

The function of Government in times of financial crisis

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Abstract

This paper is a critical summary of the function of government during the on-going financial crisis that began with the so-called 'credit crunch' in 2007. It considers whether traditional macro-management of a country's economy is no longer possible, given the global interconnectedness of economic activity and business and that a government's role is now to regulate financial markets. Sustained reliance on the assumption that the value of houses would continue to rise, fuelled unprecedented levels of debt and resulted in a speculative bubble that inevitably burst. The background, to how this was allowed to happen and indeed, forecast, is explained. Recent data and analysis is used throughout as well as links to business cycles throughout economic history, including the Preston Banking Crisis of 1866. The difference is that never before has the global effect been felt so suddenly and governments left in disarray as to how to use their macroeconomic tools of monetary and fiscal policy to steer the economy. It is argued that the lessons are clear: the actions of an individual government are not necessarily enough. The global economy needs reliable, accurate and timely statistics, analysed by those with an understanding of them, and supported by strict regulation of the markets.

Keywords: Credit Crunch, Financial Crisis, Economic Policy, Financial Regulation, Minsky Moment.

Recent economic events relate to the financial crisis and economic downturn that followed what has become known as the 'credit crunch'. Some argue that the problem began on August 9th, 2007 (Mason 2009), although it had been forecast in March of that year by George Magnus (senior economic advisor at the global conglomerate, UBS), when he asked: 'Have we arrived at a Minsky moment?' (Magnus 2007b). A Minsky moment (coined by Paul McCulley in 1998 after economist Hyman Minsky) comes after a period of prosperity and increasing investments which have encouraged borrowing. In July 2007 Magnus wondered if we were 'getting closer' (Magnus 2007c), and later asked: 'Is the global monetary system starting to crack?' (Magnus 2007a). This followed an admission by HSBC that it was suffering from defaults on subprime mortgages in the United States, a situation that BBC business editor, Robert Peston, suggested was a warning to other banks to be wary (BBC News 2007).

At the start of the current crisis there was a slump in house prices. Although prices rose steadily between January 2000 and June 2006, they fell dramatically between August 2007 and May 2008 (see Standard & Poors 2011).

The reliance of individuals, banks and governments on the ever increasing value of houses to fund debt was a bubble that would inevitably burst, given the free and easy credit that had been made readily available in previous years.

On the 2nd April 2007 New Century Financial, a leading lender of subprime mortgages, filed for Chapter 11 bankruptcy (its creditors included the UK's Barclays bank). A few months later, on the 9th August, the credit freeze began, due to a 'complete evaporation of liquidity' in the asset backed security market (BBC News 2007). The lack of available credit led to Northern Rock receiving emergency funding from the Bank of England and news of such led to a 'run' (panic removal of deposits and savings) in September (BBC News 2010).

However, the financial crisis can be traced back to the repeal in the USA of the 1933 Glass-Steagall Act. Gramm's Law (1999), which replaced it, was designed to remove the legal need to separate investment banks from the savings of ordinary people. In its entirety, however, it laid the foundation for four crucial developments:

1. Deregulated investment banking
2. Expansion of subprime mortgages
3. Global derivatives market - \$370 trillion June 2006 to \$596 trillion Dec 2007
4. Fusion of banks and insurance companies

In its wake a whole shadow banking system developed, designed to get around the need for a 'capital cushion' and exploited a regulatory loophole. 'Conduits' were created in tax havens and 'structured investment vehicles' (SIVs), risky joint ventures between banks and hedge funds. Both were kept secret from investors.

Simultaneously, subprime mortgages arrived, being loans to those with a higher risk of default and often at a higher interest rate with an upfront fee. Importantly, these lucrative loans were attractively dressed and many, who could have attained cheaper credit (55%), were given a

subprime loan. The banks then bundled these riskier loans with others into collateralised debt obligations (CDOs), to hide the nature of the problem (Mason 2009).

Hyman Minsky (1992) argued that an economy has stable and unstable financing regimes and that following periods of prolonged prosperity it is inevitable that it would end in crisis with a collapse of asset values. This had already been demonstrated.

Although some economists point out that: 'The business cycle is an enduring feature of the economy' (Krugman & Wells 2009, 575) they, along with many others (including Begg, Fischer & Dornbusch 2008, Sloman & Wride 2009, Parkin, Powell & Matthews 2008, and Lipsey & Chrystal 2007) fail to even mention Minsky.

Business cycles have been traced as far back as the sixteenth century, although the causes have differed, including technological change, demographic shocks, trade disruptions, agricultural crises, financial market disturbance and war. The Scottish economist Adam Smith (1723-90) made comment on the fluctuations of the corn and textile markets during the eighteenth century and American economist Joseph Schumpeter (1883-1950) sought to categorise cyclical activity depending on its length and cause as follows:

- Seasonal: agriculturally led and having run their course normally within a year
- Kitchin: three to five years in length, normally related to interest rates and wholesale prices
- Juglar: ten years plus, linked to fundamental financial and demographic changes
- Kuznet: circa 20 years following structural change in important industries and technologies
- Kondratieff: 50-60 years representing historic economic changes eg. Industrial Revolution

(Craig & Garcia-Inglesias 2007)

Importantly, Minsky's model is of a capitalist economy that falls outwith the boundaries of the business cycles described above which, he says, are compounded by internal dynamics and a 'system of interventions and regulations' that 'keep the economy operating within reasonable bounds' (Minsky 1992). 'When markets reach a fantasy land', it only takes a minor change for everything to fall apart or for the bubble to burst (*The Economist* 2009).

Financial crises are not a new phenomenon. John Kenneth Galbraith (1908-2006) writes of the 1929 crash as 'the greatest cycle of speculative boom and collapse in modern times' (Galbraith 1992, 9). In 1720 speculators caused the South Sea bubble to burst because most of the £75 million invested was as pledges rather than in cash. Collection became difficult and stock values diminished rapidly (Floud & Johnson 2004, 169).

There are other causes too. The American Civil War caused an acute shortage of cotton exports to Great Britain for a four year spell, bringing a whole industry to almost a standstill and causing hardship for the populations of manufacturing towns in North West England. It led to The Preston Banking Company suspending its operations on July 19th 1866. Local philanthropist Joseph Livesey (1794-1884) came to the rescue: he became a director, the bank recovered its position and, eventually, in 1894 amalgamated with the Midland Bank (now part of HSBC) (Livesey Collection 1997). The *Preston Chronicle* wrote of Livesey: 'The depositors had faith in him – believed what he had to say, relied upon his suggestions; for they knew that his words and recommendations were thoroughly honest' (Anon, 1869a). *The Preston Herald* was equally convinced of his abilities:

In the hour of despair Mr. Livesey's advice and assistance were sought; it was said, 'If we can only get a man to lay a statement before the public whose word will be implicitly believed, we may calm over the excitement and tide over our difficulties.' And Joseph Livesey was that man; 'he was made the mouthpiece of those engaged in the work or revival' (Anon 1869b).

Traditionally, a government has used the macroeconomic indicators of inflation, unemployment, balance of payments, economic growth and exchange rate to measure its relative health and position. It has used fiscal policy (alterations to tax or government spending) and monetary policy (interest rates and money supply) to affect one, some, or all of the above. These are the interventions to which Minsky referred. However, regulators had failed to keep the economy within reasonable bounds. Additionally, it has to be noted, that affecting one positively may have an opposite effect on another: e.g. reduced unemployment may lead to inflation as aggregate demand increases. One has to ask, are these measures now redundant, given global interconnectedness and the ways in which one country's economy relies and depends on other countries and even the world economy as a whole.

Importantly in this regard, the current Chancellor of the Exchequer, George Osborne, in his Autumn Statement of 2011, failed to attempt any of the fiscal and monetary policy tools mentioned above, with the exception of some government spending announcements on infrastructure totalling £5bn, and a kick-start scheme to the tune of £400m for construction projects. He forecast an extra £111bn of government borrowing over the next five years (BBC News 2011a). Perhaps there was an admission in his tinkering, rather than a sowing of the seeds of economic growth, that there is little we can do unilaterally as a country except wait for a global recovery. It seems the fallout from the events of 2008 are more severe than thought, the eurozone crisis has a knock-on effect and we have imported inflation through rising international commodity prices seen by consumers daily in the current price of a litre of petrol (Landale 2011).

It was not just in the USA that debt had spiralled. Similar lending/borrowing booms had been seen throughout Europe, and for those in the Eurozone problems escalated in 2010. Our reliance on the fortunes of other countries is represented in Figures 1 and 2 below (data from BBC News 2011b).

Figure 1: Who owes what to whom? (£bn) end of June 2011

Country	UK	USA	France	Spain	Portugal	Italy	Ireland	Greece	Japan	Germany
UK	—	578.6	209.9	316.6			113.5		122.7	379.3
United States	834.5		440.2	170.5					835.2	414.5
France	227.0	202.1		—		37.6			79.8	123.5
Spain	74.9	49.6	112.0		19.7	22.3			20.0	131.7
Portugal	18.9	3.9	19.1	65.7		2.9				26.6
Italy	54.7	34.8	309.0	29.5					32.8	120.0
Ireland	104.5	39.8	23.8						15.4	82.0
Greece	9.4	6.2	41.4		7.5	2.8				15.9
Japan	101.8	244.8	107.7							42.5
Germany	141.1	174.4	205.8			202.7			108.3	

Figure 2: GDP (2010) and Foreign Debt (end June 2011)

Country	GDP (€ tn)	Foreign Debt	Foreign Debt (€) per person	Foreign Debt to GDP	Government Debt to GDP	Risk Status
UK	1.7	7.3	117,580	436%	81%	Low
United States	10.8	10.9	35,156	101%	100%	Low
France	1.8	4.2	66,508	235%	87%	Medium
Spain	0.7	1.9	41,366	284%	67%	Medium
Portugal	0.2	0.4	38,081	251%	106%	High
Italy	1.2	2.0	32,875	163%	121%	High
Ireland	0.2	1.7	390,969	1093%	109%	High
Greece	0.2	0.4	38,073	252%	166%	High
Japan	4.1	2.0	15,934	50%	233%	Low
Germany	2.4	4.2	50,659	176%	83%	Low

Concerns about Portugal, Italy, Greece and Spain (the PIGS) became more prevalent in early 2010. Figure 2 shows them all with high levels of debt to GDP and this indebtedness was clearly unsustainable and threatening all countries whose currency is the Euro, leading to bailouts for Portugal and Greece and the buying of Italian and Spanish Government bonds by the European Central Bank. Ireland was to follow (BBC News 2011c).

Christine Lagarde, head of the International Monetary Fund (IMF), confirmed the global interconnectedness of the problem confirming the global outlook was ‘gloomy’ and, ‘[t]here is no economy in the world immune from the crisis that we not only see unfolding but escalating’ (Urquhart 2011).

The growing interconnectedness was forecast by the Federal Reserve in its November 2003 bulletin: ‘Many observers believe that significant global integration is under way in the banking industry and that, in the coming year, individual banks will expand their reach into many countries’ (Berger & Smith 2003).

The interconnectedness of trans-national corporations is described by researchers as, ‘forming a giant bow-tie structure’ with huge elements of controls within, ‘a small tightly-knit core of financial institutions’, a veritable, ‘super-entity’ (Vitali et al. 2011, 1-6). The study analysed 43,060 conglomerates and the share ownership that linked them. It narrowed its research to 1318

companies (representing 20% of global operating revenue) to those with links to two or more other businesses and on average they had 20, adding a further 60% of global operating revenue. Among this group exists a 'super-entity' of 147 (less than 1% of all firms in the study) tightly-knit firms that between them controlled 40% of the network's wealth. It includes Barclays Bank, JP Morgan Chase and Goldman Sachs. Such concentration of power in itself is not enough to cause concern, but large networks can be unstable and if just one suffers distress, contagion may spread (Coghlan & MacKenzie 2011, 8-9).

In conclusion, it is clear that single government macro-management of their economy is largely redundant; global interconnected of banks and other large companies means that individual actions cannot necessarily take the desired effect when global markets are operating all around it. The head of the IMF talks of no global economy being immune, the debt of web is worldwide and the UK's Chancellor of the Exchequer delivers an Autumn Statement lacking in macroeconomic policy.

Minsky was an economist at the Levy Institute from which Charles Whalen comments: 'Most economists underestimated the economic impact of the credit crunch'(Whalen 2008). The Bank for International Settlements (2010) argues:

One of the lessons of the global financial crisis which started in August 2007 is the crucial importance for policy makers and supervisors of having access to a wide range of reliable, timely and detailed financial statistics (Bank for International Settlements 2010).

However, it is not enough to just have statistics. Someone has to understand the statistics and regulations must be in place to ensure that capitalist economies operate within reasonable bounds, have anticipated business cycles and are not, therefore, subject to the crises forecast by Hyman Minsky when an economy becomes unstable.

Although there have been financial crises in the past including the South Seas Bubble, The Wall Street Crash and the Preston Banking Crisis, there are key differences:

1. The speed at which the crisis spread throughout the globe is without precedent, fuelled by the global interconnectedness of financial institutions that all had fingers in the debt pie leading to contagion.

2. There was no Joseph Livesey on hand, 'to lay a statement before the public whose word will be implicitly believed' (Anon 1869b) and, therefore, nobody to induce calm in the world markets.
3. The level of debt has been unprecedented when measured in terms of cash or relative to GDP.

Indeed, 200 years after his birth, perhaps we should listen to Charles Dickens, who described credit as a system whereby 'a person who can't pay, gets another person who can't pay, to guarantee that he can pay' (*Little Dorritt* 1857, Book 1, Chapter 23), and realise that even if debt is guaranteed, such a guarantee may be worthless and therefore remove the speculation that creates the next bubble.

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