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Complacency is Really Dangerous: Three Great Economic Crises

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The conventional discussion of the international financial crisis that erupted in the summer of 2007 is that few professional economists saw it coming, nor anticipated its ferocity in devastating the US and European economies and financial systems, leading to civil unrest and fears of greater violence in the EU.

Why weren't the authorities and public warned before mid-2007? At the time, a tiny number of vocal Cassandras who delivered warnings in the media were roundly ridiculed. Now these prophets are lauded in the media. What is not widely appreciated is that there were far more professionals who gave private warnings to the large financial institutions, government regulators and central banks. These people tender their analysis in private because professional analyses of dangerous economic risks are subtle, and potentially incendiary in the hands of political populists, irresponsible media pundits and corrupt vested interests. The last thing any prudent professional would wish is to precipitate a panic. It is a tragedy that many of those who gave private warnings, were ignored, ridiculed, or in some cases, lost their jobs for challenging the financial and economic conventional wisdom. It may have been conventional, but it was far from wisdom.

Because the economic crisis is continuing and imposing large costs on Western societies, it is crucial to listen again to the Cassandras. More importantly, there is not one, but three separate crises - International Private Debt, International Productivity and Income Distribution, and Western Fiscal Policy. These three crises appear to be quite separate in origin and have been brewing for decades, but the economic stresses they impose have interacted, greatly increasing their impact.

The consequences of these crises for the Australian economy could be severe. Although many in the Australian establishment have boasted that Australia is relatively immune: it is a "Lucky Country", and has avoided the crises through wise policy, this is at best a partial truth. Professionals within and outside Australia have been warning for years that the country is not immune: downside risks have been increasing. Complacency is really dangerous.

1.The International Private Debt Crisis

The debt crisis first appeared in public in the US housing market in mid-2007. It crossed the Atlantic and played havoc with international banks and other institutions that held the defaulting mortgages. Financially stressed institutions became only too aware that similar risky practices were common in other countries: Ireland, Portugal, Iceland, Spain and the UK.

Although the crisis burst into view in mid-2007, its roots were only too apparent to shrewd risk management professionals by 2003. As the international housing boom took flight, ultimately plateauing in 2006, and declining in the first half of 2007, financial blog sites in the US were ringing alarm bells, and some astute bank regulators in the US were earlier battling to expose risky and crooked lending practices. Bank exposures to mortgage losses were only too obvious to the professional risk manager, especially when probing questions were asked about the fragility of credit securitization systems, credit insurance and counterparty risk.

Through 2007-2009, financial losses mounted and large numbers of large and small banks failed in the US and the EU. Many governments panicked. Bullied, black-mailed or bribed into subsidizing imprudent lending by large banks, Western political establishments prayed that these subsidies would buy time to sort out the mess that the complacent political, bureaucratic and financial establishment had created.

The roots of the Credit crisis are simple (although the details are subtle and complex). Bankers have not found new ways to lose money. The rapidly expanding securitization of credit created perverse incentives for mortgage originators and securitizers to over-expand the construction of houses, consumer credit, car loans, and so on. Mortgage originators were rewarded for generating loan volume with little regard to default risk. Banks who packaged mortgages sold the risky mortgage packages to unsophisticated investors who realized too late where the risks were buried. The inevitable day of reckoning came when the absurd housing bubble burst. The US and other governments played a key role in providing taxation and other incentives to induce poorer citizens to make capital gains on real estate. Alan Greenspan chairman of the US Federal Reserve Board, Presidents Clinton, Bush and others in Washington peddled the story that real estate wealth gains were a money machine for the poor. This was a foolish fable: the end result has been to increase poverty – a classic example in public policy of the Law of Unintended Consequences.

Contrary to what is reported in the popular media, there were commercial banks, large and small, in the US and elsewhere, that saw the mounting risks, and avoided most of the consequences. These banks had a strong culture of professional and effective risk management embedded in their organizations. Successful bankers require high intellect; serious mathematical and statistical skills; a deep appreciation of history and politics; and shrewdness in evaluating social and economic risks. Sadly, in far too many cases, not only did financial leadership fail, but also the governance, organizational structure and culture of major financial institutions were found to be wanting. Too many Financial Masters of the Universe, who had mediocre banking and risk management skills - and wildly inflated egos - failed spectacularly. Some others, who survived either through good fortune or government bailouts, have deluded themselves that they are far cleverer than evidence indicates. Thankfully, good bankers who survived, understood the risks, were prudent, and are well aware that there are still substantial downside risks.

2. The International Productivity and Income Distribution Crisis

Since the mid 1980's, economists who study productivity growth and income distribution have puzzled over the decline in the growth of productivity and the stagnation in median male incomes in the US and other Western economies. Various explanations have been proposed: the increased participation of women in the work force leading to downward pressure on male incomes; increased use of computerization reducing labour demand for manufacturing, clerical and other jobs; off-shore manufacturing, and so on. Recently, Robert Gordon of Northwestern University has proposed a more worrying cause. He argues that, historically, technical innovations have come in waves that have created rapid increases in productivity, before growth died away, leaving productivity at a higher plateau. The first great wave was the introduction of steam power in manufacturing and transport in the mid to late 19th century. The second wave began in the late 19th century and continued into the first half of the 20th century. It was a sequence of major innovations: electricity, telephone, radio, the internal combustion engine, aircraft, municipal water works and sanitation, and greatly improved medical techniques. The second wave's main impact had played out by the mid 1970's. The third wave was the computer revolution that began in the 1960's, but (according to Gordon) had largely run out of steam in terms of productivity growth by the late 1990's.

Secondly, economists have been disturbed by a major increase in income and wealth inequality in the Western World. (The same phenomenon has been observed in China, India, Russia and other rapidly developing countries.) The media and politicians have seized on this topic labeling it as the 1 per cent versus the 99 per cent. More detailed analysis suggests that increases in income inequality are due to increased profitability for innovators associated with new technology; the explosion in the size of the finance industry; and more disturbingly the rise of corruption and rent-seeking as wealthy entrepreneurs lobby governments to reduce competition, impeding new entrants from eroding monopoly and oligopoly profits. This increase in rent-seeking has been accurately labeled as Crony Capitalism. Assuming that there are policy measures to remove regulatory barriers to entry, removal of implicit subsidies to large financial institutions, and increased competition, incomes of bankers and monopolists should return to lower and more normal historical levels.

Whether slower productivity growth, and more extreme income and wealth inequality is a passing phase, is hard to predict. Innovations and the development of new ideas cannot be taken for granted. If innovation slows for a few decades, implying an extended period of slow growth in real incomes per capita, it will have serious consequences for pension planning, redistribution policies, and ultimately long run budgetary policy.

3. The Crisis in Western Fiscal Policy

The first two crises have important implications for fiscal policy. The decline in productivity growth had been apparent for many years, and had been discussed by policy analysts, particularly those analyzing the viability of pension and health care systems. Because the problem had been perceived as a long run issue, the media and political establishment treated it as either an aberration or a problem for a future government and largely ignored it. By reducing taxation revenues and increasing expenditures on social and fiscal stimulus packages, the Credit Crisis and the resulting recession, simply exacerbated underlying fiscal problems.

Far from being a new problem, demographics and other projections had long indicated that gradual reforms and adjustments were preferable to last minute panic reactions to a long-run, slowly escalating problem. Sadly, the long run is now here.

Is Australia Different?

Australian claims that it is different from other Western economies. In particular the official line has claimed that Australia will continue to grow strongly, powered by Chinese commodity exports, exploiting Australia's (apparent) proximity to Asia and, that through judicious fiscal policy and prudential financial regulation, Australia avoided the horrors of the Credit Crisis observed in the US and EU. Both arguments are highly dubious.

Australia has experienced a sequence of historical commodity cycles over its history. The current episode is running true to form. Given a sharp increase in international demand, commodity prices will rise above long run marginal costs of production. This leads to short run excess profits and attracts an expansion of supply from domestic and international suppliers. As international supply catches up with demand and/or demand falls, prices fall, imprudent suppliers fail, and lenders suffer losses. The downside risks are only too obvious to anyone who knows economic and financial history - and risk management. Observing commodity markets over 2012, the downside risks have begun to materialize. The 'Going to Infinity with China' fantasy is looking increasingly foolish.

Australia benefited greatly from the Chinese government's fiscal expansion in 2008. Over 2007 and 2008, China suffered a major fall in manufactured exports to the West. China responded with a massive infrastructure-building program that sharply increased demand for iron ore, coal and other commodities. Australia, Canada, Brazil and other commodity exporters were beneficiaries. Shrewd international observers queried the longevity of this boom. Due to internal stresses, China is attempting to change the direction of its economy, reducing infrastructure construction. Expanded capacity by international commodity suppliers is depressing prices. Both factors increase downside risks for Australian commodity export revenues. Just to add to producer woes, government regulations and taxes are increasing costs of production.

The Australian government panicked in October 2008, with a poorly planned and executed fiscal expansion. This increase in domestic demand was compounded by a sharp expansion in the mining industry. The resulting boom created distortions and dangerous future downside risks. The mining industry risks are now obvious. But international observers have long been critical of the country's real estate bubble, the dangers of high private debt levels, credit exposures, and the scale of foreign borrowing by the domestic banking system. Australian officials have dismissed these concerns. Recently, official nervousness has become evident as the risks have become more obvious to the complacent Australian establishment.

Basic economic logic and market forces that operate overseas are not suspended at Australian immigration barriers. Australian nationalists and fantasists would like Australia to be “Different”, a “Lucky Country” where economic water flows up hill. But sooner or later, these forces will retaliate with painful consequences. Keith Hancock remarked in his *Australia* (1930) ‘… the crisis, when it comes, is likely to be prolonged and severe. The wretched Government has so many scraggy chickens, and when they come home to roost they will seem to come at the same time.’