Origins of the Credit Crisis

Two overlooked structural mismatches.

BY BERNARD CONNOLLY

Throughout this decade this writer has argued that massive intertemporal misallocation in the world—too much bringing forward of spending from the future—would create an economic shock as severe as that of the 1930s unless firms and households were given more and more incentives to keep on bringing spending forward. But giving them those incentives would involve bubbles and Ponzi games. Ultimately, the choice would lie between much more extensive government control of many areas of financial and economic activity, and a devastating financial and economic collapse—a collapse whose political consequences would be unpredictable in detail but almost certainly malign.

That choice has been staring the world in the face for several months. But the underlying reasons for the terrible choice have still not been understood. Blame is being misdirected, and policy reactions are likely to be misguided. Most emphatically, the crisis does not represent a failure of capitalism; rather, it represents a failure of governmental (including central bank) involvement in capitalism.

Whether hundreds of banks lent and hundreds of millions of households borrowed without sufficient regard for ability to pay is a question with a moral aspect. But the nature of bankers' and households' moral universe, whatever it is, is unlikely to have changed much in recent years. What caused the crisis was not a sudden disappearance of a moral compass. The most important factors were two structural mismatches in the world

Bernard Connolly is an independent economic consultant in London.

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888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

Alan Greenspan

Alan Greenspan's Misunderstanding of Capitalism

The Greenspan Fed signally failed to understand the implications of the mid-1990s productivity acceleration in the United States. In effect, then-Fed Chairman Alan Greenspan failed to understand how capitalism works. When some firms have good ideas and their anticipated rate of return goes up, what should happen (cutting a few analytical corners) is that rising interest rates crowd out less good investment ideas elsewhere, ensuring that investment resources are allocated as efficiently as possible, both among firms and over time. If that does not happen, there will be over-investment, and inefficient investment. Too much spending is brought forward from the future. When the future beckons, there is an incipient investment crash as firms belatedly realize consumption demand cannot be strong enough to take up all the output of newly installed capacity. That is what looked likely to happen in the United States at the end of 2000. The Fed responded by pushing rates down hard. That prevented "liquidation." But it exacerbated the problem of bringing too much spending forward from the future. And, until the day of the Apocalypse, the future will keep on coming.

—B. Connolly

economic and financial system. One was between the spread of "Anglo-Saxon" financial markets and the victory of the Bundesbank model of central banking. The second was between the globalization (in effect, the de-nationalization) of financial markets and economic activity on the one hand and the persistence of potentially overriding geopolitical considerations on the other. Together, these two structural mismatches sent extremely strong perverse signals that constituted massive moral hazard.

What are central banks for? In the beginning, banks such as the Riksbank and the Bank of England were created to finance wars. But by the final third of the nineteenth century, social choices had been made in many countries that the central bank's function was to protect depositors via a lender-of-last resort function. Central bankers might insist that the objective was preventing systemic problems caused by the collapse of a solvent but illiquid bank. But the politics went beyond that, increasing the degree of moral hazard.

Moral hazard in financial markets is tolerable only as long as central banks see their lender-of-last resort function—and a desire not to have to exercise it—as the overriding one. That is, the very existence of central banks implies that their main focus should be on financial stability. But, just as financial markets were becoming, from the mid-1980s onwards, more innovative, more globalized and, in many countries, less heavily regulated—that is, as world financial markets became more "Anglo-Saxon" again—increasing the need for central banks to concentrate on ensuring that the lender-of-last-resort function would not need to be exercised—the trend of central banking philosophy and practice was moving in precisely the wrong direction: the Bundesbank model (ironically, initially imposed in Germany by the "Anglo-Saxon" post-war occupation authorities) was gaining sway.

Because the Americans and British wanted to diffuse power within post-war (West) Germany, they insisted that a central bank (initially, the Bank deutscher Länder) must be as politically independent as possible within a democratic framework. Reconciling central bank independence with democratic accountability (a trick not achieved in European monetary union, of course) meant restricting the focus of the bank. Given the common, if arguably mistaken, identification of Weimar instability with the 1923 hyperinflation (and with the post-war hyperinflation having just taken place), the natural focus was price stability. In the extremely conservative, diffuse, de-developed and essentially insular German financial system of the 1950s and 1960s, additionally restrained by the capital-controls world of Bretton Woods, there was little systemic financial risk. The central bank could happily focus on price stability.

In the 1970s, the central banking mistakes in most of the world—failing to understand that negative supply shocks implied a lower "natural" rate of output and lower real wages if serious inflation was to be avoided—led to widespread admiration of the Bundesbank, encompassing both its independence and its price stability focus. In the 1980s, governments around the world began moving

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to bring inflation down and at the same time to reduce the burden of financial market regulation and encourage innovation. The widespread failure of exchange-rate targeting gave additional impetus to the search for a new monetary policy anchor. It seemed a natural thing to mimic the Bundesbank model of an independent central bank wedded to price stability.

But the moves towards less regulated and more innovative financial markets and towards economic and financial globalization had very strong implications for monetary policy. In particular, "price stability" simply will not do in a dynamic, entrepreneurial, globalized, free-market capitalist system: the sort of system everyone should want. The essence of such a system is entrepreneurship and risk-taking: identifying and implementing investment projects with a high anticipated rate of return. Central banks managed to understand that the more entrepreneurial an economy is, the higher its rate of productivity growth will tend to be. But those central banks too often viewed accelerating productivity growth as meaning that interest rates did not have to be as high as otherwise. But if real *ex ante* rates of interest do not go up along with the expected rate of return, on average across the economy, capitalism is prevented from working properly. Asset price bubbles and Ponzi games become inevitable. The most accurate answer then, to the question of who created the created the credit bubble/Ponzi game is simple: the central banks in the second half of the 1990s.

The creation of a monetary union in Europe also contributed massively to the credit bubble.

Among those banks was the Greenspan Fed, which signally failed to understand the implications of the mid-1990s productivity acceleration in the United States. In effect, then-Fed Chairman Alan Greenspan failed to understand how capitalism works. When some firms have good ideas and

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Suppose there had not been a credit bubble in the middle of this decade. Suppose, that is, that banks and households had not responded to central bank signals. Less spending would have been brought forward. But to keep output at its natural rate and to prevent inflation sliding below target, central banks would have felt they had to push interest rates even lower relative to the level they thought appropriate given what actually happened. Even-lower rates would have accentuated the "search for yield." Evidence of central bank determination to prevent the emergence of a negative output gap would have further increased markets' belief—already explicitly encouraged by the Fed—that recession would never happen. That combination would have created a credit bubble. To postulate the absence of a credit bubble in the middle of this decade is thus a reductio ad absurdum, irrespective of how one assesses bankers' or households' "moral compass."

It would be wrong to assign all the blame to the Greenspan Fed. The creation of a monetary union in Europe also contributed massively to the credit bubble. Monetary union replaces currency risk with credit risk. Credit spreads within the euro area should thus have increased. Instead, the European Central Bank's need, in the early days of the euro, to help out the then-uncompetitive German economy meant over-loose policy for the area as a whole and even more for the peripheral countries. And, amazingly, the ratings agencies actually upgraded peripheral-country entrants to monetary union—a decision that, logically, could only imply a belief in a bailout commitment. Asset price booms and credit bubbles were thus stoked in the periphery, with the inevitable subsequent bust now all too visible in countries such as Ireland, Spain, Portugal and—coming up on the rails—Greece, and adding to the global problem.

Next, one has to recognize that the macro Ponzi game implied by market pricing of interest-rate differentials and credits in the face of the U.S. current account deficit (a macro Ponzi game evident in intensified form in the case of countries such as Spain, Portugal, and Greece), implied a geopolitical dimension to credit assessments. There were—and are—only three possible ultimate outcomes to the problem of the U.S. current account. One is a massive contraction—perhaps on the order of 20 percent—in U.S. domestic demand that produces, in effect, a U.S. depression. The U.S. authorities will seek to prevent that. The second is a massive dollar depreciation that offsets, within the United States, the output and employment effects of a domestic demand contraction; the authorities in the rest of the world will seek to prevent that. The third is that the current account deficit runs on without adjustment, implying that foreign claims on the United States become worthless in the limit. Will the relevant foreign authorities, notably in China, Japan, and the Middle East, seek to prevent that? If the question were a purely an economic one, the answer would seem obvious. But very long-term geopolitical strategy will intrude, as in European monetary union. Nonetheless, the three options we have set out are the only ones available. Questions of moral responsibility, however they are answered, cannot alter this macroeconomic reality, just as they cannot alter the similarly stark choices facing monetary union in Europe. ◆