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The Current Financial Crisis

The current financial crisis certainly poses problems, but these problems are neither insurmountable nor do they sound the death knell for the market economy.

What started the ball rolling were the downturns in the housing market that have occurred over the past year in the United States, Ireland and the United Kingdom. Taken by themselves, these downturns would have been enough to slow economic growth and, depending on their severity, perhaps lead to declines in real output and recession. Ireland has already seen such a decline in GDP. In the U.K. GDP growth in the second quarter was zero and in the U.S. still postive.

The situation, however, has become worse as a result of the credit crunch and, for a time, outright panic that has shaken the world's financial markets. Here the problem is not housing *per se* but the low quality mortgage loans that U.S. banks came under increasing political pressure to make. For the past two and a half decades, U.S. banks have functioned essentially as mortgage brokers. They cut the deal and then sold the mortgages to be packaged into tradable securities. The principal intermediaries in this process were the Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("Freddie Mac"), both privately owned but nevertheless, government sponsored enterprises.

When house prices fell, these securities lost their value, Fannie and Freddie became bankrupt and institutions holding the securities that the two issued saw the values of their portfolios erode. How much in many instances became anyone's guess. Credit markets froze and some of these institutions failed.

In the first half or so of the nineteenth century, such crises were a regular feature of

British and American economic life and then, as now, they reverberated from one country to the other. The details were never exactly the same, but the general outline was very similar.

The U.S. cotton crop, for instance, failed. An American bank with bad loans to cotton producers went under. A British bank, in Lancashire, that had loans out to manufactures of cotton cloth, went belly up. System-wide runs on banks in the two countries ensued. Britain experienced a gold outflow and the Bank of England raised its lending rate to stem the outflow and gold then flowed from the U.S. to Britain exacerbating the decline in U.S. money . Interest rates in Britain and America, whose financial markets were closely linked, spiked and credit became excessively costly.

The major difference between these earlier crises and this one is there have been no bank runs in this episode. In the nineteenth century, such bank runs mushroomed into system-wide withdrawals of deposits and money supplies fell. Spending plummeted as a result and severe recessions ensued. In the United States such crises continued into the 1930s. The three waves of banking failures that reduced the money supply by a third in that period were the reason that an already somewhat severe recession turned into the Great Depression.

In the current episode, this has not happened. Money supplies have not been adversely affected. Firms' inabilities to borrow are clearly a negative but, in the absence of monetary effects, not so powerful a force that we need fear anything close to a great depression.