

STAIRWAYS TO HELL (HISTORICAL INTERVENTIONISM AS A TRULY ROOTS OF CURRENT GLOBAL ECONOMIC CRISIS)*

Marco Djogo**

Tamarra Starovlah Djogo***

Abstract: Economic crisis in Euro- Atlantic economy came in it's fifth year although governments of developed countries have taken all measures that they were using more or less successfully in last 60 years. And while governments keep looking for more drastically measures to end the crisis, we believe that the time has come for analyzing this situation from another angle. That angle is integral historical analyses of actual roots of this crisis instead of shallow partial analysis that take place these days.

Key words: Economic Crisis, State Intervention, Free Market

JEL classification: E02, E58, E6

1.INTRODUCTION

The historical background we would like to emphasize was created by series of measures made by governments of developed countries in the past. Those measure were driven by insatiable intention of these states to spread over private sector almost equally by taking its material goods (via direct and indirect taxes and abduct called "nationalization"), and by always increasing interfere in private jobs (through regulation explained by good intention).

Objective of this work is to, by exposing these historical circumstances, appoint at defectiveness of these measures and above all of wild spread opinion that financial liberations caused this crisis. Financial liberation, indeed, deepened this crisis, but it is not its real cause.

Different diagnosis of crisis leads to diametrical different measures.

If we are right (and duration of crisis approves our attitude), measures taken this days by government of USA, EU etc, will, in the best scenario, delay crisis for few decades, after which its will come back in even worse shape. In the worst case (or maybe better) these measures will not bring results and crisis will continue.

Short list of events that made financial liberation be understood ads a "beast" given by time sequence (but exposed in sequence easier for reader to understand) is next:

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** PhD, Sinior Asistent, University of East Sarajevo, Faculty of Economics, e-mail: markodjogo@yahoo.com, marko.djogo@ekofis.org

*** Bachelor of Low, marko.djogo@ekofis.org

- Taking away of a part of monetary freedoms from citizens through constitution of “privilege” banks (by the time this banks will became central banks) with an object to find additional funds for covering budget deficit. These were nucleus of the first real root of crisis that came by putting powerful financial institutions under state influence;
- Putting OMO in function of covering budget deficit, which took place during 1920's;
- Accepting concept of active monetary policy by developed countries during 1930's as respond at great depression, what was attempt to neutralize economic cycles. Without them market economy can not function;
- Establishing agencies like Fannie Mae and Freddie Mac during 1940's which distorted free market arbitration on very important segments of financial market;
- Establishing IMF during 1940's what definitely slushed violent concept of central bank developments, and, even worse, change of IMF functioning concept during 1970's;
- Introducing of Basel standards on capital adequacy during 1980's, which indeed equalized “laws of the game“ for a banks from developed countries. Yet, these standards where written so prejudiced that favored banks lending to governments have caused huge increase of public debts.

2. ESTABLISHING FANNIE MAE AND FREDDIE MAC- REACHING OR LEAVING AMERICAN DREAM?

The beginning of present economic crisis is directly connected to the activity of these two financial institutions. While being quite common to talk about this crisis as debacle of economic liberalism, it is very interesting that those two agencies are *de facto*² state institutions.

Exactly, they were „invented” in 1938. (actually, at the beginning only Fannie Mae has been established), as a part of Roosevelt's “New deal”. Their tasks were to by enable Americans with middle and lower income to buy real estate supporting of process of securitization³. This way sharply increased gross amount of loans to householders by granting a credit to those more risky clients.

That has been explained as a way to help “American dream come true”. That dream meant that anybody who has been working hard and had good ideas could become reach, afford himself luxury life, including decent home.

Unfortunately, many presidentially administrations have understood this dream in socialistic way and replaced word “any” with “every”. So, while American dream implied that there is no obstacles by class, race, religion and others basis to get reach and become someone important, establishing of these agencies were motivated by aspiration to allow to less competent Americans to become owners of high value real estates.

Although that sounds noble, we are all witnesses that last attempt to make everybody live reach (communism) ended with unprecedentedly outspread misery (is it necessary to

² These two agencies were for a long time and *de jure* state institutions (100% state owned). Exactly, Fannie Mae were state owned in period 1938-1968, Freddie Mac in period 1969-1989. Than they where transformed in public companies.

³ Securitization is a process of transforming pull of uniform loans in the securities. In this transaction pull of loans serves as income source for payoff to owner of securities.

remind that Yugoslav communists were assuring our citizens for a long time that “to day days everybody gets as much as it is possible but wery soon time will come when everyone will get as much as he wants (meaning unlimited).

That is why this attempt of American equalization by negation of social differences which market made had to end so badly. Besides series of scandals which just showed that private interests does not disappear with establishing of government agencies, but changes its shape in robbery under state protection without restrictions which free market made, this agencies insert serious mistakes in American financial system.

Overall, existence of these institutions motivated banks to grant credits to objectively bad clients calculating that they will extricate them (credits) very soon through these agencies and earned on series of fees⁴, while risk will be transposed on buyers of securities issued in this process. On the other hand, buyers of those securities thought that fact that those papers were issued with state agencies support means that they were low-risky. That explains very low interest rate on those securities, just a little higher than at USA Treasury bonds.

Granting credits to risky clients must come back to financial system soon or latter. This finally happened in 2007.

If there were not those quasi-state agencies, banks would never dare to grant credits to clients with so low solvency, while buyers of these securities would be much careful. In these circumstances nothing of this would happened, or at least crisis would be surpassingly smaller.

To recapitulate, even these concrete reasons for beginning of crisis suggest that there cannot be question of some huge freedom. On the contrary, this crisis began because states heavily interfered in market processes.

3. STABILIZATION OF FINANCIAL SYSTEM AS NEGATION OF FREE MARKET

Second process which, indeed, less directly but more drastically, brings to today crisis is attempt of negation of economic cycles through monetary intervention with declarative objective to stabilize financial system. History of this attempt is directly connected to experiences with Great Depression and fact that then President of USA Herbert Hoover rejected to intervene with expansionist monetary policy (although he took whole series of fiscal measures and public works). Because of this, even ingenious Milton Friedman convicted FED’s passivity and claimed that, with more actively monetary police, this crisis would be just one of many minor crises in history. At another coast of Atlantic, Keynes developed macroeconomic tools and required more active economic police.

Consequences of those two men actions are that big majority of modern economists accept interventionism of central banks explained by financial market stabilization as

⁴ Even after transfer of ownership right over credits from bank to another financial institution that would issue securities, banks usually continued to provide services like acceptance of annuities from borrower, money transfers, issuing of a guarantee etc. That is just a part of banks income from this transaction because even before this transactions become banks were already charge fee for working on granting credits, and after this transaction is over majority clients stay loyal to bank and use other banks services unaware that banks transfer ownership over them credit to another financial institutions.

something normal. There is no discussion any more does this occurrence distort free market mechanism to achieve economy equilibrium. Only discussions are *how much it should last*.

This is disappointing because all information indicates that free market mechanism is tricked during the crisis. For example, if you look for results of World banks research named “*Bank Ownership and Lending Patterns during the 2008–2009 Financial Crisis Evidence from Latin America and Eastern Europe*”⁵, you will see that statistic dates unambiguous show that in developed countries supply of credits rises and interest rates fall during the crisis.

This appearance is absolutely opposed to normal market logic. First of all, unavoidable part of crises is grown of non-performing loans (NPLs). By logic and low, credits with lateness over assigned time banks are obliged to take as expenditure⁶. If there are big amounts of them (bigger and bigger crisis brings to more and more NPLs) banks becomes scoring losses. In those moments banks have to theoretical ways. First is to find many new quality clients who will regularly return credits and so earned enough money to banks to cover losses from bad clients. Chances for this to happen are in domain of science fiction. Second, and really only way is for banks to introduce more restrictive lending conditions including rise of interests rates⁷ and so, via increase net interest rate spread compensate losses.

But, in practice, in countries which are capable to guide independent monetary police, this is not going on because of monetary authorities making available enormous amounts of cheap money to banks on which they could earn only if they would grant it to clients (often to same clients who are not returning previously taken loans).

While those authorities measures undoubtedly help for crisis to end earlier, question is how market could work at all when governments take him oportunities to punish wrong activity of banks, businessmen or states, does not matter. This forms cycle in which banks are not punished for granting credits to bad clients. Bad clients are not punished for not returning previously taken loans, but they continue to work on new and cheaper credits. State is even awarded with cheaper financing of budget deficit. It looks like wolves are saturate and sheep are ok. But, this is happiness in short time. In long terms, this police brings to uncompetitive business subject, and high inflation rates which additional devastate economic tissue of any societies.

⁵ Bertay A, Demirgüç-Kunt A, Huizinga H, „*Bank Ownership and Credit over the Business Cycle Is Lending by State Banks Less Procyclical?*” The World bank, WBS 6110, Washington D.C, 2012. pg. 15.

⁶ For example Banking agency of Republic of Srpska: “*Decision on Minimum Standards for Banks’ Credit Risk Management and Asset Classification*”, Official Gazette of Republika Srpska Number 12/03, 85/04, 01/06, pg. 7, <http://www.abrs.ba/propisi/odlukeeng/DecMinStandBanksCredRiskMngmntAndAssetsClass.pdf>, date of access 14.11.2012.

⁷ Every IMF reports for countries in Southeast Europe in 2009, 2010. anticipated that banks will tighten landing standards. For example: IMF County Report No 09/185, “*Republic of Croatia: 2009 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Croatia*”, pg. 14, <http://www.imf.org/external/pubs/ft/scr/2009/cr09185.pdf>, date of access 14.11.2012, and

Country Report No 10/348: “*Bosnia & Herzegovina: 2010 Article IV Consultation, Second and Third Reviews Under the Stand-By Arrangement, Request for Waiver of Nonobservance of a Performance Criterion, and Rephasing of Purchases*”, <http://www.imf.org/external/pubs/ft/scr/2010/cr10348.pdf>, date of access 14.11.2012, pg. 13.

4. IMF – SUPERSTRUCTURE ON SUSPICIOUS

Opinions that IMF and WBG are global bulwarks of liberalism are overspread. Although, this “new” IMF formed during last crisis it is not even by opinion such keynesian like Paul Krugman⁸ is.

However, it is importance to notice that although IMF participate in defining of “Washington consensus”, it is established and created as political organization on suspicious basis which support uncountable governments to avoid deserved punishment.

When we are talking about disputable genesis of IMF we think first of all at concept of central banking which is wide spread today and which is in roots of IMF. Modern central banks are products of state need to collect disguised taxes by using (monetary) authority on their citizens.

To explain this claim we have to go back in the past for the moment. In this way unquestionable fact is that before central bank were established, commercial banks were institutions which issued their banknotes (*de facto* money of that time). Everyone had freedom to choose bank whose banknotes he would use. That had made pressure on banks to work responsibly because every suspect in their solvency would bring to abandoning of their money.

This situation changed when contemporary rulers made such a mess⁹ in public finance that there were no bank ready to grant state a new credit. Intendly to bring back any order in budgets, instead of decreasing of public spending, governments decided to use power by selling “rights” at issuing banknotes to some banks. This is how “privileges” commercial banks were established. These were normal commercial banks dealing with all kind of usual banking jobs but in exchange for beneficial credit to government they got right that their banknotes become “legal tender” at whole state territory (thus established currency). Shortly, some banks made deal with states which allowed them to using force become monopolists in issuing money.

This covering of budget deficit were paid with taking away part of monetary freedom which citizens used to enjoy, and, over all, this created background for manipulating with monetary police which practically did not exist before.

Citizens of some countries had fought against this process longer then others. For example USA was country without central bank up to the Civil war in 1862, so banknotes during this period were issued by more then 700¹⁰ banks. However, governments used wars to establish central banks and co-opt management over them. So, almost all privileged banks stay privately owned all to the WW II. After allies victory even governments of developed countries nationalized central banks and, thus, joined fascistic and communistic countries which did that before the war.

USA stayed, for some time, more or less exception because FED stayed *de jure* in mixed ownership all to this days. But, to banks members of FED it was prohibited to issue

⁸ Look for Paul Krugmans interview to journal Press published at 3. October 2012. (<http://www.pressonline.rs/info/drustvo/bolna-tacka-srbije-nije-javni-dug-vec-konkurentnost>, date of access 15. October 2012.)

⁹ Bank of England, History/Timeline (<http://www.bankofengland.co.uk/about/Pages/history/timeline.aspx>) date of access 17. October 2012, Djogo M, “*Story about money: history of money and monetary police*”, RS Associations of Economists SWOT, Banja Luka, 2012, pg. 27.

¹⁰ http://en.wikipedia.org/wiki/History_of_central_banking_in_the_United_States, date of access 18. October 2012.

their money till money reforms in 1971. That is how, from five kinds of dollars in use up to 1960, today only once is left. This, closed to majority of Europe countries, USA by level of un-freedom.

But even in Europe still existing bright exceptions like Scotland and North Irish. These members of Great Britain obtained that Bank of England did not spread its monetary sovereignty over them. Since they represent developed areas, it is clear that what to majority people looks strange - to live without central banks and their money - is actually good for them.

Why we come out with this under subtitle connected with IMF?

Because, when IMF has established at the end of the WW II (as a part of same processes of taking over banking system by states) it anchored previous government violence! More precisely, IMF was imagined like central point in web of international monetary system constituted by national central banks (that imply that every country has its central bank and its currency). If Keynes proposal were adopted, situation would be even worse because IMF would become international central bank with full authorizations.

All those are just a part of problems with IMF. Second part of the problem is in fact that during 1970-s IMF lost clear mission of existence (in period 1946-1973. Aim of IMF was to help maintenance of fixed exchange rates). Instead of that, Fond became fireman who fight fire (by borrowing¹¹) in areas where irresponsible governments caused mess with their short-sighted behavior. **With this Fond encouraged governments on moral hazard and reduce market power by its intervention which created good soil for developing crisis including this current.**

5. BASEL STANDARDS- RISK ASSESMENT METHODOLOGY AS INSTRUMENT FOR SUPPORTING TO STATES

Basel standards are one more instruments of regulation usually considered like instruments in service of globalism by establishing unique “rules of the game” for banks from all over developed countries which helps in forming “global players”. This is explained by introduce of unique methodology to calculate capital adequacy to cover outstanding bank loans. However, manner in which risk weight were established could be described with “prosecutor are judging to me”. That means that authorities involved in writing standards made deal to weight for all loans to developed countries should be zero (0), what means that risk at such borrow is same like store money in banks treasures! Otherwise said – for those loans banks do not have to hold any capital reserves.

This favoritism of “regulators” made banks to gladly grant credits to governments of developed countries (number of these “developed” grown rapidly). That granting continuous when amount of public debt cross 50% of BDP, than 100% and in some case even incredible 300%.

¹¹ In the very beginning IMF working principles defined that country could borrow just 25% of its quota. Rest of standby arrangement was or drawing resources which country previously paid to become member of Fond, or currency conversion. During 1980s this principles were change to allow Fond to borrow much more money to countries in trouble.

Shortly, if you were citizen, banks would never lend you so much money that you could not give back in reasonable period. If you are state, it is possible for you because same standards approve it. Point is clear. **Smaller danger to stability of global financial system would represent system without any kind of regulation than this one. In that system banks would probable diversify states according to condition in their public bills.** Thus banks relied on standards established by states what brought to crisis of public debts and consequentially crisis of banking system which were the biggest owner of that debts.

Even this did not affect authorities to turn over deregulation. In fact they are near solution which is tragicomic. So, states find that banks crisis could be over if they would recapitulate banks. Since public budgets are empty this recapitalization could not be done without new lending from banks to states. That brings us to situation in which we do not know any more who is sick and who is a doctor!

This nonsense is possible by Basel standards because, if banks would borrow to states which keep their credit rating high, that would not raise capital requirements for banks but it would give enough money to states to invest in same banks and so complied standards.

So after nationalization of central banks in the middle of XX century, at beginning of XXI century probable is particular nationalization of banking system what just show trend of “development” of so– called “capitalistic” countries!

6. OMO – IRON FIST OF INTERVENTIONISM IN SILKY GLOVE OF LIBERALISM

Open market operations are believed to represent market way of managing monetary police (on the opposite of administrative measures like minimal reserves are).

But, when we look behind a curtain, it is easy to see that market orientation of OMO is in a way of their implementation, while motives and consequences are same or even worse, then with administrative measures. This is not surprising for us because OMO were established as product of disguised interventionism in society which believed in liberal ideas.

The first country whose monetary authorities adopted OMO in greater scale was USA since 1914. In the beginning this operation was completely excluded from measures of monetary police and put in function of development of New York money market (artificial, administrative pushing of development of this market in order to become more competitive to then leading London money market). Since 1917 those operation were directly put in function of supporting USA Treasury to collect funds for financing the war, but even this was just an episode. Turnover happened in 1923 when Fed adopted OMO as major instrument of monetary police. In that moment states securities represented only 27.5% of asset in Fed portfolio.

Table 1: Part of states securities in Fed portfolio

Year-end	Treasury securities	
	(dollars in millions)	(percent of total)
1915	16.0	19.8
1916	55.0	31.2
1917	122.0	31.4
1918	238.0	45.5
1919	300.5	80.8
1920	287.4	60.6
1921	234.1	61.8
1922	433.4	61.5
1923	133.6	27.5
1924	540.2	58.3
1925	374.6	50.2
1926	314.8	45.2
1927	560.0	64.4
1928	197.2	31.1
1929	487.3	67.4
1930	686.1	70.4
1931	774.6	78.3
1932	1,851.1	99.8
1933	2,435.3	95.7
1934	2,430.3	100.0
1935	2,430.3	100.0

Resource: Marshall D, „Origins of the use of Treasury debt in open market operations: Lessons for the present“, Federal Reserve Bank of Chicago, 1Q/2002, Economic Perspectives p. 48.

As you can see, untill 1934 that percent has risen at 100%, which means that Fed directly subject monetary police to needs of fiscal police. And that is not all. Unlike earlier years when Fed bought / sold securities at open market, that practice were abandoned very soon thru opening of its own broker (part of FOMC), and by making the list of accredited partners (it is not posible any more to any commercial actor become buyer/seller in transaction with Fed as it has been in the beginning).

Shortly, it is a long time ago since OMO become instruments which forced banks to finance budgets deficits and by that indirectly support development of public sector at prejudice of private sector. To paraphrase, OMO become iron fist of interventionism in silky glove of liberalism.

7. INSTEAD OF CONCLUSION: RETURN TO LESE-FAIR ECONOMY AS ONLY CURE

We believe that processes which were previously explained clearly show that real cause of today crisis is in the rise of public sector which neutralise market and shark private sector. It is particularly easy to be seen in processes of establishing modern central banks, introducing of Basel standards and excepting of OMO as primary instruments of monetary police. Everyone of these processes were used to support states to finance ever growing expenditure.

Establishing of IMF and adopting of active monetary police were just attempt of “fire fighting with gasoline“, i.e. attempt of solving problems which governments made with their interference in economic processes.

That is why only long-term sustainable development is in radically reducing of state interference in economy by decies of state authorizations and al kind of regulations.

This would clarify real conditions in public finance and competitiveness of economy. In the beginning, it would, probably, cause deep economic and social crisis because “all bills would get at charge”, but in the same time, it would release countries from ballast of interventionism they carry-on for centuries and which brake their development.

At the end, one truly lese-fair economy is not hard to imagine. In that economy state would hold just few essential competences like defense, public order, legal system, primary education and basic service from secondary medical care. That would be sociaty without central banks, and buying of states securiates would take place without government forcing. Banks would grow and sink, but it would not cause deep crisis because they would develop mechanism of protection like deposit insurence agencies are today (example of those agencies are New York Safety Fund in USA during 1837-1862 period) or Agencies for guarantee of banknotes (like Boston’s Suffolk Bank from the same period are).

Short period of crisis would change with periods of prosperity. Redistribution from outstanding to less capable would take place at willing basis, what would return economy to its primary definition “maximizing output with limited resources” what is not cause right now.

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