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Credit Crunch and Recession: What Have we Learnt?

Martin Wolf

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Report by Matthew Shelley

The World after the Financial Crisis

Martin Wolf, Chief Economics Commentator for the Financial Times*, addressed the causes of the current economic crisis and the prospects for recovery. His lecture concentrated on the UK, whilst placing it within a global context. The event was organised by the Royal Society of Edinburgh in collaboration with the David Hume Institute. Mr Wolf was welcomed by RSE President Lord Wilson of Tillyorn and Institute Director Jeremy Peat, and the event was chaired by Bill Jamieson of* The Scotsman*.*

The global economic crisis has not only left the UK economy severely damaged, but there is no clear sign that a route to strong and sustained recovery is being charted. Mr Wolf argued that there are currently few indications that the conditions exist for a recovery led either by exports or private domestic spending.

Mr Wolf opened with three quotations which he said cast light on the crisis and its aftermath. The first was Stein's Law which says "Things that can't go on forever don't". Despite its simplicity, it is highly relevant, as so much that occurred in the early 2000s in terms of accumulations of household debt, asset prices and global current accounts, was unsustainable. It is also important for the future, not least because our swapping of immense private sector obligations for huge public sector obligations is equally unsustainable.

A second quote was from Paul Volcker, who told the Economic Club of New York in 2008: "The bright new financial system, with all its talented participants, with all its rich rewards, has failed the test of the marketplace." Mr Wolf added that the Club is Wall Street's meeting place and that "there were probably a thousand people there, and he told them that they were incompetent and had screwed up completely". The third quote, from John Maynard Keynes, was that "A sound banker is … one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no-one can really blame him". The collective failure of the banking sector, and subsequent bail-outs, has demonstrated Keynes' point.

Addressing the nature of the crisis, Mr Wolf said the central insight he can offer is that it is of a type frequently associated with developing countries, but at the core of the world economy. It is a classic Minsky Cycle. This began with the emergence of new opportunities – including sub-prime borrowing – which was followed by the growth of a new class of lenders and which engendered a huge spree of borrowing. An asset price bubble grew, then burst, leading to panic, as there was no way of identifying the worth of assets and, therefore, little chance of selling them.

The crisis has involved a combination of macro-economic and financial causes and ideas. This included belief in "the great moderation", that the business cycle had been tamed, achieving sustainable low-inflation, monetary stability and stable growth. This encouraged the financial sector to underestimate risk even though investors, such as pension funds, were eagerly seeking higher returns. But the dominant factor was the burgeoning of global imbalances

and extraordinary accumulations of reserves. Emerging countries, especially China, kept large current account surpluses and reserve accumulations, and became capital exporters. This capital fuelled a house price bubble in the West, made worse as consumers then borrowed against their property (with household debt markedly higher in the UK than elsewhere in the G7). The backdrop was one of accommodating monetary policies and regulatory failure.

Mr Wolf offered a detailed analysis of key causes of the crisis, arguing that the decisive element was “the scale of the growth of the financial sector itself”. Over the past 25 years its balance sheet went from c.20% to c.120% of GDP, doubling in the last decade – with the UK situation being even more extreme, reaching 250% of GDP. Even more extraordinary was the growth of aggregate assets of UK banks. This occurred within the context of a financial system which is inevitably fragile because it bets on the unknowable future.

Mr Wolf identified three characteristics which make the present crisis distinctive. These are:

● that it hit the core of the world economy

● that lending patterns were complex and opaque

● and, more positively, that the most affected economies were able to spend their way through the crisis.

Looking at the prospects for a return to stability Mr Wolf began by focusing on the massive retrenchment in private spending. This means there is a long way back to private spending-driven health and leaves us dependent on a government-driven economy. In the UK alone the cost of public sector support operations, to avoid recession turning into slump, has been the equivalent of 74% of GDP. At the same time bank holding write-downs are about $600 billion, half that of the US.

At a macroeconomic level the UK, like other developed countries, has reversed its position from one of spending far more than its income, to one where the household and corporate sectors have slashed spending and are building up savings. The result is that governments have ended up with deficits of wartime proportions (UK indebtedness is projected to rise from below 40% to c.90%).

A return to economic good health requires some combination of strong recovery in private domestic demand and high levels of export-led growth. Household debt levels hamper the former and a structural lack of competitiveness, plus inadequate global demand, make the latter very difficult. This creates huge challenges in cutting the public sector deficit without causing further economic damage. At present the prospects for growth in 2010 are below trend at only 1–1.5%.

Mr Wolf said there have been three big lessons for macroeconomics:

● that contemporary economic theory is in serious trouble – modern theory having been abandoned in favour of Keynesian models and ways of thinking;

● inflation targeting failed to deliver stability;

● and that we cannot handle global capital flows in a stable manner.

Underlining the second point, Mr Wolf attacked the concept adopted by central bankers that the difficulty of identifying bubbles makes it better to clear up after they burst than to try to intervene beforehand. This is because “the mess can be so large that it’s almost impossible to clean it up … it’s far better even if you don’t know exactly how big the bubble is to be roughly right than precisely wrong”. Mr Wolf expressed concern about the level of global imbalances, saying that for emerging countries to be major capital exporters is “perverse”. He characterised a situation in which “we have used the excess savings of Chinese households to build houses in the Mid-West that nobody wants” as “crazy”. A rebalancing of demand is needed and poor countries must be able to run current account deficits. This in turn demands more effective global insurance mechanisms.

Turning to whether we can fix the financial system so that it doesn't generate large instabilities, Mr Wolf was pessimistic. Whilst we do learn from history, we soon forget its lessons. The bail-out of financial institutions has negated one option, which is to make people more afraid of the consequences. The other main option is to find ways of controlling future problems and making the system more robust. At the moment efforts are being directed towards raising capital requirements and creating a more effective resolution regime. However, Mr Wolf doubted that these measures are sufficient. Considering a series of more radical solutions being proposed by some economists, he concluded that they either held too many dangers or were politically unacceptable. However, each points to the inherent fragility of the existing system, which is too large to be managed and contained. Even more worrying is that the response to each of the many crises over the past 30 years has been the pouring out of ever more money. Mr Wolf raised the spectres of whether the end games would be fiscal collapse or massive inflation.

Mr Wolf concluded by saying that the current economic position cannot be sustained and that it is unclear how the UK, and the world, will return to stability. "In the end I'm afraid that I don't offer up answers to the crisis. This is a very disturbing event, and we have not resolved the crisis in any way."

Questions:

● Asked if central banks are losing their independence, Mr Wolf agreed that there were signs that this been happening and that it is possible that it could be eroded much further, not least because some US politicians resent the power of the Fed.

● On whether capital controls could be introduced in the UK and US, he said that he used to think the chances were zero. However, recent events mean they are possible. More likely is a bout of severe inflation without credit controls.

● Asked if the US needs to threaten the Chinese with trade protection to help end global imbalances, Mr Wolf said China's economic policy has been hugely destabilising. He suggested the time may have come for President Obama to tell China to allow its exchange rate to appreciate significantly or face import surcharges.

● On business banking, Mr Wolf said there is a strong argument for a new network of institutions dedicated to financing smaller businesses. These might well be regional, small and possibly structured either as mutuals or using some form of public/private partnership.

The evening ended with a vote of thanks for Mr Wolf's lecture, which was described as a "*tour de force*".

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