

Suman Bery: The fire this time

Suman Bery / New Delhi October 15, 2008, 1:22 IST

Crises are teachers. There are lessons to be learnt from the current one as well, says Suman Bery.

In awarding the 2008 Nobel Prize for Economics to Paul Krugman (currently teaching at my alma mater, the Woodrow Wilson School at Princeton University), the Nobel committee cited his work on economic geography and trade theory.

These days Prof Krugman is much better known as a columnist for The New York Times in which role he has been a fierce critic of what he sees as the mendacity, unfairness and incompetence of the Bush administration's economic policies. As with the award of the Nobel Peace Prize to Al Gore (jointly with the Intergovernmental Panel on Climate Change—IPCC) last year, one cannot help but feel that politics has entered the Nobel selection process a little more than is healthy.

Prof Krugman's contributions are much wider than either his journalism or the specific areas cited by the Nobel committee. He was one of the early commentators on the Chinese pattern of growth, arguing that it was excessively dependent on increased use of inputs (labour and capital) and not sufficiently based on productivity growth. Of particular significance, given events in the world today, though, is his work over several decades analysing financial and balance of payments crises in the developing world.

Traditional analysis attributed balance of payments crises to an excess of domestic expenditure over domestic income, leading to an unsustainable current account deficit. This diagnosis led to the traditional IMF package of emergency liquidity support, fiscal contraction and devaluation. In a series of articles, Krugman pointed out that more recent financial crises (such as those in Latin America in the 1980s and East Asia in the 1990s) stem more from perceived or actual imbalances in the balance sheets of the main economic entities in the economy. In addition to the government, these can be corporations, households and financial institutions, and the mismatches can be in maturity, in currency, or in asset quality. In such an environment, expenditure contraction may aggravate the underlying problem rather than solve it. This has been part of Joseph Stiglitz's critique of the US Treasury and the IMF in its handling of the 1997-98 Asian crisis.

While Krugman's interest began with emerging markets, where financial crises and balance of payments crises typically occur together and reinforce each other, he has also analysed the stubborn persistence and enormous growth costs of the Japanese banking crisis of the 1990s. As a neo-Keynesian, he was particularly struck by the seeming ineffectiveness of fiscal policy in rescuing Japan from deflation in an environment where monetary policy was close to powerless.

What implications does Krugman's work (and that of others in his tradition) have for addressing the global financial crisis that has been raging over the past year?

Krugman's analysis of financial crises demonstrates that asset markets can be a powerful and long-lasting source of instability. Yet Alan Greenspan, and to a degree his successor Ben Bernanke, are famously associated with the view that it is not the job of monetary policy to nip asset bubbles in the bud. In their view it is impossible to spot a bubble in advance; the role of monetary policy is instead to protect the real economy once the bubble bursts.

The events of the last year have been instructive on this matter. As is implicit in the very concept of a bubble, asset markets are highly prone to overshooting in the course of price discovery. The same, unfortunately, applies on the way down as well, with massive implications for the capital position of financial institutions, and for their ability to undertake normal credit operations.

The obvious response is to appeal to tighter regulation, but as has been repeatedly pointed out in the financial press, it is the highly regulated thrift institutions, Fannie Mae and Freddie Mac, which have got into the greatest difficulty, while the more lightly regulated hedge funds, even if hurt, have not created a major headache for the payments system or for public finances.

This debate is inextricably linked with two other issues: the structure of

depository banking; and the nature of capital requirements. As is well-known, following the US banking crisis of the early 1930s, the Glass-Steagall Act separated commercial and investment banking, and the two were reunited in the US only in the late 1990s. An unexpected consequence of the current crisis has been the emergence of the retail deposit-supported universal bank as the victor over pure investment banks dependent on the wholesale markets. In Europe where no such separation was enforced, the universal bank model was the norm.

What is equally surprising is that it is the most elaborately regulated portion of the financial system, the deposit-money banks, which are proving to be the most troublesome financial intermediaries for the authorities, as was the case in Japan in the 1990s. The major difference is that in the case of Japan the "toxic" assets were typically loans, while in the present crisis they have been marketed, but difficult-to-value securities. Clearly, the elaborate (and expensive) apparatus of capital adequacy rules under Basel-I and Basel-II were of little help when the big wave came, and arguably may have made matters worse.

What, if any, are the implications for India? The OECD countries have been able to fling public money at the problem (and to reduce interest rates) because of the strong institutional credibility of both their public finances and their monetary authorities. We are in a weaker position on both. For these reasons, our bank regulators have no choice but to be alert to asset bubbles, even if this imparts a conservative bias to monetary policy.

Given our weak fiscal position and high debt stock, there is every reason for us to insist on higher levels of regulatory capital in our commercial banks, and to insist on prompt corrective action. By the same token though, where the public sector banks are concerned, the protection provided by government-provided capital is essentially redundant, because it overlaps with the implicit sovereign guarantee that underlies all banking systems as recent events have shown. Paradoxically, then, a lower public ownership stake might actually increase the safety of the banking system.

The writer is the Director-General, National Council of Applied Economic Research (NCAER), New Delhi.

Views expressed are personal. Contact: sbery@ncaer.org