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WILLIAM E. WEISS LECTURE

THE GLOBAL CRISIS AND ITS AFTERMATH



SOME QUESTIONS ABOUT THE CRISIS

- ✘ What happened?
- ✘ What consequences?
- ✘ Why did it happen?
- ✘ Are we done with it?
- ✘ Could it happen again?

Crisis? What crisis?

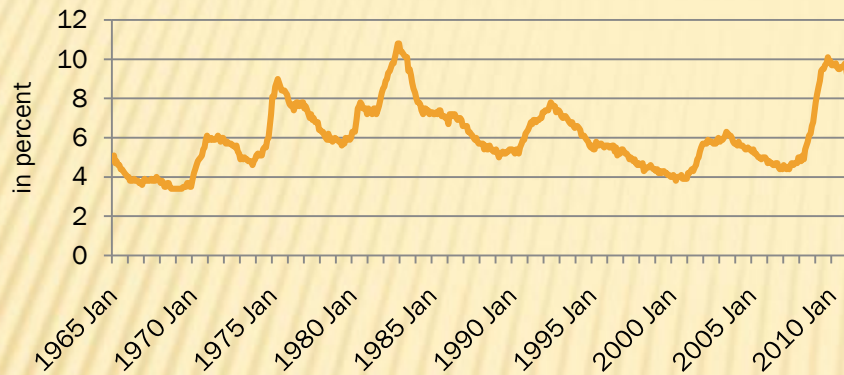
1. INTRODUCTION

CRISIS? WHAT CRISIS?

- ✘ Started as the “subprime mortgage crisis”
 - + “At this juncture . . . the impact on the broader economy and financial markets of the problems in the subprime markets seems likely to be contained” (Bernanke Mar07) 
- ✘ Turned into a “global financial crisis”
 - + “The financial crisis that began in August 2007 has been the most severe of the post-World War II era and, very possibly – once one takes into account the global scope of the crisis, its broad effects on a range of markets and institutions, and the number of systemically critical financial institutions that failed or came close to failure – the worst in modern history” (Bernanke Jan10). 
 - ✘ The “Great Trade Collapse”, the “Great Recession”
- ✘ Truly a severe crisis, financial & economic & global!
 - + Crisis followed the “Great Moderation” (Bernanke Feb04).

GREAT RECESSION: LABOR MARKET IMPACT

Unemployment rate



Source. Bureau of Labor Statistics
Note: Seasonally adjusted

Employment-population ratio

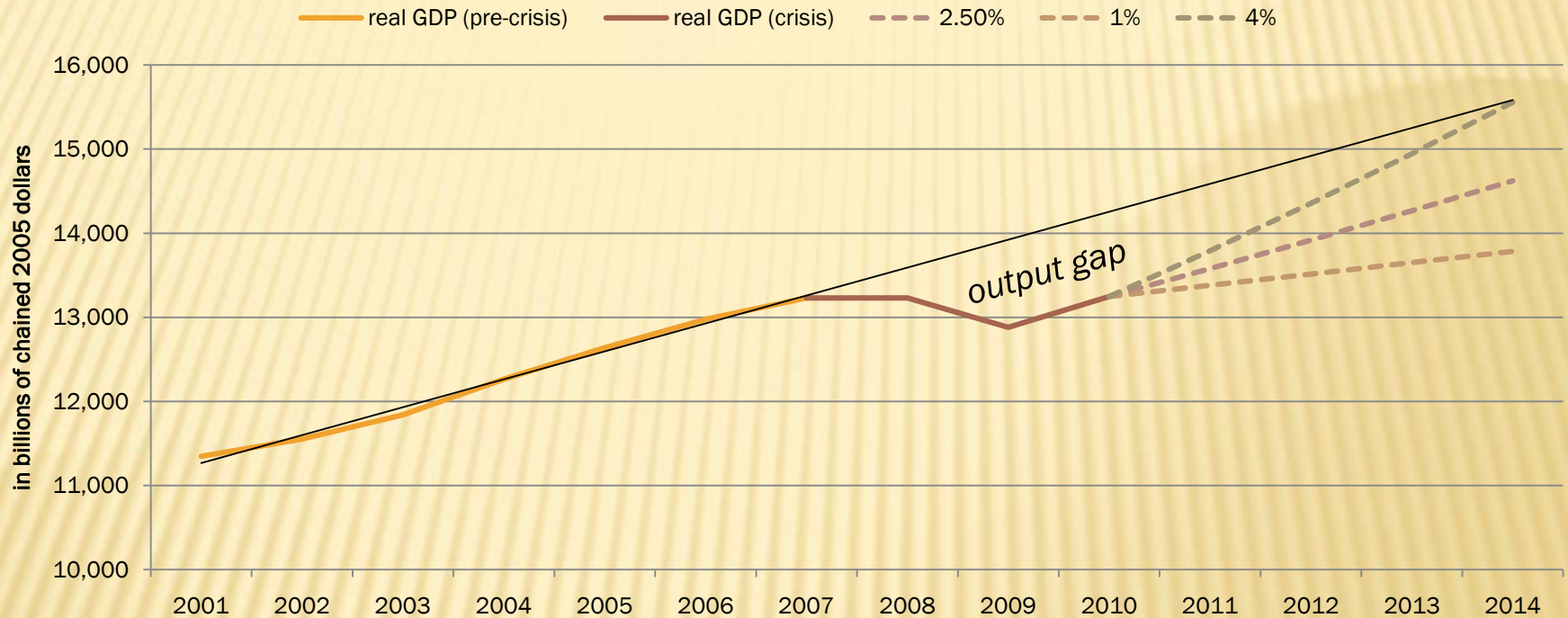


Source. Bureau of Labor Statistics

- ✘ Unemployment rate surged
- ✘ High long-term unemployment
- ✘ Some decline of late
- ✘ Only part of picture though

- ✘ Discouraged workers have withdrawn from labor market
- ✘ ~8.5mn jobs lost in Great Recession; still down ~7mn today
- ✘ Plus new entrants since 2008
- ✘ Wages barely rising (~2%)
 - + Below inflation!

THE CHALLENGE: MIND THE GAP

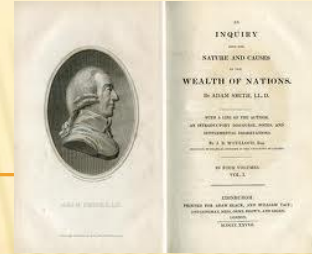


- ✘ Scenario A: 2.5% trend; the '00s, i.e. not great
- ✘ Scenario B: 1% trend; “eurosclerosis”
- ✘ Scenario C: 4% trend; better than “roaring ‘90s”
- ✘ Not even scenario C would yield “maximum employment” by 2014

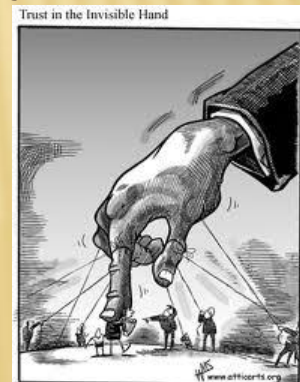
The invisible hand when panic strikes

2. WHAT HAPPENED?

THE INVISIBLE HAND



- ✘ Microeconomics and the vision of self-regulating market forces
 - + “... by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is ... led by an invisible hand to promote an end which was no part of his intention.”
 - + “It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. The taylor does not attempt to make his own shoes, but buys them of the shoemaker. The shoemaker does not attempt to make his own cloaths, but employs a taylor. The farmer attempts to make neither the one nor the other, but employs those different artificers” (Smith 1776).
- ✘ Specialization, size of the market & globalization
- ✘ Prices guide allocation of resources; income distribution by markets
- ✘ Some issues: externalities, information, market power
- ✘ Role of government?
 - + Globally?
 - + Regionally? (EU)



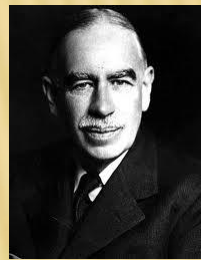


HOW ABOUT “WAIT & SEE”?

- ✘ What if everyone, perhaps scared by certain events, decides to withhold spending?
 - + As sales drop, firms cut production and fire workers, i.e. incomes drop.
 - + As incomes fall there may be all the more reason to cut spending ...
 - + Where does this cumulative process end?
 - + The invisible hand cannot quite handle this!

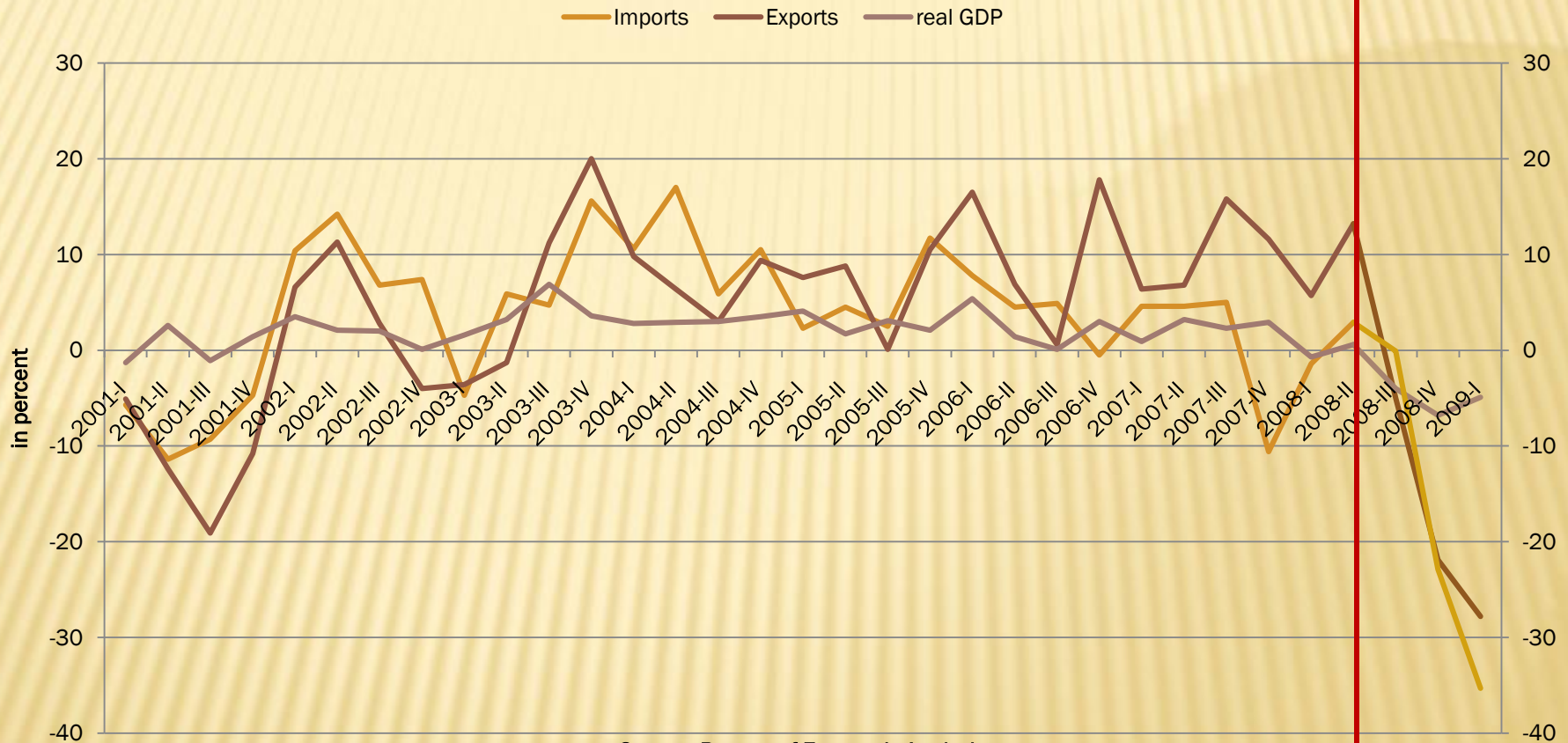
- ✘ Macroeconomics: My spending is someone else's income!
 - + In the aggregate, we cannot earn more than we spend (Keynes).
- ✘ Global income equals global spending.
- ✘ But any particular nation may spend more or less than its national income. The difference is called: current account balance.

- ✘ “Wait and see” = one key aspect of global crisis! Global indeed!





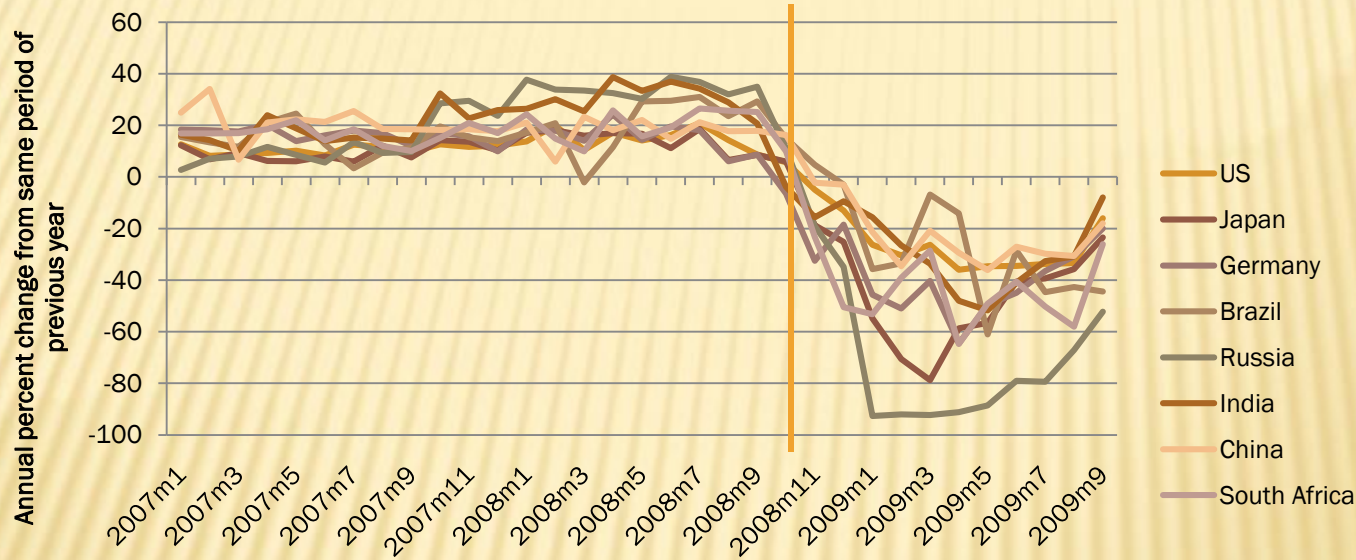
AS AMERICA STOPS SHOPPING



Source. Bureau of Economic Analysis
 Note. Percent change from preceding period. Seasonally adjusted at annual rates.

WORLD TRADE FALLS OFF THE CLIFF

The Great Trade Collapse



Source. WTO

Note. Merchandise exports. Values in US dollars.

Anything that might stop & reverse the free fall???



- ✘ Starting in the 4th quarter of 2008 until the summer of 2009 global trade and global industrial production collapsed at a faster rate than during the Great Depression.
- ✘ Global policymakers got really scared!

WHAT MIGHT STOP & REVERSE THE COLLAPSE?

- ✘ Automatic fiscal stabilizers
 - + As incomes fall and unemployment soars, tax revenues decline and benefits rise.
 - + Government budget automatically turns into deficit, which mollifies slump, stabilizes the economy.
- ✘ Discretionary fiscal stimulus
 - + Requires decision to boost government spending or cut tax rates (so as to boost private incomes and, hopefully, spending).
- ✘ BUT: Global collective action problem to prevent free-riding.
- ✘ Remarkably, global crisis triggered global policy response (G-20).
 - + Globally coordinated fiscal stimulus packages!
 - ✘ U.S.: Obama's "American Recovery and Reinvestment Act", Feb 2009, \$787bn

Only one key aspect of global crisis and policy response! What else?

PANIC IN GLOBAL FINANCIAL MARKETS

- ✘ What if everyone, perhaps scared by certain events, decides to sell risky assets?
 - + Risky asset prices crash! How much?
 - + Until prices have dropped enough to lure buyers back into the market.
 - + It might seem that the invisible hand can handle this, but the process can actually get out of hand. Debt is the issue here!

- ✘ What do the panic-sellers want?
 - + Cash (& safe assets)! A rise in “liquidity preference” (risk aversion)
- ✘ What do the willing buyers need?
 - + Cash (or liquid assets or access to credit).

- ✘ Who can provide what everybody seems to prefer or need?
 - + Well, in principle, banks can!

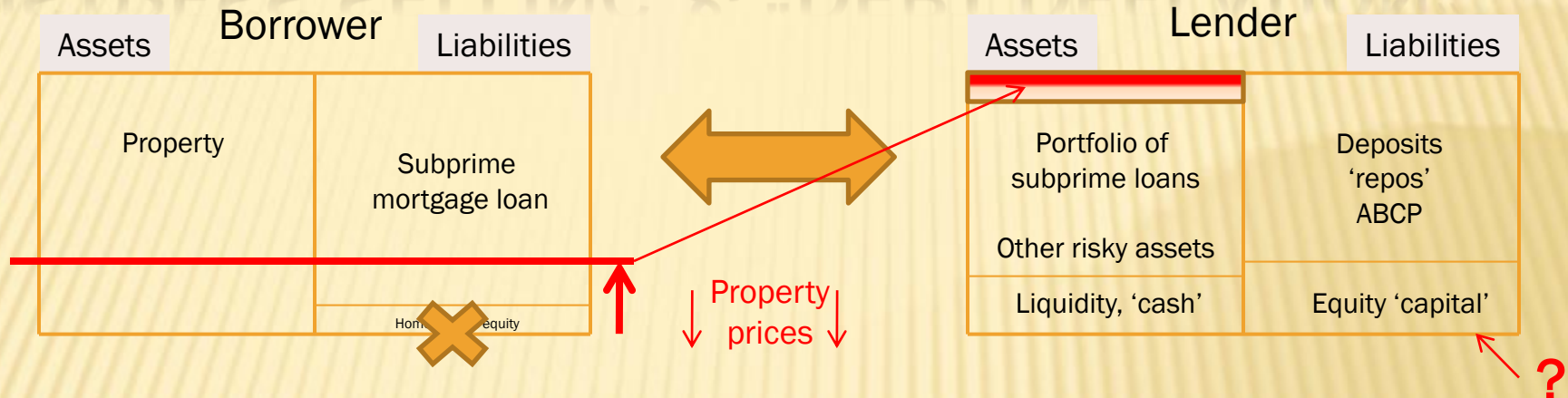
A bank's balance sheet

WHEN LIQUIDITY IS KING

- ✘ Banks are in the business of producing liquidity.
- ✘ Banks issue their liabilities (deposits) by buying assets (making loans).
- ✘ So if banks were to buy what panicky nonbanks want to sell, they could stop the crash (while producing the very liquidity that is in high demand).
- ✘ This will NOT happen if the banks' own liquidity preference surges and they themselves are frantic sellers of risky assets.
- ✘ If the banks also panic and dump assets in the market (or re-call loans or deny roll-over of loans), they actually destroy liquidity (“de-leveraging”).
 - ✘ The money stock rises when banks purchase assets and it falls when they sell assets from their portfolio.
 - + Bank de-leveraging further adds to the downward pressure on asset prices.
- ✘ The trouble is that while a risky asset worth \$100 yesterday may drop to zero today, a \$100 debt will still be a \$100 debt tomorrow!

Assets	Liabilities
Loans Risky assets	Deposits
Liquidity, 'cash'	Equity 'capital'

DISTRESS SELLING & “DEBT DEFLATION”



- ✘ Cut off from liquidity troubled debtors are forced to sell assets to pay off debts – “distress selling”, “fire sales”
- ✘ Distress selling spreads the problem across more and more debtors and markets – systemic contagion
- ✘ Fisher’s paradox: “the very effort of individuals to lessen their burden of debts increases it, because of mass effect of the stampede to liquidate is swelling each dollar owed. Then we have the great paradox which, I submit, is the chief secret of most, if not all great depressions: The more the debtors pay, the more they owe” (Fisher 1933).
- ✘ *Note that this is a standard prisoners’ dilemma: individual attempts to keep credit ratings up result in a collective worsening.*

Anything that can prevent a systemic meltdown???

THE LENDER OF LAST RESORT

Hi, They call me “helicopter Ben”. I can make it rain money.



- ✘ As LOLR the central bank is the ultimate provider of liquidity!
 - + The Fed was creative in flooding the system with liquidity when the need arose.
- ✘ The Fed issues its liabilities by buying assets (or making loans).
 - + The size of its balance sheet has inflated since the crisis (it more than tripled).
 - + Its composition has changed too.
- ✘ The Fed also acted as international lender of last resort through currency swap arrangements with foreign central banks.
 - + Reflecting the fact that the \$ is the foremost global reserve currency.
- ✘ <http://blogs.wsj.com/economics/2010/11/18/a-look-inside-the-feds-balance-sheet-7/tab/interactive/>



FOOTNOTE: HOW DID BERNANKE EARN THE TITLE?

- ✘ Analyzing Japan's protracted deflation, Bernanke (2002) devised the blueprint for actions later applied by the Fed, including "money-financed tax cuts"; the closest thing to "helicopter drops".
- ✘ The helicopter parable is due to Milton Friedman.
- ✘ Friedman & Schwartz blamed the Great Depression on Fed blunders.
- ✘ At Friedman's 90th birthday Bernanke (2002) observed: "Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again."
- ✘ "the big mistake that policymakers made in the early '30s was they essentially allowed the financial system to collapse" (Bernanke Dec08).



- + "I was not going to be the Federal Reserve chairman who presided over the second Great Depression" (Bernanke Jul09).



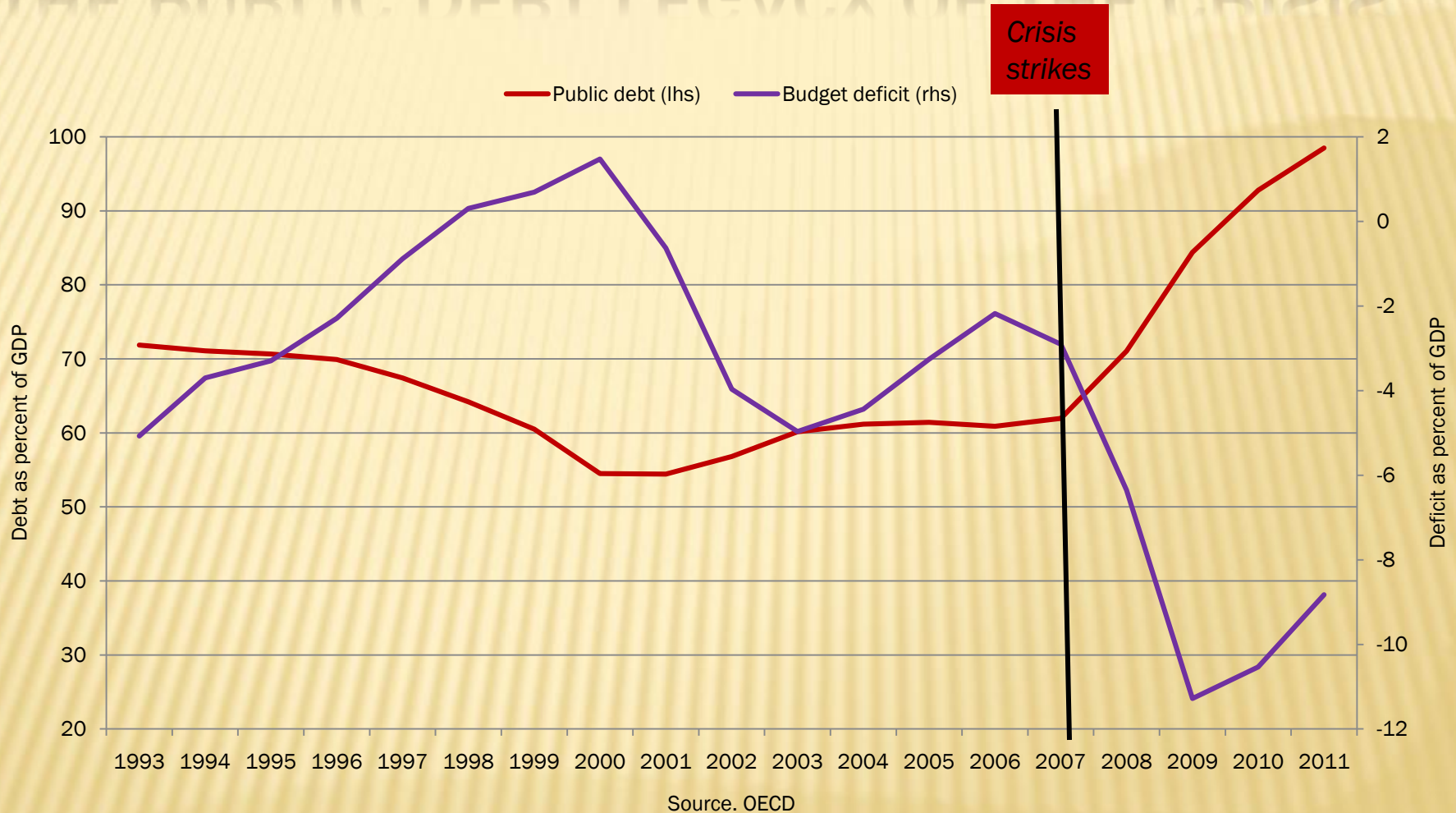
FINANCE AND THE REAL ECONOMY

- ✘ (1) “wait and see” – drop in spending/incomes.
- ✘ (2) Financial panic – debt deflation/system meltdown.

- ✘ Not separate compartments, but highly interdependent!
 - + Spending/incomes may drop because financing failed.
 - + Bank without subprime mortgage exposure may fail because its borrowers go bust/lose their jobs.
- ✘ (1) & (2) reinforce each other; negative feedback loops.

- ✘ Modern macroeconomics failed dismally.
- ✘ Policymakers were using models that had no financial sector, no banks, no possibility of bankruptcy.

THE PUBLIC DEBT LEGACY OF THE CRISIS



Private debt crisis → banking crisis → sovereign debt crisis? → political crisis?

An accident waiting to happen!

3. WHY DID IT HAPPEN?

CREDIT & HOUSING BUBBLE – AND BUST

Meet the suspects/culprits

- ✘ (1) Wall Street
- ✘ (2) Government
- ✘ (3) Federal Reserve monetary policy blunder
- ✘ (4) Global imbalances

WALL STREET

- ✘ Innovative products & practices allowed credit expansion: “shadow banking system”.
 - ✘ Securitization, structured finance & derivatives (CDOs, CDS, SIVs, conduits etc); rating agencies.
- ✘ Irrational exuberance & excessive risk-taking
 - ✘ Failures of corporate governance and risk management.
- ✘ Greed & fraud
 - ✘ “Systemic breakdown in accountability and ethics” (Angelides).
- ✘ Financial industry enjoyed strong (or excessive?) growth in business, profits and bonuses.
- ✘ Construction industry crucial job creator in 2000s.

GOVERNMENT

- ✘ Homeownership as social policy
 - ✘ “The American dream” & “democratization of credit”
- ✘ Fannie & Freddie
 - ✘ Subsidized lending rates as market distortion
- ✘ Financial regulation & supervision
 - ✘ Liberalize & deregulate mantra; market “self-regulation”
 - ✘ Or regulators/supervisors failed to use their powers
 - ✘ Regulatory arbitrage
- ✘ Peculiar role of rating agencies in credit ratings
 - ✘ S&P, Moody’s, Fitch “opinions” as stamp of approval

FEDERAL RESERVE MONETARY POLICY

- ✘ Argument: Fed held interest rates too low for too long.
- ✘ Fed slashed rates aggressively in wake of dot.com bust.
- ✘ Kept rates at record low levels until June 2004 for fear of deflation and in view of “jobless recovery”.
- ✘ Followed by preannounced cautious policy tightening (June 2004 – June 2006).
- ✘ Fact: When the Fed was done hiking, the housing bubble was done too.

GLOBAL IMBALANCES – REST OF THE WORLD

- ✘ Argument: Capital inflows from ROW depressed U.S. interest rates, sponsoring the credit & housing bubble.
 - ✘ As emerging economies (particularly China) save too much and manipulate exchange rates, their excess savings (current account surpluses) end up in U.S. (“global saving glut”, Bernanke 2005).
 - ✘ Advanced economies (particularly Europe) let their banks build up U.S. mortgage exposures, contributing toward excessively compressed credit spreads/risk premiums (Bernanke 2011).

- ✘ Fact: The U.S. has run persistent current account deficits since 1991, rising over time.
 - ✘ Means that U.S. notoriously spends in excess of income (“saves too little”).
 - ✘ WHY???

GLOBALIZATION AND THE U.S. DOLLAR

- ✘ Globalization (= integration of markets) has left nation states (= political segregation) in a precarious state.
 - + National economic policies lose effectiveness.
 - + Conflict between democracy and globalized markets.
- ✘ Globalization (& market forces process unleashes) creates universal policy focus on competitiveness.
 - + Keeps a lid on wages (↔ income & wealth distribution).
 - + Induces policy focus on competitive exchange rate.
- ✘ In U.S. case competitiveness pressures augmented by the fact that U.S. dollar “reserves” provide safety (to ROW), so that dollar is systemically overvalued.

Note: While the previous pages summarize, under four headings, the main arguments featuring in the emerging narrative about the causes of the crisis, here is my take on the “big picture” (missing in the debate).

U.S. DOLLAR AND U.S. ECONOMY

- ✘ Dollar brings sizeable benefits to U.S., especially large corporates and financial industry (“exorbitant privilege”).
- ✘ International role of dollar also comes with a “burden”, a “burden” to over-spend if global economy so requires.
 - + How that?
 - + Who does the over-spending?
- ✘ Eagerness to export and hold dollar reserves in ROW creates deflationary forces in U.S.
 - + Given rudimentary U.S. welfare system, macro policy must act.
- ✘ Unless the U.S. government chooses to overspend sufficiently, the U.S. private sector has to be enticed to do the job.

ENTER THE SUBPRIME MORTGAGE BOOM

- ✘ 2001 recession triggers aggressive Fed easing
 - + Corporate sector in repair mode (dot.com bust)
 - + Wealthy households in (dot.com bust) tears
 - + Bush tax cuts & Iraq “little bang for the buck” in the U.S.
- ✘ Inviting a new class of borrowers, hitherto denied credit access, to indulge was rather convenient for everyone.
 - + Wall Street “creativity” and public policy in accord.
- ✘ New demand critical for driving up property market.
 - + Properties in general, not just subprime segment.
- ✘ Property market boom critical to recovery *with jobs*.

- ✘ Who would want to spoil the party????
 - + Perhaps the “Financial Stability Oversight Council”?

Recovery remains fragile and unbalanced

4. ARE WE DONE WITH IT?

SOME CRITICAL ISSUES

- ✘ Labor market: a headache for years to come
 - + Healing will require a long & robust upswing.
- ✘ Public debt
 - + Poor public finances reflect poor state of economy. Economy has to improve for public finances to improve.
 - + Austerity risks making deficit bigger.
- ✘ Highly accommodative Fed policy here to stay
 - + Limited effectiveness (oil).
 - + Source of global tensions (G-20 can't agree anymore).
 - + Risk of new bubbles?

After the crisis is before the crisis. Lessons learnt?

5. CAN IT HAPPEN AGAIN?

FINANCIAL CRISES RECURRENT

- ✘ 40 years of tranquility following Great Depression was exceptional.
 - + Followed drastic financial reform in wake of Great Depression
- ✘ How about this time?
 - + “Never allow a crisis to go to waste” (R. Emanuel Nov08).
 - + Dodd-Frank “Wall Street Reform and Consumer Protection Act”
- ✘ Today, Wall Street is back!
 - + Big banks bigger than ever, bigger than before crisis!
 - + Profits, bonuses ... campaign contributions ...
- ✘ Economy does need finance! What kind of financial industry though?
- ✘ What is the best way to rob a bank?
 - + “The Best Way to Rob a Bank is to Own One: How Corporate Executives and Politicians looted the S&L Industry” (W. Black 2005).
- ✘ And a state?
 - + ...