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Causes & Consequences of the Global Financial Crisis

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In memory of my mother,
Margaret Jean Farlow,
and with gratitude to my father,
William Kenneth Farlow

PREFACE

Who would have believed it? By now we are accustomed to mid-crisis life—and yet, had this book been published just five or so years ago, its author would have been roundly condemned as completely and utterly mad. Its fanciful speculation about the future, and not its sober reflection on the past, would have been a danger to the banking system and to all those whose lives depend upon it. Back then, we were living in the best of times, the season of light. The consensus of educated opinion was that we were wise too. Never before had we had such sophisticated financial models to predict and, some said, to control the future. We had everything before us, even Heaven—which in those days, by recent convention, meant economic stability—itself. By day, gentle words of 'no more boom and bust' mesmerized and numbed our senses. By night we slept soundly, safe in the knowledge that never again would we be plunged into such frightening economic nightmares.

But the nightmares did not stay away. Slowly at first, then surely, they swept back in. One by one, our delusions were washed away. Millions watched on helplessly as their savings, and income from savings, sank, debts spiralled, and homes fell in value. Unemployment became the daily curse of many, austerity the grim reality of most. It gradually dawned that in our past we had squandered our future, and that in our future the reward of our every effort, and that of our descendants, would be eaten away by debt repayments and higher taxes as far as our eyes could see. Our hopes had turned to doom, our dreams had turned to dust. We had been willing participants not in an age of wisdom, but in an age of folly. We had sipped on lies and we had liked them. We had asked for more and we had been given it. Greed and credulity had been our bedfellows. And now we were going to pay.

President Obama seemed to understand this. In February 2009, in his first address to a joint session of Congress, he declared, 'We have lived through an era where too often, short-term gains were prized over long-term prosperity; where we failed to look beyond the next payment, the next quarter, or the next election. A surplus became an excuse to transfer wealth to the wealthy instead of an opportunity to invest in our future. Regulations were gutted for the sake of a quick profit at the expense of a healthy market. People bought homes they knew they couldn't afford from banks and lenders who pushed those bad loans anyway. And all the while, critical debates and difficult decisions were put off for some other time on some other day. Well that day of reckoning has arrived, and the time to take charge of our future is here.'[1] Then again, he could say such things; the past belonged to someone else.

In the United Kingdom, where the writing of this book was underway, the past belonged to those still in power—at least for a little bit longer. In mid-2010, in the midst of a general election campaign, according to focus-group evidence—for that is the way we do sound public policy these days—the average voter was not unlike a sick patient pondering through a dizzy haze three smartly suited surgeons in the hope that the illness would be less severe, and the cure less painful, if only the one with the nicest prognosis and the most reassuring smile could be picked. Astonishingly, with the country rapidly heading towards a government debt of a trillion, in the last televised debate before the election the three protagonists batted back and forth just six of those thousand billions. Nastier medicine was on the way, but talking about it now would only scare the patient.

By the middle of 2012, as the book went to press, the truth was out. It was not a pretty sight. In the United States, with a Presidential election fast approaching, the Tea Party, on flights of peculiar economic fantasy, had made inroads into Obama's vote. In the UK, a coalition government was engaging in the biggest ever experiment in UK peacetime austerity, and the economy was dipping its toes back into recession. Europe was tearing itself to pieces because of its seemingly irreconcilable economic and political contradictions. And China and a range of emerging economies were starting to wonder whether the next crash had some of their names scribbled all over it.

The causes and consequences of the recent crash are multi-dimensional, entangled like a ball of string, layered like an onion. Yet a book can only be written in a linear fashion. We have to prise the individual bits apart, stretch them out, pin them to the page—one after the other—and, sometimes with tears in our eyes, try to make sense of the blur. I have done this by separating material into three parts with a preface and some closing thoughts to seal the ends and keep the material from falling out.

Part I looks at the causes of the crash. Some go back forty years, others proliferated in less than ten. Of special interest are the interacting weaknesses in the financial and economic systems. For the crash was as much of economies as it was of banks.

Part II, no sadder than the first but hopefully just as informative, tells the story of the crash and of the efforts made to save the banking system.

Part III—half the book—looks at how policymakers set about rescuing their economies and the unemployed, dealing with collapsing housing markets, tackling long-term sovereign debt difficulties, handling the eurozone crash, managing global instabilities, and reforming monetary policy, financial regulation, and banking. It is both a chronicle and an analysis of the events and of the thinking of these years.

Throughout I strive to be critical but fair. Yet, since I know that there is nothing more irritating than a thoroughly balanced argument that is not the least bit opinionated, I will try to take a position as and when I feel the evidence supports it.

Of the many themes running through the book, one is an evaluation of President Obama's economic presidency. It would not be unfair to say that Obama arrived equipped for a very different kind of presidency to the one thrust upon him when the global banking system collapsed just weeks before his election. Arriving without the requisite economic and financial skills, how did he cope? Another is a necessary corrective to the account of the crash by former UK finance minister and prime minister Gordon Brown, published at the end of 2010, which glossed over the many failures that led to disaster for the UK. In contrast to Obama, for thirteen years Brown positioned himself as 'an expert renowned for his remarkable financial acumen ... Long admired for his grasp of economic issues'.[2] Yet, in his account, Brown described the crash as a complete surprise to him, and even accused banks of tricking him. Surely, posterity will record that when it comes to financial acumen and the grasp of economic issues, Brown was not modest but had much to be modest about. Merkel, Sarkozy, Berlusconi, Cowen, Wen Jiabao, Papandreou and others will get their moments in the spotlight.

These days it is de rigueur for commentators to claim prescience of the events of the crash. It would be remiss of me to break from such an agreeable new tradition. To my advantage—and unlike some who threw themselves into the bright lights in their shiny new chameleon hues—a series of papers on which I base my own modest claim can be readily found online, placed there a few years before the crash.[3] In those papers I did not buy the story that we were living in the best of times, the season of some shimmering new economic light. In the first paper I tried to pick apart the explanations given for recent rapid rises in house prices, especially, but not exclusively, in the UK.[4] The prevailing justification was that the world was now so much more stable, real (i.e. adjusted for inflation) interest rates so much lower, and credit constraints so much reduced that a permanently higher level of house prices was the rational and decent way to go. I could not make the logic work and it worried me. In the second paper I argued that house buyers, and the banks supplying them with their credit, were pumping a bubble that one day would collapse.

It seems I was not alone. In 2010, out of the blue, and not requested by me, I was sent a small package, the result of a Freedom of Information request to the office of the British prime minister. It transpired that—by the deft hand of Martin Wolf of the *Financial Times*[5]—the logic of those papers had reached in and twanged a raw, if rather brow-beaten and somewhat sedated, economic nerve in the head of the British Prime Minister of the day, Tony Blair. As part of a power-sharing deal, Blair had long ago relinquished all but the tiniest crumbs of economic policy to his finance minister, Gordon Brown. Even Blair's 2010 autobiography does not deal with the economy until its postscript, written after the crash. There never had been a British prime minister so blissfully unengaged in the economic affairs of the nation. Or so it had seemed.

It turned out that Blair, breaking momentarily from habit, was sufficiently worried that he immediately sought advice from the UK Treasury. As a parable of the way economic decisions were made in the UK a few years before the crash, a substantial (by the standards of such things) briefing paper duly arrived at the door of Number 10,[6] and gently reassured the prime minister that all his fears were unfounded. As one journalist put it, '[I]t turns out Blair was rather more worried about the state of the economy than you might have thought . . . It underlines the simple fact that the Treasury under Gordon Brown was blind to the possibility that things could go horribly wrong—even within the confines of Downing Street. It turns out no-one was allowed to challenge the "end to boom and bust" trope—even Tony Blair himself.'[7] In the Irish parliament, the two papers triggered a question about the state of the Irish economy. Didn't this indicate that the Irish housing market and the Irish economy were heading for a crash? Irish prime minister Bertie Ahern, like Brown a self-styled economic visionary, had taken to labelling naysayers as 'cribbers and moaners', and he and his colleagues were having none of it. It is always nice to hear that people in high places get to hear one's views. It is a little less encouraging to know that it doesn't make the slightest jot of difference.

In 2005 I wrote a third paper in which I made a number of arguments that, according to various banking colleagues, economists, and journalists, turned out to be highly prescient in the light of what was to come. I was, as it were, one of the few to join up all the dots. To borrow an analogy from the music industry, the papers were an instant hit. The head of my department's IT unit expressed astonishment at the extremely high number of downloads in one year of just those three papers. The general public was interested. Wouldn't it be exciting to hear that Blair and others were too? Indeed, as Blair revealed for the first time in his autobiography, this was the time of greatest pressure from his supporters to sack Brown. He did not because in his view Brown 'was the best chancellor for the country', and having Brown 'inside and constrained was better than outside and let loose'.[8]

Just for the record, and to frame the thinking in this book, this seems the appropriate place to review the arguments I made a few years before the crash that attracted such interest. After all, this book gains some of its credibility from such a background. The reader can read the original papers for themselves; by agreement with the Oxford University Press, the content of this book is totally new so that those papers can stay available online. Having waited patiently for several years, I hope the reader will pardon me my little peccadillo. If nothing else, it might encourage the casual browser to make his or her purchase, an act that I can assure them will, in these straitened economic times, be very good for the economy.

Like many others, I identified the unsustainable imbalances in the global economy in the years before the crash, in particular between China and the US. I discussed the increasingly unbalanced nature of economies such as those of the US and the UK, as unsustainable levels of debt and property-based bubbles generated their apparent economic 'success' stories. I argued that extremely low interest rates and heavy banking competition had encouraged the rising indebtedness of banks, the 'chasing of yield', and the mispricing of risk on a global scale, with large levels of speculative investment in mortgage markets and housing, exploiting the belief that house prices could not fall. I argued that, on the contrary, property-market risk was being grossly underpriced. I also discussed the vulnerability of many US mortgages. Low interest rates could have encouraged productive investments, but I argued that all too often they had not.

I warned that house-price bubbles made financial firms' balance sheets look healthier than they truly were, falsely suggesting an ability to take on much more risk, while giving consumers an illusion of greater wealth than they really had, distorting their spending and saving decisions. I suggested that the effect of the implicit government guarantee of the US mortgage industry was being spread outside the borders of the US. I argued that holders of mortgage-backed securities (MBSs) needed to continuously roll over their positions, and that sooner or later this would not be possible. I discussed the various directions from which the crisis—essentially a bank run—might come, including from falling house prices, rising interest rates, and a reversal of bubble-generated low volatility. I explained how financial contagion would spread to the rest of the world via, in particular, mortgage bank and government balance sheets, and with it real economic contagion. Many were worrying about the imbalances between the US and China, but fewer had spotted that the real danger of a crisis was lurking in the US banking system. Indeed, it was not at the time by any means the conventional wisdom.

I described how, in response to the collapse of the equity-based bubble that expanded over the 1990s, policymakers had fed a debt-based bubble in the 2000s. I argued that debt-based bubbles are much more dangerous than equity-based bubbles, because of the underlying properties of debt. Eventually the burden would be shifted to sovereign (that is government) debt. I urged therefore a reduction in the government budget deficit[9] of economies such as those of the US and the UK to help give more of a cushion to deal with the impact when it came. I identified in particular the poor ability of UK public finances to withstand a crisis that was likely to be particularly severe in its impact on the UK (previously, I had written too about the long-term fiscal problems of the US).[10]

I contended that the past mispricing of assets and of risk would leave many households in countries such as the US and the UK with too much debt and too little saving, including savings in their pension funds. I noted that when the downswing came, the efforts of households to correct their 'balance sheet' mistakes by saving more and deleveraging (i.e. scaling down their debts relative to their asset worth) would coincide with governments finding themselves much more fiscally burdened by the shifting of the consequences of the collapsing bubble onto *their* shoulders and needing to support demand in their economies by running larger fiscal deficits. I argued that inflation had morphed from traditional measures based on goods and service prices into measures based on asset prices, in particular house prices, that when standard interest rate tools were unable to go below zero per cent unconventional monetary policy would be needed, and that recovery would be complicated by the knife-edge balance between inflation and deflation in a balance sheet recession. I concluded that failure to take early action was feeding imbalances that would become ever more difficult to unwind, and that policymakers were simply pushing off a 'day of reckoning' and by doing so making that day much worse.

A fourth and fifth paper were in the pipeline, about 80% complete, dealing with the risk and liquidity problems in global property and mortgage markets.[11] At that point I wondered why I should release these for free when the evidence suggested there would be good sales if all could be combined in a book. But 2006 was quite unlike 2007 and even less like 2008. The academic publisher I approached politely wondered if there would be a market for a book about a crash that had not happened, especially one involving such a prominent role for the US. The trade publisher proposed something 'hard-hitting' (could I 'do left-wing polemic'?) and thought it helpful to suggest that I write under a *nom de plume*. I did not have the standing to take the ridicule of academic colleagues or to be seen as a maverick, and a pseudonym would be the kiss of death in academia. The book went on hold.

My inbox filled up with invitations—they sit there still, polite witnesses to a more innocent era—Lehman Brothers, Credit Suisse First Boston, UBS, Goldman Sachs, the Bank of England, the Financial Services Authority (FSA), HM Treasury, and various US policy think tanks. There were hedge funds and others wondering if I might be interested in making a buck or two when the housing market crashed. However, I was getting increasingly involved in the field of 'global health'. Given my concerns about the state of the global economy, the recent financial flows into global health were vulnerable, and, it seemed to me, the efficiency and financial sustainability of global-health initiatives needed to be improved. Over just a few years I wrote about three-quarters of a million words on various areas of global-health policy and took a series of stands that, though often painful at the time, eventually started to bear some fruit.

In August 2008, a few weeks before the collapse of Lehman Brothers, the book shot up the agenda again. A group of investment bankers arranged a meeting with me in London in which they explained how the original papers had spread by word of mouth through their company following the financial collapse over 2007 and early 2008 along lines I had described. All summer long they had struggled without success to get the UK Treasury and the office of Prime Minister Brown to take the dangers seriously and recapitalize the banking system. In the US, a presidential election campaign had raged all year and there was no chance of action there. They urged me to get back to writing the book. With evidence at last that the exercise would be worth it, and thinking that the prescience of the prior papers would help sell a copy or two, the delegates of the Oxford University Press commissioned the book.

Usually, by the time historians pan the murky streams of time, at least some of the particles of evidence have settled to the bottom. When John Kenneth Galbraith produced his book on the 1929 crash, he had the good sense to wait 25 years.[12] Freidman and Schwartz published their analysis of the monetary policy mistakes that followed the crash of 1929 a thoroughly sensible 34 years after it.[13] Surely only a foolhardy person would write a book when events are still spinning? We live in a different era. These days the just-in-time media presence at the scene of the latest financial crash generates a veritable avalanche of instant data and analysis. Every dimpled, crumpled, jagged edge of the wreck gets gawped at, photographed, and written about, and then it's on to the next exciting story even before the full consequences of the last one have fully settled in. We will know a great deal more in five or ten years about exactly what happened and why. By then, econometricians will have processed the life out of every speck of data that passed through every ministry of finance in the world, through umpteen rounds of refinement that will have polished them into permanently stable lines and columns on a graph. But the time to learn the lessons and change direction is now.

I wish to extend my huge appreciation to colleagues and friends in Oxford and especially in Oriel College. I am enormously grateful too to all at the *Wissenschaftskolleg zu Berlin*, where I spent the academic year 2010–2011, for their generosity and kind hospitality. Maintaining my sanity while writing the book had much to do with being surrounded by a truly wonderful group of fellows, partners, and families. The OUP economics and production editors, in particular Sarah Carro, Adam Swallow, Aimee Wright and Kizzy Taylor-Richelieu, deserve very special thanks. They repeatedly, and graciously, went well beyond the call of duty. Every time they panicked that the crisis would be over long before I made any sales, I simply reassured them with the rather unprepossessing proposition that I knew enough about crashes, and this one in particular, to know that its consequences were going to drag out for years on end, and that—when I was being especially eloquent—watching and reflecting upon policy responses was a timely and even wise strategy.

All financial crashes have been compared to that of 1929. One suspects that in time this crash will take on some of the mantle of the 1929 crash. Maybe this will be for good reason—because policymakers handled it in some respects better than that one. But it might also be because this one turns out to be a great deal more intractable, and marks a turning point in our understanding of global capitalism. Or perhaps we will have done the usual, and forgotten the lessons until next time.

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Part I

Before

1

Global Imbalances and the Rise of Debt

The Great Moderation Myth

On 4 December 1928, in his final State of the Union address, President Calvin Coolidge, looking back over 150 years, observed that 'No Congress of the United States ever assembled, on surveying the state of the Union, has met with a more pleasing prospect than that which appears at the present time. In the domestic field there is tranquillity and contentment . . . and the highest record of years of prosperity.' As Coolidge was speaking, the US stock market was approaching its zenith and, within a year, its nadir, the crash of 1929, and the economic infamy of the 'Great Depression'. The US economy would contract by nearly 30% from peak to trough. Unemployment would soar until one in four in the US was without work. Thousands of banks would collapse with little or no protection for tens of millions of savers. Up to three-quarters of all mortgage holders in the US would default. Monetary policy would be contractionary, as the US strapped itself tightly to the gold standard, and deflation would set in. Many countries would respond with trade protectionism; by 1933 US trade was 33% of its pre-crash level.[1] Taxes would be raised and government spending cut to balance the books, as the US economy dug itself into an even deeper hole. Before the crash, Coolidge had made a virtue out of inertia; as journalist Walter Lippmann observed in 1926, 'This active inactivity suits the mood and certain needs of the country admirably.'

On 16 March 2005, in his budget speech to Parliament, the UK's finance minister, and subsequent prime minister, Gordon Brown—not the sort ever knowingly undersold—declared, 'Britain is today experiencing the longest period of sustained economic growth since records began in the year seventeen hundred and one.'[2] He praised 'Britain and North America that have over the last eight years grown at twice the rate of most of our G7 competitors, our living standards also rising twice as fast'. He rebuked the French, Germans, and, for good measure, Americans for their lackadaisical employment records. He gallantly deflected the warnings of the International Monetary Fund (IMF), Bank for International settlements (BIS), and the Organization for Economic Cooperation and Development (OECD), and defied all who had made 'predictions of a recession—predictions wrong in 1997, wrong in 1998, wrong in 1999, wrong again in the years from 2000 to now'. Even as Brown was speaking, the banks of the global financial system were bulging ever closer to bursting point and a flood that would scour and transform the global financial landscape forever. Within a couple of years, like a dropped ball of string atop a very steep hill, the UK's economic 'success' story would be unravelling fast, with Brown chasing and struggling to catch it.

Perhaps presidents and prime ministers get a bit carried away at times? A touch hubristic perhaps? A hazard of the job maybe? A more useful observation is that both Coolidge and Brown *could* point to economic data to support their claims, if only with just the right angle of light and the occasional bit of torture to make the data confess—and their views were not out of line with the mood and certain needs of their times. We now know that there was something about the very fact that they *could* say such things that should have warned us that something was wrong. Many of the 'good' signs—vibrant stock markets, record rates of economic growth, and rapidly rising house prices—were themselves signs that risks were increasingly being stored up like energy in a spring. Truly, it was both the best of times and the worst of times. Fancy sat right next to fact, abundance to austerity, pleasure to pain.

In economic circles the justification for such high hopes was known as the 'Great Moderation', a phrase coined by Ben Bernanke in 2004[3] to describe the 'remarkable decline' of inflation and output volatility in the US and other developed economies (though not, by then, Japan) over the previous 20 years.[4] Bernanke argued that rather than structural change or 'luck'—by which he meant a pattern of shocks that had been unusually fortuitous but which would not last—'improvements in the execution of monetary policy can plausibly account for a significant part of the Great Moderation'. That is, policymakers should take the credit.