this session to "Economic Theory, Politics and Policy". My own belief is that serious mistakes have been made with respect to all three, leading in the end to harmful policies. However, over the last thirty years, all three have been linked in a fundamental way; the primary focus of each has been on economic outcomes over a relatively short time horizon. Even inflation targeting, which is certainly a better policy framework than the employment maximizing approach that preceded it, generally focuses on outcomes over the next two years. While we expect politicians to have short term horizons, it is worth noting that most conventional models of the economy are also inherently short term in that they focus on the "flow" of incomes and expenditures. If stocks and "imbalances" that can build up over longer time periods play no role in theory, it is not surprising that they have had such little influence over policies.

A short term orientation on the part of policymakers is particularly unfortunate, since private sector behavior seems even more strongly inclined this way. In consequence, there has been no public sector counterweight to what the BIS has referred to (for welll over a decade now) as the inherent "procyclicality" of the economic and financial system. Simple extrapolation of past successes has been the order of the day, not just by traders, but also by public sector officials who used such successes to justify their own views of how the world worked. And, as an important corollary, policy makers preoccupied with short term results paid little attention to the buildup of moral hazard over time as "safety net" measures were

continuously expanded. Getting off this "bad path", is now the biggest policy challenge of our time.

The parable of Pharaoh's dream, in both the Bible and the Koran, reminds us that the problem of short-term extrapolation of recent experience is deeeply imbedded in human nature. As a result, it will not be amenable to easy policy solutions. At the very least, and this is the admirable purpose of the Institute for new Economic Thinking and this conference, we need to have an open mind about both the causes and the solutions for our current problems. As Mark Twain once rightly said "It ain't the things you don't know what gets you into trouble, it's the things you know for sure what ain't so." We need to cast aside a lot of old ideas; not least about rational behavior, self equilibrating systems and the idea that credit excesses have nothing to do with monetary policy.

B. Causes of the current crisis

I would like to distinguish between two schools of thought; the "school of what is different" and the "school of what is the same". The former has received more attention in the press and by policymakers because it is inherently more comforting to do so. The latter has received less attention, because it is less comforting. Both schools are relevant, but the latter is inherently the more important.

The "school of what is different" focuses on the developments in financial markets that were new this time around. Such innovations as CDS's, structured products, SIV's and conduits, extensions of the originate to distribute model and the role of rating agencies, would all become centers of attention. Each in some measure increased complexity and reduced opacity, and contributed to the sudden meltdown in financial flows in the summer of 2007. In effect, with it being impossible to value many new products, there was enormous uncertainty as to who was solvent and who was not and lending ceased accordingly.

This school of thought is relatively comforting to all those involved in the governance of the economic and financial system. New developments always have unanticipated side effects, and it would be unrealistic to expect those in charge to anticipate all of them in advance. John Kenneth Galbraith once observed that "once a bubble bursts, attention shifts to the way the bubble manifested itself in the form of instruments, techniques and the like, while the key factor- speculation- is ignored." To some degree this is happening again today, with the added benefit that such a focus puts incompetent and venal bankers at the heart of the problem. Given that human nature says that "someone must be blamed", this is all very convenient.

The school of "what is the same" begins by noting that boom-bust cycles have been characteristic of liberalized economic and financial systems from time immemorial. Moreover, while each one is different (as noted just above), in fundamental ways they all look the same. What is less "comforting" about this school of thought is that it charges all those responsible for the governance of the economic and financial system with having

missed obvious historical parallels. With Ken Rogoff in the room, I am hesitant to go into too much historical detail, so let me just focus on this last cycle and the more distant events leading up to it. George Soros in his comments implied that the current crisis had its roots in the 1960's. I agree, but will restrict my comments to some particular contributions made by policy since the late 1980's.

The expansion phase of the last credit cycle, and the associated buildup of "imbalances" began in the summer of 2003. First, virtually any asset price you can think of, including most commodities, experienced an inflection point at that moment and then continued to rise rapidly to inexplicably high levels. Second, credit standards were repeatedly lowered, leading to a massive increase in sub prime lending to households, cov-lite loans to corporations and similar increases in other loans (not least commercial property) based on rising collateral values. Credit and term premia collapsed as did the cost of insurance against bad events. Through both lower lending standards and increased leverage, the risk exposure of banks and financial institutions rose sharply.

These financial developments also had real counterparts. A third imbalance was a sharp decline in household saving rates (and an associated increase in debts) in many English speaking countries, and an unprecedented rise in investment ratios in China. Fourth, with consumption in the former highly import intensive, and investment in the latter geared to exports, global trade imbalances exploded. Fifth, the structure of production became highly skewed towards goods and services in high demand (banking services, construction, wholesale distribution etc.), and towards manufacturing capacity being increasingly concentrated in developing Asia.

The crisis erupted at a "Minsky moment" in the summer of 2007, catalyzed by BNP's decision to halt withdrawals from three of its off balance sheet vehicles. However, its underlying cause was the nexus of credit driven imbalances described above. It was an accident waiting to happen, and could have started anywhere.

While private sector behavior ("procyclicality") played a crucial role in these event, central banks also contributed heavily. It is likely not a coincidence that the expansion phase of the last credit cycle began with policy rates at their lowest in the major industrial countries. As well, with increases in policy rates carefully signaled, there was an open invitation to take on more leverage in response to declining carry margins as policy rates rose. Further, in emerging market countries, upward pressure on their exchange rates was fiercely resisted through both FX intervention and easier monetary policy. In this way, the problem of excess "liquidity" became truly global. Finally, it is not farfetched to suggest that many of the developments that made this crisis "different" were also encouraged by low policy rates. These led to more risk taking in "the search for yield", as well as efforts (off balance vehicles and new instruments) to disguise these risks. Unfortunately, disguised risk is not the same as reduced risks, as eventually became apparent.

The tendency of central banks to ease policy sharply in the face of economic or financial difficulties goes back a long way. One important event was the sharp lowering of interest rates after the crash of 1987. This contributed to the subsequent property bubble and associated financial problems in many countries in the early 1990's. Again, the answer was sharply lower interest rate in the advanced industrial countries which encouraged the Asian boom (as their currencies were tied to a declining dollar) and the Asian crisis in turn. Interest rates were then put on hold (and a "New Era" declared), which likely contributed to the excesses leading up to the LTCM debacle. With interest rates subsequently lowered in response, the stage was set for the TMT and NASDAQ bubbles which soon collapsed. In turn, this led to the unprecedented cut in policy rates that set the stage for the current crisis as described above. Throughout all this period, central banks felt little need to raise rates and saw plenty of room to lower them. Price stability was increasingly the objective of policy, and inflation was generally thought to be well under control.

All of these policy moves by central banks seemed perfectly reasonable at the time; that is, being evaluated from the perspective of a one period or short term model. But, over time, they had two particularly pernicious side effects. First, as George Soros suggested in his comments, those who helped create the debt crisis of the 1980's came out of it stronger as a result of public policy. Safety net provisions of various sorts, including the "Greenspan put" just described, have encouraged increasingly imprudent behavior in successive financial crises. Banks have thus been encouraged to become bigger, more interdependent, more complex and in the limit "too big to fail". Further, the successive recourse to lower interest rates encouraged ever more borrowing, ever more debt accumulation, and ever larger "imbalances".

Taken together, these side effects implied that successive crises were both more likely and of increasing seriousness. In effect, the Expected Loss from crises was rising. Perhaps worse, because of increased private debt burdens (to say nothing of rising government debts), the capacity of policy to stimulate the next upturn was falling. In such circumstances, it was not surprising that monetary policy was used ever more aggressively to resist successive downturns. Unfortunately, the logic of such a dynamic process is that it culminates in a "superbust" almost totally resistant to macroeconomic stimulus. The future ceases to be an extension of the past. With creditors no longer wishing to lend and debtors no longer wishing to borrow, that might be where we are today.

C. Why were the warnings unheeded?

Contrary to the Queen of England's recent assertion at the LSE, there were some who saw the current crisis coming. A number of us at the BIS warned repeatedly, and more stridently with time, that we were on an increasingly dangerous path. The more interesting question is why those warnings had so little (if any) influence. Indeed, in a recent paper, Bill Poole speaks of more than a decade of attendance at FOMC meetings at which (pre crisis) such issues were never even raised. To me this is both surprising and humbling, since at least two

of those attending the FOMC meetings were always present at the bimonthly meetings of the BIS in Basel. Evidently, our concerns were not thought worthy of being passed on to policymakers themselves.

Perhaps, in the case of the BIS, the problem was that we had been too prescient. Like George Soros, we had issued warnings as far back as the Asian crisis that dynamic processes having their roots in credit excesses in the main financial centers would eventually implode from the periphery to affect the center. However, when this failed to happen for over a decade, our lot became very much that of the "little boy who cried wolf". People just stopped listening.

There were also more fundamental reasons why warnings from the BIS and other sources were ignored. In particular, they did not play to the prejudices of the various actors involved. For most of the time, those in the private sector were making enormous sums of money. Indeed, just prior to the crisis, the financial sector accounted for 40 percent of all the profits recorded in the United States. No one was inclined to suggest that this was due to more risk taking rather than cleverness. Further, there was general satisfaction in both the private and public sectors that the very substantial measures taken to improve risk management and financial stability had indeed paid off.

In central banks, there was a similar reaction. The "Great Moderation", which is said to have begun in the United State in the middle of the 1980's, was generally deemed to have been the byproduct of improved central banking practices. Central bankers in the advanced market economies had committed themselves to reducing inflation and keeping it low, and they had delivered on the commitment. In turn, the performance of the real economy had improved as anticipated. The spread of explicit "inflation targeting" to many emerging market countries implied, moreover, that the benefits would be reaped worldwide. Downturns (including those arising in the financial sector) could be effectively offset by Keynesian stimulus (as indeed had been the case in previous downturns).

Prejudices rest, of course, on a set of beliefs. Perhaps the most important reason for the warnings to be ignored was that the analytical frameworks being used by most people made no mention of stocks, much less "imbalances" that could grow dangerously over time. In effect, they simply provided no room for crises of the sort we are currently experiencing. This is true for the New Keynesian and New Classical models preferred by academics, as well as the Applied Keynesian Models traditionally used by central banks, the IMF and the OECD. As Keynes rightly pointed out, "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else" .

While the very fact of the crisis might have been expected to spark a wholesale reevaluation of existing analytical frameworks, it is striking that the policy response to date has in fact been "more of the same". That is, there has been recourse to massive Keynesian stimulus in the form of both monetary and fiscal policy. The fact that this has triggered an

unprecedented increase in the price of financial and other assets globally has elicited more satisfaction than concern about “yet another bubble”. Moreover, measures to support the banking system have been turned to again and have led to even more concentration in that sector. Finally, a number of policies designed to support demand (cars for clunkers in the US, and the reversion to a dollar peg by China) seem sure to aggravate all the real side “imbalances” described above. In short, to date, we do not seem to have learned a great deal from our past experiences.

This having been said, a re evaluation of existing analytical frameworks might be getting closer. Many current problems are now being recognized as the byproducts of policies followed in earlier periods. With policy rates having ratcheted down to zero, and government deficits and debts exploding, there is evident concern that the scope for still more Keynesian policies has been much reduced. Arranged mergers and acquisitions in the financial sector have also led to worries in some countries that institutions have become “too big to save” rather than just “too big to fail” . Further, many are now prepared to admit that it was wrong to assume initially that the problems in the financial sector were due to illiquidity rather than to more serious fears of insolvency. And, finally, the global crisis along with the Greek crisis in Europe have provided a new focus on exchange rate arrangements and the scope they can provide for dangerous trade imbalances to build up over many years. Should the global economy now suffer a double dip, and traditional policy responses prove ineffective, the pressure to rethink fundamental beliefs will likely mount sharply. To paraphrase Dr. Johnson, the need to develop a Plan B would “focus minds wonderfully”.

D. The need for a new analytical framework

Since this is the first panel of the first conference, hosted by a brand new institute, it would be presumptuous to make concrete suggestions as to where a new macroeconomic framework might take us. However, as building blocks for such a framework, I suggest as a starting point an increased focus on stocks (balance sheets) in addition to Keynesian flows, some additional insights from the Austrians, and still others from the work of Hyman Minsky. An increased emphasis on stocks and balance sheet considerations would embellish our understanding of the demand side of the economy, while certain Austrian insights (recognizing in particular the importance of stocks of physical capital) would do the same for the supply side. The writings of Minsky are also important in that they draw attention to the implications of a complex financial system (experiencing both credit risk and liquidity risk) for the functioning of the economy as a whole.

As described, these references to existing literature might seem little more than a call for an improved understanding of each of the IS, AS and LM functions in textbook Keynesian models. However, what is also required is a greater understanding of the dynamics of economies that are seriously out of equilibrium. In the boom phase, are there particular indicators that are useful in predicting the timing and character of crises? Once the bust occurs, does the economy have robust self equilibrating tendencies or not? The current

crisis, as well as many others in history, indicates that economies can be far from self-equilibrating. Indeed, history suggests that forces can arise that reinforce the disequilibrium, resulting in high rates of unemployment that last for many years.

Assuming that a new analytical framework admitted that major economic and financial crises were possible, the obvious next set of questions is what policy should do in response? First, it might be that crises could be prevented through preemptive policy action; the “lean versus clean” debate. After the crisis, the question is what public policies might contribute best to restoring equilibrium on a sustainable rather than just a temporary basis? The insights drawn from the analysis of stocks, the Austrians and Minsky indicate that simple demand side stimulus (as at the present time) might not provide a lasting solution to such problems. If a new analytical framework would also provide guidance as to what would work in restoring growth after a crisis, that would be particularly valuable.

At the least, a new analytical framework that allowed for crises would recommend taking measures ex ante to make crisis management easier. This would include ensuring adequate deposit insurance schemes, MOU between domestic policy makers, special insolvency arrangement for financial institutions, international burden sharing agreements and a host of other initiatives. Evidently there is a lot of thinking yet to be done, and a lot of practical work needed to exploit that new thinking to the benefit of everyone.

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