Course 8

From Crisis to Crisis and Today's Policy Dilemmas

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

Today’s policy dilemma

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 in early 2000s: what risks?

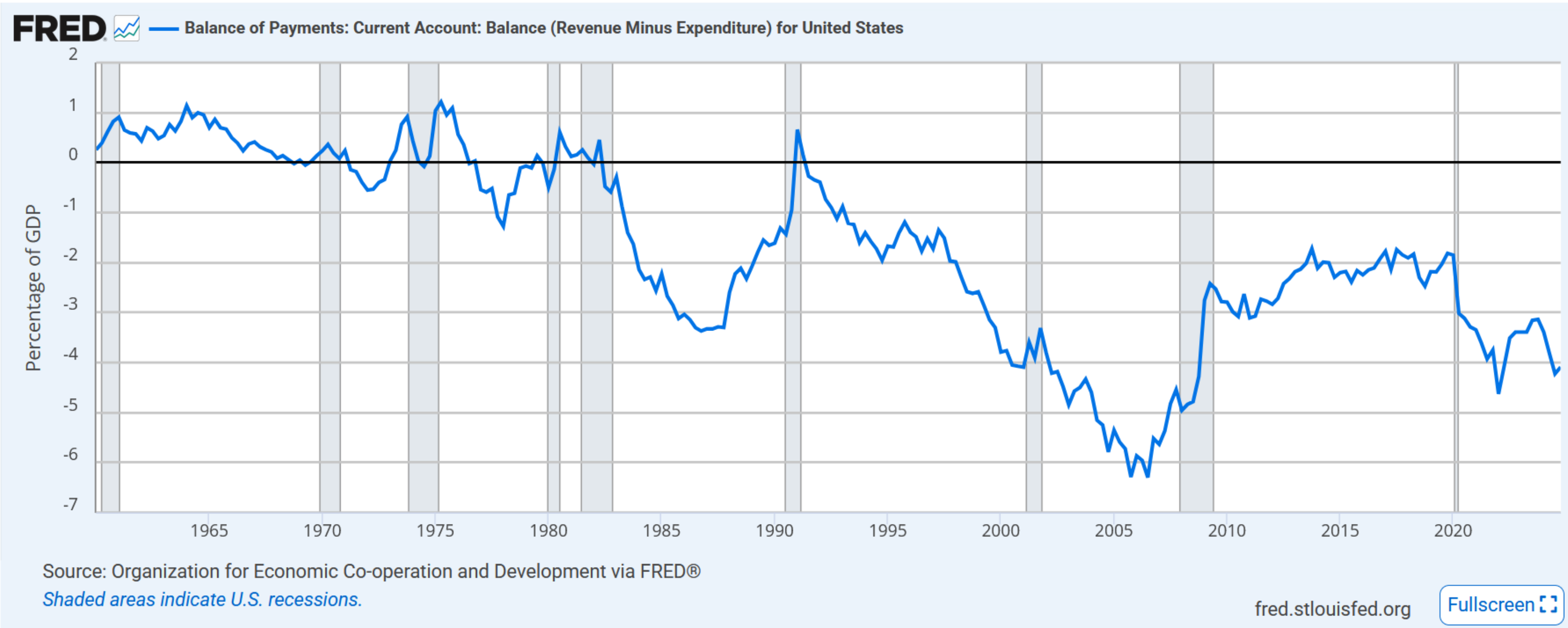
The Global "Savings Glut" (Bernanke) and The "Minotaur Economy" (Varoufakis)

"global surplus recycling mechanism" (GSRM)

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

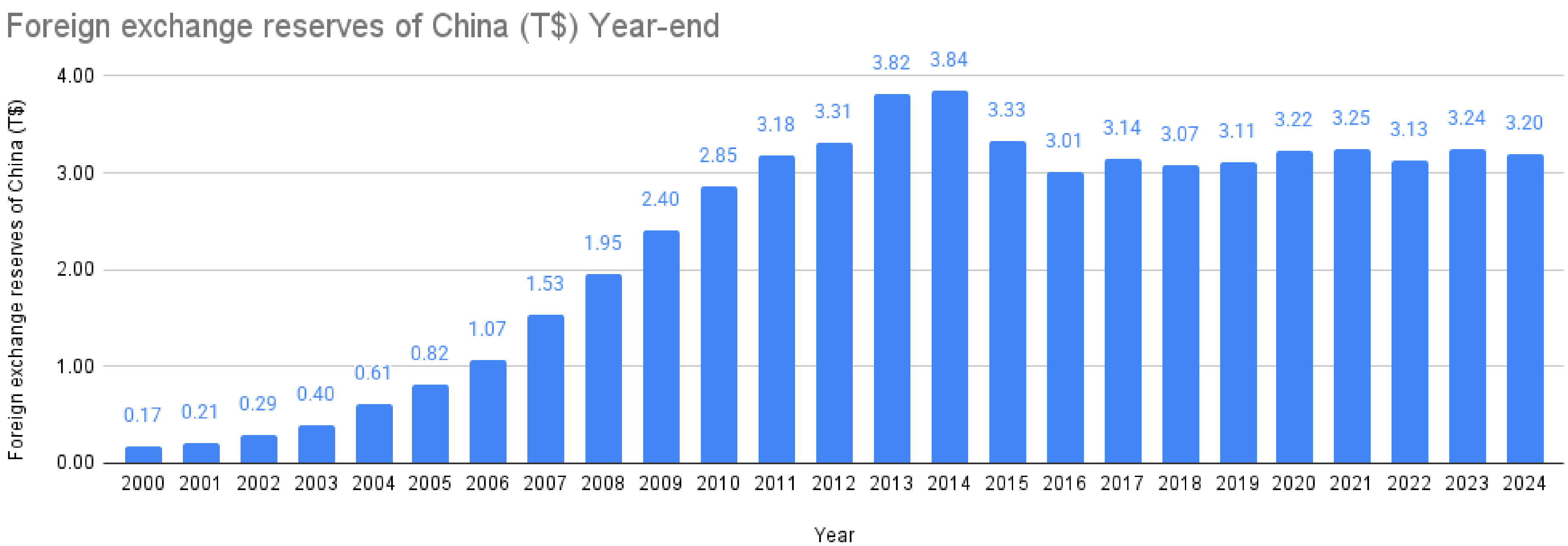
China (especially) and other Asian countries were lending to the US and exporting to the US

US trade balance: the "consumer of last resort"



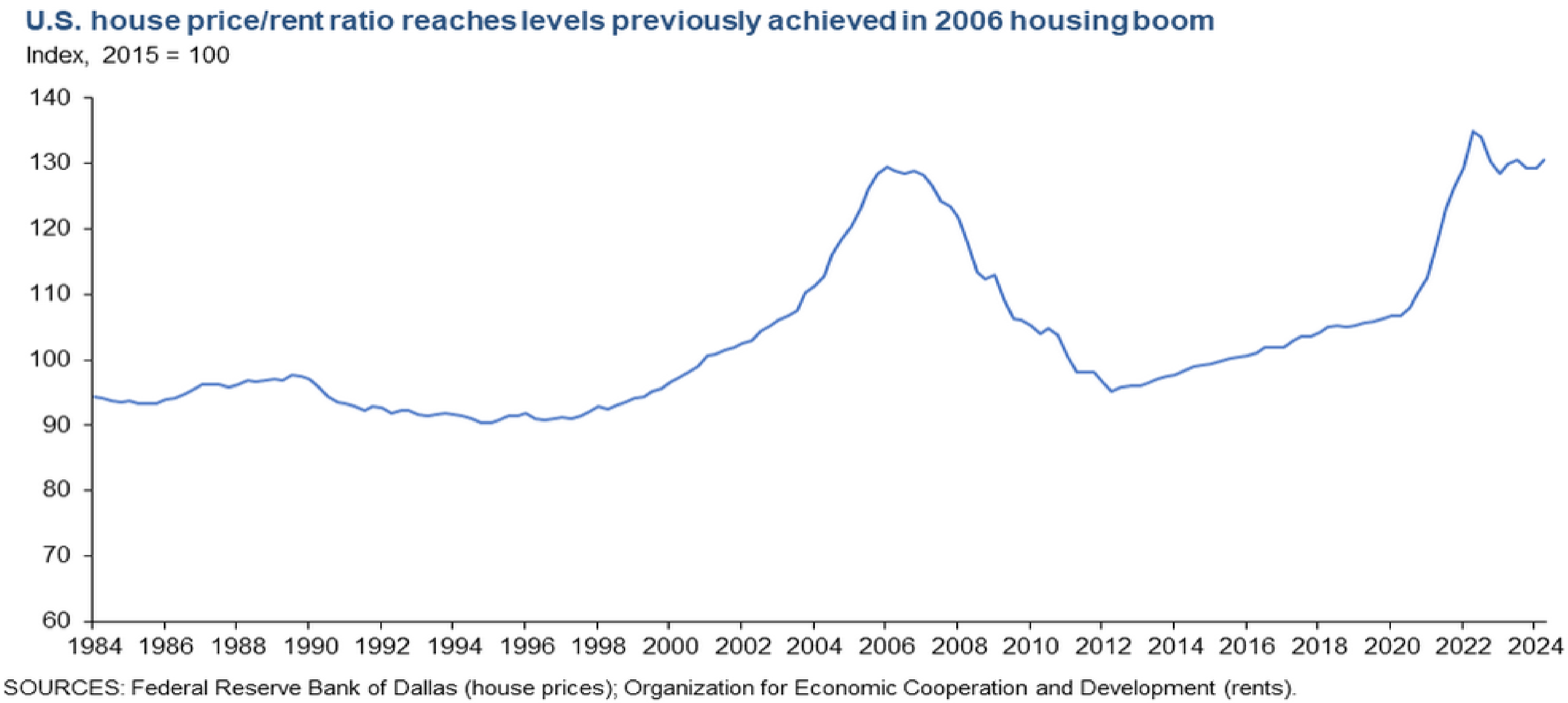
Source: Federal Reserve of Saint Louis, Fred: https://fred.stlouisfed.org/series/USAB6BLTT02STSAQ, retrieved 25 March 2025

China Foreign Exchange Reserves



Source: Wikipedia: Foreign Exchange Reserves of China, retrieved 25 March 2025.

The US housing bubble(s)



Source: Federal Reserve Bank of Dallas: https://www.dallasfed.org/research/economics/2025/0225, retrieved 2 April 2026.

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 being 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 mobilized $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*

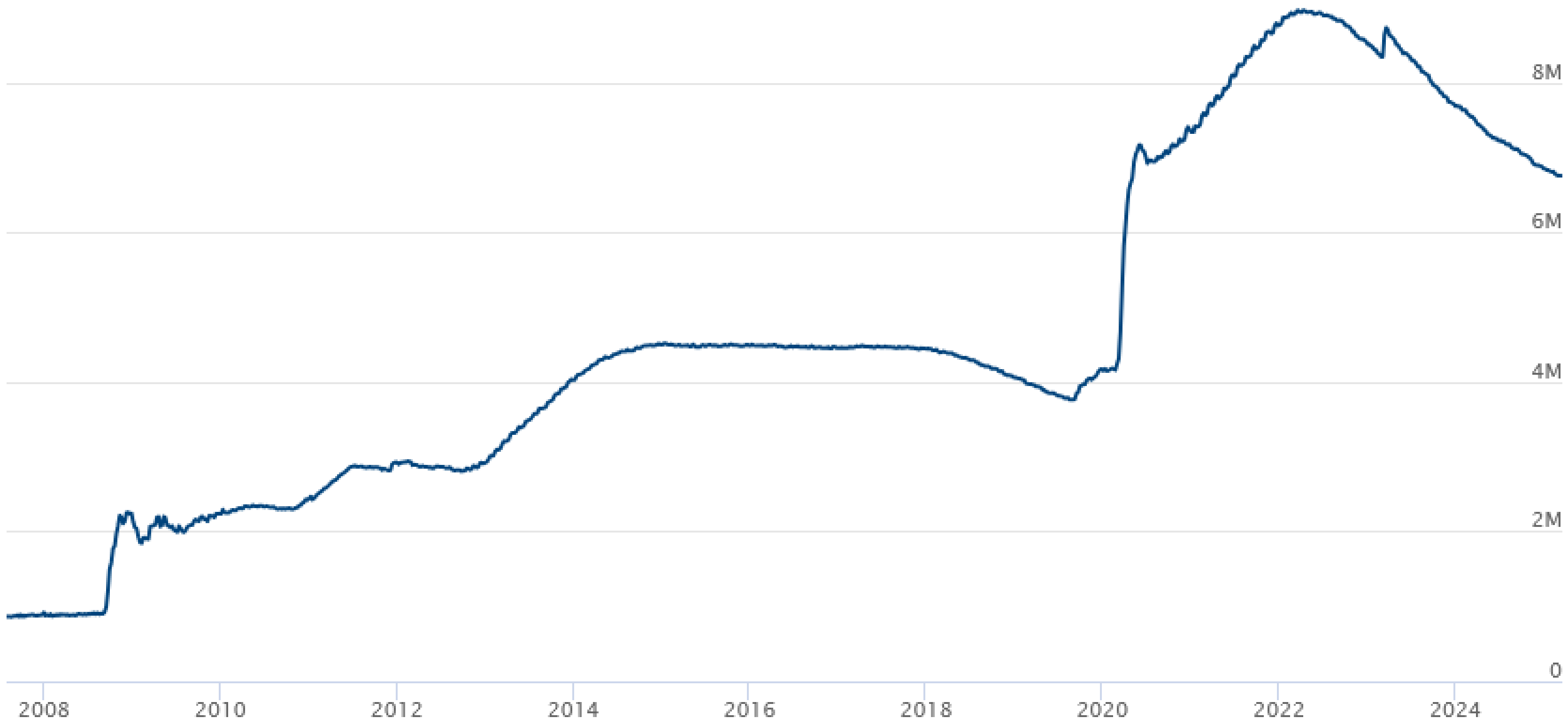
MOHAMED A. EL-ERIAN

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: Federal Reserve, retrieved 25 March 2025.

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

Evergrande and China's real estate bubble

Massive construction investment since GFC – fueled by debt

Demand from households who invest For their pensions…

Market weakness in recent years – Evergrande troubles
Some pick up in early 2023

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

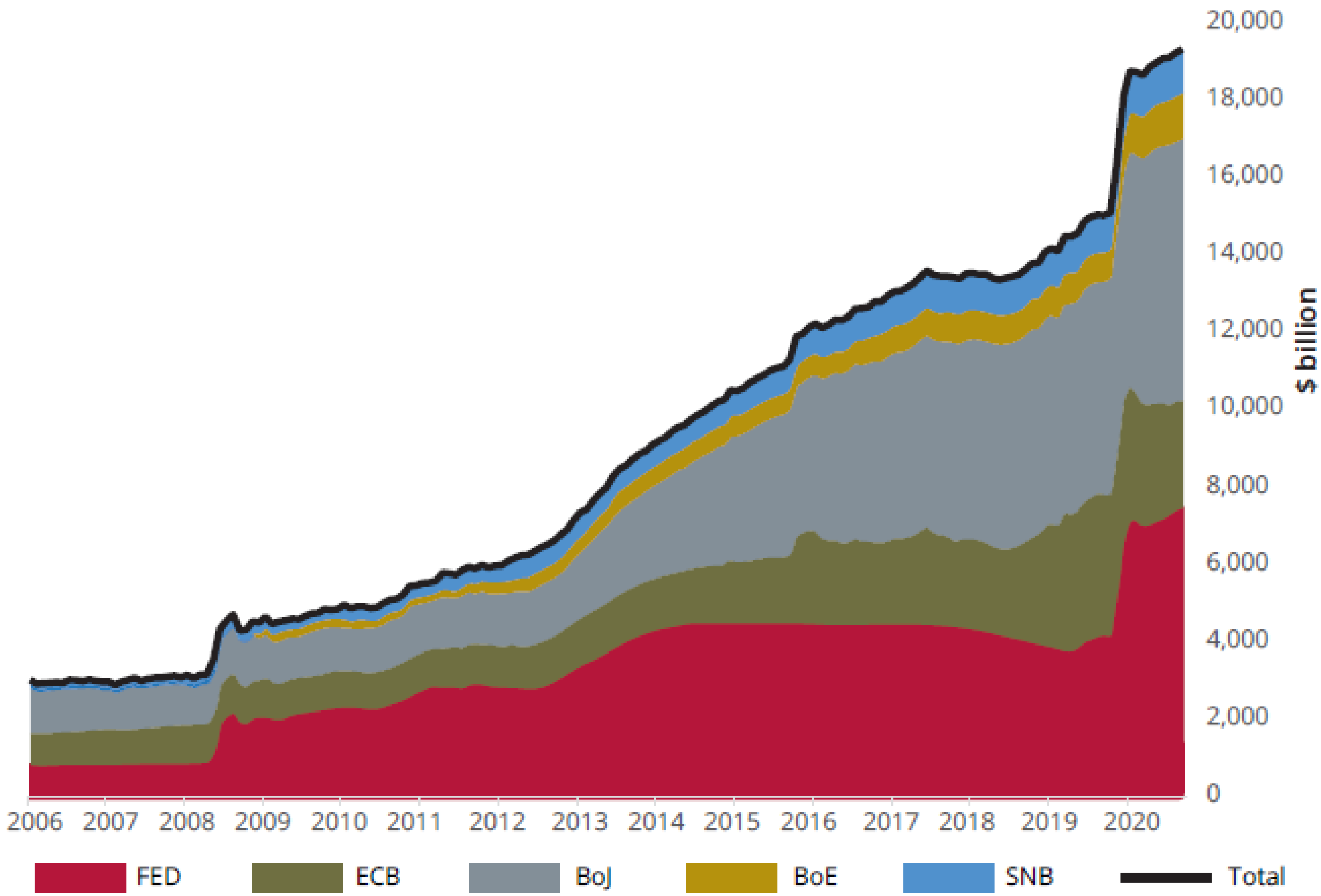
The Start of the COVID-19 Crisis

- 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 generalized cash payments)
- Are there limits to what the authorities can do?

Renewed massive interventions worldwide

- 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 industrialized countries)

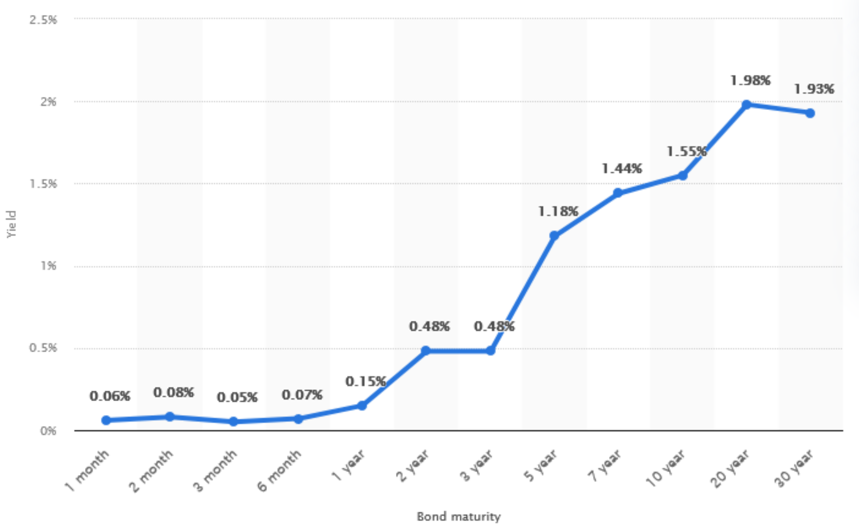
Central bank balance sheets



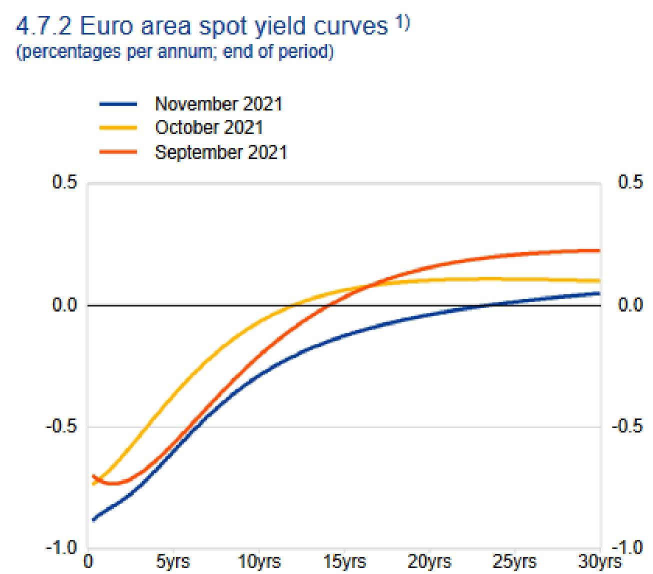
Source: Andy Haldane, speech on Inflation: A Tiger by the Tail?, 26 February 2021, p 9: https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/february/inflation-a-tiger-by-the-tail-speech-by-andy-haldane.pdf [accessed 5 July 2021]

Flat yield curves

Treasury yield curve in the United States as of October 2021

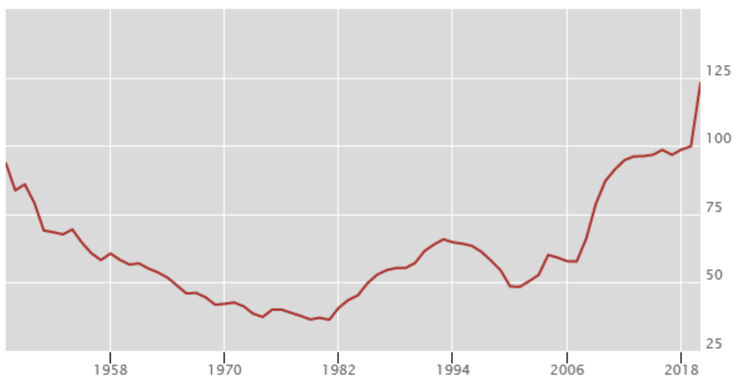


Euro area spot yield curves (for AAA-related euro area central government bonds)

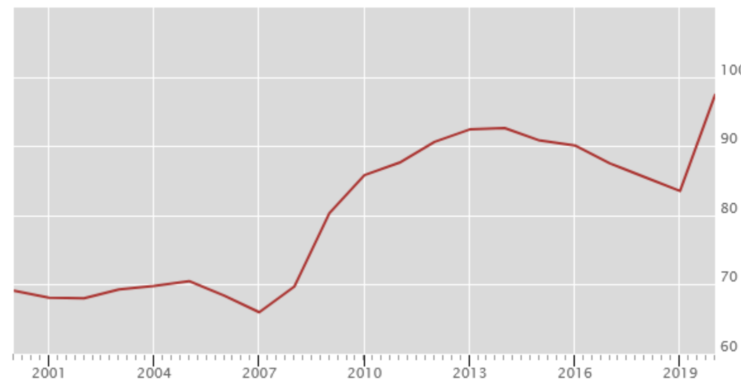


Total credit to government sector at nominal value (core debt), as a percentage of GDP: Source BIS

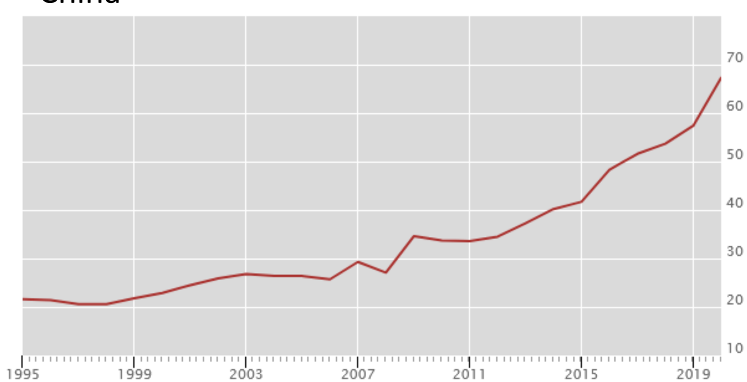
USA



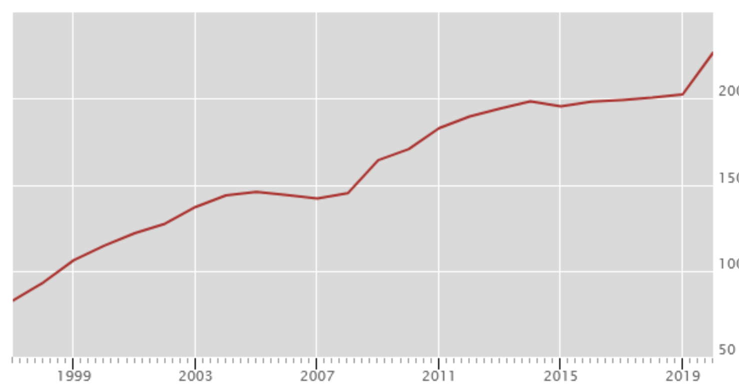
Eurozone



China



Japan

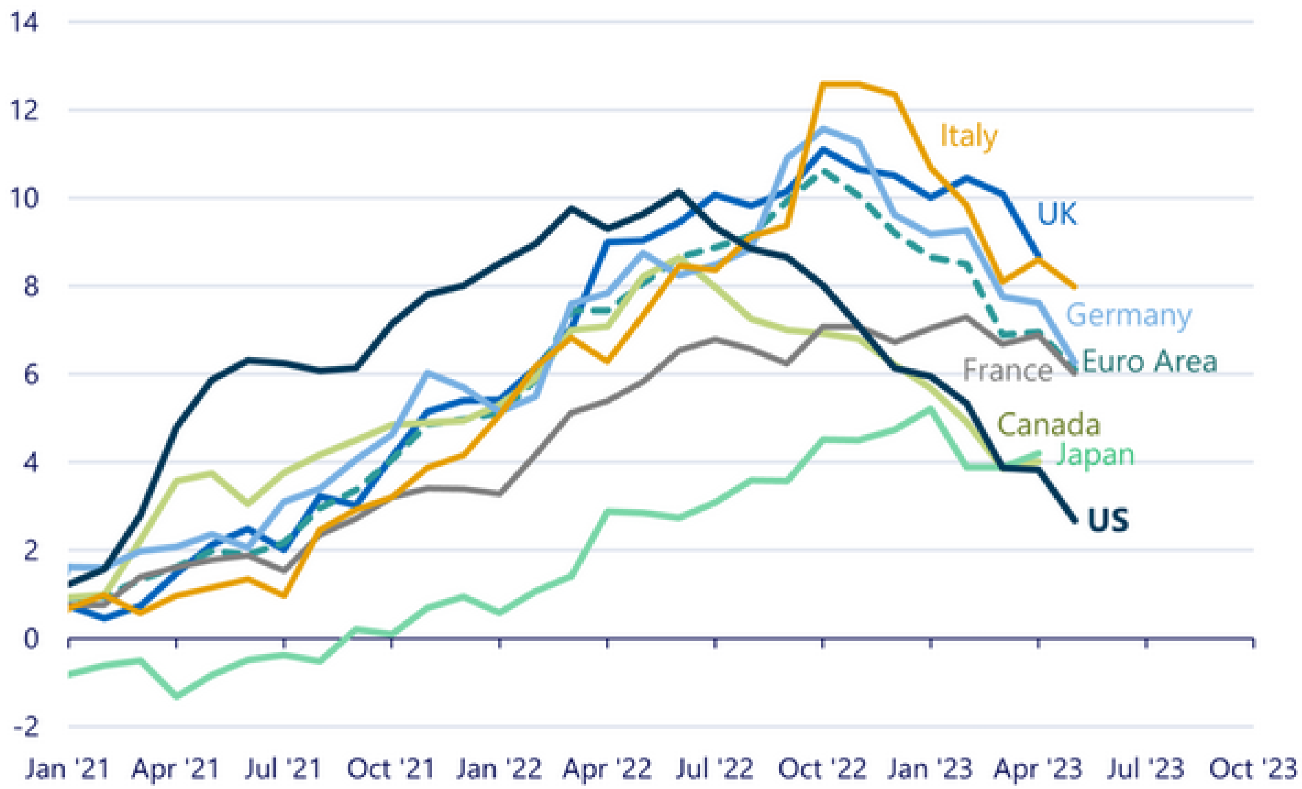


The new inflation, “accidents”, uncertainties and soft landings

The return of inflation (in the West)

Figure 1. Harmonized Headline HICP Inflation in the G7

All items, HICP basis (Year-on-year percent)



Council of Economic Advisers

Sources: Eurostat, ONS, BLS, Statistics Canada, MEI, CEA analysis.

Note: Euro Area: HICP; UK: CPI; US: R-HICP-U; Canada: CPI ex. Mortgage Interest, Replacement Cost, & Property Taxes; Japan: CPI ex. Imputed Rent.

As of June 20, 2023 at 6:00pm.

***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)

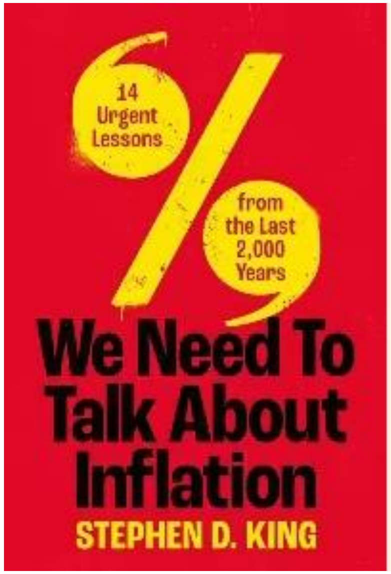
Inflation, higher interest rates…

… especially with spending on elderly

… but greater equality as labour has more power

Policy-makers are slow to see change!

THE FEARS OF STEPHEN KING (HSBC ☹)



- We don't know how long inflation will last
- It creates winners and losers
- Economic inefficiency as price mechanism weakens

- Governments are always tempted to print money
- Governments and central banks are like Liz Taylor and Richard Burton…

...they try to separate
but always come together

Or for younger folk, "Benifer"

Cryptos – have escaped regulation

Source: Financial Times, 30 November 2022

- Cryptos have so far remain unregulated: due to their nature (decentralised ledgers), their complexity, operations across jurisdictions.
- Central banks have warned investors about total losses.
- (Tooze – after FTX collapse – suggested regulating like gambling)
- Ponzi scheme nature
- Illicit business
- CBDCs could be a way forward: centralised – problems of civil liberties and competition with banks

Silicon Valley Bank (SVB) – bank run – closed March 10, 2023

Under EGRRCPA, SVB (and others) nor required to calculate and report <u>Liquidity Coverage Ratio</u> (LCR),
the <u>Net Stable Funding Ratio</u>, or carry out liquidity assessment reviews.

Capital and Liquidity are not the same thing.

SVB not obliged to calculate <u>Net Stable Funding Ratio</u>

Trump weakened Comprehensive Liquidity Assessment Review (for serious stress-testing).

Largest failure since 2008

-concentration in one sector

-higher interest rates made getting new venture capital hard, companies (start-ups) withdrew cash > bank run

-SVB held long-term government bonds – safe but low yields (2%). As interest rates rose, prices fell.

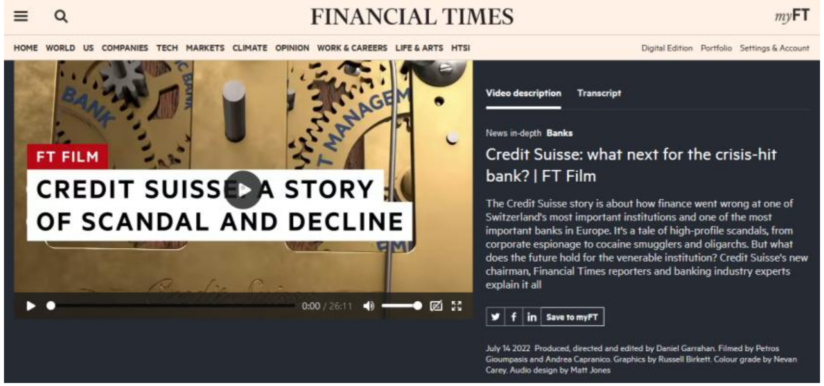
-**Fed stepped in to bail-out depositors with more than $250,000**

“Credit Suisse falls prey to a crisis of confidence”

SVB’s collapse has led to jittery markets seeking banking’s weakest link, Editorial Board, Financial Times, March 16, 2023

Credit Suisse received an emergency $54bn backstop from the Swiss central bank but it is unclear whether the support will be more than a sticking plaster in the longer term © Pascal Mora/Bloomberg

A complex failure following multiple errors, including significant conflict within top management.



[Financial Times video, July 14, 2022]

Essentially a private bank for wealthy individuals.

A rescue with UBS was organised, which itself had to be bailed-out after the GFC.

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 globalization we have experienced over the last three decades,"

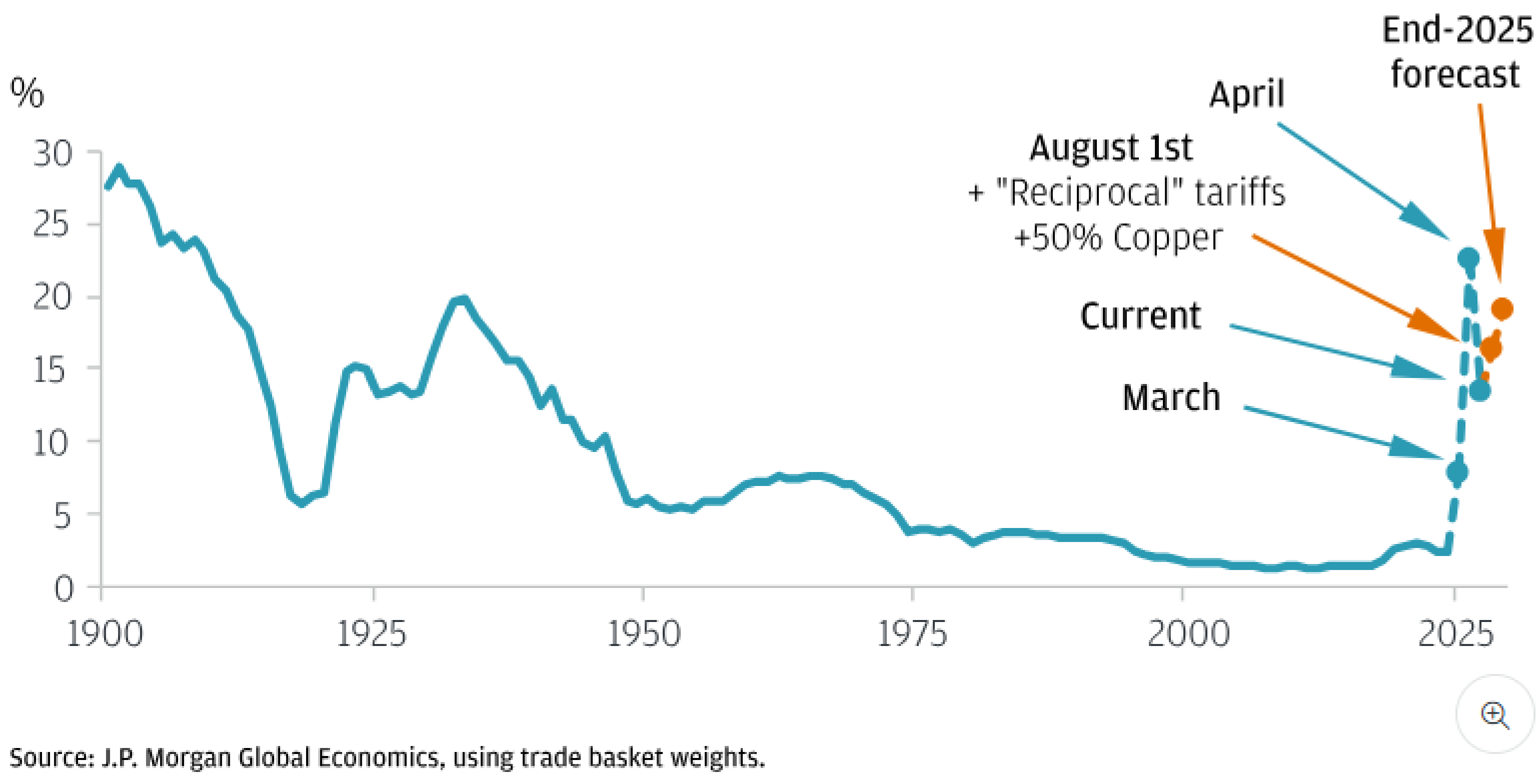
Larry Fink in letter to shareholders

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

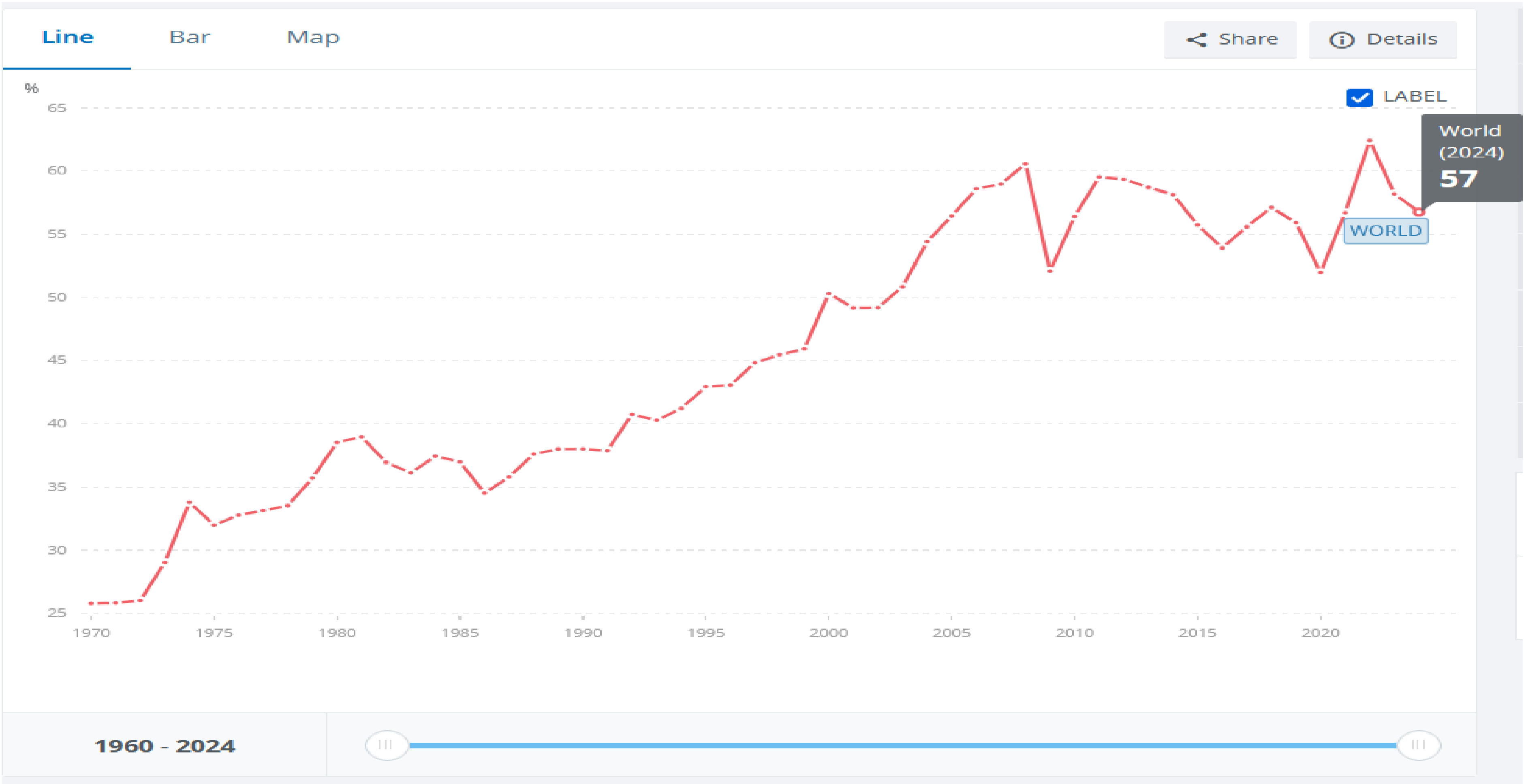
Much compounded by Gaza and now the war of choice & aggression against Iran

US average tariff rate



Source: JP Morgan Global Research, [US tariffs… March 18, 2026]

Globalisation: trade as a % of world GDP ((M+X)/Y x 100)



Source: World Bank, retrieved 2 April 2026

Policy Dilemmas before the new Gulf War (March 2026)

- Inflationary pressure has calmed but the 2% target is still illusive
- Interest rates divergence between jurisdictions
- Government deficits and debt in major economies (including China) are a worry
- The end of “Financial dominance”?
- Central banks forced to provide cheap money for fear of financial instability?
- How stable is the US government bond market?

Takeouts

- Finance has (perhaps) been made more stable since the GCF – regulation, oversight, policy
- Finance has not been restructured
- “Finance” is very varied and complex, with unknown fragilities
- The consequences of the present rise in inflation and interest rates are still going on.
- Significant policy dilemmas for central banks – especially as government debts are rising