The Great Crash of 2008: Causes and Consequences

Deepak Lal

In the early 1980s, I was working as the research administrator at the World Bank, while the Third World was engulfed by a debt crisis. The current global financial crisis has eerie similarities, but different outcomes. Why?

First, both the crises arose because there was a surplus of savings in a number of countries—the oil producers in the 1970s, the Asian economies and commodity exporters today—which was recycled through the international banking system. Second, highly liquid banks imprudently funneled cheap credit to uncreditworthy borrowers: the fiscally challenged and inflation-prone countries of Latin America and Africa in the 1970s, the *ninja* (those with no income, no jobs, no assets) subprime mortgagees of the current crisis. Third, there was a rise in commodity prices and a worsening of the terms of trade of the OECD, posing the stagflation dilemma for their central banks, having aided and abetted the earlier asset boom. Fourth, the imprudent banks sought bailouts from taxpayers, claiming their demise would fatally damage the world's financial system.

But, the outcomes have been different. The 1980s crisis was finally solved after a prolonged cat-and-mouse game when the banks

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Deepak Lal is James S. Coleman Professor Emeritus of International Development Studies at UCLA. This article is a revised version of his Adam Smith Institute Lecture given in London in June 2009. The lecture was based, in part, on the author's monthly columns in the Indian *Business Standard* and on papers presented at a special meeting of the Mont Pelerin Society on "The End of Globalizing Capitalism? Classical Liberal Responses to the Global Financial Crisis," held in New York in March 2009. These papers are available at www.montpelerin.org.

accepted substantial write-downs of their Third World debt, sacked their imprudent mangers, and shareholders suffered large losses. But no systemic threat to the world's financial system (or the global economy) emerged. By contrast, today the Western financial system seems to be dissolving before our eyes, and with the U.S. Federal Reserve's ever expanding balance sheet, bailouts are no longer the exception but the norm. Many now foretell a deep and perhaps prolonged recession, with deflation, rising unemployment, and Keynes' famed liquidity trap about to engulf the world's major economies.

Changing Financial Structures

What explains this difference in outcomes? It cannot be purported "global imbalances," which were the origins of both crises. It is the differences in financial structures within which these temporally separated but largely similar crises occurred. In the 1970s the recycling of the global surpluses was undertaken by the offshore branches of Western money center banks, which were neither supervised nor had access to the lender of last resort facilities of their parent country's central bank. Hence, when their Third World Euro dollar loans went into "default," there was no direct threat to the Western banking system.

The present crisis emerged in a radically different financial structure: the rise of universal banks from the United Kingdom's "Big Bang" financial liberalization in the 1980s, and the Clinton era abolition of the Glass-Steagall Act, which had kept a firewall between the commercial and investment banking parts of the financial system since the 1930s. The former had implicit deposit insurance and access to the central banks' lender of last resort facilities. The latter did not. It is worth explaining why this matters.

This distinction between what were previously nonbank financial intermediaries and banks is important because it is only clearing banks that can add to (or reduce) the stock of money. A clearing bank holds deposits in cash (legal tender base money) from nonbanks, repaying deposits in notes and making payments for depositors by settlements in cash through an account in the central bank. When a clearing bank extends a loan it adds to its assets and simultaneously creates deposit liabilities against itself, increasing the broad money supply at "the stroke of a pen." This ability to create money out of thin air is limited by the bank's capital and cash. As cash can be borrowed from the central bank, the ultimate constraint on its ability to create money is its capital. But it is only because banks take in cash deposits—Keynes's "widow's cruse"—that they can create money.

By contrast, a nonbank financial intermediary, say a mortgage lender, when it takes deposits or makes a mortgage loan has to "clear" these through deposits held at the clearing banks. Thus, when someone deposits "cash" at an S&L, this comes out of the depositor's bank account with a clearing bank. Similarly, when the S&L makes a loan to a mortgagee, this comes from the S&L's bank account with a clearing bank. Thus, the essential difference between nonbank financial institutions and clearing banks is that they cannot create the bank deposit component of broad money (M2 or M4).

When the FDIC was created as part of Roosevelt's New Deal to prevent the bank runs that the earlier universal banks' gambling had engendered, Marriner Eccles, who redesigned the Federal Reserve system for FDR in the Great Depression, insisted that with deposit insurance the banking industry must be split in half: the public utility part of the financial system, which constitutes the payments system, must be kept separate from the gambling investment banking part, which is an essential part of a dynamic economy. For these gambles impart the dynamic efficiency through the cleansing processes of creative destruction. But if these gambles are protected against losses by taxpayers, as the payment system activities have to be because of deposit insurance, the gamblers will always win: keeping their gains when their gambles are correct and passing their losses onto taxpayers when their gambles turn sour. Hence, the Glass-Steagall Act.

Given this "moral hazard," many classical liberals have favored free banking. Banks combining the payment and investment functions and issuing their own notes should be *monitored by their depositors,* who would stand to lose if their banks undertook imprudent lending. But with the near universality of deposits as a means of payment, there is little likelihood of this monitoring function being effectively exercised. While the rise of Demos precludes any government being able to resist pressures to bail out imprudent banks to protect their depositors. This makes deposit insurance inevitable, and to prevent investment banks from gambling with the taxpayer insured deposit base, something akin to Glass-Steagall remains essential.

Policy Errors

The recent emergence of universal banking was followed by a number of public policy mistakes on the path to the current crisis. The *first* was the bailout of LTCM in 1998. Its failure posed no obvious systemic threat. Its public salvation changed expectations of market participants that nonbank financial institutions could also hope for bailouts. Next, the infamous Greenspan "put," which put a floor to the unwinding of the dotcom stock market bubble, promoted excessive risk taking. Third, the promotion of "affordable" housing for the poor by the Clinton administration, through the unreformed and failed Freddie mortgage twins, led to the development of subprime mortgages. Fourth, the Basle II capital adequacy requirements led banks to put their risky assets into off-balance sheet vehicles—the structured investment vehicles or SIVs—leading to the opacity currently being bemoaned. Fifth, when the housing bubble burst, and the credit crunch began with the gambles taken during it turning sour, the Fed chose to bail out Bear Sterns, sending the signal that the Fed's balance sheet was open to nondeposit taking "banks" as signaled by the earlier LTCM bailout. Sixth, and most heinously given all that had gone before, the U.S. authorities then chose *not* to bail out Lehman's—like a fallen woman suddenly finding virtue. This dashing of the bailout expectations that the authorities had endorsed only in the spring, led to the intensification of the credit crunch. Seventh, as the authorities finally seemed to tackle the toxic subprime infected financial assets that caused the crisis through TARP, it calmed the markets. When TARP was changed to be used only to recapitalize banks, markets went into free fall. The essential step, of forcing banks to come clean on their balance sheets, and then removing the toxic assets they reveal into a newly created institutional *cordon sanitaire,* has still not been taken. Worse, instead of recreating a firewall between the payment part and the gambling part of the banking system, even the pure investment banks, like Goldman Sachs, were pushed into becoming universal banks with access to the Fed's balance sheet and thence taxpayer's money.[1]

[1]The recent embrace by President Obama of the Volcker Rule, which seeks to create a new Glass-Steagall type firewall between investment and commercial banks, is a step in the right direction in my view. But it remains to be seen whether it will be passed by a Congress facing intensive lobbying against it by Wall Street.

Given these public shortcomings, the near universal calls for greater regulation and state intervention is astounding. Public agents, not private ones—who reacted rationally to the implicit or explicit "rules of the game" promoted—are to blame for the crisis. It would be foolish to blame the puppets for the failings of the puppeteer.

Remedies

What of the remedies? In answering this question, it is essential to be clear about the nature of the crisis, and to view it from the correct theoretical perspective. Because of the association of Keynes's name with the Great Depression, the crisis and its cures are being seen through "crass Keynesian" lenses. Is this appropriate? To answer this question, I briefly outline the alternative theoretical perspectives, which seek to explain the current crisis as well as the remedies.

Here a personal note is in order. When I got my first academic job as a lecturer at Christ Church, Oxford, my senior colleague was Sir Roy Harrod—Keynes's first biographer and keeper of his flame. On having to provide a reading list for my tutorials on "economic fluctuations and growth," I asked him what I should ask my pupils to read. I expected him to say Keynes, and his own work on trade cycles and growth. But after some reflection he said: Wicksell. So before I prescribed this to my pupils, I immersed myself in *Interest and Prices* and *Lectures on Political Economy.* Since then I have been pleasantly surprised that most of the macro economic perspectives on offer really hark back to Wicksell.[2]

Wicksell asked: How could the price level be anchored in a pure credit economy? Bagehot had observed in *Lombard Street* that the whole of the Bank of England's note issue depended on a slender and declining gold ratio. What if this ratio went to zero? asked Wicksell. His answer was that, if the Bank rate were set at the *natural* rate of interest, which balances productivity with thrift, the price level could be kept constant. This is, of course, the theory underlying inflation targeting, as embodied in the Taylor Rule. As John Taylor (2009) has noted, it was the failure of the

[2]The following section has benefited from a paper by my UCLA colleague Axel Leijonhufvud (2009). I had in Lal (1995) applied the Wicksellian theory to examine alternative monetary regimes for Brazil.

Greenspan Fed to follow this rule that led to the credit bubble after the dotcom bust.

The reasons for this failure are provided by Hayek's refurbished Austrian theory of the trade cycle. Hayek saw divergences between the Wicksellian natural and market rates of interest as causing booms and slumps. If increased bank credit led to market interest rates below the natural rate, businesses will undertake relatively more capital-intensive projects with relatively low rates of return. There will also be an unsustainable boom, with more projects undertaken than can be completed, leading to resource scarcities that end the boom. The financial crash which follows will lead to the liquidation of these "maladjustments," followed by an economic recovery with resources being reallocated in line with intertemporal consumer preferences and resource availabilities. While broadly accepting the quantity theory of money, Hayek argues that it assumed the absence of "injection" effects, which even with prices stable could lead to false signals in the pattern of intertemporal prices, and thence to maladjusted investments. The recent U.S. housing boom, with a stable general price level, provides an example of these maladjustments.

But Hayek's prescription that the slump should be allowed to run its course came to be disowned even by his LSE circle led by Robbins in the 1930s. As Gottfried Haberler (1986: 422), a close friend and member of Hayek's Austrian circle, noted in his astute appraisal of Hayek's business cycle theory: "Keynes, Robbins, and many others were correct: if a cyclical decline has been allowed to degenerate into a severe slump with mass unemployment, falling prices, and deflationary expectations, government deficit spending to inject money directly into the income stream is necessary. Moreover, Hayek himself has changed his mind on this point."

Though Keynes, unlike Hayek, provides no explanation for the boom preceding the slump, he was right in emphasizing "effective demand" failures in the face of a financial crash, and the need for deficit spending. Though not, as advocated by many current Keynesians, through counter cyclical public works. Thus, Keynes (1942: 122) wrote: "Organized public works at home and abroad, maybe the right cure for a chronic tendency to a deficiency of effective demand. But they are not capable of sufficiently rapid organization (and above all cannot be reversed or undone at a later date), to be the most serviceable instrument for the prevention of the trade cycle." A point reinforced by the Congressional Budget Office's assessment of the planned Obama infrastructure spending.

Friedman, unlike Hayek, was closer to Wicksell in concentrating on the effects of divergences between the natural and market rate of interest on the *general* price level and not as Hayek's theory presupposes on *relative* prices. With the *real* (natural) rate being determined by productivity and thrift, monetary expansion will only raise nominal interest rates through inflationary expectations. Given the natural rate of interest, there will also be a corresponding *natural rate of unemployment.* Monetary policy can only lead to transitory deviations from these natural rates, if capital and labor markets are efficient. There is little about credit markets in Friedman, or in his successors of the New Classical and Real Business cycle schools. As the current New Neoclassical synthesis is based on these models (with some twists of Keynesian "imperfections"), but contains neither money nor finance, it is useless in explaining or providing cures for the current crisis.

Thus, though Hayek provides the best diagnosis of the cause of the current crisis, neither he nor Keynes provides an adequate explanation of the financial aspects of business cycles, assuming these are endogenous to the fluctuations in the real economy. It is Irving Fisher who provides the correct diagnosis of the nature and cures for the current crisis. Fisher saw a "balance sheet recession" as an essential element in the Great Depression. He argued that, while there were many cyclical factors behind trade cycles, for Great Depressions the two dominant factors are "*over-indebtedness* to start with and *deflation* following soon after" (Fisher 1933: 341). Like the Austrians, he saw over-indebtedness as caused by "easy money" (p. 348). This provides a succinct explanation of the current crisis and pointers to its cure. We have a Hayekian recession with Fisherian consequences.[3]

Having learned the lessons of Friedman and Schwartz's work on the Great Depression, Ben Bernanke has made sure that the second leg of a Fisherian debt deflation will not occur. But, past and present U.S. authorities have failed to adequately restore the

[3]This was also my diagnosis of the Japanese slump in Lal (2003).

balance sheets of over-leveraged banks, firms, and households. U.S. banks urgently need to be restored to health, perhaps through temporary nationalization as in Sweden in 1992.[4] Meanwhile, stimulus packages have failed to adopt the obvious means to restore household and firm balance sheets—namely, by a massive across-the-board tax cut accompanied by an equivalent fiscal deficit. It is argued that most of this extra income will be saved not spent. But this is to be bewitched by the wholly inappropriate Keynesian income-expenditure analysis, which fails to deal with balance sheets. If this Fisherian aftermath of a Hayekian recession is caused by attempts to reduce unsustainable debt, the "savings" generated by the tax cut (i.e., reducing liabilities to the government)[5] will allow the necessary deleveraging, without a downward spiral in income and increased bankruptcies. By facilitating households to pay off their mortgage and credit card debts, it will prevent further impairment of bank assets.[6] Instead, we have the dog's breakfast of the Obama stimulus package and a dubious Geithner "plan" to clean up the banking sector. This, like Nero, is to fiddle while Rome burns.

[4]Though there is considerable doubt that it would work in the much larger and more diverse U.S. market. Also public choice rightly warns us not to rely on nationalization: witness the continuing travails of AIG and Freddie Mac and Fannie Mae.

[5]Unlike the 1930s, governments in developed countries have much more leeway to do this as the share of general government revenue (their tax cut) as a share of GDP had increased from about 20 percent in the United States and Great Britain to about 32 percent in the United States and 38 percent in Britain in 1997 (Tanzi and Schuknecht 2000: 52).

[6]As Guha (2009: 9) reported, the parts of the Obama stimulus package that have worked were the "fast acting tax breaks and transfer payments [that] largely explain why disposable income rose 2.9 percent from January to May, even as earned income fell 0.7 percent, allowing the savings rate to rise without a collapse in spending." If the whole of the $787 billion stimulus package had consisted of an across-the-board tax cut, there would have been a large deleveraging of the economy with an increase in private savings without an equivalent cut in private spending—the increased private savings being matched by public dissavings reflected in the increased budget deficit. Also the tax cut could be reversed once the economy recovered, providing an easy "exit strategy" from the fiscal stimulus.

A New Financial Oligarchy?

Finally, I want to consider who are the winners from this ongoing global financial crisis. The answer is: China, India, and Goldman Sachs!

Let us consider the latter. This also provides a clue to the political economy behind the current crisis in its epicenter—the United States. As in the numerous Third World financial crises, the question to be asked is: Who are the "rent-seekers" who created the crisis, and whose reluctance to take a "haircut" prevents the domestic polity from accepting the obvious cures? So that, ultimately, the intervention of an external agency like the IMF is needed to administer the necessary cures.

The current crisis was caused by financiers taking ever more risky gambles with the complicity of the government. This is reflected in the changing share of U.S. domestic corporate profits that have gone to the financial sector. From 1973 to 1985, it was 16 percent. In the 1990s, it oscillated between 21 and 30 percent. In the last decade it reached 41 percent. This was accompanied by a dramatic increase in pay, which rose from 108 percent of the average for all domestic private industries in 1999 to 181 percent in 2007. This great increase and concentration of wealth has created a new financial oligarchy similar to the one in the early years of the last century, which has great political weight in the United States. At its head is Goldman Sachs. It has provided the Treasury secretaries under the last two U.S. presidents and numerous alumni have held and continue to hold influential posts in devising and implementing U.S. economic policy (see Johnson 2009).

This explains some of the bailouts. Why for instance was Lehman allowed to go the wall but AIG was "saved"? Lehman had the misfortune of both being a major competitor to Goldman's and being run and staffed by the "barrow boys" from the Bronx rather than the Ivy League gentlemen manning its rival. AIG was saved, I suspect because, as appeared when Congress forced AIG to disclose what it had done with its bailout money, it had to disclose that most if it was to pay off its counterparties, the major one being Goldman! It is ironic that just as the century-old rise, decline, and now fall of GM, which marked the era of American industrial ascendancy, with one of its chairman claiming that "what was good for GM was good for America," should now be followed by an era in which seemingly "what is good for Goldman is good for America," or more generally Wall Street.

Geopolitical Consequences

What of China and India? Though their growth rates have fallen with the backwash from the U.S. crisis on global trade, they are still likely to grow robustly. This suggests some important geopolitical consequences of the current crisis.

The last two centuries have been dominated by two Anglo-Saxon empires—the British and the United States—whose liberal international economic orders have allowed the wholly benign processes of globalization to bring untold global prosperity (Lal 2004, 2006). The interwar imperial interregnum saw a period of grave disorder and the emergence of fascism and communism. Today, will the United States be able and willing to maintain its hegemony, allowing globalization to continue?

On October 10, 1916, in the middle of a British financial crisis, Keynes wrote a memorandum to the Treasury, noting that financial hegemony had passed across the Atlantic (Skidelsky 1983: 335).[7] Is the collapse of Lehman Brothers on September 15, 2008, a similar turning point? For with the three high-savings countries—China, Japan, and India—as the major source of funding for the exploding U.S. public debt, will the United States have to adopt the policy Keynes recommended for Britain: "not only to avoid any form of reprisal or even active irritation but also to conciliate and please?" And which of these countries is likely to replace or help U.S. hegemony?

Japan because of its continuing reluctance to match its economic with military power and with its stagnant economy and demographics is an unlikely candidate. This leaves the two emerging Asian giants.

China, which has signaled that it is not planning to sell its holdings of U.S. debt, along with the Gulf State sovereign funds, is the most likely source of finance for the exploding U.S. budget deficit. So

[7]It however took another 40 years and another World War for the United States to replace Britain as the world's financial hegemon.

expect talk of Chinese "currency manipulation" and lectures on human rights to diminish as the U.S. *faut mieux* has to follow Keynes' advice. Though, at present, it is impossible for China to take over America's hegemonic role, it will undoubtedly have increasing leverage over U.S. foreign and domestic policy as the financier of the United States.

This is likely to make the U.S. war against the current totalitarian threat from militant Islam more difficult. For given China's desire to assure supplies of primary products—particularly oil—for its rapid industrialization, China's foreign policy is unlikely to antagonize many natural resource producing countries, like Iran and Sudan, which continue to aid and abet international terrorism. Nor, given China's historical support of the current crucible of jihadists, Pakistan, as a counterweight to its emerging Asian rival, India, can much help be expected in this quarter.

This leaves India, which even more than the United States (as the Mumbai attacks demonstrated), has to fear the rise of militant Islam and the impending implosion of the Pakistani state. George W. Bush's most notable achievement was the strategic partnership he established with India, cemented by the Indo-U.S. nuclear deal. But India's economic and military power is at present dwarfed by China's. It is unlikely to be able to take over the U.S. burden.

In many ways it would be the natural partner of the United States with its large army to accompany the technological wizardry of the U.S. military. But is it able or willing to take on the role of a partner in the U.S. Imperium? This is unlikely. For though it also faces the threat from militant Islam, the fear that its large indigenous minority Muslim population, which hitherto has been largely uninfected by jihadism, could be radicalized if Indian troops were actively participating in the "war on terror," would lead it to forbear.

Meanwhile, as the other potential partners of the United States in sharing its imperial burden—the Europeans—have (apart form the British) clearly signaled, with their refusal to send more troops to Afghanistan, that they are going to continue to be free riders, the United States stands alone in maintaining global order. Will the aftermath of the current crisis leave it with the means and will to do so?

The parallel with Rome is instructive. The causes of Rome's decline were ultimately economic. As the past rents acquired during the empire's growth had been in part committed to a vast expansion of a welfare state without extending the domestic tax base, the empire faced an endemic fiscal crisis. It tried to close the deficit by levying the inflation tax by debasing the currency. Not being enough, taxes had to be raised, leading by the middle of the fourth century to tax evasion and avoidance by high officials and large landowners. The fiscal crisis also led to problems in maintaining the old military organization. Without the means to provide the *Italici* satisfactory treatment, recruitment was expanded to the provincials and in the late Empire to the barbarians. Having let them inside the gates the empire sealed its doom.

That the U.S. Imperium is on a similar primrose path was pointed out in a dire warning by the former U.S. comptroller general David Walker in August 2007, when the U.S. budget deficit was only projected to be under $500 billion. He explicitly drew parallels with Rome, including "declining moral values and political civility at home, an over confident and over extended military in foreign lands and fiscal irresponsibility by the central government" (Grant, 2007).

This irresponsibility has increased manifold with the current crisis. The 2007 GAO budget report (Walker 2007: 6) noted that it was primarily the health entitlements that made the U.S. budget unsustainable. This is the entitlement Obama is planning to enlarge. Walker also warned that the crisis could not be solved by growing out of the problem, eliminating earmarks, wiping out fraud, ending the Iraq war or cutting defense expenditures, restraining discretionary spending or letting the Bush tax cuts expire (Walker 2007: 18). These are the very policies that Obama is hoping will reverse exploding future deficits. With projected reductions in military spending, it seems likely that the United States like its Roman predecessor will find it difficult to maintain the sinews of the forces that have maintained global order. With no obvious alternative to provide this global public good, I fear the ensuing erosion of global order, so essential for the processes of globalization to work, is likely to be the most serious long-term consequence of the global financial crisis.

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