The Economic Crisis and the Crisis in Economics

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The Economic Crisis

The global financial crisis of fall 2008 was unexpected. A few people had been predicting that serious problems were looming, and even fewer had placed bets accordingly, but even they were astounded by what happened in mid-September.

What did happen? There are many layers to unpeel, but let me begin with the three main events that triggered the severe global phase of the crisis. (See http://BaselineScenario.com for more on what came before, how events unfolded during fall 2008, and where matters now stand).

- On the weekend of September 13–14, 2008, the US government declined to bail out Lehman Brothers. The firm subsequently failed, i.e., it did not open for business on Monday, September 15. Creditors suffered major losses, and these had a particularly negative effect on the markets given that through the end of the previous week the Federal Reserve had been encouraging people to continue to do business with Lehman.
- On Tuesday, September 16, the government agreed to provide an emergency loan to the major insurance company, AIG. This loan was structured so as to become the company's most senior debt and, in this fashion, implied losses for AIG's previously senior creditors; the value of their investments in this AAA bastion of capitalism dropped 40 percent overnight.
- By Wednesday, September 17, it was clear that the world's financial markets—not just the US markets, and particularly US money market funds—were in cardiac arrest. The secretary of the Treasury immediately approached Congress for an emergency budgetary appropriation of $700 billion (about 5 percent of GDP) to be used to buy up distressed assets and thus relieve pressure on the financial system. A rancorous political debate ensued, culminating in the passing of the so-called Troubled Asset Relief Program (TARP), but the financial and economic situation continued to deteriorate both in the United States and around the world.

Thus began a financial and economic crisis of the first order, on a magnitude not seen at least since the 1930s and—arguably—with the potential to become bigger than anything seen in the 200 years of modern capitalism. We do not yet know if the economic consequences are "merely" a severe recession or if there will be a prolonged global slump or worse.

The Crisis in Economics

Does this economic crisis constitute or imply a crisis for economics? There are obviously two answers to this question: no, and yes.

Let me discuss the "no crisis" view first. There are actually several variants on this view. The first is that the post-Keynesian consensus comes through the crisis just fine. In fact, the current emphasis on fiscal stimulus in the United States (and the debate about fiscal stimulus elsewhere) supports the position that we are back to Keynesian fundamentals. There is a decline in private spending underway, and governments around the world are seeking to replace that with public spending (or, if you prefer, the private sector suddenly wants to save more, so the public sector better rush to save less.)

More broadly, there was also some kind of bad expectations trap, in which everyone expected everyone else to default and that kind of fear of counterparty risk is obviously self-fulfilling.

A more nuanced version of this view adds some financial accelerators, or perhaps we should now call them decelerators. We obviously had a series of bank runs in mid-September, but not just by small depositors and not just on banks. We also had a situation where falling values for collateral triggered more asset sales (either for accounting reasons or due to market pressure of various kinds), and this led to further lowering of collateral.

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In other words, this view is that we can retrofit our favorite mainstream models to accommodate what happened, at least at a fairly high level of abstraction. There is no crisis for macroeconomic thinking, let alone for economics.

An alternative interpretation is that mainstream macroeconomics is in big trouble. You can think about this in terms of whether standard thinking provides plausible answers to four current policy issues. (Daron Acemoglu of MIT has an important essay in preparation, arguing that there are deeper problems for economics, including for the most fundamental microeconomics—such as how we think about firms and reputations—in the light of the crisis.)

First, let's begin with whether macroeconomics can answer definitively or even informatively the most important question of the day: Are we in danger of falling into another Great Depression, with a prolonged, worldwide fall in output and employment?

The mainstream answer to this question is: No, because we've learned a lot about economics since the Great Depression and because we also learned a great deal about policy both during and after the 1930s.

I am not so convinced. For example we know that a key policy mistake in the early 1930s was to allow banks to fail. This will not happen again, at least not for "systemic institutions," as the G-7 made clear in October. But bank failure was a problem because it contributed to a big contraction in credit—this has been well established in the work of Ben Bernanke and others. Unfortunately, we know relatively little about how to stop today's process of falling credit around the world, known as "global deleveraging."

Second, consider the current consensus on saving the day in the United States and around the world through a large US fiscal stimulus, probably $800 billion over several years, which would constitute the largest peacetime boost ever for the US economy. Is this really the right approach?

We know that allowing the price level to decline was an essential error of the early 1930s, as this increased the real debt burden for everyone with fixed nominal obligations. We think we know how central banks can prevent this kind of deflation, and Mr. Bernanke's now famous November 2002 speech laid out a clear road map for appropriate policies—even to the extent of "quantitative easing," i.e., extending more credit without sterilization through selling Treasuries, thus increasing the monetary base.

Still, I am struck by the fact that while the opinion leaders among US-based macroeconomists eventually called for some version of "credible irresponsibility" (to counter deflation or even produce inflation) in Japan during the 1990s, we have still not reached the point where such terms have joined the acceptable lexicon for most of the mainstream on the US economy today. (Some leading economists, I find, are willing to talk in these terms in private, but not yet in public.)

I would stress that nothing in the Fed policy or the Obama plan has yet turned the corner on this issue. In fact, inflation expectations have not risen significantly since it became clear Mr. Obama would win the election and introduce a major fiscal stimulus.

Monetary policy will not stop bubbles and regulators will always fall behind; responsibility for making sure we can handle major financial crises rests with fiscal policy.

Think about that in terms of monthly payments on your (or my) house. Let's say the interest rate on your mortgage is 6 percent, which is roughly the average for the United States. When inflation runs around 2 percent (as is typical), the real, inflation-adjusted rate you pay is lower, actually only 4 percent. But the price level is now expected by the financial market to be flat on average for each of the next 5 years. So in this case the real interest rate will be 6 percent. In other words, the advent of deflation implies a massive unexpected transfer of income from borrowers to lenders. With the face value of outstanding mortgages over $10 trillion, this will likely depress spending by more than can be compensated for by any reasonable fiscal stimulus.

The appeal of recreating positive inflation expectations is that it would put downward pressure on the dollar and thus push our major trading partners to cut interest rates and engage in their own forms of monetary expansion, or face appreciation of their currencies and a fall in exports. The result will be higher global inflation to be sure, but this is the only realistic way to persuade EU members to take the measures necessary to stimulate their stronger economies or even save their own weaker economies from default.

President Obama can ask our allies to provide stimulus until he is blue in the face, but the fact of the matter is that the very size of our own fiscal expansion gives the Germans and others the incentive to free ride—they are hoping to recover on the back of exports to our infrastructure projects. It is only more expansionary monetary policy in the United States that will force their hands in the right direction, for us and for them.

Third, what is the deeper cause of this crisis? A supersized financial system—the obesity of banks and shadow banks—helped create the vulnerabilities that made the September crisis possible. This financial system captured its regulators and took on far more risk than it could manage (or even understand). And this is a statement not just about US banks, but also about most parts of the global financial system.

The answer lies with the political economy of the US financial system, including the power politics of large financial firms. These grew large relative to the institutions that support and constrain them. In effect, we created an emerging-market type of structure. There is nothing in the mainstream textbooks or working papers about this—the general working assumption has been that institutions in the United States were significantly better than in emerging markets. The time has obviously come to question in what sense this is really true.

The US banks have received generous bailouts, at least after the Lehman-AIG events, with no change in management. Have they become stronger or weaker? After the crisis we will have probably no more than 6 major banks in the United States, with little threat from new entrants and small hope of controlling their actions indefinitely through effective regulation.

The problems are even more pressing if it is the case that these banks need to be recapitalized fully. They oppose this policy, for obvious reasons. The fiscal stimulus may well prove ineffective in the face of this political opposition, which is still well represented at the heart of the new administration's economic strategy. Again, however, I find leading economists to be surprisingly quiet on this key issue.

The fourth question is: What are the implications for the eurozone? Again, there is a huge divergence of opinions among economists on this point. Personally, I am struck by the growing pressure on some of the weaker sovereigns that belong to the euro currency union. Greece faces the most immediate problems, as demonstrated both by widening credit default swap spreads and, over the past few weeks, increasing spreads of Greek bonds over German government bonds. The cost of servicing Greek government debt is thus rising at the same time that Greece has to roll over debt worth around 20 percent of GDP in the coming year.

Greece has a debt-to-GDP ratio over 90 percent, and the perceived risk of default is significant. In my baseline view, Greece receives a fairly generous bailout from other eurozone countries (and probably from the European Union). This, however, does not come early enough to prevent problems from spreading to Ireland and other smaller countries, which then also need to implement fiscal austerity or to receive support. Italy is also likely to come under pressure, due to its high debt levels, and here there will be no way other than austerity. With or without a bailout, Greece and other weaker euro sovereigns will need to implement fiscal austerity.

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The net result, in my opinion, is less fiscal stimulus than would otherwise be possible, and in fact there is a move to austerity among stronger euro sovereigns as a signal. Governments will therefore struggle to dissave enough to offset the increase in private-sector savings. But the global mainstream economics approach still seems to be emphasis on fiscal policy coordination.

In any case, monetary policy in Europe will be slow to respond. The European Central Bank (ECB) decision-making process seeks consensus and some key members are still more worried about inflation down the road than deflation today. Eventually the ECB will catch up, but not before there has been considerable further slowing in the eurozone.

Existing macroeconomic thinking can probably accommodate this kind of analysis. It's a blend of financial market analysis with political economy. But I don't know any models, let alone much empirical work, that bear directly on, or comes close to testing, any dimensions of this issue. Economics is in thin air.

My guess is that, among other things, we need to change dramatically our ways of thinking about fiscal policy. This needs to prepare for irregular but large crises, which implies being more countercyclical, and that implies less growth in boom times. Monetary policy will not stop bubbles and regulators will always fall behind; responsibility for making sure we can handle major financial crises rests with fiscal policy.

Rethinking the Structure of the Global Economy

If economics is in so much trouble, what does this imply for thinking about economic policy, both in terms of sensible crisis management and more medium-term attempts to rebuild a reasonable global system?

In order to create the conditions for long-term economic health, we need to identify the real structural problem that created the current situation and that has likely pushed the global economy into a new phase of instability. It wasn't a particular set of payments imbalances (read: US-China), as these can and will change (which does not excuse policymakers who refused to address this issue). It wasn't the failure of a particular set of domestic regulators, as regulatory challenges and responses change over time (which doesn't excuse the specific regulators).

Let me suggest a way to think about these economic issues, although I know this will not sit well with many macroeconomists (although it may go down better with those who focus on longer-run growth issues). The underlying problem was that, after the 1980s, the "Great Moderation" of volatility in industrialized countries created the conditions under which finance became larger relative to GDP and credit could grow rapidly in any boom. In addition, globalization allowed banks to become big relative to the countries in which they are based (with Iceland as an extreme example). Financial development, while often beneficial, brings risks as well. None of these points would have sat well with mainstream finance or economics two years ago, but perhaps the consensus around some of these points has shifted recently.

The global economic growth of the last several years was in reality a global, debt-financed boom, with self-fulfilling characteristics—i.e., it could have gone on for many years or it could have collapsed earlier. The US housing bubble was inflated by global capital flows, but bubbles can occur in a closed economy (as shown by experiments: http://baselinescenario.com/2008/12/07/financial-crisis-bubbles-causes-psychology/). The European financial bubble, including massive lending to Eastern Europe and Latin America, occurred with zero net capital flows (the eurozone had a current account roughly in balance). China's export-driven manufacturing sector had a bubble of its own, in its case with net capital outflow (a current account surplus).

But these regional bubbles were amplified and connected by a global financial system that allowed capital to flow easily around the world. I am not saying that global capital flows are a bad thing; ordinarily, by delivering capital to the places where it is most useful, they promote economic growth, in particular in the developing world. But the global system also allows bubbles to feed on money raised from anywhere in the world, exacerbating global systemic risks. When billions of dollars are flowing from the richest countries in the world to Iceland, a country of 320,000 people, chasing high rates of interest, the risks of a downturn are magnified, for the people of Iceland in particular.

The prevalence of debt in the global boom was also a major contributing factor to today's recession (although major disruptions could also arise from the busting of pure equity-financed booms). Debt introduces discontinuities on the downside: Instead of simply losing money, companies with high debt levels go bankrupt in hard times. Lehman, AIG, and now GM all created systemic risks to the US and global economies because one default can trigger a series of defaults among other companies, and simply the fear of those dominos falling can have systemic effects. Similarly, emerging-market defaults can have systemic effects by spreading fear and causing investors to pull out of unrelated but similarly situated countries (and causing speculators to bet against their currencies and stock markets).

Ideally, global economic growth requires a rebalancing away from the financial sector and toward nonfinancial industries such as manufacturing, retail, and health care (for an expansion of this argument, see our opinion piece on this topic.) Especially in advanced economies such as the United States and the United Kingdom, the financial sector has accounted for an unsustainable share of corporate profits and profit growth. However, the financial sector, despite the experiences of the last year, is still powerful enough to resist significant structural reform. While this will not prevent a return to economic growth, it will maintain all of the risks that led to the current situation—in particular, the risk of synchronized booms and busts around the world.

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Understanding how to prevent stability from creating future vulnerability will require us to rethink a great deal about economics and how economies operate. Political economy is probably the place to begin, but a lot more needs to be done on fundamentals. Whether or not our economies manage to avoid a major global depression, economics is in crisis.

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Comments from members of the Association for Comparative Economics are gratefully acknowledged. Conversations with Daron Acemoglu and Adam Davidson helped to shape these remarks and this essay draws freely on joint work with Peter Boone and James Kwak (see http://BaselineScenario.com for details), but the views expressed here are solely those of the author, Simon Johnson, copyright 2009.