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Economic Crises: The Impact on Australia and Canada

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The International Financial and Economic Crises: The Impact on Australia and Canada

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Abstract:
The Financial Crisis accelerated a latent Fiscal Crisis that had been brewing in many Western countries. The paper outlines the causes of the Financial Crisis, and how this increased expenditure and reduced revenues for many Western governments. But these additional fiscal stresses merely advanced the day of reckoning when fiscal problems had to be faced Demographics (the Baby Boom effect) dictated that reforms would be required in taxation, health care and pensions to smooth the transition. Many governments had not prepared adequately, so that the added burden of the Financial Crisis provided a double impost on budgets. The paper compares Canada and Australia in this framework, showing that there are similarities and differences that are instructive. Both countries avoided the initial Crisis, but they may not be so fortunate in the near future.
JEL Codes: G01, G10,H30,H60.

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The standard explanation of the 2007-9 financial crisis, beginning in the United States and spreading to Europe, discusses risky bank lending and the shadow banking system. But the more recent international economic crisis beginning in 2010 - especially what we are observing currently in the European Union - indicates that there is a more complex story.

Contrary to many claims in the media, there were economists who, in public and in private, argued long before, and during 2007, that serious economic and financial problems were brewing[1]. The reason that the public did not hear about most of these concerns, was that they were largely ignored by the media, politicians and bureaucracies.

Subsequently, some of the most vehement attacks on economists came from people in the media, politicians and financial sectors trying to create scapegoats and distract attention from their own culpability and incompetence. I am not claiming that all economists got it right - that clearly is not true. But it is equally true that not all economists got it wrong!

Furthermore the economists who understood the problems argued that the crisis would be long-lived, international and would have very serious implications for the public and private sectors[2]. In particular, the economic contraction caused by a severe credit crisis would decrease income and wealth, and increasing budget deficits.

But the impact of the financial crisis merely exacerbated a long run fiscal problem in many countries. Government commitments for health care, pensions for retiring Baby Boomers, and other costs, implied serious growing fiscal problems in many Western countries.

To understand these claims, we need to look at the historic roots of the crises to see the causes.

[1] Most economists who gave public warnings are now well-known. Others have been overlooked because they were ignored at the time, or their warnings were in private to officialdom. For example, I had been providing warnings in private to UK, Canadian and Australian policy officials from 2006, and especially early 2007. These warnings culminated in a paper (Milne (2008)) that was drafted in the Fall of 2007.
[2] The long term view of financial Crises has been exposited by Reinhart and Rogoff (2009).

1. A Sketch Economic History of the Western World from 1970 – 2006:

I want to take a longer term view that goes back into the 1970's so we can discuss the roots of the crisis in the real and financial sectors.

In the 1970's the Western economies were struggling with high inflation and stagnating growth in real GDP. (I will not discuss the roots of those troubles, but they were fueled in the US by high oil prices, military expenditure in the Vietnam War etc.) The UK was also in serious trouble with highly intrusive government policies and aggressive and highly disruptive trade union activity.

In the early 1980's there were banking crises in a number of countries. For example, the S&L crisis in the US created a major financial disruption in the US[3]. The main banks in Canada were in trouble with leverage ratios (debt to equity) of 30-40 to 1.

As the 1980's progressed the economies recovered, but hit another downturn in the early 90's. In Canada, the US and Australia there were recessions. The US recovered relatively quickly, but Canada and Australia took longer to recover as they had serious public debt problems that required budgetary restraint, slowing the recovery. In Australia some state banks failed; and one of the major banks was in trouble. These failures were due to poor lending practices in real estate.

An additional concern in the early 90's were projections of Baby Boom retirement pensions and medical costs increasing to such an extent that government budgets would come under increasing stress. In Canada there were attempts to address some of those issues by trimming budgets and increasing pension contributions. Australia in the late 90's undertook similar measures reducing Federal debt to nearly zero by the mid 2000's. Washington simply ignored the issues, although one can quote a number of

[3] For an excellent account of the corruption and perverse incentives surrounding the S&L Crisis see Black (2005).

budget analyses that warned of the looming problems[4]. The UK and other EU countries faced similar problems, but did little to address the concerns[5].

A second issue that appeared in the 1970's, and continues to this day, is the stagnation in real US median male salaries. Female median incomes have increased and more recently plateaued. This statistic has been discussed at length in the economics literature, but only recently has been discussed in the media. Various hypotheses have been proposed, but none seem to be definitive. There appear to be multiple causes, some more important than others[6].

Another relevant statistic is the slow-down in productivity in the Western world since the early 1970's. Since then, productivity growth has been around 1%, whereas in the post WWII period it was around 2%. This translates directly into slower growth in average standards of living. Again there has been much discussion of the causes. Some argue that the data does not take adequate account of quality increases. (e.g. computers today are much faster than a few years ago.) Other writers think that technological change has slowed as the major scientific innovations in the late 19th and early 20th Centuries worked their way through the system[7]. The full impact of computer innovation may take decades to feed through the economic system to improve productivity.

The rapid expansion in the Chinese economy (and to a lesser extent India and the rest of Asia) has led to major changes in international manufacturing locations, types of manufacturing, and lower costs of production. Parts of the US have de-industrialized. This may tempt you to think that China and Asia will dominate manufacturing. But this is not consistent with the growth of German manufacturing and exports in the 2000's, and some recent signs of manufacturing recovery in the US. Real relative costs are changing in favour of the US. There are subtle effects coming from changes in the quality of technical training, clusters of appropriate skills, etc. that may reverse the decline in US manufacturing. Nevertheless, the percentage of the workforce

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[4] See Kotlikoff and Burns (2005) (2012) and Johnson and Kwak (2012) for discussions of the fiscal crisis in the US, the history of numerous warnings that were ignored by Washington, and proposals for US budgetary reform.

[5] There had been little discussion in the EU of looming budgetary problems, until the recent crisis, when falling revenues and real estate collapses forced the sovereign bond markets to reevaluate the fiscal sustainability of many EU countries.

[6] For a recent discussion see Galbraith (2012) Ch.6.

[7] See the book by Cowan (2011).

in manufacturing has been in long run decline in much the same way that has been observed in agriculture over the last century: mechanization and computerization have reduced labor inputs.

Over the last 30 years we have observed an increase in income inequality, especially in the US (see Figure 1.). Progressive taxation and social welfare policies reduce the impact in most countries, but the US has extreme inequality that appears to rival that seen in the 1920's. The economic crisis has exacerbated this trend as long term unemployment increased poverty and low incomes. Economists have argued that income is highly correlated with particular types of training and education that have become more or less valuable as some industries have expanded, while others have contracted. Increased competition from offshore manufacturing in China and other economies have reduced domestic manufacturing and domestic manufacturing workforces. It is clear that these are important factors: but there are other factors are at work as well. Whether this is a transitory phase or a more disturbing long-run trend is contentious[8].

[8] See Galbraith (2012) for such a discussion.

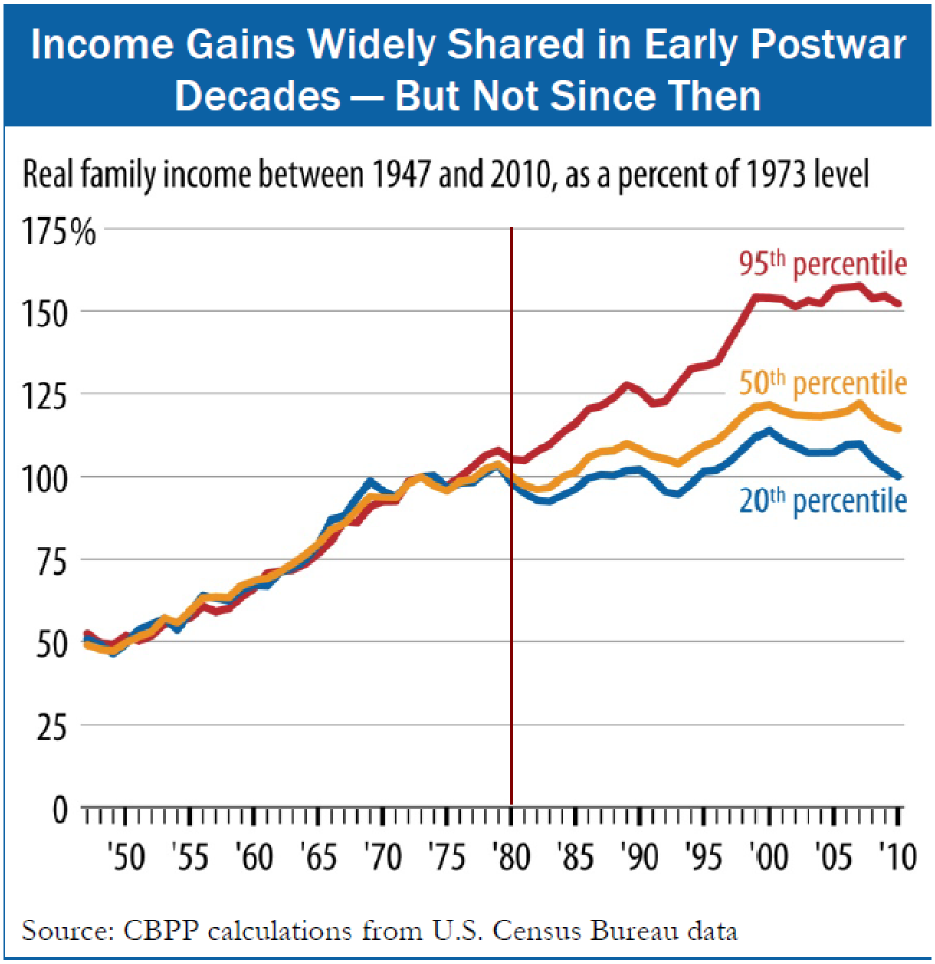

Figure 1.

During the same period we have seen a rapid increase in the size and profitability of the banking and financial industry. Just before the crisis, in the US, slightly less than 40% of all corporate profits were from the finance industry (traditionally it would have been around 10%). In addition there have been huge increases in salaries and bonuses in the industry, attracting an army of talented engineers, economists, physicists, etc. There has been considerable discussion of whether the current size and composition of the finance industry is sustainable. Currently the number of employees in the Western financial system is shrinking, with large numbers of layoffs. I will speculate later on the future size and composition of the finance industry.

2. The Crisis in the US and International Financial System[9]:

[9] This section draws on Milne (2008).

The roots of the US financial Crisis lay in the real estate sector. The US housing sector boomed from the early 2000's, plateauing in 2006. The causes were multiple:

In the US, mortgage interest payments are tax deductible. This subsidizes house borrowing. Many other countries do not have this policy, but they have also seen a "housing bubble" that has since collapsed (eg. Spain, Ireland.). Australia has negative gearing which allows tax subsidies for Real Estate investment.

The US held interest rates very low for too long after the September 11th event, encouraging excessive borrowing. This is a contributing factor in the US, but in other countries interest rates were higher, so we must look for other causes.

During the early 2000's there were discussions in Washington and the Federal Reserve that increasing home ownership would help compensate for the increased income and wealth inequality. This was not a prudent policy as it promoted policies that encouraged over-borrowing on housing.

Another culprit was the emergence of a "shadow banking" system that allowed US, UK and EU banks to avoid bank regulations and supervision. The basic idea was simple: mortgage companies originated the housing loans, on-lending them to Investment banks who created Special Investment Vehicles (SIV's) that then sliced up the returns into AAA, AA, etc rated short term "bonds". These securities were sold to pension funds, mutual funds, banks etc. The assets were sold and managed in the US, UK and EU. Credit analysis of these complex securities was poor – many buyers and sellers did not understand the true risks. They were predicated on the assumption that there would be regional housing downturns, but not a national downturn (This argument is based on factor models where regional housing risks can be diversified away).

The securities were rated by the agencies (Moodies, S&P, etc). The regulators of this system were not standard bank regulators, but securities regulators who had little expertise in credit instruments. There has been serious criticism of the agencies and their incentives in rating securities where they are paid by the issuer.

The credit problems infected the large US banks, who were holding significant amounts of these high risk assets. Bear Sterns, Fannie and Freddie, Lehmans and others went bankrupt (or were taken over in special deals arranged by the US government.). Many commentators have dated the crisis from the failure of Lehmans; but a careful reading of the period 2007-8 reveals that the Lehmans' failure and the resulting panic, were merely symptoms of deep credit problems that had been brewing for several years[10].

Some large US (and international banks) were sitting on heavy losses and there were market fears that they were (and are) insolvent. Washington and Federal Reserve intervention provided heavy subsidies to these banks so that they have survived – so far.

Other countries also had major bank losses stemming from exposure to US real estate or from their own real estate bubbles. Ireland, Iceland, UK, Spain, Portugal all saw major banking failures. There were varying degrees of government subsidies to banks, masquerading as "liquidity support". While some banks were arguably solvent and suffering short term funding problems, other banks were insolvent and subsidized to continue in operation, protecting management, share-holders and creditors[11].

3. The Crisis In Canada:

Canada is often touted as having a solid banking system and a model for the rest of the world. There have been numerous comments in the international press about the stability of the Canadian banking system.

This self- congratulation is dangerous as it can breed complacency. Also it is premature.

Canada had an asset backed commercial paper melt-down in mid-2007, creating large losses for Canadian investors. The non-bank Asset-Backed Commercial Paper (ABCP) collapsed in 2007, at the same time as the US ABCP collapse, and for the same reasons. The Canadian banks had been

[10] See Crean and Milne (2012) for a detailed analysis of systemic crises that stem from credit problems in industries with high fixed costs, low marginal costs and high leverage – real estate is merely a leading example of this type of industry.
[11] See Barofsky (2012) for a recent discussion of the US case; and Haldane (2010) for a more general discussion of bank subsidies.

more prudent than many of the US banks, prodded by the bank regulator (OSFI) to avoid the excesses of the US shadow banking model[12]. Nevertheless this was an embarrassing episode that has been quietly omitted in recent Canadian public discussions.

The crisis is far from over: the current problems in the EU are spilling over into the US and UK. Canada relies heavily on the US for exports (80 % of exports go to the US).

Some of the Canadian banks have major subsidiaries in the US and have direct and indirect links to the US financial system so that US credit problems can spill over into the Canadian banks. Although the banks have minor exposure to EU credit, they have more substantial exposures via the US exposures to the EU.

Vancouver and Toronto have major condominium and housing bubbles that have drawn comments from the Bank of Canada and some senior Canadian private bank executives. There have been regulatory changes to toughen the Canadian Mortgage and Housing Corporations insurance terms on bank loans.

4. The Crisis in Australia: A Comparison with Canada

Australia has been claiming that it has had a very stable banking system. This claim is shaky. Some financial institutions that relied heavily on overseas short term funding markets failed in 2008; some regional banks merged or were absorbed by major banks in 2008-9. Competition policy concerns were waived during the Crisis in late 2008.

Although warned repeatedly by international observers to prepare for financial shocks, the October 2008 bank funding crisis created a panic[13]. A week after Ireland introduced blanket bank guarantees, the Australian government introduced similar guarantees over the banking system when international short term funding for their banks dried up. Australia did not have a formal deposit insurance system (unlike almost every Western country). The blanket guarantee was an ex post deposit insurance system.

[12] See Chant (2009).
[13] See Sykes (2010)

Although premia were paid during the crisis period, the emergency funding has since been retired. This is rather like a system of fire insurance where the uninsured householder sees the bush-fire at the back fence, calls the insurance company for fire insurance cover, pays a premium, and as soon as the fire passes, cancels the insurance[14].

Neither Canada nor Australia refer to each other, so they appear (to the local Main Stream Media) to be unique. In fact there are strong similarities. Both countries have major housing bubbles and extended consumer credit; both have highly concentrated banking systems; both are commodity currencies reliant on strong commodity exports.

The differences are also instructive. Canada long had a formal deposit insurance system. Canada is strongly connected to the US and Latin America through trade and financial links. Australia is heavily connected through commodity links to Asia, particularly China, Japan, Korea and South-East Asia. Canada has major export markets in Oil, Gas, Wheat, Lumber, Diamonds and other commodities.

Canada has a major manufacturing sector – the car industry is linked to the US and Japanese manufacturers with major exports to the US. Proximity allows cheap transport costs via rail and road. Canada has a major aircraft and train manufacturer (Bombadier) and a more advanced Hi Tech sector than Australia.

Australia's recent prosperity is heavily dependent on commodity exports to China. The rapid expansion in the mining industry has led to a two-speed economy. But we should not exaggerate the size of the mining sector (about 10-15% of GDP depending upon related industry effects). This is similar to Canada where Alberta and the West have been booming and Ontario and Quebec have lagged because of decreased manufacturing exports.

Like Canada, the Crisis is far from over for Australia. In fact, the impact of the Crisis in the non-commodity sectors has been felt for some time. Observe this graph of Real GDP/Capita for Australia from 1960 – 2011.

Consider the long view in figure 2:

[14] For an analysis and quantification of bank subsidies during the crisis, see Noss and Sowerbutts (2012) and Ueda and Weder di Mauro (2012).

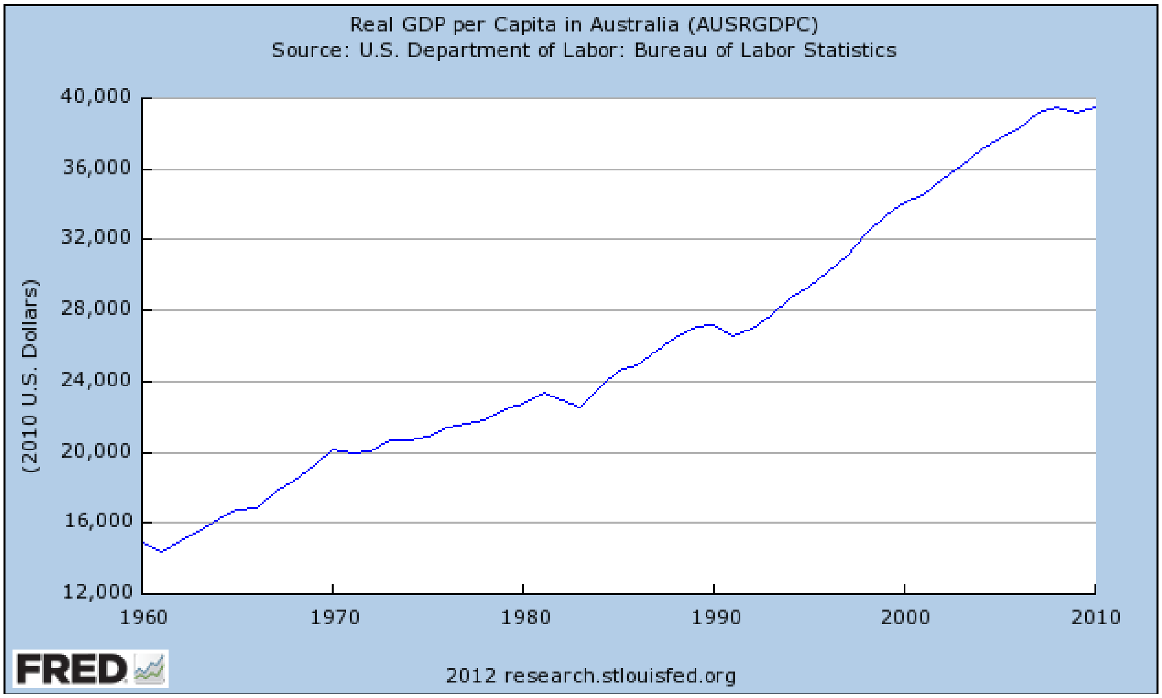

Figure 2.

Note:
1.There is solid growth in the 1960's.
2.There is a slow-down in the 1970's and early 80's.
3.Growth in the commodity boom in the mid late 80's is followed by the serious early 90's recession.
4.After a catch up in the mid 90's, there is a resumption of increased growth until 2007.

Now observe 2007 -2012 in Figure 3.
From 2006 until 2011 GDP/capita has been not trending up or down. Since 2011 GDP/Capita has risen sharply, but given recent statistics are open to revision, these numbers may be unreliable.

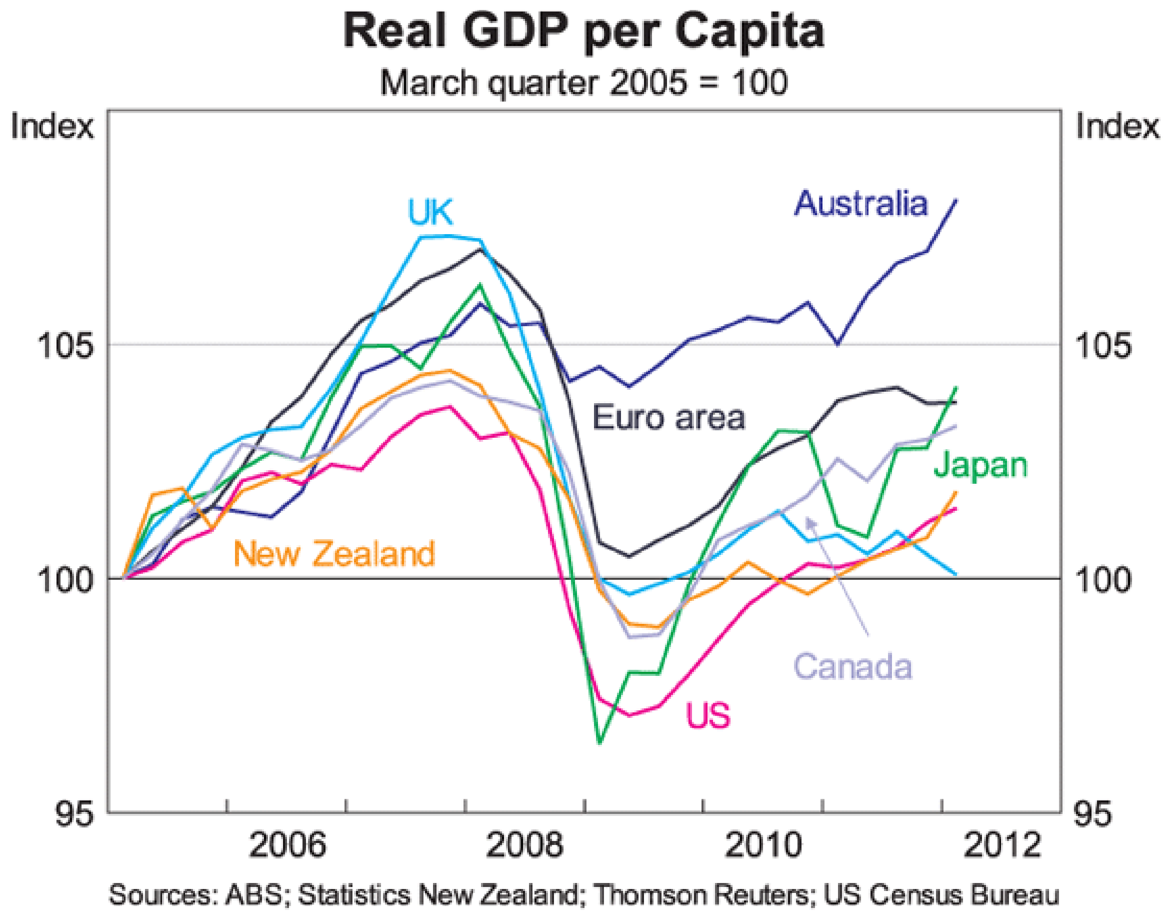

Figure 3. (Source Stevens (2012))

Taking out the booming commodity sector (about 10-15% of GDP depending how you count it), you can see a flat performance in real standards of living.

One might be skeptical of recent GDP numbers as they are often revised. But if we look at Retail Turnover per Capita in Figure 4, we see the same result: a significant slowdown in activity from around 2006. This is consistent with flat GDP/capita and a booming commodity industry in Western Australia and Queensland.

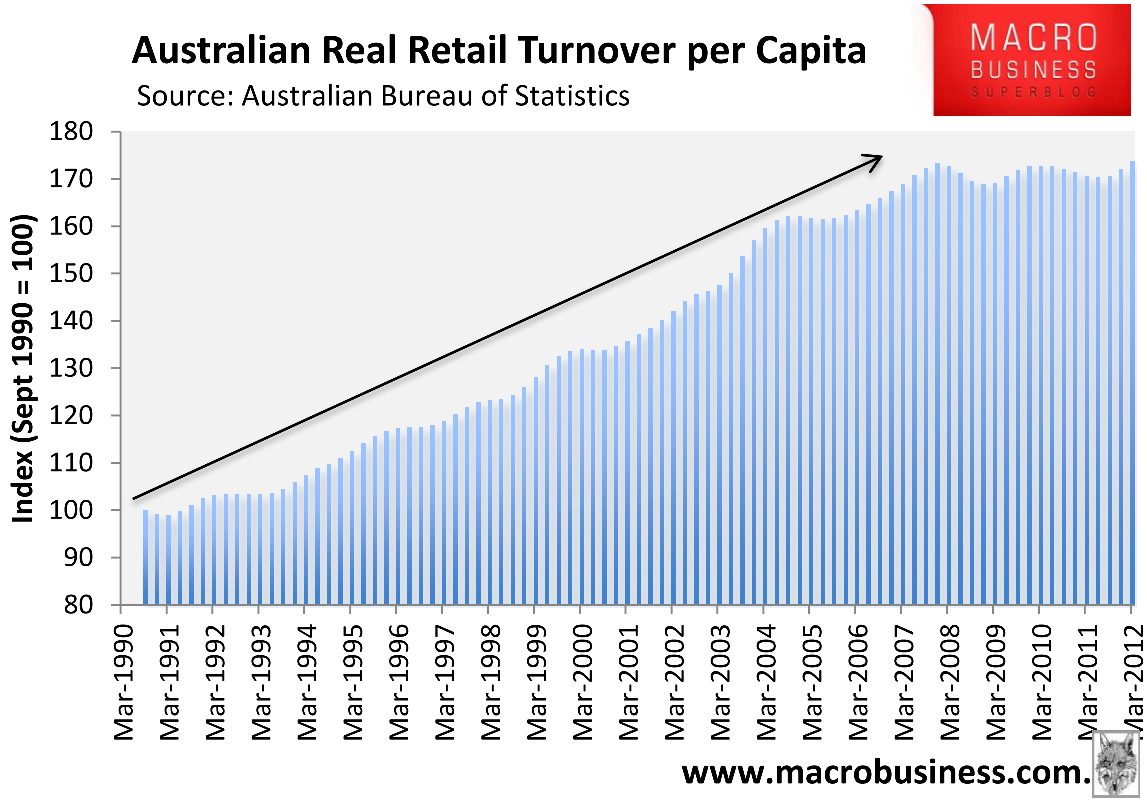

Figure 4.

5. The Australian Housing Bubble and Consequences for Banking.

From a recent *Demographia* report (2012), calculations of Canadian and Australian housing affordability show serious problems in a few large cities. Canada has 3 – Toronto, Vancouver and Calgary. Australia has 5 large cities[15].

House prices in Australia increased due to Demand and Supply factors. Negative gearing, expansive credit by the banks, encouraged by governments, have stimulated demand. More recently there have been signs of a reduction in demand as borrowers have become wary of continued house price fluctuations and declines. Supply constraints induced by restrictive zoning regulations etc. have constrained supply in high demand areas.

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[15] The Reserve Bank of Australia denies that a bubble exists – see Stevens (2012).

House prices have been fluctuating or slowly falling in many areas over the last couple of years. A few speculative areas have seen major declines in prices.

Australian financial institutions, especially the major banks have growing exposure to housing mortgages (See Figure 5 below).

Although the major banks survived the crisis of late 2008, a number of medium and small financial institutions did not survive – either being resolved, or absorbed by the large or remaining medium sized banks[16]. Subsequently the government complained that the banking industry had become more concentrated and less competitive. Increased financial concentration has occurred in the US, UK and EU as a consequence of the crisis. This increased concentration has been criticized, as it is seen as a consequence of Too Big To Fail or To Interconnected To Fail policies that subsidized very large banks.

[16] See Sykes (2010) and Harper (2012). Harper has called repeatedly for a full review of the Australian financial system along the lines of the 1996-7 Wallis Inquiry.

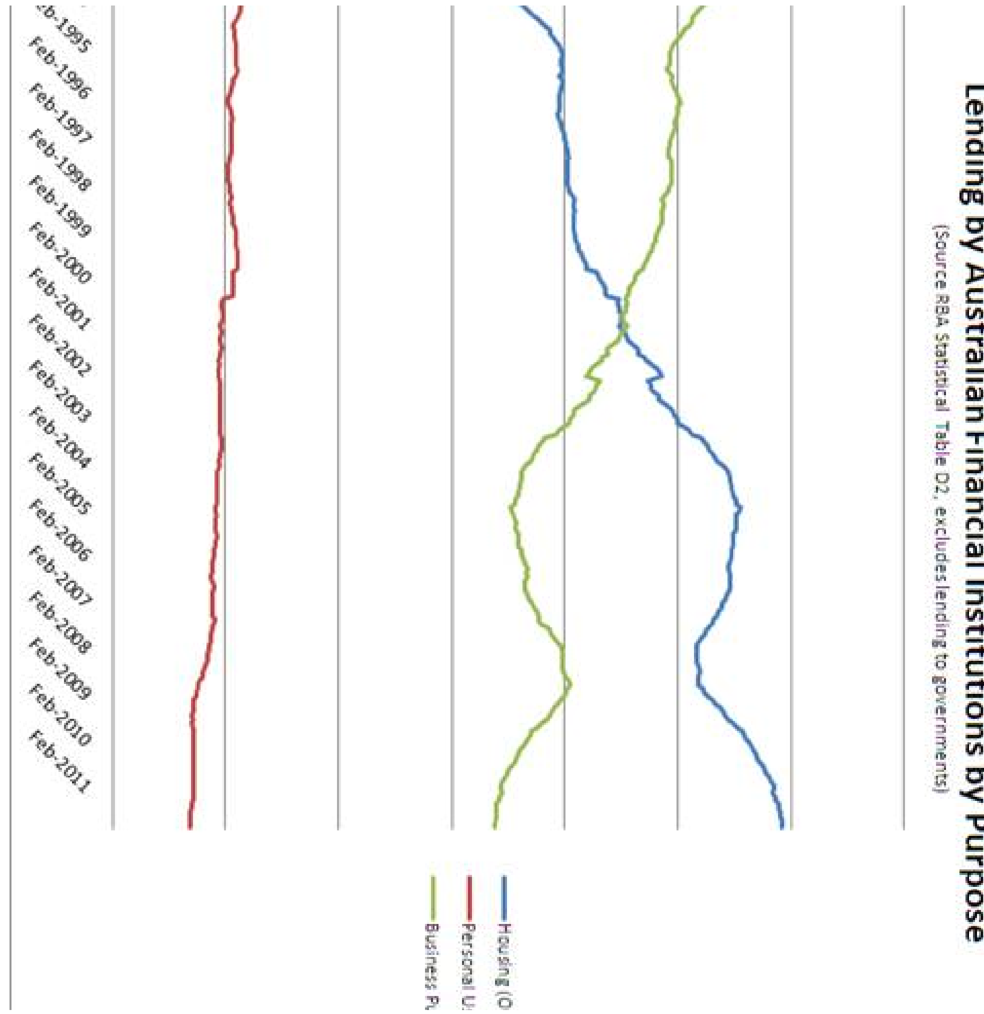

Figure 5.

6. The Canadian Housing Bubble.

Similar factors had been at work in Canada. Additional factors have been lower government interest rates (1%) and the implicit subsidies coming from the Canadian Mortgage and Housing Commission. CMHC insures high risk home lending by the banks, charging below market premiums on the risks – this has perverse incentives in encouraging risky bank lending.

Recently CMHC has tightened its terms: the Governor of the Bank of Canada and the Minister of Finance have made repeated warnings about high condominium and house prices in Toronto and Vancouver, and the risks of increasing consumer credit. There is growing concern in Canada that consumer credit and real estate excesses are imposing serious risks on the economy.

7. Australia and Canada – Credit Problems Waiting to Happen?

Australian officials have claimed that there is no housing bubble nor serious credit risks in Australia. Indeed, Australia is the "Lucky Country".[17] For a number of years, international experts and official bodies have been challenging that complacency. The warning message has been taken up more recently domestically on a number of blog sites and now is appearing in the main stream media[18].

Australian real estate values have been fluctuating or deflating in some areas over the last 2-3 of years. As Figure 5 reveals the major banks have heavy exposure to Real Estate. There is evidence of consumer deleveraging. Consumers are becoming increasingly cautious – we have seen retail sales falling in the main states and increased saving as consumers tighten their belts.

8. The Australian Non-Commodity Sector is Slowing:

The non-commodity sector, which is the bulk of the economy, is slowing. There is evidence of a softening labour market since 2008 (see Figure 6). The reregulation of the labour market is increasing costs. Observers from North America are amazed by the very high minimum wages (approximately $16 per hour) and various loadings. In a downturn, this will feed into increased unemployment, defaults and loan losses by lenders.

[17] For such a view, see Stevens (2012).
[18] See the website http://www.macrobusiness.com.au/author/leith/ for numerous articles on the Australian housing market, and critiques of the RBA and Treasury position.

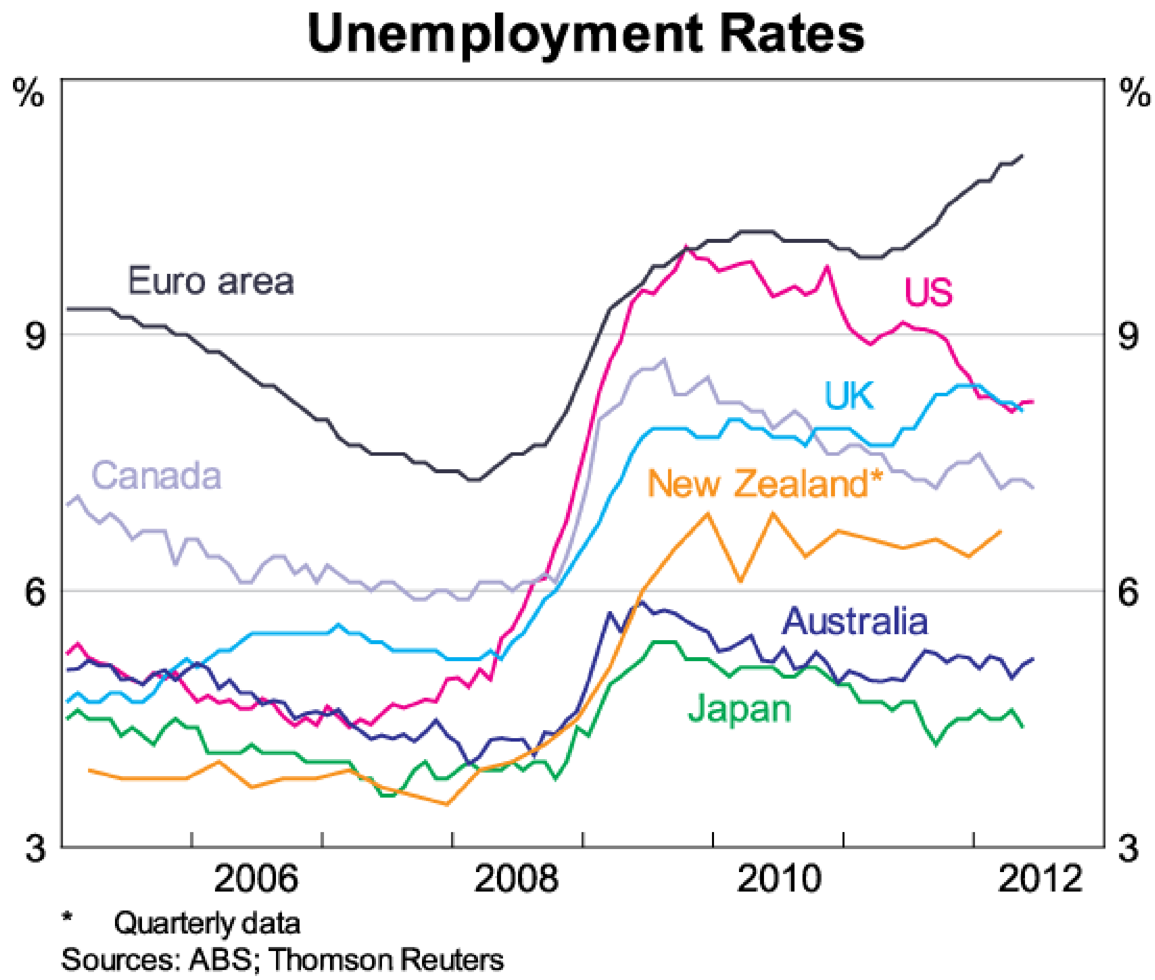

Figure 6. (Source Stevens (2012))

There are growing concerns by the Productivity Commission, Business Organizations and other observers that Australian productivity growth has slowed in recent years[19]. Many observers have argued that the complacency of the late 90's through to relatively recently, has let productivity increasing reform and careful analysis of deeper problems slip off the policy agenda. The commodity boom in Western Australia and Queensland has masked these deeper problems. Serious economists have been sounding warnings in private for some years, but the media and the Federal bureaucracy have been tone-deaf.

9. Australia's Dependence on Commodity Exports to China:

[19] For example see Parham (2012).

Since the financial crisis, the Australian economy has grown much faster than other Western economies, in line with the growth of Australia's commodity exports to Asia (see Figure 7).

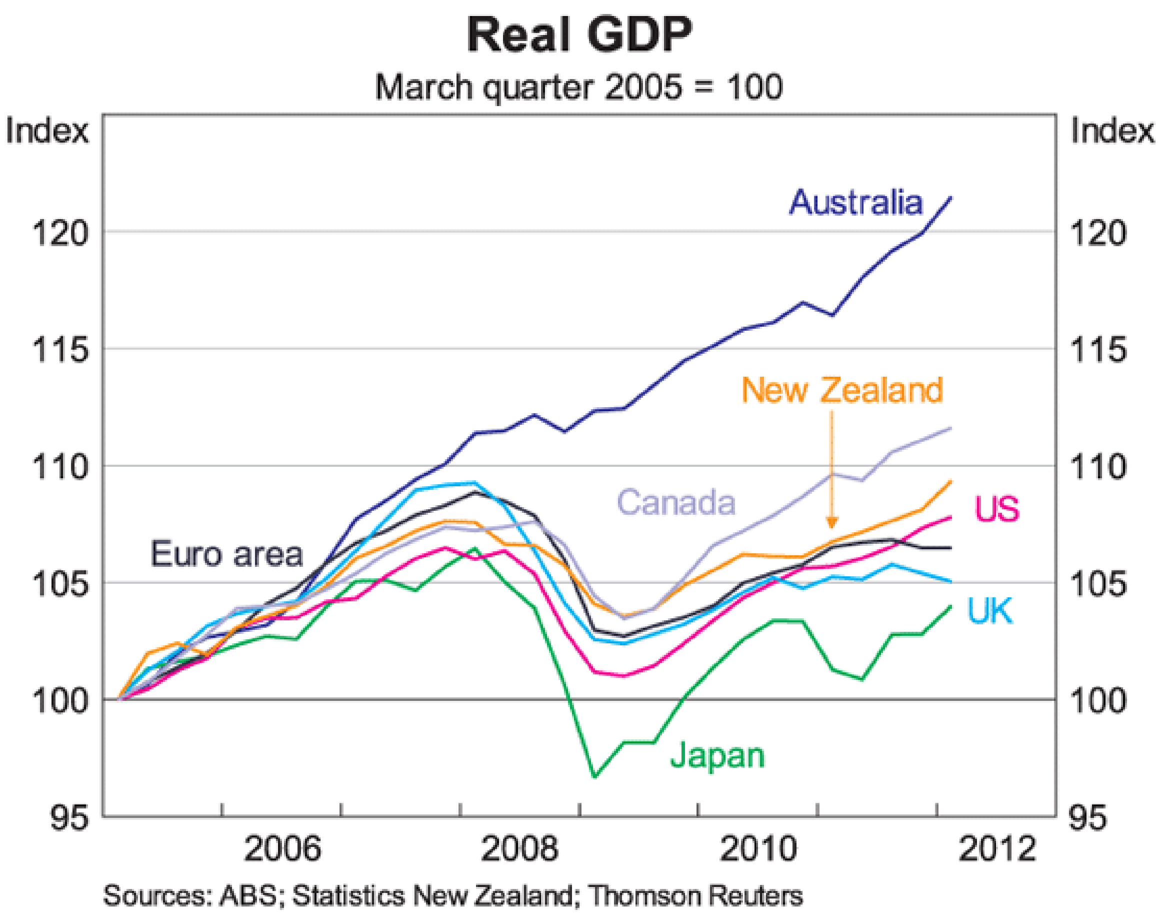

Figure 7. (Source Stevens (2012))

The government repeats the clichés that "Australia is the Envy of the Western World", or that it is "The Lucky Country". Unemployment has been low. The government has run a series of budgetary deficits since 2008, but that has been rationalized as a standard fiscal response to stimulate the economy. As the economy has now largely recovered from the muted impact of the crisis, the government is planning to return to a surplus. China is predicted to continue to grow rapidly and Australia will benefit in the long term from this expanding export commodity market. Although there are risks originating in Europe, the outlook has been basically optimistic[20] .

[20] See Parkinson (2011).

But serious commentators have long warned that Chinese growth has downside risks. The impact of a serious Chinese recession would lead to a decline in export commodity income, adversely impacting the commodity exporting states and the Australian economy[21].

10.The Sovereign Debt Crisis:

As we observed earlier, many Western countries had weak fiscal positions: the present value of revenue streams was far less than the present value of expenses and future liabilities. Myopic political decisions had pushed the hard decisions into the future.

The financial crisis merely advanced the day of reckoning for fiscal crises. The financial crisis implied that tax revenues declined as GDP fell; and expenditures rose with expanded social programs and bank bailouts.

Countries are no different to other institutions in that their long term viability requires them to be credible borrowers. Many countries have been in this situation in the past (e.g. Latin American countries) that either restructured (defaulted on) their debt; or printed money so as to create high inflation, devaluing the face value of their debt, and effectively devaluing to increase exports and decrease imports. We are seeing attempts to do both: Greece is effectively defaulting in a restructuring. The impact will be a significant decrease in the Greek standard of living. Private banks are desperate to have central banks (and taxpayers) introduce back-door bailouts so that they will be partially insulated from their sovereign loan losses.

The use of the Euro is constraining countries like Greece and Spain from devaluing their domestic currencies. There is speculation that Greece, Italy, Spain et.al. will leave the Euro. But this is not a panacea as the debts are denominated in Euros.

The sovereign debt crisis is impacting back into the international banking system through bank holdings of sovereign debt. We should expect more bank failures, but limited bailouts, as governments are now over-extended and there is serious political resistance to bailouts.

[21] Australia would not be alone: Brazil and other commodity producers would also be adversely affected. See Pilling (2012). See also the website http://www.macrobusiness.com.au/author/leith/ for a series of comments on the dangers of Australia's dependence on commodity exports to China.

The debts and counterparty risks in international banking are threatening banks in the UK, US and ultimately countries like Canada and Australia. China is partially insulated, but has serious domestic banking problems and (apparently) a slowing economy.

11. Where Do We Go from Here in Regulation?

It is clear that bank regulation has been inadequate. Regulators and central banks are increasing their surveillance of banks and increasing their policy instruments at the Micro and Macro levels. The latter is still rather amorphous, but some progress is being made.

Banks are stepping up their efforts in risk management, attempting to correct holes in their models. Prudential regulators are overseeing this process. Many of the Risk Management models performed poorly and require careful rethinking[22].

Banks are aware of perverse incentives provided by their compensation schemes and are under increasing pressure to reform their salary and bonus systems to bring them into line with more prudent behavior.

There is widespread concern that subsidies (especially bailouts) to large financial, institutions are counterproductive: they can induce risky behavior. Currently, there is serious work analyzing various policy options to deal with major bank failures. These fall into two categories: ex ante policies that provide incentives to reduce risky behaviour; and second, ex post resolution regimes. The latter can be addressed by a number of policies that have different consequences for shareholders and various creditor claimants. Given the complexity of very large international banks, crossing international regulatory regimes, this is a difficult task to make implement effectively.

It is not clear that proposed regulations coming from Basel will remove the problems. Some academics and central bankers (e.g. Paul Volker) are proposing more drastic measures in breaking up large banks, and/or only regulating “narrow banking”.

[22] See Milne (2009) and Crean and Milne (2012) for analyses.

There is serious planning at the Bank of England and FDIC in the US for dealing with large bank risk management problems, appropriate regulation and resolution mechanisms for large bank failures. The aim will be to try and avoid bailouts, and to force the costs onto those who created the problems. Given that bankers and financiers will see that as a credible mechanism, the hope is that they will be more prudent.

But there is strong resistance to this type of regulatory intervention from the large international banks. Similar resistance is coming from large banks in Canada and Australia. The result is very much work in progress.

12. Where will the Banking in Finance Industry Be in Five Years?

This is a very difficult question. But here is my best estimate.

The international financial sector is contracting (200,000+ job losses so far, and more losses coming.) The industry is changing its business model, but to what end is not clear. Some observers (including myself) predict that Investment Banking will shrink dramatically back to its core functions before the large increase in scale in the 90's. Trading activity will decline as investors realize that over-trading by pension funds and mutual funds is a losing proposition. It creates revenue for dealers on the sell-side through fees and reduced returns for investors. The adverse impact on investor returns from frequent trading has been widely documented for decades[23].

Commercial banks will reemphasize risk management and credit risk analysis – traditional strengths of commercial banks. Monitoring of credit risks cannot be securitized and outsourced without creating perverse incentives. Lenders have been badly burned and will be very skeptical of these types of securities.

Implicit government subsidies (implied by bailout schemes) of the large banks will be under increasing political pressure. They are far larger than the public and most regulators realize[24]. Such schemes subsidize large scale banks compared to smaller banks who are deemed small enough to be

[23] See Bogle (2012) for a lucid discussion of the evidence. He also discusses reasons why excessive trading rewards intermediaries at the expense of savers. The severely reduced trading volumes in the US may be an indication that investor/savers have learned their lesson.
[24] See Haldane (2010) (2011).

resolved (about 3-4 small/medium banks have been resolved by the FDIC every week in the US over the last 3 years). The subsidies induce a more concentrated oligopoly structure, introduce perverse risk-taking incentives and increase the risks of major financial crises.

These comments assume that national governments are able to effectively regulate financial markets and large banks. This is debatable. Some people[25] speculate that political pressure, lobbying and corruption in Washington has exacerbated the crisis and slowed reform. The UK appears to be more determined to take action. But the large international banks can undertake regulatory arbitrage and avoid some of the consequences. The outcome of this policy conflict is not obvious.

13. The Western Economies: How Fast Will They Recover?

First the Bad News:

We know from previous international credit crises (e.g. the Great Depression) and past national credit Crises (see Reinhart and Rogoff (2009)) take many years to rectify before allowing a return to long run potential economic growth.

We also know that these types of crises increase government debt as revenues fall and expenditures increase. These budgetary problems take years to return to more normal GDP/Debt levels. Canada and Australia faced this problem in the early 1990's and we know it took years of fiscal restraint[26].

As this is an international problem in the US, EU and UK, then Canada and Australia will feel the consequences in terms of reduced exports and restricted borrowing through higher than normal borrowing rates.

Then Some "Good" News:

From our observation over centuries of economic development, these bad periods will pass (absent wars, natural disasters, incompetent and corrupt governments and other major disruptions) so that we will return to growth in

[25] For example see Ferguson (2012), Barofsky (2012) and Zingales (2012)
[26] I am referring not merely to the Federal governments, but also to Provincial and State governments.

GDP/Capita. This is critical if we are to raise the standards of living of our population measured in terms of real consumption of goods and services supplied by the private and public sectors.

From the observations of Cowan (2011), the work of economic historians[27] and more recent observations of economists studying productivity growth, major innovations take many decades to percolate through the economy, creating growth spurts that can last decades before fading back into slower growth. What we see now in computerization may be merely the beginning of decades of productivity enhancement through innovation in information, service provision and production techniques. In 20 or 30 years' time, our grandchildren may laugh at the Twitter and Facebook fads as time-wasting amusements, compared to the developments they will have observed.

My grandmother saw early biplanes in the early 20th century: they were mere toys compared to the Jumbo jet liners she saw in the 1960's. In her life time, she saw the introduction of mass international travel, radio, TV, the automobile, modern kitchen appliances, major advances in medicine (she had a heart pacemaker), computers, nuclear weapons etc. Her world was utterly transformed in half a century. Yet as Cowan and Smil observe, these innovations were a direct outcome of 19th century scientific discoveries, inventions and innovations that took many decades to evolve.

Most researchers claim that high quality education, training and retraining are very important for long-run productivity growth. It is important to get the balance right, not falling for passing fads; or indulge in wasteful blanket government funding for "education". Populist policy responses and their predictable failures, can discourage long-run investment into good research, training and education[28].

The emergence of increasing numbers of Chinese and Indians from extreme poverty is to be celebrated. One hopes that similar results can transferred to other poor countries in Africa and elsewhere. These economic transformations disrupt older manufacturing centers when new manufacturers produce commodities at lower costs, leading to factory closures and unemployment in high cost countries. Rather than respond by tariff and other protection, it is more productive to retrain the displaced

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[27] See for example Smil (2005).

[28] See Wolf (2002) for a discussion of wasteful and problematic education programs in the UK and elsewhere.

workforce, and use more capital intensive and innovative technology. Remember that manufacturing (like the evolution of agriculture) requires a shrinking percentage of the workforce to produce the same output. There are gainers and losers as we evolve, but the overall international impact is positive. This is especially true when we take a longer view of economic development over decades or even centuries.

The road to the future is never smooth: it is littered with booms, busts, surprises, disappointments and failures. We should adapt, looking for the opportunities and encouraging our fellow citizens, through thoughtful policy implementation. It is foolish to be myopic, swinging between euphoria and despair. The Main Stream Media, with its frantic 24 hour news cycle, encourages this manic depressive view of domestic and international problems. More prudent policy formation understands economic history, long term technological trends, plans ahead, and takes thoughtful contingent policy positions that address the underlying causes (and not symptoms) of our problems.

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