Chapter 1 Asian Currency and Financial Crises In the 1990s

Asia was beset by three major economic crises 1990-2010: 1) the Japanese financial crisis 1989-90, 2) the 1997 pan-Asian financial crisis, and 3) the global financial crisis 2008-10.

The first two were primarily caused by local and regional policies. Both could have been prevented by Asian authorities, and were ultimately resolved by them with some foreign assistance. The global financial crisis was an entirely different matter. Although, Chinese dollar hoarding contributed to accumulating planetary disequilibrium, the crisis's epicenter was Wall Street. The shock which followed devastated Asian exports, but with the exception of Japan didn't have long lasting contractive Keynesian multiplier effects. This chapter recounts the Japanese and Asian financial crises, evaluates whether they could have been dealt with better at the time, and assesses the adequacy of reforms designed to prevent and mitigate recurrences.

Japan's Financial Crisis: The Lost 1990s and Beyond

Japan was hit by a speculative tornado 1986-91, commonly called the *baburu keiki* (bubble economy). It was localized, brief, and devastating, with allegedly paralytic consequences often described as *ushiwanareta junen* (two lost decades). The phenomenon was an asset bubble, within an otherwise healthy economy, distinguished by low inflation and robust growth. Speculation was particular rife in land and stocks, but also extended to Japanese antiques and collectibles (such as high quality native ceramics and lacquer ware).

The Nikkei 225 (*Neikei Heikin Kabuka*) stock market index rose from below 7,000 in the early 1980s to 38,916 on December 29, 1989, plummeted to 30,000 seven months later, continuing to fall with fits and starts thereafter before reaching a 27 year low March 10, 2009 at 7,055. It was approximately 8,400 in early January 2012. At its height, Japan's stock market capitalization accounted for 60 percent of the planetary total, now it is worth is a pale shadow of its former glory. The real estate story was similar. Condo prices increased 140 percent between 1987 and 1991, on top of already globally sky high values, then plummeted 40 percent by 1994.[1] At the bubble's apex, the value of a parcel of land near the Emperor's Tokyo imperial palace equaled that of California. By 2004, prime "A" property in Tokyo's financial district had slumped to less than 1 percent of its peak, with the total destruction of paper wealth mounting

[1] Bloomberg, Real Estate Economic Institute, Japan, Home Price Indices, as of March 18, 2009.

into the tens of trillions of dollars. The speculative frenzy, predictably ended badly, but also displayed uniquely Japanese characteristics.

Its technical cause was financial; an institutional willingness to accommodate domestic hard asset speculation in lieu of low, zero and even negative returns on business investment and consumer savings accounts. Corporations and households having piled up immense idle cash balances during the miraculous "Golden Sixties," and subsequent prosperity through 1985, (Johnson, 1982). They were encouraged to believe that the best was yet to come despite diminishing returns to industrial investment, and therefore seized on stock and real estate speculation as the next great investment frontier. They succumbed to what savvy Wall Street insiders called a "bigger pig" mentality, persuading themselves that fortunes were at their finger tips because whatever price little pigs paid today for stocks, real estate and collectibles, there always would be bigger pigs tomorrow willing to pay more. Banks capitulating to the frenzy began binge lending; rationalizing that clients always would be able to repay interest and principle from their capital gains, until one fine day when they ruefully discovered that there were no bigger pigs at the end of the rainbow. This epiphany, coupled with a panic driven free fall in assets values and capitalization, left bankers both in a predicament and a quandary.

The predicament was that government regulation required them to write down the book value of their assets, contract loan activity, and pressure borrowers to meet interest and principal repayment obligations, even if this meant driving clients into bankruptcy. The quandary was that Japanese cultural ethics strongly discouraged maximizing bank profits at borrowers' expense. (Rosefielde, 2002) Through thick and thin, Japanese are trained from birth to communally support each other, subordinating personal utility and profit seeking to the group's wellbeing. Watching out first for number one is never the right thing to do, as it is in competitive, individualist societies. Tough love isn't an option; burden sharing is the only viable course,[2] which in this instance meant refusing to "mark capitalizations to market," seeking government assistance, and stalling for time hoping that with patience, clients' financial health ultimately would be restored.

The judgment wasn't wrong. Japanese corporations operating under the same cultural obligation immediately began earmarking revenues from current operations for debt reduction at the expense of new capital formation, and refrained from new borrowings to cover the gap. Banks

[2] Westerners once knew this, but have forgotten. See Ruth Benedict, *The Chrysanthemum and the Sword – Patterns of Japanese Culture*, Cambridge: Houghton Mifflin, 1946. Cf. C.Douglas Lummis, C. Douglas,"Ruth Benedict's Obituary for Japanese Culture," 2007. Lummis contends that Benedict failed to comprehensively study culture among all social strata, and like Sigmund Freud was inspired by literature and art. This is correct, but doesn't negate most of her insights.
http://www.japanfocus.org/-C__Douglas-Lummis/2474

for their part, not only maintained the fiction that outstanding loans were secure, but provided cash for current corporate operations and consumer loans at virtually no cost above the bare minimum for bank survival. Moreover, they kept their lending concentrated at home, instead of seeking higher returns abroad.

These actions averted the broader calamities that typically accompany financial crises. Japan didn't swoon into hyper depression (GDP never fell, growing 1.7 percent per annum 1990-93),[3] or experience mass involuntary unemployment. The country wasn't swept by a wave of bankruptcies. There was no capital flight, sustained yen depreciation, deterioration in consumer welfare (Sawada et al., 2010) or civil disorder. There was no need for temporary government deficit spending, long term "structural deficits," "quantitative easing," comprehensive financial regulatory reforms or high profile criminal prosecutions. Interest rates already were low, and although the government did deficit spend, arguably it didn't matter in a Keynesian universe because Japanese industrial workers in large companies were employed for life (*shushin koyo*). For pedestrians on *hondori* (Main Street) who blinked, it seemed

[3] An hyper depression is any depression greater than the great American depression of 1929. See Angust Maddison, *The World Economy: Historical Statistics*, Geneva: OECD, 2003, Table C3-b, p.298.

as if nothing had happened at all beyond a moment of speculative insanity.

However, matters look very differently to western macro theorists and Japanese policymakers, particularly those who erroneously believe that structural deficits, and loose monetary policy are the wellsprings of sustainable rapid aggregate economic growth (as distinct from recovery). Their prescription for Japan's "toxic asset" problem was to bite the bullet, endure the pain, and move on swiftly to robust, ever expanding prosperity. Given ideal assumptions, writing off non performing loans and shunning problematic loans is best because it doesn't sacrifice the greater good of maximizing long term social welfare for the lesser benefits of short term social protection. Advocates contend that the Japanese government fundamentally erred in condoning bank solicitude for endangered borrowers, and abetting banks with external assistance because these actions transformed otherwise healthy institutions into "zombie banks"(the living dead),[4] unable to play their crucial role in bankrolling investment, technology development and fast track economic growth.

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[4] Caballero, Hoshi and Kashyap contend the zombie banks crowd the market and the resulting congestion has real effects on the healthy firms in the country. They find the cumulative distortionary impact of investment and employment to be substantial. See Ricardo J. Caballero, et al. (2006) cf. Akiyoshi and Kobayashi (2008). For a detailed historical review of the Japanese banking crisis see Kanaya and Woo (2000).

Their claim has merit,[5] but also is seriously incomplete. It is true that Japanese growth has been impeded by "zombie banks, "deflation, the "liquidity trap" conjectured by Paul Krugman in the 1990s,[6] faulty banking policy (Akiyoshi and Kobayashi, 2008) and the aftermath of stock and real estate market speculation, but isn't the whole story because other factors should have been stimulatory. Japan is more competitive vis-à-vis the rest of the world today on a real exchange rate base than it was in 1990. Japanese inflation during the 1990s and 2000s has been non-existent, while it was in the mid single digits abroad. Moreover, the government has tenaciously pursued a zero interest, loose credit policy, in

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[5] Miyajima and Yafeh (2007). The authors find that small, undercapitalized firms were the primary victims of the credit crunch. These firms contribute little to Japanese productivity growth, undercutting the claim that the financial crisis caused Japan's two lost decades.

[6] Paul Krugman contends that after Japan's bubble burst savings rose (consumption collapsed) and the natural interest rate (needed for full employment general equilibrium) turned negative, the money interest rate reached the lower bound of zero, rendering monetary policy impotent. The actual real interest rate immediately after the crash and for decades to come often was slightly positive; the combined effect of modestly falling prices(due partly to collapsed demand and retail liberalization in an otherwise keiretsu price-fixed environment), and a zero money interest rate. This created a small Keynesian output gap(albeit with negligible unemployment) that was addressed with fiscal deficit spending, but it is still possible to argue that deflation and a "liquidity trap" kept, and still keep Japan's GDP and employment below its full competitive potential. Krugman contends that Japan's "liquidity trap" was the first manifested since the Great Depression, and sends a signal to monetary authorities like Ben Bernanke to be alert to the danger. He recommends that Japan's and America's output gaps should be closed with quantitative easing (central bank purchase of medium and long term government securities) and nurtured inflationary expectations through a Phillip's mechanism. The suggestion is sound in principle (albeit controversial) for contemporary America. Japan's institutions prevent its economy from attaining natural output levels. There may be a gap between Japan's achieved and potential institutionally constrained GDP, but it's impossible to reliably measure these gaps. See Krugman (1998), Krugman (2010) cf. Stiglitz (2010) cf. Aoki and Saxonhouse (2000).

[6] Rosefielde (2010), www.ggdc.net/Maddison/oriindex.htm; Russia, China 1991-2008 (EU benchmark)

[6] It is unclear whether Krugman ascribes Japan's second lost decade 2000-2010 to his conjectured "liquidity trap."

tandem with high deficit spending that has raised the national debt to 150 percent of GDP. If Japan's growth retardation were really primarily due to insufficient "zombie bank" credit, government stimulus should have mitigated much of the problem.

There is a better explanation for Japan's two lost decades that has little to do with two concurrent, and isolated speculative incidents, one in the stock market, the other in real estate with scant sustained effects on production and employment. The advantages of Japan's postwar recovery and modernizing catch up diminished steadily in the 1980s and were fully depleted by 1990, when its per capita GDP hit 81 percent of the American level. Thereafter, Japan's culturally imposed, anticompetitive restrictions on its domestic economic activities became increasing pronounced, causing its living standard to diminish to 73 percent of America's norm.[7] Japan, at the end of the 1980s was poised to fall back, with or without a financial crisis, and it is in this sense that the two lost decades are being erroneously blamed on the bubble, and its "zombie banking" aftermath.[8] Yes, there were eye-popping speculative stock market and real estate

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[7] Rosefielde (2010), www.ggdc.net/Maddison/oriindex.htm; Russia, China 1991-2008 (EU benchmark)

[8] It is unclear whether Krugman ascribes Japan's second lost decade 2000-2010 to his conjectured "liquidity trap."

price busts, but they weren't the national economic debacles they are usually painted to be, either in the short or intermediate term.

This interpretation raises a larger issue that cannot yet be resolved, but nonetheless is worth broaching. Does Japan's fate, presage China's future? When the advantages of catch up are depleted, its population grays,[9] and the delusion of permanent miraculous growth subsides, will the end of days be punctuated with a colossal speculative bust, followed by uncountable lost decades? Perhaps not, but still it is easy to see how history may repeat itself.

The 1997 Asian Financial Crisis and Out of Region Spillovers

The Asian financial crisis which erupted in 1997 was a foreign capital flight induced money and credit implosion.[10] It began as a run on Asian banks by foreign short term depositors, and expanded into an assault on government foreign currency reserves, sending shock waves as

[9] Japan's population growth had slowed noticeably by 1990, was still positive when its financial crisis hit. Deaths first began exceeding births in 2007, and the trend won't be swiftly reversed. Demographers are currently forecasting that more than one in three Japanese will be over 65 in 2055, with the working age cohort falling by over a third to 52 million. Immigration could alleviate the pressure, but the Japanese are resolutely opposed to it because of unvoiced fears of being inundated by the Chinese. The long term demographic prospect for China, including the possibility for expanded immigration mimics the Japanese pattern due to Deng Xiaoping's one child per family policy, and xenophobia. See Eberstadt (2007) and Eberstadt (2010).

[10] Stiglitz (1996), Radelet and Sachs (1998), Rajan and Zingales (1998), and Fratzscher (1998). Rajan and Zingales contend that "hot" money in Asia is white hot, because in the absence of the rule of contract law, in a relationship based culture, short term foreign investors are especially wary.

far as Russia's and Argentina's shores.[11] Banks were decimated by acute insolvency. They didn't have the cash on hand to cover mass withdrawals of short term deposits because these funds had been lent long, sparking asset fire sales, slashed capitalizations and credit and money contractions, which in turn triggered widespread business failures, depressions and mass unemployment. Thailand's GDP plummeted 8 percent, Indonesia's 14 percent and South Korea's 6 percent 1997-98.[12] Foreign capital flight (repatriation of short term deposits), compounded by insufficient government foreign currency reserves, soon compelled steep devaluations that increased import costs, reduced "command national income," (domestic purchasing power including "command" over foreign imports), disordered balance sheets, and otherwise diminished real national consumption.

These events, unlike Japan's financial crisis eight years earlier, were triggered by foreign capital flight rather than domestic stock and real estate meltdowns, and weren't quarantined. The crisis started in Thailand, spreading rapidly to Indonesia, South Korea, Hong Kong,[13]

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[11] Argentina's money supply contracted sharply because constitutionally its money base was tied peso for peso to its foreign reserves, which wreaked havoc on business activity when hot money fled the country under its fixed foreign exchange regime.

[12] Angus Maddison, *The World Economy: Historical Statistics*, Geneva: OECD, 2003, Table C3-b, p.298.

[13] Hong Kong's currency board, however, was successfully defended by massive foreign reserve sales, and purchases of private equities.

Malaysia, and the Philippines, with lesser reverberations in India, Taiwan, Singapore, and Brunei, but fledgling market communist regimes in China, Vietnam, Laos, and Cambodia were spared runs on their banks and foreign currency reserves by stringent state banking and foreign exchange controls. They experienced secondary shocks from diminished regional economic activity, but otherwise escaped unscathed.

The root cause of the runs on Asia's banks and foreign reserves lay in foreign financed Asian economic development, and east-west interest rate differentials. After World War II Asia became a magnet for both foreign direct and portfolio investment, driving foreign debt-to-GDP ratios above 100 percent in the four large ASEAN economies (Thailand, Malaysia, Indonesia and the Philippines) 1993-1996, and local asset market prices to soar(real estate and stocks). Rapid, near double digit GDP growth contributed to the asset boom, inspiring confidence that investments were safe because Asia's miracles were expected to continue for the foreseeable future. Thailand's, South Korea's, and Indonesia's GDP growth rates during the decade preceding the Asian financial crisis respectively were 9.6, 8.2 and 7.2 percent per annum.14 At the same time, Asia's high interest rates attracted the "carry trade;" short term borrowing of low yielding currencies like the Japanese yen, and their subsequent short term investment in high yielding foreign bank deposits

[14] Maddison, *Op.Cit*.

and similar liquid debt instruments. Short term "hot" money (including large sums from Japanese financial institutions searching for positive returns on near money instruments well after Japan's financial crisis ended) poured into the region, creating what increasingly came to be perceived as a pan-Asian bubble economy, exacerbated by "crony capitalism,"[15] severe political corruption and instability(especially Thailand, Malaysia and Indonesia).

Foreign investors steeled by their faith in Asian miracles at first weren't perturbed by the frothiness of the orient's markets, but the swelling bubble, compounded by surging current account trade deficits undermined their confidence. Speculators, hot money carry traders, and other investors gradually grasped that the high returns they were reaping could be wiped out by catastrophic devaluations, and began planning for the worst, realizing that those who fled early would preserve their wealth; those who dallied would be left holding an empty bag. The incentive to flee was increased further by developments outside the region. America's Federal Reserve Chairman, Alan Greenspan began nudging U.S. interest rates higher to deter inflation, creating an attractive safe haven for hot

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[15] Crony capitalism is a vague term often used to describe market economies, especially in the Third World, where business depends heavily on patronage in closed privileged networks of officials, relatives and friends that thrive even though under other circumstances their companies would fail the competitive test. These systems are considered morally hazardous, corrupt, inefficient and ripe for disaster. See. Pempel (1999).

money hedging, made more appealing by the prospect of an appreciating dollar.

The precise combination of factors that ignited full throttle capital flight is open to dispute. Southeast Asian export growth dramatically slowed in the Spring of 1996, aggravating current account deficits. China started to out-compete its regional rivals for foreign directly invested loanable funds. The domestic asset bubble began to pop with stock and land prices in retreat, forcing large numbers of firms to default on their debts. No doubt for these and many other reasons including asymmetric information, (Mishkin, 1999) opacity, corrupt corporate governance, and "crony capitalism;" foreign investors rushed for the exits in early 1997, symbolically culminating in the Thai government's decision on July 2, 1997 to abandon its fixed exchange rate, allowing the value of its baht to "freely" float. Over the course of the next year, the Baht's value fell 40 percent. The Indonesian, Philippine, Malaysian and South Korean currencies swiftly followed suit, declining respectively 83, 37, 39 and 34 percent.

Devaluation, stock and real estate market crashes, bankruptcies, mass unemployment, wilted interest rates, and heightened risk aversion dissolved the fundamental disequilibria that had beset the region before the fall, only to be immediately replaced by urgent new priorities. Downward spirals had to be arrested, economies stabilized, and steps

taken not only to achieve rapid recovery, but to foster structural changes supporting long term modernization and growth. Thai economic planners and their counterparts elsewhere in the region had a coherent overview of what needed to be done (mundane partisan squabbles aside), but unlike the Japanese seven years earlier, sought external foreign assistance from the International Monetary Fund, the World Bank, the Asian Development Bank and individual nations including China to finance balance of payments deficits and facilitate structural adjustment.[16] Japan didn't run a current account deficit during its crisis, didn't need foreign exchange rate support, nor structural adjustment assistance funding, and so relied entirely on its own resources, whereas the dependency of noncommunist developing Asia on the developed west was placed in stark relief. The region of course could have gone it alone; however its aspirations for fast track convergence, and counter crisis stimulus were clearly tied to its integration into the global financial system, and perhaps acceptance of some bad IMF conditionality as the price for the good.

Much ink has been spilled over whether Washington Consensus style monetary and fiscal stringency, combined with mandated economy

[16] Introducing changes to a nation's economy: the promotion of exports; liberalization, through a reduction in government subsidies in order to bring domestic prices more in line with world prices; privatization of public-sector institutions to improve the technical efficiency of production; and the controlling of inflation through currency devaluation, and/or by restricting the rate of increase of the money supply, which means reducing budget deficits and therefore cutting public services.

opening structural reforms imposed by the International Monetary Fund helped or harmed Asia.[17] This issue is important, but only so for present purposes insofar as structural reforms increased or diminished the likelihood of future crises. The evidence to date on balance, despite strong claims to the contrary, favors the regional decision to follow the IMF's tough love advice. Asia accepted fiscal austerity and monetary restraint. It liberalized, amassed large foreign currency reserves, maintained floating exchange rates and prospered. After enduring a protracted and perhaps excessively painful period of adjustment, Asia not only resumed rapid growth within the IMF's framework, but when push came to shove in 2008, weathered the global financial shock wave better than most. It appears that although global financial liberalization does pose clear and present speculative dangers as IMF critics contend, the risks can be managed with prudence and discipline.[18]

Some have suggested that Russia provides a cogent counter Washington Consensus example because having liberalized after its own financial crisis in 1997, and recovered, its economy was crushed by the

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[17]The term Washington Consensus was coined by John Williamson in 1989 to describe ten standard reforms advocated in Washington DC for ameliorating crises and promoting sustainable growth in developing countries. These reforms include fiscal discipline, structural investments (in education, etc.), tax rationalization, market determined interest rates, competitive exchange rates, trade liberalization, privatization, deregulation and rule of law. See Williamson (2002) cf. Blustein (2001).

[18] Stiglitz (2011) argues that controls can dampen the destabilizing effects of productive and financial regional and global integration. See also Lee and Jang (2010).

2008 financial crisis. The claim however is misleading on a variety of grounds. There simply are too many dissimilarities for the Russian case to be persuasive. Unlike Asia, Russia was mired in hyper depression when it defaulted on its sovereign Euro denominated debt in 1997. It never received significant sums of direct and/or hot money inflows into the private sector during the Yeltsin years, had a floating peg exchange rate, and received no IMF support after the ruble collapsed. Consequently, it is fatuous to lump Russia into the same basket with Asia.[19] Asia's and Russia's systems and contexts are too disparate for them to be pooled. The same argument for different reasons applies to Argentina 1999-2001. Russia's and Argentina's crises were both linked to sovereign debt issues, but their problematic, and roles within the global economic and financial system place them in separate categories.

[19] Vavilov (2010), Rosefielde’s (2011) “Review of Vavilov's, The Russian Public Debt and Financial Meltdown,” and Rosefielde (2005) cf. Shleifer and Treisman (2004). The only thing that really links Russia's 1998 financial crisis to Asia's is the demonstration effect. When the Asian bubble burst July 1997, Europeans started to reassess Russia's creditworthiness, after being assured by Anders Aslund, the IMF, World Bank and the G-7 that Russia had become a "capitalist market economy" on the road to recovery. The real story is that Yeltsin officials after scamming their own people innumerable times including the infamous 1996 "Loan for Shares" swindle of the millennium, began a massive issue of GKO (*Gosudarstvennoye Kratsrochoye Obyazatel'stvo*; government short term obligations) designed to entice foreign hot money by paying 150 percent interest, at a time when it could not cover its budgetary expenses with tax revenues hopelessly in arrears. Yeltsin insiders knew that the obligations couldn't be met, but also saw opportunities for self-enrichment and played the situation that way. They secured a 22.6 billion IMF rescue package on July 13, swapping GKOs for long-term Eurobonds to string the process out, before finally repudiating their GKO and Euro-denominated obligations, and abruptly devaluing on August 17, 1998. In the Asian case, foreign capital fled because private sector risks had increased. By contrast, in the Russian case it fled because carry traders realized that the Russian government was intent on ripping them off. The only question was when, not if, the Kremlin would strike. See Goldman (2003), Aslund (1995), Rosefielde and Hedlund (2009).

Clarity in this regard is essential for gauging the Asian financial crisis's historical significance. Some like Niall Ferguson contend that Asia's financial crisis was the first tremor of the second globalization age that emerged after the Bretton Woods international monetary and financial order collapsed in the late 1970s, early 1980s; weakly implying that future crises will mimic Asia's experience. (Ferguson, 2008, 2010) This is implausible. Asia's crisis provides an object lesson on the broad danger posed to a wide variety of economies in various stages of economic development by overly exuberant international financial liberalization, but doesn't offer a blueprint about how things must unfold.[20]

Prevention

Japanese and Asian policymakers not only failed to prevent their respective crises, but were complicit in creating the bubbles that overwhelmed them. This failure to prevent cannot be attributed to an absence of early warning signs, or a faulty understanding of the rudiments of economic stabilization.

[20] The rebirth of financial globalization, and the possibility of serial crises of increasing intensity, evoke memories of Rudolf Hilferding's Marxist classic *Das Finanzkapital*, 1910, but the fit is inexact because Hilferding stressed the international capitalist concentration of financial power, rather than the competitive variety evident today.

The Japanese had ample warning throughout the eighties that the nation was at risk for a hyper bubble, concentrated in the financial and construction sectors. The Nikkei 225 index nearly tripled 1982-1987 and more than quintupled 1982-1990. Real estate prices and collectibles followed the same trajectory, while consumer prices were tame and GDP expanded at a rapid clip(5 percent per annum). This segmentation of the real consumer economy from the real estate and financial sector simplified the prevention task. A multitude of price (interest rate), quantity (licensing, permits, etc.) and regulatory measures (suspension of margin privileges) could have tempered the speculative fever without distorting production and arresting economic growth.

Japanese authorities and market participants moreover should have realized quickly that rising asset prices could not be explained by any sensible estimate of foreseeable future rates of return.[21] The great real estate and stock price ascent was propelled by euphoria, not rational expectations.

Various factors contributed to this euphoria, including aggressive behavior by financial institutions, financial deregulation, inadequate risk

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[21] Shigenori Shigatsuka, The Asset Price Bubble in Japan in the 1980s: Lessons for Financial and Macroeconomic Stability, in Real Estate Inidicators and Financial Stability, *BIS Papers* No 21, International Monetary Fund, 2005, pp.42-62. Jose Scheinkman and Wei Xiong, "Overconfidence and Speculative Bubbles," *Journal of Political Economy*, Vol.111, pp.1183-1219.

[21] The Plaza Accord was an agreement among the United States, West Germany, France, Britain and Japan to appreciate the yen and the deutsche market signed at the Plaza hotel, Manhattan, September 1985. The expectation of an appreciating yen attracted hot money from abroad into Japanese direct and portfolio investments, fueling rising prices in these assets.

management, the introduction of the Capital Accord(banking system restructuring 1988), protracted monetary easing, taxation and regulations fostering land price inflation, Tokyo's rise as an international money center, the Plaza Accord,[22] enthusiasm for high tech Japan,[23] and prattle about the Japanese miracle.[24]

Japanese leaders for diverse reasons found it convenient to portray the nation as a phoenix, reborn from the ashes of WWII in a new and better form. The story line varied, but the essence was that thanks to Japan's superior communalist culture and planning the nation had forged an innovative technocratic model that surpassed the western competitive paradigm, capable of crisis free, fast track economic growth and perpetual prosperity.[25] Although, Paul Krugman later successfully debunked these miraculous claims, the fable had the twin effect of blinding policymakers who had a duty to protect against bubbles, and providing grist for the mill

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[23] Hugh Patrick and Larry Meissner, *Japan's High Technology Industries: Lessons for Industrial Policy and its Limitations*, Seattle: University of Washington Press, 1986. Sheridan Tatsuno, The Technopolis *Strategy: Japan, High Technology, and the Control of the Twenty-First Century*, New York: Prentice Hall, 1986.

[24] Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy 1925-1975*, Stanford: Stanford University Press, 1982. Aaron Fosberg, *America and the Japanese Miracle*, Chapel Hill, NC: University of North Carolina Press, 2000. Paul Krugman, "The Myth of Asia Miracle," Foreign Affairs, November/December 1994, Vol.73, No.6, pp.62-79.

[25] Masahiko Aoki, *Information, Incentives and Bargaining in the Japanese Economy*, Cambridge: Cambridge University Press, 1988.

of market speculators who gladly urged new entrants, Ponzi scheme style, to throw good money after bad in the dizzying pursuit of capital gains. Moreover, the cozy relationship among politicians, speculators, financiers, banks and *keiretsu* further impeded timely preventative intervention.[26]

This suggests that Japanese policymakers should consider devising "cultural stress tests" alerting themselves to present dangers they prefer to ignore, and bracing them to act in the common interest when tradition favors accommodating powerful groups. The issue hasn't arisen again during the subsequent two lost decades(going on three) because euphoria has been replaced by risk aversion and leaders can no longer gull themselves into believing that the east belongs to Amaterasu.[27] But China could benefit from Japan's cautionary tale.[28]

Drawing lessons about prevention from the Asia crisis, extended to include Russia and Argentina requires a nuanced understanding of specific conditions in each affected country. The Russian case is clearest. Citizens must somehow find a way to discourage their leaders

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[26] A conglomeration of businesses linked together by cross-shareholdings to form a robust corporate structure.

[27] Amaterasu is the Japanese Shinto sun goddess, and the original female progenitor of the Japanese Imperial family.

[28] Kazuo Ueda, "Japan's Bubble, The USA's Bubble and China's Bubble," *China and World Economy*, vol.19(1), pp.47-62. Wei Xiong, and Jialin Yu, "The Chinese Warrants Bubble," *American Economic Review*, forthcoming.

from issuing sovereign debt with the intention of defrauding foreign investors. For east Asia emboldened by its "Asian values" rhetoric, prevention circa 1996 boiled down to a failure to anticipate the ferocity of hot money contagion, and take appropriate defensive measures including prudently liberalizing financial markets, improving information and transparency, reducing incentives for excess private risk taking in lending, promoting more flexible exchange rate regimes, insulating the domestic financial systems from short-term capital inflows(through tax disincentives and tight regulation), amassing sufficient foreign currency reserves, and by creating international regimes for coordination and mutual surveillance.[29] East Asia subsequently learned most of these lessons the hard way. Its currencies now are more flexible (dirty float) and its foreign currency reserves are ample, although it continues to run significant current account surpluses suggesting that currencies remain undervalued. Also, it would be a mistake to suppose that policies which are working in a globalization era, will remain appropriate if polarities reverse and the world shifts toward protectionism and de-globalization.

Finally, it seems wise to avoid making strong judgments about Japan's and east Asia's crisis management strategies. It is always possible to claim that if Tokyo had adopted alternative fiscal, monetary and

[29] Manuel Montes, "Lessons from the Economic Crisis in Asia," *Asia Pacific Issues*, No. 35, March 1998, pp.1-8,

regulatory policies its performance after 1990 would have been even worse, but it is difficult to see why Japan deserves high crisis management marks. Government and business have experimented with innovative ways to reinvigorate the economy, without conspicuous success and if there is a magic bullet, it has eluded everyone's detection.

It is interesting to speculate whether Japan would have been afflicted with more than two decades of dyspeptic growth had it arrested the bubble at an early stage. On one hand, the extraordinary length of Japan's postcrisis bust raises the possibility that demographic, political, institutional and anticompetitive structural factors were determinative, and would have slowed growth to a crawl even if authorities had nipped the bubble in the bud. Japan's two lost decades from this angle are best interpreted as a structural, rather than a business cycle phenomenon. However, on the other hand, it can be counterargued that the trauma transformed Japan from a risk taking to a risk adverse society with severe growth retarding consequences. If the trauma had been avoided, the structural factors would have been subsidiary. Most observers have preferred the latter theory, but as time elapses without a cyclical reversal, it seems prudent to give substantial weight to both explanations.

The east Asian story is untidy. The Washington consensus solution was excruciatingly painful for several years, but then induced a pro-

competitive resurgence that significantly benefited the region. East Asia also weathered the 2008 final crisis better than most. Further liberalization could pay similar dividends, but a new epoch might call for novel crisis management tools, and better defenses against protracted collateral damage.

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Chapter 2 The 2008-09 Global Crisis

Asia was victimized by the global financial crisis 2008-10 spawned on Wall Street, but the east's beggar-thy-neighbor foreign trade practices, particularly China's dollar reserve hoarding exacerbated U.S. unemployment and impeded recovery.[30] This suggests that while preventing a repeat performance of the 2008 crisis is primarily Washington's responsibility, Asia has a stake in repairing global monetary imbalances. America, the European Union (EU), Asia, the World Bank, International Monetary Fund (IMF) and World Trade Organization (WTO) have done a shabby job managing the 2008 crisis's aftermath, and leaders don't seem anxious to learn the essential lessons. This chapter recounts the story of the 2008 financial crisis, evaluates whether it could have been handled better, assesses the adequacy of reforms designed to prevent and mitigate recurrences, and considers what steps if any Asians should take to eliminate global imbalances and restore financial discipline.

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[30] Eric Fisher, "The Asian Dollar Surplus," volume, Chapter 10. If Keynesian multiplier effects are disregarded, the Chinese dollar reserve hoarding may be compatible with optimal Samuelson intergenerational equilibrium, or any harm done could be limited to global overtrading. Ben Bernanke however would dispute the link between. Chinese dollar reverse hoarding and American unemployment because Beijing's holdings of American treasury bonds facilitates monetary ease and low interest rates.

Prevention

American policymakers not only failed to prevent the 2008 financial meltdown, they were complicit (unintentionally or otherwise) in creating the bubble that overwhelmed them. This failure to prevent cannot be attributed to an absence of early warning signs, or a faulty understanding of the rudiments of economic stabilization.

Washington had ample warning throughout the eighties, nineties and the early 2000s that its push for deficit spending and financial deregulation put the nation at risk for a hyper bubble, concentrated in the financial, commodities and real estate sectors. The 160 billion dollar savings and loan debacle, the 1998 collapse of Long-Term Capital Management hedge fund debacle, the 2000-02 dot.com bubble, the 2001 stock market crash, the natural resource price bubble triggered by 9/11, the subprime mortgage fiasco, the 2006 American housing bust toxifying mortgage and derivative financial instruments, Chinese dollar hoarding, and the emergence of "institutional" bank runs should have signaled caution, but instead were read as precursors to a financial revolution that would permanently turbo-charge the economy and provide politicians with a goose laying an inexhaustible supply of golden eggs.

This imprudence was easily rationalized because consumer prices were tame, employment was under 5 percent(the instantaneous rate

defined as "full employment), and GDP was expanding in line with the long term postwar mean of 3.3 percent per annum. Likewise, pundits touted "divine coincidence" and belittled bubble talk, focusing instead on transient issues and forecasting blue skies forever. Watch dogs wanted to believe and did, ignoring their duty to protect. They could have easily curtailed subprime mortgages, curbed mortgage backed derivative trading, slowed money creation, trimmed the federal deficit, but never seriously considered braking excess aggregate effective demand or proscribing financial adventurism.

American policymakers unlike their Japanese counterparts two decades earlier weren't euphoric. They were purblind and self-serving, eclectically pressing pet programs, and remain unchastened, confirming Reinhart's and Rogoff's findings in *This Time is Different: Eight Centuries of Financial Folly*.[31] The Federal Reserve and regulators have taken the position that America's disequilibrium macroeconomic governance, including laissez-faire financial management and one-way street "state-private partnerships" are optimal except for a few refinements like "stress tests" and circuit breakers that now make the system failsafe.

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[31] Carmen Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly,* Princeton, NJ:Princeton University Press, 2009. It is worth noting that the failure to learn doesn't depend on the particular economic belief system since the study spans eight century. There always appear to be rationales for doing the wrong thing.

Their attitude is revealingly illustrated by the absence of any watchdog institution tasked to alert policymakers to impending bubbles. The Council of Economic Advisors and the Joint Economic Committee of Congress could take on the role, but their primary loyalties are to perpetuating "divine coincidence" myths, assuring everyone that everything is under control. These organizations are prepared to debate issues of fine tuning, but seldom start from the premise that the present system is prone to recurrent crises.[32]

There are occasional voices in the wind fretting about "irrational exuberance,"[33]and predicting bubbles and crises. The media notes the warnings, however, American policymakers historically have not responded in timely fashion (recurrent crises have been the norm), and are invariably taken off guard when bubbles burst. Washington today shrugs off its colossal federal deficit (more than 100 percent of GDP),[34] refusing to connect the dots between excess spending and bubble risk in the name of this or that greater good. Policymakers preoccupy themselves with "optimal" fine tuning, rather than preempting meltdowns. The Congressional Budget Office, for example recently warned that the national debt is on pace to exceed GDP by 160 percent within a decade, a

[32] Steven Rosefielde and Quinn Mills, *Democracy and Its Elected Enemies: The Root of the West's Paralysis, Crisis and Decline*, Cambridge: Cambridge University Press, 2012.

[33] Alan Greenspan, "The Challenge of Central Banking in a Democratic Society," December 5, 1996.

[34] As of January 8, 2012 America's national debt exceeded its GDP by a 100 billion dollars: 15.2 versus 15.1 trillion dollars. http://www.usdebtclock.org/

level on a par with contemporary Greece that could provoke an European-style debt crisis with catastrophic global implications unless policymakers in Washington can slam the brakes on spiraling deficits.[35] The report elicited yawns.

The reaction is unsurprising. The last thing American political authorities want to hear is that they should curb destabilizing deficit spending, "loose money", and indulgent financial regulation. Indeed, calls for substantially increasing the budget deficit without explicit limit are routinely heard from prominent public economists.[36] Witness the recent call of Larry Summers, one of President Obama's former chief economic advisors for 200 billion dollars of additional payroll tax cuts, and untold billions more spending on construction in order to avert a Japanese type "lost decade."[37]

There is no reason to expect constructive change soon,[38] nonetheless, a sound crisis prevention initiative can be crafted by

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[35] Andrew Taylor, "CBO: Debt Crisis Looms Absent Major Policy Changes," Yahoo!Finance, June 22, 2011

[36] Paul Krugman, "Nobody Understands Debt," Op Ed, *New York Times*, January 1, 2012. "So yes, debt matters. But right now, other things matter more. We need more, not less, government spending to get us out of our unemployment trap. And the wrongheaded, ill-informed obsession with debt is standing in the way."

[37] "Summers: More Stimulus Required to Avoid a "Lost Decade," Yahoo!Finance, June 13, 2011. Western governments also have become prone to lying about the scale of their deficit spending. For example, the European Commission is now insisting that an increase of 100 billion euros on its programs doesn't increase its budget! London Daily Mail, July 1, 2011.

[38] The US government for the first time is poised to become the largest source of outstanding loans for home mortgage and consumer credit loans, eclipsing the private sector. Government financed borrowing for these purposes now runs at $6.3 trillion per year(up from $4.4 trillion in 2006) in the

recognizing the lacunae and calling for the establishment of an independent government agency with a duty to protect against bubbles and crises that not only monitors, but accurately diagnoses disorders and surgically intervenes. Stakeholders, including foreign governments, need not be direct participants, however, they should familiarize themselves with the crisis prevention effort, offer counsel and coordinate policies.

Reinhart's and Rogoff's historical study of financial crises demonstrates that the creation of an independent government bubble monitoring and interdiction agency always was appropriate. Careful analysis of the origins of the 2008 global financial crisis confirms their finding and reveals moreover that prevention today is more urgent than ever before. Post "New Deal" deregulation coupled with a full employment imperative (honored in name, but not the breech) have skewed macroeconomic policy toward a perpetual excess aggregate effective demand regime that fans the flames of "irrational exuberance" with all its attendant risks. The same basic story holds for the European Union, modified to take account of democratic socialist influences and the supranational character of the organization. The EU isn't a unitary state; it is a transnational entity with elements of shared governance that make it even more crisis prone than America.

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first quarter of 2011. Private mortgage and consumer credit by contrast was $6.6 trillion down from $8.5 trillion in 2006. Gillian Tett, "The State is Now the Dominant Force in US Capital Markets," *Financial Times*, July 1, 2011.

The 2008 Financial Crisis and Subsequent Great Recession

The origins of the 2008 financial crisis can be traced to various milestones in the construction of the post World War American economy. During the 1950s, Keynesianism became orthodox at the same time momentum built to rescind sundry New Deal and wartime restrictions on free enterprise including wage-price controls, and fair trade retail pricing (Miller-Tydings Act 1937; McGuire Act 1952, both rescinded in 1975 by the Consumer Goods Price Act). Deregulation in rail, truck and air transportation during the 1970s, ocean transport in the 1980s, natural gas and petroleum sectors 1970-2000, and telecommunications in the 1990s created opportunities for asset value speculation, soon facilitated by complementary deregulation initiatives in the financial sector. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), and Garn-St. Germain Depository Institutions Act(1982) both increased the scope of permissible bank services, fostered mergers, facilitated collusive pricing, and relaxed accounting rules (Moody's for example is permitted to accept fees from insurers it rates). Beginning in the early nineties banks shifted from the direct loan business to packaging and marketing novel debt instruments like mortgage-backed securities (ultimately including subprime loans) to other financial institutions, and shortly thereafter President William Jefferson Clinton approved the Gramm-Leach-Bliley Act(1999) enhancing business flexibility. The

Glass-Steagall Act 1933(Banking Act of 1933) had compartmentalized banks, prohibiting those engaged in stable businesses like mortgages and consumer loans from participating in riskier stock brokerage, insurance, commercial and industrial activities with the intention of building a firewall against speculative contagion. The repeal of provisions banning holding companies from owning other financial companies ushered in an era of financial merger mania across old divisional lines, allowing companies like Citicorp and Travelers Group to unite.

These developments, replicated across much of the globe, were all positive from the standpoint of neoclassical microeconomic theory because they enhanced competitive efficiency, with the proviso that moral hazards and speculative abuses were optimally contained by residual regulations ("liberalization"). However, if residual "laissez-faire" (do whatever you want) regulations were inadequate, then ensuing financial crisis costs could easily outweigh deregulatory efficiency gains.

Clearly, there are legitimate grounds for conjecturing deregulatory involvement in the 2008 global financial crisis, but deregulation isn't the only suspect. The financial environment also was placed in jeopardy by revisionist Keynesianism. John Maynard Keynes was an apostate monetarist who devised and spread the counter-depressionary gospel of deficit fiscal spending in his *General Theory of Employment, Interest and Money* (Keynes, 1936).

He contended that the Great Depression had been caused by deficient aggregate effective demand brought about by negative income effects, prolonged by a liquidity trap and claimed that full employment could be easily restored by offsetting private hoarding (speculative idle cash balances) with government expenditure programs(deficit financed state procurements and programs). Other things equal, Keynes insisted competitive markets could and would achieve perpetual full employment, if it weren't for income (multiplier) effects, and this destabilizing force could be overcome without inflation through countercyclical government deficit spending and countervailing surpluses. There was no place in Keynes's universe for continuously mounting "structural deficits," sovereign debt and/or "managed" inflation that could feed speculation and cause financial crises.

Nonetheless, immediately after World War II, the U.S. government passed the Employment Act of 1946 prioritizing the attainment and maintenance of full employment (further codified and expanded in the Humphrey-Hawkins Full Employment Act, 1978). The law didn't fix quantitative targets, but marked the Truman administration's expansion of federal powers to include macroeconomic administration, management and regulation, without explicit constitutional sanction, and established the Council of Economic Advisors to aid presidential policymaking, as

well as the Joint Economic Committee of Congressmen and Senators to review executive policies.

These actions enabled Washington to go beyond the perimeters of Keynesian orthodoxy, whenever full employment could not be sustained with trans-cyclically balanced federal budgets. The exclusion remained moot throughout much of the 1950s until William Phillips discovered, (Phillips, 1958) and Paul Samuelson popularized the notion that full employment could only be maintained with "excess" monetary and/or fiscal stimulation accompanied by inflationary side-effects (Phillip's Curve). Keynes, many concluded was almost right. Deficit spending was essential, but it also should be applied no matter how much inflation it generates to secure the higher goal of full employment. Full employment zealots like Paul Krugman and Larry Summers insist that governments are "morally" obliged to deficit spend forever,[39] a position still widely maintained despite Milton Friedman and Edmund Phelps demonstrations that Phillips was wrong in the medium and long runs by omitting inflationary expectations.

The orthodox Keynesian straitjacket was loosened further by Walter Heller, Chairman of President John Kennedy's Council of Economic Advisors, 1961-64, who introduced across the board tax cuts as a counter-recessionary stimulus, even though this meant creating credit

[39] There may be a political aspect to this advocacy because unemployment is believed to turn voter sentiment against the incumbent party.

not just for investment, but for consumption as well. Keynes's employment and income multiplier theory required stimulating investment as the only legitimate method for combating deficient aggregate effective demand [Works Projects Administration 1932(WPA) providing 8 million jobs, and later investment tax credits]. He argued that new investment creates new jobs, wages, and derivatively increases consumption, whereas deficit consumption spending via diminished marginal propensities to consume merely transfers purchasing power from one recipient to another, without increasing employment. Heller's revisionism brushed Keynes's concerns aside, making it possible for politicians to claim that any deficit spending which benefited them and their constituents would stimulate aggregate economic activity and employment, including inter-temporal income transfers from one consumer's pocket tomorrow to the next today.

This logic was extended by falsely contending that deficit spending and expansionary monetary policy accelerate long term economic growth. Although, there are no grounds for claiming that structural deficits and lax monetary policy accelerate scientific and technological progress (the ultimate source of sustainable economic growth), policymakers couldn't resist the temptation to assert that deficit spending and inflation are indispensable for maximizing current and future prosperity. The ploy has been successful as a political tactic, making deficits and inflation seem

more palatable, but also has widened the door to compounding past abuses by upping the ante whenever the economy sours. Policymakers' reflex isn't to retrench, but to do more of what caused problems in the first place.

Academic macroeconomists likewise succumbed to wishful thinking, brushing aside the speculative momentum embedded in postwar institutional liberalization and fiscal indiscipline. Influenced by Robert Lucas (1972), and Phil Kydland and Edward Prescott (1982), the conventional wisdom of 2000-2008 came to hold that business cycle oscillations were primarily caused by productivity shocks that lasted until price- and wage-setters disentangled real from nominal effects. These shocks sometimes generated inflation believed to be best addressed with monetary policy. Accordingly, central bankers were tasked with the mission of maintaining slow and stable, Phillips Curve compatible inflation. Although, central bankers were supposed to be less concerned with real economic activity, many became convinced that full employment and two percent inflation could be sustained indefinitely by "divine coincidence."[40] This miracle was said to be made all the better by the discovery that real economic performance could be regulated with a single monetary instrument, the short term interest rate. Happily, arbitrage across time meant that central bankers could control all

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[40] The term refers to situations where stabilizing inflation is the same as stabilizing output.

temporal interest rates, and arbitrage across asset classes implied that the U.S. Federal Reserve could similarly influence risk adjusted rates for diverse securities. Fiscal policy, which had ruled the roost under the influence of orthodox Keynesianism from 1950-80 in this way, was relegated to a subsidiary role aided by theorists' faith in the empirical validity of Ricardian equivalence arguments, and skepticism about lags and political priorities.[41] The financial sector likewise was given short shrift, but this still left room for other kinds of non-monetary intervention. The consensus view held that automatic stabilizers like unemployment insurance should be retained to share risks in case there were any unpredictable shocks. Commercial bank credit similarly continued to be regulated, and federal deposit insurance preserved to deter bank runs, but otherwise finance was lightly supervised; especially "shadow banks", hedge funds and derivatives.

A similar myopia blinded many to the destabilizing potential of Chinese state controlled foreign trading. As postwar free trade gained momentum, liberalizers not only grew increasingly confident that competitive commerce was globally beneficial, but that trade expansion of any kind increased planetary welfare. Consequently, few were perturbed after China's admission to the World Trade Organization (WTO) in 2001 either by the conspicuous undervaluation of the renminbi

[41] See De Grauwe (2010).

(RMB) fixed to support export-led development, or by Beijing's ever mounting dollar reserves. It was assumed that even if China over-exported (at the expense of foreign importables jobs), this would be offset by employment gains in the exportables sector as China increased its import purchases. "Overtrading" as theory teaches is suboptimal, but not seriously harmful to aggregate employment and has the compensatory virtue of expanding international commerce.

However, a fly spoiled the ointment. The Chinese (and some others like Brazil) chose to hold idle dollar reserve balances (hoard), instead of importing as much as they exported, compounding a "saving glut" caused by a broad preference for relatively safe American financial assets.[42] Beijing's dollar reserves grew from 250 billion in 2001 to 2.6 trillion in 2010. In a perfectly competitive universe this wouldn't matter because others would borrow these unused funds, but not so in a Keynesian world where rigidities of diverse sorts transform idle cash balances into deficient aggregate effective demand, and simultaneously serve as a vehicle for financial hard asset speculation. For reasons that probably involve the Chinese Communist Party's desire to protect privileged

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[42] Ben Bernanke, Carol Bertaut, Laurie Pounder DeMarco, and Steven Kamin have provided convincing evidence that foreign investors during the 2000s preferred what they perceived to be safe American financial assets, particularly US treasuries and Agency-sponsored collateralized debt obligations. Although, European foreign trade surpluses were smaller than China's, they leveraged their balance sheets, issuing large volumes of external dollar liabilities to finance purchases of US mortgage based securities, stoking the American housing bubble. See Bernanke, et al. (2011).

producers in both its domestic importables and exportables sectors (implicit, stealth "beggar-thy-neighbor" tactics), Beijing became an immense source of global real and financial sector disequilibrium, contributing both to the 2008 financial crisis and its aftermath. Chinese leaders in its state controlled foreign trade system had, and have the power to reset the renminbi exchange rate, and increase import purchases, but they chose, and are still choosing to do little.[43]

The cornerstones of 2008 financial crisis in summary are: 1) an evolving deregulatory consensus, 2) a mounting predilection for excess deficit spending, 3) a penchant for imposing political mandates on the private sector like subprime mortgage, student loan lending, and excess automobile industry health benefits which drove GM and Chrysler into bankruptcy in 2009, 4) waning concern for labor protection manifest in stagnant real wages and therefore flagging mass consumption demand,[shift towards promoting the security of other social elements] 5) a proclivity to prioritize full employment over inflation, 6) the erroneous belief that structural deficits promote accelerated economic growth, 7) the notion that government insurance guarantees, off budget unfunded obligations like social security, and mandated preferences to savings and

[43] The G-20 is trying to pressure China into curtailing its dollar surpluses without conspicuous success. The parties are still quibbling over technical measurement indicators. Rosefielde (2011), "China's Perplexing Foreign Trade Policy: "Causes, Consequences, and a Tit for Tat Solution," *American Foreign Policy Interests*", Steinhauser and Keller, "Fuzzy Compromise Threatens Relevance of G-20," Yahoo!News, February 19, 2011. The renminbi appreciated 4.7 percent in 2011, less than the Japanese yen, which increased 6.3 percent.

loans banks were innocuous, despite the 160 billion dollar savings and loans debacle of the late 1980-1990s, 8) deregulatory myopia, and activist social policy, including the encouragement of subprime loans, adjustable rate mortgages(ARM), and tolerance of finance based credit expansion which flooded the globe with credit,[44] 9) lax regulation of post-Bretton Woods international capital flows(early 1970), 10) the "shareholder primacy" movement of the 1980s partnered Wall Street with CEOs to increase management's ability to enrich itself at shareholder expense, widening the gap between ownership and control first brought to light by Adolf Berle and Gardner Means in 1932,[45] 11) an indulgent attitude toward destructive financial innovation apparent in the 1987 "program trading," and 2000-02 "dot.com bubble" stock market crashes,[46] as well

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[44] Subprime mortgages involved loans to people likely to encounter difficulty maintaining their repayment schedules. ARMS allowed homeowners to borrow inexpensively, but obligated them to pay more if interest rates rose. Additionally, during the new millennium it was common for banks to waive down payments, enabling "owners" to walk away from their properties when housing prices (and values) fell, leaving banks with an huge inventory of bankruptcy repossessions and distressed sales. The Clinton Administration pushed subprime lending. The value of U.S. subprime mortgages in 2007 was 1.3 trillion dollars. In an inflationary environment, driven in part by people borrowing from their home's inflationary premium, home buying was transformed into a speculative game. The ratio of global liquidity to global GDP quadrupled 1980-2007; doubling 2000-2007. Cross border capital flows decupled 1990-2007 from 1.1 to 11.2 trillion dollars. Derivatives rose from virtually zero in 1990 to 684 trillion dollars in 2007. American nonfinancial debt outpaced GDP growth since 2007 by 8 trillion dollars. See Mills (2009), p.51.

[45] Berle and Means (1932), *The Modern Corporations and Private Property*.

[46] The dot.com bubble began shortly after Federal Reserve Chair Alan Greenspan's "irrational exuberance" speech on December 5, 1996. For proof that dot.com stocks were grossly overvalued see Delong and Magin (2006). The Nasdaq composite index peaked at 5,132.52 on March 10, 2000 and bottomed at 1,108.49 on October 10, 2002. The Enron accounting scam, tied to energy deregulation and lax accounting by Arthur Anderson also contributed to the slaughter.

as the 1998 Long-Term Capital Management hedge fund collapse,[47] 12) a permissive approach to financial auditing,[48] including mark to face valuation for illiquid securities, 13) the creation of a one-way-street, too big to fail mentality that transformed prudent business activity into a venal speculative game on Wall Street, main street and in Washington, 14) the 2001 Wall Street stock crash which shifted speculative exuberance from stocks to hard assets (commodities, land, natural resources, precious metals, art, antiques, jewelry), and paved the way for the subordination of individual stock market investment to institutional speculation,[49] 15) credit easing in the wake of the dot.com bust, orchestrated by the Federal Reserve which started a consumer credit binge, reflected in high consumption and low savings rates, adding fuel to the inflationary fires, 16) 9/11 and the Iraq war which swelled America's federal budget deficit and triggered a petro bubble (and broad based commodity inflation), 17) an epochal surge in global economic growth led by Brazil, India, Russia and China (BRICs) wrought by technology transfer, outsourcing and foreign direct investment, which induced a

[47] Nobel Prize laureate Myron Scholes and Robert Merton famous for devising a new method for valuing derivatives were members of LTCMs board of directors.

[48] Richard Bowen, III testified to the Financial Crisis Inquiry Commission that mortgage underwriting standards collapsed in the final years of the US housing bubble (2006-2007). Sixty percent of mortgages purchased by Citicorp from some 1,600 mortgage companies were defective. Clayton Holdings reported in parallel testimony that only 54 percent of mortgage loans met their originators' underwriting standards.

[49] Jack Boogle, Founder of Vanguard Group privately estimated that 40 trillion of the 41 trillion traded on world stock exchanges in 2009 year is speculative. The institutional share of American stock market investment has risen in the last two decades from 8 percent to 70 percent.

wave of speculative euphoria, 18) Chinese stealth "beggar-thy-neighbor" renminbi undervaluation and dollar reserve hoarding, reflected in Chinese under importing, a burgeoning American current account deficit and an overseas "savings glut" which exacerbated inflationary pressures, raised prices for American treasuries and lowered interest rates,[widely mischaracterized as "financing imports"] 19) the 2006 American housing bust which toxified mortgage and derivative financial instruments,[50] 20) the emergence of "institutional" bank runs, where financial and nonfinancial companies flee repurchase (repo) agreements, 21) rapidly mounting sovereign debt in Iceland, several European Union states,[51] as

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[50] American housing prices peaked in early 2005 and the Case-Shiller home price index began falling in 2006. Prices plunged 34 percent thereafter, bottoming in 2009, and are expected to continue declining in 2011 despite more than a trillion dollars of government support. On December 24, 2009 the Treasury Department pledged unlimited support for the next three years to Fannie Mae and Freddie Mac, despite 400 billion dollars in losses. The bubble was predicted by Robert Shiller in 2000. See Shiller (2000), *Irrational Exuberance* and Shiller (2008), *The Subprime Solution: How Today's the Global Financial Crisis Happened, and What to Do About It*. As early as 1997, Federal Reserve Chairman Alan Greenspan fought to keep derivates unregulated, a goal codified in the Commodity Futures Modernization Act of 2000. Derivative like credit default swaps (CDS) were used to hedge or speculate against particular credit risks. Their volume increased 100-fold 1998-2008, with estimates of the debt ranging as high as 47 trillion dollars. Total over-the-counter derivative notional value rose to 683 trillion dollars by June 2008. Warren Buffet described the phenomenon as "financial weapons of mass destruction." *The Economist*, September 18, 2008.

[51] Debt obligations issued by nation states are called sovereign debt. Superficially, it might be supposed that sovereign bonds are more secure than their corporate equivalents, but the reverse often is the case because under the doctrine of sovereign immunity, countries cannot be forced to honor their obligations. Creditors only recourse is to passively accept rescheduling, interest reductions or even repudiation. See Eaton and Fernandez (1995) "Sovereign Debt," in Grossman and Rogoff, eds., *Handbook of International Economics*, Vol. III.. Sovereign debt initially played a subsidiary role in the 2008 financial crisis. The collapse of Iceland's main banks, and 77 percent stock plunge in September 2008, prompted rating agencies to drastically cut Iceland's sovereign debt rating from A+ to BBB-. The IMF arranged a rescue package November 19, 2008, but the cat was out of the bag. Suddenly, investors became aware that the global financial crisis's scope might be much wider than earlier supposed, raising the specter of a worldwide financial collapse that wasn't reversed until March 2009.

well as similarly onerous debt obligations in California and Illinois, 22) a naive faith in "divine coincidence," 23) a colossal regulatory blunder in imposing "mark to market" valuation (Fair Accounting Standard:FAS 157) of illiquid assets from November 15, 2007,[52] 24) increased separation of ownership from corporate control enabling top executives to excessively compensate themselves, including golden parachute perks. CEOs were institutionally encouraged to gamble with shareholders' money at negligible personal risk. (Bogle, 2011 p.488) The 2008 global financial crisis thus wasn't just a garden variety White Swan business

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Nonetheless, sovereign debt fears reemerged in 2010 due to credit rating reductions for Greek, Irish, Portuguese, and Spanish sovereign debt that forced an EU to intervene in defense of these members. The rescue involved loans for conditionality, where credit impaired sovereigns were compelled to pledge the adoption of austerity measures reducing their "structural deficits." The problem which could easily expand to include Italy, and others, doesn't appear to jeopardize the international financial system immediately, but is a bad omen for the future. Additionally, many worry that if rating cuts contingent on budgetary debt reductions don't cease, it could force the European Union to abandon the Euro as a common currency, and even result in the EU's dissolution. The root cause of the EU's problem isn't excessive debt per se, but the ability of less productive members to run EU threatening deficits in a common currency regime, without the option of individual country currency devaluation. See Dallago and Guglielmetti (2011) " Eurozone and Global Imbalances: Two Europes?" in Rosefielde, Kuboniwa and Mizobata, eds., *Two Asias: The Emerging Postcrisis Divide*. As we know from the theory of optimum currency areas, there are benefits and costs to currency integration. Benefits are the reduced costs of doing business. If they are large, forming currency areas lead to large increases in trade. This is not what happened in the Euro-zone after the monetary union was established. The key problem is building a consensus on how best to restore price equilibrium after asymmetric shocks, booms and slumps that disparately affect individual member states. Labor mobility (Robert Mundell), fiscal integration (Peter Kenen), a strong central bank serving as lender of last recourse, and a fiscal unit to bail out sovereign debts lubricate equilibration, but don't automatically resolve conflicting member interests. The EU sovereign debt issue is tutoring members about the trade-offs that must be made, if the monetary union is to survive.

[52] FDIC chairman William Issac places much of the blame for the subprime mortgage crisis on the SEC for its fair-value accounting rules, misapplied in times of crisis. The Emergency Stabilization Act of 2008, signed October 7, suspended mark to market asset pricing during crises. The new regulation is FAS 157-d.

cyclical event. It was a long time coming, and prospects for a repetition depend on whether underlying structural disequilibria, including political indiscipline are redressed.[53]

The Shock Wave

The defining event of the 2008 global financial crisis was a "hemorrhagic stroke;" a paralytic implosion of the loanable funds market that seemingly brought the global monetary and credit system to the brink of Armageddon. The September 2008 emergency was caused by the terrifying realization that major financial institutions, especially those connected with hedge funds couldn't cover their current obligations either with asset sales or short term bank credit because confidence had been lost in the value of their assets, and short term lending suddenly ceased. People everywhere were panicked at the prospect of cascading financial bankruptcies, where the securities of failed companies contaminated the value of other assets, triggering margin calls, shuttered credit access, lost savings, bank runs, stock market crashes, liquidity crises, universal insolvency, economic collapse and global ruination. All crises are ominous, but this one seemed as if it just might degenerate into a Black Swan debacle, equal to or greater than the Great Depression of 1929. After all, the U.S. Treasury and Federal Reserve Bank had reassured the

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[53] Morici (2010) "Down Grade US Treasury's to Junk". Peter Morici contends that Congress and the White House made no comprise whatsoever in extending and expanding the Bush tax cuts, including a temporary 33 percent cut in poor and middle class social security taxes, ballooning the federal deficit to 1.5 trillion dollars in 2011; to say nothing of off budget deficits ten times as large.

public that the forced sale of the "risk management" investment banking firm Bear Stearns to JP Morgan Chase on March 24, 2008 for 5.8 percent of its prior high value had fully solved the subprime loan, mortgage and derivative securitization threat, but subsequent events revealed that Bear Stearns was just the tip of a potentially Titanic sinking iceberg, with American and European banking losses 2007-2010 forecast by the International Monetary Fund to reach 1 trillion, and 1.6 trillion dollars respectively.[54] An additional 4 to 5 trillion dollars are expected to be lost through 2011, and although the Dow Jones Industrial Average fully recovered from the September 2008 highs by December 2010, 42 percent of its value was wiped out at the stock market crash's trough.[55]

The other shoe began dropping on September 7, 2008 when the Federal National Mortgage Association(Fannie Mae), and the Federal

[54] Bear Stearns, founded in 1923 had survived the 1929 Wall Street crash, and achieved celebrity status in the new millennium because of Lewis Ranieri's pioneering innovation of the mortgage backed securitization business. Its problems became public in June 2007 when the company pledged a 3.2 billion dollar collateralized loan (collateralized debt obligation: CDO) to rescue one of its hedge funds. The CDOs were thinly trade, and when Bear Stern encountered liquidity problems, Merrill Lynch seized 850 million dollars worth, but only realized 100 million in forced liquidation. During the week of July 16, 2007 Bear Stearns acknowledged that its two CDO supported hedge funds had lost nearly all their value amid a rapid decline in the subprime mortgages market. On March 14, 2008, the Federal Reserve Bank of New York agreed to grant Bear Stearns a 25 billion dollar loan collateralized by free and clear assets from Bear Stearn in order to provide liquidity for 28 days. The deal however was changed two days later into a forced bailout when the Federal Reserve decided that the loan would be given to Bear Stearn's shotgun bride, JP Morgan, enticed into the marriage by a 35 billion non-recourse Federal Reserve loan. The action approved by Ben Bernanke, putting public money at risk, was justified by the necessity of preventing systemic failure, and forestalling the need for further intervention.

[55] The Dow Jones Industrial Average peaked October 9, 2007 at 14,164, and bottomed March 9 at 6,470. In early September 2008, it traded around 11,500, just where it stood at the end of 2010. The DJIA rose 4.7 percent in 2011.

Home Loan Mortgage Corporation(Freddie Mac)[specializing in creating a secondary mortgage market] were placed into conservatorship by the Federal Housing Financing Agency after new mark to market accounting regulations(FAS 157) created havoc in the mortgage industry.[56] At the time, Fannie Mae and Freddie Mac held 12 trillion dollars worth of mortgages.[57] Three days later on September 10, 2008, the "risk management" investment bank Lehman Brothers declared bankruptcy after having failed to find a buyer, or acquire a Federal bailout to cover a 4 billion dollar loss. Merrill Lynch finding itself in similar dire straits was sold to the Bank of America on the same day. Six days later, the Federal Reserve announced an 85 billion dollar rescue loan to the insurance giant American International Group (AIG), also heavily involved in "risk management" securitization activities. The news ignited a wave of Wall Street short selling, prompting the SEC to suspend short selling immediately thereafter. Then on September 20 and 21, Secretary of the Treasury Henry Paulson and Federal Reserve Chairman Bernanke appealed directly to Congress for an endorsement of their 700 billion dollar emergency loan package designed to purchase massive amounts of sour mortgages from distressed institutions. Forty eight hours later,

[56] Lending institutions were abruptly required to write their illiquid mortgage assets down to rapidly falling current values, forcing them to sell securities to raise capital, and generating a vicious downward credit spiral.

[57] Both firms were subsequently delisted from the New York stock exchange, June 2010 because their share prices fell below one dollar.

Warren Buffett bought 9 percent of Goldman Sachs, another "risk management" investment bank for 5 billion dollars to prop the company up. On September 24 Washington Mutual became America's largest bank failure ever, and was acquired by JP Morgan Chase for 1.9 billion dollars.

These cumulating disasters, exacerbated by parallel developments in Europe and many other parts of the globe addicted to structural deficits, Phillips Curve justified inflation, financial deregulation, asset backed mortgages, derivatives, electronic trading, and hard asset speculation sent shock waves through the global financial system, including the withdrawal of hundreds of billions of dollars from money market mutual funds (an aspect of the shadow banking system), depriving corporations of an important source of short term borrowing. The London Interbank Offered Rate (LIBOR), the reference interest rate at which banks borrow unsecured funds from other banks in the London wholesale money market soared, as did TED spreads[T Bills versus Eurodollar future contracts], spiking to 4.65 percent on October 10, 2008, both indicating that liquidity was being rapidly withdrawn from the world financial system. In what seemed like the blink of an eye, the global financial crisis not only triggered a wave of worldwide bankruptcies, plunging production, curtailed international trade, and mass unemployment, but morphed into a sovereign debt crisis. Countries like Iceland, Ireland, Greece, Portugal, Italy and Spain found themselves

mired in domestic and foreign debt that dampened aggregate effective demand, spawned double digit unemployment and even raised the specter of European Union dissolution. (Dallago and Guglielmetti, 2011)

These awesome events, together with collapsing global equity, bond and commodity markets unleashed a frenzy of advice and emergency policy intervention aimed at staunching the hemorrhaging, bolstering aggregate effective demand, and repairing regulatory lapses to restore business confidence. FAS 157-d (suspension of mark to mark financial asset pricing) broke the free fall of illiquid, mortgage backed asset valuations, offering some eventual support in resale markets. The Emergency Stabilization Relief Act bailed out system threatening bankruptcy candidates through emergency loans, and toxic asset purchases. FDIC savings deposits insurance was increased from 100,000 to 250,000 dollars per account to forestall bank runs. The SEC temporarily suspended short selling on Wall Street. The government pressured banks to postpone foreclosures invoking a voluntary foreclosure moratorium enacted in July 2008.[58] The Federal Reserve and Treasury resorted to quantitative easing(essentially printing money) to bolster liquidity and drive short term government interest rates toward zero, effectively subsidizing financial institutions at depositors' expense. The federal government quadrupled its budgetary deficit in accordance

[58] The moratorium was suspended in March 2009, but then applied again in 2010 by most states. Calls for further moratoria are still being heard in 2011.

with Heller's neo-Keynesian aggregate demand management tactic, concentrating on unemployment and other social transfers, instead of the direct investment stimulation advocated by Keynes.[59] Committees were formed to devise bank capital "stress tests," coordinate global banking reform, (Levinson, 2010) improve auditing and oversight, prosecute criminal wrong doing including Ponzi schemes (Bernard Madoff),[60] and investigate regulatory reform of derivatives and electronic trading(Dodd-Frank Wall Street Reform and Consumer Protection Act, July 2010).[61] In Europe many imperiled banks were temporarily nationalized, and a series of intra-EU austerity and rescue programs launched. In the larger global

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[59] Alan Blinder and Mark Zandi,(July 17, 2010) "How the Great Recession Was Brought to an End," the breakdown of the American 1 trillion dollar counter crisis fiscal stimulus package is divisible into two baskets: spending increases ($682 billion) and tax cuts ($383 billion). The Economic Stimulus Act of 2008 spent $170 billion. The American Recovery and Reinvestment Act of 2009 disbursed another $582 billion dollars on infrastructure($147 billion; including $109 billion dollars of "nontraditional" infrastructure); transfers to state and local governments($174 billion dollars: Medicaid $87 billion dollars, education $87 billion dollars), transfers to persons($271 billion dollars: social security $13 billion dollars, unemployment assistance $224 billion dollars, food stamps $10 billion dollars and Cobra payments $24 billion dollars). Tax cuts under the 2009 act totaled $190 billion dollars, allocated to businesses ($40 billion dollars), making work pay ($64 billion dollars), first time homebuyer tax credit ($14 billion dollars) and individuals ($72 billion dollars). Subsequently, the government also provided $55 billion dollars of extended unemployment insurance benefits. See Table 10, p.15. More than 90 percent of the stimulus was targeted at bolstering aggregate effective demand through transfers and tax rebates in the post 1960s Heller fashion, rather than in direct investment assistance(traditional infrastructure, business tax credits and first time home buyer credits) as Keynes himself recommended.

[60] Bernard Madoff, non-executive chairman of NASDAQ and founder of Bernard L. Madoff Investment Securities, LLC was sentenced to 150 years imprisonment and forfeiture of 17 billion dollars for a Ponzi scheme fraud costing investors 10-20 billion dollars, exposed by the 2008 financial crisis. Robert Stanford, Chairman of the Stanford Financial Group was charged with a similar fraud. His trial is scheduled for 2011.

[61] The Dodd-Frank Act contains 16 titles, strewn with prohibitions, rules and rate fixing. It is difficult to render a summary judgment, but has been criticized for not addressing the too big to fail issue, and indulging political at the expense of regulatory goals.

arena, the International Monetary Fund, World Bank and others provided emergency assistance, and the deep problem of Chinese state controlled trading was gingerly broached.

With the advantage of hindsight, it is evident the American government's Troubled Asset Relief Program(TARP), including the "cash for clunkers" program, other deficit spending and quantitative easing, passive acceptance of Chinese under-importing (dollar reserve hoarding), continued indulgence of destructive speculative practices(program trading, hedge funds, and derivatives), together with regulatory reforms and confidence building initiatives didn't cause a Black Swan meltdown and the subsequent hyper-depression many justifiably feared.[62] Some of these same policies may deserve credit for fostering a recovery, tepid as it is,[63] but also can be blamed for persistent, near double digit unemployment, a resurgence of commodity, stock and foreign currency speculation, and the creation of conditions for a sovereign debt crisis of

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[62] Carmen Reinhart and Kenneth Rogoff have discovered startling qualitative and quantitative parallels across a number of standard financial crisis indicators in 18 postwar banking crises. They found that banking crises were protracted(output declining on average for two years); asset prices fell steeply, with housing plunging 35 percent on average, and equity prices declining by 55 percent over 3.5 years. Unemployment rises by 7 percentage points over four years, while output falls by 9 percent. Two important common denominators were reduced consumption caused by diminished wealth effects, and impaired balance sheets resistant to monetary expansion (liquidity trap). These regularities indicate that forecasts of a swift V shaped recovery after the 2008 financial crisis were never justified based on historical precedent, although, it appears that this time a double dip recession, and a Black Swan catastrophe have been averted. See Reinhart and Rogoff (2009).

[63] America's real GDP as of January 1, 2012 remained below the end year 2008 level, but up from the 2009 bottom. Recovery is conventionally measured from the trough.

biblical proportions in the years ahead when the globe is eventually confronted with tens of trillions of dollars of unfunded, and un-repayable obligations.[64]

At the end of the day, it shouldn't be surprising that the institutionalized excess demand disequilibrium of the American and European macroeconomic management systems would produce some relief, even though their policies were inefficient and unjust. Financial stability is being gradually restored, and output is increasing for the moment, but the adjustment burden has been borne disproportionately by the unemployed, would be job entrants, small businesses, savers, pensioners, the next generation (impending national debt crisis), and a myriad of random victims, while malefactors including politicians and policymakers were bailed out.[65] Moreover, the mentality and institutions which created the crisis in the first place remain firmly in command. Incredibly, the Obama administration under cover of the Frank-Dodd Act already has begun mandating a massive expansion of the very same subprime loans largely responsible for the 2006 housing crisis and the

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[64] The figure includes unfunded social security obligations, but excludes mortgage insurance guarantees.

[65] "The Perfect Bailout: Fannie and Freddie Now Directly to Wall Street," Yahoo! Finance, February 2, 2011. Treasury Secretary Tim Geithner is providing Fannie Mae and Freddie Mac with as much credit as they need to purchase toxic mortgages held by banks at prices that won't produce book losses. This amounts to a stealthy taxpayer payer funded bailout, giving a green light to all parties to repeat the reckless lending that caused the 2008 financial crisis confident that they will reap the gains, and taxpayer will eat the losses.

2008 financial debacle that swiftly ensued.[66] This action and others like it will continue putting the global economy squarely at Black Swan risk until academics and policymakers prioritize financial stability over parochial, partisan, ideological and venal advantage. (Wedel, 2009)

The 2008 financial crisis also has placed macroeconomic theory in a quandary. The "divine coincidence" is now seen for the pipedream that it was, but there is no new consensus to replace it other than the pious hope that structural deficits, loose monetary policy and better financial regulation (aggregate demand management) will foster prosperity no matter how irresponsibly politicians, policymakers, businessmen, financial institutions, special interests and speculators behave. (White, 2010) Worse still, there seems to be little prospect that a constructive consensus soon will emerge capable of disciplining contemporary

[66] Wallison and Pinto (December 27, 2010), "How the Government is Creating another Bubble," *AEI Articles and Commentary*. Wallison and Pinto contend that the Dodd-Frank Act allows the administration to substitute the Federal Housing Administration (FHA) for Fannie Mae and Freddie Mac as the principal and essentially unlimited provider of subprime mortgage, at taxpayers' expense. Since the 2008 government takeover of Fannie Mae and Freddie Mac, the government-sponsored enterprises' regulator has restricted them to purchasing high quality mortgages, with affordable housing requirements mandated in 1992 relaxed. This reduces the future risk, but the good is entirely negated by shunting the old destructive practices to the FHA on the pretext of supporting the soundness of the entire mortgage industry. The gambit in the usual way, allows the administration to present a prudent face with regard to Fannie Mae and Freddie Mac, while diverting attention from the 400 billion dollar loss previously racked up by Fannie Mae and Freddie Mac, and recklessly reprising the Housing and Urban Development Administration's (HUD) prior destructive policies. Wallison, Pollock and Pinto (January 20, 2011) "Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market, AEI Online. Peter Wallison, Alex Pollock and Edward Pinto report that the US government sponsored 27 million subprime and Alt-policies. To correct the situation they recommend that the government get out of the housing finance business. Government regulation should be restricted to ensuring mortgage credit quality. Assistance to low-income families should be on-budget. Fannie Mae and Freddie Mac should be privatized.

societies for the greater good by promoting optimal efficiency, growth and economic stability. The global economy is flying blind, propelled by an intransigent mentality that spells trouble ahead with scant hope for learning by doing. Most players seem to believe that contemporary monetary and fiscal management, combined with better financial regulation will work well enough, but they appear to be conflating wishful thinking with economic science.

Prospects

The EU similarly is suffering from protracted postcrisis adjustment distress, with one important twist. The adjustment burden has fallen asymmetrically on the PIIGS (Portugal,Ireland, Italy, Greece and Spain), threatening the viability of the Euro, and even EU survival. Labor and other factor costs escalated rapidly during the bubble years following the signing of the Maastricht Treaty(1992), accelerating after 1999 due to foreign capital inflows encouraged by the adoption of a common currency in the eurozone. These speculative increases weren't matched by productivity gains vis-a-vis other member states, particularly Germany, making it extraordinarily difficult for PIIGS to cope with diminished post crisis aggregate effective demand. They cannot rely on the ECB (European Central Bank) to work efficiently as a lender of last recourse to floundering commercial banks. Their only residual instrument is fiscal policy, but decades of excess public spending have placed tight

constraints on further debt accumulation forcing them to shoulder the quadruple burdens of high debt service, depression, massive unemployment and vanishing social services. PIIGS cannot depend on yet-to-be-developed EU financial institutions for government facilitated debt restructuring. EU government financial credits could have mitigated the sovereign debt problem. High unemployment likewise could have been ameliorated by stronger EU labor mobility, but none of these options were viable. The PIIGS consequently are compelled to resolve the disequilibrium roundabout restoring competitiveness through a painful process of factor cost reduction and productivity enhancement that is slow and risky. They could choose to default on their sovereign debt forcing creditors to share the burden, but might well find themselves ensnared in a vicious contractive spiral without a fiscal antidote.[67]

Some American states like California and Illinois face similar

[67] The root cause of the EU's problem isn't excessive debt per se, but the ability of less productive members to run EU threatening deficits in a common currency regime, without the option of individual country currency devaluations. See Bruno Dallago and Chiara Guglielmetti, "Eurozone and Global Imbalances" in Steven Rosefielde, Masaaki Kuboniwa and Satoshi Mizobata, eds., Two Asias: The Emerging Postcrisis Divide, Singapore: World Scientific, 2011. As we know from the theory of optimum currency areas, there are benefits and costs to currency integration. Benefits are the reduced costs of doing business. If they are large, forming currency areas leads to large increases in trade. This is not what happened in the Euro-zone after the monetary union was established. The key problem is buiding a consensus on how best to restore price equilibrium after asymmetric shocks, booms and slumps that disparately affect individual member states. Labor mobility (Robert Mundell), fiscal integration (Peter Kenen), a strong central bank serving as lender of last recourse, and a fiscal unit to bail out sovereign debts lubricate equilibration, but don't automatically resolve conflicting member interests. The EU sovereign debt issue is tutoring members about the trade-offs that must be made, if the monetary union is to survive.

difficulties, but the depressive effects of reduced government spending are alleviated by superior labor mobility and a more uniform distribution of factor costs and productivity across the nation. Most importantly, America has well functioning federal fiscal institutions which can redistribute income across states. The United States has hardly gotten off scot free, but the greater flexibility of its governance system has forestalled the threat of disunion.

Duty to Prevent

The risk of a PIIGS crisis was widely discussed prior to the adoption of the Maastricht Treaty establishing the European Union in 1993. Telltale signs that a bubble was building were readily observable during the 2000s, yet precious little was done to avert it. Obviously, America isn't the only part of the west that prefers to accept crises rather than self-police its destabilizing policies. The record reveals a profound myopia, intransigence, and unwillingness to learn on both sides of the Atlantic that are unlikely to be remedied by better theory and patchwork stress tests.

There are no panaceas, but establishing a government body dedicated exclusively to monitoring, diagnosing and surgically remedying bubble phenomena well before any great rupture surely should be considered a constructive first step. The Bubble Prevention

Authority(BPA) cannot supersede other regulatory and advisory agencies, but it could prove a counterweight to wishful thinking by putting the government formally on notice that cumulative disequilibria are getting out of hand. This can be easily accomplished by requiring the BPA to submit seminal annual reports to Congress detailing risks and proposing concrete action, both in the short and intermediate term.

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Chapter 4 PIIGS

Supranationalism

The global financial crisis which erupted in the United States instantaneously swept across Europe. Like the United States, the European Union (EU) was ripe for a crash. It had its own real estate bubble, indulged in excessive deficit spending, financially deregulated, and rapidly expanded credit (partly through derivatives).[68] Policy responses and recovery patterns for key EU members like Germany, France (within the eurozone) and the United Kingdom (outside the eurozone) were similar. However, after the bubble burst and the crisis began unfolding it became clear that the eurozone's plight differed from America's in one fundamental respect. There was no exact counterpart of eurozone PIIGS (Portugal, Italy, Ireland, Greece and Spain) in the United States. Some American states had over-borrowed, but the sovereign debt crisis didn't place individual states at deflationary risk, or threaten the viability of the federal union. This wasn't so for some members within the eurozone.

The disparity is easily traced to the EU's and eurozone's special form of governance called "supranationality" (a partially sovereign transnational organization) that has been largely ignored in economic treatises about the costs

[68] *European Financial Stability and Integration Report 2010*, European Commission, Economic Staff Working Paper, Brussels, April 11, 2011.

and benefits of customs unions and economic communities.[69] Until now, it has been tacitly assumed either that supranational governance was as good, or better, than national economic mechanisms; that any policy regime accessible to nation states could be replicated without dysfunction by supranational communities.

Nation states before World War II never voluntarily surrendered their control over fiscal and monetary policy as part of a package to achieve political goals, even though they participated in international institutions like the League of Nations. The horrors of WWII, combined with cold war politics, the welfare state tide, and unreflected sympathy for World Governance,[70] however, propelled Europe along a novel supranational trajectory with unintended consequences. On September 19, 1946 Winston Churchill gave a speech in Zurich not only advocating Franco-German rapproachement, but a kind of United States of Europe, called a European "Third Way." He also advocated a "Council of Europe", formed soon thereafter with the assistance of French Foreign Minister Robert Schuman, mandated to create supranational communities on the path to a fully democratic, integrated Union.[71] The Schuman Declaration May 9, 1950 reaffirmed the concept in conjunction with the formation of the European Coal and Steel Community

[69] Wolfram Kaiser and Peter Starie, eds., *Transnational European Union: Towards a Common Political Space*, London: Routledge, 2009.
[70] Steven Rosefielde and Quinn Mills, *Democracy and Its Elected Enemies: The West's Paralysis, Crisis and Decline*, Cambridge: Cambridge University Press, 2012.
[71] The term supranational community was coined by Jean Monnett, head of France's General Planning Commission.

(ESCS). It proclaimed the European Community as the world's first supranational institution, marking the "birth of modern Europe," and initiating an epoch where intra-European wars were impossible. The Soviet Bloc formed a rival economic community, the CMEA(Council for Mutual Economic Cooperation) in 1949, but Comecon as it is sometimes called was more like the OECD (Organization for Economic Cooperation and Development), rather than a supranational economic governance mechanism superior to national authorities.[72]

Schuman's utopian vision which can be traced back to France's first socialist Claude Henri de Rouvroy, the Comte de Saint-Simon (1760-1825) [On the Reorganization of European Industry, 1814] was the prelude to a succession of developments culminating in today's European Union including the European Economic Community (EEC), known as the Common Market(1958), the European Community(1967) [together with the European Commission and the European Council of Ministers], the European Council(1974), the European Monetary System(1979), the European Parliament(1979), the Schengen Agreement(1985), The Single Market Act (1986), the Maastricht Treaty(1993) founding the European Union(EU), and European Monetary Union (2002), which inaugurated the euro.

[72] The members of CMEA were the Soviet Union, Poland, East Germany,Hungary, Czechoslovakia, Romania, Bulgaria, Cuba, Vietnam and Mongolia.

Europeans are broadly pleased with the result. There has been no intra-member war, a common European identity has emerged, members are democratic and socially progressive, there is free travel and capital mobility within the EU space, the economy has been liberalized, and living standards have risen. However, EU economic performance has hardly matched Schuman's idealist claims for communal supranationalism. Growth has been anemic, unemployment high, and moral hazard problems severe. Supranational governors have found it easier to agree on broad principles, than to effectively implement them. Schuman felt sure that communitarians would be considerate, fair, self-restrained, and altruistic or could be tutored to act responsibly, but this judgment is now being called into question for being the triumph of hope over experience.[73] On one hand, the supranational deck was stacked in favor of over-borrowing by the PIIGS and east Europeans. On the other hand, the PIIGS were misled into prematurely surrendering control over their monetary and foreign exchange rate policy without receiving fiscal *quid pro quos*. As a consequence, the EU finds itself in an

[73] Jakub Grygiel, "One Market, One Currency, one People" The Faulty Logic of Europe," Foreign Policy Research Institute, ENOTES, January 10, 2012. "Were the EU a term paper, a lenient professor would likely give it a D+… The project of a united Europe is based on the belief that economic unity (itself poorly defined) will lead to political unity. Such a line of causation demanded a technocratic approach. Missing the underlying national unity, the establishment of a common market and a common currency had to be pursued by a supra-national elite with a very tenuous electoral accountability.Absent a demos, the technocrats had to take over the decision-making process. The hope, based on the assumption that a common economy creates a unified people, was that at a certain point a European demos would arise allowing the functioning of a European democracy. But until then, technocracy would have to suffice, and indeed, it was the only way to manage European affairs. The "democratic deficit" of EU institutions is, therefore, a direct outcome of the faith in the transformative powers of economic structures."

idealistically incorrect position, where the gap between rich and poor members is widening, at a time when supranational institutional arrangements are forcing the PIIGS to extricate themselves from their predicament with painful and problematic deflationary tactics necessary to regain their competitive strength.

The contradictory social democratic mandate to bring ever more relatively poor countries into the fold, boosting their creditworthiness with implicit guarantees, pressuring them to adopt the euro, and straitjacketing their fiscal options, while undermining fiscal discipline with sympathetic approval of entitlements and leveling has solutions within a nation state framework (a true United States of Europe) that could be simulated by a supranational organization. However, this is extraordinarily difficult to accomplish because Schuman's communitarian optimism was misplaced. The EU has yet to find a supranational architecture that reconciles his idealism with a political will for optimal transnational macroeconomic regulation.[74] It is in this sense that the 2008 financial crisis's aftermath is more a culturally conditioned supranational systemic dilemma than a relatively simple matter of conventional international macroeconomic policy, and as such an overlooked element in the half century long debate on optimal economic

[74] The supranational entitlement and moral hazard problem mirrors domestic disorders often said to cause Eruosclerosis, but is potentially more pernicious because governments can borrow more than individuals.

unions and communities. If the EU does eventually go the way of the CMEA, it won't be because economists failed to grasp the theory of unions and communities, but because they didn't endogenize EU supranational theory in institutional and political practice.

Road to EU Monetary Union (EMU)

The road to the European monetary unification, the monetary centerpiece of a full European Economic Community and Union, went through the European Monetary System (EMS) 1979-1998, where eight member countries tried to dampen fluctuations in their foreign exchange rate parities.[75] They pegged their currencies to the Deutsche Mark in what turned out to be a futile effort to curb inflation and advance European Community integration. Nonetheless, eleven members of the European Union upped the ante by choosing a solution that required more, rather than less cooperation in forging the future eurozone. On

[75] Daniel Gros and Niels Thygesen, *European Monetary Integration*, London: Longman, 1999. After the demise of the Bretton Woods system in 1971, most EEC members agreed to maintain stable foreign exchange rate parities. Fluctuations were restricted to no more than 2.25 percent (the European "currency snake"). The system was replaced by the European Monetary System(EMS), and the European Currency Unit(ECU) was defined. It fixed parities, set an exchange rate mechanism(ERM), extended European credit facilities, and created a European Monetary Cooperation Fund that allocated ECU to member central banks in exchange for gold and US dollar deposits. The German Deutsche Mark was the defacto anchor because of its relative strength and the country's low-inflation policies. In the early 1990s the EMS was strained by conflicting macroeconomic policies in Germany and England. Britain and Italy withdrew in 1992. Speculative attacks on the French Franc led to widening the band to 15 percent August 1993.

January 1, 1999 they created a common currency area (European Monetary Union: EMU) that effectively imposed a fixed exchange rate on all member countries. Participants surrendered their authority over national monetary policy and vested it in the supranational hands of the European Central Bank (ECB), forcing members to rely exclusively on fiscal and regulatory policy to manage macroeconomic disequilibria. The decision was an act of blind faith because many members failed to honor their Maastricht pledges to contain inflation and deficit spending prior to monetary union. Aspirants seeking EU accession were supposed to hold inflation to no more than 1.5 percent per annum; to maintain a stable exchange rate with the ERM without devaluation, to run public sector deficits less than 3 percent of GDP, with a public debt under 60 percent of GDP. Many established members and aspirants alike flunked the tests after they joined the EMU, setting a pernicious precedent for future PIIGS, and providing an early warning that even if a eurozone satisfied the structural conditions for ideal customs union, moral hazard might be significant.

Eurozone Trilemma

Was the decision to persevere in forging an eurozone wise in the face of the EMU's failure? Few pondered the precedent, focusing instead on the first principles of customs and monetary union theory. Here too, however, they were grounds for concern. The theory of optimal currency areas clearly implied that monetary union wasn't a one-way-street. Its merit depended on various tradeoffs. Milton Friedman observed that nations can deal more deftly with disorders if they have their own currency, allowing them to vary prices and wages, but this requires them to accept high costs of doing business across national boundaries. Consequently, monetary unions are attractive where there is a high volume of intra-regional trade and labor mobility, and unattractive otherwise. The supranational fiscal regime likewise is a matter of concern. If it is strong, and tasked to assist members confronted with deficient aggregate effective demand, the risk members incur in surrendering the monetary option is partly compensated by pledges of supranational fiscal aid. If it is weak, nations place all their eggs in the supranational monetary basket, with no recourse other than accepting painful deflationary adjustments.

The United States provides a good example of an optimal currency area. It has a high volume of intra-national trade (Mckinnon). American labor is mobile

(Mundell), and Washington has the muscle to effectively use fiscal power in alleviating distress in vulnerable states (Kenen). Also, the Federal Reserve has the authority to act as a "lender of last resort" if Washington's fiscal policy is insufficient.[76]

The EU by contrast is a dubious candidate for an optimal currency area (eurozone) because although it too trades intensively within the region, national work restrictions greatly impair intra-European labor mobility, and supranational fiscal power is feeble because rich members don't want to assume heavy financing burdens during turbulent times. The obverse also is true. Countries like Sweden and Norway which shunned the euro are thriving and appear to have benefited by retaining their monetary option.[77]

Robert Mundell and Marcus Fleming have succinctly formulated the problem the theoretical problem facing the supranational eurozone (setting aside the further

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[76] See: Robert A. Mundell, "A theory of Optimum Currency Areas" *The American Economic Review*, September 1961, 51, 657,-64 ;Ronald I. McKinnon, "Optimum Currency Areas", *The American Economic Review*, Vol. 53, No. 4 (Sep., 1963), pp. 717-725; Kenen, Peter B. (1967), "Toward a Supranational Monetary System," in G. Pontecorvo, R.P. Shay, and A.G. Hart, eds., *Issues in Banking and Monetary Analysis,* New York: Holt, Reinhart, and Winston; and Paul De Grauwe, The Greek crisis and the future of the Eurozone.
The structural problem in the eurozone is created by the fact that the monetary union is not embedded in a political union. Eurointelligence 11.03.2010. See also Paul De Grauwe, *Economics of Monetary Union*, New York: Oxford University Press, 2000.

[77] The same argument holds for North America. Canada's economy has performed well without forging a monetary union with the United States.

issue of moral hazard),[78] in the form of a two-not-three trilemma.[79] Countries seeking to form a supranational monetary union can enjoy two, but only two desirable policy goals: 1) free international capital flows (connected with optimal fiscal policy), 2) potent monetary policy to stabilize output, employment, inflation and financial markets, and 3) exchange rate stability. The United States picked free capital mobility and monetary independence, letting their foreign exchange rate float. China decided to retain its monetary independence and control its exchange rate, abandoning free capital flows, while the European Union has selected a third way. It mimicked the United States at the supranational level, accepting floating exchange rates for the euro, but at the national level failed to complement the choice with a supportive fiscal regime for distressed economies and friction free labor mobility, leaving vulnerable nations like the PIIGS in a lurch. When times are bad, the euro appreciates as investors shift to what they perceive as a German safe haven reducing the PIIGS export competitiveness, while idle labor is prevented from migrating.

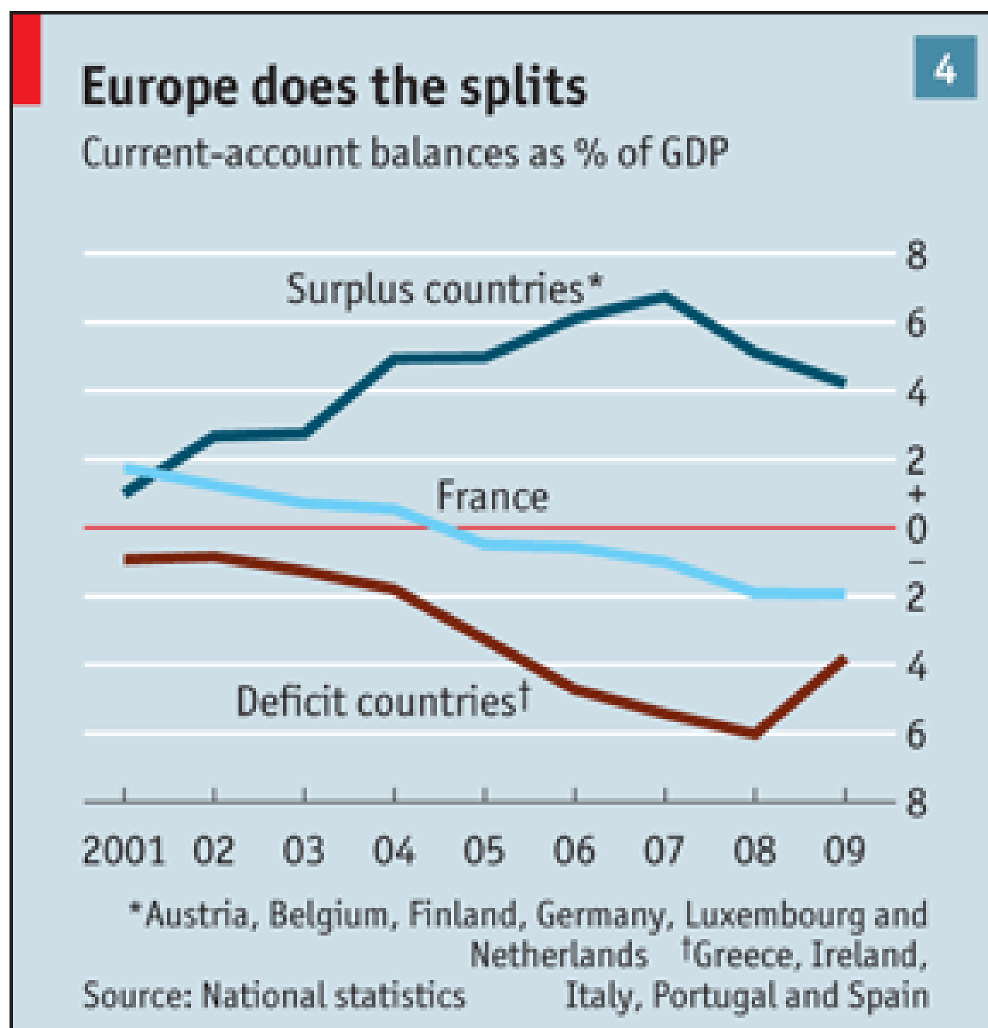
PIIGS Predicament

[78]. Robert Mundell, "Capital Mobility and Stabilization Policy Under Fixed and Flexible Exchange Rates" *Canadian Journal of Economic and Political Science*, Vol.29, No. 4, 1963, pp.475-85. Marcus Fleming, "Domestic Financial Policies Under Fixed and Flexible Exchange Rates," IMF Staff Papers 9, 1962, pp.369-79.

[79] There are two basic types of trilemma. The most common occurs where people are compelled to choose among three undesirable options. The economic usage is different. Trilemmas here all involve favorable options, but picking any two precludes acquiring the third.

What works for America, doesn't for Schuman's supranational EU because of the omitted variables in optimal monetary union discourse (labor immobility and fiscal rigidities).[80] The optimal trilemma solution for an ideal customs union is unattainable for the PIIGS, and fellow current account deficit eurozone members. Their option isn't choosing two out of three virtuous "lemmas." Each finds itself instead in a pickle having to rely on domestic wage and price adjustment because members unwittingly relinquished their independent monetary, exchange rate, and fiscal policy (due to excessive debt) in an immobile labor regime, while Germany and other current account surplus members retain free capital flows, a supranational monetary policy tailored to their needs, and the appreciating currency they desire. See Figure 4.1. (The Economist, 2010) for the consequent divergencies within the EMU.

[80] The ECB sets eurozone wide interest rates, but if these rates are inappropriate for distressed economies like Greece, Athens lacks an independent currency to remedy the problem. Likewise it has no national central bank to act as "lender of last resort." THE ECB cannot act as a "lender of last resort" for Greek banks because it does not get easy mandate from its Board to do so for political reasons, as well as the fact that regulation of banks and deposit insurance is mostly in the hands of national authorities.



The PIIGS aren't entirely straitjacketed. They can extricate themselves from depression and financial ruin with a "real depreciation" or "internal devaluation," but this is little consolation because it places an immense burden on prices, wages, and productivity growth in an adverse financial environment.[81]

[81] Not all "internal depreciations" are intolerable. The reunification of East and West Germany provides a relatively painless example. Germany held wages down and increased productivity to alleviate unemployment and cope with income transfers flowing to the former communist east.

Competitive Asymmetries

Superior German productivity growth, moreover, makes a bad situation for the PIIGS even worse.

Figure 4.2 (The Economist, 2011) reveals that PIIGS unit labor costs rose steadily 2001-2010, while German unit labor costs fell reciprocally. *Ceteris paribus*, the incentive for Germany to outsource and invest in PIIGS diminished at the same time foreigners were coaxed into diverting their purchases of EU exports from the PIIGS to Germany. Given the EU's supranational straitjacket, there

doesn't appear to any compelling reason to anticipate a swift reversal of the PIIGS's ill-fortune. A utopian welfare-state vision intended to ameliorate transnational income inequality, thus may perversely aggravate the problem.

Social Democratic Culture

Needless to say, this outcome was unintended, and indeed would not have occurred if PIIGS acted like virtuous Germans. They would not have assumed unmanageable debt obligations, and EU fiscal, monetary and foreign exchange rate policies would have been appropriate for them. These requirements however underscore two fundamental defects in the EMU (eurozone) supranationalism. First, the systems architecture is too rigid. A meritorious regime should provide good solutions across a wide spectrum of initial conditions. For the moment at least, the EU has not devised the supplementary internal mechanisms needed to achieve efficient outcomes for all its members. Second, EU social democratic culture fostered values which enticed PIIGS to overextend themselves. They may well have done so on their own volition, but this doesn't change the fact that the Schuman ethos abetted their delinquency by encouraging them to believe in miraculous free rides.

The weak link in EU social democratic utopianism is a predilection for egalitarian outcomes combined with an ambivalent attitude toward equal effort and value added (labor immobility and fiscal rigidities aside). EU leaders were pleased that the EMU enhanced the PIIGS's creditworthiness in private investors' eyes, and welcomed outsourcing from the wealthy core to the periphery. They were delighted that Germany, France, Britain and others shared in the windfall gains generated by these capital flows, and PIIGS's excess sovereign borrowing. This enthusiasm was tempered by the PIIGS's declining unit labor productivity and exorbitant social spending, but not enough to outweigh the satisfaction derived from narrowing the intra-union per capita income gap. Moreover by raising the prospect of "haircuts" (debt forgiveness), the European Council and parliament telegraphed the message that financial indiscipline and extravagant social programming ultimately may prove to be winning strategies. This double think, expecting responsible behavior, and doing little to encourage it makes it unlikely that European leaders can construct a well functioning eurozone anytime soon.

PIIGS in Crisis

Speculative bubbles like the one sparked by EU's contradictory welfare state political goals often end in crises. Investors panic when they discover that sand

castles are crumbling, and debts may never be fully repaid even if they are restructured. This is what has been transpiring in fits and starts after the Autumn of 2010. Ireland was the first victim. Its toxic debt had been accumulating for a decade fueled by Irish bank borrowing in the international wholesale market to finance a property development bubble. When real estate crashed, private bank balance sheets melted down panicking the government into plugging the hole with a 50 billion euro commitment, equivalent to a third of Ireland's GDP. This dubious pledge was swiftly followed in 2008 by an equally ill-advised 100 percent guarantee of all bank deposits and most debt. The ECB joined the party allocating a quarter of its eurozone lending to Irish banks by September-October 2010, all to no avail. Ireland ultimately managed to staunch runs on its private banks by borrowing approximately 145 billion dollars (70 percent of GDP), but this raised its debt-to-GDP ratio to stratospheric Greek levels, effectively bankrupting the nation. The Irish government saved its banks and their creditors by forcing the Irish people to shoulder an unbearable burden. A 10 percent drop in GDP slashed jobs, driving the unemployment rate to 14 percent.

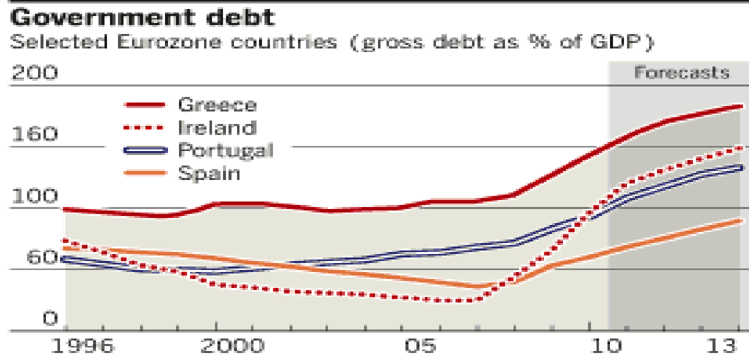
Spain's experience followed a similar script, but its real estate bubble which began in 1985 was home grown, with the government providing incentives for owning rather than renting, including 40 and even 50 year mortgages. Speculation

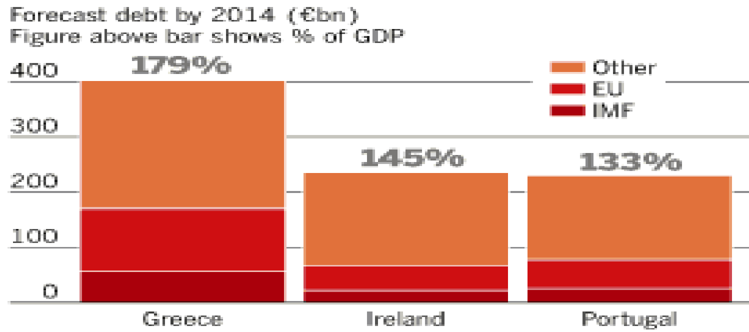
accelerated after Spain adopted the euro driven by huge capital inflows until 2008 when the global financial crisis took the wind out of the real estate market's sails, throwing the country into deep recession. The national budget plummeted into deficit. It was 9.2 percent in 2010, and even if pared the debt-to-GDP ratio is expected to rise to 90 percent. On balance, Spain appears stronger than other PIIGS because of its conservative banking philosophy. However, Madrid isn't out of the woods yet. Further deterioration in housing prices in adverse times could threaten mortgage dependent private bank solvency, and intensify the decline in housing demand because under Spanish law evicted owners remain liable for their mortgage debt.

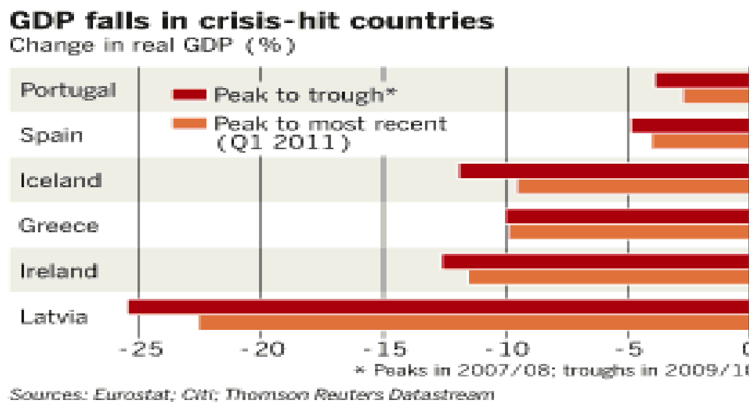
Greece's version of the supranational EU melodrama has a different plot. The principal culprit in Hellas was unrestrained government welfare expenditures financed with overseas borrowing. Greek governments customarily have run large public deficits to fund government sector jobs, pensions and other social benefits since democracy was restored in 1974. Its debt-to-GDP ratio has exceeded 100 percent since 1993. The burden was softened before 2001 by drachma devaluation, but this option was foreclosed in 2001 when Greece adopted the euro. At first this didn't seem to matter because euro accession allowed Athens to finance debt on favorable terms, an advantage leveraged by persistently falsifying official data on

the country's financial condition. The chickens however finally came home to roost. On April 27, 2010, the Greek debt rating was cut to "junk" status by Standard & Poors. The ECB has tried to help by suspending its prohibition on buying junk collateral, but the situation continues deteriorating despite new austerity measures approved by parliament July 2011 in part because the fear of default raises interest costs that cannot be paid.

The best current estimates of the PIIGS's budgetary deficits and cumulative debt forecast that Greece's debt-to-GDP ratio will reach 180 in 2014. Ireland's plight will be nearly as dire with a debt-to-GDP ratio of 145, followed by Portugal at 135 and Spain 90. See Figure 4.3. (Martin Wolf, Financial Times, June 2011).







Obviously, while Europe's sovereign debt crisis can go from bad to worse as Germany and France permit, the longer PIIGS delay getting their houses in order, the direr the consequences will be.

What Can Be Done?

Schuman would have known what to do. EU rich should pay. The people should be protected and EU bad boys should be admonished to grow up (to forswear levering and resist moral hazards). This is the social democratic way that inspired supranationalism, and is the formula that will be applied, rhetoric to the contrary notwithstanding. The exact prescription is up for continuous negotiation.

The maxim that the rich should pay at the supranational level means that the ECB, perhaps supplemented with new institutions will grudgingly provide loans to prevent PIIGS from defaulting on their sovereign debt. They also could provide "solidarity" grants by analogy with foreign catastrophe aid. If these tactics prove insufficient, wealthy EU members like Germany and France can consent to partial "haircuts." This could be done in diverse ways, but the details aren't matters of high principle. What matters is that creditors will be transformed into limited liability partners sharing the cost of past transgressions so that debtors can have a fresh start without being formally cast into permanent default.

Paul De Grauwe(Grauwe, 2011) recently called for the ECB to be even more ambitious, serving as lender of last resort both to eurozone member banks and

those facing sovereign debt crises, stressing how easily liquidity crises can degenerate into system-wide insolvency. His argument is that sovereign debt in a single currency area is denominated in "foreign" money (money that cannot be issued by the governor of the individual central bank), because the individual central bank cannot perform as “lender of last resort" by printing money. Only the ECB can do it and this requires complex coordination with other ECB governors. Therefore, De Grauwe argues that it is wrong to restrict ECB monetary policy to inflation fighting, ignoring contagion of sovereign debt crises from one country to another as financial perils develop. Inflation fighting he insists, contrary to Goodfriend's advice (Goodfriend, 2011), must be integrated with a war against insolvency because the catastrophic potential of insolvency dominates the moral hazard risk.

What Will Be Done?

De Grauwe doesn’t downplay the moral hazard problem, but claims reassuringly that it can be managed by imposing rules that constrain government debt issuance. He is right in principle, but glosses the problems of national entitlements and supranationality. The sovereign debt crisis besetting the EU today hasn't arisen

because European Council encouraged PIIGS to misbehave, or the German's are fixated on inflation fighting. It erupted because the PIIGS refuse to curb domestic entitlements, and the EU cannot compel them to desist regardless of whether the ECB adopts a conservative or liberal monetary regime.[82] The eurozone debt crisis thus isn't really about "optimal debt."[83] It is driven by the domestic and supranational politics of social entitlement that depend little on short term ECB monetary accommodation.

Being good little PIIGS means promising Brussels to try curbing entitlements, probing the envelope of toleration, and biding ones time for the right moment for another spending spree. There are limits, but they are soft because supranational social democracies usually acquiesce to recidivism.

It is highly unlikely therefore that the European Union will confront a moment of truth in the foreseeable future when members seriously contemplate secession, tough talk to the contrary notwithstanding.[84] Winners in the daily trench wars (as distinct from attaining the competitive ideal)

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[82] Paul De Grauwe, "The European Central Bank as a Lender of Last Resort,"August 19, 2011. Marvin Goodfriend, "Central Banking in the Credit Turmoil: An Assessment of Federal Reserve Practice," *Journal of Monetary Economics*, 2011.

[83] Greece Paid Goldman $300 Million to Help it Hide its Ballooning Debts, according to http: www.businessinsider.com/henry-blodget, 2010-2.

[84] Social democracy in Europe is not only good politics, it is good business for insiders. The commitment of EU leaders to supranationalism consequently runs deeper than idealism. See Steven Rosefielde and Quinn Mills, *Democracy and its Elected Enemies: The Root of the West's Paralysis, Crisis and Decline*, Cambridge: Cambridge University Press, 2012.

like Germany which enjoy current account surpluses, high national savings, rising productivity and moderate per capita GDP growth risk losing more than they gain from exiting the EU, even if they have to pay for partial haircuts. Germany still carries the baggage of distrust from the Nazi era, and is able to pursue its business and foreign policy agenda much more effectively under EU cover than if it tried to prize similar concessions by other means. The French value the EU relationship for other reasons, but like Germany are far from the threshold of secession.

The EU's bailout of Greece on July 21, 2011 confirms this surmise. The eurozone countries and the International Monetary Fund (IMF) will give Greece a second bailout worth euro 109 billion (155 billion dollars), on top of the euro 110 billion granted a year ago. Banks and other private investors will add euro 50 billion (71 billion dollars) more to the rescue package until 2014 by either rolling over Greek bonds that they hold, swapping them for new ones with lower interest rates or selling the bonds back to Greece cheaply. The deal involving private creditors may well be deemed a "selective default" by rating agencies, making Greece the first euro country to ever be in default, but this isn't expected to have drastic consequences given the other positive aspects of the rescue package. To dampen adverse effects, the eurozone will back new Greek bonds issued to banks with guarantees. This is essential because Greek banks use Greek government debt

as collateral for emergency support from the European Central Bank. Those bonds would no longer qualify as collateral if hit with a default rating, meaning Greek banks would lose ECB support and quickly collapse. Bond rollovers, or swaps will give Greece more time to recover and cut approximately 21 percent of its future debt burden.[85] Authorities agreed to provide the new eurozone rescue loans to Greece at a 3.5 percent interest rate, with maturities between 15 and 30 years, plus an additional 10 year grace period. Moreover, EU bailout overseers were given the power to intervene in countries before they are beset with full blown crises, an institutional reform opposed by Germany.[86]

Survival

PIIGS for their part regret having to pay the piper (creditors, reduced government spending, depression and mass unemployment), but the political and economic benefits of EU membership still lopsidedly exceed costs, even in a worst case scenario where defaults trigger a decade of suffering. They might contemplate exiting the EMU in order to increase the number of instruments for dealing with

[85] The new Greek bonds issued to the banks would have long maturities of up to 30 years and low interest rates according to the Institute of International Finance, the group representing private sector creditors. French President Nicolas Sarkozy estimated that the rates would average 4.5 percent.
[86] Economists often pretend that public programs Pareto efficiently maximize social welfare, but Kenneth Arrow long ago showed that the claim is misleading, due to information-based market failures in the context of medical care, finance, etc.

problems largely of their own making, but not the EU which provides valuable customs union benefits, enhanced creditworthiness and the possibility of compassionate transfers when the going gets tough. Moreover, rich members seeking to rid themselves of noisome PIIGS cannot compel them to exit the EMU by treaty, and practical difficulties will likely dissuade PIIGS from attempting to resurrect national currencies on their own.

The same principles apply for new entrants. Costs and benefits of EU and EMU accession will depend on each individual case more than generic economic considerations. It follows directly not only that talk of EMU, and or EU dissolution is premature, but EU enlargement considered the partnership's greatest foreign policy success, remains on track. Croatia is acceding, Montenegro and Macedonia are official candidates, and negotiations are in process for Turkey and Iceland. Preliminary discussions have been conducted with Russia.

The substantive issue moving forward therefore is whether members are sufficiently dissatisfied with muddling that they are willing to reform or ditch supranationality. Inertia favors doing nothing fundamental. Resistance to replacing member governance with unified federal rule is likely to be insurmountable now that the bloom is off the rose, while German and French authorities will be charier

than ever of ceding ultimate control over the purse to supranational bodies. The EU's inflexible supranational architecture is the patchwork result of contradictory social democratic goals, not a failure of intellect. Any changes made therefore only are apt to improve flexibility at the margin rather than functioning as a viable surrogate for a unified state. As such reform may deter or mitigate crises in some instances, but shouldn't prevent them. Politics has been in command from the beginning, and continue to take precedence over economic potential and performance.

Nonetheless, this judgment should not be construed to mean that a default, should it occur, would be innocuous. The inflexibility of the EU's supranational architecture raises the specter of hyper-deleveraging. For example, if the EU's latest rescue plan for Greece proves inadequate and its sovereign debt goes into full default despite eurozone guarantees, Greek bank lending capacity will plummet placing extraordinary downward pressure on wages, prices and aggregate effective demand because Athens doesn't control its interest rate (equivalently, its money supply) or foreign exchange rate. Argentina's experience in 2001 under less rigid conditions suggests that EU supranationality could make PIIGS pain and suffering a protracted ordeal.[87]

[87] Miguel Kiguel, "Argentina and Greece: More Similarities than Differences in the Initial Conditions," August 16,

EU Supranationality: Net Assessment

It therefore can be reasonably concluded that the political and economic benefits of EU supranationality as they are currently constituted are asymmetric. The EU has wrought substantial political benefits including the democratization of new members and intra-European major war avoidance, but eurozone architecture is economically inefficient, bubble prone and subject to serious systemic risk. This package may be good enough for supporters of the welfare state, but prospective Asian emulators should weigh the evidence more judiciously.

2011. Argentina, like Greece was confronted with a conundrum. It sought to restore access to the international capital market(sovereign debt problem) by raising taxes and cutting public expenditures to pay down its indebtedness. But, in doing so it risked making repayment more difficult by plunging the economy into deep depression. Kiguel argues that Argentina's budget cutting had precisely this adverse effect, and cautions the EU accordingly. His preferred solution is to hold the line on deficit spending insofar as possible, and promote productivity and competition with non-deflationary tactics. Another complementary approach that he fails to consider is steamrolling vested political interests, streamlining government services and earmarking savings for debt repayment. The structural similiarities between Argentina and Greece that guide Kiguel's recommendation are: 1) loss of devaluation option(currency board and dollarization in the Argentinian case; replacement of the drachma with the euro in the Greek case), 2) loss of access to the international capital market(excess sovereign debt), 3) and loss of monetary options due to dollar/euro-ization. On the policy front, both Argentina and Greece tried to acquire external assistance and ultimately failed to obtain enough. They also resorted to deflation to spur competitiveness, but here too were unsuccessful.

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