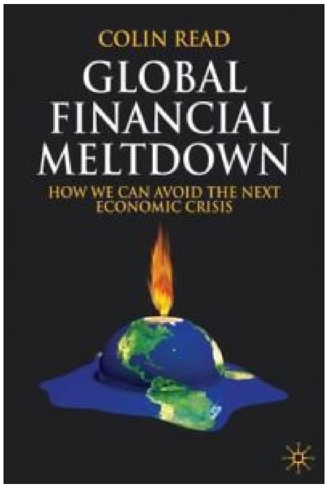

Book Global Financial Meltdown

How We Can Avoid The Next Economic Crisis

Colin Read
Palgrave Macmillan, 2009

Recommendation

Author Colin Read writes that the purpose of his book is “to provide an economic education for the educated reader who does not have a college major or minor in economics.” The book goes a good distance toward achieving that admirable goal. This broad survey of important economic ideas has a minimum of jargon. As its hopeful subtitle suggests, the book’s major emphasis is how to avoid another global financial crisis. It is especially timely as people all over the world are trying to understand the reasons for the crisis and the roles of the different players. While it seems to have been proofread in haste, *BooksInShort* recommends this readable book to anyone who wants a firmer, basic understanding of economics without having to get a degree in the subject.

Take-Aways

- Markets are informed but imperfect and prone to irrational reactions.
- Inefficient pricing of goods and services is the economic cost of market failures.
- Increases in personal savings can depress economic growth.
- The American tax code is complex, unfair and inefficient.
- While regulation is costly, lack of good regulation may be even costlier.
- Fundamental reform is necessary when consumers are too fearful to spend and too distrustful to invest.
- Economic stimulus packages can work, but often have unintended consequences.
- Monetary policy is a powerful tool that works best in coordination with fiscal policy.
- Emotion has inflated investment “bubbles” in housing and other industries.
- Traders with sophisticated technology and instant access to information are better equipped than ever, but perhaps no more rational.

Summary

Markets and the Economy

Financial markets first emerged during the Italian Renaissance more than 400 years ago. For much of the time since then, finance and investment activities remained the exclusive domain of the wealthy. Most investors were experts in the areas or industries where they invested. However, by the early 20th century, rising levels of prosperity enabled even ordinary citizens to become investors. In stark contrast to their predecessors, these new “consumer-investors” put money in businesses that they scarcely understood at all.

> “We have learned it is necessary to take hold of our economic futures, but we have not been given the tools to understand an economy or marketplace that grows more complicated every day.”

Not all consumer-investors got rich, of course. Readily available credit for U.S. stock investors made equity investment potentially more lucrative, but also more risky. Irrational investor behavior produced wild stock market swings from the early decades of the 20th century to the concluding one: Both the “Roaring ’20s” and the 1990s ended with stock market dives.

"Never before have so many hundreds of millions of people directly or indirectly participated in something so complex that only thousands or tens of thousands truly understand."

Nevertheless, U.S. market-based models for producing goods and services spread worldwide. These models generated global economic growth from three sources: increased labor productivity, greater production of relatively high-value products, and a proliferation of the "factors of production," such as materials and labor.

"Even the most perfect of all markets can be rife with market failures."

The economic "pie" has grown, and so has the number of people who share pieces of it, primarily due to the technological revolutions that punctuated the course of human history. Innovation has built on innovation. The printing press accelerated the spread of knowledge. New metals made tools more productive. The Industrial Revolution harnessed the power of machinery. Mechanized agriculture contributed to the establishment of modern cities as it depopulated farms.

Credit and Thrift

Effective central bank regulation is critical to the proper functioning of markets and to economic growth. Banks earn their profits on the spread between the interest rates they collect on loans and the rates they pay on deposits. Because banks lend out their depositors' money, banking integrity is an essential element of people's confidence in the financial markets.

"One of the reasons why markets fail to perform well is because big participants can manipulate prices."

Established in 1913 as the U.S. central bank, the Federal Reserve is charged with managing the national money supply, ensuring adequate credit availability, and supervising bank safety and soundness. The Federal Reserve uses two primary tools to control the money supply. It can discourage lending by requiring banks to carry more reserves. And because banks often borrow from the Fed to cover their reserve requirements, the central bank also can stimulate lending by reducing the so-called "discount rate" it charges on such loans, or it can discourage lending by raising the rate.

"The economic pie is distinct from the financial pie."

Monetary policy can be effective at getting banks to do what the Fed wants. However, it does not work in every circumstance. When consumers are too scared to borrow and spend, even lowering the discount rate to zero may not be enough to stimulate economic activity. Domestic economic growth also may suffer to the extent that monetary policy encourages bankers to lend to borrowers abroad instead or to follow other practices that impede normal domestic lending.

"The importance of well-enshrined property rights is absolutely essential for strong economic development, at least in the Western sense."

Disciples of economist John Maynard Keynes support government spending to create jobs and ensure economic growth. The multiplier effect of such stimulus spending ensures that each additional job will help create others. One problem with this solution is that workers in government-created jobs may spend their pay on imported products, effectively exporting the impact of domestic fiscal stimulus instead of feeding it back into the domestic economy.

"The pace of innovation and change would be staggering to contemplate, if we didn't happen to find ourselves smack dab in the middle of it."

The Fed's job became more complicated after the 1980s when new types of nonbank financial institutions emerged, some wielding an economic impact rivaling that of major banks. Because the Federal Reserve has jurisdiction only over banks, the emergence of these near-banks greatly reduced its power to affect economic events.

Supply-Side Economics

In the 1980s, the economic rallying cry of Reaganomics under President Ronald Reagan was "supply side." But by 2003, even the conservative business newspaper, *The Wall Street Journal*, admitted that Reaganomics was dead. At the time, supply-side economists advocated lower taxes as a way to increase business investment, production, employment and tax revenues.

"To come to the realization that a weakening U.S. dollar can become a national asset will require a new acceptance that the United States is becoming a participant in global economics rather than the leader of global economics."

However, these economists faced a paradox. Their views neatly align with an economic theory known as Say's Law. It postulates that supply creates demand, which means that producers and investors pay workers to produce and the workers spend their pay to buy what they produced. But Say's Law conflicts with another principle of economics, the "Paradox of Thrift," which holds that savings can both provide investment funds and kill investment incentives. Workers who fear bad economic times often choose to save rather than spend, and when too many workers save too much, aggregate demand for goods and services falls, and businesses lay off workers.

"The government must demonstrate that it stands shoulder to shoulder with the citizens and will do whatever is in anyone's, or perhaps everyone's power, to remedy the situation."

People who still have jobs during such a recession may save even more out of fear, leading to less demand for goods and services, more layoffs and a deeper slump. Government can offset the economic impact of this type of downward spiral by spending to create demand for goods and services.

Market Failures

Markets are excellent mechanisms for allocating scarce resources. Adam Smith used the term the "invisible hand" to identify the mysterious process that happens within the markets when individuals pursuing their own self-interests also bring about a wealthier community. But markets sometimes fail, and when they do, government has an appropriate and even necessary role in mitigating the impact.

"Coordinated monetary policy has typically been born out of financial calamity."

One noteworthy source of market failures is asymmetrical information. Prices may fail to reflect reasonable value if one market participant has information that is not available to others. Markets also can fail due to an imbalance in the number of buyers relative to sellers. Another type of price distortion occurs if the buyer fails to pay the full cost of a product. For instance, prices may not cover the cost of production-based pollution.

"The Internet and television financial news fundamentally changed access to the market, for good or for bad."

Supply and demand calculations are indispensable to understanding price moves, but they do not completely account for how price levels adjust. For example, demography can affect the demand for goods and services. Young, growing nations tend to have higher demands than older, stagnant nations. Rising demand puts upward pressure on prices. Higher prices may bring more supply into the market, but if supplies are fixed, rising demand merely increases producers' profits.

Social Security and Insecurity

The aims of market efficiency and social equity are often misaligned. Markets are very good at creating wealth. However, they do not distribute wealth equally. The U.S. government has created payment transfer systems that spread wealth. But Social Security, one of the biggest such programs, is constrained by adverse demographic trends.

"Our children now sense that we are, perhaps more than ever, in control of and responsible for our own economic destiny."

Social Security was designed for an earlier different society. In 1935, when the age of eligibility for Social Security pension payments was set at age 65, the average American lived only 63 years. Extended life spans and aging populations in the U.S. and around the world are threatening Social Security and similar transfer-payment systems in many other developed countries.

"The sooner we absorb this new economic reality, the better."

Americans also face a long-term potential decline in the value of the U.S. dollar. The U.S. government budget deficit is at historic post-World War II highs and poses a significant risk of inflation. In fact, the U.S. has "twin deficits," in that imports of both products and capital exceed exports.

The international monetary system effectively established the U.S. dollar as the world's default reserve currency, but mismanagement of the U.S. economy may lead to a shift away from the dollar in favor of the euro or the Canadian loonie, or both. Lofty oil prices are one indication of the dollar's dwindling value, relative to other currencies. However, a weaker dollar is not all bad news for Americans, because it can make U.S. exports less expensive and pare the trade deficit.

Irrational Market Behavior

According to the efficient market theory, stock prices rapidly reflect new information. Savvy traders who recognize that significant news about a company will change the price of its stock often buy or sell the stock in anticipation. This buying and selling pressure affects demand for the stock and, therefore, also moves the price. This theory, however, postulates that market decisions are purely rational. In fact, hyper-investment bubbles in housing and other markets illustrate the potential impact of investor irrationality.

Technology has made markets faster and more powerful. Even amateur day traders have laptop access to information and trading opportunities that used to be available only to the biggest, most sophisticated banks. Capital markets move fast, and globally, but they are vulnerable to acting or reacting on the basis of irrational impulses and poor information. One reason is that the media generally have done a mediocre, if not poor, job of educating citizens on how to make sound economic decisions.

Who's in Charge Here?

Regulation has proven ineffective for several reasons. Business leaders generally distrust and sometimes despise government regulatory bureaucracies. Regulators and the companies they regulate often have adversarial relationships.

The subprime mortgage loan crisis and the economic problems it precipitated have shown the U.S. political-business complex in a poor light. Auto companies that failed to innovate and compete have become broken recipients of government-funded fiscal fixes. Financial institutions that made disastrous decisions got government rescue packages because they were too big to fail. The complex, contradictory and politically driven U.S. tax system distorts economic decision making by giving taxpayers incentives to take actions that have adverse, long-term economic consequences.

Clearly, a new approach to regulation is in order. Sound and prudent regulation will be necessary to restore the investor confidence that markets need. However, regulators face a daunting challenge. Lawmakers and regulators should adopt "a twelve-step program" to build U.S. economic strength over the long term:

1. Reform the educational system to provide flexible, interdisciplinary instruction.
2. Develop an energy policy to replace the use of hydrocarbons.
3. Establish an industrial policy that emphasizes cooperation and that reforms the patent system.
4. Simplify the tax code so that it provides the right incentives for a growing economy.
5. Link fiscal and monetary policy so that they do not work at cross purposes.
6. Reduce the deficit and cut government borrowing.
7. Establish institutions to enforce accountability, transparency and ethics in business.
8. Reform executive compensation to minimize moral hazard.
9. Reform regulation to focus on the long run and the common good.
10. Invest in the nation's physical, legal, human and commercial infrastructure.

11. Update the legal system to make antitrust and patent provisions relevant.
12. Make sure the citizenry is informed enough to demand action that would ensure sustained economic growth.

About the Author

Economics and finance professor **Colin Read** is the dean of the School of Business and Economics at the State University of New York in Plattsburgh. A former research associate at the Harvard Joint Center for Housing Studies, he served at the Ministry of Finance in Indonesia.