Title Global Recession: How Did it Happen?

Description Linda Yueh talks to Jonathan Michie about the credit crunch and looming global recession, the effect it has had on both banks and businesses, and how a Green New Deal may provide a solution to the crisis.

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Linda: I'm Linda Yueh, I am a fellow in economics at St. Edmund Hall, University of Oxford. I am an economist and actually also a lawyer by training, but I teach economics at the University.

I have a couple of recent books, one of them is 'Macro Economics', an undergraduate textbook, which will soon need to be updated given the events of the past year. And another book which is coming out next year called 'The law and economics of globalization' to look at the ways in which the economy has been changed, in both economic and legal terms, over the last few years.

Jonathan: My name is Jonathan Michie, I am also an economist by training, although I am now director of Oxford University's department for

continuing education, which does a range of part-time courses including online courses, and in fact our most popular online course is on the global economy by Doctor Linda Yueh. I am also President of Kellogg College. My most recent book is a handbook on globalisation.

Linda: I think 2008 has been a tremendous year in terms of economic developments. One of the things that perhaps we ought to think about is how we got here, in terms of the financial crisis. So we know at some point last year, around last summer, the sub-prime mortgage crisis in the United States really began to take hold. The most obvious manifestation was of course the failure of Northern Rock, which generated the first bank run on a British bank run in about a century.

Since then of course, things have only gone from bad to worse. In March of this year we know that the failure of Bear Stern, which was forcibly sold to JPMorgan Chase, essentially marked the start of the prospect of systemic banking sector failure, and this culminated with the collapse of Lehman Brothers on September 15th. That roughly brings us to where we are today in terms of the financial crisis.

And I should probably also say that it is not just the financial crisis in the banking sector, we also know this has generated what has been called 'The credit crunch' where there is just not lending coming out of the banking sector, which has real implications for mortgages, for business lending, for keeping individuals and companies going. And that, I am afraid, is the challenge that we face now along with the real economy downturn.

Jonathan: Yes I would agree with that. I think the finger of blame for the current crisis though has to be also put at the systematic deregulation, during the 1980's and 1990's, removing the requirements on banks to hold proper levels of reserves and so on. For example, Northern Rock was a successful building society, as with the other building societies in Britain, which were very sensible institutions where people put their money in to save and then drew out money to buy their houses.

The demutualisation of the building societies, I think, was totally unjustified by any economic or moral argument having profited the current members of the building societies who managed to cash in the value which had been built up over years and decades, and of course profited the individual banks and consultants who were giving advice. I think if it hadn't been for that deregulation and demutualisation, there wouldn't have been the build-up of such an unsustainable, credit fuelled boom which led to this big bust.

Linda: I think it's certainly the end of Wall Street as we know it, and the British equivalent, I'm not quite sure what that is, maybe the City, will not look the same again. I have always found that is a very unusual circle we've drawn between the 1930's and now, because one of the big parallels with this crisis is that this looks like the great depression, banking sector failure followed by economy downturn, global recession.

One of the interesting things that came out of the great depression was the Glass-Steagall act. In the United States what this did was it safe-guarded retail deposits away from investment banking

functions as essentially separated the two. It was in many ways the birth of Wall Street, in the sense of having investment banks which are fuelled not by deposits, but by overnight lending, short-term lending on overnight markets, the wholesale money market.

Of course, with deregulation in the 80's and 90's Wall Street flourished, and again the equivalent in the City, really flourished on the back of this. And one of the things which is really coming about now is that these investment banks no longer exist. The most prominent ones: Goldman Sachs and Morgan Stanley, they have now become normal bank holding companies, and this is because of the crisis, and it is also because in 1999 the Glass-Steagall act was abolished essentially by legislation in the United States, meaning that these banks could grow even bigger, including taking on retail banking function.

So we have these gigantic banks, and I think what then happened was that when they began to have difficulty we were looking at systemic banking failure which could threaten the entire credit system. That institutional safeguard separating the investment banking's bankers more risky endeavours were now not separated from the entire banking system. So in that sense I suppose, the talk now of trying to do something about the crisis, I think leads us to rethink what has happened to this institutional structure really over the last century.

Jonathan: Yes, I think that's right, and I think the point about systemic implications of what has happened is important because that means that the financial sector, the banking system, is quite different from other sectors: high street shops or care sales

warehouses, where if one company goes bankrupt it may not matter, others can take up the business.

Whereas with the financial sector, if banks go bankrupt it can have an effect on the whole economic system, which is of course why both the British and the American governments have stepped in to save banks. Not so much because that particular company needs to be saved, but if the banks had been allowed to go under and AIG insurance company in America, it would have had knock on effects on the wider system.

So the problem is we have had all of this speculation and so-called innovation, invention of new financial products to be traded around the world, where the gains from inventing these new products and selling them on have led to huge increases in the personal bonuses being earned by the speculators. The problem is that in theory one might think well if an individual or a company is successful they can profit from it, if they are unsuccessful they will lose out, the company will go bankrupt and so on.

In this case where there is the systematic implications of failure, governments think they are not able to let the companies go bankrupt. So in effect, the gains of being privatised going to individuals and companies privately, but the risks have been socialised basically the tax payer, which is why the tax payer is having to pick up the tab now to the tune of tens of billions or even more.

Linda: Very much so. I think quite a lot of the drivers, we know from what the British Government keeps saying, is this crisis came from the United States, but I think there is something also about the way that

the British banking financial sector has developed that makes it a much more home grown problem. And I think that by recognising the problem perhaps we might be able to do slightly more in terms of resolving the crisis.

We know that these massive bail-out packages of banks in the US, and the UK, have been premised on a few principles. One is recapitalisation, the British government came upon this much more quickly than the American government. Two is liquidity. Liquidity is of course the fact that as these banks lose market value, as they write down these toxic debts or troubled assets, they are essentially short of liquidity. And thirdly the government has extended to them guarantees of lending originating now. So this is to try to ensure the credit crunch doesn't end up resulting in lots of corporate bankruptcies and mortgage foreclosures.

So these are the steps taken so far by the British government, and the Americans were slightly different. They initially didn't want to recapitalise, they were more intent on buying up the troubled assets, the so-called 'Tarp Plan'. But they famously did a U-turn on this and they decided not to buy up the toxic debts, and that was a bit surprising I think for markets, but I suppose the big question now is: is that something the British and the American governments are going to have to look seriously at.

Because despite a £50 billion recapitalisation plan and nearly unlimited liquidity extended to the banking system, the banks say they are not in the position to lend, they are still shoring up their balance sheets. So what that is suggesting is that they still have write downs to come from the troubled assets. What we have seen so far may only be write downs of the so-called 'credit derivatives',

so these are the hedging instruments, but there is also collateralised debt obligations.

So, in other words, more generally securitised assets, so assets which are traded on the basis of sub-prime mortgages or buy to let mortgages, which then become securitised and traded as debt instruments. Those are still out there off balance sheet, and if those are not written down by the banks or declared, then banks themselves take whatever capital and liquidity there is. They continue to shore up their balance sheets, they refuse to lend, and we are still in a credit crunch despite the billions being poured into the credit system.

So the current debate about whether or not the government should give the banks even more money to resolve the credit crunch, I think slightly misses the key point which is; what is going to happen to these troubled assets? We know that keeping them on the books in problematic, that's what Japan essentially did in the early 1990's. They didn't really remove them from the balance sheets of the banks, hoping that the banks could work it through in a kind of rescue plan, but we know that didn't work very well.

So I suppose for me that would be the big challenge at the moment is; will the British government now do what TAUP was originally intended to do, force the banks to write down these bad debts. And especially if they own majority shares in lots of these banks, like Royal Bank of Scotland, perhaps they are in a position to do that, or perhaps they're not.

Jonathan: Yes that's right, I mean Gordon Brown the British Prime Minister famously said that the light touch regulation - that they had been so

keen to boast about over the last few years of the boom - the light touch regulation wasn't soft touch regulation.

But actually I think now we can see that it precisely was soft touch regulation because, unlike in the previous regulated era where banks and financial institutions were required to hold a certain proportion of assets to back up lending they were doing, the banks and financial institutions were in fact able to just create this new money themselves without the regulator of the financial services authority checking that they really were genuine assets. They were just put on the balance sheets despite the fact that we now see actually they were quite spurious.

Linda: Yes, I think as a lawyer I am always slightly sympathetic to regulation being behind markets, but I am not sympathetic to regulators not asking the hard questions. Light touch regulation doesn't mean no regulation. It means that if something looks slightly too good to be true, it probably is.

So I think…I don't think we are through the financial crisis at all, and I think that needs to be dealt with, and I also think that we need to deal with the real economy effects. Because one of the worst things that can happen is to have this kind of asset bubble bursting or financial crisis, and then have the government not deal with the effects in the real economy. That is the lesson of the great depression.

By doing policy too late, a financial sector problem becomes a real economy problem. I know that the British government has undertaken now to borrow a record amount of debt to try and get us out of the recession, which is inevitable, and the pre-budget report

has the government spending borrowing up to something like a trillion pounds over the next few years, with national debt to GDP ratio in 2013 predicted to peak at some 57% of GDP.

Now I originally didn't think this was too bad, because they always said the average debt to GDP ratio was 60%, but I have decided I have changed my mind a little bit, because it still is…just because other countries like Italy have debt to GDP ratios of over 100%, it doesn't mean it is a good thing. So I think I am still optimistic they can bring it down because they are nowhere near Japan levels, which is something like 200% of GDP at the moment. But I think what all this borrowing is intended to do of course, is to try to get the real economy back on track.

The fiscal stimulus part of course is centred on a few things. There is obvious candidates like cutting taxes, or in the case of the PBR tax credits and is given to the very poor and the elderly. There is also of course the VAT cutting measure, which is intended to put money into consumer pockets straight away, and the plan for VAT has under quite a bit of criticism, because most people think a 2.5% cut in VAT is really not anything to write home about.

What I thought was slightly good about the plan was that it is announced to last for a year, so if you have a major purchase that you were thinking of making, you may want to make it say in 2009 instead of 2010 when VAT goes back up to 17.5%. So that being said, I still think that the VAT cut is slightly on the small side, so I am left to worrying that the stimulus may be less than meets the eye and we are taking in a whole lot of debt to pay for it.

Jonathan: Yes and there are a number of important issues there aren't there? The key economic one, going back to economic theory and Keynes's contribution in the 1930's when they were in that last big slump as to what policies should be. The key economic question is: if the government borrows an extra billion, sorry, increases borrowing by a billion to spend, what effect will that have on the economy? Obviously if it has no effect then it is a worthless policy and the level of debt, national income, will rise.

However if the economy is in recession, where unemployed resources, idol factories, unemployed works and so on, the government borrows a billion pounds and spends in to build bridges and roads as Barack Obama is talking about, and that boosts the economy by say two billion pounds, then actually the effect is to reduce the debt to national income ratio. So it is very difficult, as the economists or policy analysts all know beforehand what the effect of increasing borrowing will be on the ratio of borrowing to national income, the key question then is to try to target the money that you borrow in ways that will boost the national income and so will reduce the borrowing to national income level.

So then we come to the question of whether cutting VAT was the best way of doing that. I think it is a difficult question, but I would agree ironically that probably cutting VAT by 2.5%, from 17.5 to 15% is probably not enough to make a difference, particularly in the current climate.

I have just come back from an afternoon of Christmas shopping, where prices have been slashed by 20%, 30%, well obviously 50% in Woolworths, but in other shops, successful shops, prices have been slashed by 20% or so, the 2.5% may not make much of a difference. Plus there are a lot of organisations where the cut

doesn't really make any difference because they pass the VAT on anyway. On top of that there is a lot of extra work and effort and costs put on to business, including small businesses, to change all their prices and then they will have to change them all back in a years' time and so on.

So I think perhaps if it had been larger, perhaps a 5% cut, then it would have been worth all the hassle of doing it. As it was, perhaps they would have been better using that twelve billion or so on direct intervention measures as has been talked about more in the States. But also, as the rest of the package did, they did bring forward winter fuel payments to pensioners and so on, which probably will have a bigger and better impact than the VAT cut itself.

Linda: The VAT threshold is quite interesting because the EU requires VAT to not fall below 15%, so I think in a sense it kind of leads us to think about the kind of spill-over to the European level, because it is certainly not just the UK which is concerned about the stimulus. It is also…efforts have been put forward at the European Union level to try and do is. And I think the economic rationale for it is quite good, and this is something that the UK Prime Minister Gordon Brown has advocated, which is when you boost your own economy, part of that spending goes on to imports, so that actually benefits the country which sells to you.

If all countries coordinated their fiscal stimulus and their loose monetary policy, cutting interest rates, boosting their economy, then that spending would also fall into the…your exports, and so you would get this nice coordinated fiscal monetary policy, boosts to

these different countries, which of course has a much larger effect than if countries were to do this in isolation.

I think one of the interesting facets about state ownership, of which there are many of the banking system, is it going to effect the banks' lending practices. We are very concerned about that because we don't want the credit crunch to result in bankruptcies, if we can afford it, of good companies. But it looks as if the government is taking an arm's length view on this, so even though they may be a majority shareholder, for instance, in commercial banks, they essentially rely on banks to operate on a commercial basis.

That of course meant that even though the government has asked the banks to restore lending to 2007 levels, the actual amount of lending to businesses hasn't really picked up, and that's why the current debate about banks wanting more money in order to do this, and I think the real concern here is really what happens to businesses in short supply, needing liquidity, needing credit. So I think that the real concern here is what happens to businesses which just need that extra bit of credit to get them through certain periods. For instance, I heard that the Queen's tailor has had to declare bankruptcy because of the credit crunch.

But I suppose the big headline news item of this time is Woollies, Woolworths shutting down after 98 years, although I suppose I would question whether or not it is a victim of the credit crunch or whether there was something more fundamental with Woolworths brand and shops that has caused it to essentially go under.

Jonathan: Yes, there is an argument that economic slumps, even crisis, are a necessary part of capitalist development, and it is good because it can wipe out the inefficient firms and so on, and help subsequent recovery. The problem with that argument is, if you look at the companies that do go bankrupt in recessions there are some, maybe it is unfair to pick on Woolworths, there are some that you think, “Well maybe they weren’t very successful and dynamic companies,” but there are thousands of others that you can see are very successful. Or potentially dynamic companies who had credit withdrawn and collapsed for no good reason, probably would have gone on to be very successful companies.

So it is a very costly process, there are plenty of perfectly good firms who are bankrupted because overdraft facilities are withdrawn, or credit which normally would be provided isn’t. It is strange that the government spent so much of our taxpayers money buying shares in the banks to the extent they are in effect nationalised, they are majority owned. They complain on television that the banks aren’t behaving properly, and yet they are the owners and they are not telling the banks what to do, they are not running the banks in the countries interest.

It is not as if the public sector doesn’t have experience of running financial institutions and banks as well as other organisations: obviously Universities, local authorities, hospital – the NHS is Europe’s largest big employer, all very well managed and run in the public sector – but also the Bank of England was nationalised in the 1940’s and has been run in the public sector since.

There are plenty of good examples of public sector banks in Britain and elsewhere providing credit for industry, and I think that is what the government should be doing with the banks that they now do

own, making sure that they do keep people on the board to ask difficult questions, which as we know is part of the problem of how we got here in the first place, that the financial services authority, the regulator wasn't asking those difficult questions. There are plenty of people that the government could put in on to the boards at the banks to ask those questions and to ensure that credit is provided to companies for productive use in the UK economy, as opposed to unsustainable speculation which happened over the last few years.

Linda: I worry that if they don't, we could see unemployment rise dramatically as the economy goes deeper into recession. The government's projections for its budget and for its spending in the economy is that the UK economy will turn around in the second half of 2009. If their stimulus package turns out to be less than it is, if the global picture is worse than it is, if our major export destinations are also in a worse slump than we thought that they would be, we may well see the economic recovery take longer than the next six months and you could see unemployment beginning to rival the levels that we saw in the early 1990's recession for instance, certainly in earlier periods.

So at the moment unemployment is under two million, it still looks vaguely cyclical, but if this downturn continues and bankruptcies increase in the public sector, and people get laid off, we could see unemployment rise to say three million, then we are really looking at some of the most severe downturns the UK economy has had.

There is another avenue for resolving part of the credit crunch, or at least rescuing companies, although this is I suppose slightly tricky. It is probably best explained by an analogy. After the Asian

financial crisis in South East Asia, healthy economies underwent tremendous falls in output and the centre of their economies went into free fall. Lots of good companies there had no access to credit and they were just suffering from the downturn. Mergers and acquisitions, M and A activity rose during that period, because Western organisations swooped in and bought the good deals, cheap assets, on sale.

Can this work in reverse? Can you get companies from emerging economies to turn around and buy up Western companies. It is an avenue, although I don't see…I don't think they have the kind of multi-nationals of sufficient scale to buy up the size of the Western companies that we are talking about. But I wouldn't rule out, for instance, companies coming from the developing world like China or the Middle East at least buying equity stakes in Western institutions. We have certainly seen that, and I am not just talking about football clubs like Manchester City.

Jonathan: Yes, the danger of being stuck in long-term recession, and unemployment rising and sticking there, would take us back to the 1930's, both in terms of economic history and analysis, because it has been interesting the way Keynes – John Maynard Keynes – has been rediscovered in the media by politicians, where because of this policy of borrowing to try to stave of recession, which is indeed one of the things that Keynes said you could do. But his more fundamental point was just that the capitalist economic system isn't self-righting.

It is just not true what the textbooks of the day said, that interest rates automatically fall to a point at which full-employment will be restored. His argument was that you could indeed get stuck in long-

term recession with high unemployment and so I think that does need to be taken seriously. I mean, it is interesting with interest rates, and again this really proves Keynes's point, interest rates now have been cut back to already quite low levels whereas it is not clear they can be cut much further. I think in the States they are already down to 1%.

But it is interesting as well that the last few years the UK government has boasted about the great economic policy decision they took to hand over responsibility for interest rates to the Bank of England, rather than government having the responsibility, and that was applauded by the media for all these last decade, or when looking back, actually there was very little to do. It was pretty obvious what should be done to interest rates, we could have done it just as well in this room. The one time it came to a difficult decision about what to do, the bank completely blew it and kept interest rates far too high over the last few months, before finally cutting them now at the last minute, possibly too late.

Linda: Yes, I mean I think…I agree. I mean central bank independence and inflation targeting became really the en vogue since actually New Zealand was the first company that adopted it in the early 1990's, then it sort of spread through the developed world. And it was always very difficult to know whether or not the independence of the central bank was responsible for the nice decade of strong growth, low inflation, low interest rates, or whether or not it was just a very benign global environment. And I am afraid we sort of now know the answer.

But I suspect the main problem with this crisis was that by making a central bank independent, divesting the regulatory role that the

central bank usually serves, as well as being the lender of last resort in setting monetary policy, divesting these roles into a triumphant of the FSA, the Financial Services Authority, the uniform regulator in the UK, the treasury and then the Bank of England, nobody was in charge when a crisis erupted and I think that has been quite a painful lesson.

I certainly agree with the point of low interest rates and deflation because given we do have a Bank of England, who is now cutting interest rates to try and stave off this recession, dramatic cuts – a 1.5% cut, 1.0% cut – these are cuts of the like we have not seen in decades. We are now down to interest rates of 2%. This is the 1951 level, this is historically, extremely low. The US is 1% and the ECB is just above the UK, and Japan is down to zero interest rates again. So you are essentially looking at rich countries simultaneously going into recession, and simultaneously suffering from possible deflation.

Deflation, believe it or not, before the 1970's wasn't actually a concern and neither was inflation. Because before the 1970's inflation and deflation was just the price cycle: the price rises, the price falls with the economic cycle. But then the shocks of the 1970's changed our model, made us fixated on inflation. But if you look outside of the rich world, say in the Asia financial crisis, East Asia had periods of deflation, trying to have negative prices for two years in 1998 and 1999. It just goes with the decline in the economic cycle.

So not every deflation episode ends up in a liquidity trap as outlined by Keynes, which is what japan was in, in the 1990's when interest rates had no effect whatsoever on the economy. So you are essentially…you were in this trap, liquidity trap. So we don't have

to be Japan, we could be more like, say for instance, East Asia during the crisis. But the difficulty for policy makers is traversing that line, cutting interest rates to stimulate the economy, but not cutting them so low without sorting out what is called the 'Monetary transmission mechanism,' the process by which the interest rate translates into commercial banking, and then funding for the corporate sector.

If you don't sort that out, which is what Japan didn't do, then cutting interest rates could have no effect, and you end up getting yourself into a deflationary trap. So long as they are aware of that, I am hopeful they can traverse it. And this actually brings us back to the start of the discussion, is one of the reasons why the monetary transmission mechanism is clogged at the moment, is because the banks don't lend, probably because they have troubled assets on their books. So I think to get to the heart of the problem would be crucial before using…just using interest rates and wondering why a 250 basis point cut, over the last two months in the UK, hasn't stimulated lending.

Jonathan: Yes, that's right. Having very low interest rates is sometimes described as 'Pushing on a piece of string and wondering why nothing is happening at the other end.' It is argued that having low interest rates is no good if no-one wants to borrow. We have got the additional problem at the moment that although we have got low interest rates, even where companies do want to borrow, the money is not being made available to them at those interest rates. There is no good having low interest rates if the borrowing is not being made available. So that is one problem.

Then the other problem is this pushing on a piece of string point, that there is no point having low interest rates, and even availability of credit, if there are no companies out there who are confident enough that the economy is going to pick up and growth restore in order to invest now and start producing more goods and services. If people think that the economy is going to continue in a downward spiral, then that can be self-fulfilling. Which again comes back to the point about the budgetary impetus, the government tried to give the economy, which they might have to repeat again in a couple of months' time.

The key thing is to be seen to be doing things which will stimulate the economy, so that other companies will then start increasing their investment in order to produce, to supply, the companies that they think will be demanding more inputs as the economy picks up. That is a sort of Barack Obama point about building bridges and so on, then the companies that provide parts for bridge building will be more confident about investing and keeping in production.

Linda: I think the US analogy is quite a good one in many ways, because the US had already done a fiscal stimulus package which was worth just over 1% of US GDP, which is considerable, but is clearly not enough. So the UK has just put forward this fiscal stimulus package of a similar magnitude but is it going to have to do another one? The US are certainly contemplating another one.

Well, one can argue that the US went into recession December 2007, so their recession is already longer than what it is for European countries. But I certainly wouldn't rest my laurels on that point, and instead I think the plans that Barack Obama has put forward to create some 2.5 million jobs, and especially to push

green investment. So a green new deals has been described as formulating a low carbon economy. This kind of spending tends to be quite good for employment and as has said, quite good for businesses, if it can be done quickly enough to turn the economy around, and of course secondly, if it is needed.

If it is green I would argue that it is probably more likely to be needed. Because one of the other problems with Japan is that they tried this but they built infrastructure which wasn't needed. They had a very good infrastructure in Japan. But for the UK, certainly investment in infrastructure and transportation is very much needed, and perhaps there would be more of a push for the next stimulus, to go after an Obama like plan, and begin to modernise some of the very old infrastructure in Britain, which could certainly use that kind of investment.

Jonathan: Yes, I think that is absolutely right and extremely important. I would say that it would be worth now the government bringing forward now a major package, but 100% devoted to a green new deal. That is important for a number of reasons. All of the ones that Linda has just said, but also the key point to get out of recession is that consumers, and crucially businesses, really believe that growth will pick up next year, the year after that and the year after that. So they start raising their investments so they won't lose out. Looking at economic history over the long-run, one hundred years or so, there are short booms and slumps every few years, but also there do seem to be quite long periods of economic expansion for twenty, thirty years and then sometimes downturn.

Then the long periods of economic expansion, I think it has been argued quite convincingly, tend to cluster around a series of major innovations and products: the motor car and associated goods in

the 50's and 60's and so on. And looking over the next ten, 10 or 20 years, it does seem as the global warming climate change seem to be evermore convincing that there really is an extremely serious problem looming very large.

A green new deal could be seen as not being something just for a few months, which might then peter out, but actually something which will have to be repeated and stepped up continually over the years, next year, the year after that and the year after that. So if the focus of the recovery could be on that, I think it would give individuals and companies confidence to invest in order to establish themselves in that area of the economy, and invest to take part if you like in that creation of green industries.

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