THE FINANCIAL CRISIS: ONE DECADE ON INTRODUCTION

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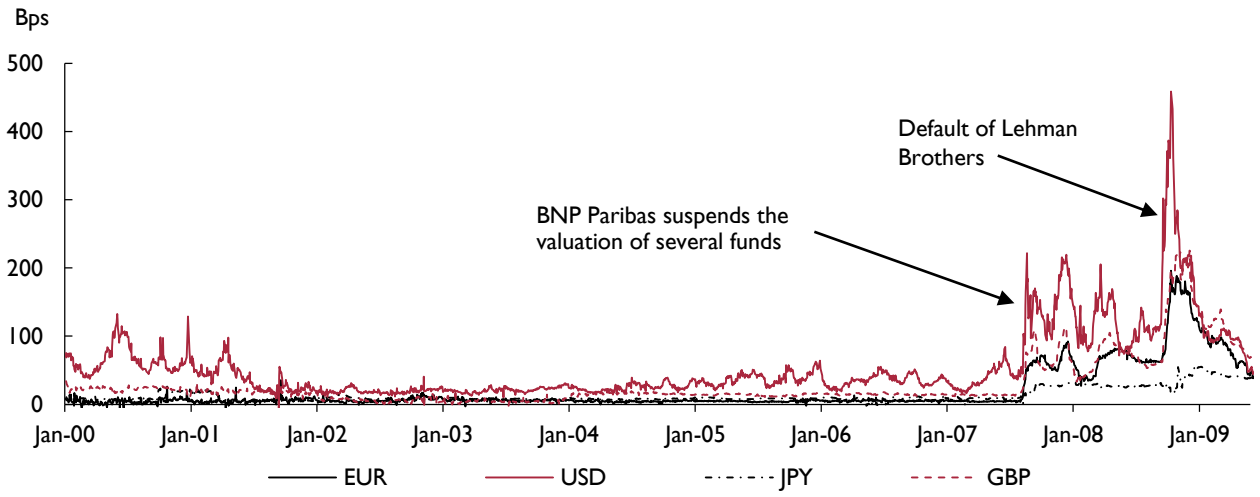
"Surpluses, the liquidity crisis, exchange depreciation, and finally bank failure and money collapse produced the fateful mixture."

Charles P. Kindleberger, p94, *The World in Depression*, 1929–1939

The financial crisis started ten years ago when BNP Paribas closed three funds in August 2007, temporarily as it turned out, when they argued that it was no longer possible to value accurately the portfolios of assets and liabilities. From that date interbank markets froze (figure 1) and to some great extent are still in the midst of an Ice Age. Liquidity between private agents was severely restricted and the public sector was asked to step in and provide financial support. That early shock, like the fall of Credit-Anstalt in 1931, triggered a sequence of events from which ten years after we can still observe the repercussions. In this special issue we examine many of the resulting debates for monetary, fiscal and financial policy.

Figure 1.Three-month interbank spreads vs T-bills or OIS



Source: Reuters EcoWin.

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Real or financial

The rumblings throughout the earlier part of that year, indeed, from as early as Christmas 2006 onwards on the trading floors was that a sub-prime crisis was about to erupt. In a variety of tongues the spectre of sub-prime entered our vocabulary. For a brief time, the most actively watched website on the floors was www.mortgage_imploderometer.com as it tracked rather excitedly the number of US mortgage providers that had gone bankrupt and these bankruptcies seemed to drive the then rather esoteric VIX volatility index. The most tangible analyses of the crisis at the time concentrated on the real economy either (i) from the perspective of analysing the household balance sheet (which was dissaving at an alarming rate, by which we mean consuming more than current income and running down any stock of savings); (ii) the wild path of fundamentals required to justify many asset, and in particular house, prices; or (iii) an analysis of global savings and investment, which suggested that capital was flowing uphill (from poorer to richer nations). It was becoming clear to many careful commentators that demand in the advanced economies would fall.

Perhaps what was not clear *ex ante* was that the epicentre of the crisis was ultimately to be in the financial sector. And it is the failings in the financial sector that have caused us to ask the questions as to what does finance do and why does it matter when it cannot do it anymore?

Let us rehearse the arguments about why finance matters. Finance allows individuals and firms to disconnect in time and space their abilities to earn and to spend and hence concentrate on one or other at any particular moment. The advantages of specialisation allow firms and households to benefit from the greater production of goods and services by facilitating inter-temporal as well as geographical options to share resources. Finance also allows us to share risk, so that we can offset idiosyncratic shocks (that is individual rather than aggregate surprises or shocks) to income, which may arise from fires or illnesses.

But we do know that the allocation of funds from savers to borrowers is subject to severe informational constraints and also various temptations to renege: the mitigation of these problems requires significant regulation, institutional capability and investment in reputation-building. These kind of first order problems do not in general sort themselves out and it is possible even to write about the vast sweep of economic development itself in terms of the history of solutions, failed or otherwise, to these types of problems. Financial institutions allocated capital and geared up their asset creation on the back of ever smaller slithers of capital. Do note that these ever smaller slithers were not illegal and complied with regulatory standards. This meant that when the losses from the real economy started to pile up the actual value of risk far exceeded the provisions made in many cases and as a result of losses banks quickly became threatened with bankruptcy. This is because although banks had capital, they had lent many times their capital in arguably inflated asset price markets. So when losses mounted, capital was quickly threatened and the consequent fall in bank shares prices further reduced available bank capital.

Given that banks could no longer lend in sufficient quantities to the private sector and could no longer lend to each other to offset idiosyncratic shocks to their own deposit and asset structure, we were faced with illiquidity. And this illiquidity itself resulted in a further severe contraction in interbank lending and private sector financial flows with the result that household consumption was constrained by current income, firms' investment plans were constrained by current profits and jobs were lost as demand faltered with the future unable to feed the present. And so financial institutions tottered and in some cases fell.

Given our less than perfect knowledge how should we design our decision rules to bring about a Panglossian outcome or to try and do the least harm possible? Before turning to the papers in this *Review* let me rehearse the basic reasons for the crisis: i) A long business cycle expansion, leading to (temporarily) self-fulfilling prophecies of stability or moderation; ii) a(n) (Asian) savings glut which promulgated capital inflows to consumer-based societies and lowered required rates of return and inflated asset prices; iii) a boom in financial engineering that was able to create liquidity and excessive levels of bank leverage; iv) monetary and fiscal policy in advanced economies that ran the domestic economy at more than full capacity, in the belief that inflation was the only reliable indicator of macroeconomic health, whilst inflation itself was increasingly providing a misleading signal; v) a regulatory framework that was not sufficiently aware of risk in the whole system and a system of bank regulation that did understand fully the trading picture and capital structure of the institutions it supervised.

In light of the crisis Sinclair (Birmingham) and Allen (NIESR) outline the 'new normal' in so many of the world's central banks, and specifically the UK. They provide a wide-ranging examination of the position of the monetary policy framework, instrument settings, the

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underlying models, unconventional policy measures, real interest rates, and the interface with macroprudential policy, and explore both the advantages and challenges involved in any move to return towards pre-crisis arrangements and an elevation in interest rates. They emphasise the need for coordination across policy arms but also that there are important distortions arising from the tax treatment of firm interest rate payment on debt and also on the treatment of imputed rent from households.

Barwell (BNP Paribas Asset Management and London Institute of Banking and Finance) argues that a fit for purpose policy regime requires a reliable general equilibrium model of the system in question and a well specified description of the objectives that the policymaker is trying to pursue. The current financial stability regime, which has multiplied quickly in several dimensions, without these critical foundations is as a result fragile and incomplete. He argues that the flurry of activity since the crisis has meant that there is no proper anchor on the conduct of financial policy, no possibility of genuine accountability and as a result there are reputational risks for policy institutions.

McMahon (Warwick) reminds us that a defining feature of (at least) the last three general elections has been the emphasis placed on each political party's fiscal credibility and their ability to deliver "sound public finances". The frequently-used metaphor of applying the logic of household book-keeping and balancing the fiscal budget captures such soundness. He argues that there is little evidence that a balanced budget is necessarily sound in all states of nature. Instead, the evolution of public finances depends on (1) both the fiscal choices made on the level of spending and taxation, (2) the underlying growth of the economy, which depends on far more than fiscal decisions, and (3) interest rates on government debt and the financing needs of the government. As the economic situation changes, so too does the likely path of debt to GDP and hence the possible fiscal options open to a country. Sticking to the soundbite of "sound finances" may have distracted attention from the underlying menu of political choices and may be a disruptive narrative in the UK.

Chadha (NIESR), Kara (NIESR) and Labonne (NIESR) document how the financial crisis has led to a change in the mix of capital and labour employed in the UK and a sharp decline in total factor productivity. And this has meant that labour productivity has not recovered to any great degree since the financial crisis. They explore the role of overall and sectoral productivity in explaining the fall in labour productivity, but also cast doubt on the measurement of productivity in the service, particularly the financial, sector and also the extent to which intangible capital may be being measured with error. They outline the links between a constrained financial sector and a fall in overall productivity and illustrate how a financial sector providing intermediate services may act to amplify the business cycle impetus from a total factor productivity shock within the context of a calibrated model. They would like more work to be undertaken on the impact of financial constraints on the supply as well as the demand side of the economy.

Aksoy (Birkbeck College London), Basso (Banco de Espana) and Smith (Birkbeck College London) suggest that in the decade since the onset of the financial crisis, the disappointing recovery has sparked renewed concern about the medium-run outlook for advanced economies. Rather than returning to its pre-crisis trend, output has continued to diverge from it. It is difficult to know whether this is a cyclical phenomenon, which involves a slow recovery towards steady state, or a secular change in the nature of steady state growth: so-called secular stagnation. While there may be an important, but transitory, cyclical component in the poor performance of the past decade, they emphasise the secular forces: the impact of demographic structure and innovation. They highlight the impact of changes in demographic structure on macroeconomic outcomes and suggest that changes in the age profile not only have significant implications for savings, investment, real interest rates and growth but also for innovation. For instance, if in 2015 the UK had the age structure it had in 1970, it would have added some 0.7 percentage points to the long-run annual growth rate. Their model suggests that the population ageing predicted for the next decades will tend to reduce output growth and real interest rates across OECD countries.

Next steps

Ultimately, decisions on any policy rely on judgement and that can, unfortunately remain faulty even in the presence of wisdom and foresight. Some difficult lessons have been learnt over this crisis that bear repeating. First and rather obviously, inflation targeting alone cannot prevent boom and bust and needs to be augmented with more instruments and better judgement on the whole economy. The operations of the financial sector through the creation of various elements of broad money and also at the zero lower bound, as it changes its demand for central bank money, complicates choices about the path and long-run level of Bank Rate. Policy rates are no longer being perturbed around their normal levels

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and the duration of rates at very low levels is stretching patience.

Not only do financial frictions complicate the choices of policymakers because changes in the financial settlement may make the transmission of policy hard to gauge, but they have always acted through both the supply and demand side. This complication means capacity judgements become very hard to make and, it is probably the case, the key monetary policy judgement involves that of working out the current and likely future levels of spare capacity in an economy. The sensible application of liquidity and capital targets via macro-prudential policy seems likely to reduce business cycle variance, albeit at some cost of permanent output, and so transitional judgements will have to be even more careful than usual not to treat the permanent as the temporary and *vice versa*.

The interactions between fiscal, financial and monetary policy notwithstanding, we also now accept that fiscal policy as well as underpinning aggregate demand can also provide support to fragile financial institutions, if and only if the private sector wishes to hold government IOUs. This further contingent role for government debt makes the case for slightly more conservative fiscal policy than aggregate demand considerations would themselves imply. During the long and lonely march back to normality, public debt will take 10–15 years to get back to 'normal' and as long as demand for that debt remains inelastic, positive or negative changes in net supply will impact on price and complicate choices on Bank Rate. And so it would seem that plotting the policy path will be considerably more complicated during recovery and the return to normality and so requires significantly more explanation than we have had in the past.

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