

The Economic- Financial Crisis

A Diagnosis and Some
Prescriptions

What's the Problem(s)?

- Most pressing: The financial crisis-panic
- Next: The collapse of the housing market boom-bubble
- Finally: Skewed economic development and policy priorities

The Financial Crisis-Panic

- Collapse of essential money-credit, not equity or stock, markets
- Which markets?
 - Commercial paper
 - Interbank lending (Fed Funds, London Interbank)

The Financial Crisis-Panic

- What's the interbank lending market?
 - If money is the “lifeblood” of the economic circulatory system
 - Then the interbank lending market is the “heart” pump
- In turn, a financial panic is the equivalent of:
 - A massive heart attack!
 - “Hemorrhaging,” “seizure,” etc.

The Financial Crisis-Panic

- Why? Crisis of confidence among banks
 - “Counterparty risk:” solvency of borrowers!
- Realistic expectations, not mere “market psychology” like in Wall Street
 - US: Bear Stearns, Lehman, Meryl Lynch, WaMu, Wachovia, Citigroup, etc.
 - RoW: UBS, Fortis, Bradford-Bingley, etc.

The Financial Crisis-Panic

- Lehman Brothers as a Case Study
 - Excessive debt relative to equity or net worth (“leverage”)
 - Invested in risky assets, especially mortgage-related securities
 - Large losses in latter wiped out equity and put Lehman on the brink

Collapse of the Housing Market Boom-Bubble

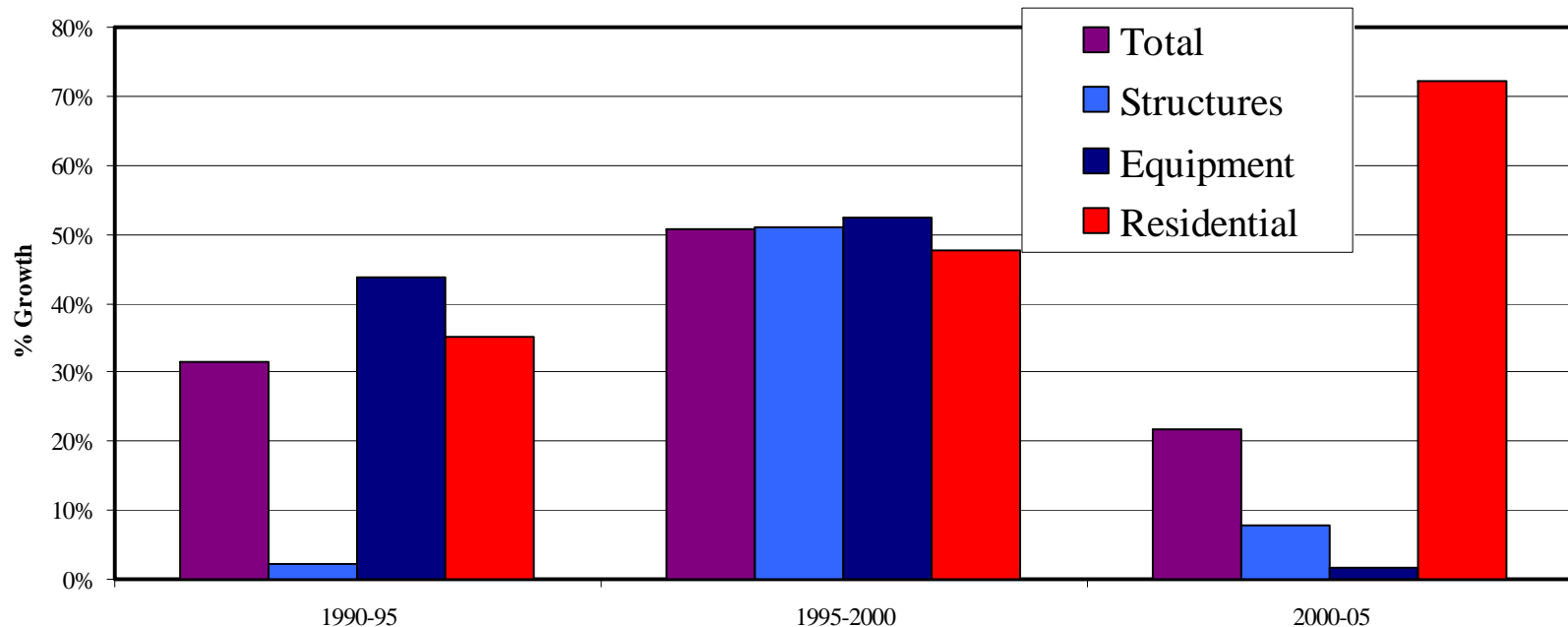
- The US and other countries (UK, Spain, etc.) face another serious problem:
 - Serious economic downturn or recession
 - Because of the collapse of the housing market boom-bubble

Collapse of the Housing Market Boom-Bubble

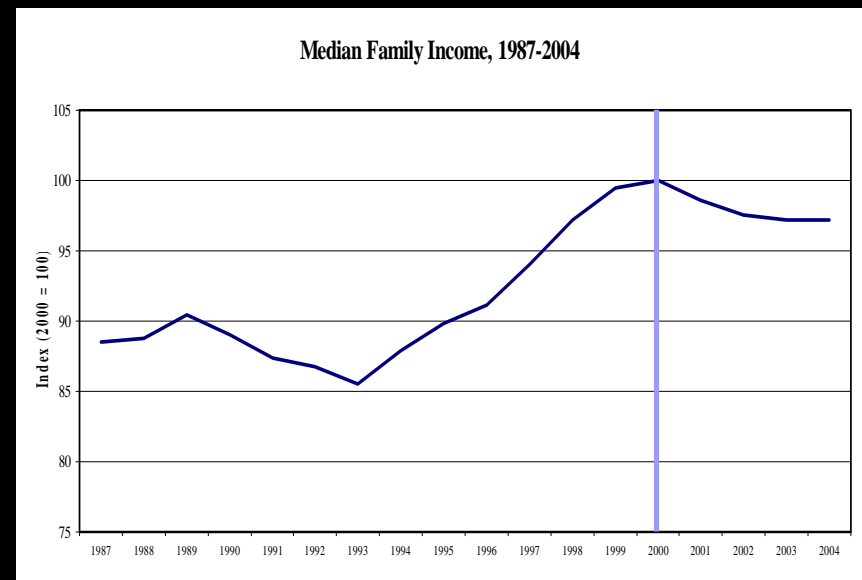
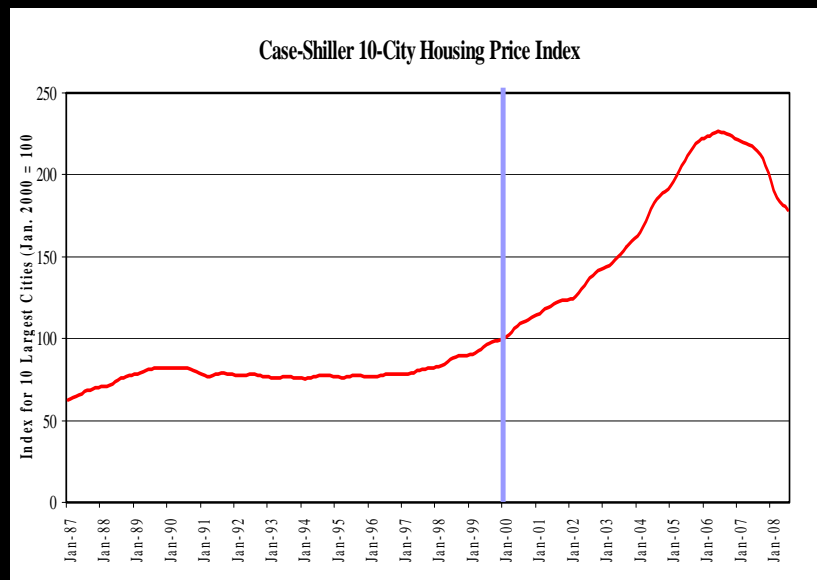
- Origins of the boom in the skewed economic expansion since 2000
 - Fueled mainly by investment in residential construction and related sectors
 - In turn, fueled by the speculative bubble in housing prices
- Three pictures (worth a thousand words)

Collapse of the Housing Market Boom-Bubble

**% Growth in Private Fixed Investment
by Type (1900-2005)**



Collapse of the Housing Market Boom-Bubble



Collapse of the Housing Market Boom-Bubble

- Why?
 - Unscrupulous lenders and credulous borrowers in the sub-prime mortgage markets
 - Of looming concern, foreclosures in prime mortgage markets
 - Speculative impulse (“mania”) of households and developers
 - Financed by increasingly lax standards of banks

Collapse of the Housing Market Boom-Bubble

- Bursting of the bubble?
 - Slower growth, not decrease, in housing prices!
 - Unrealized expectations saddled households with excessive financial burdens
 - Reinforced by Greenspan's rapid reversal of "cheap" money policy

Policy Prescriptions

- First, attend to the panic! The patient's condition is dire!
 - If fatal, then "IT" could very well happen again!
- Serious medicine: Partial, if not, full nationalization of the financial system
 - "Recapitalization" plan = government purchases of stock (ownership stake in) private banks
 - Fed's direct private lending

Policy Prescriptions

- Patient is “stabilized,” but not “out of the woods.” Next on the list of urgent problems:
 - Recession in the US and beyond
 - Foreclosure crisis
 - Mutually reinforcing – vicious downward spiral!

Policy Prescriptions

- Staunch the foreclosure crisis
- Moratorium on home foreclosures
 - Affordable monthly payments: initial mortgage installments, fair rental rates
 - Dean Baker plan

Policy Prescriptions

- During hiatus, administered “workouts” or “modifications” of home mortgages
 - Orderly process to return values of homes, mortgage debt, and mortgage-backed securities back to earth
 - Like chapter 11 bankruptcy “reorganization”

Policy Prescriptions

- Conditions on banks (in exchange for “bailout”)
 - Submit to “binding” arbitration to restructure outstanding mortgage debts and related securities
 - Suspend dividend payments
 - Limits on executive compensation

Policy Prescriptions

- Another round of stimulus
 - Extension of, improvement in unemployment insurance coverage
 - Federal government transfers to state-local governments
 - Increased public expenditures on backlog of infrastructure projects

Policy Prescriptions

- Over longer horizons (after the election), a lengthy agenda of change:
- Re-regulation of the banking-financial system
- Repair and reform of tattered, if not shattered, social safety-nets: (e.g.)
 - Minimum (living) wage and other mechanisms to reverse the mounting inequality
 - Social security and private pensions

Policy Prescriptions

- Fiscal (tax and spending) reforms: realign
 - tax system to more equitably and adequately fund
 - spending priorities that “literally” invest in our futures:
 - Education
 - Mass transit
 - “Green” technologies, etc.