Joseph Stiglitz Shadow Gn New York February 4/5 2009-02-03

The Crisis, the Solutions and More Problems

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The Nature of the Crisis:

The general lineaments of our current crisis are well known,

--A systemic breakdown of the Financial System in the G8 and beyond.

-- A massive write down of asset values and a logjam about valuing toxic assets which are still out there

-- Failures of banks especially universal banks but particularly investment banks due to excessive leveraging and carelessness about risk taking

-- the last mentioned may have been caused by a failure on part of the banks and major non-financial players eg insurance companies as well as the regulators to understand the nature of financial innovations which have sprung up in the 25 years since Black-Scholes which gave the impression that risk had been minimised if not eliminated and which also allowed banks to economise on cash and build a big inverted pyramid of credit on a slim cash base

--Despite the hype about globalisation and the fact that flows of credit were global (hence the puzzlement of European regulators when 'their' banks got into excessive risk taking) regulatory systems are still national and as in the case of USA (post Sarbanes/Oxley) and UK there is a ' beggar my neighbour' tactic among regulatory regimes

- BIS is the one institution that tried to lay down a global regulatory framework via BASLE 2 . It was criticised even when it was proposed as underestimating the risk banks were taking on;; but as BIS is the only global regulatory agency its capacity needs strengthening so that it gets the solution right next time around

-- Also the failure to appreciate that global imbalances could be recycled in the new global financial markets and the benevolent regime of low inflation and low interest rates and good growth was not due Alan Greenspan's genius but the Chinese ability to export cheap manufactures, sell them to the Americans and then lend the balance of payments surplus back to them

-- Lack of coordination among national regulators as between commodity trade and financial trade (missing out the overspill of money into commodity markets especially oil in late 2007 to mid 2008

--Echoing Sherlock Holmes the strange case of the dog that did not bark- IMF and BIS who failed to signal with any effectiveness the oncoming disaster; whatever happened to the Financial Stability Forum ?

Independently of the Financial systemic breakdown in terms of timing but now intimately correlated is the macroeconomic recession/depression which requires an urgent response because politically it hurts many more people;
Emerging market economies though somewhat insulated from the Financial systemic breakdown since they had not fully liberalised are feeling the impact of the macroeconomic recession and are experiencing a growth recession

Some European economies have had serious problems of sovereign solvency-Iceland in particular but also Hungary This has required IMF to shift its attention away from LDCs to DCs

Policy Response :

The general approach has been to

--Recapitalisation of banks by the Nation State after some initial private sector activity of takeovers, and bankruptcies

-- Aggressive fiscal spending with no traditional regard for Debt-GDP ratios--Keynes redidivus

-- Aggressive cutting of interest rates by central banks with no regard to inflation targeting etc.

BUT IT IS NOT WORKING; NOT AS YET

Credit between the banks and from the banks to the businesses is gummed up.

There is a feeling that the worst is not yet over and banks are sitting on toxic assets which have not seen the light of day.

The macro economy is not responding as yet to the various fiscal stimulus packages

Protectionism is rising in US and also in Europe.

WHAT CAN ECONOMIC THEORY SAY ABOUT THE CRISIS:

We did not know the financial system would all fail so totally, nor that the recession would be so deep and stubborn.

Even if some of us had doubts about the boasts of the Masters of the Universe, we did not and do not have a theoretical explanation of why and how. [Apologies to all who saw it coming clearly and have an unpublished Discussion Paper about it]

Walras has no money in his model. And no cycles- Real Business Cycle Theory notwithstanding.

Marx's theory of the cycle is the wage profit nexus and works independently of the financial system though in Volume III of Capital Marx does talk about 'fictitious capital' which has dubious value and can be priced high or low as sentiment changes.

Keynes does not have a theory of the financial system integrated into his macroeconomic analysis despite what some Post Keynesians may say. There is Minsky but his analytical model is not fully stated and cannot be used on this occasion.

Hayek does have a theory of bank misbehaviour-malinvestments as he calls them when a Wicksellian gap between the Natural Rate and the Market Rate opens up. The excessive liquidity of the last few years is that sort of gap. Banks take excessive risks according to Hayek (ignore his capital theory which is arcane and wrong). When they realise they have overstretched themselves (loss of gold in those Thirties days) they panic and the Market Rate shoots up way beyond the Natural Rate. A crisis occurs which leads to idle labour and idle capital.

Hayek lacked a policy prescription for making the idle resources work. His answer was to do nothing till the all the malinvestments –toxic assets ?- were washed out of the system and ' the natural gradient of prices was re-established '. Toxic assets may yet prove the main obstacle to restoring confidence in the banking system and hence in reflowing of credit.

Japanese experience lend support to a Hayekian view which requites a lot of time for the economy to get back to equilibrium. It is very likely in my view that the present crisis may also take a long time to sort out. The controversial aspect of Hayek's analysis is that the reflationary policy packages themselves cause the delay.

International Financial Architecture:

The global macroeconomics of financial imbalances has been not fully understood. Yet it is basic to the redesign of the international financial architecture (IFA). In 1942-44 at Bretton Woods, the creditor country USA had the clout and the British or at least Keynes had the ideas. The outcome was a mishmash and the Bank is the Fund and the fund is the Bank. There was also no symmetry as between surplus and deficit countries as Keynes wanted; he was from a deficit country but the surplus country cracked the whip.

IMF and World Bank are governed in an undemocratic fashion. IMF has not covered itself in glory It has given bad advice to developing countries over the last thirty years . It has failed to forewarn about the financial crisis and it has treated the Developed countries especially G1 more softly than the developing countries. Its voting system needs revamping. Its manner of appointing the head needs more transparency and wider reach.

This time around the creditors are China and other Asian countries and the Middle East oil exporters. The debtors are the countries which were in control originally and have stayed there. A central issue was the recycling of Chinese surpluses via US T-Bills which caused its won problems.

We need to examine whether a new asset can be created which can harbour global surpluses which can be defined in more currencies than the US dollar and may be across commodities too. This would remove some of the seigniorage gains from the US which can only be healthy. But will the US agree to such a reform?

There is as yet no proposal from the creditor countries and this is urgently needed before the April G 20 meeting. Bretton Woods had Keynes; where is the source of ideas for the current crisis and a new IFA?