

ON THE HETERODOX VIEW OF THE CRISIS

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I. INTRODUCTION

The crisis had at least one important silver lining. It showed the sheer irrelevance of mainstream macroeconomic theory for understanding what caused the crisis and for policy guidance in its aftermath. For a theory based on the very premise that markets work efficiently at all times the crisis simply could not have happened, and the fact that it did was an anomaly too big to ignore. The few – most notably Paul Krugman among them – who have been trying to take stock seem to have provoked a defense of the beleaguered theory by some of its true believers. Yet, no real mainstream explanation of what has gone wrong has emerged and a few arguments that blame the government or the Fed for the crisis lack conviction. In this lacuna, there has been a hasty retreat to “crude” Keynesianism, yet it is too early to tell how much of a lasting influence that will have either.

The situation is arguably different with heterodox macroeconomists. Not only many among them predicted the crisis, but more importantly their reasons why rested on a coherent theoretical view. So, it is no exaggeration to say the crisis was an intellectual vindication of sorts. But, having said that, it is also true that heterodox theorizing needs to take stock and draw its own lessons from the crisis as well. If the recent discordant slew of articles on whether the crisis was indeed a “Minsky moment” is any indication heterodox economists do not all seem on the same page on the nature of the crisis and what to do about it – that is, beyond platitudes.

It is in this context that the opportunities for discussion and interaction afforded by conferences such as the one organized by New School students on March 5 of this year is to be especially welcomed. This paper, drawing from a presentation made at this conference, is an attempt to contribute to the heterodox discussion on the crisis, focusing on some of its lessons. Two among these top my list: the crucial role asset price bubbles play in a profit-led macroeconomic system and the importance of reading global imbalances from the capital account side. At the end of the paper it will hopefully be clear how insights from these can enhance our understanding of the predicament the world economy is in today.

II. ASSET PRICE INFLATION

The conceptual distinction between ‘demand-led’ growth and ‘profit-led’ growth goes way back among heterodox economists and thus can be a helpful point of reference for the foregoing discussion. The main point I want to emphasize here is the crucial role asset price bubbles seem to play in how a profit-led regime actually works. Consider the monetary/financial institutional dimension, especially how maturity and liquidity risks are kept under wraps, respectively, in the two *regimes*. The power central banks have had over commercial banks to rein in or stimulate credit growth, as well as their lender of last resort function, was a defining characteristic of the older ‘demand-led growth’ era. By contrast, in the era of financial liberalization and deregulation that followed, both the overall credit supply and provision of liquidity became market driven and closely tied to changes in asset prices which in turn became especially sensitive to international capital movements.

True, in the earlier era mainstream economists exaggerated the power the monetary authorities had over commercial banks, going to the extreme of assuming that it was in the central bank’s discretion to control the money supply exactly as it desired. This had made it possible for monetarist economists in the 1970’s to argue that inflation was solely a monetary phenomenon, caused by too rapid a growth of the money supply. That also meant that it could simply be contained if the central bank curtailed the money supply. Ever since, Post Keynesian economists challenged this monetarist view by correctly arguing that the central bank could not possibly control the money supply the way monetarist economists alleged. While the central bank had considerable discretion in setting the policy interest rate it had next to none over the money supply, which it was argued simply lagged overall bank credit. For the loans commercial banks issued to meet the credit demand from businesses simply returned to the banking system in the form new deposits, a process which the central bank was powerless to check unless it put at risk the very integrity of the payments system. Thus, Post Keynesians argued, the influence of the central bank over the economy rested not on its ability to control banks and the money supply as such but instead in its ability to lower or raise the interest rates that impacted businesses’ willingness to borrow. Others thought that the point was overdone, for they recognized that the central bank policy influenced banks’ ability and willingness to make loans as well and emphasized the role of financial innovations. However, as heterodox economists we have long failed to resolve these issues and instead found ourselves mired in a long running debate between, so-called “structuralists” and “accommodationists.”

While we argued, the real world moved on. Financial liberalization and deregulation - the monetary/financial dimension of the broader set of institutional transformations that brought about a new macroeconomic configuration that we term ‘profit-led growth’ for short - has changed the very landscape of financial intermediation. Most notably, the overall mechanism

A Heterodox View of the Crisis

of credit creation became increasingly market driven as the relative importance of traditional banking decreased in both credit creation and the money supply process. This also meant that the central bank's traditional instruments of control over commercial banks became less and less important in controlling the overall supply of credit in the economy. But, ironically, this was also the time when central banks took credit for "Big Moderation," the lower price inflation, which enhanced their ability to *talk* financial markets and shape expectations. Though a 'red herring' as it later proved to be, inflation targeting became the official doctrine of central banking and was widely believed effective in controlling price inflation. At the same time, the very perception that central banks conquered price inflation itself contributed to the official complacency about asset price bubbles. In the earlier era, wage pressures almost invariably increased during business cycle expansions causing increased expectations of price inflation, and that impelled the central bank to take measures (or raised expectations that it would) to dampen the growth of bank credit. In the new era, however, globalization severed the connection between output expansion and price inflation as cheap manufactured imports from emerging economies and the threat of capital flight in the core countries kept both price and wage pressures in check. Thus, given the absence of any sign of an uptick in price inflation, central banks remained complacent in the face of asset price inflation and the credit expansion it fueled. Little else it appears could have prevented asset prices from becoming the engine of credit growth and source of market liquidity in the new institutional structure that emerged.

In this new era, banks became dependent on financial markets just as much as their own customers. Higher asset prices not only increased the borrowers' collateral and willingness to borrow but also raised that of banks' own, increasing their ability and willingness to underwrite more lending in one shape or another, on or off their balance sheet. Also, just as higher asset prices stimulated credit, the increase in credit in turn stimulated spending as well as speculation, pushing up asset prices further. As traditional banking decreased in importance in the credit creation process, so did the ability of the central bank to directly intervene.

Considering that the crisis first broke out as a liquidity problem, perhaps more important was the fact that rising asset prices also came to play a crucial part in how the system dealt with liquidity risk. The financial innovations that were made possible by deregulation meant that progressively an ever smaller base of short term liabilities supported an ever larger volume of long term debt in the financial system as a whole. Of course, the big neoliberal assertion was that this did not involve an increase in the maturity risk and thus not a cause for concern. It was argued that risk was much more efficiently distributed in the system since deregulation enabled the market to be the arbiter of who bore it. This also meant that the "unregulated" shadow banks – and proxy institutions set up by "commercial" banks – became the fulcrum of the financial system. That these institutions did not enjoy the lender of last resort

protection from the central bank was not a cause of concern for it was believed the market would provide whatever liquidity was needed as long as risk was priced right, which in turn was axiomatically held to be true. Indeed markets were flush with liquidity and it was easy to borrow short term under favorable terms as long as asset prices kept rising. Relying on the ‘lender of last resort’ protection of an overbearing central bank seemed an archaic way to deal with liquidity risk. Now, of course, we know only too well how market liquidity disappeared once the rise in asset prices came to an end and need no further elaboration. But, the question is what does this all mean in terms of how the macroeconomic system worked?

Conceptually, the central role asset prices have come to play in unregulated financial markets since the 1990’s is reminiscent of Keynes’ discussion in his *Treatise on Money*, where not only a sharp distinction is made in terms of how asset and goods prices are determined but also asset mispricing is an important part of the business cycle dynamics. Consider the distinction Keynes makes between a *bull market with a consensus of opinion* and a *bull market with a division of opinion* in his discussion of how sentiment in financial market evolves over a business cycle expansion. In the latter phase, characterized by asset price mispricing, a growing number of agents choose to remain liquid because they think that asset prices are excessive. That is what Keynes calls the *bear position* (and, *alternative opinion* in 1937). What happens next to the asset price bubble depends very much on the role the banking system plays, whether – and, the extent to which - it recycles bear funds to the bulls. When it does a potentially destabilizing dynamic emerges: the expanding bear position transferred to the bulls turns into increased asset demand, making the bubble expand further, which in turn makes the bear position even bigger and the funds recycled to bulls even larger, causing the cycle to repeat itself on a larger scale. Keynes argued that during these periods of runaway speculation ‘financial circulation’ rose disproportionately to ‘industrial circulation.’ Keynes’ conceptual framework in the *Treatise* can be helpful in on how we understand global imbalances and their impact on speculative credit booms in the U.S. and around the world.

III. LOOKING AT GLOBAL IMBALANCES FROM THE CAPITAL ACCOUNT SIDE

The U.S. trade deficit has been rising ever since the early 1990’s, and rising especially faster since the late 1990’s almost continuously until the outbreak of the crisis. Overall, this was also a period of rapid economic growth in much of the world economy when asset prices and debt rose rapidly. There was a relatively brief interlude after the U.S. dot-com stock market bust and the recession that followed in 2001, but the resumption of expansion in 2003 caused trade imbalances to increase at even a faster clip than in the late 1990’s. As U.S. house prices and household debt rose to unprecedented levels personal savings plummeted and imports exploded, culminating in the financial crisis that began in 2007. The descriptive story is well

known of which global imbalances are assumed an essential part, though little clarity exists on what exactly was its driving force.

There are basically two different ways of understanding the causal mechanism behind the global trade imbalances as to whether we read them from the ‘current account’ side or the ‘capital account’ side. For instance, from the current account side, overspending in the U.S. is the ultimate cause of the global imbalances, while ‘policy exchange rates’ allegedly pursued by countries running trade surpluses get the other part of the blame. While trade imbalances emerge because of overspending in the U.S. they persist due to the surplus countries’ practice of keeping their currencies from appreciating. If only exchange rates were flexible the argument goes surplus countries’ currencies would continue to appreciate against the dollar until the imbalances disappeared. Unsurprisingly, surplus countries like to blame the profligacy of the deficit countries, while the latter blame the former of circumventing market forces. But, everyone agrees that the ultimate solution calls for measures that enhance higher savings in the U.S. and flexible exchange rates overseas.

The alternative is to look at global imbalances from the capital account side, which gives a very different understanding of the problem. A well known example is Bernanke’s ‘savings-glut’ thesis. It basically says that the U.S. overspending that caused the trade deficit was in turn caused by the money flowing into the U.S. from the rest of the world through its capital account. The resulting credit expansion and lower long term interest rates were what made U.S. households to overspend, making U.S. household consumption the engine of world growth. Note that in this capital account view what needs to be done is not as obvious as in the previous case. Here, the overspending in the U.S., along with the trade deficit it gave rise to, appear as a “solution” to a deeper problem involving excessive savings in the global economy. Unless this deeper problem is addressed simply reducing global imbalances by having the U.S. raise its savings or having the Chinese appreciate their currency would end up pushing us into a worldwide slump. In fact, the “remedy” might prove much worse than the disease.

Thus, before we can address what needs to be done, two other questions need answers first. One is what causes excessive savings in the world economy, and a second, especially pertinent one if it turns out that global excessive savings are due to structural causes that are not responsive to policy, is: What, if anything, can take the place of U.S. overspending in offsetting the potential ill-effects of global excess savings? In relation to the first question, Bernanke’s own argument emphasizes the high propensity to save in surplus countries in Asia due to demographics and cultural/historical factors. Others have more convincingly pointed at the collapse of investment after the Asian crisis as the real cause of the “savings glut.” But, in one respect both explanations are similar: both underscore long term factors that are unlikely to be easily amenable to policy manipulation at least in the short run – though, admittedly not to the same degree.

Different from the first two on this score is yet a third explanation that emphasizes the recycling of reserves overseas through the U.S. financial system. Because they are disproportionately kept in dollar denominated assets, the effect of any accretion of reserves overseas is an increase in demand for U.S. financial assets. Thus the steady rise in foreign reserves overseas is directly tied to the ever rising inflow of funds into the U.S. financial system from abroad, fueling asset prices bubbles and credit expansion in its wake. “Excessive” reserve accumulation overseas in turn is often explained either by the attempt of emerging economies to self-insure against speculative currency attacks or to keep their currency from appreciating in order not to lose their export competitiveness.

There is no denying that the Asian crisis and the speculative currency attacks of the 1990’s in general left an indelible mark on policy makers in emerging economies, and building a war chest in the form of large foreign currency reserves came to be seen as one of the very few things that could be done to discourage speculative attacks. In more recent years, once reserves became sizeable, the effort to prevent currency appreciation has become the more operative cause of reserve accumulation. Reliant on exports, emerging countries again felt they had little choice but to keep their currency from appreciating to make sure their economies did not slump.

Another important source of reserve accumulation overseas especially after the dotcom bubble burst has been simple money creation, what more recently came to be termed, “quantitative easing” by central banks in advanced economies. Though, this is not as much discussed as the previous two causes, its importance has once again risen in the current period. Prior to the crisis, it mainly worked indirectly through the monetization of U.S. debt by foreign central banks. The most notable example of this was, of course, the massive purchases of U.S. debt by the Bank of Japan during the period 2002 to 2003, which arguably played an important role in igniting the real estate bubble and reviving U.S. growth in 2003. After the crisis, the Fed itself began to engage in quantitative easing on a massive scale, causing the carry trade to reverse by making the dollar the funding currency in search of yield overseas. For the recipients of this outflow overseas, such as China, the speculative capital inflow became yet another source of funds in addition to their trade surplus that had to be absorbed by their central banks to prevent their currencies from appreciating. Thus, along with the reserves that grew faster overseas, so did the demand for “safe” U.S. assets. The reserves thereby recycled to the U.S. returned overseas in search of yield anew and repeat the cycle on a larger scale.

IV. TOWARDS AN ALTERNATIVE UNDERSTANDING

The main point of the discussion about global imbalances is that the U.S. financial system has been functioning globally just the way the ‘banking system’ propagates bubbles in a

A Heterodox View of the Crisis

national economy in Keynes' discussion in the *Treatise* above. Except, in this instance the financial system not only kept transferring global "bear funds" to "global bulls" but began to create money at an increasing clip as well. In other words, though increasingly dysfunctional, what we have here is a unified system of global financial intermediation in an emergent *transnational* global economy, rather than an *international* one consisting of the sum of individual countries with their own distinct systems of financial intermediation. That is the first salient point; and the second is that in this global financial intermediation, the U.S. financial system plays the role of the world's banker, i.e., when it is working properly. It issues short term liabilities to the rest of the world and invests long in other countries. This clearly is no longer happening smoothly because the very system of global intermediation is unraveling.

In recent articles, Jane D'Arista and I have argued that this crisis can be understood as this very process of unraveling (D'Arista & Erturk 2010a, 2010b, Erturk 2009). We argued that a system of global financial intermediation had gradually come into existence during the era of financial liberalization after the breakdown of the Bretton Woods system. Signs of distress, however, began to accumulate by the end of the 1990's. First, the Asian crisis along with the threat of contagion in other emerging economies and then the burst of the dotcom bubble led to a recession in the U.S. in 2001, causing a sharp worldwide slowdown in the private capital inflow to and outflow from the U.S. Massive monetization of U.S. debt by Bank of Japan and the ensuing real estate boom jumpstarted growth in 2003, giving rise to a new wave of credit expansion in the U.S. that came to an end with the outbreak of the crisis.

The U.S. real estate boom was perversely functional because it kept alive a dysfunctional system of global financial intermediation – though, in an unsustainable way. The credit boom was the means by which the ever expanding dollar reserves overseas could be loaned out in the U.S. as it became harder and riskier to do so in emerging economies. It made it possible for U.S. households to absorb an ever larger part of these global surpluses over time. But that also meant that the U.S. became the epicentre of debt build up as well, which eventually wrecked the balance sheets of its households and the banks that lent to them.

The policy response to the crisis so far has been to substitute public spending for the falling private consumption and keep banks on life support until no longer necessary. The overall aim seems to be to revive the recycling of global imbalances to the U.S. on more sound footing by revamping financial regulation and using U.S. sovereign credit to vouch for its impaired private counterpart such that U.S. private consumption can again spearhead world growth. But, the trouble is that this has already given rise to the fear of a future sovereign debt crisis in the U.S. as it is now unfolding in Europe. Even if we think the bleak expectations behind this fear are far-fetched and wildly overblown, the point is that the fear is real and will impair the continued use of public stimulus here and now, increasing the

likelihood of a double-dip. That also means that U.S. private consumption will not be able to lead the world economy out of its doldrums. As that sinks in it might also become clear that the real problem is not global imbalances but global excess savings. It only remains to be seen if the policy discussion then moves onto what can replace U.S. overconsumption to revive global financial intermediation. It might at long last be recognized that the real policy challenge will be to figure out how to put to use the large dollar reserves to finance development in poor countries which will potentially benefit everyone including the rich.

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