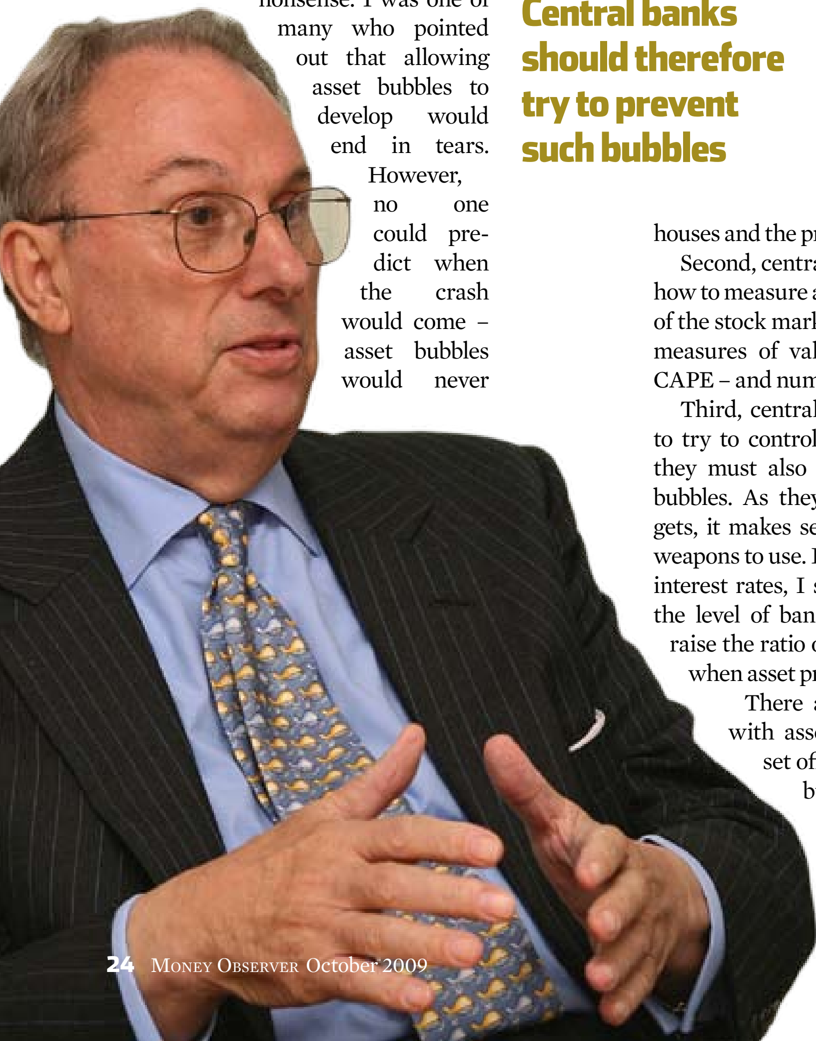
A test of nerve

We know what went wrong in financial markets, but opinion is divided as to whether the response has been adequate. Andrew Smithers argues that only courageous political action will prevent a repeat

What went wrong in financial markets? It's simple. Asset prices, including shares, houses and risky debts, fell sharply, causing demand to fall so that the economy weakened. The loss of jobs and declines in income and wealth have caused a great deal of pain. We can't avoid occasional mild recessions; they are necessary for avoiding huge ones. But the most recent crash was unnecessary and shouldn't be repeated.

Those responsible for bad policies and those who failed to foresee the consequences like to believe that 'no one predicted the turmoil'. This is nonsense. I was one of many who pointed out that allowing asset bubbles to develop would end in tears. However, no one could predict when the crash would come – asset bubbles would never happen if it were possible to predict the point at which they will peak. As major changes in asset prices have a profound effect on the real economy, it is equally impossible to predict the timing of the subsequent recessions.



Time for action

Major collapses in asset prices only occur after bubbles and are always followed by severe recessions. Central banks should therefore try to prevent asset bubbles. I have argued for years that this is necessary, though few economists agreed. Today it is hard to find any that disagree.

> **Collapses in asset prices only occur after bubbles. Central banks should therefore try to prevent such bubbles**

This agreement now needs to result in action. First, central banks must agree on the asset prices they need to monitor. In *Wall Street Revalued*, I argue that the key asset prices are shares, houses and the price of risky debts.

Second, central banks must agree on how to measure asset prices. In the case of the stock market, there are two valid measures of value, known as Q and CAPE – and numerous invalid ones.

Third, central banks must continue to try to control consumer prices, but they must also seek to prevent asset bubbles. As they have these two targets, it makes sense to give them two weapons to use. In addition to adjusting interest rates, I suggest that they vary the level of banks' equity capital and raise the ratio of equity to total assets when asset prices become too high.

There are four big problems with asset bubbles. First, they set off recessions when they burst, partly because households increase their savings and cut back on their consumption when their wealth falls and partly because banks cut back on lending as they see the value of houses and shares fall.

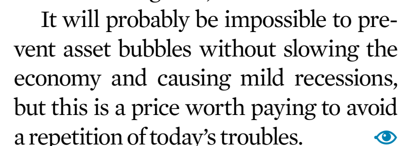
The second problem is that central banks lose control of the economy, as cuts in interest rates cease to stimulate demand. This happens because changes in short-term interest rates usually affect asset prices, and changes in asset prices affect the economy. But the impact of interest rates on asset prices is short-lived. The fundamental value of shares does not change and, if their prices are driven up too far, they will fall, even if interest rates are also falling. In these conditions, as we have seen recently, central banks are unable to prevent major recessions developing and large increases in government deficits are needed to get economies back on track.

The third problem is that the swings in asset prices produce suffering and unfairness, for example, with the failure of pension funds. The fourth problem is that taxpayers suffer hugely from the costs of bailing out the banks.

If central banks act to suppress asset bubbles, these problems will be modified, but additional measures are needed to limit taxpayer losses. The agreed way to do this is to increase banks' equity capital by two or three times.

Bankers don't want to raise it from the market, so they seek to reduce their need for equity by cutting back on lending. As this hinders recovery, banks should be forced to raise new equity quickly. I fear that politicians will flunk this. As television's Sir Humphrey Appleby would say: 'That would be most courageous, minister.'

It will probably be impossible to prevent asset bubbles without slowing the economy and causing mild recessions, but this is a price worth paying to avoid a repetition of today's troubles.



Andrew Smithers is chairman of economic consultancy Smithers & Co (www.smithers.co.uk). *Wall Street Revalued: Imperfect Markets and Inept Central Bankers* is published by Wiley, RRP £16.99