

# **Financial Crisis, Recession and Remedies**

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October 2008 will go down in history as heralding the onset of the most severe economic crisis since the Great Depression began in 1929. The crash in share market values sent shock waves through the global economy and an economic recession now seems inevitable. How deep and how long remain open questions, the answers to which are not independent of our strategic responses. Understanding what has happened and what needs to be done is imperative.

## **ORIGINS**

The warning signs of a likely crash have been evident for more than a year since the emergence of the sub-prime crisis in the United States in 2007. The egregious business practices of a range of financial institutions were the immediate cause of the problem. The financial institutions had been making loans to low income people wishing to buy houses, knowing that they would be committing their customers to rising interest rates and creating a high probability of default. During a period of rising house prices, mortgage payment defaults are not a major problem for the lenders because they acquire increasingly valuable housing assets. However, after the US housing price bubble burst a couple of years ago and prices started to fall, the whole situation changed dramatically. Both borrowers and lenders can become losers in these circumstances.

A devastating transmission process has ensued. The problem of mortgage defaults spread from the financial institutions originally making the loans, because the debts had been repackaged – as collateralised debt obligations – and sold to other institutions. These institutions, spread across many countries and commonly including other banks and local governments, believed the assets to be less risky than proved to be the case, partly because they had been given inappropriate reassurances from the big credit ratings agencies like Moody's and Standard and Poor's.

When the extent of the actual risks was revealed, not surprisingly, financial institutions became less willing to continue holding these mortgage-backed securities (or should we call

them insecurities?). As in any market, when there are lots of sellers but few buyers, prices inevitably fall. So did the stock market values of these financial institutions, now holding securities that were worth less (if not worthless). With the collapse of a number of these major financial institutions, particularly in the US and the UK, a general financial crisis has emerged.

So what originated as a sub-prime crisis of largely US origin became generalised as a global financial crash. Not even government bailouts have been able to restore the level of confidence necessary for failing financial institutions to resume normal trading with each other. Now the contagion is spreading from financial markets to the 'real' economy in which goods and services are produced, leading to the prospect of a severe global recession.

## RESPONSES

This is a deeply troubling situation. As the crisis widens from speculative financial markets to productive capital investment, consumer spending and labour markets, job losses seem a probable consequence. The Australian economy has been relatively buoyant in recent times because of the high value of minerals mined and exported to the rapidly expanding economies in Asia, particularly China. But now even Chinese growth is slowing, and the terms of trade for Australia's commodity exports are becoming less favourable. The federal government's own relatively rosy projections indicate an expected rise in the unemployment rate over the months ahead. As a society we cannot afford to have unemployment diminish, divide and demoralise us.

The Rudd government, to its credit, quite quickly perceived the urgency of responding to the crisis. Its decision to add more than \$10 billion to its own budgeted expenditure for the fiscal year 2008-9 was a useful, standard type of Keynesian fiscal policy response. So too is its more recent decision to add a further \$42 billion of expenditure on household handouts and longer-term investments. This policy package pumps more spending power into the economy to offset the tendency towards recession. The government's decision to make the payments directly to households was also clearly motivated by the concern to boost consumer spending as quickly as possible.

The government deserves more credit for its speed in introducing this emergency response than for the specific policy details. For example, seeking to boost spending on housing by increasing the first home buyers' subsidy is particularly problematic. The evident intention is to encourage aspiring first home purchasers to buy now, rather than later, when the extra subsidy may have been scaled back or withdrawn. Housing demand is boosted if first home-buyers do respond in this way, thereby pushing prices higher than they would otherwise have been. Existing home owners become the principal beneficiaries because the subsidies tend to be capitalised in the value of the housing assets. The government's policy initiative illustrates the fundamental incompatibility of trying to make housing more affordable while implementing policies that keep house prices up.

Similar tensions arise from the Rudd government's quickly announced decision to guarantee deposits in major financial institutions. This was an intervention directly aimed at reducing public panic at the onset of the crisis and, as such, it was urgently needed. However, guaranteeing deposits in some of but not all financial institutions predictably created circumstances conducive to people switching their deposits between those institutions. Some further elements of financial volatility were thereby created, with some quickly-felt effects on superannuation funds and entitlements in particular.

As for the the government's more recently announced handouts, these are being welcomed by people on low and middle incomes, of course, but there are concerns about fairness. Unemployed people don't qualify for the payments but some households can get multiple payments under other eligibility categories. The boost to spending is also uncertain. People who think that the government's policy package signals very difficult times ahead may respond by saving their handouts. That is good for them but it reduces the overall economic stimulus. Similarly, if the extra spending is on imported goods not be many local jobs will be generated.

What is interesting about the Rudd government's policy response is how quickly it the neoliberal economic orthodoxies that emphasise fiscal restraint and deregulated markets have been set aside. Australia is not unusual in this respect. Worldwide, the financial crisis is now commonly perceived as a crisis of neoliberalism too. Free markets are manifestly not delivering good outcomes. Economic instability is rife. Neoliberalism, formerly perceived by

some political economists as creating ‘the victory of capital over labour’, is apparently now not even serving the interests of capital.

Not surprisingly, this situation has led to many calls for government to take a more directly interventionist role in economic management and regulation. Even public ownership is now on the agenda in countries like the UK and USA, although usually applying only to large financial enterprises that are in danger of closing. It seems to be accepted that governments can and should step in where this is necessary to prevent further economic downturn. Privatising profits and socialising losses is a familiar theme in capitalist economies, of course. One might ask, why only lame ducks? What about governments taking a generally more interventionist approach to economic management - blending selective public ownership, stricter regulation of markets, industry development policies and economic planning?

## REMEDIES

An effective policy response to the crisis needs to go beyond short-term measures. Long-term investment is needed to put the economy on a sounder footing for the future. Therein lies the opportunity to link redress of the current financial crisis with other policies to create more stable, secure and ecologically sustainable economic arrangements.

In the Australian case key focal points could include investments in infrastructure projects, improved land and water management practices, energy-efficiency programs and the provision of green energy. Keynesian economics can thereby be combined with policies for ecological sustainability. Indeed, it is crucial that more priority be accorded to green policies in responding to the current economic crisis. Strident voices from the business community will predictably argue the opposite: that we cannot ‘afford’ to pursue environmental objectives until the economic situation improves. In fact the embrace of a job-creating green agenda could not be more timely.

A new report issued jointly by the ACTU and Australian Conservation Foundation illustrates the potential growth of ‘green-collar’ jobs. It identifies key industry sectors like renewable energy, energy-efficiency, sustainable water systems, biomaterials, green buildings and waste recycling. The report estimates that up to half a million additional jobs could be created by

2030 if governments provide the necessary support by investing in market creation strategies for these emerging industries. Among other things, that implies a key role for TAFE as a public-sector institution (not privatised) to ensure that workers get reliable access to programs for the required skills development.

A focus on infrastructure improvements also has both a social and economic logic. Public transport, education and health all need upgrades after long periods of neglect. Directing public expenditure to these sectors would renew the concern with long-term 'nation building' that has been allowed to wither during the era of neoliberal dominance. This public infrastructure investment may require government budgets to move into deficit but, on standard Keynesian economic reasoning, that is appropriate as a counter-cyclical policy. The extra tax revenue that the investment tends to generate helps to bring the budget back out of deficit anyway. On similar reasoning, incurring public debt to finance the expansion of infrastructure investment is economically responsible if its effect is to increase both employment and productive capacity.

The possibility of linking superannuation funds to public investment also warrants consideration in these circumstances. About \$1.2 trillion of workers' savings is currently tied up in these super funds. The rate of return will be 'anything but super' this year, of course, because of the lower market values of many of the financial assets held by the funds. More long-term stability would be achieved if the funds were required to channel some part of their investments into public infrastructure at a reliable, steady rate of return.

The stricter regulation of financial institutions should also be on the agenda. Governments always have a role in setting 'the rules of the game'. The question is 'which rules best serve the public interest?' Private players – very wealthy people and corporations in particular - show infinite ingenuity in finding ways round whatever rules are set, of course. But what the current financial crisis makes clear is that much more attention needs to be given to developing rules that aim at reducing speculation.

Tax reform, as well as regulatory reform, deserves consideration in this respect. In land markets a uniform national tax on all properties would have the effect of diminishing the speculative behaviour that drives inflationary booms, because accretions in land values would then go primarily to the government. Those additional state revenues could be returned to

citizens through cuts in other taxes or, better, through more government spending on public housing, thereby helping to stabilise prices and make housing more affordable.

International cooperation in developing structures of regulation and taxation that are more conducive to economic stability are important too. The long-standing proposal for a 'Tobin tax' – a tax on short-term transactions in foreign exchange markets - deserves renewed consideration as a means of discouraging speculative international capital flows.

There is also a strong case for targeting the corporate executive incomes that have grown so rapidly in recent years, creating spectacular rewards seemingly unrelated to productivity, professionalism and probity. Political leaders, including Kevin Rudd, have commonly described these managerial self-rewards as 'excessive'. The incomes could be disallowed as business expenses for the purpose of assessing the tax to be paid by the companies who employ them (if the income is more than, say, ten times average workers' wages).

## CONCLUSION

The financial crisis of 1929 – which ushered in the subsequent great depression – was carefully analysed by the wise and witty American political economist J.K. Galbraith in his book 'The Great Crash'. It is worth reading or re-reading. Although Galbraith didn't live quite long enough to observe the current financial crisis, his book points to some features that appear common to the two situations. Of course, we hope that the parallel is less than complete. In summary, the problems that Galbraith says underlay the crash of 1929 were: '(1) the bad distribution of income; (2) the bad corporate structure; (3) the bad banking structure; (4) the dubious state of the foreign balance; and (5) the poor state of economic intelligence'. These features seem all-too-evident in the current situation, do they not?

Governments cannot eradicate the problems that are intrinsic to capitalism – instability, insecurity, inequality and unsustainability. They can, however, develop appropriate monetary and fiscal policies. Cutting interest rates, as the Reserve Bank of Australia has already done, probably helps a little. However, businesspeople are understandably reluctant to invest in expanding productive capacity, even when borrowed money has become cheaper, if the prospect of a recession makes them pessimistic about the future demand for their products. Increased government spending, of the sort that the Rudd government is undertaking, has a

more reliable stimulatory effect. However, some of the additional spending by consumers invariably is on imported goods: that ‘leakage’ reduces the domestic stimulus, although it may be helpful to other national economies. The bigger challenge, as I have argued in this short article, is to look beyond conventional monetary and fiscal policies to bolder strategic interventions that focus on green jobs, public infrastructure investment, reform of superannuation, taxation and financial re-regulation.

All sections of the society need to be engaged in shaping strategic responses to this crisis. Trade unions and other community groups should be direct participants in developing a modern New Deal. Policy development is not just a matter for economists and technocrats. Indeed, as Galbraith’s book reminds us, crises tend to reveal the ‘poor state of economic intelligence’. The current crisis shows how hopelessly inadequate is the ‘economic intelligence’ of the neoliberal apologists for market mayhem and corporate self-indulgence. To re-cycle another of Galbraith’s memorable phrases, ‘the march of circumstances’ now demands a new political economic approach.

#### FURTHER READING:

# J.K. Galbraith’s ‘The Great Crash’ was originally published in 1955 by Hamish Hamilton, London.

# [The ACTU/ACF report on creating green-collar jobs is available online at acfonline.org.au/uploads/res/Green\\_Gold\\_Rush\\_final.pdf](http://acfonline.org.au/uploads/res/Green_Gold_Rush_final.pdf)

# The June 2008 issue of the Journal of Australian Economy was a special issue on ‘the economic boom in Australia 1992-2008’, containing articles on the emerging contradictions and crisis tendencies. The December 2008 issue of the same journal contains a long article on US debt and the sub-prime crisis. JAPE is available by mail from Box 76, Wentworth Building, University of Sydney, NSW 2006 [send \$15 to cover the cost of both issues plus postage].

# Australian Options will be launching a special supplement on the economic crisis in early 2009 and including it in the autumn issue of this journal.