Institute for New Economic Thinking

Session 8 –

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When Wolves Cry "Wolf":

Systemic Financial Crises and the

Myth of the Danaid Jar

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Tonneau des Danaïdes

Overview

- Look Only at Developed Country Cases With Large Banks Failing
  - IMF or External Creditors Play No Role
    - S&L and Swiss Canton Banks Not Included- Small Banks
- Three Bailout Periods
  - 2008
  - 1990s Japan and Scandinavia
  - 1930s Germany, Italy, U.S.A.

Key Questions

- Did authorities act quickly to address crisis or Did they coverup and delay?
- How did they handle immediate bailout costs?
- How do they address moral hazard implications of their bailout policies?

BAILOUT COSTS

Country/Date	Capital Injections		Purchases of Assets and Lending by the Treasury
	(%GDP 2008)		(% GDP 2008)
2008-9			
United States	2.4		0.7
Austria	1.7		0
Belgium	4.7		0
France	0.8		0.4
Germany	NA		NA
Italy	0.1		0
Japan	0		1.2
Netherlands	2.4		5.5
Norway	0		7.2
Sweden	0.2		0
Switzerland	1.1		0
United Kingdom	3.3		3.4

SOURCE: IMF: The State of Public Finances Cross Country Fiscal Monitor , November 2009

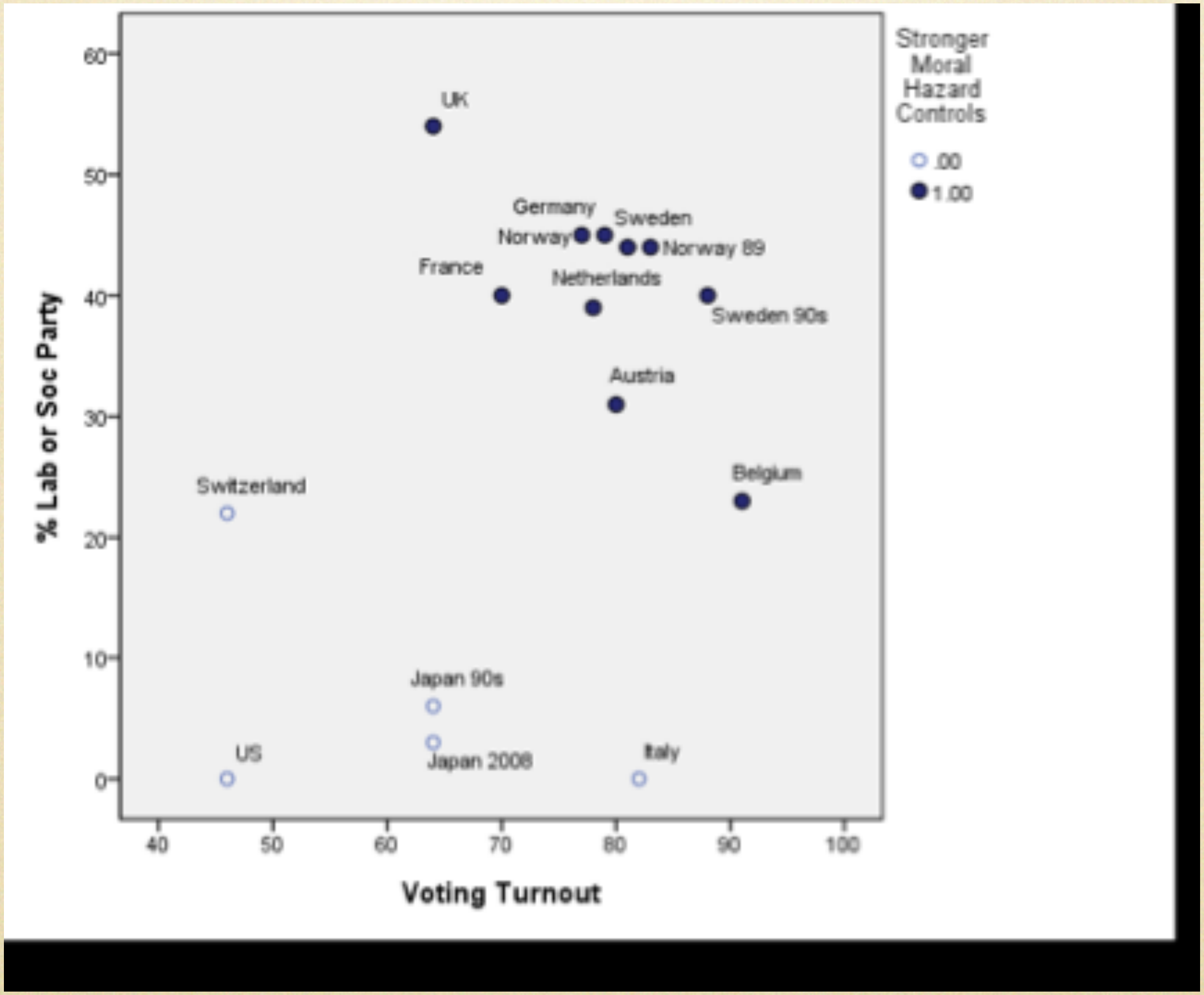
Data Challenges

- Guarantees are contingent claims with little ability to estimate how much they will cost taxpayers.
- Similarly massive expansion of central bank balance sheets implies taxpayer risk that is difficult to measure.
- Accounting forbearance another form of contingent liability.

Moral Hazard Deterrence

- Do political system differences explain constraints on bankers?
  - Turnout
  - Importance of Labor/Socialist parties in Parliament/Congress

Moral Hazard Controls by Voter Turnout and Labor or Socialist Party Parliamentary Strength



The USA - New Deal and Now

- Once upon a time Democrats were a mass based party but not socialist.
- Now under a Democratic Administration U.S. bankers are paying themselves record bonuses barely a year after taxpayers bailed them out.
- There is no precedent in world history for this.

What Happened?

- Union strength declined from 30 to 12 percent.
- No dues paying membership base in the Democratic Party- In contrast with most of Europe
- The role of money in U.S. politics has exploded.

Investment Theory of Politics

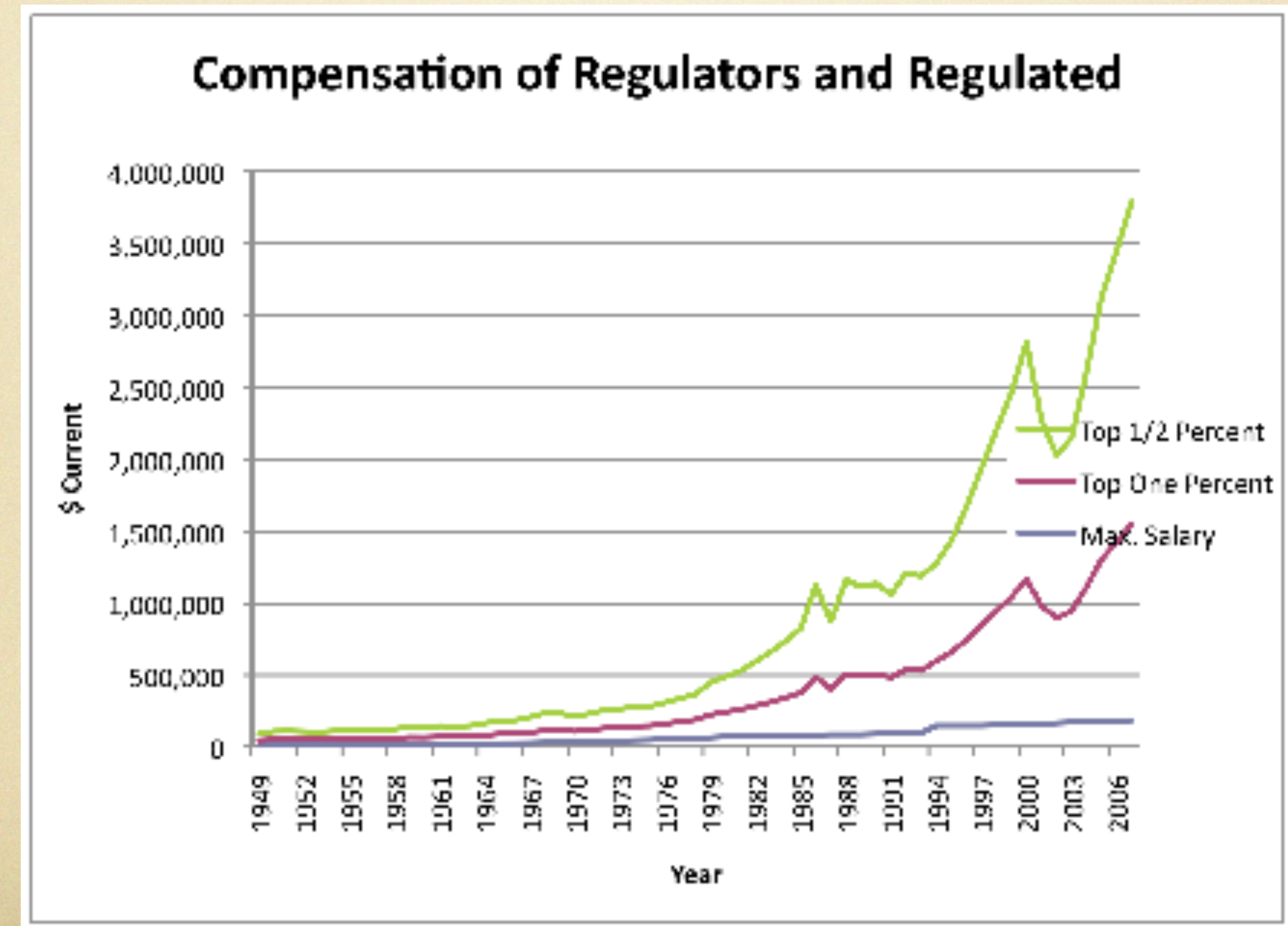
- Median voter model is the equivalent of market fundamentalism
- Only positions that can be financed on a large scale are represented in the public sphere, even if everyone knows that a heavy majority of the population desperately desires a different policy
- Role of Labor/Socialists in Coalition

Money in U.S Politics

- Campaign Contributions.
- Removal of Congressional Staff Pensions.
- Congressional members rate of return on investment portfolio significantly outperforms the market and even outperforms corporate insiders.
- The Regulators as employment agencies for the regulated.

The Opportunity Cost of Doing Good:

Salaries of Regulators Compared with Incomes of the Regulated Over Time: Enforcement-Bubble Amplifying Feedback Loop



Macroeconomic Response

- Scandinavian countries in the 1990s- The role of devaluation
- Japan in the 1990s - Official forbearance coupled with financial de-leveraging requires sustained public spending. New Deal mistake of 1936 offers a second example
- Hoover USA, Italy and Germany 1931: A policy of cutting state expenditure with high unemployment is virtually guaranteed to run deficits up rather than down as tax revenue declines when national income plummets. The Danaid Jar Again!