Antieconomics and financial crisis *

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Questions

1. What was the origin of the financial crisis?
2. Was it due to a lack of government intervention or an excess of government intervention?
3. What does the occurrence of a financial crisis mean for the “efficient-market hypothesis”?
4. What does it mean for the market system?
5. How much should we do to avoid financial crises and/or economic crises (business cycles?
6. What does it mean for economic theory?

Interesting debate following an article by Robert Lucas in The Economist [Lucas (2009)].

Lucas, Robert (2009). In defence of the dismal science. The Economist, August 6, 2009 (with comments).

1. Anticapitalism and antieconomics

Since the beginning of the industrial revolution, capitalism has met with hostility based on a moral ground.

The search for private profit has been viewed as “immoral”.

During the same theory, economics as a scientific discipline started to develop, bringing the idea that the search for private profit (“greed”) can a “good” from a social viewpoint:

1. Mandeville’s fable of the bees;
2. Adam Smith’s invisible hand.

Critiques of capitalism has come from two main origins:

1. far-right: aristocratic quarters who resented the ascension of the “bourgeoisie” during the 19th century;
2. socialists who wish to have an economy directed by the state.

For an interesting history of antieconomics.

Coleman, W.O. (2003). Economics and its Enemies: Two Centuries of Anti-Economics, Palgrave Macmillan, Houndsmill, U.K.

Every time we live a deep crisis, we can see a festival of anticapitalist and “antieconomics” discourse.

2. Alternative explanations of the 2008-2009 crisis

Widespread agreement on the events of 2008-2009.

1. A recession starts gradually in the U.S. around the end of 2007 or the beginning of 2008.
2. The slowdown appears to be linked to a slowdown in housing markets, especially mortgage related securities:
   derivative securities involving subprime mortgage loans which turned out much riskier than buyers thought.
3. Some banks had difficulties; in particular, a fairly large investment bank (Bear Stearns) had to be rescued in the Spring of 2008.
4. In September 2008, Lehman Brothers goes bankrupt and U.S. authorities refuse to rescue it.
5. This quickly leads to a liquidity crisis during which banks stop (to a large extent) lending to each other and a period of a several weeks during which stock markets dropped dramatically.
6. The ongoing U.S. recession goes much deeper and extends to most of the world.
7. Governments undertake exceptional interventions:
   (a) monetary: reserves in U.S. banks increase from 50 B$ to more than 800 B$ between September and December 2008;
   (b) fiscal: big spending programs have been adopted (although not all spent).

8. The end of the recession has been declared finished during the summer of 2009.

Explanations then diverge on the longer-run origin of the crisis. Two basic interpretations.

1. Excessive deregulation and financial innovations based on deficient financial models (Krugman, Stiglitz, media).
2. Misguided fiscal and monetary policies:
   (a) fiscal policies to encourage property (Fannie Mae, Freddie Mac);
   see Sinn (2009);
   (b) excessively expansionary monetary policy after 2001 (Taylor);
   (c) these imbalances may have been hidden temporarily in the U.S. case by an inflow of foreign capital (savings glut" hypothesis. Wolf).

Must we choose between these explanations:
the plain fact is that the conjunction of these factors made the deep crisis we faced possible.

3. Meaning for economics and the market system

Questions

A. What does the 2008-2009 crisis entails on the success (or failure) of economic theory?

B. What does the 2008-2009 crisis entails on the success (or failure) of market economy?

1. Does the financial crisis entail the failure of the “efficient-market hypothesis”?
2. What is the meaning for financial theory?
   Gaussian copulas theory.
   Further discussion; Balkema, Embrechts and Lysenko (n.d.).
3. Does the failure of forecasters to predict the meltdown of September-October 2008 entails the failure of macroeconomics ?
4. Have we seen the failure of macroeconomics ?
5. Should governments have intervened much earlier?
6. Should we try to make impossible economic crises?
7. Should we try to make price bubbles impossible?

4. Regulation reform

Two functions of central banks

A Monitoring of the nominal anchor:
ensure a predictable price level (inflation rate).

B Avoid the collapse of credit services:
banking and financial system.
Lender of last resort.

Both these functions have **real objectives**:

1. enhancing economic efficiency;
2. stabilizing macroeconomic activity.

In recent years, due to strong growth, emphasis has been put on nominal anchor function.

The recent financial crisis, which has led to what appears to be the deepest post-war recessions, has put forward again the financial stability and lender of last resort functions.

Two basic interpretations of the 2008 financial crisis

1. Deregulation
   (a) 2004 SEC decision to suppress reserve requirements for investment banks.
   (b) Weak regulation of large segments of financial markets, especially for relatively new products (hedge funds, etc.).
2. Bad fiscal and monetary policy decisions, which contributed to the housing market boom (and bust).
   (a) Fiscal programs and institutions aimed at increasing home ownership (Fannie Mae Freddie Mac, interest deductibility, non-recourse mortgages).
   (b) Low interest monetary policy in U.S. during 2002-2005 (Taylor).
   (c) Wrong policy responses at the Early stages of the current recession (liquidity vs. counterparty risk).
   (d) Decision to let Lehman Brothers fail in September 2008. Inconsistent policy.

In the end, the first interpretation may be more pleasing to regulators and central bankers than the first one.

Irrespective of the interpretation, Canada did not misbehave in this story.

In all cases, financial regulation has played a role in the transmission of the monetary crisis.
A reassessment is required.

Financial sector policies

1. General objectives
   (a) Reduce the probability of financial collapse,
   in particular the buildup of excessive leverage in large sets of financial institutions which may later require public help (systemic risk).
   (b) Reassess the role of the wider financial sector in monetary policy rules.
2. Financial sector monitoring
   (a) Better evaluation of the balance sheets of banks and financial institutions (important work at the Bank of Canada):
      i. riskiness,
      ii. level of liquidity,
      iii. probability of default measures.
   (b) Accounting:
      i. mark-to-market,
      ii. measures based on longer-run criteria (average, lowest value, most probable value),
      iii. foreign-held assets (hidden risk).
   (c) Credit rating agencies:
      i. paid by lenders or borrowers ?
      ii. independent rating agencies ?

3. Regulation of risk behavior:

   (a) mortgage market equity requirements;
   (b) liquidity and equity requirements for financial institutions;
   (c) international harmonization of bank and financial regulation: international standards.
   Role of the International Monetary Fund ?
   Basel II ?

4. Application of regulation.

   Are existing regulations well applied ?

   Will "improved" regulations be applied ?

5. Integration of usual monetary policy rules and objectives (inflation targeting) with financial market monitoring (and stabilization).

   Interest rates – on which monetary policy focuses.– are only one of “fixed-income assets”.
   But risk (probability of default) is another important feature.
   In the future, monetary policy will have to devote more attention to it.

   New role for monetary (or financial) aggregates in the conduct of monetary policy?

6. Important trade-offs for optimal macroeconomic policy:

   Risk-return trade-off.
   How much to pay for financial and economic stability ?
   Reassess the welfare value of economic stabilization.

7. Usefulness of recent macroeconomic modelling for dealing with financial crises:
   representative agents, rational expectations, calibration.
   How useful have they been for managing the recent crisis ?
   What should be the direction of research?

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