

The Global Credit Crisis as History

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As a financial historian, I have come to expect phone calls from reporters whenever the stock market tanks. “Could this be the start of another Great Depression, they ask?” No, I respond, a stock market crash is not the same as a depression. More to the point, policy makers have learned the lessons of history. Ben Bernanke, the chairman of the Board of Governors of the Federal Reserve System, is a student of the Great Depression. He understands that policy mistakes were responsible, in good part, for the economic crisis of the 1930s. He is committed to avoid their repetition. What happened before will not be allowed to happen again, I confidently conclude. Now I have stopped taking reporters’ calls.

Joking aside, there is at least one respect in which this conventional wisdom is correct. The views of the current generation of policy makers are very much informed by this historical episode, when the Fed for several years made relatively little use of monetary policy, allowing deflationary expectations to set in, and failed to execute its responsibilities as a lender of last resort, allowing the banking system to collapse. The Hoover Administration and Congress meanwhile raised taxes in a futile effort to balance the budget, reinforcing the collapse of private demand. The economic downturn was underway in the second half of 1929, but not until 1933 were significant steps taken to halt the fall in prices, stabilize the banking system, and encourage investment spending.

This time, with memories of that episode still fresh, there has been little hesitation on the part of our policy makers to act. No sooner did the crisis erupt in August 2007 than the Fed began flooding financial markets with liquidity. The expansion of its balance sheet is

unprecedented. As the economy weakened, our central bankers lowered policy rates toward zero and followed with quantitative easing. A first dose of fiscal stimulus was administered in early 2008, and both candidates for the presidency committed to the early application of more. Clearly, the other macroeconomic lesson of the 1930s – that when interest rates have already been cut to very low levels, fiscal policy remains the most effective instrument for stabilizing the economy – has been taken to heart.

Leaving two questions. Why, given that this is a global credit crisis and recession, have policy makers in other countries failed to move as aggressively? And why have U.S. policy measures, if so appropriate and well informed, not halted the downward spiral? The answer to the first question may be that the crisis has been slower to manifest itself in other countries. In addition, some countries, notably emerging markets with debts denominated in foreign currencies, have resisted loosening policy if this means allowing the exchange rate to weaken. They find themselves in the same position as countries whose central banks were prevented from loosening in the early 1930s by the restraints of the gold standard. Their reluctance is not irrational: sharp depreciation can mean bankruptcy for firms and banks with debts denominated in dollars and for households with mortgages and car loans in euros and Swiss francs. But the result is that policy is hamstrung.

Another factor may be that policy in other countries, European countries in particular, is not informed by the same powerful historical narrative in which the economic crisis of the 1930s was caused by the inaction of governments and central banks. There are no European counterparts of Milton Friedman and Anna Schwartz who devoted more than 100 pages of their influential monetary history of the United States to this interpretation of the Depression. Rightly or wrongly, Europeans drew other lessons from their economic history: the importance of

avoiding competitive currency depreciation and of keeping policies on a steady course. Fine conclusions though these are, they may have less salience in the current crisis than economist's variant of the Powell Doctrine: the need, when economic and financial war breaks out, for policy makers to respond with overwhelming force.

As for why U.S. policies have not been more successful in containing the crisis, part of the problem may actually be the tendency for policy makers to take their history too literally. While Black Thursday (October 24, 1929) and, more generally, the 1929 stock market crash feature prominently in popular histories of the Depression, scholarly accounts treat the Great Crash largely as a side-show and emphasize the crisis in the banking system. Such accounts are organized around the First, Second and Third Banking Crises in 1930, 1931 and 1933. Appropriately so: the U.S. economy in the early 1930s was more heavily bank based than today. But with time nonbank financial institutions and markets have become more important, reflecting the progress of disintermediation and securitization. The current crisis has been a crisis not just for banks but for insurance companies (like AIG), for hedge funds (whose distress sales of securities have created problems for other investors), and for the securities markets themselves.

Ironically, memories of the financial crisis of the 1930s, which was first and foremost a banking crisis, may have led our policy makers to focus on this segment of the financial system to the neglect of others. At first they lent freely to commercial banks but not to other institutions, and they have been playing catch-up ever since. They have accepted an ever expanding range of collateral. (Shades of the second Glass-Steagall Act of 1932 – not the notorious tariff but the law relaxing the definition of the securities that the Fed could hold as backing for that portion of its liabilities not collateralized by gold.) They have begun purchasing commercial paper directly

from the issuer. They have provided capital and liquidity insurance to nonbank financial institutions like AIG.

This more comprehensive approach may yet produce the desired results. But there is a clear sense in which the U.S. Treasury and the Fed have been playing financial “whack a mole.” This may reflect the very power of the analogy with the 1930s. It may reflect the difficulty of realizing that while history repeats itself it never repeats itself in exactly the same way.

There has also been a clear influence of ideology framing the response. The reluctance of the U.S. Treasury to use the Troubled Asset Relief Program (TARP) to inject equity capital into the banks reflected an ideological bias against government ownership of financial and nonfinancial firms. For months Treasury Secretary Paulson was unable to utter the word “nationalization” despite the all-but-unanimous insistence of professional economists that capital injections were essential for stabilizing the banks. Even then the U.S. government, unlike its British counterpart, refused to take voting shares in banks receiving public money, a step which would have enabled it to appoint members to their boards of directors. Officials then learned to their surprise that the banks preferred to use public funds for acquisitions rather than lending and that they could do nothing about it. One is reminded of the ideology of the gold standard, which prevented policy makers from responding to worsening economic conditions in the 1930s. The gold standard mentalité, as it is sometimes called, led contemporaries to associate economic stability with exchange rate stability even when all visible signs pointed to the opposite association. So long as the exchange rate remained stable, the prevailing ideology sanctioned inaction. One cannot help but think that ideology has similarly played a role in the current episode, both during the run-up, when the conviction that markets can take care of themselves

encouraged neglect of the authorities' supervisory responsibilities, and after the crisis erupted, when belief in limited government delayed the necessary steps.

None of this is to deny that policy makers have done better this time. Of course it would have been hard for them to do worse.

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There has also a good deal of international cooperation. Central banks have been in constant communication, which of course they also were in the 1930s. But in contrast to the 'thirties, this time there has been a readiness to back words with deeds. There have been very extensive currency swaps between the Federal Reserve System, European Central Bank, and Bank of England. There has been the extension of euro and dollar swap lines by the ECB to European countries outside the euro area and by the Federal Reserve to Mexico, Brazil, South Korea and Singapore. These liquidity swap facilities did not magically solve the financial problems of these countries. But it did relieve the immediate problem of dollar and euro shortages caused by the repatriation of funds by U.S hedge funds and European commercial banks. This is quite unlike the situation in the 1930s, when France delayed and then scaled back the extension of credits to Austria through the Bank for International Settlements owing to talks about the formation of an Austrian-German customs union and Germany's decision to build pocket battle ships, both in violation of the terms of the Versailles Treaty – a decision that allowed the European financial crisis to spiral out of control.

Asia is the one place where there are audible echoes of the interwar tangle between France and Germany. Relations between China and Japan resemble those between France and Germany after World War I more than after World War II. While Asian countries have created a regional system of financial supports known as the Chiang Mai Initiative, they have not been

willing to activate it. Delicate political relations make it impossible for Asian countries to demand policy adjustments by their neighbors, in whose absence they are reluctant to put their money at risk.

To finesse this point, disbursing credits through the Chiang Mai Initiative, after the first 20 per cent, requires the recipient to negotiate an adjustment program with the International Monetary Fund, but with memories of the 1997-8 financial crisis still raw, governments are unwilling to approach the Fund. (Recall that the 1997-8 crisis is known in Asia as the “IMF crisis.”) Beijing prefers to see the creation of a more extensive financial support system within the region, while Tokyo resists this on the grounds that China would be the dominant party in that system. The Japanese government for its part would prefer recycling Asian reserves through the IMF, where it has twice the voting power of China and designates one of the deputy managing directors, whereas China, whose voting power in the Fund is roughly equivalent to that of Belgium, is understandably reluctant to go this route.

It is tempting to draw an analogy between China’s reluctance to top up the financial resources of the IMF and the refusal of the United States to join the League of Nations after World War I. Pushing this further, there is the parallel with Charles’ Kindleberger’s interpretation of the interwar depression – that it resulted from the inability of the declining power, Great Britain, to exert leadership and the unwillingness of the rising power, the United States, to do so. In fact this comparison is overdrawn. China’s economy is still less than a quarter the size of that of the United States at market exchange rates, where it is market exchange rates that matter for international transactions. In contrast, the United States had already surpassed Britain in absolute economic size in the 1870s, as an exporter in 1915, and as an international creditor in 1917. A Chinese contribution would be helpful for solving current

problems, no doubt. But China is not yet in the position to exert the kind of leadership that could be reasonably expected of the United States in 1929.

In fact, China has displayed both leadership and restraint: leadership in the application of fiscal stimulus, having announced a big new government spending package in early November 2008, and restraint in managing its portfolio of dollar securities. In 1931, following the devaluation of sterling, which inflicted losses on central banks holding reserves in London, the Bank of France, the National Bank of Belgium and other central banks liquidated not just their sterling balances but also their dollar reserves, aggravating the credit crisis in the United States. This time neither the outbreak of the subprime crisis nor the problems of Fannie Mae and Freddie Mac have caused the Chinese to stop buying U.S. treasury and agency securities, much less to liquidate their existing holdings.

Can China do more? It would be useful for the country to recycle some of its foreign reserves through the IMF, which desperately needs additional financial firepower to aid emerging markets. The question is what Beijing can expect in return. A larger voice in the Fund is the obvious answer, the problem being that quota revision takes time. The last round of revisions took two years to negotiate and produced a mouse. That 180 some countries were involved in these negotiations of course renders the disappointing outcome less than a surprise and cautions against going the same route again.

Another possibility is making China a member of the G7, the ad hoc steering committee for the world economy. An appropriate G7 for the 21st century would be made up of the US, the EU, Japan, China, Saudi Arabia, South Africa and Brazil. Others might argue for including, say, India, but three Asian countries out of seven is a handful, and a true global steering committee should have representation from the oil exporting countries, Africa and Latin America. Be this

as it may, this is a parlor game any number can play. The important innovation would be to include China. While there also exists the trendier Group of Twenty, 20 is too many for an emergency conference call. This was a lesson of the “New Bretton Woods Conference” on 15 November 2008. A five hour conference with 20 participants was fully occupied by the 15 minute opening statements, leaving no time for serious deliberation.

A third possibility is agreement by Tokyo to simultaneously pursue the option of an Asian monetary fund or Asian reserve pool with Beijing as co-leader. This would require Tokyo’s asset to China doubling its contribution to the Chiang Mai Initiative so that it matches that of Japan.

But whichever route is taken, not accommodating the rising power by giving it a seat at the table and a voice in key deliberations is a recipe for disaster.

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Given the manifest failure of the international financial system, one increasingly hears the question of whether globalization might now be rolled back. It is all but certain that financial globalization will be rolled back. National financial systems will be more tightly regulated. Banks will have less freedom to buy collateralized debt obligations or whatever new derivative securities succeed them. International financial transactions relying on credit such as the carry trade, where investors borrow in markets like Japan where interest rates are low and invest in emerging markets promising higher yields, will be more difficult to finance. It had of course been the same carry trade that contributed to the unstable equilibrium of the late 1920s, as investors funded themselves at 3 per cent in New York and Paris in order to lend to Germany at 6 or 8 per cent. Then as now, the migration of capital from low- to high-interest-rate countries was predicated on the mirage of stable exchange rates, which ultimately dissolved, with disastrous consequences. This points to the urgency of one policy reform, namely greater exchange rate

flexibility on an ongoing basis to remind market participants of this risk, so they do not repeat, yet again, this same dangerous mistake.

In the current crisis, countries on the receiving end of capital inflows have suffered the gravest difficulties as those flows reversed direction and current account deficits became impossible to finance. Countries like South Korea, where half of all domestic stock market capitalization was owned by foreigners, mainly hedge funds, have seen their markets crash as those foreigners repatriated their funds in order to repair their balance sheets. In contrast, countries that had most strongly resisted the internationalization of their financial markets have suffered less serious disruptions. This experience reinforces a growing body of scholarly work that questions the benefits of portfolio capital inflows.

Thus, not only will the countries that have been the source of the capital flows be less able to provide them, but those on the receiving end will be less willing to accept them. They will deploy regulations and controls, both transparent and covert, to limit their volume. They will keep them in place until as long as memories of the crisis remain vivid. The time involved may be measured in decades rather than years if the experience of the 1930s is any guide.

But what is true of finance is less obviously true of other aspects of globalization. International trade has been booming. Most economic forecasts may not be worth the paper they are written on, but trade is still forecast to rise in 2009 (this according to the IMF's November update of its *World Economic Outlook*). Global supply chains and regional production networks have grown exponentially. U.S. appliance manufacturers do their assembly in Mexico. German auto companies source many of their parts in Eastern Europe. East Asia is of course the prime case in point. The region's vertical intra-industry trade (essentially trade in parts and

components) has been growing explosively. China is effectively been serving as a gigantic assembly platform for not just the region but the world.

Fundamentally these developments reflect declining transport costs. The cost of air transport has fallen by two-thirds since 1950. Ocean freight rates have fallen by a quarter as a result of containerization and related advances. And what is true of transportation is even truer of communication: the cost of satellite communications is barely 5 per cent what it was in the 1970s. Then there is the cost of communicating via the Internet, a medium which didn't even exist four decades ago. Low costs of communication allow just-in-time sourcing, with direct electronic links between the cash register in Des Moines and the factory in Guangdong. The outsourcing of back office services, transcription, data entry, and now software engineering and financial analysis to economies like India reflects these fundamental advances in communications technology which are not going to be rolled back.

Admittedly, there are channels through which the backlash against financial globalization could spread. Consider the complementarity between international finance and international trade. Trade grows more quickly when there is easy access to trade finance. Already the difficulty of securing letters of credit, which are important both for financing export transactions and giving exporters confidence that they will be paid, has had a depressing effect on export and import transactions. HSBC, a leading trade finance bank, reported in November that the cost of insuring a letter of credit had doubled as a result of the crisis. Still, this is more an effect of the crisis than an indication of the post-crisis regime. Even if cross-border financial transactions remain more limited than in the past, it will still be possible for U.S. exporters to get trade credit from U.S. banks and for Korean exporters to get trade credit from Korean banks.

There is also a complementarity between the politics of domestic economic liberalization

and the politics of globalization. If the crisis results in an extended period of high unemployment, the voting public may grow disenchanted with the prevailing policy regime, which they identify with economic liberalization. They may grow disaffected with globalization on the grounds that it has failed to deliver the goods. This backlash could be across the board. There are some disturbing indications from the U.S. presidential election, such the not-so-veiled protectionist rhetoric of Barak Obama during the Ohio primary. Here it will be important for our leaders to make the case free and open trade, and specifically for President Obama to counter the impression left by Candidate Obama. It will be important for leaders to draw a firm distinction between financial globalization and other aspects of globalization. It will be important for them to draw a distinction between the need for tighter regulation of financial markets, where the justification is clear on consumer protection, market integrity and systemic stability grounds, and tighter regulation of other markets, where the need is less evident and the response should be on a case-by-case basis.

These distinctions were not sharply drawn in the 1930s, when there was a political backlash against both trade and finance, and when governments intervened equally in domestic and international markets. Experience after World War II is more reassuring. Global trade expanded enormously in the third quarter of the 20th century despite the fact that international financial transactions remained heavily controlled. And notwithstanding enduring political hostility to the deregulation of financial markets and liberalization of international financial flows, political consensus favoring trade liberalization was successfully maintained through

successive GATT rounds stretching over half a century. This offers at least cautious grounds for hoping that the same will again be possible.

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This reference to the GATT brings us full circle back to the financial crisis. What I mean is this. The GATT reflected a recognition of the importance of countries cooperating on their trade policies. Restrictive national policies could have negative repercussions for other countries. Efforts to move in the direction of freer trade faced a difficult free-rider problem. At the same time, sovereign states were unwilling to delegate responsibility for their trade policies to a supranational entity. The GATT was a middle way between nationalism and supranationalism. It established a process through which countries could move together in the direction of greater trade liberalization and avoid beggar-thy-neighbor policies.

The GATT was also a more limited alternative to the International Trade Organisation, the third of the Bretton Woods triplets, along with the IMF and World Bank. (The ITO was actually negotiated in Havana in 1948, of course, not at Bretton Woods, presumably because the Bretton Woods Conference was dominated by treasury and finance, not trade, officials.) The ITO died a quiet death in 1950 when the U.S. Congress failed to support U.S. participation. Congress' fear was that the ITO would infringe on U.S. sovereignty. It would have had the power to override U.S. laws that conflicted with the provisions of its Charter. The less bureaucratic and more ad hoc General Agreement on Tariffs and Trade was then put in its place. Eventually, after 48 years of experience with the latter, the World Trade Organisation, which is reminiscent of the ITO, succeeded it. The WTO features binding obligations for members, dispute settlement panels of independent experts to determine whether countries are in violation

of those obligations, and penalties and sanctions for countries that fail to comply.

It is now time to move in the same direction for finance. A GATT-like process to foster closer cooperation on supervision and regulation, internalize cross-border externalities and avoid beggar-thy-neighbor financial policies has already been proposed, notably Gordon Brown. The brains behind this operation, which would describe best practice and define the obligations of members, would be the Financial Stability Forum of finance and supervisory officials. Membership of the FSF, which currently includes only representatives of the F7 countries, Hong Kong and Singapore (which are important financial centers) and the relevant international organizations would have to be expanded to ensure its representativeness and legitimacy. Fortunately, this was already agreed to by G20 leaders at the summit on November 15th. The result would be a college of regulators, where information would be shared and best practice would be defined.

Where the FSF would provide the brains, the IMF would supply the brawn. Acting as the financial cop on the beat, it would monitor the compliance of countries with best practice and sound alarm bells on detecting violations. Naming and shaming countries would intensify both market discipline (it would become more expensive for their banks to fund themselves) and peer pressure (the country's officials would presumably be shunned by other members of the college). A process like this, it is argued, would have forced the excesses that led to the subprime crisis.

While these are positive steps, the truth is that they constitute little more than incremental improvements in existing arrangements. The FSF already provides guidance on best practice in supervision and regulation, such as its "Report on Enhancing Market and Institutional Resilience" issued in April 2008. The IMF already conducts reviews of supervision and regulation in its member countries (so-called Financial Sector Assessment Programs undertaken

jointly with the World Bank). But the Fund is reluctant to name and shame its members, especially large ones. It is understandably hesitant to bite the hand that feeds it. At a minimum, serving as cop on the beat would require a more independent IMF, the case for which some of us have been arguing for years.

A more ambitious alternative would be a World Financial Organisation akin to the World Trade Organisation. Membership would be obligatory for all countries seeking freedom of access to foreign markets for domestically-chartered financial institutions. The WFO would define obligations for its members; they would have to meet international standards for the supervision and regulation of their financial markets and institutions. It would empower independent panels of wise men to determine whether countries were in compliance with those obligations. Importantly, it would authorize the imposition of sanctions against countries that failed to comply. Other countries would be within their rights to restrict the ability of banks and nonbank financial institutions chartered in the offending country to do business in their markets. This, then, would provide a real incentive to comply.

The move to a WFO would presumably occur after some years of satisfactory experience with its GATT-like predecessor – hopefully less than half a century. It will be objected that countries like the United States would never let an international organization dictate its domestic regulatory policies. The rebuttal is that the WFO would not dictate. The specifics of implementation would still be left up to the individual country. There would be scope for the United States to tailor supervision and regulation to the peculiarities of its financial markets. But those specifics would have to comply with the broad principles set down in the WFO charter and associated documents. We already do the equivalent for trade. Dispute settlement panels already determine whether, inter alia, U.S. tariffs on timber imports from Canada are in compliance with

our WTO obligations. If not, we have the choice of whether to change those laws or incur sanctions and retaliation. If the U.S. accepts this in the case of trade, why should it not accept it for finance?

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