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History lessons

Nicholas Crafts explains what the Great Depression of the 1930s taught the economics profession, and how these insights proved invaluable in facing the Great Recession of this century.

The Great Recession of 2008-2009 came as a big shock to economists as well as to the general public. Many policy experts and economists had become accustomed to the serene conditions of the so-called Great Moderation, which had led to triumphalist claims that cycles of boom and bust had been abolished and a complacent belief that monetary policy guided by an independent central bank would inevitably deliver steady growth with low inflation.

These delusions were shattered by the financial crisis that erupted in 2008. In the panic that ensued, the frighteningly real possibility loomed of a repeat of the Great Depression of the early 1930s when real GDP and prices both fell by more than 25 percent in the United States, one in three American banks failed and a seventh of bank deposits were wiped out.

Because the current crisis caught the economics profession unawares, some viewed it as a sign that economics had not learned from the Depression. Indeed, in 2008, when Queen Elizabeth II asked why no one had seen the crisis coming, she spoke the question on the minds of many and reflected an undercurrent of broader unease about the capabilities of modern economic science.

In some senses, the recession of our times underscored weakness and the strengths of state-of-the-art economics.

The lack of foresight does represent a failure of economics, that will foretell the next crisis, and "early warning" models on threats to financial stability remain far from satisfactory.

Yet at the same time, the crisis demonstrated just how many important insights and policy tools economists gained by analysis of the 1930s. These policy lessons, learned in the wake of the modern world's deepest economic crisis, were sufficiently understood that contemporary economic science arguably prevented the Great Recession from becoming another Great Depression.

The most essential tools in fighting a banking crisis prove to be an aggressive central bank and regulation to limit excessive risk taking.

This represents an enormous triumph of economic science. Yet, at the same time, some of the most important lessons have been learned in theory by the profession, but have yet to be put into meaningful practice in public policy.

A look back at the American Great Depression gives us a useful perspective on these issues. Then, too, the crisis
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Credit and crocodile hearts

Herakles Polemarchakis, Warwick professor and economic adviser to the Greek government, examines what he has learned in confronting the financial crisis in Greece.

Larissa, with about 250,000 inhabitants, is the capital of the agricultural region of Thessaly in central Greece. A rather faceless locale, but it is the talk of the town in Stuttgart, the cradle of the German automobile industry, and, particularly, in the Porsche headquarters there. The reason? Larissa tops the list, world-wide, for the per-capita ownership of Porsche Cayennes, the pricey SUV. The proliferation of Cayennes is a curiosity, given that farming is not a flourishing sector in Greece, where agricultural output generates a mere 3.2 percent of GNP in 2009 (down from 6.65 percent in 2000) and transfers and subsidies from the European Commission provide roughly half of the nation's agricultural income. A couple of years ago, there were more Cayennes circulating in Greece than individuals who declared and paid taxes on an annual income of more than €50,000, a figure only slightly above the vehicle's list price.

The surreal situation in Larissa offers an apt metaphor for the predicament of Greece itself. By the end of 2009, Greek public debt stood at 127 percent, the deficit at 15.5 percent and the current account deficit at 11 percent of GDP. In

addition, the outgoing conservative government had failed to address these long standing problems and had succeeded in driving the country to the brink of bankruptcy. At the same time, it had consistently misreported statistics to European authorities, compromising the credibility of the country at a time when it needed it most.

The value of mortgage defaults underlying the crisis was modest, but the fiscal stimulus needed to offset them was large.

The country finds itself in a sorry state that is the outcome of easy money, the legacy of the enormous credit available to both the public and private sectors after the 2001 integration of Greece into the euro zone. This combined with many factors, among them, corruption, a failed political culture and an educational system that failed to provide citizens with needed skills.

During recent weeks, violent and escalating riots against laws that, among others, reduce salaries in public

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Five policy lessons from the Great Depression:

Economics tells you why but not when banking crises will happen.

Central banks must act aggressively in the face of a banking crisis. A competent U.S. Federal Reserve Bank could have largely prevented the Depression.

Containing moral hazard, excessive risk taking, is a fundamental duty for regulators. It is very difficult to get it right because vested interests tend to hijack the politics of regulatory design.

Exiting from the gold standard and devaluing currencies proved a valuable strategy for countries confronting the Depression. This has resonance for current euro zone countries.

The crisis has shown that economists and policy makers should know more economic history and apply its lessons carefully.

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was not forecast. But economic analysis after the Depression has revealed its sources, its consequences and its policy implications.

With the benefit of hindsight, there is no great mystery about what went wrong in the United States in the early 1930s. We know that the American banking system was fragile. It was undercapitalized and badly regulated. Banks had made many bad loans. So-called unit banking prevented banks from establishing networks of branches. There was no federal deposit insurance, and the U.S. Federal Reserve Bank, the lender of last resort, was inexperienced and incompetent.

These weak banks were unable to withstand a recessionary shock. Bank failures led to a credit crunch and a collapse of the money supply. Real interest rates soared into double digits as the result of monetary shocks and deflationary price expectations. Investment virtually ceased. In the absence of deposit insurance, there was a scramble to hold cash rather than to put money into bank deposits. This put even more pressure on banks.

The catastrophic outcome was the result of a passive response by the Federal Reserve. Recovery required regime change. The United States left the gold standard. Banks were re-capitalized and re-regulated. Federal deposit insurance was established. Expansionary monetary policy created strong demand growth.

To develop models to forecast sequences of events such as these would be extremely difficult if not impossible, but to learn from these experiences is necessary and very possible.

Two key lessons emerge.

First, the Great Depression showed the unrivalled importance of a central bank's aggressive response to crisis. This lesson was well understood and well executed in the recent recession, especially by the Federal Reserve led by Ben Bernanke, a scholar who has made seminal contributions to research on the period. Aggressive policy responses prevented a collapse of the banking system and injected fiscal and monetary stimulus which limited the downturn. Similar actions in 1930-1931 would have averted the economic catastrophe that followed for the United States. However, at that time, the state of economic analysis available to policymakers was not up to the task. So, when the 2008 banking crisis began, the historical lessons offered guidance to limit the impact to the level of Great Recession rather than Great Depression.

A second key lesson from the Great Depression involves regulation and the need to confront the pervasive problem of moral hazard – lending on the basis that the bank management takes any upside but losses are borne by someone else (taxpayers, depositors, shareholders). During the 1930s, as today, reliance on market discipline

appeared unrealistic.

From the 1930s, the standard response to these market-failure problems was a combination of partial deposit insurance together with regulation of bank behaviour. There is a trade-off since very tight regulation may achieve financial stability but impose high costs through preventing the realization of economies of scale and scope or inhibiting valuable innovations.

Over time and after several decades of financial stability, these costs seemed increasingly onerous. The strict regulation that stemmed from the debacle of the 1930s was relaxed in countries like the United States. However, the idea that systemically important banks were “too big to fail” and would always be bailed out by government ensured that moral hazard was alive and well. In this circumstance, a banking crisis becomes more likely and if it can't be prevented, then the requirement of policymakers is to make an effective response to contain the crisis.

For regulation to work effectively, it is crucial that it be well-designed. Yet a sobering lesson from the 1930s is that it most probably won't be. Vested interests are likely to hijack the politics of regulatory design. Tighter regulation was appropriate then and is still needed now to contain moral hazard. Fears about bank solvency in a world of imperfect information can lead to “bank runs” as depositors seek to withdraw their funds or interbank lending dries up.

Fortunately, banking crises are relatively rare in advanced economies. They are very expensive in terms of the depth and length of the downturns with which they are associated. For governments, the fiscal legacy of a crisis is evidenced through increased deficits and debt-servicing. For individuals, the toll is evidenced in the severe and sustained decline in the well-being of people who join the ranks of the long-term unemployed. For these reasons, policy makers and the economics profession ought to study and apply the lessons learned from the painful experiences of the Great Depression.

The author

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and semi-public enterprises have brought Greece to a standstill. The economic adjustments require extremely painful measures. And the public's willingness to suffer the consequences is not a given. When workers and pensioners already on a financial edge face cuts, one never knows whether the response will be stoic acceptance or the angry recrimination of rioting and voting out political leaders.

A year ago, when I arrived in Greece to work for the government then just confronting the enormity of the crisis, I was told to brace for the worst. "You don't understand how terrible things are," a man who greeted me insisted. With panic, he said, "It is so bad that we no longer have any comparative advantage."

His comments offer a wry punch line to economists, for whom a comparative advantage, the ability of a place to produce a certain good or provide certain services more cheaply than another, cannot in theory or in practice simply evaporate. But the man's remarks underscore the extraordinarily bleak outlook pervasive in Greece, and the need for the best economic tools our profession can wield.

In the spring of 2010, the situation for Greece became untenable. The steady and rapid rise in the interest rates faced by Greece to finance its deficit or to refinance its debt resulted in an inevitable appeal to the support mechanism set up by the European Commission, the European Central Bank and the International Monetary Fund. The support provided by the mechanism amounts to €110 billion over a three-year period, during which Greece enjoys full protection in the fulfilment of its financial obligations.

According to the Memorandum of Understanding signed with the European and international authorities in May 2010, Greece has implemented severe deficit reduction measures: among them, a 15 percent decrease in public sector salaries and pensions (some already painfully low), and a 4 percentage point increase in the VAT. But, problems remain: Sustainability of the public finances is still uncertain. The debt to GDP ratio is expected to peak at about 150 percent in 2014-15. The severe reductions in public expenditures, public investment among them, may plunge the country into a prolonged recession, with adverse consequences for long-term growth as well as for fiscal stabilization. The structural reforms required are extensive.

Public support for painful economic measures that are needed cannot be taken for granted.

Following Greece, Ireland next had to appeal to the international support mechanism. And the Irish crisis was not a public debt crisis as its Greek predecessor. The Irish crisis grew out of the decision of the Irish government to bail out a banking sector that had faltered. This situation resembles events in the United States, where the financial crisis was the outgrowth of defaults in the subprime mortgage markets and the failure of financial institutions. There is fear that Portugal, and even Spain and Belgium are next in line.

As the spreads, European politicians and technocrats are busy setting up a permanent support mechanism to avoid the ad hoc intervention the Greek crisis required. In this context, they have to address fundamental, difficult and divisive problems: the trade-off between stimulus and restraint, with its implications for inflation, taboo from the German point of view, or the participation of the private sector in future bail outs. Such a "bail in" implies that different members of the euro zone would face different interest rates, with evident complications for the conduct of a common monetary policy.

But in economics, so often buffeted by politics and

public opinion, the temptation to find someone who offers fast and easy solutions, the economic equivalent of the medicine man proves almost irresistible at times.

Meanwhile, mainstream academic economists have been conspicuously absent from the policy deliberations and public debates that the debt and the financial crises have required and generated.

This is not a time to abandon academic economics for quack "cures."

A good starting point for the practice and teaching of economics to address for the public good at this time would be the consumption-savings problem. Asset markets and the ability of individuals and firms to borrow and lend determine the allocation of value and goods over time. But two major obstacles prevent the optimal operation of asset markets. First, market participants do not know the prices of commodities and assets that will prevail in the future. Ponzi schemes may allow market participants to evade budget constraints; collateral requirements in asset markets or the excessive deficit restrictions in the Stability and Growth Pact of the euro zone are at best imperfect rules of thumb. Neither the practice nor the theory of economics has figured out how to cope with mistakes in the allocation of value and goods and how to contain their multiplier effects.

For example, the value of the mortgage default that led to the financial crisis was modest. But the fiscal stimulus required to offset the economic default was many times larger, and quite substantial. The current system exaggerates the size of the default. Someone who has defaulted on a \$1million house may be able to pay \$750,000.

Academic economics was not able to predict the financial crisis or to offer a way out. At times, it does not even seem to possess the categories required to comprehend the problem. But, what options are there?

The situation has a parallel in medicine. One can recall a time when modern medicine, despite its research in biology and chemistry, could not treat or cure for illness that have since been conquered. When modern medicine failed, desperate patients turned to the village medicine man and his promises. A Western doctor visiting Egypt a few years ago, for instance, was shocked to find that villagers preserved and nibbled on crocodile heart as a cure for impotence, as the local medicine man had advised.

When medical research falls short, few argue that one should turn to the village medicine man rather than to further study of chemistry and biology. But in economics, buffeted by politics and public opinion, the temptation to find someone who offers fast and easy solutions, the economic equivalent of the medicine man, proves almost irresistible in promising to cure suffering and loss.

These crises of our times create an urgent call for good economics: the intellectually demanding, hard core theory and empirical work that provide the underpinnings for sound economic policies. These policies will not offer quick, painless solutions to the world's economic woes. Alas, for Greece and other nations, there is no viable crocodile heart cure.

The author

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The new majority

Christopher Woodruff takes a look at one legacy of the financial crisis: the re-positioning of the developing world's economies as the majority source of the globe's economic growth.

Low- and middle-income countries have been at the epicentre of almost every major financial crisis in the past 50 years. They have, thankfully, largely sat this one out. Growth remained above 9 percent in China and above 6 percent in India. Brazil's growth slowed in 2009, but its economy is expected to have grown by around 7 percent in 2010. Each country's growth story differs, but mostly, they have thrived because they have avoided both banking and currency crises.

In fact, when we look back on this period, I think we will say this is the time during which the emerging markets became the source of the majority of the world's economic growth. The combined GDP of the BRICs (Brazil, China, Russia and India) still represents less than a third of the combined GDP of the United States and Europe—about \$9 trillion vs. \$30 trillion, according to data from the International Monetary Fund. But growth rates in these and other emerging markets are likely to be more than triple those in the U.S. and Europe, even after the more developed regions recover from the crisis.

The slump in the United States and the European Union, with continued rapid growth in the emerging markets, makes the emerging economies big enough that even after recovery, they will account for more GDP growth than the U.S. and the E.U. With this, the balance of political power will inevitably shift as well. All of this was coming at some point, but the financial crisis has accelerated the change.

As the situation underscores, the term global crisis is something of a misnomer. The reach of the crisis extended to world's traditional power centres, while sparing the up-and-comers.

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The madness of crowds

Andrew J. Oswald examines the intersection of zoology and economics as a way of re-thinking what happened in the financial crisis.

The financial crisis was an example of the madness of crowds. But why, in the economic sphere, does herd behaviour exist and what should society do about it?

Start by imagining a bit of zoology.

Herding happens when *relative* position matters. Think of sheep in a field or fish in a pool. They cluster together because safety from outside predators comes from being on the inside of the group.

Although most do not recognize it in themselves, human beings are like other animals. Consider money managers. They are paid according to their success relative to the performance of other fund managers. Therefore, because it is so risky to stand out on the lower edge of the pack, they have a powerful incentive to follow the others. In the dotcom bubble, the analysts who got trampled were the ones who spoke up against the crowd. These brave people correctly said that huge prices would not be sustained, but were speedily sacked from their jobs.

Our current crisis has seen equivalent behaviour. Home buyers paid extraordinarily high prices for houses, even though not justified by fundamentals, because they felt they were trailing behind the Joneses. Brokers sold

unsound mortgages not because they were convinced of the absolute merits of those products but because they had to keep up with rival brokers. Most economists kept quiet about the house-price bubble; they were frightened of speaking up.

The word 'herd' does not appear in most economics textbooks. In consequence, those texts do not offer an intellectual framework that could predict, or can help policy-makers in, our current dilemma.

In a world with imitative crowd behaviour, there is an intellectual case for government intervention. The cool-headed individuals of traditional economics textbooks do not need to be regulated.

Because of the self-propelling externalities they create, herds do.

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The competition conundrum

Michael Waterson explains the counter-intuitive effects of a recession upon competition, showing why businesses are likely to compete less, not more.

What happens to competition in recession? A first thought might be that firms become more competitive as times get hard. One might think that prices would become keener and service would improve. However, counter to this first intuition, firms might actually reduce the extent to which they compete in response to hard times.

In recessions, two forces push in this opposite direction.

The first force stems from the fact that more firms will survive in an industry if the degree of competitiveness is reduced. This creates pressure to reduce competition in markets to some extent. In practical terms, this can either happen in a couple of different ways. Firms may agree to

merge, so that the number of firms falls but the resources in the industry largely remain unchanged. Firms may also gain support for "codes of fair competition" as a response to recession. In effect, these codes amount to cartelisation.

In the first case, when firms merge, any competition between them is eliminated, so that the overall level of competition in the industry is reduced. We have seen this pressure for very substantial mergers most clearly in the airline industry in recent years, as flagship carriers have combined throughout Europe, as exemplified by Ryanair's recent attempt to gain control of Aer Lingus.

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Then, too, “codes of fair competition” can be disguised in many ways, for example as assistance for small businesses, or creation of “national champions”.

This is more than fanciful armchair theorising. The experiences of the United States during the Great Depression offer prime examples. At that time, several acts reduced the impact of existing competition policy. Among them are the National Recovery Act, 1933, which introduced codes of “fair competition”, the Robinson-Patman Act, 1936, which strengthened prohibitions of price discrimination, and the Resale Price Maintenance Act, 1937. The impact of the last two was to reduce if not eliminate price competition among retailers, enabling small and relatively inefficient ones to survive the hard times. Big business also benefited hugely from the largely isolated nature of the US economy. While in more competitive industries, such as farm produce and commodities, prices plummeted. Meanwhile, in key monopolistic industries such as cigarettes, nickel and aluminium, so-called “administered prices” were maintained despite falls in costs. The mechanism by which this came about is somewhat unclear, but the phenomenon was widespread.

A second force at work in this recession involves exchange rates. Within the euro zone, currencies cannot fluctuate, which leads to problems that have been widely

observed relating to the weaker members inside the euro zone. But consider the conditions outside the euro zone: between the start of 2003 and around August 2007, the pound-euro exchange rate naturally fluctuated, but between a rather narrow band, approximately €1.4-1.5 euro per pound. Since then, the pound has sunk a good deal, so that during the past two years, the rate has hovered only between €1.1-1.25 per pound.

Why is this relevant? For a surprising number of products, often the type of thing we think of as ubiquitous, such as sand and brine, the number of producers in the UK is as few as one or two. The main competitive constraints on these firms therefore come from abroad. (Clearly, in these two examples, transport is expensive, so the constraint does not often bite.) But if the pound falls against the euro, that constraint becomes much weaker, reducing competitive pressure on *domestic* producers. Therefore these products can experience considerable latitude to maintain or increase prices.

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The two-word crisis

Gregory S. Crawford distils the many complex forces that created the financial crisis down to a two-word phrase that conveys it all: moral hazard.

Moral hazard is the phrase that captures the essence of the financial crisis, and it remains its unresolved legacy.

The term moral hazard means that we should worry about the decisions people make when they don't have to take responsibility for the consequences. The term originally arose in insurance settings: insurers worried, for example, that if they fully paid for repairs in the case of an accident that drivers would drive less carefully. It is for this reason that insurance policies typically have co-payments or deductibles: they ensure that drivers pay at least part of the consequences of their decisions.

Moral hazard played a role in practically all key aspects of the crisis. Those involved in writing mortgages for properties pocketed fees for their services, even if the properties weren't of sufficient value or sold to individuals who weren't able to pay (or both). Did these underwriters have to pay when the loans went bad? No. They had bundled these loans into securities called “collateralized debt obligations”, or CDOs, and sold them on to others in a market. Why did others buy them? One factor was that credit ratings agencies (such as Moody's and Standard and Poor's) had given them their stamp of approval. Did the ratings agencies have to pay when the loans went bad? No. They had collected fees for their ratings, regardless of whether they were accurate. Eventually the loans landed on the balance sheets of banks and other financial institutions. Did the banks have to pay when the loans went bad? Well, Lehman Brothers paid. But the vast majority of banks were “too big to fail”: the costs to the functioning of modern economies of the widespread failure of banks would have been enormous. So, no, they didn't have to pay either.

In the end, who had to pay? Taxpayers. At each step in the supply chain, rational economic decision-makers took on risks and pocketed rewards, but didn't have to pay the consequences when the risks went wrong.

A standard policy solution in the presence of moral hazard is regulation. Why weren't the banks (and especially the non-banks that were so important to the

overall functioning of the market) more tightly regulated?

First, regulators may not have understood the risks. A general presumption assumed that CDOs, like other types of financial derivatives, helped diversify risk. We now know instead that there was an important element of systemic risk: one bank's bad securities imperilled the viability of other banks. Because banks are critical to the functioning of modern industrial economies, governments couldn't let them fail, despite the huge price tag.

Second, and more worrying, is what we call the political economy of regulation. Beneficiaries of lax regulation, the financial sector, were well-funded, organized and well-informed. Those who ultimately paid the bill for lax regulation, taxpayers, were poorly-funded, unorganized, and poorly informed. Unless the regulator is insulated from the influence of lobbying - a hard thing to do consistently over time - policies inevitably will favour those organized to wield influence.

Stronger liquidity requirements and regulation generally for non-bank financial institutions would prevent them becoming as highly leveraged as they did. This may reduce their profit potential (and slow economic growth), but better enable them (and us!) to survive adverse shocks to their holdings. By making them ultimately responsible for the quality of their decisions, requiring banks to hold onto at least a share of their loans might help too. Reforming executive compensation is something to consider as well and might have spill-over benefits beyond banks! Finally, and perhaps most importantly, a strong, independent regulator that has the analytical strength and political muscle to design and implement policies to prevent further such crises is critical. Would that such a creature were on the horizon.

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The copycat problem

Mark Harrison finds market economies and command communist economies vulnerable to crises as a result of the same issue: the human tendency to copy one another.

In 1961, the Soviet economy saw a credit crunch. How did this work? The Soviet economy was managed on a command system: Everyone had their orders to produce this or deliver that. These orders were called plans.

Planning was a continuous process, and managers' abilities to deliver the plan were continuously being probed and tested. Think of this as analogous to the way, in a market economy, rating agencies evaluate the default risk on corporate bonds. There was a moment – in January 1961 – when it turned out that many managers' promises to fulfil plans, especially for foodstuffs, had been overrated. The political market for such promises immediately collapsed.

For a while, no one knew whose promises they could trust anymore; normal business came to a sudden stop. Much of the farming sector turned out to be financially insolvent and was bailed out.

History suggests that highly regulated economies can be just as unstable as market economies, but with more fatal consequences.

Many “toxic assets” of the day were human rather than financial, however. Too many people had made fools of themselves and others – including Nikita Khrushchev, the leader of the time. Cheating managers and the government officials that colluded with them were dismissed; some were put on trial for “deceiving the state.” Khrushchev carried on, but carried the stigma until 1964 when he was dismissed.

At first sight, the global financial crisis that began in 2007 has little in common with this story. It had many causes, including unwise government policies in the preceding period, but one important factor, it is widely thought, was a market failure. After a long period of economic stability and easy credit, many shared the prediction of Gordon Brown, then chancellor: “No return to boom and bust.” Markets were overvaluing real estate and financial assets, and derivatives backed by them. Their prices had risen far above fundamental values.

Buyers and holders of these assets were not properly discounting them by the true risks in the financial system. However uneasy any of them might have felt about the general expectation of a rising market, each went along with the others and carried on buying – until the bubble burst. The boom was followed by a slump. When the market adjustment came, it turned into a collapse, with consequences that will be felt for many years.

There are clear implications for the “efficient markets” hypothesis. It seems that markets for housing and equities weren't efficient. Some go further, translating this diagnosis into an indictment of “market fundamentalism,” “neoliberalism,” or “free-market capitalism.” The remedy they propose is much tighter regulation of markets, or even the replacement of markets by a socialist economy.

My own research is on socialist economies, not financial markets. But it has taught me to be wary of such conclusions. History suggests that highly regulated systems can be just as unstable as market economies, but with more fatal consequences.

Although socialist economies were not as exposed to market risks, they were much more exposed to political risks. Market economies tend to place natural limits on aggregate demand; this is one reason that John Maynard Keynes diagnosed a tendency of capitalism to underemploy resources. When politics is in command, however, those

natural limits tend to be ignored. Under Joseph Stalin and Mao Zedong, communist government programmes to develop Soviet and Chinese military and economic power periodically far outran the capacities of those economies to supply the needed capital goods and weapons.

A market economy would have given warning signals of overstretch: rising food prices, for example. With prices controlled, goods rationed, and private exchange criminalized, there were no market warnings. When alarms were raised privately, they were punished as politically inspired signals of disloyalty. There was no shortage of cheerleaders, especially when discontent was controlled by the secret police. Ordinary people paid the price. There was no misery of mass unemployment; everyone was in a job, working to fulfil state plans. But having a job did not help when food shortages tipped over into famines in which millions died.

This sounds quite different from what happens in financial markets, but one underlying cause was the same: the human tendency to look for safety in copying each other. In stock markets, buying seems to be the safe thing to do when everyone else is buying. Under socialism, when everyone else was cheering for mass struggle and industrialization, it was safer for each person to do the same, regardless of the eventual results. The results were more serious under socialism, however. Capitalist overoptimism eventually destroys jobs; Stalin's overoptimism killed people in millions and Mao's killed them in tens of millions.

The hard-wired human tendency to copy each other does not require market institutions to cause booms and slumps. It is equally evident in communist command economies.

One might object that a socialist economy does not have to be ruled by a dictator who is pathologically indifferent to social welfare. Rather than being enforced by a secret police, cooperation could be achieved by agreement on idealistic norms. A test of this came in the 1950s after Stalin's death. Khrushchev became Soviet leader. The Soviet economy was more stable than ever before. Government policies were becoming much kinder to the population. Khrushchev was ready for “new era” thinking. He wanted every working family to be properly housed and have meat on the table – quickly. He announced grand targets to achieve this within a few years. Dramatic improvements were soon reported, but the Russian archives show these achievements were deceptive to a large extent. Flats were being built, but people were moving into apartment blocks without glazing, plumbing, and even roofs. There was no more meat than before; farms and government agencies were achieving higher targets by selling promises of future meat and reselling the same carcasses to each other on a revolving carousel.

The liars were ordinary managers and local officials who wanted to show loyalty by accepting Khrushchev's challenges. The pressure on each to do this was all the greater because everyone was doing it. In exchange, they expected resources, large bonuses, and promotion. But having made unrealistic promises, they could only pretend to have met them. They were encouraged when they looked around and saw everyone else pretending too. When each got away with it, all expected to get away with it. Cheating on the plan grew and spread across entire regions. In

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reality, the more the habit spread, the less sustainable it became.

Think of the managers operating in a socialist political market, where they exchanged promises to supply products in return for favourable treatment. The values of these commitments were being inflated beyond the capacity of the economy to supply them. If a promise to supply a good is an asset, there was a bubble in the political market for these promises. False promises were exposed when the bubble collapsed, just as the recent credit crunch in market economies exposed both ordinary insolvencies and several notorious pyramid schemes and frauds.

My conclusion is that the global financial crisis was preceded by a market failure, but one cause of these failures was not in markets as such. It was the hard-wired human tendency to copy each other. This tendency does not require market institutions to cause booms and slumps. It is just as evident in the command economies of the Soviet Union and communist China. The consequences

there were even more serious than in a market economy. Too much regulation did not stop people from behaving badly. It just led to shows of pretended loyalty and conformity, while destroying valuable, even life-saving market information. There are some problems that regulation cannot eliminate. Rather, the challenge is to regulate economic activity in ways that accept human nature as it is, neither assuming nor forcing us to be better than we are. Regulators are human, too.

The author

Mark Harrison is a University of Warwick economics professor who specializes in Soviet economic development and history. This article draws on research forthcoming in the *Journal of Comparative Economics* as "Forging Success: Soviet Managers and Accounting Fraud, 1943 to 1962." It is available at:

<http://go.warwick.ac.uk/markharrison/public/jce2011.pdf>

The Pierian Spring approach

Robin Naylor examines the underpinnings for the about-face in UK funding of higher education.

As recently as 2000, students from all round the UK were graduating from university after enjoying the benefits of free higher education.

The next year, the door to tuition fees opened, but it was left only slightly ajar. Following the Dearing Report, students from within the European Union were asked to contribute a modest £1,000 per year.

Ten short years on and the world has been turned upside-down: the Browne Review published in October 2010 recommended changes to student finance which were beyond anything anticipated over the course of the intervening decade. In December, after debate about various possible figures, legislation established £9,000 per year as the upper limit, with implementation to begin in the academic year 2012-13.

So what has changed to generate such a transformation of funding of higher education in the UK? Defending a policy of such a substantial step-change in tuition fees, the coalition government partners are appealing to the need to make drastic public expenditure cuts in light of the size of the public deficit. This is especially true for the Liberal Democrats, whose election pledge was to oppose any increase in tuition fees and whose leader, Nick Clegg, was campaigning for fees to be replaced by a graduate tax as recently as October 2010.

The implication is that had the recession not hit and had public debt not soared as a consequence, then the higher education funding regime need not have been over-hauled to such an extent.

So, is the recession to blame for the drastic increase in higher education fees? An alternative explanation for change on the scale proposed is philosophical preference rather than short-term economic necessity.

Under this view, the state of the macro-economy and of public finances provides merely a convenient foil. Outside of the STEM (Science, Technology, Engineering and Maths) subjects, taxpayer subsidy towards the costs of higher education will not exist. The policy perception is

that no external benefits whatsoever accrue from advanced study of the arts, humanities or social sciences.

Thus, we are witnessing a transition from a position of 100 percent subsidy for higher education to zero in some cases – practically overnight.

Indeed, it is worth noting that the original proposals in the Browne Review go even further than a complete withdrawal of the public subsidy. Rather than subsidising a university degree, Browne proposed that fees above £6,000 be subject to tax. The marginal rate of this tax would be rise to 75 percent on fees above £11,000. So a degree course entailing costs to a university of £9,000, for example, would require students to pay more than £12,000 and yield to the government tax revenue of over £3,000.

Is higher education now deemed to be an economic 'bad'? Perhaps policy-makers are inclined toward mistaken extrapolation: if 'a little learning is a dangerous thing', what social cost attaches to higher education?

We would do better to read Alexander Pope's poetry: "Drink deep, or taste not the Pierian Spring." In an insight Pope achieved some four centuries ago and phrased with such elegance, a little learning isn't enough.

Our policies ought to encourage education, so that the generations acquire the skills and intellectual prowess they need in these complex times. Wisdom and understanding, the fruits of a demanding education that is available to as many who will take on its challenges. These are the sorely needed skills that will benefit our economy, and, indeed, our society.

The author

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The final word

Abhinay Muthoo explains the genesis of this special edition, focused on the signature economic issue of our day.

The global financial crisis is the defining economic issue of our times. For a while, it seemed that the world stood at the edge of a precipice, on the verge of tumbling into an economic disaster as catastrophic as the Great Depression, three quarters of a century earlier. Utterly unexpected, the economic collapse developed with sudden speed and terrifying force, putting the modern world's banking system on the brink of collapse. Before various acts of the crisis had played themselves out, Bear Sterns, Lehman Brothers, Freddie Mac and Fannie Mae had lost their stature as icons of financial acumen and trust and become instead shorthand names for the financial meltdown.

During 2007-2008, a shocking collapse led all key economic variables to fall at faster rates than they had during the early 1930s. The U.S. housing boom imploded. The volume of world trade and industrial output plummeted. The European Central Bank was forced to intervene to restore calm to distressed markets. By 2009, UK GDP contracted by 4.8 percent, the steepest fall since 1921. And, of course, the crisis upended politics as usual in many countries, paving the way, for instance, for the UK's first coalition government since the World War II era. The crisis also upended lives. Untold numbers have lost their homes, their savings, their jobs – perhaps along with their faith in certain financial institutions and in government, and their hope for a more prosperous future.

We approach the three-year anniversary of the February 2008 nationalization of Northern Rock, taken over by the government just months after the first run on a UK bank in 150 years. This is an opportune time to reflect on the crisis and what we as academic economists have learned from

the events of the past several years.

Any lessons will be particularly important as the next acts of the crisis unfold - with emergency measures taken to rescue Greece and Ireland; speculation over whether Portugal, Spain, and even Belgium could be next; and discussion about whether this may spell the beginning of the end of the euro.

Against this sobering backdrop, this special edition of the Bulletin of the Economic Research Institute brings together a wide array of expertise and insights from some of the best specialists in the University of Warwick Department of Economics. This edition reveals that while we share the same discipline, we hold widely varying points of view on the crisis, its contours, and its revelations. We take on the crisis through the lens of history and of current events; from the economies it hit with destructive force and from the economies it spared; and from a wide range of perspectives, taking account of the power of institutions, societies, human nature, and, even zoology as they played a role in this unfolding drama.

In the end, we intend for this edition to offer you fresh perspective on this, the most significant economic issue of our times.

The author

Abhinay Muthoo is the Head of the Warwick University Economics Department and the Director of the Economics Research Institute.

The University of Warwick Economics Research Institute

The ERI is an integral part of the Department of Economics at the University of Warwick. Its members include the academic and research staff and research students of the Department of Economics; visitors attached to the Department of Economics; and scholars from other institutions who are associated with programmes of research administered within the Institute.

The Director of ERI is Professor Abhinay Muthoo. You can contact him at a.muthoo@warwick.ac.uk.

The aims of ERI are to promote directly and indirectly research in economics and interdisciplinary research that has an economic aspect; to facilitate the funding and organisation of collaborative research projects involving the participation of members of the Department of Economics; and to support scholarly activities such as conferences and research networks that extend beyond the

routine scholarly life of the Department of Economics.

The Bulletin of the ERI appears once a term. Each issue features summaries of published or forthcoming research by ERI members. The Bulletin's editor is Karen Brandon. You can reach her at K.Brandon@warwick.ac.uk. The Bulletin's editorial consultant is Romesh Vaitilingam. You can contact him at romesh@vaitilingam.com.

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