Notes on the Banking Crisis and the Economic Outlook

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Background on the banking crisis

This crisis arose out of the mispricing of repackaged US mortgages that were made to poor Americans over a long period of time. The history of this mortgage provision to 'sub-prime' borrowers stretches back to 1992 when Congress passed the first law instructing Fannie and Freddie, the two US government-backed mortgage funders, to ensure that a substantial percentage of their portfolio went to such borrowers. In later years these percentages were ratcheted upwards. The mortgage packages were then sold on to investors all over the world, and the 'top slices' (e.g. the first 50% claim on a repossessed house) were rated AAA by the rating agencies. It did not seem to occur to anyone with power to alter things that in the event of an economic downturn in which house prices fell even these top slices would be worthless. Basically, as long as the US expansion continued and house prices rose, no one worried, including non-US regulators whose banks had stuffed 'special investment vehicles' (i.e. various hedge funds etc to which they made large loans) with these packages.

This is another of the many historical episodes of capitalist bust. It is, however, spectacularly big- the Bank's October Financial Stability Report estimated the total losses so far worldwide at $2.8 trillion. This is a fifth of US GDP and 5% of world GDP. The bust happens to be in the financial sector; but then so was for example the collapse of the US thrifts (aka home mortgage companies of that time) that resulted in the 1989 Resolution Trust Corporation (RTC). Even the numbers are not dissimilar for the US; the US government put some 5% of GDP into the RTC. Today Paulson's proposed sum of $700 billion is about the same percentage of GDP. As it happens the US government made no serious loss on the RTC which managed to dispose of its assets advantageously over calmer times. The same could happen again. Other governments have now put similar percentages of their GDP into banks as capital injections- for example the UK Treasury package of capital injection is of this order (other amounts relate to liquidity provision and guarantees which are much less exposed to loss).

Underpinning the attitude of the Fed and the US government lies their predecessors' experience of another great financial bust: the crash of 1929 and its sequel in the collapse of one third of the US banking system and the Great Depression. Just as Walter Bagehot concluded from 19th century experience that lender of last resort action by the central bank was necessary, so today's US authorities have concluded that the financial system cannot be allowed to collapse. The fact that that system has extended so widely to embrace a host of new financial intermediaries has merely extended the scope of today's lender of last resort requirements. Other governments came around to the US government viewpoint as the damage spread to their own financial systems.

This viewpoint tells us that finance and banking are too important to the rest of the economy to be allowed to collapse, unlike any other sector- be it dotcoms, telecoms, railways, or bits of manufacturing. Partly this is due to modern politics: ordinary people's deposits, savings and, yes, houses must somehow be kept safe by the politicians. The implicit political compact of democratic capitalism is that markets can be free, the high rollers of the market economy free too to make and lose large amounts, but in return the ordinary voter must have some basic guarantees, among them that their finances will be protected.

Partly it is due to the key role of finance in the capitalist machine. As we see currently in the UK housing market, if finance withdraws from a market more or less totally (apart from existing contracts), the market freezes up; if this went on for very long, the market would have to reorganise itself on a quite different model, with only large players or wealthy people holding housing and the rest renting. This is very far from the ideal model of 'complete contracts' in which people can smooth consumption across contingencies. One could imagine a world of free financial markets without any such implicit public guarantees; it would be one in which there was a restoration of massive caution with financial firms selling themselves on safety to a pre-eminent degree. However, there is not much point in thinking long about it since it is not on offer.

Unfortunately the bank crisis, and the 'credit crunch' coincided with a boom in emerging markets which drove commodity prices to dizzy heights during the early part of 2008. So while the credit crunch was raising effective

BOX 1 - Anatomy of the two shocks and monetary policy reactions: current crisis- what should monetary policy have done and now do?

To assess what needs to be done we need first to assess the scale of the shocks currently hitting the economy. The two figures that follow later show estimates of the 'commodity price shock' and the 'credit crunch shock' for Europe generally, based on a reworking recently carried out of a model of the EU by Smets and Wouters (SW), two ECB economists. This reworking undertaken by the Julian Hodge Institute of Applied Macroeconomics was done to improve the model's capacity to match the data.

Figure 1 shows the commodity price shock, together with the likely response of interest rates- by quarterly periods from the date of the shock. As one can see a slowdown results as well as some rise in inflation; and interest rates rise a bit to discourage firms from raising domestic wages and prices.

Figure 2 shows the credit crunch effect quarter by quarter from the date of the shock. Here we see a much larger recessionary shock, with inflation plunging too and interest rates, on a proper monetary response, being cut sharply in reply. The cuts in rates greatly more than offset the credit crunch rise due to bank risk and crisis; so base rates are cut sharply because of the effects on the economy of the crunch.

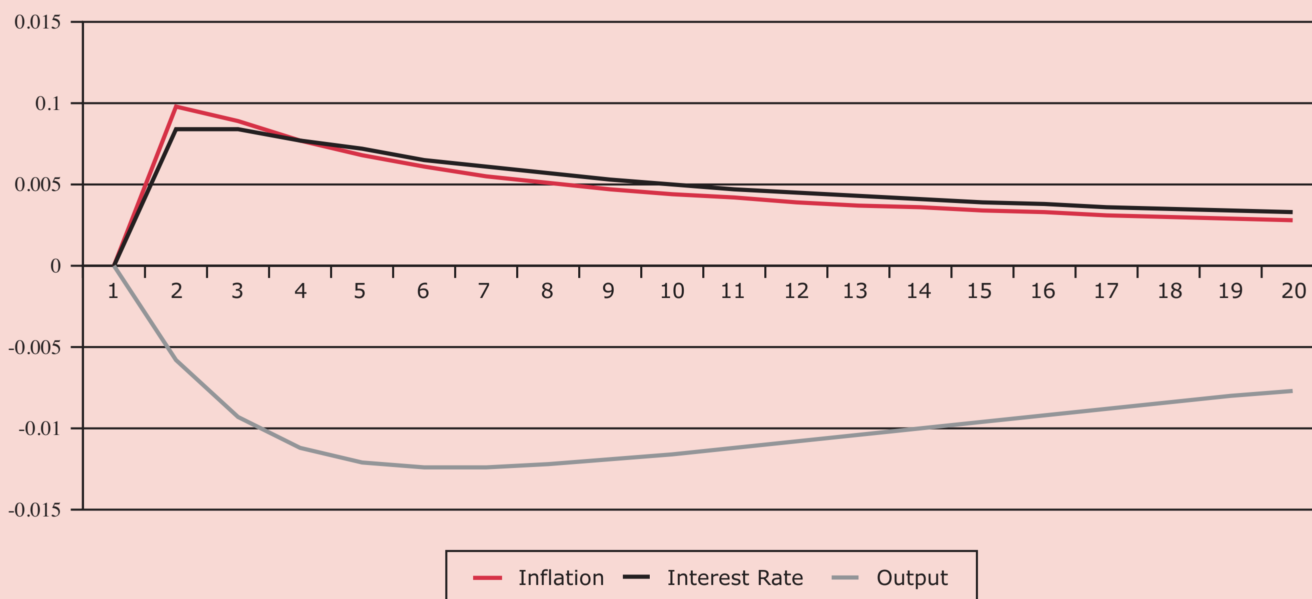
The implication when the two shocks are added together is that the damage to the economy overall is extensive. The 1.5% cut in interest rates was welcome, but further significant cuts are needed to make up for lost time - as with the latest 1% cut in December.

rates of interest in the marketplace by something like 6% per annum, central banks this side of the Atlantic were extremely twitchy about the effect of this commodity price boom on their consumer price indices; as a result they did little at all to offset the credit crunch, allowing it in effect to tighten monetary policy without they themselves having to raise base rates. In Box 1 I argue that this twitchiness was quite wrong and that they should have gone ahead and cut interest rates sooner to offset the credit crunch, explaining that the commodity price boom would raise inflation in the short term but leave it unchanged in the longer term. By delaying interest rate cuts until very recently these central banks have allowed their economies to slip into a recession which just started, in the third quarter of this year and now has a serious momentum. This recession in Europe, joining the US slowdown as well as (correct) monetary tightening by emerging markets, has in turn led to the collapse of commodity prices over the past couple of months.

How quickly can normal monetary service resume?

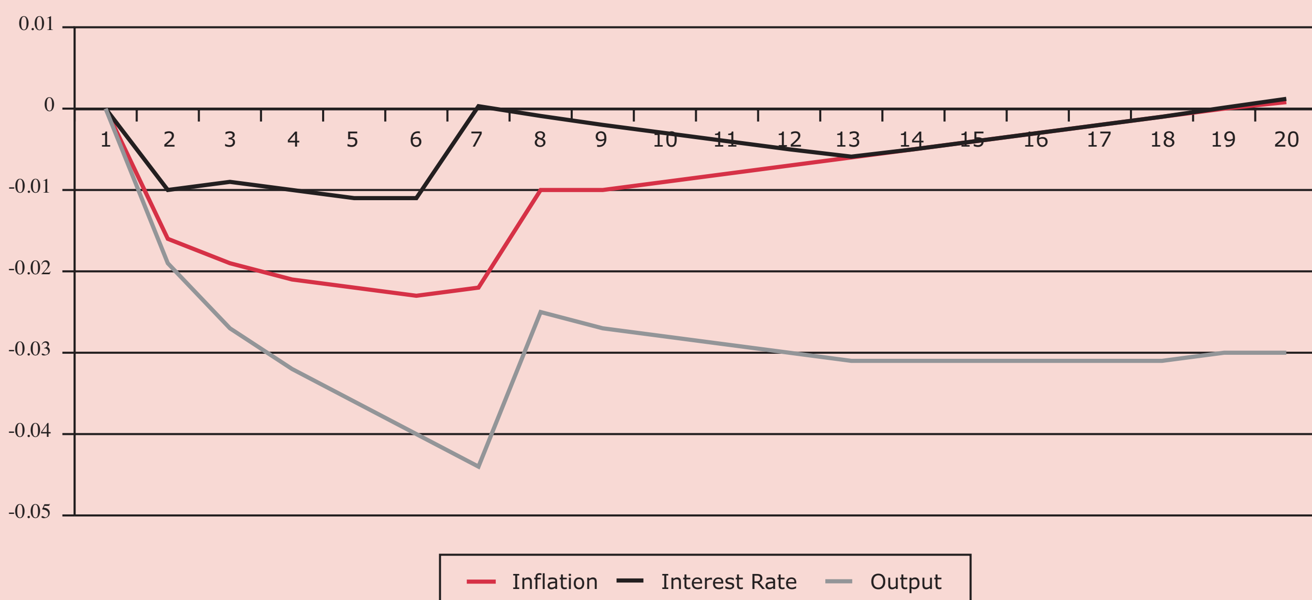
The economy is now in a weakened state. Third quarter growth in the UK was -0.5%. In Europe the figures are almost as bad. The US had a fairly robust second quarter and policy has

Figure 1: World inflation — effects of rise in world inflation on EU



Note: This is a simulation of the "weighted" model described in Meenagh, Minford and Wickens, 2008, on Minford Cardiff webpage.
Inflation/interest rate in fraction per quarter; output fraction of potential output. The horizontal axis shows quarters.

Figure 2: Credit Crunch shock (weighted model) - effect on EU



Note: The horizontal axis shows quarters.

been far more supportive, but also events there have been more hostile, with repossessions now becoming widespread as homeowners on 'no-recourse' mortgages (i.e. ones where the mortgage debt is extinguished if the house is surrendered for repossession; these are the bulk of US mortgages) simply leave their homes empty. The result is that the US too has had falling GDP in the third quarter.

All this is the lagged effect of the extreme 'credit crunch' conditions that have prevailed for the past 15 months. These have driven the effective cost of credit to the average borrower up by a large percentage; in the UK and the euro-zone where central banks have barely if at all offset this tightening, the amount as above we at the Julian Hodge Institute estimate to be of the order of 6% (remembering that a large chunk of marginal borrowers were denied credit altogether except on punitive terms). Such tightening was bound to slow these economies down sharply; only in the US has there been a serious mitigation by cuts in the central bank lending rate but even there we saw a significant net tightening.

The bank crisis took a nasty turn when Lehman went bankrupt. This caused money market funds major losses; the 90 cents in the dollar losses on Lehman bonds when recently auctioned have kept this uncertainty alive, as no one knows still which banks were the insurers and whether any of them have been hit by big new holes in their balance sheets. Because of this uncertainty governments were forced to act, now in most cases via large capital injections into the banking system. These have been accompanied by concerted central bank rate cuts, the provision of massive extra liquidity and other government guarantees of banks' security.

One question now is how long this will take to calm money market fears so that the spreads between three-month's Libor and Bank base rates decline. There is currently some easing but in the UK for example the spread is still around 100 basis points. Another question is how long will it take for lending activity to resume, in line with governments' commitment and conditions for these actions. Some wonder how the government can force banks to lend; but this is no mystery - the answer is; just as any dominant shareholder would do, via the chief executive. In the UK some banks are not participating in the government package but they will be affected by the emergence of competition from those that are lending again.

Our view is that both these processes will roll out in the period to Christmas. In the UK this is urgent politically for a government that has its back to the wall, with a general election only a year and a half away at most.

Alistair Darling's recent budget projects a risky level of borrowing, and the tax cuts will not be effective as they will soon need to be offset by tax rises. If worries surface about UK solvency the budget changes could be counter-productive as it will force up interest rates on longer term borrowing.

We expect further cuts in interest rates in the short term as the Bank now has no alternative, given the abrupt and dramatic reversal in commodity prices. Just as the past year of tightening has done its damage in today's slowdown, so its reversal will bring about a recovery. Our tentative forecast is that late 2009 will see the beginning of that so that 2010 will see growth again.

That may seem a boldly optimistic view in today's climate of opinion. But it must be borne in mind that bad and deep recessions - such as 1974-5, 1980-81, 1990-91 - were all brought about by monetary tightening that was lengthy and determined and not reversed until inflation had fully responded to the monetary medicine. Today domestic inflation (or 'long-term' inflation) has not risen at all; therefore there is no pressure to keep the tightening in place. In fact as we have seen government and central banks are now falling over themselves to loosen conditions. In our view a year or so of very tight conditions if rapidly reversed will not be sufficient to produce a prolonged and deep recession.

The business cycle experience of Wales is rather similar to that of the rest of the UK. In this downturn all sectors are equally badly affected, services (including of course financial services) and manufacturing. So while Wales has somewhat more manufacturing than the rest of the UK this will not make much difference in this recession. Public employment too, a big part of the Welsh economy, will be cut as government finances plunge deeply into the red.

In sum, though there is currently general panic among politicians, with much talk of 'Keynesian spending', the recession has been caused by very tight monetary conditions stemming from the credit crunch. It can be reversed by a determined loosening of monetary conditions, together with a restoration of normality in the credit markets by the government bank support packages. The return of normality will take a few months but return it surely will. Central banks this side of the Atlantic have been chastened by their dreadful misjudgements of the past year into a mood to cut rates sharply. As for Keynesian packages, European governments are going to have such large budget deficits anyway as tax revenues melt away and benefit spending rises that they cannot contemplate extra spending without damaging their credit status in world markets- if they do that the extra spending will damage demand and output too by raising long term market interest rates. So perforce the burden of countering the recession monetary tightening has unleashed will fall on monetary policy and central banks.