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The Financial Crisis: Causes and Cures

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The financial crisis experienced in the U.S. and the U.K. is the major contributor to the worldwide economic downturn and to fears of a lengthy slump to follow. This financial crisis was triggered by the collapse of the speculative overshoot in housing prices in these two countries. Various factors subsequently magnified the ensuing crisis. It may be that the financial sector will ultimately heal itself. But will it, in doing so, serve to revive fully the economy? I will argue that to regain any normal level of prosperity it will be necessary – whether or not sufficient – to reshape the financial sector. I am hopeful it will be sufficient.

The perspective I take on the crisis may be called *structuralist* to distinguish it from *monetary* perspectives. In my perspective, the emerging slump of employment is *not* caused by a deficiency of "*aggregate* demand" or by a policy error at central banks that leaves interest rates too high. I agree, of course, that a shortage of money would force a contraction in any modern-day economy. But there are no longer signs of such a shortage. (The elevation of corporate and loan rates reflect a large "uncertainty premium.") Indeed, I would say that the rise of on long-term U.S. governments over recent months indicates worry in bond markets that a period of inflation is on its way. (The continued excess of the interest rates on government bonds over those on inflation-protected government bonds also points to expectations of inflation.) I also agree that the U.S. and U.K. economies badly need an increase in a *kind* of demand. But, in the determination of total employment, the *structure* of demand matters: Increased consumer demand may be unproductive, even counterproductive, while a resumption of a normal level of *investment* demand is crucial to a normal level of employment.

The speculation in housing prices had more sources than is commonly understood. Extraordinary excesses of national saving over domestic investment in Germany, China and many Middle East countries led to a flood of capital into the U.S. and U.K., since they had broad bond markets. (There is no EU government bond!) To go on stabilizing the inflation rate, the central banks had to allow interest rates to fall. The banks moved to take advantage of the reduced cost of borrowing, though they had long lacked the expertise to embark on a big program of lending to the business sector. Instead, the banks directed the increased capital into the assets they knew – mortgages, especially residential mortgages (though also commercial mortgages).

Alongside the increased *supply* of credit there was also an increased demand for credit by American households, which is less well-known. It became government policy in the late 1990s to encourage increased “home ownership” not only by stimulating increased lending to the housing sector but also by stimulating households to *borrow* in order to buy a home. And the Bush tax cuts enacted in 2002 gave households official encouragement to step up their consumption – which meant, essentially, stepping up their possession of housing as well as consumer durables generally.

The steep increases in housing prices that resulted led to speculation that *even higher* prices would be seen in the near future. ("Herding" is common and not clearly irrational either: one assumes that the first-movers have done their homework, so one is encouraged to imitate.) Speculators in the U.S., particularly where protected against losses by state laws, obtain mortgage loans with which to buy houses in anticipation of capital gains.

As is well-known, the banks themselves became caught up in the speculative process. Banks in the present decade were more and more hard pressed to find profitable lending opportunities – the law of diminishing returns was in operation and new borrowers were less and less credit-worthy. A prudent response by the bankers – one in the interest of the shareowners – would have been to restrain their lending. Instead they maintained the hectic pace of their lending: they leveraged their meager capital to ever greater lengths by taking on ever larger levels of debt in order to have ever larger levels of loans. And they lowered their loan standards. Of course, this was a dramatic failure of personal responsibility, both to shareowners and to their country. In addition, there was the amateurish mistake of treating securitized packages of mortgages as though they had carried no risk! And, finally, the added indebtedness the banks took on was excessively short-term. Thus the banks were quite vulnerable when housing prices fell and brought down the value of their housing loans.

This crisis led the bankers to do everything they could to protect themselves from bankruptcy and the loss of their jobs. One action they took was to curtail sharply their lending. The resulting “credit crunch,” in which most borrowers have found it difficult or impossible to obtain credit, is the main feature of the financial crisis.

This “credit crunch” is causing reduced asset prices generally – witness the the terrible decline in share prices – and a further fall in housing prices.

What will happen after we hit bottom? And what ought governments to do to improve the outcome?

Even if most of the banks survive and most of these surviving banks gradually succeed in decreasing their leverage, they will be doing so at the cost to the economy of decreasing their loans (along with their borrowings). That decrease in the stock of loans may open up opportunities for additional banks to start up; but it is not clear that they could raise capital if the established banks were unable to raise additional capital. In any case, the completion of such a process might take a number of years. The government might step in to help with the creation of additional banks or the raising of additional capital.

But do we want a return of banking as we know it? Is there enough profit to support a revival of residential mortgage lending? If not, what then?

It might be thought that additional banks would go into the activity of lending to the business sector. But a consideration that has been largely neglected in the current discussion is that, over the present decade, there has been a decline in the dynamism of the business sector in the U.S. and perhaps the U.K. as well. In the 1990s the number of initial public offerings (IPOs) by young companies – typically raised to adulthood by venture capital firms – were running at the rate of 350 per year. In the present decade, the number of IPOs have been only 50 per year. I am pretty sure that the rate of new firm formation has likewise declined. Venture capital firms in Silicon Valley are shrinking.

It seems to me, therefore, that a return to any normal level of prosperity (an unemployment rate under 6%, say) will require a restructuring of the financial sector. The government will have to help with the establishment of a new class of banks – banks that possess or acquire the expertise to serve the business sector by means of lending to companies for long-term investment and for innovation. This help by the government might take the form of a subsidy to reduce the new banks' cost of capital. Or it might take the form of an initial endowment contributed to each bank by the government.

It seems clear that with the rest of the world effectively blocking a large increase in U.S. exports and with the prospects of profitable lending to the housing sector extremely dim, the road to normal prosperity requires *rehabilitating* the financial sector in order to revive business investment and innovation.

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PROPOSAL

The restoration of prosperity in the U.S. requires restoration of banking lending. But the existing banks appear unable to raise the necessary capital in view of their past performance. Furthermore, the revival of aggregate investment activity will require a strong revival of business investment in view of the patent unprofitability of investing in housing at past rates. And the existing banks lack the expertise to serve the business sector of the economy. So the U.S. economy will require banks of a new kind – banks dedicated to serving the business sector.

Yet the dynamism of the business sector in the U.S. and perhaps the U.K. as well has been in decline for many years. In the 1990s the number of initial public offerings (IPOs) by young companies – typically raised to adulthood by venture capital firms – were running at the rate of 350 per year. In the present decade, the number of IPOs have been only 50 per year. It is likely therefore that the rate of new firm formation has likewise declined. Venture capital firms in Silicon Valley are shrinking. Thus, the new class of banks will require government support. The government will have to help with the establishment of a new class of banks – banks that possess or acquire the expertise to serve the business sector by means of lending to companies for long-term investment and for innovation. This help by the government might take the form of a subsidy to reduce the new banks' cost of capital. Or it might take the form of an initial endowment contributed to each bank by the government.

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