

Is The Global Financial Crisis a Liberal Crisis?

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September 9, 2009

It depends what *liberal* means

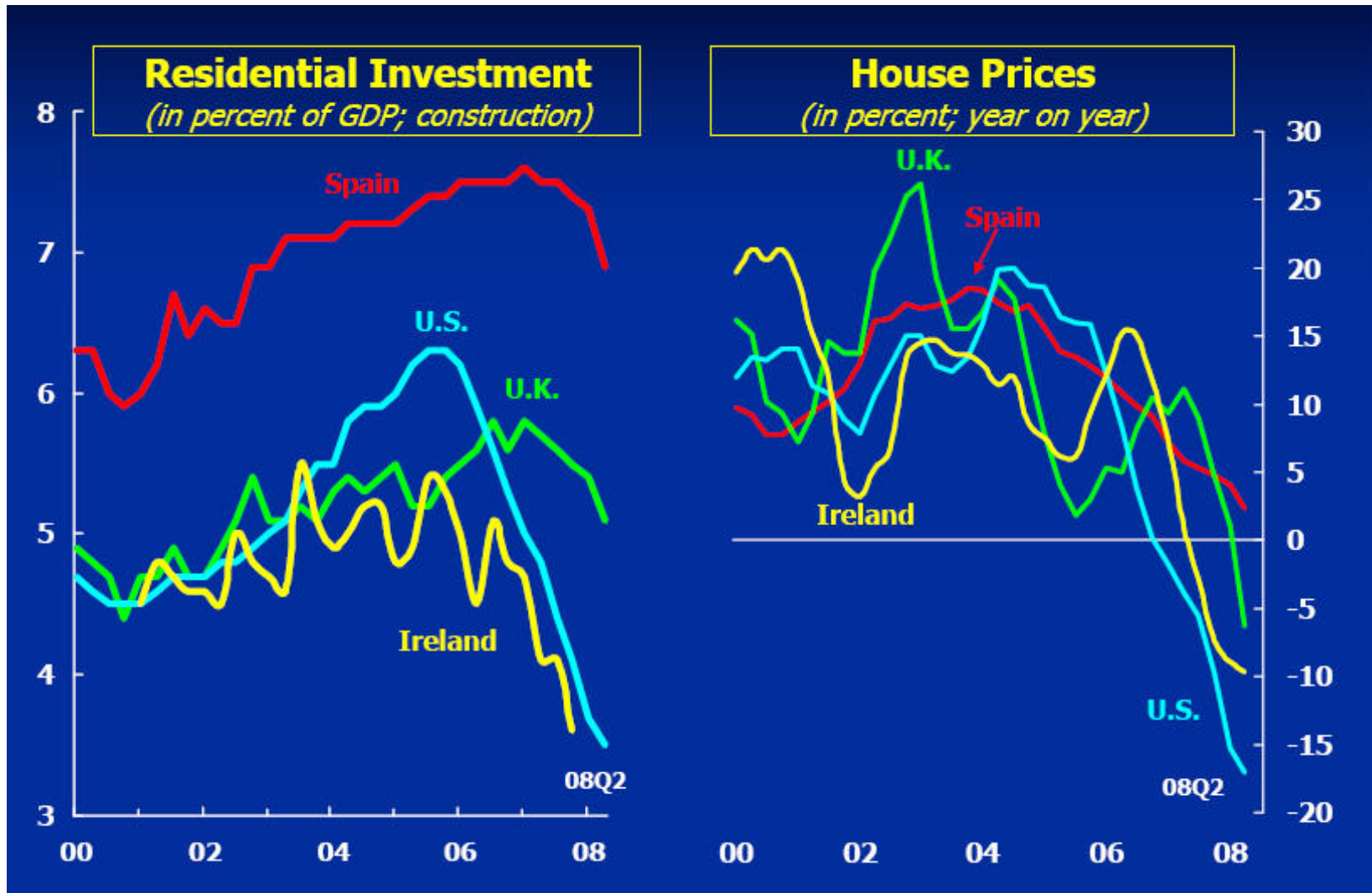
- **NO** if it means "tending in favor of freedom and democracy" or "associated with ideals of individual especially economic freedom, greater individual participation in government, and constitutional, political, and administrative reforms designed to secure these objectives"
- **YES** if it means "that particular brand of free-market fundamentalism, extreme capitalism and excessive greed which became the economic orthodoxy of our time" (Kevin Rudd's straw man)

Bernanke's Description of the Situation Six Months Months Ago

Global financial system has been under extraordinary stress for almost one and a half years.

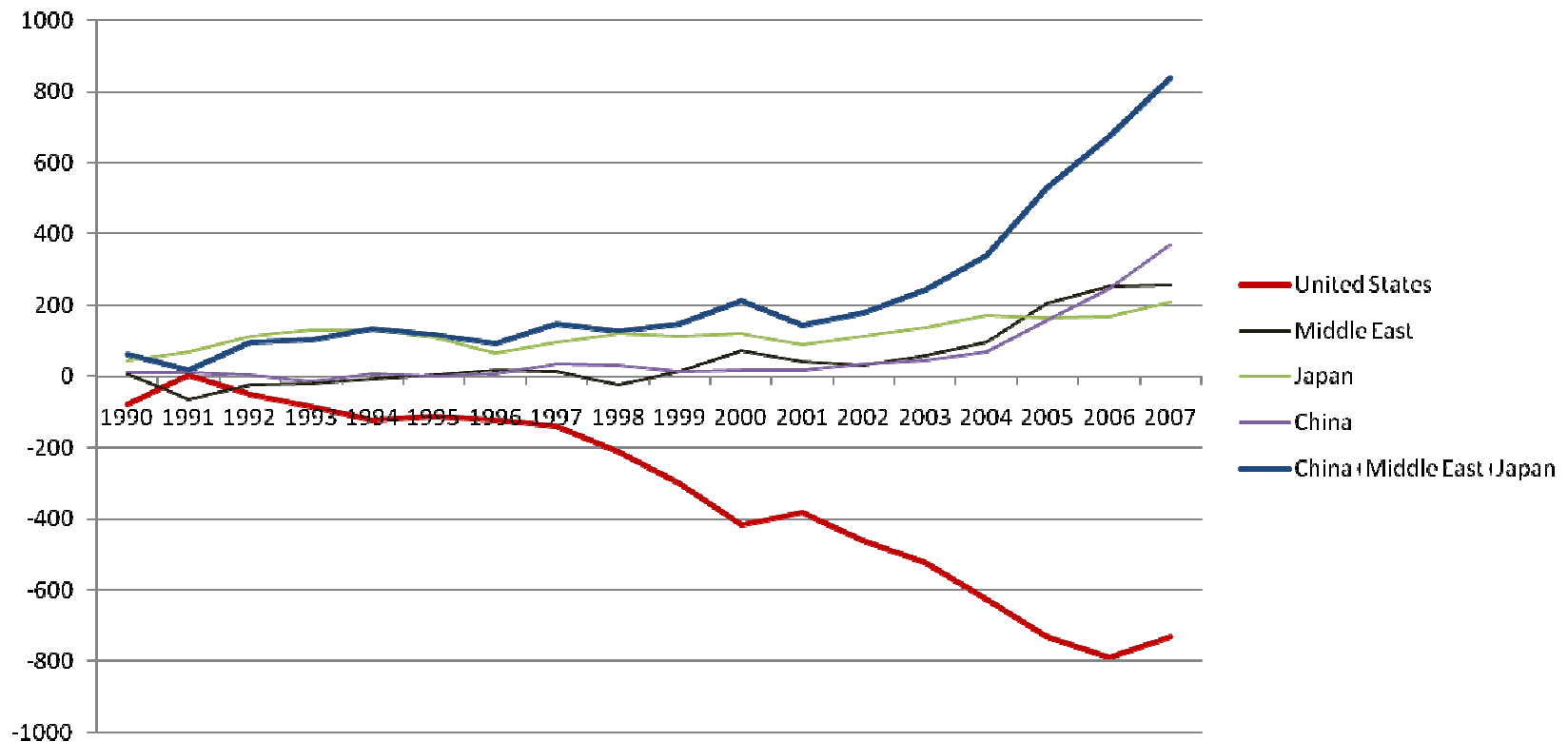
The stress has spilled over broadly over the global economy

Huge savings from Asia, Germany and oil-exporting countries and leveraging (expanded by opaque derivatives such as CDOs, MBS) financed a housing bubble, not just in the United States but other countries like U.K., Ireland and Spain as well.



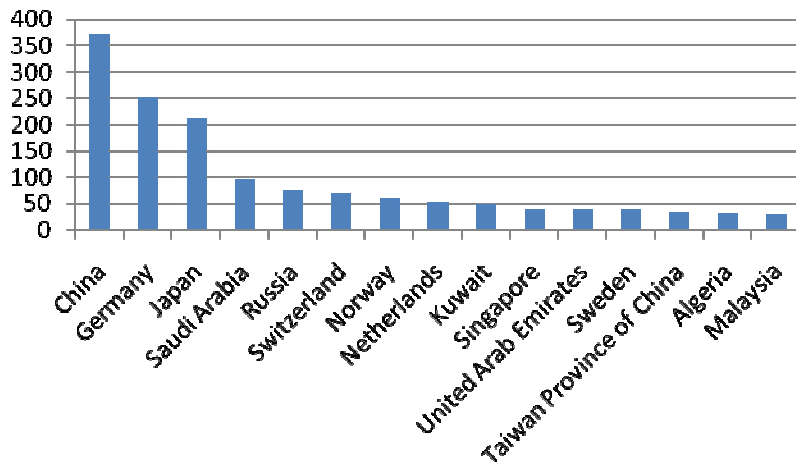
Rapid growth of US aggregate demand was the main driver of global economic growth. But this was financed by a rapid and unsustainable growth debt and current account deficits.

Current Account Balances of the US, China, Japan and the Middle East (in million US\$)

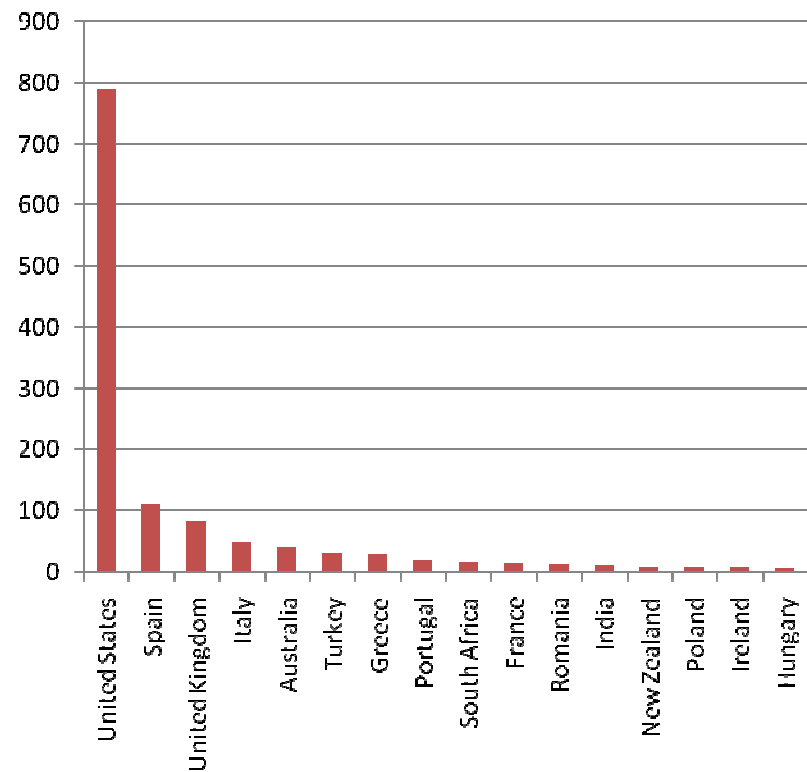


U.S. share of the BOP total current acct. deficit is larger than the combined share of China, Germany, Japan and Saudi Arabia in the total current account surplus.

Countries with the Biggest Current Account Surpluses (Billion US\$) in 2007



Countries with Biggest Current Account Deficit in 2007



It was not just a housing and real estate bubble; it was also a stock market and bond market bubble

**Dow Jones Industrial Average:
1990-2008**

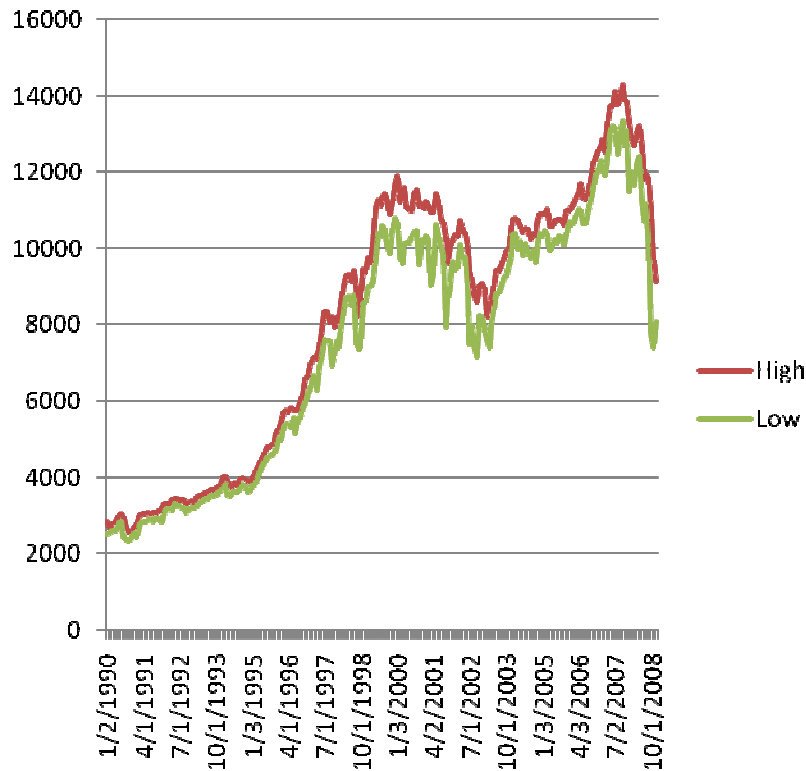
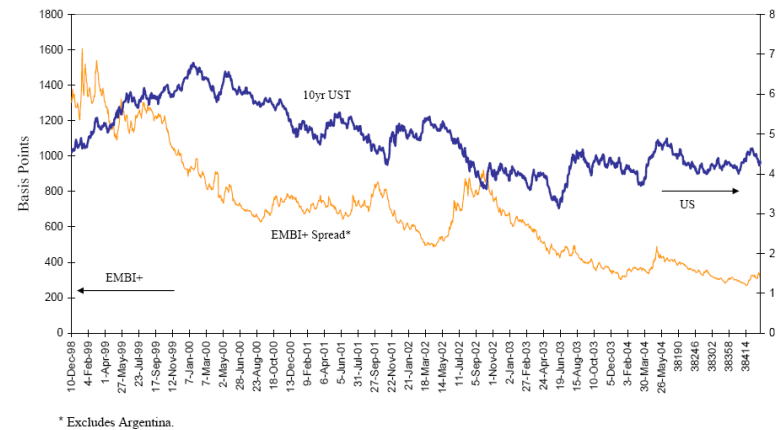
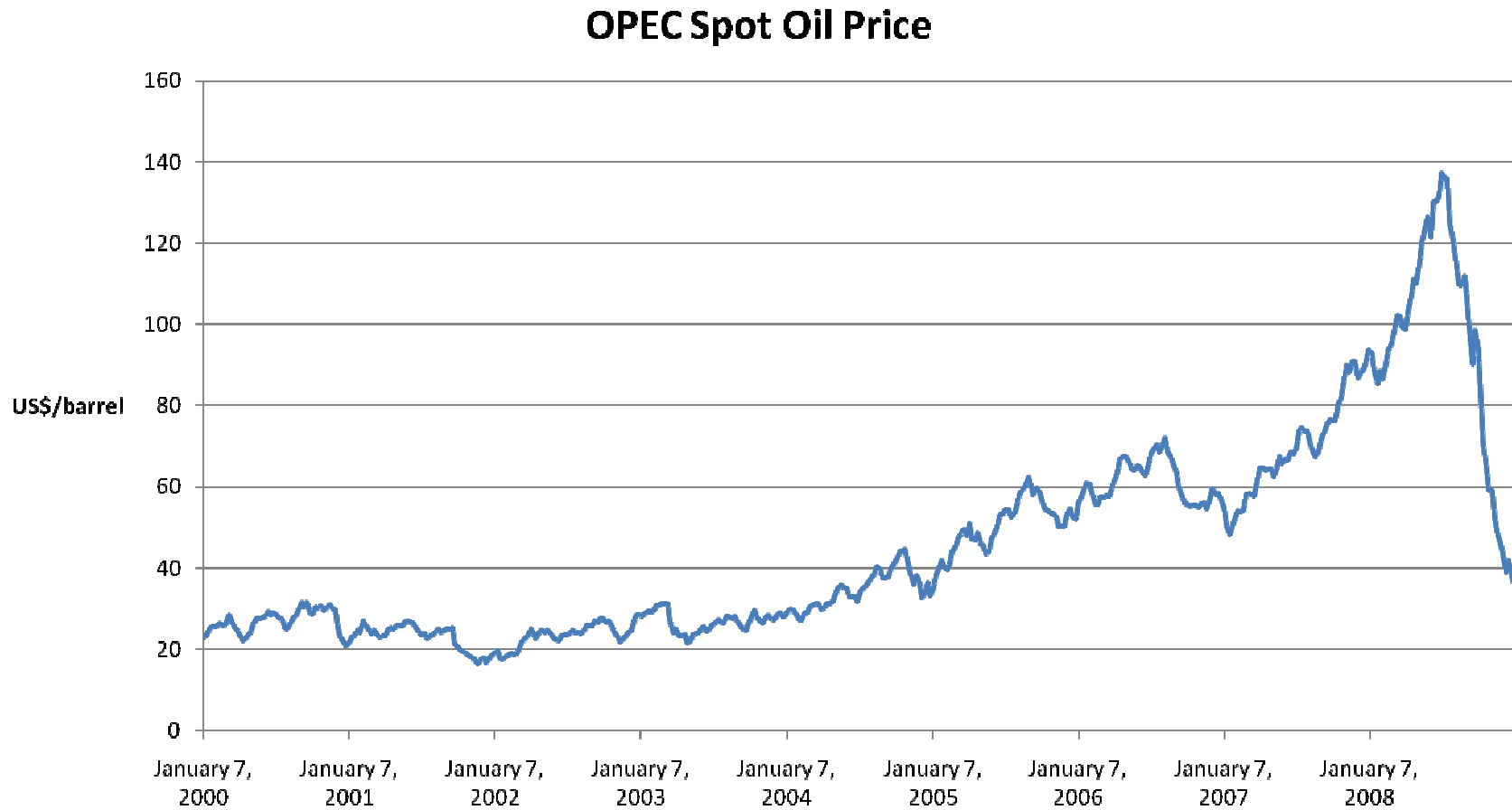


Figure 2 Yield on U.S. Ten-Year Treasury Bond vs EMBI+ Spread*



* Excludes Argentina.

It was also a commodity bubble.



Is the GFC a crisis for mainstream Anglo-American Macroeconomics?

Krugman classifies mainstream macroeconomists as:

- (a) “those who insisted that free-market economies never go astray”
- (b) “those who believed that economies may stray now and then but that any major deviations from the path of prosperity could and would be corrected by the all-powerful Fed.”
- (c) Or a milder version (b): It’s less costly to clean up after the bursting of bubbles than to try anticipate them and prevent them from occurring . The cost to the economy of tightening money supply and credit to prick self-limiting, or even non-existing, bubbles was assumed to be much higher than the cost of dealing with bubbles after they burst. (The ability of monetary authorities to anticipate bubbles is weak and bubbles tend to be small relative to the macro-economy and the powers of the FED, e.g. LTCM.)

Taylor rule best exemplifies what was wrong with mainstream macroeconomics

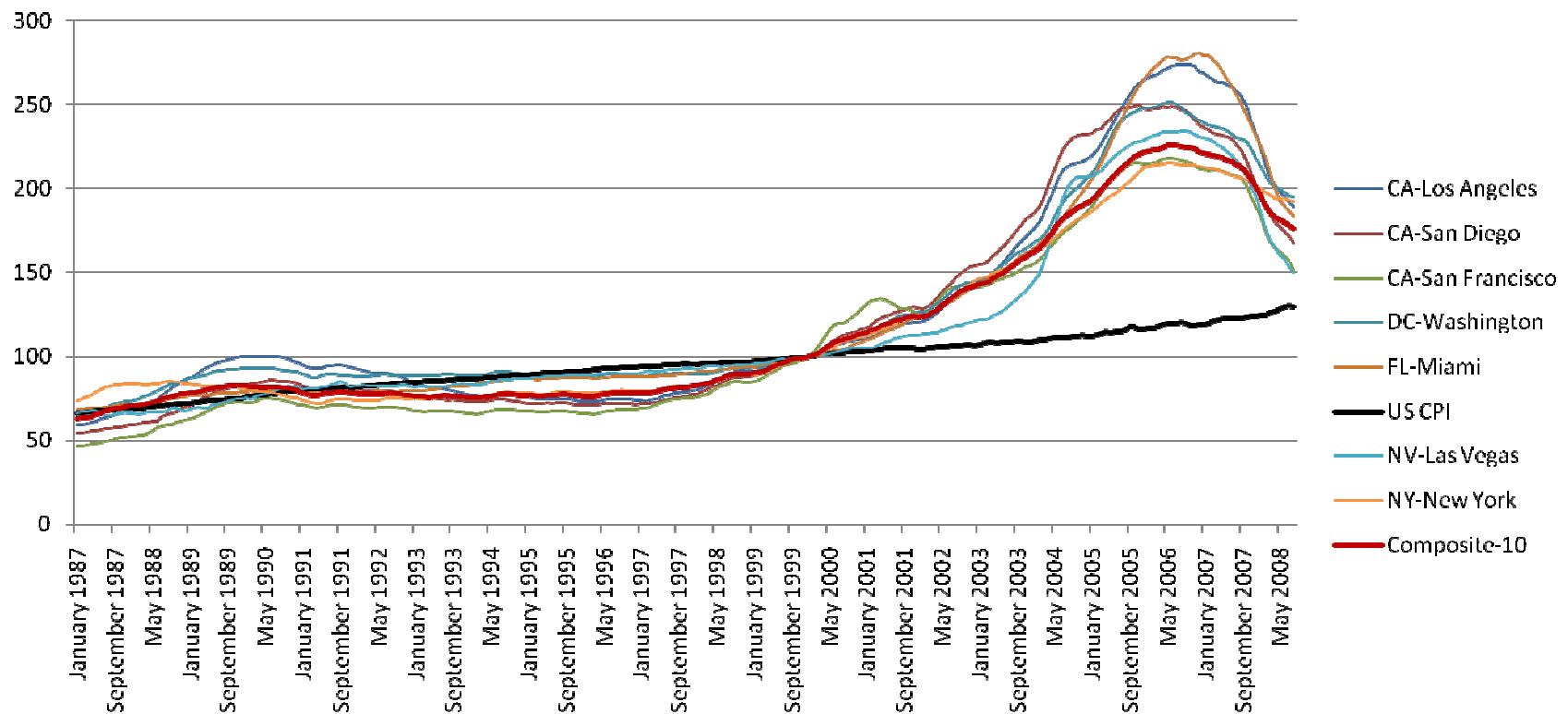
Taylor rule is mainstream macroeconomics' monetary-policy prescription that stipulates how much the central bank should change the nominal interest rate in response to divergences of actual inflation rates from *target* inflation rates and of actual Gross Domestic Product (GDP) from *potential* GDP

$$i_t = r_t^* + a(\pi_t - \pi_t^*) + b(y_t - y_t^*)$$

Asset and real estate prices are not in the equation because of the implicit assumption that market imperfections are in the goods and labor markets, not in the financial markets)

In spite of warnings from economists like Shiller and Roubini, the FED did not raise interest rates because inflation was low.

S&P/Case-Shiller Home Price Indices
Jan. 1987 to Aug. 2008



Funded by global (e.g., Asian) savings, excess liquidity from the US Federal Reserve and complicated and opaque financial derivatives (e.g., CDO's, CDS), large banks and investment houses acquired a lot assets (for Lehman Bros. nearly 30 times equity). When asset prices rose, they made a killing. When asset prices fell, they became bankrupt or nearly bankrupt.

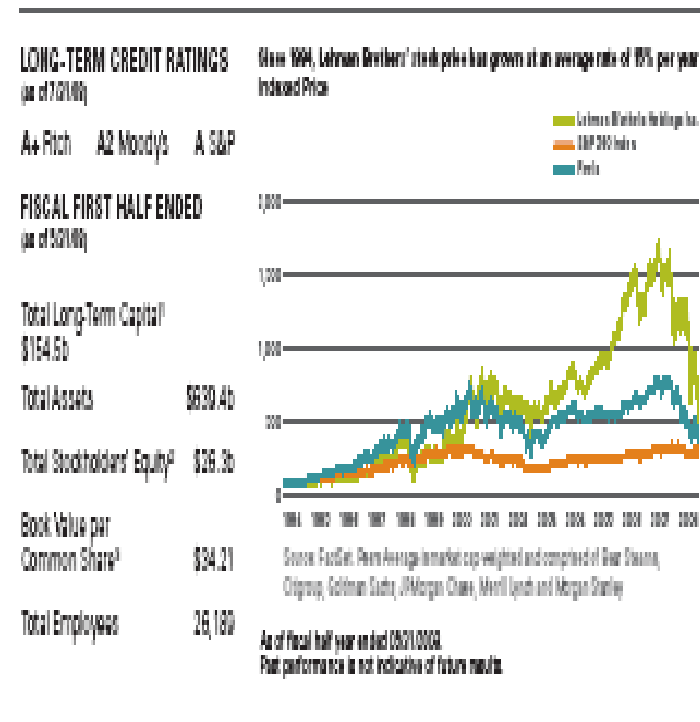
Lehman in June 2008, before it went bankrupt

Credit ratings --- *Fitch A+, Moody's A2, S&P A*

Total Assets ---\$639 B

Long-Term Capital --- \$155 billion

Shareholders Equity---- \$26 billion



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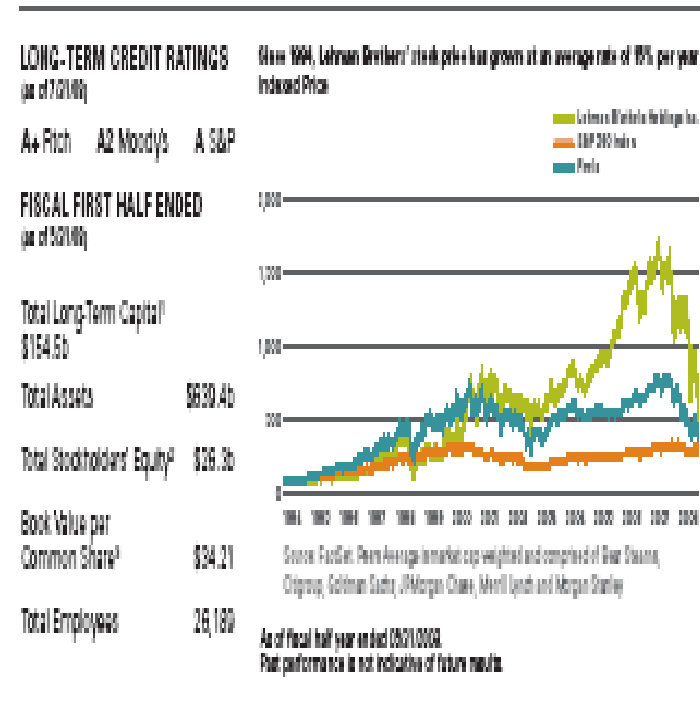
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So many things had to happen to cause the Global Crisis--- and they all happened.

1. Global saving glut that resulted from the rise in the incomes of the BRICs and the Oil Exporting Countries, (depressing interest rates and driving the search for new safe assets, which turned out to be unsafe).
2. After the collapse of the tech bubble in 2000 - 2001, US monetary policy was too expansionary starting 2003, flooding the world with excess liquidity. Monetary authorities were not concerned that this caused a real estate bubble because it did not result in consumer price inflation, because supply from China reduced inflation.
3. The unsustainable current account deficit of the US seemed sustainable through the willingness of China and other Asian and emerging markets to accumulate large dollar reserves.

So many things had to happen to cause the Global Crisis--- and they all happened (continuation)

4. Regulatory and supervisory failures which occurred after the shift to a self-regulating version of the transactions-oriented from a relationships-oriented model of financial intermediation (TOM from ROM) and the creation of new derivatives (e.g., in 2004 the US SEC abolished net capital rule, which had limited broker-dealers and investment banks like Lehman, Bear Stearns, Lehman Brothers, Merrill Lynch, Goldman Sachs, and Morgan Stanley to a 12-to-1 leverage)
5. Political pressure to give implicit government guarantees to housing loans (e.g., Fannie Mae and Freddie Mac)
6. 30 years of high growth and macroeconomic stability (the “Great Age of Moderation”) bred complacency and excessive risk taking

There's plenty to share the blame. Does this make the GFC a failure of capitalism? Or is it simply Murphy's law?

- **The FED for creating too much liquidity and thinking that monetary policies should not be concerned with asset prices**
- **Rating agencies for giving high ratings to bad debt instruments.**
- **Politicians for giving implicit guarantees to housing loans**
- **Banks for making bad loans**
- **The shadow banking system for securitizing the bad loans**
- **Economists and regulators for failing to see that the increase in moral hazard resulting from shift from TOM to ROM posed a great threat to the system .**
- **Economists for preferring mathematical elegance to relevance of their models**
- **The Chinese government for preferring to finance excess American housing than Chinese consumption**

Is this a liberal crisis or just the cost of learning-by-doing in a decentralized and globalized economic system? Will this swing the pendulum from too little to too much regulation of the financial sector? Will the new regulations raise cost without increasing safety?