“Bhagwati thoughts on crisis”

Question 1: How big is the U.S. crisis?

Answer:

It is really big in the sense that it has led to panic on an immense scale among nearly everyone who has any assets in the banks or mutual funds, or mortgages on their homes, which means the bulk of the population in the US, and also among commercial and investment banks who risk failure. My tax lawyer, a wise man, told me that, even though I was recovering from a knee replacement surgery, I should withdraw moneys from Mutual Funds and then walk on my crutches down Broadway (the big Avenue near Columbia University which has many banks) and open up several bank accounts, each with $100,000 deposits (that being the limit of the deposits covered by the Federal Deposit Insurance Corporation)! No matter whom you talk to, the sense is that this crisis is reminiscent of the Great Crash of 1929.

Yet, there are no real parallels: the crisis this time around is complex but is being contained. At the outset, the 1929 crisis resulted in terrible consequences in massive unemployment and economic distress. So far, we have managed to confine the lost jobs principally to the layoffs in the commercial and investment banks: the unemployment rate has not been affected significantly. Second, the 1929 situation witnessed a tight monetary policy which accentuated the depression, and there was no sense that fiscal policy should be expansionary because the Keynesian insights were a result of the experience with the Great Crash and were not available to countervail the Crash! Third, the trade policy went berserk in 1930 with the passage of the Smoot-Hawley Tariff by the US which led to retaliatory tariff-raising elsewhere, beggaring everybody. This time around, there is no willingness to indulge in such destructive, crisis-worsening trade policy. Liberalizing trade is going to be more difficult; but moving backwards into protection is most unlikely. Fourth, the policymakers, led by Fed Chairman Ben Bernanke (who narrowly missed being my student at MIT) and Treasury Secretary Paulson, are totally pragmatic and determined to do whatever is necessary to stop the crisis in its tracks.

Question 2: What does this crisis tell you about how to prevent future crises?

Answer:

No one knows where the next crisis will come from. My old teacher Professor Kindleberger, who wrote the famous book about Panics, Manias and Crises, was writing about financial crises that had occurred in history. Each time, he went back still further. So, I joked with him that, he might one

day work back to the Garden of Eden but that, while Adam and Eve certainly had a crisis, it was not a financial one!

In recent times, we have had four major crises, including the present one. In the October 1987 crisis, the "Black Monday" when stocks collapsed, everyone thought Capitalism had collapsed: it did not. Then, we had the LTCM (Long term Capital Management) Hedge Fund Crisis, where the problem was highly leveraged investments by this hedge fund, with pension funds and banks heavily invested in LTCM and the fear of systemic spread of the crisis was enormous. Then, we had the East Asian Financial Crisis which began in July 1997 and went through 1998. And we finally have the current crisis.

What is the common theme? In each case, the problem was that we succumbed to the euphoria that surrounds each "innovation" in financial policy or financial instruments, rather than simple "deregulation". Thus, during the Asian financial crisis, the IMF pushed for capital account convertibility, thinking it was clearly a major innovation in policymaking. But, when disaster struck even though these countries had sound fundamentals, the reason was that the banking systems were fragile and not ready to support the convertibility. No one had considered this downside. Again, when the LTCM crisis happened, a good friend of mine in the Bank for International Settlements told me that they had convened a Conference of leading central and commercial bankers, and it turned out that most of them did not know what a "derivative" was! The innovation had gone beyond the comprehension of the players and the regulators. Similarly, in the current crisis, I was told by a leading German banker that when the sub-prime mortgages were securitized, they thought they were spreading risks and instead they were growing a crisis that happened now. Besides, flexible interest rate mortgages extended massively to low-income families by Freddie Mac and Fannie Mae, an increase in interest rates would be fatal to these families, leading them into default: flexible rate mortgages were like poison pills that would start killing you eventually.

In short, in nearly every case, the problem has been that new instruments and new policies were introduced without careful thought. In each case, the downside was not worked out: it was like the current Iraq War where the downside was not worked out either and it was assumed that, as with the previous Iraq War, the war would have ended in a month. My diagnosis, leaving out details which the current crisis managers must address, is that the chief lesson of these "systemic" financial crises is that the regulators and monitors of the system must ensure that "innovation" does not go beyond "comprehension" of the possible downsides. I often think of what Keynes once wrote to a friend once: "The inevitable never happens. It is always the unexpected". It is a typical Keynesian exaggeration; but it contains acute insight.

Question 3: Are the current measures to handle the crisis adequate?

Answer:

I think that Bernanke and Paulson are on the right track. They have intervened forcefully, with every policy action that they could take.

If I were a cartoonist, I would draw a cartoon which shows the sub-prime crisis as Rosemary's baby in the bathtub, with Bernanke and Paulson standing at the edge of the bathtub with hoses in their hands, one marked monetary policy, another fiscal policy, one marked Freddie Mac and Fannie Mae nationalization, yet another marked RTC (just announced, like the RTC after the Savings & Loan Crisis in the late 1980s in the US which had no global contagion), all hoses turned on to drown the baby! It is a gigantic job, and no one knows how deep the crisis would be if nothing was done to address it; and no one knows how deep it will be after even the Bernanke-Paulson interventions begin to turn around the lack of confidence that is critically affecting the system.

Professor Stiglitz has recently said that this crisis is like the Berlin Wall collapse for "market fundamentalism” regarding free trade and other liberal policies. I am afraid this is nonsense. He likes to think that any use of markets makes on a "fundamentalist". Is one a fundamentalist if one is an environmentalist and believes in carbon taxes or cap-and-trade? Is one a market fundamentalist if one believes, based on logic and evidence, that free trade leads to more rapid growth and hence a faster reduction of poverty than protection would? After all, that is what China and India achieved: by integrating themselves into the world markets on trade, just as the East Asian economies did earlier, they achieved remarkable growth of income and pulled hundreds of millions out of poverty. In fact, it is Professor Stiglitz who is the ideologue, who cannot see facts, who avoids evidence and argumentation, and then astonishingly calls us "fundamentalists"! As the English say, "everything seems yellow to the jaundiced eye"!

That financial markets, including international financial markets, raise deep questions requiring prudential regulation and management, has been so deeply understood and accepted for decades, and equally it is so well understood that other non-financial markets do not share these problems, that Stiglitz's attempt to argue as if all these problems can be lumped together and discussed under the rubric of "market fundamentalism" is laughable. It is also tragic as the public often thinks that a good economist cannot offer bad economics.

Unfortunately, Professor Stiglitz is determined to prove otherwise.