

Course 8

From Crisis to Crisis to Crisis:

Cheap Money Forever?

Outline

Crisis after crisis: Dotcom & 9/11, GFC, Covid-19, War

The Global Financial Crisis – causes & consequences

Cheap money forever > Covid and more cheap money

... mid-2021, the rise of inflation... and now war.

The road to the 2007-2009 global financial crisis

- The rise of financial globalisation and return of financial crises
- Development of financial instruments
- Deregulation
- Information technology
- Greenspan put – clean not lean
- Dotcom crash 2000 and broader crash after 9/11 (2001) > low interest rates 1% (6/2003-6/2004) due to a fear of deflation

Fear of deflation: what risks?



U.S. recessions are shaded; the most recent end date is undecided. Source: Board of Governors of the Federal Reserve System (US)

fred.stlouisfed.org



The Global “Savings Glut” (Bernanke) and The “Minotaur Economy” (Varoufakis)



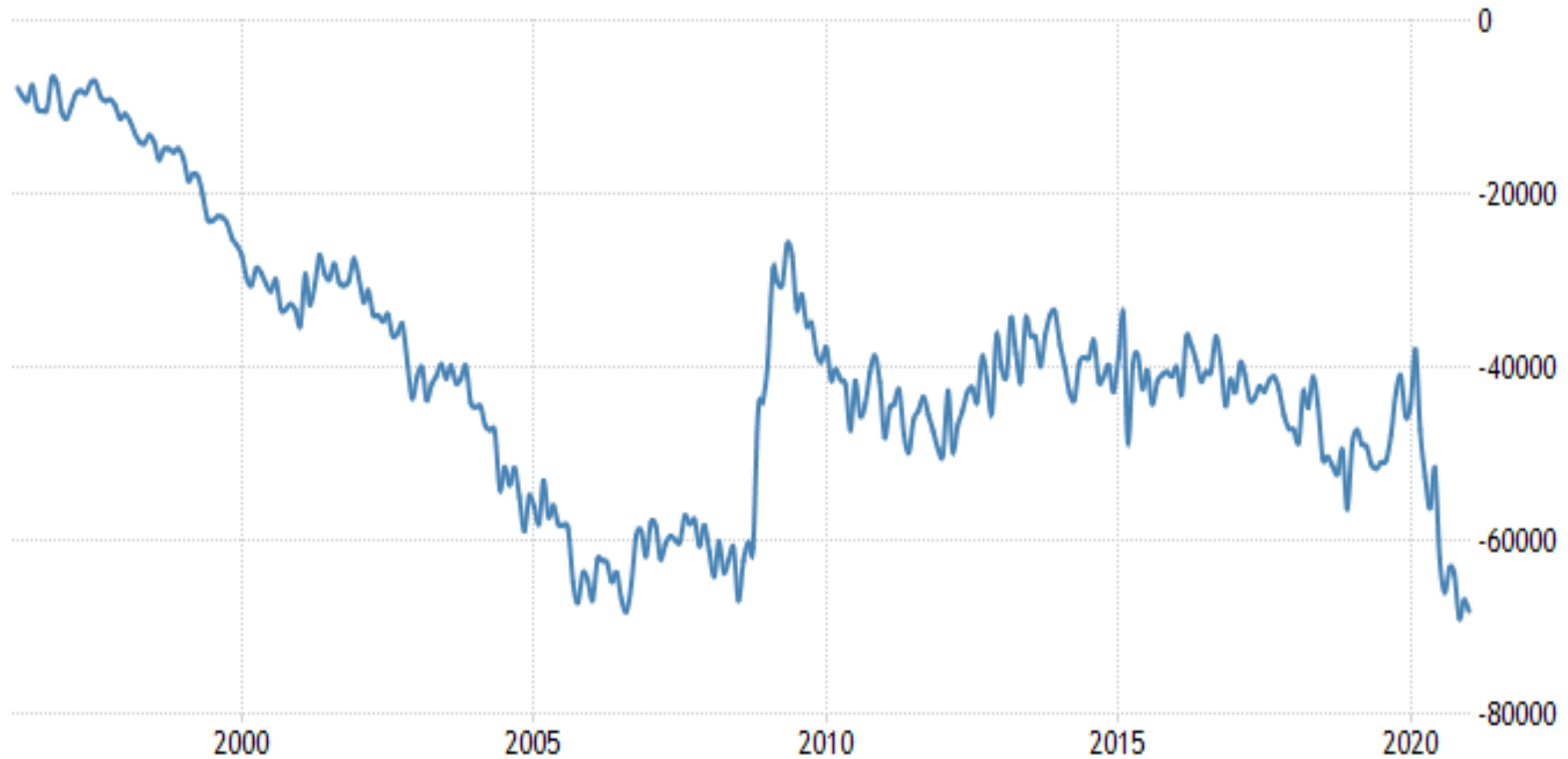
“global surplus recycling mechanism” (GSRM)

US: consumer of last resort after post 9/11 global slowdown, US was holding up world demand

China (especially) and other Asian countries were lending to the US and exporting to the US

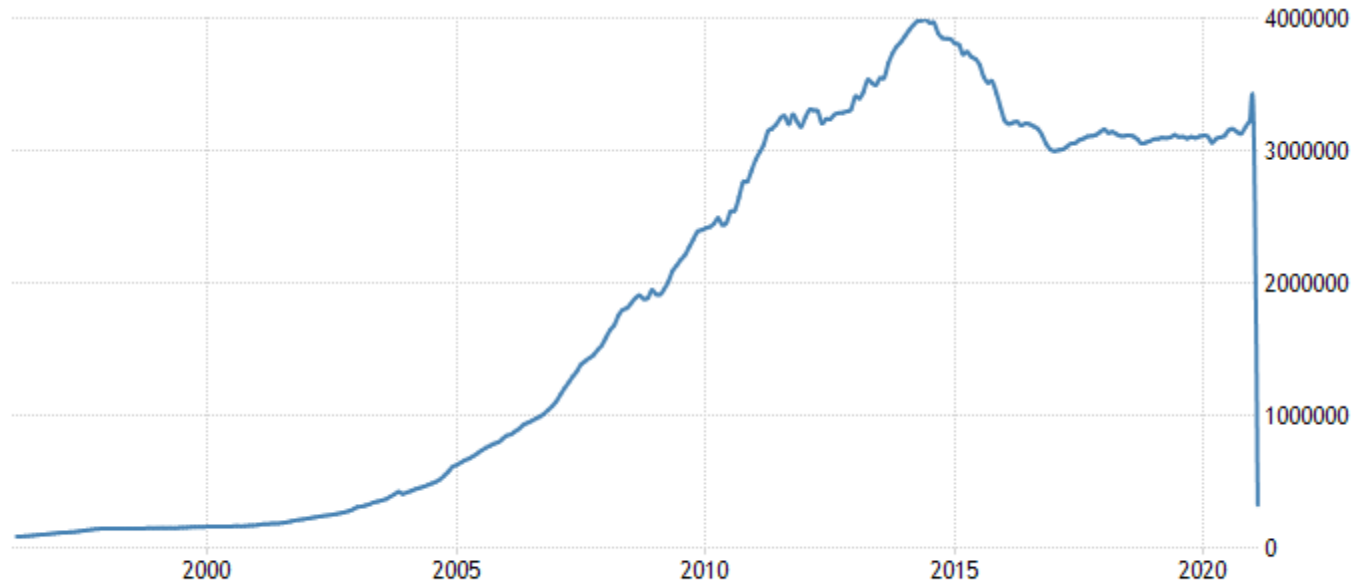
US trade balance: the “consumer of last resort”
(2003: Rogoff “the best recovery money can buy”)

Sustainable for ever?



SOURCE: TRADINGECONOMICS.COM | BUREAU OF ECONOMIC ANALYSIS (BEA)

China Foreign Exchange Reserves (Trading Economics)



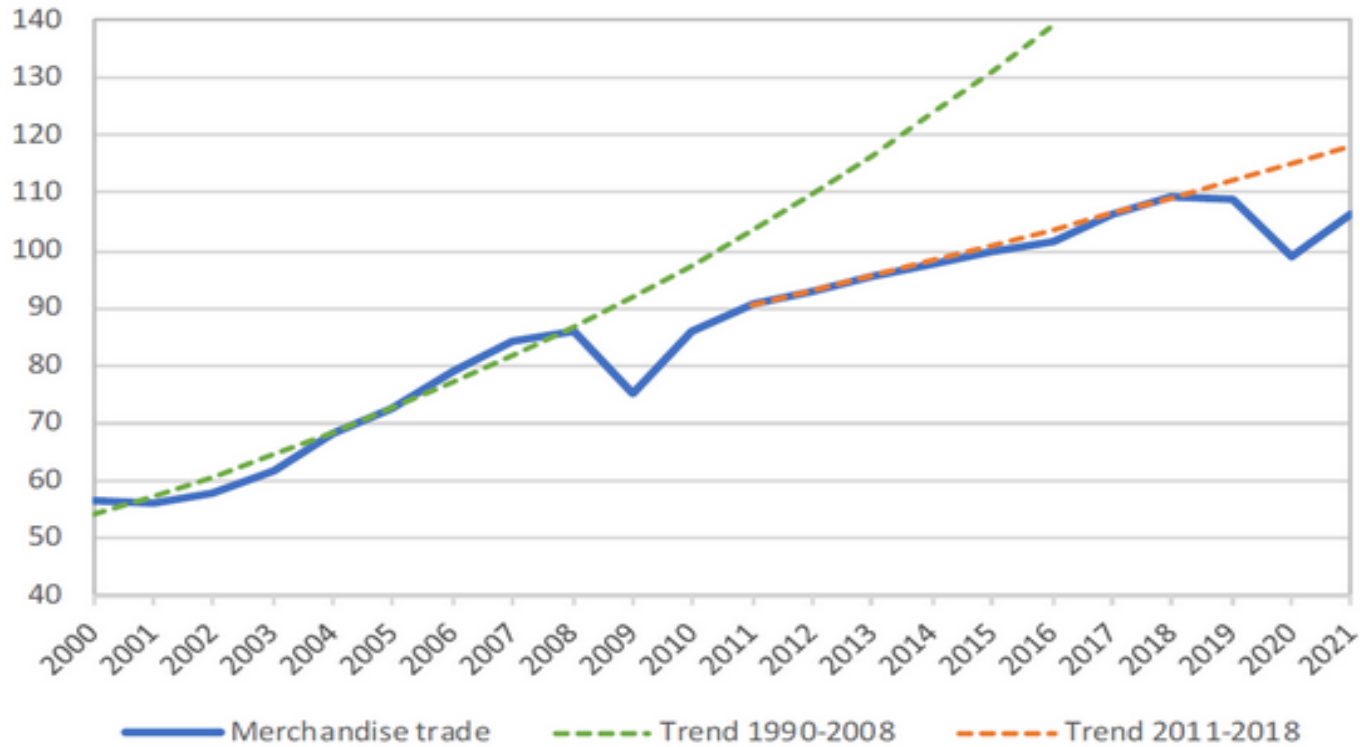
SOURCE: TRADINGECONOMICS.COM | PEOPLE'S BANK OF CHINA

Source: <https://tradingeconomics.com/china/foreign-exchange-reserves>

Globalisation: trade/GDP

Chart 1 - World merchandise trade volume, 2000-2021

Indices, 2015=100

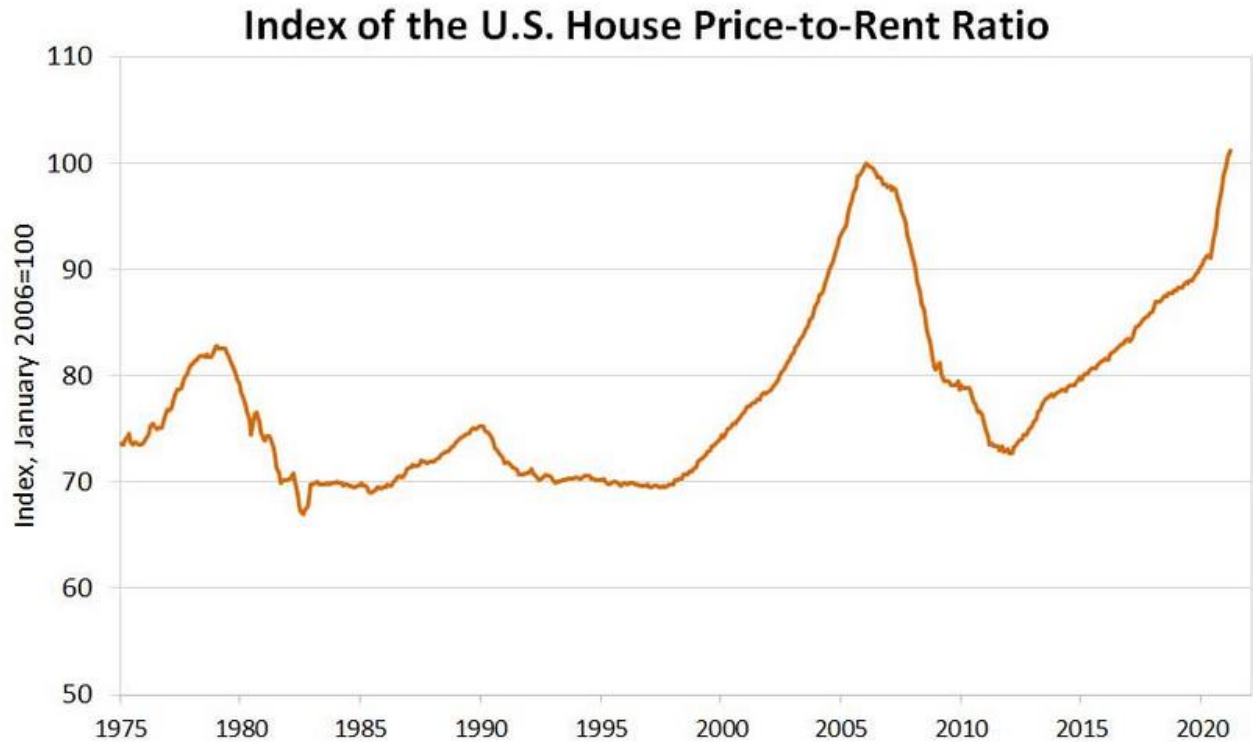


Source: WTO Secretariat.

Note: Figures for 2020 and 2021 are projections.

Source: WTO press release 6 October 2020.

The US housing bubble(s)



NOTE: The figure shows the indexed ratio of two variables between January 1975 and March 2021: (1) a monthly nationwide house price index (HPI) as described in the appendix below, and (2) the monthly shelter component of the consumer price index for all urban consumers (CPI-U).

SOURCES: Federal Housing Finance Agency, Freddie Mac, Bureau of Labor Statistics and author's calculations.

Federal Reserve Bank of St. Louis

Easy borrowing > asset price inflation >
wealth effects > consumption

The GFC: causes & consequences

Lehman Brothers: September 2008

- August 2007: BNP Paribas freezes funds
- September 2007: Northern Rock bank run
- March 2008: Bear Stearns bailout
- September 7, 2008 Fannie Mae and Freddie Mac placed in conservatorship
- September 15, 2008: Lehman Brothers file for bankruptcy .
- September 16, 2008: AIG bailout up to \$85 bn

“Why had no-one predicted the crisis?” The Queen opening a building at the LSE, November 2008

British Academy replied 17 June 2009, reasons:

- 1/ many did foresee the crisis: problems of timing, and willingness to act – how?
- 2/ many warnings about global imbalances, global savings glut, equity withdrawal etc.
- 3/ wishful thinking combined by all - politicians charmed by the market - models good at predicting short-term, small risks.
- 4/ people trusted the skills of bank management;
- 5/ a general “feel good” factor: households cheap goods and credit; bankers making money; governments receiving taxes > a psychology of denial;

Letter to the Queen continued 2

- 6/ the authorities lacked instruments to “take away the punch bowl” – “light-touch” regulation;
- 7/ inflation low > no sign of overheating;
- 8/ everyone seemed to be doing their job; failure to see series of interconnections
- 9/ psychology of herding.

Other factors:

- Chuck Prince, CEO Citigroup: “**When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing,**” 9 July 2007 to FT.
- Fraud, especially as boom intensifies (Martin Wolf)
- Raghuram Rajan: 2005 warning Jackson Hole
 - 2010 “Let them eat credit” > neoliberalism fueled by credit as household income stagnated.
- André Orléan: **when credit is cheap and asset prices are rising, rising prices lead to *higher* demand!**
- Hyman Minsky: **“stability breeds instability”**

Massive intervention

- Interest rates slashed
- Fed and other central banks lent massively to markets in the face of the credit crunch:
Bagehot's principle
to lend "quickly, freely and readily", at a penalty rate of interest, to any bank that can offer "good securities" as collateral. (Lombard Street, 1873)
- Numerous short-term lending facilities established (Fed even substituted itself for the commercial paper market)
- Globally, public authorities mobilised \$14 trillion to provide direct capital to banks and guarantees.

Fiscal stimulus

- Significant short-term stimuli in 2008-2010
- -tax cuts – to boost immediate consumer spending
- -support for car industries
- -infrastructure spending (not so easy)

US, China and other developing countries provided a fiscal boost of 5% of GDP.

Cheap money forever

Unconventional monetary policy

- Quantitative easing:
 - US (QE1, QE2 and QE3) November 2008 to October 2014: \$4.5 trillion
 - UK (March 2009 to end 2012: £375 billion); the policy was relaunched in August 2016 after Brexit referendum
 - ECB January 2015 - €60 billion per month
- Forward guidance – including unemployment targeting!

NEW YORK TIMES BESTSELLER

"The one economics book you must read now ... If you want to understand this bifurcated world and where it's headed, there is no better interpreter than Mohamed El-Erian." *TIME*

MOHAMED A. EL-ERIAN

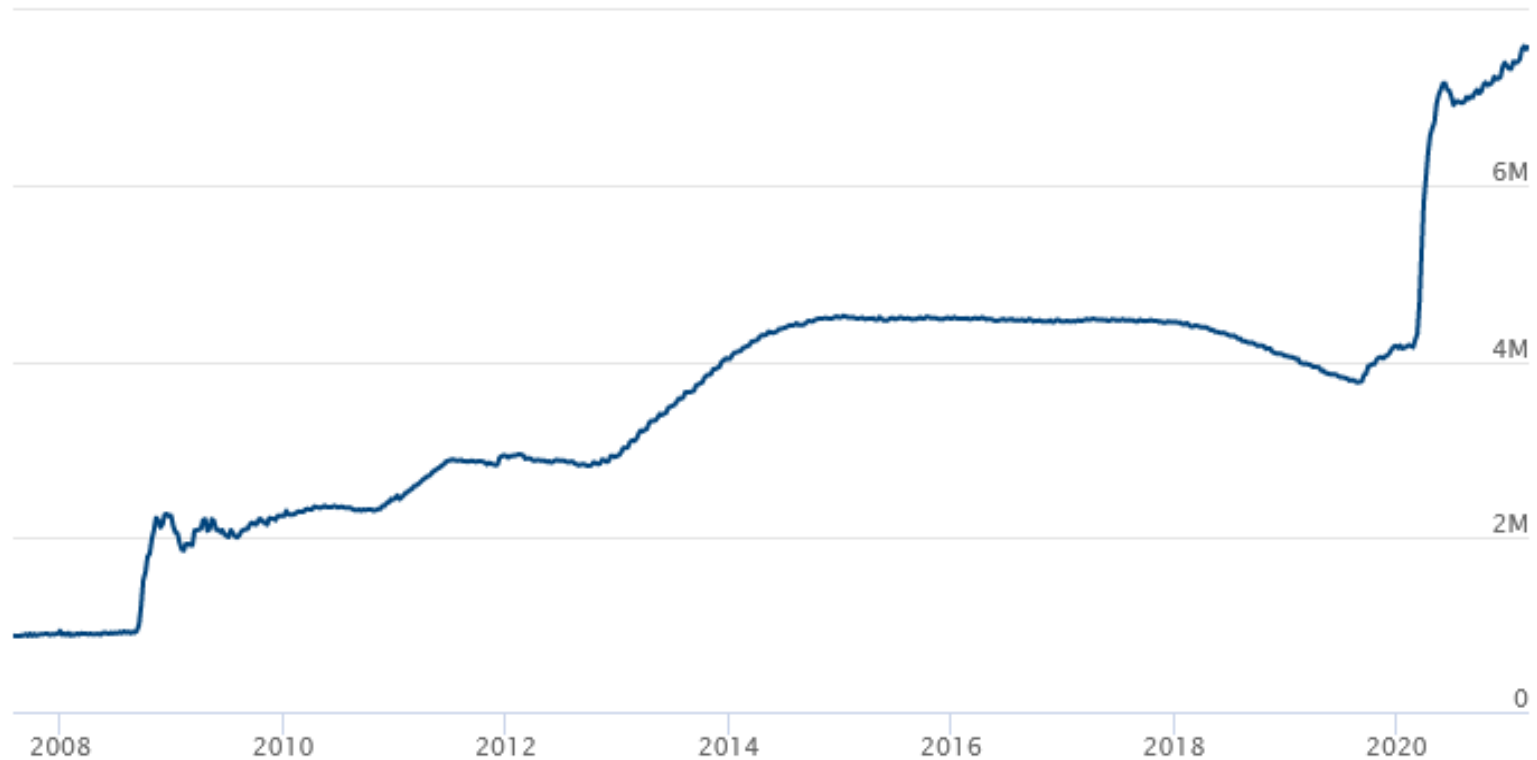
With a new
Introduction
by the author



THE ONLY GAME IN TOWN

**CENTRAL BANKS,
INSTABILITY, AND AVOIDING
THE NEXT COLLAPSE**

US Federal Reserve: Recent balance sheet trends



Source: https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm

How successful?

- John Kay: QE a “leaky bucket” (2013) – House of Lords (2021): QE an “imperfect policy tool”
- Fiscal policy followed by “austerity” in Europe after 2010, because of traditional public spending worries, and Reinhart & Rogoff empirical study: when debt exceeds 90% of GDP it leads “on average” to a fall in growth rate of 1%.
- Eurozone experienced a significant public spending crisis: sovereign debt crisis.

Bank Re-regulation G20

- Higher reserve ratios, under Basel III (risk-weighted capital ratios): G-SIBs (globally systemically important banks).
- Standardised derivatives are not traded on exchanges (central counter-parties).
- Bank resolution procedures (living wills) have been established, to bail-in private investors.
- Stress-testing of major banks (G-SIBs).
- Stronger consumer protection for households.

China's experience

- Return to growth much more rapid.
- More effective and sustained fiscal stimulus.
- Through State-owned enterprises: they could commit to produce during recession, even if at a loss.
- China's financial markets not integrated into world economy.
- But debt build up has been substantial

Secular Stagnation – Lawrence Summers

- Increasing propensity to save
- Real natural (neutral) interest rates (Wicksell) are too low to be achieved by conventional monetary policy (at the lower bound)
- Savings $>$ asset price inflation (M&A, private equity buyouts)
- Inequality, uncertainty over pensions $>$ saving
- New Economy companies awash with capital, and traditional investment opportunities reduced

Secular Stagnation – Lawrence Summers

- Reinhart & Rogoff: debt pile-up
- Robert Gordon: declining productivity
- Bernanke: continuation of “global savings glut”
- Krugman: old style liquidity trap
- Conclusions:
 - Constraint is on the demand side
 - Competitive monetary easing > currency wars
 - Coordinated fiscal expansion

2019 New Thinking on Inflation and fiscal policy

At the Fed:

- Extensive review of low-inflation environment
- “Fed listens” > town hall consultations
- Toleration of above target inflation to compensate for years of below-target inflation

- O. Blanchard (presidential address of AEA, 2019):
Long term (real) interest rates on govt debt tend to be less than rate of growth > greater sustainability of govt. deficits and debt...?

Covid-19 – more stimulus and
more cheap money

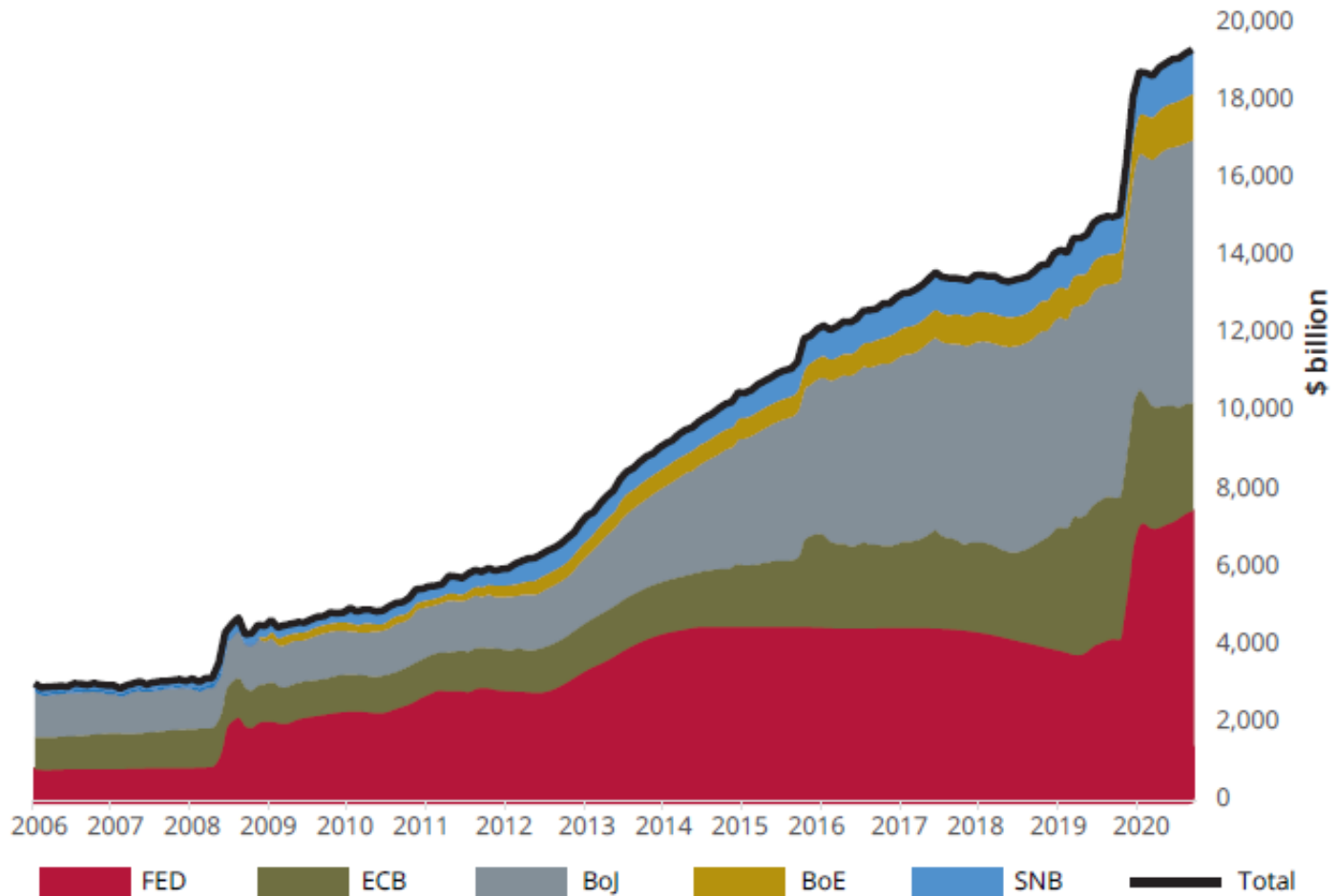
The Start of the COVID-19 Crisis

- The financial and economic crisis literally exploded in mid-March 2020 – almost overnight
- The trigger was outside the financial sector: shutdowns and boarder closures hitting the travel and hospitality sectors, and retailers more generally (except food outlets probably)
- Massive interventions by authorities to provide liquidity to markets, cash to companies and cash to individuals (part-time unemployment pay, even generalised cash payments)
- Are there limits to what the authorities can do?

Actions and Constraints Today: instant commentary ☹️

- Uncharted waters: monetary policy loose before the crisis, fiscal policy hampered by debt.
- And yet governments in the old industrialized countries have to do something.
- Massive liquidity injections, tax holidays for businesses, direct payments to households.
- US Fed providing [swap lines](#) to other central banks to provide international dollar liquidity
- Massive QE
- Massive fiscal support (in the old industrialised countries)

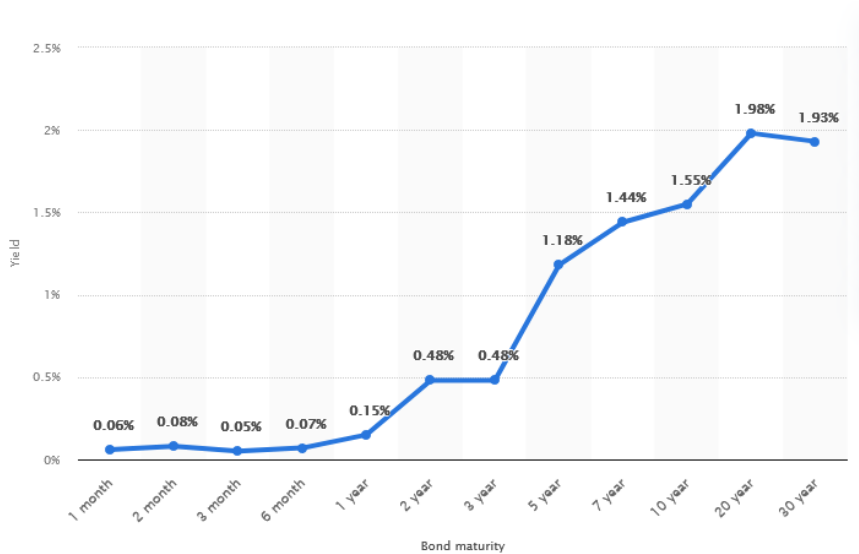
Central bank balance sheets



Source: Andy Haldane, speech on *Inflation: A Tiger by the Tail?*, 26 February 2021, p 9: <https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/february/inflation-a-tiger-by-the-tail-speech-by-andy-haldane.pdf> [accessed 5 July 2021]

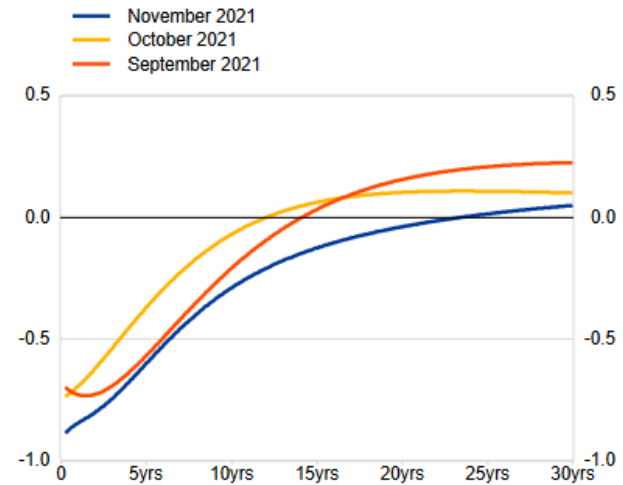
Flat yield curves

Treasury yield curve in the United States as of October 2021



Euro area spot yield curves (for AAA-related euro area central government bonds)

4.7.2 Euro area spot yield curves ¹⁾
(percentages per annum; end of period)

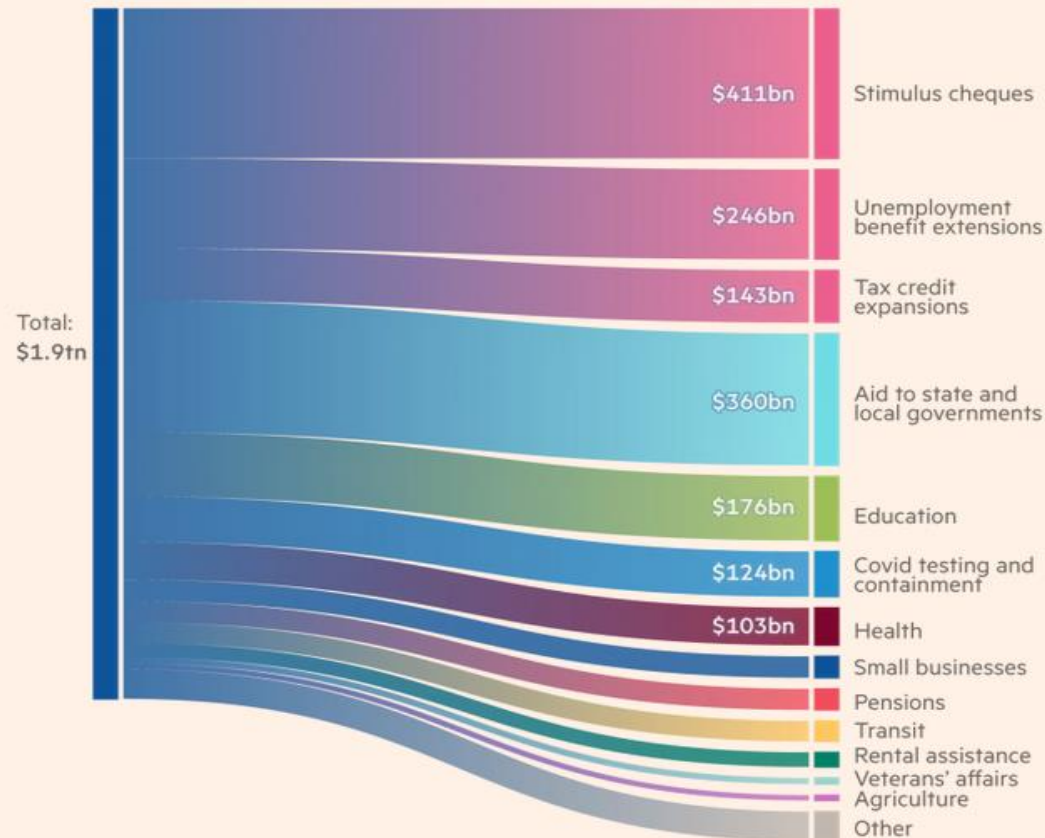


Biden Economic Stimulus

Where the \$1.9tn stimulus will go

Estimates

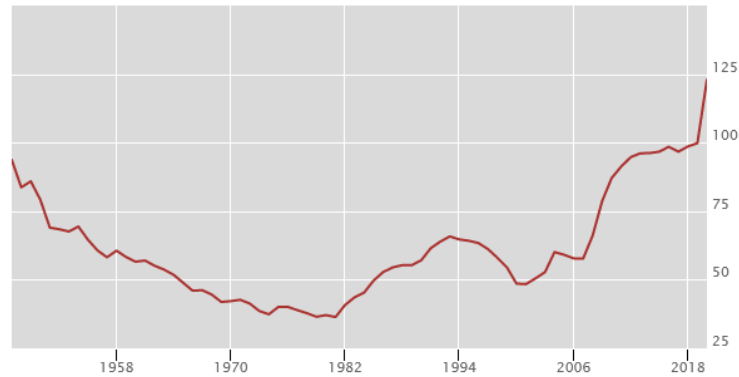
Much of the aid is going towards **direct support** to individuals and households



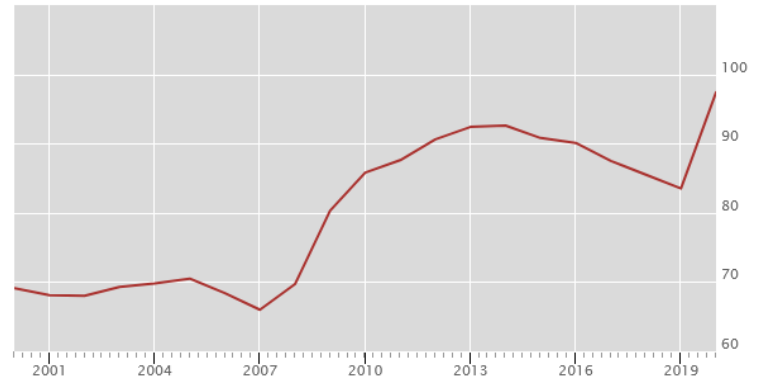
Some figures are based on earlier versions of the bill
Sources: Committee for a Responsible Federal Budget; FT research
© FT

Total credit to government sector at nominal value (core debt), as a percentage of GDP: Source BIS

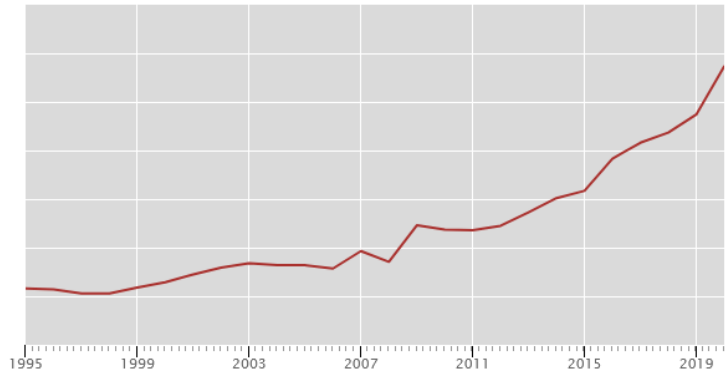
USA



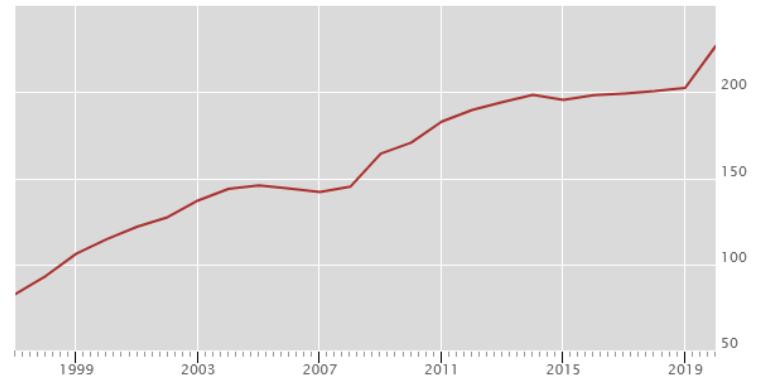
Eurozone



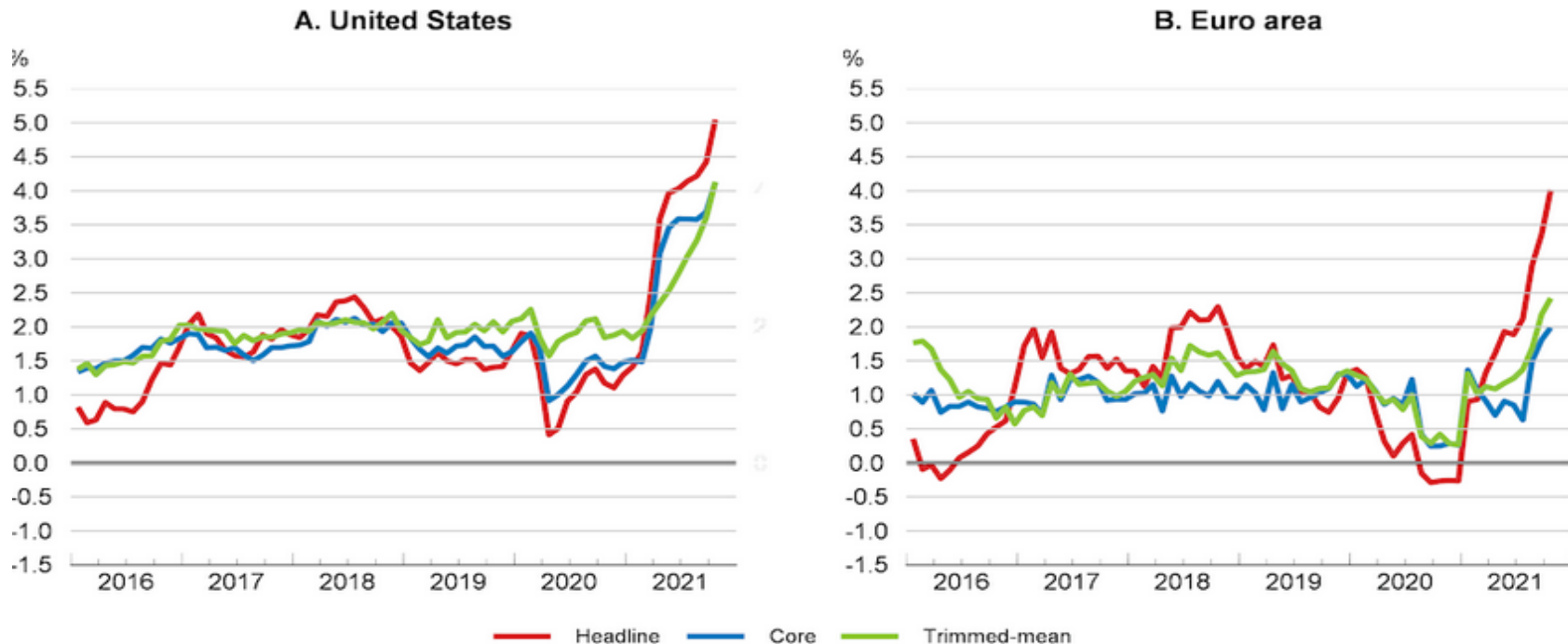
China



Japan



But now inflation is rising... rapidly?



Headline = normal consumer price index; Core = excludes energy and food-related products; Trimmed-mean inflation trims 10% in terms of weights at the top and bottom of the distribution of the year-on-year growth of prices. Ibid OECD.

The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival, 2020



Charles
Goodhart

"When a measure becomes a target, it ceases to be a good measure."



Manoj Pradhan

The great rise of global labour is over:
Women – China – Eastern Europe

(Recalls Immanuel Wallerstein (1983):
capitalism goes global not for markets,
but for labour)

Inflation, higher interest rates...

... especially with spending on elderly

... but greater equality as labour has more
power

Policy-makers are slow to see change!

The end of neoliberalism and a new role for government?

- **Ronald Reagan** (August 12, 1986):

“the nine most terrifying words in the English language, *‘I’m from the government, and I’m here to help.’*”

(<https://www.reaganfoundation.org/ronald-reagan/reagan-quotes-speeches/news-conference-1/>)

- **Margaret Thatcher** (interview with *Women’s Own* magazine, September 23, 1987):

“there's no such thing as society. There are individual men and women and there are families.”

War and the end of globalization?

“The Russian invasion of Ukraine has put an end to the globalisation we have experienced over the last three decades,”

Larry Fink in letter to
shareholders

Brooke Masters, “BlackRock chief Larry Fink says Ukraine War marks end of globalization”, *Financial Times*, 24 March 2022



Chairman and CEO of BlackRock, which
manages \$10 trillion.
\$10,000,000,000,000