Amol Agrawal
amol@stcipd.com
+91-22-66202234

Economists Debate: What were the causes of the 2007 crisis?

The Global Financial Crisis 2007-09 (GFC) has questioned the role of economists and prevalent economic thinking. The scale of the crisis even prompted the Queen of England to ask how economists missed seeing the crisis.

Meanwhile, economists have been debating various aspects of the crisis. The initial war of words was limited to crisis related economics but has now shifted to larger issues of designing financial regulation, role of central banks and government, international monetary system etc. This is a very important phase in the field of economics. A consensus here will lead to shaping economic policies in the future. As debates are still unraveling, it is unlikely to be an exhaustive list of the issues and debates are expected to continue in many areas.

In this paper, we explore the debate on the causes of the crisis. Drawing from medical field analogy, unless we diagnose the reasons for the disease, we cannot really treat the patient. More importantly without knowing proper causes, one cannot ensure precautions are taken to prevent such a disease in future.

This paper is a continuation of series of papers we have been releasing to explain the fallout of the crisis. The earlier papers have looked at what are the policies in a liquidity trap situation **(US in Liquidity Trap - What are the Options?, Oct-10)),** how central banks would balance monetary and macroprudential policies **(Macroprudential Policy and Central Banking, Nov-10),** how central bank independence is being questioned **(Central Bank Independence - A major victim of the 2007 crisis, Dec-10).**

There are quite a few causes of the crisis listed by various economists and policymakers. We will go through the main causes and the debates/research associated with each of them.

I. Easy Monetary Policy

John Taylor of Stanford University has been the leading proponent of this theory. In a 2007 paper (Housing and Monetary Policy), Taylor blamed the crisis on lose monetary policies by Fed post 2001 recession. For his analysis, Taylor uses his famous "Taylor Rule" which shows how much the policy interest rates should be given the inflation and output gap.

Taylor rule came across as a very simple and powerful tool as it showed the impact of US monetary policy on the economy over the years. When the policy rates were closer to Taylor rule, the economy worked efficiently with moderate inflation. This was the phase in 1980s and 1990s. The opposite was true as well as US economy saw in 1970s. This showed the power of the rule which soon became the standard tool for monetary economists.

In the 2007 paper, Taylor showed that policy rates should have been higher than what they actually were. For instance, as per Taylor rule the Fed funds rate should have been 4% in 2004 but it was just 1%. This led to lower real interest rates with investors searching for higher yields which were eventually found in housing finance markets. In another paper, OECD economists (Monetary Policy, Market Excesses and Financial Turmoil, 2008) showed most central banks in other advanced

economies also followed easy policies leading to bubbles in other economies as well. Further, Taylor himself estimated that ECB policy rates were around 2% lower in the pre-crisis period.

Some policymakers/economists like Donald Kohn pointed to limitations of Taylor rule even before the crisis. The criticisms were:

- Calculation of output/inflation gaps was very difficult
- There are various indicators for inflation with each showing different results in Taylor rule.
- Taylor rule uses just two variables whereas economy is much more complex.
- Certain economic events require discretion of the policymaker and simple rules do not help in such cases.
- There have been many variants of Taylor rule since the original one was developed in 1993. This leads to confusion on which one is to more effective for policymakers.

The same points were raised by Fed chief Bernanke in defending the role of Federal Reserve in the crisis. In a speech in 2010 (Monetary Policy and the Housing Bubble), Bernanke also added following points to above criticism:

- As monetary policy works with a lag one should use forecasts as values for output and GDP instead of current values. Once we include forecast values, Taylor rule shows fed funds rates closer to the actual rates. Hence there was limited deviation and not as large as shown by Taylor.
- The speech also showed that based on another version of the Taylor rule would have called for very high interest rates in the first few months of 2008. This was the time when the crisis was intensifying and Fed was actually cutting interest rates.
- He pointed to research by Federal Reserve economists (Monetary Policy and the Housing Bubble, 2009) which showed higher monetary policy tightening would have led to a marginal hike in interest rates and would have not kept people away from the housing sector. Hence, the housing bubble would have happened anyways.

  Further, research by IMF (Lessons for Monetary Policy from Asset Price Fluctuations, World Economic Outlook, October 2009 Chapter 3) showed that international evidence on the link between monetary policy and house price appreciation was weak. For example, 11 of the 20 countries in the sample had both tighter monetary policies, relative to the standard Taylor-rule prescriptions, and greater house price appreciation than the United States.

John Taylor responded to Bernanke criticism in a WSJ article (10 Jan 2010):

- Fed's forecasts of inflation were too low in 2002-05 period. This automatically led to lower policy rates. Economists like Athanasios Orphanides and Volker Wieland showed one should use private sector inflation forecasts instead of Fed's forecasts. If we use private sector inflation forecasts, Taylor rule would have shown higher policy interest rates.
- Taylor disagreed that his rule would show policy rates should have been higher in early 2008. He had shown in his testimony at the House Financial Services Committee in February 2008 that interest rates would not be so high as suggested by Bernanke.
- He points to OECD research (highlighted above) which showed that there is a statistically significant relationship between policy deviations from the Taylor rule and housing booms in other economies.
- He pointed to research by ECB economists (Frank Smets and Marek Jarocinski) who showed that monetary policy has significant effects on housing investment and house prices. The duo

said that easy monetary policy designed to stave off perceived risks of deflation in 2002-04 contributed to the boom in the housing market in 2004 and 2005.

The debate again came to life when Ben Bernanke was questioned in a Senate hearing in Feb 2011. In the hearing Bernanke was asked questions with respect to whether the monetary policy was appropriate as per Taylor rule. Bernanke answered that as per Taylor rule the policy rates should be negative currently. Also there are different versions of Taylor rule and they give different answers. John Taylor responded to the hearing on his blog. He said as per the original Taylor rule (which he prefers), the rates should be around 0.9% implying Fed should be raising policy rates soon. He also criticized Fed for not having a coherent strategy and making monetary policy discretional.

Overall, the initial paper by John Taylor has led to huge debate and research amidst economist. The papers are clearly divided as seen so often in the economics profession as we have explained above. The papers are expected to continue in this space.

In a recent paper, Carmen and Vincent Reinhart said low policy rates cannot be responsible for the 2007 crisis. They say changes in the federal funds rate have no systematic effect on either long-term interest rates or housing prices over nearly a century. Indeed, since the mid-1990s the policy rate had a negative relationship with long-term interest rates.

Other papers have explored whether monetary policy has a risk channel where financial firms build positions based on central bank policy decisions. Raghuram Rajan has been suggesting that low interest rates lead financial firms to take higher risks and rise in moral hazard. In each crisis, the central bank pushes lower interest rates which make firms confident that they would be bailed out. The central bank also maintains these low rates for an extended period leading to again a new round of risk taking.

This risk channel research has become very fertile after the crisis linking central bank interest rate decisions with risks in financial firms. This research should have been very vibrant as monetary transmission is done via the financial system and latter looks closely at central bank decisions. Hence, this should have come across naturally to economists but has not been the case.

II. Global imbalances

This is cited by economists post crisis as one of the central reasons responsible for the global crisis. Though the genesis of the argument goes to Bernanke who made this point in a much quoted and discussed speech (The Global Saving Glut and the U.S. Current Account Deficit) in 2005. Though, Bernanke does not believe this to be a reason for the global crisis. He instead lists several financial sector related issues which led to the crisis in US and global economies.

In global imbalances context, Bernanke said the world economy is divided with some economies like China and oil economies running persistent and large current account surpluses and others like US and UK running current account deficits. China had huge savings and export income which was leading to wide surpluses where as US had huge consumption and almost negligible savings leading to deficits. The surplus savings were in turn invested in US Treasuries leading to a huge demand for USD based assets in particular US Treasuries. This demand for US assets also led to much lower interest rates than desired. He termed this flow of money as global savings glut.

The savings glut situation had both positives and negatives.

- **Positives:** The increased supply of foreign saving boosted U.S. equity values and helped to increase U.S. home values during the more recent period. The low interest rates also helped increase investment levels in US economy. The developing economies that brought their current accounts into surplus did so to reduce their foreign debts, stabilize their currencies, and reduce the risk of financial crisis. The shift of these economies from borrower to lender status provided at least a short-term palliative for some of the problems they faced in the 1990s.

- **Negatives:** Over a long term there are issues. First, developing countries should be using the capital for themselves so that they can grow instead of lending it to industrial countries that already have large quantities of high-quality capital to work with. Second, the foreign savings are mostly getting into construction related activities and promoting homeownership. This is good but for long term productivity, one needs to promote business investment. Third, the foreign flows can reverse in case of a financial shock.

Economists have now picked this theme as one of the reasons for the global crisis. As these imbalances were unsustainable, a correction was waiting to happen. Hence, financial factors could be held responsible for crisis in US. But for it to become a truly global event, these imbalances played a major role. The economies became highly connected to each other and sent shockwaves throughout the world economy. A similar case was seen before Great Depression as well with global economy in similar imbalances (discussed later).

Martin Feldstein, a noted economist from Harvard University had even cited the growing current account deficits and low savings as a trigger for future crisis in US. Though, he did not mention it could be a global crisis as well.

In a recent paper co-written with Fed economists, Bernanke shows that Asian and Middle Eastern oil economies invested their surpluses in very safe and liquid U.S. assets especially Treasury securities. He adds some European economies were running surpluses as well but invested in broader range of U.S. securities including private-label mortgage-backed securities (MBS) as well as other highly rated asset-backed securities. Though, the researchers don't cites this as a reason but one can clearly extrapolate that safer securities led Asians to escape unharmed from the crisis, where as same was not the case for Europe.

Though, John Taylor has criticized global imbalances as the reason for this crisis. He says it was not a global saving glut but a global saving deficiency! The savings rates have been declining in each decade since 1950s. He adds as high current account deficits by US were met by similar surpluses from abroad, there was not likely to be an impact on interest rates. This is simply global accounting.

Other economists like Axel Weber (President of Bundesbank) say global imbalances are nothing but a manifestation of problems in domestic economies. By calling it a global problem domestic policymakers might want to absolve all blame on factors beyond their control.

III. Role of financial firms and financial regulation

This clearly has been the most cited reason by most economists and policymakers. UK policymakers have been very severe on the role of financial firms in this crisis. Though, there is a little background to all this discussion.

Previous to the crisis we had a phase of high growth with low inflation and volatility, nicely termed as Great Moderation. There were hardly any crisis /recessions since 1991 which could shake the world economy. The reasons for crisis in 1990s in Latin America and South East Asia were given as poor institutions and weak economic policies of developing economies. Adair Turner at fourteenth C. D. Deshmukh Memorial Lecture (February 15, 2010) said there are differences between 1997-98 South East Asian crisis and 2007 crisis. In 1997, sudden drying of cross border capital flows played a major role whereas 2007 crisis is because of US and European financial systems. It is rooted in over-exuberant credit extension in developed markets, and in the development of complex and opaque forms of securitised credit and of new and risky forms of maturity transformation.

Then even 2001 crisis was seen as a result of hyped valuations in information technology sector and did not damage the economy much apart from initial shock. The recession was weak and based on revised GDP figures economists say it was not a recession as well.

All these sentiments fueled rise of euphoria over financial markets and light touch regulation. Charles Bean of Bank of England in a speech (25 August 2009) points how this buoyant sentiment along with powerful efficient markets hypothesis pushed regulators into a comfort zone (this is shared by many other policymakers as well). The best comments came from former Fed chief Alan Greenspan. He was seen as a major believer in free markets and allowing financial firms to self-regulate themselves. His philosophy seems to have influenced other policymakers as well leading to a weaker regulatory regime in most economies. In a testimony in 2009, Greenspan said he was shocked to see how his principles have been tested and he needs to review his previous beliefs.

Ben Bernanke in a speech (Causes of the Recent Financial and Economic Crisis, Sep 2010) provides a comprehensive list of financial factors responsible for the crisis:

- ***Dependence on Unstable Short-Term Funding:*** The financial firms in particular investment banks relied on wholesale/repo markets for most of their funding. These funds were then invested in long-term assets like mortgage backed assets, securitized vehicles etc. This typically the objective of a financial firm is to manage this duration mismatch, but in this case liabilities were even of shorter duration and dependent on markets. Unlike banks which depend on deposits which are stickier, here in case of a shock this source of funding would be under stress. This is what happened after Lehman fallout as counterparties refused to roll-out repo borrowings. This caused wide-stress on the whole financial system.

  Unlike a bank run where borrowers run to banks to take out their deposits, we witnessed a repo run. The parties had changed but overall the idea of runs was similar. This then led to drying up of securitized asset markets leading to concerns in asset markets intensifying the whole cycle. It was like a castle of cards which fell as cards collapsed one after the other.

  As discussed above, European investors had large position in US securitized asset markets. As crisis spread, European investors also faced currency mismatches as some European firms guaranteed the liabilities of some US investments. As markets froze, lenders asked European banks to honor their dollar liabilities leading to further stress on dollar markets. This led European central banks to tie with Fed to provide swaplines for Dollar funding.

- ***Low capital and high leverage:*** This is always the central reason for most financial crises. In good times, both banks and real sector increase leverage which then amplifies the impact of the crisis. As value of assets decline but value of debt does not change, higher the initial leverage,

more difficult it is to come out of the crisis. In Japan's crisis, banks and corporate leverage had risen and in US case it was banks and households.

In this crisis apart from high leverage, banks and financial institutions had very low capital. Andrew Haldane of Bank of England in a paper (The Contribution of the Financial Sector - Miracle or Mirage? 2010) has shown how capital levels in both UK and US have been lowest since 1880. Meanwhile assets in UK have risen from around 20% of GDP in 1970 to 500% in 2006. In US the rise in assets has been somewhat lower from 50% in 1970 to 100% of GDP. In other words, on this metric measures of balance sheet leverage rose from around 4-times equity capital in the early part of the previous century to around 20 times capital at the end.

Once markets declined, high leverage and limited repo funding, forced banks to sell assets leading to further lower asset prices. Lower valuation and high losses made raising capital more difficult. The highly interconnected financial firms crashed the whole system.

The work of John Geanakoplos of Yale University in particular has come to limelight. He has been mentioning about leverage cycle and how central it is to a financial system (Solving the Present Crisis and Managing the Leverage Cycle, 2010). In monetary policy we focus on interest rates but value of collaterals or leverage is as important. In good times, one needs very little collateral for credit leading to high leverage. When the cycle reverses, value of collateral rises sharply leading people to default and worse crisis outcomes.

- ***Too Big to Fail:*** The issue of financial firms becoming too big and therefore not being allowed to fail has been highlighted in this crisis, Gary Stern, former President of Minneapolis Fed highlighted this issue early in 2000s but was ignored. As mentioned, at that time Alan Greenspan's ideology was more popular and acceptable.

  This issue creates a moral hazard problem. Firms take more risks as they know they would be bailed out. This moral hazard started increasing once Continental Illinois Bank was bailed out by the US officials in 1987. Then LTCM which was a hedge fund was saved by a coordinated bailout in 2000. These bailouts gave strong messages to the financial industry that risks do not matter. If higher risks results in positive gains it helps the shareholders and if it results in losses, the government would bail them out. This led to rise in leverage and lower capital ratios explained above.

  In this crisis, moral hazard has increased significantly as most TBTF firms were saved barring Lehman Brothers. Richmond Fed economists estimate this expansion of federal safety net. In 1999 federal safety net covered around USD 2.8 trillion of all banking liabilities which is about 45% of total banking liabilities. In 2008, this safety net has increased to almost USD 25 trillion, which is about 59% of total bank liabilities.

  One could understand commercial banks being bailed out as they hold public deposits, but bailing out investment banks has been hugely criticized. John Taylor (and numerous others) have criticized this inconsistent bailing out of financial firms. Others like Lorenzo Bini Smaghi of ECB have questioned why US could not prevent Lehman fallout as it led to a huge global crisis.

  Another strand of literature has pointed how financial sector has overall become a larger component of world economy since World War II. Thomas Phillipon of New York University shows in 1947 the financial sector accounted for 2.32% of U.S. GDP and 2.76% of employee compensation. In 2005, these fractions were 7.69% and 7.65%, respectively. He says around 50%

of the rise could be explained by rise in demand for financial services. Hence, it remains much larger than what would be the desired numbers. Others have added this rise itself shows how finance has grown so fast over the years and needs to be scaled back. It should be an enabler for the real economy and not the leader as it has become in recent years.

These large financial or TBTF firms were both sources and amplifiers of the global crisis. Research has shown how small banks in US have weathered the storm. They have actually lent more to the businesses than the large banks who are just holding on to the capital. Because of their global presence they also sent shock waves to the other regions. Policymakers in other economies are now debating the future of foreign banks in their economies. They are also discussing whether it is beneficial to have them as subsidiary or branch-model. In Latin American economies it was seen that branch model was beneficial as branches relied on local deposits for funding. Subsidiary model was used in East Europe where funding came from parent banks in Europe which faced huge stress for their own funding as markets declined.

Hence, the threats from TBTF have led to a wide debate and discussion amidst economists. Bernanke says one of the most important learnings from the crisis is to solve this growing TBTF issues. Dodd-Frank Bill proposes to make changes alongwith Basel III norms. Basel – III regulations propose to increase the capital levels and impose leverage ratios. Dodd-Frank Bill proposes a resolution regime that allows the government to resolve a distressed, systemically important financial firm in a fashion that avoids disorderly liquidation while imposing losses on creditors and shareholders.

But these proposals are being criticized. Bank of England economists say the capital ratios imposed by Basel-III are too low and give a lot of time (till 2017) to achieve them. Then the proposed resolution regime is being criticized as too discretionary without any proper rules. Identifying TBTF still remains a concern.

- ***Derivatives and Financial Innovation:*** Bernanke does not cite this cause in his speech. Financial engineering was celebrated before the crisis. Derivative volumes were many times over the spot market volumes. After the crisis some economists have called it financial alchemy which was just hiding risks. The various vehicles which held these derivatives were sponsored by banks mostly but were off the balance-sheets. As the crisis started, the losses of these vehicles finally came on to banks balance sheets. These implied losses were much higher than anticipated.

  Another problem was firms were unable to value these derivatives which they created themselves. This led to all kinds of problems of valuation and understanding the scale of losses.

  Role of financial innovation and its value is being seriously criticized. Paul Volcker, venerated former Fed chief has famously remarked that ATM is the only valuable financial innovation. In a stunning paper (Financial Innovation and Financial Fragility, 2010) Andrei Shleifer et al shows much financial innovation is socially and economically harmful. This paper is now being quoted by UK's FSA chief Lord Adair Turner to make a point that financial firms were responsible for the crisis.

  Other economists blame the inadequate risk management for the crisis. The risk managers should have pointed to the inherent risks in these financial products. More importantly, credit rating agencies should not have given these various products AAA rating. The role of these independent viewpoints has come under severe criticism in the crisis.

- ***The role of incentives:*** The above factors have all been present in previous crises as well. In this crisis what stood out was the crucial role of incentives. The financial firms rewarded employees for taking on short-term risks while ignoring the long-term fallouts of the higher risk. The short-term risks were rewarded highly by firms in form of bonuses and salary payouts. This strategy ensured the vicious cycle of high risk and leverage continued.

  Economists have long pondered over the role of skill vs. luck in finance/investment management. Volumes of research has shown that there is very limited skill involved in investment management barring a few exceptional cases like Warren Buffet, Peter Lynch etc. Hence, most executives which show higher returns either have luck on their side or have taken higher risks. Raghuram Rajan in a highly influential paper written in 2005 (Has Financial Development made the World Riskier?) had actually shown this linkage of rising sort-term incentives to rising risk in the financial system. This paper is now widely cited as one of the key researches to have sounded a warning on the financial system.

- ***Financial Regulation and Government:*** Bernanke says the regulators did not do their jobs effectively. There were statutory gaps and conflicts amidst various regulators. US had many regulators and UK just had one (FSA) but both faced severe crisis. Hence, no one model can be blamed. What was clearly missing was the willingness to regulate as regulators believed greatly in efficient markets.

  Simon Johnson of MIT University has vociferously suggested (in his book 13 Bankers) that there is an unprecedented rise in crony financial capitalism in US. There is a mutual understanding between political parties and financial firms where favors are being exchanged. There is a revolving door mechanism between key government officers and Wall Street with one switching careers from government to Wall Street and vice-versa smoothly. This has led to much weaker financial regulation policies and socializing of Wall Street losses. These are very strong words as Johnson was once chief economist of IMF, an institution which believed strongly in unfettered financial markets.

IV. Inequality

Raghuram Rajan in his book Faultlines has added another dimension on the causes of the crisis. Rajan says US economy has been witnessing high inequality since 1990s. Since the 1970's, wages for workers at the 90th percentile of the wage distribution in the US (office managers etc) have grown much faster than wages for the median worker at the 50th percentile (factory workers and office assistants). The most important reason for this rising inequality is technological progress in the US which requires greater skills amidst workforce. A high school diploma was sufficient for office workers 40 years ago, whereas an undergraduate degree is barely sufficient today. But the education system has been unable to provide enough of the labor force with the necessary education.

As any change to address this will require many years. To counter this rising inequality, the political response to rising inequality was to expand credit to low income households It was like the government asking people to literally eat credit. . The banks offered cheap credit and housing loans. It also led to lower standards in loan verification process and lax mortgage policies. This then led to a incentive structure which was a crisis in making.

Rajan says broader implication is that we need to look beyond greedy bankers and spineless regulators (and there were plenty of both) for the root causes of this crisis. And the problems are not

solved with a financial regulatory bill entrusting more powers to those regulators. America needs to tackle inequality at its root, by giving more Americans the ability to compete in the global marketplace. This is much harder than doling out credit, but more effective in the long run.

This approach has been criticized by Daron Acemoglu of MIT and Ed Glaesar of Harvard University at American Economic Association meetings- 2011. Both do not doubt that inequality rose and that poorer people gained access to more credit. But they disagree with Mr Rajan on the link between the two. Economist in an article (The beautiful and the damned, Jan 20, 2011) explains the differences.

Acemoglu argues that the expansion in credit came far too late for Mr Rajan's hypothesis. The subprime boom began around 2000. Yet those at the bottom of the income distribution were getting hammered by technological change in the 1980s. Since then, the least-skilled workers in America have not become still worse-off, largely because they work in service industries which are hard to automate. Inequality has continued to rise because the rich have done even better; it is those in the middle who have fared relatively poorly. Why would the state try to help the poorest at a time when they were doing better than before? Acemoglu thinks the reason was politicians' willingness to deregulate the financial sector, which partly reflected the industry's lobbying prowess.

Glaeser thinks that the role of easy credit in the housing bubble was not as large as Mr Rajan believes. He refers to research by Atif Mian, of the University at California, Berkeley, and Amir Sufi, of the Booth School, which shows that increased mortgage availability pushed up American home prices by only around 4.3%. This was a small fraction of the rise in prices during the boom. Irrational exuberance and a willingness to bet on prices rising for ever were probably much bigger contributors to the bubble than credit expansion.

Rajan has responded to the criticism in his blog. He says housing policies were not really targeted towards 10 percentile of population as mentioned by Acemoglu. It was more towards middle income households who could not afford homes because of rising prices. Hence, the question of inequality remains. On Glaesar he says the key issue was not role of rise in credit supply effect on house prices but on the quality of credit. These standards fell leading to a wide crisis.

Overall, this has led to very different thinking on the causes of the crisis. It looks at a more long term development in US economy which needs to be understood properly. More is going to be heard from economists on the same.

V. Warning Signs Ignored

Going back to Queen of England's question, it is not that all economists missed the crisis. There were some warning signs by a few prominent economists but they were ignored. Though, they agree that the fallout has been much more serious than they had ever imagined but had still highlighted the concerns.

Table 1 summarizes views of a few prominent economists which had warned over impending crisis. What is even more interesting is that they were all key executives at institutions that shape world policies. Their warnings should have been heeded and some policy action should have been taken. Most blame US policymakers for ignoring their warnings but they could have done something in their jurisdictions.

The warnings were not followed up with any concrete policy action. Mervyn King in his speeches has said Bank of England was like a church singing hymns (warnings) and not acting on them. Why

didn't they do anything in their own economies? Why did they choose the policies suggested by Alan Greenspan and US economists? The fallouts of the crisis could have been minimized if these key policymakers had backed their concerns more strongly.

Table 1: Blame Game

Economist/ Policymakers	Institutions	Problem Areas	Blames for ignoring warnings
William White & Claudio Borio	BIS (Key executives)	Nature of Financial Markets, Monetary Policy	US Policymakers/ Alan Greenspan/ Other economists
Kenneth Rogoff	IMF (Chief Economist)	Capital flows	US Policymakers/ Alan Greenspan/ Other economists
Raghuram Rajan	IMF (Chief Economist)	Role of incentives	US Policymakers/ Alan Greenspan/ Other economists
Jean Claude Trichet	ECB President	Under-pricing of risk	Financial Market Participants
Mervyn King	Bank of England Governor	Capital flows	IMF

Source: Speeches/Statements of the noted persons

Concluding Lesson: Never Say "This Time is Different"

The above analysis summarizes the economists' debate on the key causes of the crisis. As shown above the suggestions range from micro financial sector related issues to a more macro, rising income inequality pattern in US economy. Economists are still actively discussing the causes of the Great Depression with new papers and ideas. For instance, it is widely accepted that Federal Reserve created the double dip recession in 1937 by raising its discount rates in 1937. In a recent paper Charles Calomiris et al (Did Doubling Reserve Requirements Cause the Recession of 1937-1938? A Microeconomic Approach, 2011) say banks were anyways maintaining high reserves to balance their asset portfolios and high uncertainty. So the increase in reserves by Fed did not really impact the reserves held by banks. This has interesting implications as it absolves Federal Reserve of its role in Great Depression.

This crisis is just in its fourth year and more causes and ideas would emerge in future.

The most important point which has not been discussed above as it is not really a cause but a lesson from all the previous crises. The lesson is Business Cycle is a key component of economic theory and recessions/crises are a natural phenomenon. However, we just ignore this basic principle and was perhaps most ignored prior to this crisis. Economic history is replete with examples of how economists/policymakers say in each growth period – This Time is Different. They would explain how this era is different from previous growth phases and there will not be a crisis listing all the possible factors for the same. But each time they have to bite their words. Ken Rogoff and Carmen Reinhart have named their book covering eight centuries of financial crisis by the same name which is so apt. The book shows the same story of history repeating itself in each crisis with either same or different players.

Lawrence Summers (former head of US President's National Economic Council) in an interview with Newsweek says *"The four most dangerous words in finance are 'It's different this time."* These words are perhaps a better indicator for upcoming crises than the various indicators pointed by economists in their research projects.

STCI
Primary Dealer Ltd

STCI Primary Dealer Ltd.
A/B1- 801, A Wing, 8th floor, Marathon Innova, Marathon Next Gen Compound,
Off. Ganpatrao Kadam Marg, Lower Parel (w), Mumbai 400013.

Dealing Room: (022) 66202217-20 ● Settlements: (022)66202262-64, Fax (022) 66202288
Delhi Office: (011) 47676555-570 ● Bangalore Office: (080) 22208891
Please mail your feedback to stcipd@stcipd.com ● Website: http://www.stcipd.com

THIS COMMUNICATION IS FOR PRIVATE CIRCULATION ONLY. IT IS BASED UPON THE INFORMATION GENERALLY AVAILABLE TO PUBLIC AND CONSIDERED RELIABLE. THIS REPORT DOES NOT CONSTITUTE AN INVITATION OR OFFER TO SUBSCRIBE FOR OR PURCHASE OR SALE OF ANY SECURITY AND NEITHER THIS DOCUMENT NOR ANYTHING CONTAINED HEREIN SHALL FORM THE BASIS OF ANY CONTRACT OR COMMITMENT WHATSOEVER WITH STCI PRIMARY DEALER