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THE FINANCIAL CRISIS AND THE AMERICAN ECONOMY.

The most dramatic events of the financial crisis in the United States began in the autumn of 2008 with the bankruptcy of some prominent financial institutions, the seizing up of financial markets, and the rapid contraction of the real economy. Similar sets of events have occurred before in market systems, and usually stem from the bursting of asset price bubbles, with the bubbles themselves caused by ‘cheap money’ and excessive risk taking. Fraud is also typically involved in both bubbles and their bursting.

The proximate causes of the present crisis lie in the bursting of the American housing bubble coupled to the securitization of mortgages and other types of debt. Bubbles occur when a large class of asset prices, like the prices of equities, or the prices of houses, is determined by the expectation of future capital gains resulting from further price rises of the asset class, rather than by the fundamental determinants of value. While in principle some bubbles might continue indefinitely, in actual history they have always burst, so prices begin to fall and those who hold the assets in question suffer losses. Securitization involves combining loans, like mortgages, or car loans, or credit card debt, into a security that can be sold and traded on financial markets. These securities are also known as derivatives, although the term derivatives also include other kinds of financial instruments like options and futures. Some derivatives are standardized products, traded on exchanges, with their value changing as the prices of the underlying assets change, or as the expectations of their prices in the future change. However, many other derivatives are ‘over the counter’ customized products, and can be complex and difficult to value accurately, so that their resale prices may be very volatile. In the present crisis, once the probabilities of default on which innumerable loans had been securitized were shown to be wholly erroneous by the bursting of the housing bubble, with house prices falling instead of continuing to rise as had been generally expected, the solvency of many financial institutions holding derivatives based on mortgages and related debts became suspect, and several bankruptcies occurred in the autumn of 2008. This brought about a general contraction of financial trading as fears for the continued viability of all borrowers in financial contracts increased significantly, and this in turn created a more general ‘credit crunch’ which adversely impacted the real economy.

Behind the bursting of the housing bubble, of course, lay the causes of the price bubble itself. They stemmed principally from the deregulation of finance under the Clinton and Bush Administrations, along with a failure to enforce the regulations that remained in place. In the years immediately preceding the crisis, monetary policy was also loose due in great part to the accumulation of large dollar reserves by other countries, especially China, which kept American interest rates low and inflation in check. The United States was able to import massive quantities of cheap manufactured goods, which kept rises in the domestic price level subdued, without facing any problem of financing its huge current account deficits because foreigners readily accepted American government debt denominated in dollars.

Unless significantly repressed by strict regulation, finance has long been recognized to be a uniquely powerful source of instability, especially under conditions where borrowing is easy and cheap. But, in the latter part of the twentieth century it became the conventional wisdom that financial innovation in securitization and other derivatives, along with the 'new economy' centered on computer technology, had reduced risks, spread remaining risk more efficiently, and so dampened instability. Thus it was widely believed that the experience of the past was a poor guide to the present and the future, and that deregulation was both productive and safe because 'this time is different'. The amount of capital that financial companies were required to hold as a proportion of their liabilities could be safely reduced, and the restrictions placed upon the categories of financial trading that various types of institutions were allowed to do could be safely relaxed. However, as the events of 2008 showed, the belief in there being a new era of finance fundamentally different from that of the past proved to be erroneous. Instead of being reliable instruments of risk reduction, or more efficient devices for allocating risk, derivatives concealed the true level of risk and allocated it in a disastrous manner.

Some of the effects of the financial crisis on the real economy have been made evident in data released by the Congressional Budget Office (CBO). The CBO has shown that the American economy is currently producing a trillion dollars less than potential, and that the unemployment rate has approximately doubled since the onset of the crisis. However, the effects of the financial crisis might have been much worse. While it is true that the Federal Reserve and the US Treasury had been negligent in carrying out their duties in the years preceding the crisis, when its seriousness became clear in the autumn of 2008 they acted dramatically to contain it. In effect, the Treasury partially recapitalized many private financial companies with public money, and the Federal Reserve intervened extensively to provide liquidity, lower interest rates, protect depositors, and rejuvenate financial markets by expanding its own purchases of financial assets and by acting as guarantor for the trades of other financial institutions. The Obama Administration complemented all this with a fiscal stimulus package in 2009, which provided an increase in effective demand from the public sector as a partial offset to the reduction stemming from the private sector. The overall effect succeeded in containing the crisis and contraction in the real economy (although hardly in the most efficient way possible, as will be indicated momentarily). The fear of another Great Depression, or much worse, has now subsided and economic growth has become positive again.

Nevertheless, there remains a significant danger of new financial crises occurring in the near future. So far, there has been no significant reform of finance in the United States (or elsewhere), and much of the *ancien regime* remains in place. Indeed, the likelihood of another crisis has been increased by the fact that public resources and guarantees underpin the risky activities of many financial institutions, so exacerbating moral hazard problems in which financial executives gamble with taxpayers' money as well as that of depositors and shareholders. Even if another financial crisis is avoided, on present policies economic growth is likely to be sluggish and the level of unemployment will remain high. This is a scenario that conforms to the historical pattern in which economic downturns resulting from financial crises (in contrast to those brought on by central bank attempts to control inflation, or from non-financial shocks) are deep and long enduring as households, companies and, eventually, governments attempt to reduce debt and repair their balance sheets. Federal government budget deficits are also forecast to continue long into the future. Many commentators have suggested that financing difficulties will soon be encountered here, but this seems overly alarmist. There are presently no indications of this concern in financial markets, and there should be none because the Federal debt to GDP ratio is relatively low by international standards, the USA is geo-political and geo-economic hegemon, and the American dollar remains the principal reserve currency.

Different policies could bring the actual growth path closer to its potential. Reforming finance should be the priority. In particular, institutions regarded as 'to big to fail' should be reduced in size whenever feasible, Chapter 11 bankruptcy procedures for financial companies need to be legislated, their capital requirements raised, accounting practices cleaned up, customized derivatives curtailed, the moral hazard inherent in bonus remuneration reduced, and new regulatory authorities created which are staffed by competent and activist specialists. The overall size of the financial sector is best shrunk and what remains organized to meet the needs of consumers and companies in the real economy. Both Paul Volker (Chairman of the Federal Reserve during the Reagan Administration) and Lord Turner (currently Chairman of the Financial Services Authority in the UK), as well as many other finance specialists, like Warren Buffet, have described most of the financial innovations of recent decades as socially useless or destructive. So far as the real economy is concerned, domestic absorption has to be reduced and redirected toward capital accumulation by promoting exports and investment, and decreasing consumption. This would shrink deficits on current account, promote growth and help protect the financial integrity of the United States as a whole. While it is advisable to maintain Federal budget deficits while there remains a significant shortfall of effective demand, deficits do need to be reduced systematically over the long run. Again, this would shore up the financial viability of the United States generally, especially in the face of an ageing population and the expansion of future entitlement expenditures. Monetary policy could accommodate this by remaining loose until the path of actual growth closes in on potential. However, the balanced budget restrictions operating at the level of the States need to be repealed so enabling these governments to carry out their responsibilities in a more sensible fashion.

Of course, all this is much easier said than done because attempts to change policy will encounter resistance. Another Great Depression has been avoided so far by 'bailing out' financial institutions rather than rejuvenating them in a new structure. The Obama Administration missed the boat on enacting appropriate financial changes by vacillating on important decisions and substituting bombast for policy statements, so that the financial sector has been allowed to recover much of its power and is once again well organized politically to protect its interests. It is difficult for the federal government to reduce the international value of the dollar without cooperation from other national governments, so that curtailing domestic absorption and current account deficits in an appropriate way may prove to be impossible. Similarly, budgets at the Federal and State levels are immune to much modification because of a breakdown in the cooperation of the political parties. The ‘grand bargains’ formulated by political elites after the Second World War, in the 1960s, and again in the 1980s, do not appear to be repeatable in the present conjuncture.

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Recommended reading.

G. Gibson, *The Origin of Financial Crises* (New York: Vintage, 2008).
C. M. Reinhart and K. S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009).
J.E.Stiglitz, *Freefall*, (New York: Norton, 2010).

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