Project Syndicate - The Great Contraction of 2008-2009

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CAMBRIDGE – A popular view among economic forecasters and market bulls is that “the deeper the recession, the quicker the recovery.” They are right – up to a point: immediately after a normal recession, economies do, indeed, often grow much faster than usual over the ensuing twelve months. Unfortunately, the Great Recession of 2008-2009 is far from being a normal global recession.

The Great Recession was turbo-charged by a financial crisis, making it a far more insidious affair that typically has far more long-lasting effects. As Carmen Reinhart and I argue in our new book This Time is Different: Eight Centuries of Financial Folly, the Great Recession is better described as “The Great Contraction,” given the massive and simultaneous contraction of global credit, trade, and growth that the world has experienced.

Fortunately, despite a hobbled recovery in the developed world, emerging markets in Asia, Latin America, and the Middle East have enormous latent growth potential. Most should be able to grow strongly, despite the challenging global environment.

Nevertheless, the legacy of the huge contraction in credit is not likely to go away anytime soon. Yes, if you are a bank, particularly a big one, you can raise money easily enough, thanks to sweeping explicit and implicit government guarantees. But, for everyone else, particularly small and medium-size firms, the credit environment continues to be very challenging. Even firms in established industries such as energy report facing great difficulties in raising capital.

The optimists say not to worry. Credit will soon come to everyone else as easily as it has to the banks. After all, credit also dried up during the 1991 global recession, and yet funds were flowing briskly within 18 months.

But this parallel fails to recognize the fact that balance sheets remain far more impaired this time. Housing prices are being propped up temporarily by myriad subsidies, while a commercial real-estate tsunami looms. Many banks’ weaknesses are simply being masked by government guarantees.

Indeed, G-20 governments now face the daunting prospect of trying to rein in the monster they have created. It is now very clear that the taxpayer will always be there to guarantee that bondholders get paid. Unchecked, large financial firms will be able to tap bond markets for decades to come at rates just above what the government pays, regardless of the inherent risk of their asset positions. Lenders to banks will not bother worrying about what kinds of gambles and investments financial institutions are making, or whether regulation is effective.

The good news is that most governments do see the need to implement significant new regulation on financial firms. But here’s the rub: financial regulation is enormously complicated, all the more so given that there must be some degree of international consistency. It would be a disaster if countries were to rush in individually to implement their own new system.

On the other hand, if regulators take their time to “get it right,” there will be a huge shadow of uncertainty hanging over the financial system. Banks know that they face higher capital requirements, which will force them to scale back lending relative to their resources. But how much higher? There is much discussion of breaking up banks that are too big to fail. But what will actually happen?

Given this environment, no wonder credit is still contracting in the United States, Europe, and elsewhere. If banks don’t know what the rules of the game are going to be, they have to be very cautious about over-extending their balance sheets.

So government regulators – and ultimately all of us – are caught between a rock and a hard place. Regulate in haste, repent at leisure. Overly strict regulation could seriously impair global growth for decades. But if regulation is too soft, the next monster global financial crisis could come within a decade. And even if regulators take their time to try to get it right, as most of us think they should, the world may have to live with weak credit expansion as banks hold back, awaiting a clearer verdict on their future.

And here is another painful thought that Harvard historian Niall Ferguson often emphasizes: many of the leaders and legislators who are passing judgment on new rules for banks are the same leaders and legislators who oversaw the regulation in the run-up to the financial crisis.

I am often asked why economies get themselves into such a bind again and again throughout economic history. Unfortunately, as Reinhart and I document empirically for hundreds of financial crises, covering 66 countries and eight centuries, the answer is all too simple: arrogance and ignorance. Investors and policymakers are often altogether ignorant of the myriad historical experiences with financial crises. And the few that are dimly aware of what has happened in other times and other places all too often say, “Don’t worry, this time is different.”

Perhaps the Great Contraction of 2008-2009 will be different from other deep financial crises, and we will see a sustained sharp recovery worldwide. But G-20 policymakers are best advised not to bet on it, and to counsel patience, particularly in epicenter countries.

http://www.project-syndicate.org/commentary/rogofl62
A New Perspective on the Global Economic Crisis IV: It is NOT the economy, stupid!

I. Introduction

In the fall of 1992, President Bill Clinton ran for office with the slogan "It is the economy, stupid!" For more than four decades, ever since the end of the Second World War, the central focus of the American Presidency had been to contain the mortal dangers of the Cold War through diplomacy and military readiness. The Reagan-Bush era highlighted the importance of an American President's deft handling of foreign policy negotiations with the Soviets, under the threat of nuclear annihilation. Unfortunately, President George Bush Sr., who had displayed consummate skills of diplomacy in the foreign policy arena right up to the 1991 Gulf War, suddenly found himself ill-equipped when the domestic economy took a turn into a severe recession. It was against this background, that Bill Clinton, then the Governor of Arkansas, demonstrated, by winning the 1992 Presidential election handily, that the American people have realized that the central focus of the American Presidency ought not be foreign policy any longer. Instead, the President ought to be focused on domestic economic concerns, from which all other policies should be derived. Over the next 16 years, professional economists throughout the world have played increasingly powerful roles in determining all aspects of government policy.

With the advent of the current economic crisis, there is once again a pressing need for a paradigm shift. The Federal Reserve and the American government have spent trillions of dollars to rescue the economy from the crisis. The 'official consensus' in the economics profession is that the crisis-management policies that were followed have been a resounding success so far. Even a highly respected economist like Professor George Akerlof has claimed publicly that rescuing the economy from a recurrence of the Great Depression is a huge achievement, implying that this is the best that modern economics could do (he has said in a CNBC interview on October 30, 2009, "we have not done fairly well, we have done extremely well", in answer to the question "so, economics has done fairly well during the crisis?"). In fact, it is on this account that uncle Ben had done a victory lap among professional economists during the Jackson Hole conference in August 2009, and had managed to get himself re-appointed as the next Chairman of the Federal Reserve.

Unfortunately, even after all this trillions of blood-letting, nearly a tenth of the population is expected to be unemployed at any given time during the next two or three years. Due to the massive destruction of wealth in the stock markets and in real estates, it is believed that consumer spending is going to stay depressed for a long time. As a result, the American economy would deliver only a 'new normal' rate of growth, significantly lower than the average rate of growth during the decades prior to the crisis. These 'new normal' views have been expressed by many famous economists, particularly, Professor Michael Spence and Professor Nouriel Roubini. Moreover, the 'official consensus' holds that the US dollar needs to depreciate in value to make American exports competitive, so that America's current account deficits can be reduced. Thus it is expected that the triple phenomena of sustained high unemployment, depreciated dollar and 'new normal' growth rate would correspond to households making adjustments for a steady reduction in the standard of living in America for many years to come.

Reflecting the 'official consensus' in the economics profession, Professor Akerlof goes on to say in his interview, "And, I think we should be prepared that, we don't know where things are going to be headed from now on. I think we should view these [the current recovery] as positive signs, but one should never go through life not being prepared for both what's the positive and the negative, and so, I'm hoping that the Congress and the public and also the Fed and the administration should be prepared for the fact that perhaps things are not going to go as well as they might, and we should be prepared to have further fiscal stimulus and further intervention by the Fed, if things, ah, ..." It is precisely through this sort of enigmatic utterances that economists have brazenly conveyed to the public that over the next ten years the public debt in America would increase by nine trillion dollars. Yet, showing a rare sign of wisdom, the general public has steadfastly refused to accept these predictions of mountainous debt. This has been made crystal clear in the recent fall of nearly 20% in President Obama's approval rating.

The crisis indicates strongly that the central concerns of government policymakers ought to shift away from economics. The tools and techniques that modern economics employs have been shown to be quite inadequate for the task of overcoming the crisis. However, it is unclear exactly how this paradigm shift would take place. One should note that even though the shift away from foreign policy to economics happened in 1992, the remnant of the Cold War military-industrial complex still continues to exert a powerful hold on the Presidency. In fact, by employing scare tactics, foreign policy experts and commentators have forced the Obama administration to fall back on the policies of the previous President George W. Bush in matters of defense and national security. Likewise, the 'official consensus' in the economics profession has the ultimate goal of tying down the Obama Presidency in various economic quagmires so that the government would be forced to do its bidding. So it is not clear as yet how the paradigm shift away from economics would happen, though it is very clear that one needs to happen soon.

In this article, I highlight this pressing need for a paradigm shift by identifying some major weaknesses of modern economics, which demonstrate that the American government could not possibly continue to formulate its policies based on economic considerations alone. The way I do this is by analyzing two recent articles by renowned economists. The first article "Death Cometh for the Greenback" by Professor Joseph Stiglitz appeared in The National Interest on October 27, 2009. The second article, "Global Imbalances and the Financial Crisis: Products of Common Causes", by Professor Maurice Obstfeld and Professor Kenneth Rogoff, which was presented in the San Francisco Fed conference in October 2009. This paper is available on Professor Rogoff's website. At the outset, I should say that I have long admired Professor Stiglitz's writings, and that my severe criticism of his recent opinions on the crisis that I mention in this article are meant to be constructive. In section II, I first provide an introduction to the main weakness of modern economics, namely, that there is a widespread misconception among intellectuals that economics has been modernized by re-working it on mathematical foundations. I explain why economics, modern or otherwise, can never escape being heavily influenced by the machinations of an empire. If the