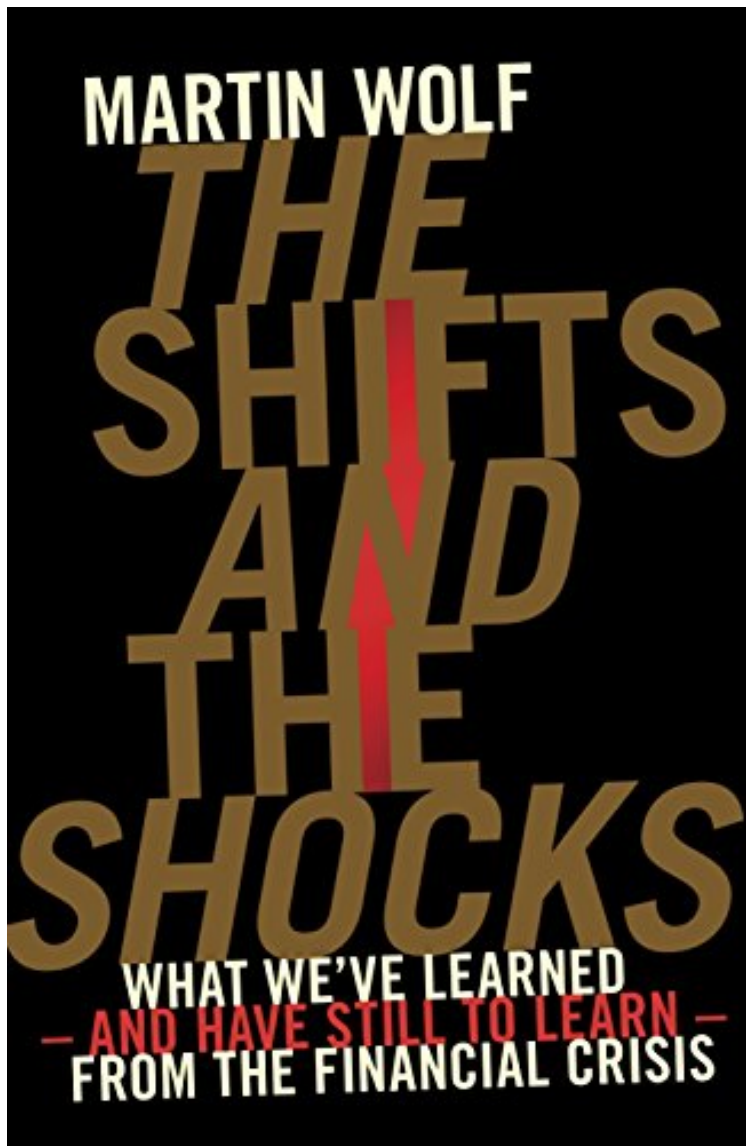


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# The Shifts and the Shocks: What weve learned and have still to learn from the financial crisis



*Par Martin Wolf*

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## Description :

Prsentation de l'diteurIn The Shifts and the Shocks, Martin Wolf - one of the world's most influential economic commentators and author of Why Globalization Works - presents his controversial and highly original analysis of the economic course of the last seven yearsThere have been many books that have sought to explain the causes and courses of the financial and economic crisis which began in 2007-8. The Shifts and the Shocks is not another detailed history of the crisis, but the most persuasive and complete account yet published of what the crisis should teach us us about modern economies and economics.The

book identifies the origin of the crisis in the complex interaction between globalization, hugely destabilizing global imbalances and our dangerously fragile financial system. In the eurozone, these sources of instability were multiplied by the tragically defective architecture of the monetary union. It also shows how much of the orthodoxy that shaped monetary and financial policy before the crisis occurred was complacent and wrong. In doing so, it mercilessly reveals the failures of the financial, political and intellectual elites who ran the system. The book also examines what has been done to reform the financial and monetary systems since the worst of the crisis passed. 'Are we now on a sustainable course?' Wolf asks. 'The answer is no.' He explains with great clarity why 'further crises seem certain' and why the management of the eurozone in particular 'guarantees a huge political crisis at some point in the future.' Wolf provides far more ambitious and comprehensive plans for reform than any currently being implemented. Written with all the intellectual command and trenchant judgement that have made Martin Wolf one of the world's most influential economic commentators, *The Shifts and the Shocks* matches impressive analysis with no-holds-barred criticism and persuasive prescription for a more stable future. It is a book no-one with an interest in global affairs will want to neglect.

MARTIN WOLF is Associate Editor and Chief Economics Commentator at the Financial Times, London. He is the recipient of many awards for financial journalism, for which he was also made a CBE in 2000. His previous books include *Why Globalization Works* and *Fixing Global Finance*.

The financial and economic crises of the Western world became visible in the summer of 2007 and reached their apogee in the autumn of 2008. The response was an unprecedented government-led rescue operation. That, in turn, triggered an economic turn-around in the course of 2009. But the recovery of the high-income countries was, in general, disappointing: output remained depressed, unemployment stayed elevated, fiscal deficits remained high, and monetary policy seemed, by conventional measures, unprecedentedly loose. This is beginning to look like a Western version of Japan's prolonged post-bubble malaise. One reason for persistent disappointment is that the Western crisis became, from 2010 onwards, also a deep crisis of the Eurozone. Crisis dynamics engulfed Greece, Ireland, Portugal, Spain and even Italy. All these countries were pushed into deep recessions, if not depressions. The price of credit remained high for a long time. By early 2013, the sense of crisis had abated. But chronic economic malaise continued, with no certainty of a strong recovery or even of enduring stability. Meanwhile, emerging economies, in general, thrived. The worst hit among them were the countries of Central and Eastern Europe, many of which had run huge current-account deficits before the crisis. Like the members of the Eurozone in Southern Europe, these were then devastated by a series of sudden stops in capital inflows. Other emerging and developing countries proved far more resilient. This was the result of a big improvement in policy over the previous decades. Particularly important was the move towards stronger external positions, including a massive accumulation of foreign-exchange reserves, particularly by Asian emerging countries, notably including China. This gave them the room to expand domestic demand and so return swiftly to prosperity, despite the crisis. Those emerging and developing countries that could not expand demand themselves were often able to piggyback on the stimuli of others, particularly China. That was particularly true of the commodity exporters. This represents an important and probably enduring shift in the world economy: the old core is becoming more peripheral. But the sustainability of the expansionary policies adopted by emerging economies, and so their ability to thrive while high-income countries continue to be weak, is in doubt. Particularly important is the risk of a sharp slowdown in the Chinese economy and the likely associated weakness of commodity prices.

1 From Crisis to Austerity The central problem of depression-prevention [has] been solved, for all practical purposes, and has in fact been solved for many decades. Robert E. Lucas, 2003

1 When I became Treasury secretary in July 2006, financial crises weren't new to me, nor were the failures of major financial institutions. I had witnessed serious market disturbances and the collapses or near collapses of Continental Illinois Bank, Drexel Burnham Lambert, and Salomon Brothers, among others. With the exception of the savings and loan debacle, these disruptions generally focused on a single organization, such as the hedge fund Long-Term Capital Management in 1998. The crisis that began in 2007 was far more severe, and the risks to the economy and the American people much greater. Between March and September 2008, eight major US financial institutions failed: Bear Stearns, IndyMac, Fannie Mae, Freddie Mac, Lehman Brothers, AIG, Washington Mutual, and Wachovia; six of them in September alone. And the damage was not limited to the US. More than 20 European banks, across 10 countries, were rescued from July 2007 through February 2009. This, the most wrenching financial crisis since the Great Depression, caused a terrible recession in the US and severe harm around the world. Yet it could have been so much worse. Had it not been for unprecedented interventions by the US and other governments, many more financial institutions

would have gone under and the economic damage would have been far greater and longer lasting. Hank Paulson, *On the Brink* (2010)<sup>2</sup> Hank Paulson is a controversial figure. For many Americans, he is the man who bailed out Wall Street too generously. For others, he is the man who failed to bail out Wall Street generously enough. In his thought-provoking book, *Capitalism 4.0*, the British journalist Anatole Kaletsky blames him for the disaster, writing that the domino-style failure of US financial institutions that autumn [of 2008] was not due to any worsening of economic conditions it was simply a consequence of the US Treasury's unpredictable and reckless handling first of Fannie and Freddie, then of Lehman, and finally of AIG.<sup>3</sup> Whatever we may think of Mr Paulson's culpability, we cannot deny his outline of what actually happened in 2007 and 2008. In this chapter, I will not attempt a detailed account of how the crisis that hit the core high-income countries in those years unfolded. That has been done in other publications.<sup>4</sup> My aim here is rather to demonstrate its scale, the extraordinary policy response and the economic aftermath. I will postpone detailed discussion of the economic and financial origins of the crisis to Part II of the book and analysis of the very different impact upon emerging and developing countries to Chapter Four. By focusing on the high-income countries, I want to show that this was no ordinary economic event. To pretend that one can return to the intellectual and policymaking status quo ante is profoundly mistaken.

### THE SCALE OF THE CRISIS

The world economy of the 2000s showed four widely noticed and, as we shall see, closely related characteristics: huge balance-of-payments imbalances; a surge in house prices and house building in a number of high-income countries, notably including the US; rapid growth in the scale and profitability of a liberalized financial sector; and soaring private debt in a number of high-income countries, notably the US, but also the UK and Spain. Many observers doubted whether this combination could continue indefinitely. The questions were: when would it end, and would it do so smoothly, bumpily or disastrously? The answers, it turned out, were: in 2007 and 2008, and disastrously. Already in March 2008, I assessed the unfolding crisis as follows: What makes this crisis so significant? It tests the most evolved financial system we have. It emanates from the core of the world's most advanced financial system and from transactions entered into by the most sophisticated financial institutions, which use the cleverest tools of securitisation and rely on the most sophisticated risk management. Even so, the financial system blew up: both the commercial paper and inter-bank markets froze for months; the securitized paper turned out to be radioactive and the ratings proffered by ratings agencies to be fantasy; central banks had to pump in vast quantities of liquidity; and the panic-stricken Federal Reserve was forced to make unprecedented cuts in interest rates.<sup>5</sup> Far worse was to follow in the course of 2008. This crisis had become visible to many observers on 9 August 2007, when the European Central Bank injected 94.8bn into the markets, partly in response to an announcement from BNP Paribas that it could no longer give investors in three of its investment funds their money back.<sup>6</sup> This event made it clear that the crisis would not be restricted to the US: in the globalized financial system, toxic paper marketed debt of doubtful value had been distributed widely across borders. Worse, contrary to what proponents of the new market-based financial system had long and, alas, all too persuasively argued, risk had been distributed not to those best able to bear it, but to those least able to understand it.<sup>7</sup> Examples turned out to include IKB, an ill-managed German Landesbank, and no fewer than eight Norwegian municipalities.<sup>8</sup> These plucked chickens duly panicked when it became clear what, in their folly, they had been persuaded to buy. On 13 September 2007, Northern Rock, a specialized UK mortgage-lender, which had been offering home loans of up to 125 per cent of the value of property and 60 per cent of whose total lending was financed by short-term borrowing, suffered the first large depositor run on a British bank since the nineteenth century.<sup>9</sup> Ultimately, the Labour government nationalized Northern Rock paradoxically, very much contrary to the company's wishes. Reliance on short-term loans from financial markets, rather than deposits, for funding of long-term illiquid assets had, it soon turned out, become widespread. This was also a dangerous source of vulnerability, since explicit and implicit insurance had made deposits relatively less likely to run than market-based finance. That lesson proved of particular importance for the US, because of the scale of market-based lending in the funding of mortgages. As managing director of the huge California-based fund manager PIMCO (the Pacific Investment Management Company), Paul McCulley in 2007 labelled this the Shadow Banking System when he spoke in Jackson Hole, Wyoming, at the annual economic symposium of the Federal Reserve Bank of Kansas City. The label stuck.<sup>10</sup> Both these lessons the widespread distribution of opaque securitized assets (the bundling of debts into marketable securities) and the reliance of so many intermediaries on funding from wholesale markets turned out to have great relevance as the crisis worsened in 2008. Then, on 16 March 2008, the *Financial Times* reported: JP Morgan Buys Bear Stearns for \$2 a Share.<sup>11</sup> The Federal Reserve provided backup funding of \$30bn for this operation,

taking some of the credit risk in the process. Just a year before that calamity the Financial Times had reported: Bear Stearns yesterday became the latest Wall Street bank to report strong earnings and insist that it does not see much lasting impact from the crisis in the subprime mortgage market.<sup>12</sup> It would say that, wouldn't it? But the likelihood is that its management, along with almost everybody else, did not imagine the horrors to come. They were probably more fools than knaves. The rescue prompted me to write in the Financial Times of 25 March 2008: Remember Friday March 14 2008: it was the day the dream of global free-market capitalism died. For three decades we have moved towards market-driven financial systems. By its decision to rescue Bear Stearns, the Federal Reserve, the institution responsible for monetary policy in the US, chief protagonist of free-market capitalism, declared this era over. It showed in deeds its agreement with the remark by Joseph Ackermann, chief executive of Deutsche Bank, that I no longer believe in the markets self-healing power. Deregulation has reached its limits.<sup>13</sup> The US government took the two government-sponsored enterprises, Fannie Mae and Freddie Mac, which then guaranteed three-quarters of US mortgages, into conservatorship on 7 September. This proved what investors (and critics) had long believed, namely, that the US government stood behind the vast borrowings of these allegedly private companies (\$5,400bn in outstanding liabilities at the time of the rescue).<sup>14</sup> Yet it then, controversially, allowed (or felt obliged to allow) Lehman Brothers to go bankrupt on 15 September.<sup>15</sup> Merrill Lynch was sold to Bank of America for \$50bn, or \$29 a share, on the same day a big premium above its share price of \$17, but a reduction of 61 per cent on its share price of \$75 a year before and 70 per cent from its pre-crisis peak.<sup>16</sup> Then, promptly after refusing to rescue Lehman, the US government saved the insurance giant, AIG, taking a 79.9 per cent equity stake and lending it \$85bn on 16 September.<sup>17</sup> In his book, Mr Paulson argues that the decisions were not inconsistent, because, Unlike with Lehman, the Fed felt it could make a loan to help AIG because we were dealing with a liquidity, not a capital, problem.<sup>18</sup> If the Fed really believed that, it was soon proved wrong. A more likely reason is that Mr Paulson believed (wrongly, as it turned out) that the markets would take Lehman's failure in their stride, but was sure the same would not be true for AIG, given its role as a seller of credit default swaps insurance contracts on bonds, including the securitized assets that had become increasingly toxic. Then, on 17 September, one of the money-market funds managed by Reserve Management Corporation (a manager of mutual funds) broke the buck that is, could no longer promise to redeem money invested in the fund at par (or dollar for dollar) because of its exposure to loss-making loans to Lehman. That threatened a tsunami of redemptions from the \$3.5tn invested in money-market funds, a crucial element in funding McCulleys Shadow Banking System.<sup>19</sup> PriceWaterhouseCoopers, the UK's bankruptcy administrator for Lehman, seized the failed company's assets in the UK, including the collateral of those who traded with it.<sup>20</sup> This came as a shock to many hedge funds and US policymakers. The fact that bankruptcy regimes were different in different countries obvious, one would have thought turned out to be a significant problem in dealing with the aftermath of Lehman's failure. As Mervyn (later Lord) King, governor of the Bank of England, famously quipped: banks were international in life, but national in death.<sup>21</sup> Funding for Morgan Stanley and Goldman Sachs, the two surviving broker-dealers, dried up.<sup>22</sup> On 21 September these two institutions turned themselves into bank holding companies, a change that gave them access to funds from the Federal Reserve.<sup>23</sup> On 25 September the Federal Deposit Insurance Corporation took over Washington Mutual, the sixth largest bank in the US.<sup>24</sup> Not long afterwards, on 9 October, Wells Fargo, the country's fifth largest commercial bank, agreed to a takeover of Wachovia, the country's fourth largest.<sup>25</sup> The mayhem was not restricted to the US. On the weekend before the Lehman bankruptcy, the UK government refused to support the takeover mooted by Barclays. As Alistair Darling, then chancellor of the exchequer, claims in his memoir, we could not stand behind a US bank that was clearly in trouble. Why, indeed, should the UK government provide guarantees that the US government had rejected? Moreover, he adds, I was determined that UK taxpayers would not end up having to bail out a US bank.<sup>26</sup> On 17 September, with government encouragement, Lloyds TSB announced a 12.2bn takeover of Halifax Bank of Scotland (HBOS). The government argued that the public interest justified clearing the deal, despite concerns over its adverse impact on competition, in order to ensure the stability of the UK financial system.<sup>27</sup> On 29 September the government decided to nationalize Bradford Bingley, the biggest lender in the UK's buy-to-let market, while its branch network was subsequently sold to Santander.<sup>28</sup> Worse, it was becoming obvious that HBOS was too bad a bank for Lloyds to support unaided. Furthermore, the Royal Bank of Scotland (RBS), which had become the biggest bank in the world by assets, partly as a result of ill-considered takeovers, notably of ABN-Amro, was also in terrible trouble. The crisis went far beyond the US and the UK, affecting Iceland, Ireland and much of continental Europe. As the panic worsened, credit

markets froze and assets were dumped, causing a vicious spiral of shrinking availability of credit to speculators and so further forced sales.<sup>29</sup> The economic consequences turned out to be less severe than those of the Great Depression of the 1930s, but the financial crisis was even worse. The earlier crisis brought down banks on the periphery of the world economy (a huge number of smaller US banks and banks in vulnerable European countries, such as Austria and Germany) more than those at the core. The more recent crisis, however, tore apart the heart of the financial system: the networks connecting the big financial institutions that dominate activity in the world's two most important financial centres, New York and London. The private sector also ceased to trust almost all counterparties other than the governments and central banks of the most important and most unimpeachably creditworthy Western economies, first and foremost the US.

Revue de presse Felix Salmon, *The New York Times Book*: Martin Wolf is as grand and important as an economic journalist can ever become.... *The Shifts and the Shocks* is extremely good at untangling the causes of the global financial crisis. Joseph Stiglitz, *Financial Times*: Martin Wolf has outdone himself. The FT's chief economics commentator has written a book that not only explains the malaise in which we have been mired since 2008 but also depressingly provides a convincing analysis of why we are likely to remain so. Already, the crisis has spawned a plethora of titles examining what went wrong. *The Shifts and the Shocks* is among the first to address the absence of a robust recovery and it sets a high bar for those that will surely follow. One of the things that distinguishes Wolf's analysis from so many others is that he sees the crisis as more than a financial crisis: an insight that is essential if we are to understand the failure to achieve a robust recovery. Wolf may have written the book to shake us out of our stupor.

Paul Krugman, *The New York Times Book*: Extended, learned, and well-informed. Since the new sort-of consensus is clearly much more realistic than the pre-crisis complacency, Wolf, the chief economics commentator of the *Financial Times*, has performed a very useful service by putting it all together in one readable book. Wolf argues rightly that a fuller picture requires paying attention to the wider world. *The Shifts and the Shocks* is an excellent survey of how we arrived at the mess we're in, and Wolf's substantive proposals at the end, especially for reform of the euro system: system-wide deposit insurance, higher inflation so that the burden of adjustment is better shared, among other reforms: are all worthy and laudable. But the gods themselves contend in vain against stupidity. What are the odds that financial reformers can do better?"

*The Economist*: *The Shifts and the Shocks* is a fierce indictment of the global economy and a call for radical reform. Mr. Wolf's contribution is comprehensiveness and a piercing logic in piecing the disparate elements together. He weaves the macroeconomic and financial elements of the crisis, its origins and aftermath, into an all-encompassing analysis. Along the way he demolishes many of the popular explanations: such as that the mess was due to greedy bankers or to loose monetary policy: as too simplistic. The result is convincing and depressing; there are no quick fixes. An important contribution that anyone involved in economic policy ought to read.

Andrew Ross Sorkin, *The New York Times*: A surprisingly refreshing look at the biggest financial calamity since the Great Depression. Just when you thought everything that could be said about the crisis had been said, Mr. Wolf adds something new. Wolf deftly weaves together the components of the crisis, examining it from 10,000 feet up: globalization, monetary policy, banking architecture.

Robert Lenzner, *Forbes*: [A] worthy and wise new book. A primer on the interaction between global macroeconomic forces and what Wolf dares to call an increasingly fragile, liberalized financial system. And it never goes off the rational, pragmatic track toward order, fragile or not.

Irish Examiner (UK): Profound, disturbing and prophetic [Wolf's] analysis is rigorous and deals fairly with opposing points of view. As a result, the proposals he presents for future action merit very close consideration.

FiveThirtyEight.com: Unsettling to anyone who thinks the financial system is any more stable now. Wolf has, once again, written an erudite, brilliant and data-heavy book on global macroeconomics.

Ben Bernanke: Building on his earlier book, *Fixing Global Finance*, in *The Shifts and the Shocks* Martin Wolf provides an insightful and timely analysis of how global imbalances, international capital flows, and economic policies have helped create a financially fragile world.

Lawrence Summers: Martin Wolf is unsurpassed in the world of economic journalists. His superb book may be the best of all those spawned by the Great Recession. It is analytical and rigorous and without ever succumbing to fatalism or complacency. It should be read by anyone concerned with macroeconomic or financial policy going forward.

George Soros: In this important book, Martin Wolf demonstrates that the Eurozone crisis was due to the interaction between powerful global economic and financial forces and the inadequacies of its economic and political structure. He also demonstrates that the Eurozone has not eliminated these weaknesses. The crisis is not yet over.

Mervyn King: A masterly account of the financial crisis seen in its true international perspective.

Adair Turner: The 2008 financial crisis was an economic

disaster, but as Martin Wolf brilliantly argues the policy response has failed to address the fundamental drivers of instability: excessive debt creation, global imbalances and inequality. To think straight about causes and solutions we must reject orthodox assumptions that more finance and global financial integration are limitlessly beneficial. *The Shifts and the Shocks* does just that, providing an intellectually sparkling and vital account of why the crisis occurred, and of the radical reforms needed if we are to avoid a future repeat.

Paul Tucker, Senior Fellow, Harvard University: Martin Wolf has ranged more widely than perhaps any other author in trying to make sense of the global financial crisis and how to avoid its recurrence. Macroeconomics, finance, ideas, institutions, policy, politics; Europe, Asia, the US they are all here. Whether or not one agrees with Wolf's analysis and prescriptions, this book will help everyone work out what they think. A must read.

Anat Admati, Stanford University; co-author of *The Bankers New Clothes: Whats Wrong with Banking and What to Do About It*: In this powerful and important book, Martin Wolf exposes the forces that shaped our fragile financial system and brought harm to so many, with particular attention to the crisis in Europe. His insights and urgent call to prevent more harm must be heard.

William H. Janeway, Warburg Pincus; University of Cambridge: "Martin Wolf has been the world's leading commentator on the Global Financial Crisis and its economic consequences: now in *The Shifts and the Shocks* he demonstrates with compelling force that the essential response to financial fragility is to make banks boring: lots more capital, much lower prospective returns."