Deepak Lal

After the Fall: A Classical Liberal Perspective on the Great Crash of 2008

Lal begins by examining the major reason purported for the current crisis based on so called "global imbalances", which he argues is mistaken, before going on to a major structural change in the US financial system (still disputed) and to list the commonly agreed policy errors which led to the crisis. He then discusses, first, the alternative theoretical frameworks which provide a diagnosis of the crisis, and the errors of omission and commission of the monetary authorities which led to the crisis as well as assessing their response in its aftermath, and, second, the fiscal and regulatory responses to the crisis and their consequences. This leads on to the basic underlying cause of the crisis which is similar to that found in many developing countries—the creation of unsustainable entitlement economies. He ends with what a classical liberal response would be to prevent or mitigate such crises in the future.

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A CLASSICAL LIBERAL
PERSPECTIVE
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Giorgio S. Frankel
L'ora della Turchia:
una potenza emergente
tra Medio Oriente e Caspio,
ai confini degli «imperi»

Valentina Matricardi
Denaro e felicità: dubbi
sul comune convincimento.
Il paradosso di Easterlin

Riccardo de Caria
Il merito alle urne? La ricerca
di un sistema elettorale
meritocratico
e i suoi troppi inconvenienti

Il libro annotato
Elena Casetta
Note in margine a
«Documentalità. Perché
è necessario lasciar tracce»
di Maurizio Ferraris

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DEEPAK LAL

AFTER THE FALL: A CLASSICAL LIBERAL PERSPECTIVE ON THE GREAT CRASH OF 2008

The text of the XXIV Fulvio Guerrini lecture, held by Deepak Lal at the Centro Einaudi in Turin on September 8: an analysis of the causes, consequences and remedies to the crisis, from a classical liberal perspective

It is now two years since the Great Crash of Sept-October 2008. An immense amount has been written about its causes and the consequences are still being worked out, not least by policy makers divided by fears of future deflation or inflation. The crisis has brought all kinds of *dirigiste* panaceas to the fore, and there seems to have been a revival of crude Keynesianism amongst the commentariat and policy makers. Some have seen the crisis as the sign of the collapse of capitalism. In March 2009 soon after becoming President of the Mont Pelerin Society—of which Luigi Einaudi was one of my earlier distinguished predecessors—I organized a special meeting of the Society in New York on the theme "The End of Globalizing Capitalism? Classical Liberal responses to the Global Financial Crisis". I used the papers from the conference[1]; as well as my own opeds from the Indian *Business Standard,* to give a lecture at the Adam Smith Institute in London in June 2009, with a title close to the one for this lecture. A revised version of this was published in the *Cato Journal* earlier this year (Lal 2010). As I stand by many of its arguments, in this lecture I will be largely basing myself on it with various addendums and additions.

I will begin by examining the major reason purported for this crisis based on so called "global imbalances", which I argue is mistaken, before going on to a major struc-

Questo è il testo della XXIV Conferenza "Fulvio Guerrini" organizzata dal Centro di Ricerca e Documentazione "Luigi Einaudi" (Torino, 8 settembre 2010). I testi delle prime venti Conferenze sono raccolti in due volumi: *Le libertà dei contemporanei. Conferenze "Fulvio Guerrini" 1984-1993*, Torino, Centro Einaudi, 1993, e *Le libertà dei contemporanei. Conferenze "Fulvio Guerrini" 1994-2005*, Torino, Centro Einaudi, 2005. Tutti vengono via via pubblicati su questa rivista.

[1] These are available at www.montpelerin.org.

tural change in the US financial system (still disputed) and to list the commonly agreed policy errors which led to the crisis. I then discuss the alternative theoretical frameworks which provide a diagnosis of the crisis, and the errors of omission and commission of the monetary authorities which led to the crisis as well as assessing their response in its aftermath. I then discuss the fiscal and regulatory responses to the crisis and their consequences. This leads on to the basic underlying cause of the crisis which is similar to that found in many developing countries—the creation of unsustainable entitlement economies. I end with what a classical liberal response would be to prevent or mitigate such crises in the future. I will not have time to discuss the equally important geopolitical consequences of the crisis. But for those interested, these can be found in my *Cato Journal* article.

GLOBAL IMBALANCES

The ongoing concern with 'global imbalances' (seen as a cause of the crisis, as well as of the 1980s Third World debt crisis and the likely source of another one in the near future) expressed by a host of commentators[2] and officials[3] gives me a tremendous sense of *déjà vu*. In my 1990 Wincott lecture (Lal 1990) I had examined the case for international coordination to deal with the purported 'global imbalances' of the 1980s, and found it wanting. Though no doubt the purported problems leading to these 'imbalances' (the low consumption share in China and its undervalued exchange rate, the inflexible labour markets in Europe and dysfunctional welfare states, Japanese reluctance to allow immigration and foreign investment etc.) may be of concern to the citizens of the respective countries being lectured to, should they be of concern to the rest of the world? The discussion of 'global imbalances' implicitly assumes they are, because of the supposed spillover effects of these various domestic policies on the global economy. But what are these spillover effects and should internationally coordinated public policy or international moral suasion be used to counter them?

To answer this question it is useful to look upon the global economy as an integrated economy, where governments, central banks, households and firms in each nation are all distinct economic agents acting in their own perceived 'self interest', with their own objectives. The international markets for goods and assets will co-ordinate these myriad decisions into changing relative prices, which at the national level will be reflected in changing macro-economic variables like interest rates, real exchange rates, and savings rates. With both public and private agents maximizing their own perceived interests, this decentralized international system is exactly like a market system.

The changes in prices and outputs that arise as a result of the different actions of these agents are exactly like the increase in demand, say, for shoes within a national economy, which *coeteris paribus* raises the price of leather and hence affects the financial circumstances of the purchaser of handbags. The macroeconomic international spillovers are exactly like those affecting the handbag buyer, which (in the economist's jargon) are 'pecuniary' externalities mediated through the price mechanism and of no

[2] Like the *Financial Times* star economics commentator Martin Wolf.
[3] Like the Chairman of the US Federal Reserve Ben Bernanke.

significance for the efficiency of the economy. They are synonymous with market interdependence and the price system and irrelevant for public policy—in contrast with 'technological' externalities like smoke from a factory which are not mediated through the price mechanism and could require public action. But, pecuniary externalities are not a sign of any 'market failure'. As at the national level, there is no need for any harmonization or co-ordination at the international level further than that provided by the market.

What then are we to make of all the prognostications of various pundits on these 'global imbalances'? They are like the numerous stock brokers reports trying to foretell market trends based on what each claims are 'fundamentals'. But we know that at best they are looking through a glass darkly. These local 'imbalances' may be of concern to particular economic agents. As a taxpayer in California and the US, I am naturally concerned about their respective fiscal deficits because of their implications for my future taxes. But for the rest of the world these are only of interest to agents in these countries if they choose to be holders of the relevant debt instruments financing them. They are not a global concern.[4]

CHANGING FINANCIAL STRUCTURES

In the early 1980s, I was working as the research administrator at the World Bank, while the Third World was engulfed by a debt crisis. The current global financial crisis has eerie similarities, but different outcomes. Why?

First, both the crises arose because there was a surplus of savings in a number of countries—the oil producers in the 1970s, the Asian economies and commodity exporters today—which was recycled through the international banking system. Second, highly liquid banks imprudently funneled cheap credit to uncreditworthy borrowers: the fiscally challenged and inflation prone countries of Latin America and Africa in the 1970s, the *ninja* (those with no income, no jobs, no assets) subprime mortgagees of the current crisis. Third, there was a rise in commodity prices and a worsening of the terms of trade of the OECD, posing the stagflation dilemma for their central banks, having aided and abetted the earlier asset boom. Fourth, the imprudent banks sought bailouts from taxpayers, claiming their demise would fatally damage the world's financial system.

But, the outcomes have been different. The 1980s crisis was finally solved after a prolonged cat and mouse game when the banks accepted substantial write downs of their Third World debt, sacked their imprudent managers and shareholders suffered large losses. But no systemic threat to the world's financial system (or the global economy) emerged. By contrast, today the Western financial system seems to be dissolving before our eyes, and with the U.S. Federal Reserve's ever expanding balance sheet, bailouts are no longer the exception but the norm. Many now foretell a deep and perhaps prolonged recession, with deflation, rising unemployment, and Keynes' famed liquidity trap about to engulf the world's major economies.

[4] Also see Cooper (2007), Corden (2007) which also support this view expressed in my February 2006 *Business Standard* article "Global Imbalances?".

What then explains this difference in outcomes in the current global financial crisis from the Third World debt crises of the 1980s and 1990s? It cannot be purported "global imbalances," even if they were as is claimed the origins of both crises. It is the differences in financial structures within which these temporally separated but largely similar crises occurred. In the 1970s the recycling of the global surpluses was undertaken by the *offshore* branches of Western money centre banks, which were neither supervised nor had access to the *lender of last resort facilities* of their parent country's central bank. Hence, when their Third World Euro dollar loans went into "default," there was no direct threat to the Western banking system.

The present crisis emerged in a radically different financial structure: the rise of universal banks from the UK's "Big Bang" financial liberalization in the 1980s, and the Clinton era abolition of the Glass-Steagall Act, which had kept a firewall between the *commercial* and *investment* banking parts of the financial system since the 1930s. The former had implicit deposit insurance and access to the central banks' lender of last resort facilities. The latter did not. It is worth explaining why this matters.

This distinction between what were previously non-bank financial intermediaries and banks is important because it is only clearing banks which can add to (or reduce) the stock of money. A clearing bank holds deposits in cash (legal tender base money) from non-banks, repaying deposits in notes, and making payments for depositors by settlements in cash through an account in the central bank. When a clearing bank extends a loan it adds to its assets and simultaneously creates deposit liabilities against itself, increasing the broad money supply at "the stroke of a pen." This ability to create money out of thin air is limited by the bank's capital and cash. As cash can be borrowed from the central bank, the ultimate constraint on its ability to create money is its capital. But it is only because banks take in cash deposits—Keynes' "widow's cruse"—that they can create money.

By contrast, a non-bank financial intermediary, say a mortgage lender, when it takes deposits or makes a mortgage loan has to "clear" these through deposits held at the clearing banks. Thus when someone deposits "cash" at a Savings and Loan (S&L) this comes out of the depositor's bank account with a clearing bank. Similarly when the S&L makes a loan to a mortgagee this comes from the S&L's bank account with a clearing bank. Thus, the essential difference between non-bank financial institutions and clearing banks is that they cannot create the bank deposit component of broad money (M2 or M4).

When the Federal Deposit Insurance Corporation (FDIC) was created as part of Roosevelt's New Deal, to prevent the bank runs which the earlier universal banks' gambling had engendered, Marriner Eccles who redesigned the Federal Reserve system for Roosevelt in the Great Depression, insisted that with deposit insurance the banking industry must be split in half: the public utility part of the financial system, which constitutes the payments system, *must* be kept separate from the gambling investment banking part, which is an essential part of a dynamic economy. For these gambles impart the dynamic efficiency through the cleansing processes of creative destruction. But if these gambles are protected against losses by taxpayers, as the payment system activities have to be because of deposit insurance, the gamblers will always win: keeping their gains when their gambles are correct and passing

their losses onto taxpayers when their gambles turn sour. Hence the Glass-Steagall Act.

Given this "moral hazard," many classical liberals have favored free banking. Banks combining the payment and investment functions and issuing their own notes should be *monitored by their depositors*, who would stand to lose if their banks undertook imprudent lending. But with the near universality of deposits as a means of payment, there is little likelihood of this monitoring function being effectively exercised, whilst the rise of Demos precludes any government being able to resist pressures to bail out imprudent banks to protect their depositors. This makes deposit insurance inevitable, and to prevent investment banks from gambling with the taxpayer insured deposit base, something akin to Glass-Steagall remains essential.

The recent emergence of universal banking has however been lauded by many on the classical liberal side (see Calomiris 2000 and Meltzer 2009: 1245), and the repeal of the Glass-Steagall Act is seen as a sensible measure of deregulating the financial system. Much of their argument is based on assessing whether the Glass-Steagall Act was necessary or an immoderate response to the Great Depression. As Meltzer states, "as George Benston (1990) showed proponents of the rule did not make a substantive case when they claimed that combined investment and commercial banking was a cause of the Great Depression" (Meltzer 2009: 1245). Similarly Calomiris, citing many studies which have examined the claim that there was a conflict of interest in mixing commercial and investment banking, whereby "banks might coerce client firms or cheat purchasers of securities", demonstrates that this argument has now been discredited. But he also notes that another concern behind the Glass-Steagall Act "was largely that of economists who correctly worried about the abuse of deposit insurance and the discount window—the possibility of government subsidization of risk in new activities" (p. xiv). This is the worry which has not gone, particularly as he notes that deposit insurance is the only part of the 1933 Banking Act which now remains "and it is difficult to imagine circumstances that will lead to its repeal" (p. xviii). This is the nub, and it is difficult to see why he or Meltzer would therefore oppose keeping investment and commercial banks separate. It is deposit insurance alone that provides a reason for public regulation of any aspect of banking. If the Glass-Steagall firewall between commercial and investment banking is maintained, there is no reason why the investment banks should not be set completely free.[5]

POLICY ERRORS

The recent emergence of universal banking was followed by a number of public policy mistakes on the path to the current crisis. The first was the bail out of LTCM in 1998. Its failure posed no obvious systemic threat. Its public salvation changed expectations of market participants that non-bank financial institutions could also hope for bailouts. Next, the infamous Greenspan "put," which put a floor to the unwinding of the dotcom

[5] Calomiris also seems very enamored of the German universal banks (see his Chapter 4), and this is the direction in which he hopes the US banking system will evolve. But this 'relationship banking' based on corporatism is the direct antithesis of the free market Anglo Saxon capitalist model. See Rajan and Zinglaes (2004) and Lal (2006: 195-203).

stock market bubble, promoted excessive risk taking. Third, the promotion of "affordable" housing for the poor by the Clinton administration, through the unreformed and failed Freddie mortgage twins, led to the development of subprime mortgages. Fourth, the Basle II capital adequacy requirements led banks to put their risky assets into off-balance sheet vehicles—the SIVs—leading to the opacity currently being bemoaned. Fifth, when the housing bubble burst, and the credit crunch began with the gambles taken during it turning sour, the Fed chose to bail out Bear Sterns, sending the signal that the Fed's balance sheet was open to non-deposit taking 'banks' as signaled by the earlier LTCM bailout. Sixth, and most heinously given all that had gone before, the U.S. authorities then chose *not* to bail out Lehman's—like a fallen woman suddenly finding virtue. This dashing of the bailout expectations that the authorities had endorsed only in the spring, led to the intensification of the credit crunch. Seventh, as the authorities finally seemed to tackle the toxic subprime infected financial assets which caused the crisis through the Troubled Asset Relief Program (TARP), it calmed the markets. When TARP was changed to be used only to recapitalize banks, markets went into free fall. The essential step, of forcing banks to come clean on their balance sheets, and then removing the toxic assets they reveal into a newly created institutional *cordon sanitaire*, has still not been taken. Worse, instead of recreating a firewall between the payment part and the gambling part of the banking system, even the pure investment banks, like Goldman Sachs, were pushed into becoming universal banks with access to the Fed's balance sheet and thence taxpayer's money.

Given these public shortcomings the near universal calls for greater regulation and state intervention is astounding. Public agents, not private ones—who reacted rationally to the implicit or explicit 'rules of the game' promoted—are to blame for the crisis. It would be foolish to blame the puppets for the failings of the puppeteer.

THEORETICAL REMEDIES

What of the remedies? In answering this it is essential to be clear of the nature of the crisis, and to view it from the correct theoretical perspective. Because of the association of Keynes' name with the Great Depression, the crisis and its cures are being seen through 'crass Keynesian' lenses. Is this appropriate? To answer this question I briefly outline the alternative theoretical perspectives which seek to explain the current crisis as well as the remedies.

Here a personal note is in order. When I got my first academic job as a lecturer at Christ Church, Oxford, my senior colleague was Sir Roy Harrod—Keynes' first biographer and keeper of his flame. On having to provide a reading list for my tutorials on "economic fluctuations and growth," I asked him what I should ask my pupils to read. I expected him to say Keynes, and his own work on trade cycles and growth. But after some reflection he said: Wicksell. So before I prescribed this to my pupils I immersed myself in *Interest and Prices* and *Lectures on Political Economy*. Since then I have been pleasantly surprised that most of the macroeconomic perspectives on offer really hark back to Wicksell.[6]

[6] The following section has benefited from a paper by my UCLA colleague Axel Leijunhufvud (2009).

Wicksell asked: how could the price level be anchored in a pure credit economy? Bagehot had observed in *Lombard Street* that the whole of the Bank of England's note issue depended on a slender and declining gold ratio. What if this ratio went to zero, asked Wicksell? His answer was that, if the Bank rate were set at the *natural* rate of interest, which balances productivity with thrift, the price level could be kept constant. This is, of course, the theory underlying inflation targeting, as embodied in the Taylor rule. As John Taylor (2009) has noted, it was the failure of the Greenspan Fed to follow this rule which led to the credit bubble after the dotcom bust.

The reasons for this failure are provided by Hayek's refurbished Austrian theory of the trade cycle. Hayek saw divergences between the Wicksellian natural and market rates of interest as causing booms and slumps. If increased bank credit led to market interest rates below the natural rate, businesses will undertake relatively more capital intensive projects with relatively low rates of return. There will also be an unsustainable boom, with more projects undertaken than can be completed, leading to resource scarcities which end the boom. The financial crash which follows will lead to the liquidation of these 'maladjustments', followed by an economic recovery with resources being reallocated in line with inter-temporal consumer preferences and resource availabilities. Whilst broadly accepting the quantity theory of money, Hayek argues that it assumed the absence of "injection" effects, which even with an overall stable price level could lead to false signals in the pattern of inter-temporal *relative* prices, and thence to maladjusted investments. The recent US housing boom, with a stable general price level, provides an example of these 'maladjustments.'

But Hayek's prescription that the slump should be allowed to run its course, came to be disowned even by his London School of Economics (LSE) circle led by Robbins in the 1930's. As Gottfried Haberler (1986: 422), a close friend and member of Hayek's Austrian circle, noted in his astute appraisal of Hayek's business cycle theory: "Keynes, Robbins, and many others were correct: if a cyclical decline has been allowed to degenerate into a severe slump with mass unemployment, falling prices, and deflationary expectations, government deficit spending to inject money directly into the income stream is necessary. Moreover, Hayek himself has changed his mind on this point."

Though Keynes' General Theory, unlike Hayek's, provides no explanation for the boom preceding the slump, Keynes was right in emphasizing "effective demand" failures in the face of a financial crash, and the need for deficit spending. Though not, as advocated by many current Keynesians, through counter cyclical public works. Thus, Keynes (1942: 122) wrote: "Organized public works at home and abroad, may be the right cure for a chronic tendency to a deficiency of effective demand. But they are not capable of sufficiently rapid organization (and above all cannot be reversed or undone at a later date), to be the most serviceable instrument for the prevention of the trade cycle." A point reinforced by the Congressional Budget Office's assessment of the planned Obama infrastructure spending.

Friedman, unlike Hayek, was closer to Wicksell in concentrating on the effects of divergences between the natural and market rate of interest on the *general* price level, and not as Hayek's theory presupposes on *relative* prices. With the *real* (natural) rate being determined by productivity and thrift, monetary expansion will only raise *nominal* interest rates through inflationary expectations. Given the natural rate of interest there

will also be a corresponding *natural rate of unemployment.* Monetary policy can only lead to transitory deviations from these natural rates, if capital and labor markets are efficient. There is little about credit markets in Friedman, or in his successors of the New Classical and Real Business cycle schools. As the current New Neoclassical synthesis is based on these models (with some twists of Keynesian "imperfections"), but contains neither money nor finance, it is useless in explaining or providing cures for the current crisis.

Thus, though Hayek provides the best diagnosis of the cause of the current crisis, neither he nor Keynes provides an adequate explanation of the financial aspects of business cycles, assuming these are endogenous to the fluctuations in the real economy. It is Irving Fisher who provides the correct diagnosis of the nature and cures for the current crisis. Fisher saw a "balance sheet recession" as an essential element in the Great Depression. He argued that, while there were many cyclical factors behind trade cycles, for Great Depressions the two dominant factors are "*over-indebtedness* to start with and *deflation* following soon after" (Fisher 1933: 341). Like the Austrians he saw over-indebtedness as caused by "easy money" (p. 348). This provides a succinct explanation of the current crisis and pointers to its cure. We have a Hayekian recession with Fisherian consequences.[7] I turn to examine the various means to deal with the crisis.

Central Banks and Monetary Policy

The first is monetary policy. The oldest central bank, the Bank of England, evolved over the centuries. With its notes becoming legal tender, it had two functions as the central banker: to maintain the purchasing power of its notes (monetary stability) and to ensure that the commercial deposit taking banks' deposit liabilities are always convertible into the legal tender at par (financial stability)[8]. Inflation targeting by a central bank independent of political influence from the government (which has an incentive in democracies to use monetary policy to generate political business cycles) is now recognized as essential to maintain monetary stability. The Taylor rule provides a rough and ready guide to central banks to achieve this aim. As we have seen, it was the Greenspan put which neglected this rule, which led to the excessive growth in the US money supply, and was a proximate cause of the crisis.

The second part of the central bank's task to maintain financial stability is fulfilled in a crisis by following the rules Bagehot laid down in the 19th century in *Lombard Street* for dealing with a financial panic. The central bank should act as a lender of last resort to the commercial banks, by lending unlimited cash to a *solvent* but *illiquid* bank, at a penalty rate against good collateral. The Bank of England successfully followed these principles without any bank runs till the bank run on Northern Rock in Sept. 2007. Its failure was in part due to the tripartite system which made the Bank of England independent with sole responsibility for maintaining monetary stability, while an independent Financial Services Authority and the Treasury were charged with maintaining finan-

[7] This was also my diagnosis of the Japanese slump in Lal (2003). In Lal (1995) I had also used the Wicksell framework to analyze the macroeconomic outcomes in Brazil in the early 1990's.

[8] Congdon (2009) provides a succinct account of the evolution of central banking.

cial stability. When the Northern Rock run started, the Central Bank with no knowledge of its balance sheet could not perform its traditional lender of last resort function. Instead, the bank was in effect nationalized with all the deposits protected, but with most of the shareholders wiped out. It turns out that the bank was illiquid and not insolvent (see Congdon 2009). The return of responsibility for financial stability to the Central Bank by the new Conservative-Lib Dem government is a move in the right direction, and should be able to avert similar panics in the future.

The US Federal Reserve, as Allan Meltzer's magisterial history shows, has by contrast "in nearly a century of experience with financial failures … never developed and announced a lender of last resort policy. Sometimes it lets the institution fail: sometimes it lends to keep it solvent. Failure to announce and follow an explicit strategy increases uncertainty and encourages troubled institutions to press for bailouts at taxpayer' expense. The credit crisis after 2007 is the latest example" (Meltzer 2009: 1233). This despite the fact that the Federal Reserve has recognized "that it is the lender of last resort to the entire financial system" (p. 1234).

The lender of last resort role to provide liquidity to solvent banks or to all financial institutions (as in the US) would avoid financial panics. But what about the insolvent banks, and for the US (given the Federal Reserve's extended lender of last resort role) insolvent financial institutions? They need to be closed down in an orderly bankruptcy procedure. With the extension in 1991, by the Federal Deposit Insurance Corporation Improvement Act (FDICIA), of the FDIC's authority to cover even solvent banks whose capital had been reduced—by losses—below regulatory limits, and allowing them to be merged or sold, a simple measure to maintain the financial stability mandate would be to extend the FDICIA to *all* financial institutions.

But, despite fulfilling the lender of last resort function, how can the central bank avoid the deflationary Fisherian consequences of a financial crisis when—after the Hayekian boom—deleveraging is required by most agents in the economy? It has been claimed (most stridently by Paul Krugman in his *New York Times* columns) that, once the Central Bank has cut interest rates close to zero, it would face the fabled Keynesian liquidity trap[9], and so the only recourse is to keep aggregate demand up through massive fiscal spending. Japan is cited as the prime example of a country which has been in such a trap with deflation and a stagnant economy since its asset price bubble burst in the early 1990s. But is this argument correct?

Central to answering this question is the transmission mechanism of monetary policy: whether monetary impulses work principally through changes in interest rates or through changes in broad money through the real balance effect which changes rela-

[9] Congdon (2010) distinguishes between two types of liquidity traps, one a narrow liquidity trap which applies to narrow money (M0 or M1), i.e. the monetary base, and a broad liquidity trap based on broad money (M2 or M4) which includes bank deposits. He shows that the first one can occur when the Central Bank confines itself to money market operations to influence the monetary base, but the second will not if it coordinates with the fiscal authorities to change the broad money supply. The classic discussion questioning the existence of liquidity traps during the Great Depression and a rigorous discussion of the implausible assumptions needed to generate them: see Brunner and Meltzer (1968). In a series of papers in the 1960's they also integrated credit markets into monetarist theory.

tive prices and net wealth. Meltzer (2003) shows clearly from charting the real interest rate against the growth of the real monetary base in the US from 1919 to 1951, that "proposition 1: when growth of real balances rises sharply, expansion follows whatever happens to the real interest rate... Proposition 2: when real balances decline, or their growth is comparatively slow, the economy goes into recession even if the real interest rate is comparatively low or negative... Proposition 3: if the real interest rate is comparatively high, the economy expands if real balances rise and does not expand if they fall" (Meltzer 2009: 744)[10]. So the transmission is from money to asset prices and inflation or deflation via the real balance effect and not through interest rates. If broad money expands, even with price deflation and hence rising real interest rates at the zero bound, the economy should expand.

Congdon (2005; 2010) in examining the long Japanese deflationary episode shows that, it was due to concentrating inappropriately on the 'narrow' money definition of money, which the Central Bank controls through *money market* operations with the commercial banks. If it had coordinated with the Ministry of Finance to expand broad money by *debt market* operations, it could have engineered an economic expansion even if there was deflation (of prices).

Ben Bernanke had clearly learnt this lesson when he argued that the monetary authorities could always increase the broad money supply at a zero interest rate through 'unconventional' means, for which he was nicknamed Helicopter Ben. During the recent crisis he has fulfilled the pledge he made to Milton Friedman on his 90th birthday that he had learnt the lesson of his great book with Anna Schwartz on the Great Depression, and through so called 'quantitative easing'—which is a polite word for printing money—ensured the second leg of a Fisherian debt deflation did not take hold in the US. This has also been true of the Bank of England and the European Central Bank (ECB). The current worries are that these Central Banks will not be able to exit from 'quantitative easing' in time, before the inflationary consequences of their exploding balance sheets lead to inflation, and rising nominal interest rates on government debt, which would worsen the debt dynamics of the public sector. But by and large the 'liquidity trap' cited by the Keynesian fiscalists as leading to the impotence of monetary policy is a paper tiger.

FISCAL POLICY

For countries with a low or no structural deficit, raising aggregate demand in the face of a severe financial crisis by running a temporary budget deficit, above that resulting from automatic stabilisers, makes sense. This was the policy adopted by many of the emerging markets, notably India and China, and they have soon got back on to their high growth paths.

[10] Meltzer bases his monetarist argument on narrow money—the monetary base (M0 or M1). Whether the Central Bank controls this monetary aggregate, or broad money (M2 or M4) has been part of a dispute amongst monetarists. Congdon (2005) argues cogently that it is broad money which is the correct variable for the Central Bank to control. As it is the real balance effect of broad money not narrow money which leads to the transmission from money to nominal output, and prices.

The US had an arguably unmanageable structural deficit. Moreover, the stimulus package it adopted in 2009 was a dog's breakfast and has failed to achieve its objectives. It failed to adopt the obvious means to restore household and firm balance sheets, by a massive across the board tax cut accompanied by an equivalent fiscal deficit. It is argued that most of this extra income will be saved not spent. But this is to be bewitched by the wholly inappropriate Keynesian income-expenditure analysis, which fails to deal with balance sheets. If this Fisherian aftermath of a Hayekian recession is caused by attempts to reduce unsustainable debt, the "savings" generated by the tax cut (i.e. reducing liabilities to the government[11]) will allow the necessary deleveraging, without a downward spiral in income and increased bankruptcies. By facilitating households to pay off their mortgage and credit card debts, it will prevent further impairment of bank assets. As the *Financial Times* (Guha 2009: 9) reported, the parts of the Obama stimulus package that have worked were the "fast acting tax breaks and transfer payments [which] largely explain why disposable income rose 2.9 percent from January to May, even as earned income fell 0.7 percent, allowing the savings rate to rise without a collapse in spending". If the whole of the $787 billion stimulus package had consisted of an across the board tax cut, there would have been a large deleveraging of the economy with an increase in private savings without an equivalent cut in private spending. The increased private savings being matched by public dis-savings would have been reflected in the increased budget deficit. Also the tax cut could be reversed once the economy recovered, providing an easy 'exit strategy' from the fiscal stimulus.[12]

This inept fiscal stimulus was then accompanied by the misguided health care reforms which have added significantly to the US structural deficit. This has made any further fiscal stimulus politically impossible, whilst at the same time aggravating the problems with any further monetary actions through 'quantitative easing'. This makes a double dip recession in the US more likely, if the extant monetary easing proves insufficient to give a nudge to the stalling economy.

In the UK, with a large structural deficit fuelled by increased welfare spending by the Labour government, there is little space for any further fiscal expansion. The new government is therefore right to create more fiscal space by a sharp cutback in public spending, by rolling back the unsustainable welfare state. But it has been wrong in keeping the 50% tax on higher incomes instituted by the previous government, and also to raise VAT. If the spending cuts are made, they will give the Bank of England sufficient fiscal space to undertake further monetary easing through quantitative easing, if the need should arise.

Similarly in the Eurozone, the ECB rightly undertook quantitative easing during the crisis whilst urging reduction of fiscal deficits. The success of Germany in following this

[11] Unlike the 1930s, governments in developed countries have much more leeway to do this as the share of general government revenue (their tax cut) as a share of GDP had increased from about 20 percent in the United States and Great Britain to about 32 percent in the United States and 38 percent in Britain in 1997 (Tanzi and Schuknecht 2000: 52).

[12] The theoretical worry that temporary tax cuts will be saved rather than raising consumption and aggregate demand is irrelevant to this case, as the purpose of the temporary tax cuts is to allow economic agents to raise their savings without reducing their previous consumption.

advice, by reversing the stalling in its GDP, points to the success of this policy. The Eurozone problems now concern financial stability related to the Greek debt crisis. As many of the banks in the non Club Med members of the zone are exposed to Greek sovereign debt, a Greek debt default would lead to a serious Eurozone banking crisis. To avoid this, an IMF type stabilization program has been imposed on Greece by the ECB and IMF. But unlike similar stabilization programs in developing countries two essential elements are missing: a large devaluation and a restructuring of the country's debt. The former is precluded by the fixed exchange rate of the Euro, the latter by the external holdings of Greek sovereign debt by European banks. But the alternative imposed on Greece is a large *internal devaluation* to engineer a large fall in domestic wages and prices through a massive deflation. It is difficult to believe that Greek politics will allow the country to follow this path, particularly when even at its end, Greece is likely to be left with a debt-GDP ratio of 150%. A Greek default and exit from the Euro seems the most likely outcome. The other Club Med countries should however be able to politically manage the fiscal retrenchment required in their less indebted economies.

FINANCIAL ENGINEERING

The story of financial engineering which created more and more complex debt instruments, in which tail risk was ignored, and was induced by the low interest rates during the Great Moderation, and exacerbated by the Greenspan put, is by now well known[13] and I will not labour it here. Two lessons however are important. First, it was the policy of the US government, ever since the Great Depression, to promote housing by giving implicit subsidies to homeowners through the financial system, which led to the subprime mortgage crisis. Second, it was the moral hazard begun with the LTCM bail out, and the subsequent bailouts of financial firms which were not commercial banks and whose bankruptcy did not threaten the deposit base—whose protection should be the sole public responsibility—which led to the mispricing of risk: with financial intermediaries coming to believe that if their increasingly risky bets were successful they stood to make immense financial gains, and if they turned sour the authorities would get taxpayers to bail them out.

These distortions in the US financial system were then internationalised by the asset backed securities which increasingly came to be held by banks around the world. By packaging a host of different securities including subprime mortgages into increasingly opaque securities, in the belief that this diversification of the assets in each security basket would lower the risk of holding the security, they made these securities even more insecure. It was like packaging different types of meat into pies and selling them around the world. When then it turned out that there was an infected piece of meat which had been baked into many of the pies in the form of subprime mortgages which turned sour with the downturn in the US housing market, none of the holders of the pies around the world knew if their pies contained the infected meat. All interbank lending based on these opaque asset backed securities ceased, and a global financial crisis was triggered.

[13] See Authers (2010), Rajan (2010), Tett (2009) for incisive accounts.

The immediate official response to the crisis, in which the insurer AIG was bailed out, which then led it to fully repay its counterparties like Goldman Sachs, bailing them out in turn, only justified the beliefs of those who had undertaken the imprudent lending that any losses would be borne by taxpayers. Moral hazard increased even further. It was further accentuated with the classification of institutions as being 'too big to fail', and has given an incentive for the creation of even larger universal banks 'too big to fail'. With the authorities egging on the conversion of previous investment banks into bank holding companies, the US financial structure has become even more oligopolistic.

Much worse, the recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act, now formalizes the Federal Reserve's role in being the supervisor and lender of last resort of the whole US banking system, which is opposite to the classical liberal view that, once investment and commercial banking are kept separate (because it is politically impossible to end deposit insurance) the Central Bank should have nothing to do with the investment banking part. This should be allowed to follow whatever innovations and risk taking it chooses in competitive markets, but it must be made to bear the full costs of any mistakes it makes.

By contrast, as Peter Wallison (2010) of the American Enterprise Institute has argued, all "financial firms will, under this new structure, inevitably be subordinated to the supervisory judgments about what the firms can safely be allowed to do... Where financial firms once focused on beating their competitors, they will now focus on currying favor with their regulator, which will have the power to control their every move. What may ultimately emerge is a partnership between the largest financial firms and the Federal Reserve—a partnership in which the Fed protects them from failure and excessive competition and they in turn curb their competitive instincts to carry out the government's policies and directions". In short it is likely to substitute a sclerotic corporatist economic model, replacing the highly competitive and innovative model which, despite its flaws, has brought untold prosperity around the world.

THE ENTITLEMENT ECONOMIES

The financial crisis has ultimately been caused like so many past crises,[14] by the particular country's past *dirigisme.* Most government interventions in the economy are equivalent to taxes and subsidies. The implicit or explicit subsidies create politically determined income streams for various favoured groups which then have to be paid for by others through implicit or explicit taxes, with governments naturally favouring implicit taxes which can not be easily monitored by the geese to be fleeced. But in time the expansion of these entitlements leads to tax resistance and a fiscal cum debt crisis.

In the case of the US subprime mortgages, which were the proximate cause of the crisis, there has been a commitment by the government since the Great Depression

[14] Reinhart and Rogoff (2009), in their empirical historical survey of past crises around the world, have shown they were no different from the current crisis. See Lal (1987), Lal and Myint (1996) for the anatomy of crises.

that home ownership should be increased. Apart from the explicit subsidy given by the tax deductibility of mortgage interest, the various government sponsored enterprises (GSEs) like the Freddie mortgage twins, and various government mandates to the banking system to finance loans to the 'poor', were used to provide implicit subsidies to homeowners. The insolvent GSEs were then taken over by the government and their losses are to be borne by taxpayers. There has been no reform of these entitlements to housing. If they are to continue it would be best to make the subsidy given through the GSEs explicit through the budget.

But, ultimately these entitlements, which are explicit in the Welfare states of Europe, are becoming unsustainable, as the current travail of Greece shows vividly. They inevitably lead to a fiscal crisis and a debt crisis whose resolution ultimately requires rescinding these politically determined entitlements. The UK has now bit this particular bullet. Greece and other Club Med countries are being made to do so by their actual or incipient fiscal crises.

The US, however, is still in denial. Instead of rescinding past politically determined entitlements particularly to health care, which the US comptroller general David Walker in August 2007 saw as the main cause of its unsustainable structural deficit of $500 billion at the time (Walker 2007), Obama has enlarged the entitlement with his misguided health care bill. So the projected deficit is now in the trillions. As Walker emphasized, the incipient fiscal crisis (even with the smaller deficit in 2007) could not be cured by growing out of the problem, eliminating earmarks, wiping out fraud, ending the Iraq (and Afghan) wars or cutting defense expenditures, restraining discretionary expenditure spending, or letting the Bush tax cuts expire. The very policies Obama is hoping for will reverse exploding future deficits. Thus not only is the current US financial crisis not solved, the seeds are there for future even more serious crises.

CONCLUSIONS

My conclusions can be brief. First, to avoid future crises the entitlement economies which currently dominate advanced economies need to be tamed if not dismantled. Second, as long as deposit insurance remains, a separation between commercial banks which can create deposits, and investment banks which can gamble with these deposits in a 'universal' bank at taxpayers expense, must be created.[15] Third, the investment banks should be free to take whatever risks they want without any possible bailout by the authorities. In the US, the orderly closure of failed and failing institutions should be done by the FDIC. Fourth, for the commercial banking part of the financial system the Bagehot rule for the lender of last resort function of central banks should be formally established and publicized. Fifth, for the monetary stability part of their mandate central banks should monitor and control the broad money supply to mitigate booms and slumps. This in essence is the classical liberal perspective on dealing with financial crises, which will always recur.

[15] Tjos remains controversial even amongst American conservative economists. See Calomiris (2000) and Meltzer (2009: 1245).

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