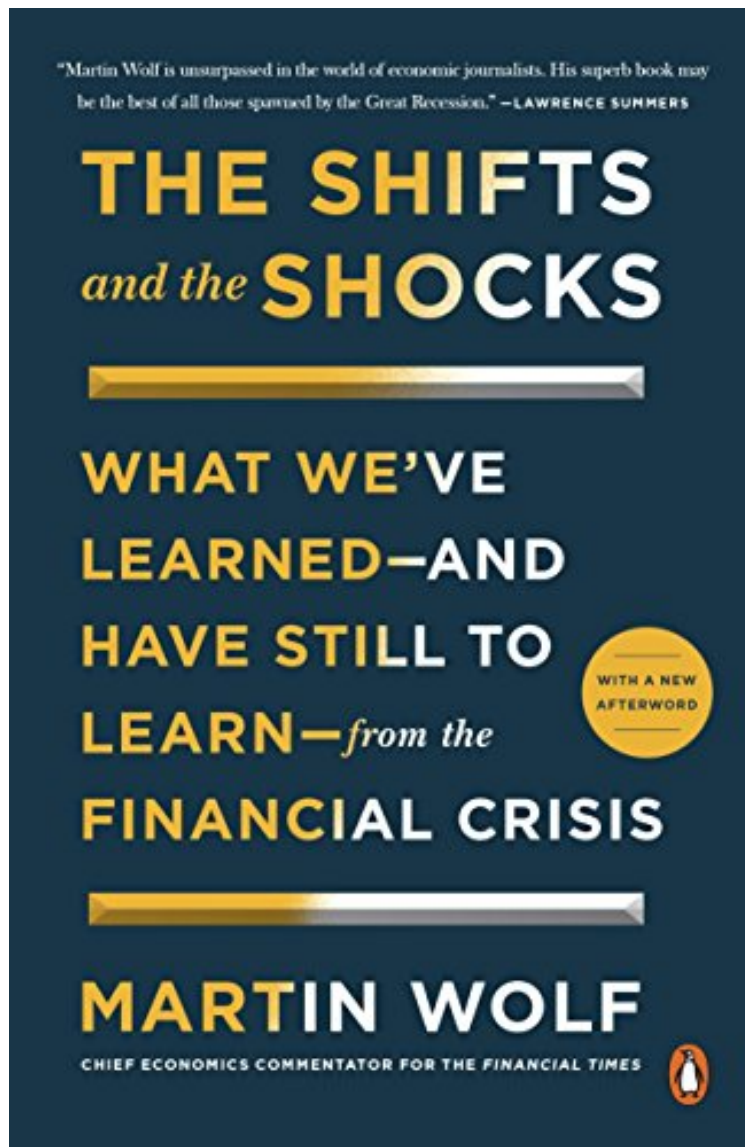


[Download] The Shifts and the Shocks: What We've Learned--and Have Still to Learn--from the Financial Crisis

The Shifts and the Shocks: What We've Learned--and Have Still to Learn--from the Financial Crisis

Martin Wolf

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Martin Wolf : The Shifts and the Shocks: What We've Learned--and Have Still to Learn--from the Financial Crisis before purchasing it in order to gauge whether or not it would be worth my time, and all praised The Shifts and the Shocks: What We've Learned--and Have Still to Learn--from the Financial Crisis:

24 of 26 people found the following review helpful. Financial and Monetary System Reform Is Still Unfinished

BusinessBy Serge J. Van SteenkisteIn his newest book, Martin Wolf relentlessly explores the ins and outs of the financial and economic crisis which began in 2007-2008. Mr. Wolf first reviews the shocks that have humbled many high-income countries, whose subdued performance stands in sharp contrast with the strong showing of many emerging and developing economies in the aftermath of that crisis. 1. A credit crash that has forced many households and businesses to stop spending consistently more than their incomes. 2. A reconfiguration of entire sectors of activity such as construction and finance in many high-income countries. 3. The higher cautiousness of chastised financial institutions in a changing regulatory environment. 4. The specter of deflation, or at least, consistently falling inflation rates in many high-income countries, especially in the Eurozone. 5. The vicious circle behind the weakening of the "animal spirits" of businesses in the same economies. The author then clearly articulates the shifts that have led to the fragility of the world economy: 1. No living memory of the large financial and economic busts of the distant past, which bred complacency among the economic, financial, intellectual, and political elites of the West before 2007-2008. 2. No clear understanding of the ramifications associated with the evolution of the financial system, i.e., liberalization, globalization, innovation, leverage, and incentives, among the same elites. Subsequently, Mr. Wolf reviews what has been done to make the financial system more resilient than it was before the above-mentioned crisis. The author is clearly not impressed with the post-crisis central-bank orthodoxy as it is embraced in the high-income countries of North America and Europe. He dubbed it the new orthodoxy, i.e. inflation targeting, macroprudential policy, the strengthening of the role of central banks as lenders of last resort, and the orderly resolution of troubled institutions. Mr. Wolf is especially critical of the sheer complexity of the regulatory structure that will probably be dead on arrival in the recurrence of a major financial and economic crisis. Unsurprisingly, the author pleads for a significant increase in the capital requirements of banks as a key improvement to the new orthodoxy. Finally, Mr. Wolf makes the case for radical reform. Radical reform does not include liquidationism light as practiced within the Eurozone under the influence of Germany. Fiscal austerity, asymmetric adjustment of competitiveness, and limited assistance with recapitalization of banks in crisis-hit countries will probably not turn around the fortunes of these countries that are operating in less auspicious external circumstances than those that benefited Germany previously. The author mentions as examples of radical reform the creation of a global currency to replace the national currencies currently used as anchors of the system, or a partial break-up of the open world economy. Mr. Wolf makes himself no illusion about the feasibility of these radical reforms. It will depend on 1) what sort of recovery emerges and 2) how much risk societies will be prepared to tolerate. In summary, the author calls for a reassessment of the merits of the new orthodoxy which will probably fail too many economies in dealing successfully with the recurrence of a major financial and economic crisis. 3 of 3 people found the following review helpful. When ideas fail, words come in very handy - Goethe. By Alexander Finch Martin Wolf has a problem with Germany. His book is full of bank bashing and German bashing. They are easy targets so why not take a free kick and win some popularity. He is a greater wordsmith than Alan Greenspan. So what did I learn? The financial world is still fragile, the next crash will be bigger, in Europe the crisis is not over, it's a balance of payments problem, weak demand etc. etc. Wolf tells you very precisely how imprecise the world is. Not sure if that really helps? But then he comes up with simple but brilliant conclusions, for example, Europe can blame Germany and the U.S. can blame the banks. In Wolf's Conclusion Chapter (page 341) he writes that Europe, under German influence, has sought to introduce Liquidationism but only on crisis-hit countries which has imposed huge costs on the peoples of some member countries. On page 177 he writes "The problem, in brief, is Germany". On page 337 "In accordance with the views of Germany, the reformed Eurozone is designed as a system for imposing discipline upon wayward countries: it is a 'discipline union'.....In essence, then, member countries are free to do precisely as they are told". Lack of discipline is what got these countries into trouble in the first place, so to argue against discipline does not seem very clever to me. On page 339 Wolf writes "the cost would be borne by the hapless taxpayers of the crisis-hit countries". BUT THESE CRISIS-HIT COUNTRIES WERE NEVER TAXPAYERS. In 1994 I spent a week on the Island of Santorini Greece. The economy on this island was booming already back then, new hotels were being built, restaurants were busy, and they were expecting a huge influx of Russian tourists after the fall of Communism. One restaurant had a queue of customers at the door each night. One night I said to the owner, you need a bigger restaurant, why don't you expand? He told me without hesitation, no one pays taxes in Greece, it's 90% cash, he doesn't know what to do with all the money he is already making, why would he need a bigger restaurant? Wolf argues that the Germans knew about this problem yet kept lending money, so it's just as much their fault, yet they should now keep lending money because to get out of so much debt you need more debt (page 273). That may be true but nowhere in the book does he explain how to change these peoples' character. Have you ever done business with them Mr. Wolf? My family bought a business in Sydney, managed by some Greeks. You have no idea how callous and dishonest they were. My family suffered for over a year. What goes around comes around. I have little sympathy. And to speak of these countries being in a depression is a beat-up, simply scaremongering, to make Germans look bad. It's a culture problem, and yes, if they don't like discipline they should leave the union. Many Greeks and southern Italians have already moved here to Australia over the last 50 years, and they are thriving here. They should all come to Australia! Not much discipline here to worry about and maybe the Germans could even pay for the flight over.....? Would the US consider taking some as well?? Detroit has many

empty houses, maybe the unemployed Greeks, Italians and Spanish might move to Detroit to get away from their depression? Even if you paid them, I don't think they would go. Maybe the Germans are not so bad after all? 1 of 1 people found the following review helpful. Best Comprehensive Review of the Financial Crisis By Customer Martin Wolf is a genius in his field, most negative publicity comes in the form of his controversial and subjective writing form. I came in with this mindset and loved the book. The book itself is a combination of facts as well as his own personal opinion on certain subject matters, a format that I found to be quite effective. He begins with an all-encompassing review of the determinants of the financial crisis and the Eurozone Crisis, and then delves into a number of interesting policy implications as well how the world will recover from such a catastrophic event. His rather blunt writing style is something I have always enjoyed, he does not dance around the facts but instead throws them in the readers face. I had the fortune of attending two of his lectures in Oxford regarding his book and he speaks in the same manner in which he writes. He allows for a gradual increase in complexity when it comes to presenting the determinants of the multiple crises. Although a daunting task at first, this book provides one of the most comprehensive review of the financial crisis and Eurozone crisis. He looks into future implications (e.g. the viability of Anglo-Saxon Capitalism) which I found extremely interesting. A must read in my opinion.

From the chief economic commentator for the Financial Times; a brilliant tour horizon of the new global economy; There have been many books that have sought to explain the causes and courses of the financial and economic crisis that began in 2007. *The Shifts and the Shocks* is not another detailed history of the crisis but is the most persuasive and complete account yet published of what the crisis should teach us about modern economies and economics. Written with all the intellectual command and trenchant judgment 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. From the Trade Paperback edition.

"*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." --Economist (London) "*The Shifts and the Shocks* is extremely good at untangling the causes of the global financial crisis." --New York Times "[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." --Forbes "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." --Irish Examiner(UK) "*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?" --New York of Books "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." --Ben Bernanke, American economist "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." --Lawrence Summers, president emeritus, Harvard University About the Author Martin Wolf is Chief Economics Commentator at the Financial Times. He has been visiting professor at Oxford and Nottingham universities, a fellow of the World Economic Forum in Davos, and a member of the UK's Vickers Commission on Banking, which reported in 2011. His books include *Why Globalization Works* and *Fixing Global Finance*. In 2000, he was awarded the CBE for services to financial journalism, and in 2012 he received the Ischia International Journalism Award. Excerpt. copy; Reprinted by permission. All rights reserved. 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. 1 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

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)

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."

3 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.⁴ 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.⁵

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.⁶ This event made it clear that the crisis would not be restricted to the US: in the globalized financial system, 'toxic papers'—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.⁷ Examples turned out to include IKB, an ill-managed German Landesbank, and no fewer than eight Norwegian municipalities.⁸ 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.⁹ 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.¹⁰ 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'.¹¹ 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.'¹² 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 market's self-healing powers'. Deregulation has reached its limits.¹³ The US government took the two government-sponsored enterprises, Fannie Mae and Freddie Mac, which then guaranteed three-quarters of US mortgages, into 'conservatorships' 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).¹⁴ Yet it then, controversially, allowed (or felt obliged to allow) Lehman Brothers to go bankrupt on 15 September.¹⁵ 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.¹⁶ 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.¹⁷ 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.'¹⁸ 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 bucks'—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 McCulley's 'Shadow Banking System'.¹⁹ 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.²⁰ 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'.²¹ Funding for Morgan Stanley and Goldman Sachs, the two surviving broker-dealers, dried up.²² On 21 September these two institutions turned themselves into bank holding companies, a change that gave them access to funds from the Federal Reserve.²³ On 25

September the Federal Deposit Insurance Corporation took over Washington Mutual, the sixth largest bank in the US.²⁴ 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.²⁵ 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'.²⁶ 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'.²⁷ 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.²⁸ 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.²⁹ 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.