The Slump Goes On: Why?

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Paul Krugman and **Robin Wells**
by Raghuram G. Rajan

In the winter of 2008–2009, the world economy was on the brink. Stock markets plunged, credit markets froze, and banks failed in a mass contagion that spread from the US to Europe and threatened to engulf the rest of the world. During the darkest days of crisis, the United States was losing 700,000 jobs a month, and world trade was shrinking faster than it did during the first year of the Great Depression.

Nouriel Roubini; drawing by John Springs

By the summer of 2009, however, as the world economy stabilized, it became clear that there would not be a full replay of the Great Depression. Since around June 2009 many indicators have been pointing up: GDP has been rising in all major economies, world industrial production has been rising, and US corporate profits have recovered to pre-crisis levels.

Yet unemployment has hardly fallen in either the United States or Europe—which means that the plight of the unemployed, especially in America with its minimal safety net, has grown steadily worse as benefits run out and savings are exhausted. And little relief is in sight: unemployment is still rising in the hardest-hit European economies, US economic growth is clearly slowing, and many economic forecasters expect America's unemployment rate to remain high or even to rise over the course of the next year.

Given this bleak prospect, shouldn't we expect urgency on the part of policymakers and economists, a scramble to put forward plans for promoting growth and restoring jobs? Apparently not: a casual survey of recent books and articles shows nothing of the kind. Books on the Great Recession are still pouring off the presses—but for the most part they are backward-looking, asking how we got into this mess rather than telling us how to get out. To be fair, many recent books do offer prescriptions about how to avoid the next bubble; but they don't offer much guidance on the most pressing problem at hand, which is how to deal with the continuing consequences of the last one.

Nor can this odd neglect be entirely explained by the mechanics of the book trade. It's true that economics books appearing now for the most part went to press before the disappointing nature of our so-called recovery was fully apparent. Even a survey of recent articles, however, shows a notable unwillingness on the part of the dismal science to offer solutions to the problem of persistently high unemployment and a sluggish economy. There has been a furious debate about the effectiveness of the monetary and fiscal measures undertaken at the depths of the crisis; there have also been loud declarations about what we must *not* do—warnings about the alleged danger of budget deficits or expansionary monetary policy are legion. But proposals for positive action to dig us out of the hole we're in are few and far between.

In what follows, we'll provide a relatively brief discussion of a much-belabored but still controversial subject: the origins of the 2008 crisis. We'll then turn to the ongoing policy debates about the response to the crisis and its aftermath. Not to keep readers in suspense: we believe that the relative absence of proposals to deal with mass unemployment is a case of "self-induced paralysis"—a phrase that Federal Reserve Chairman Ben Bernanke used a decade ago, when he was a researcher criticizing policymakers from the outside. There is room for action, both monetary and fiscal. But politicians, government officials, and economists alike have suffered a failure of nerve—a failure for which millions of workers will pay a heavy price.

1.

Call it the great North Atlantic real estate bubble: in the first decade of the third millennium, prices of both housing and commercial real estate soared in parts of Europe and North America. From 1997 to 2007, housing prices rose 175 percent in the United States, 180 percent in Spain, 210 percent in Britain, and 240 percent in Ireland.

Why did real estate prices rise so much, in so many places? Broadly speaking, there are four popular explanations (which aren't mutually exclusive): the low interest rate policy of the Federal Reserve after the 2001 recession; the "global savings glut"; financial innovations that disguised risk; and government programs that created moral hazard.

Low Interest Rate Policy of the Federal Reserve

After the technology bubble of the late 1990s burst, central banks sharply cut the short-term interest rates under their direct control in an attempt to contain the resulting slump. The Fed took the most dramatic action, cutting the overnight rate on loans between banks from 6.5 percent at the beginning of 2000 to just 1 percent in 2003, and keeping the rate very low into 2004. And there's a school of thought—one to which Raghuram Rajan is strongly sympathetic in his book *Fault Lines*, and that gets more qualified support from Nouriel Roubini and Stephen Mihm in *Crisis Economics*—that views this prolonged period of low rates as a terrible policy mistake, setting the stage for the housing bubble.

There are, however, some serious problems with this view. For one thing, there were good reasons for the Fed to keep its overnight, or "policy," rate low. Although the 2001 recession wasn't especially deep, recovery was very slow—in the United States, employment didn't recover to pre-recession levels until 2005. And with inflation hitting a thirty-five-year low, a deflationary trap, in which a depressed economy leads to falling wages and prices, which in turn further depress the economy, was a real concern. It's hard to see, even in retrospect, how the Fed could have justified not keeping rates low for an extended period.

The fact that the housing bubble was a North Atlantic rather than purely American phenomenon also makes it hard to place primary blame for that bubble on interest rate policy. The European Central Bank wasn't nearly as aggressive as the Fed, reducing the interest rates it controlled only half as much as its American counterpart; yet Europe's housing bubbles were fully comparable in scale to that in the United States.

These considerations suggest that it would be wrong to attribute the real estate bubble wholly, or even in large part, to misguided monetary policy.

The Global Savings Glut

The term "global savings glut" actually comes from a speech given by Ben Bernanke in early 2005.[1] In that speech the future Fed chairman argued that the large US trade deficit—and large deficits in other nations, such as Britain and Spain—didn't reflect a change in those nations' behavior as much as a change in the behavior of surplus nations. Historically, developing countries have run trade deficits with advanced countries as they buy machinery and other capital goods in order to raise their level of economic development. In the wake of the financial crisis that struck Asia in 1997–1998, this usual practice was turned on its head: developing economies in Asia and the Middle East ran large trade surpluses with advanced countries in order to accumulate large hoards of foreign assets as insurance against another financial crisis.

Germany also contributed to this global imbalance by running large trade surpluses with the rest of Europe in order to finance reunification and its rapidly aging population. In China, whose trade surplus accounts for most of the US trade deficit, the desire to protect against a possible financial crisis has morphed into a policy in which the currency is kept undervalued, which benefits politically connected export industries, often at the expense of the general working population.

For the trade deficit countries like the United States, Spain, and Britain, the flip side of the trade imbalance is large inflows of capital as countries with surpluses bought vast quantities of American, Spanish, and British bonds and other assets. These capital inflows also drove down interest rates—not the short-term rates set by central bank policy, but longer-term rates, which are the ones that matter for spending and for housing prices and are set by the bond markets. In both the United States and the European nations, long-term interest rates fell dramatically after 2000, and remained low even as the Federal Reserve began raising its short-term policy rate. At the time, Alan Greenspan called this divergence the bond market "conundrum," but it's perfectly comprehensible given the international forces at work. And it's worth noting that while, as we've said, the European Central Bank wasn't nearly as aggressive as the Fed about cutting short-term rates, long-term rates fell as much or more in Spain and Ireland as in the United States—a fact that further undercuts the idea that excessively loose monetary policy caused the housing bubble.

Indeed, in that 2005 speech Bernanke recognized that the impact of the savings glut was falling mainly on housing:

> During the past few years, the key asset-price effects of the global saving glut appear to have occurred in the market for residential investment, as low mortgage rates have supported record levels of home construction and strong gains in housing prices.

What he unfortunately failed to realize was that home prices were rising much more than they should have, even given low mortgage rates. In late 2005, just a few months before the US housing bubble began to pop, he declared—implicitly rejecting the arguments of a number of prominent Cassandras[2]:—that housing prices "largely reflect strong economic fundamentals."[3] And like almost everyone else, Bernanke failed to realize that financial institutions and families alike were taking on risks they didn't understand, because they took it for granted that housing prices would never fall.

Despite Bernanke's notable lack of prescience about the coming crisis, however, the global glut story provides one of the best explanations of how so many nations managed to get into such similar trouble.

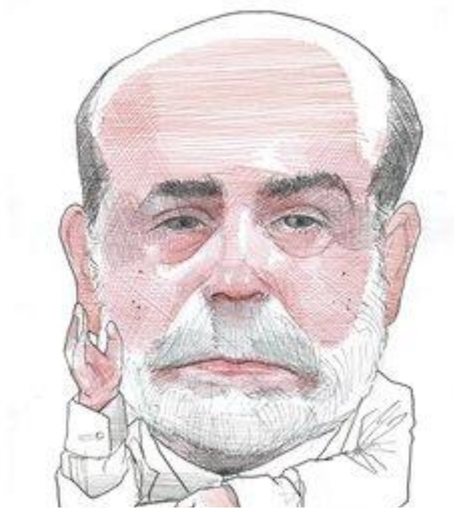
Out of Control Financial Innovation

Mary had a little lamb,
And when she saw it sicken,
She shipped it off to Packingtown,
And now it's labeled chicken.

The famous ditty summarizing Upton Sinclair's *The Jungle* seems all too appropriate as a description of the financial practices that helped feed the housing bubble, especially in subprime mortgages. By now the litany is familiar: the old model of banking, in which banks held on to the loans they made, was replaced by the new practice of originate-and-distribute. Mortgage originators—which in many cases had no traditional banking business—made loans to buy houses, then quickly sold those loans off to other firms. These firms then repackaged those loans by pooling them, then selling shares of these pools of securities; and rating agencies were willing to label the resulting product chicken—that is, to bestow their seal of approval, the AAA rating, on the more senior of these securities, those that had first claim on interest and principal repayment.

Everyone ignored both the risks posed by a general housing bust and the degradation of underwriting standards as the bubble inflated (that ignorance was no doubt assisted by the huge amounts of money being made). When the bust came, much of that AAA paper turned out to be worth just pennies on the dollar.

It's a disgraceful story. It's important, however, to step back and ask how important these dodgy financial practices were in setting the stage for crisis.


Ben Bernanke; drawing by John Springs

Three points seem relevant. First, the usual version of the story conveys the impression that Wall Street had no incentive to worry about the risks of subprime lending, because it was able to unload the toxic waste on unsuspecting investors throughout the world. But this claim appears to be mostly although not entirely wrong: while there were plenty of naive investors buying complex securities without understanding the risks, the Wall Street firms issuing these securities kept the riskiest assets on their own books. In addition, many of the somewhat less risky assets were bought by other financial institutions, normally considered sophisticated investors, not the general public. The overall effect was to concentrate risks in the banking system, not pawn them off on others.[4]

Second, the comparison between Europe and America is instructive. Europe managed to inflate giant housing bubbles without turning to American-style complex financial schemes. Spanish banks, in particular, hugely expanded credit; they did so by selling claims on their loans to foreign investors, but these claims were straightforward, "plain vanilla" contracts that left ultimate liability with the original lenders, the Spanish banks themselves. The relative simplicity of their financial techniques didn't prevent a huge bubble and bust.

A third strike against the argument that complex finance played an essential role is the fact that the housing bubble was matched by a simultaneous bubble in commercial real estate, which continued to be financed primarily by old-fashioned bank lending. So exotic finance wasn't a necessary condition for runaway lending, even in the United States.

What is arguable is that financial innovation made the effects of the housing bust more pervasive: instead of remaining a geographically concentrated crisis, in which only local lenders were put at risk, the complexity of the financial structure spread the bust to financial institutions around the world.

Moral Hazard Created by Government Programs

The idea that the government did it—that government-sponsored loans, government mandates, and explicit or implicit government guarantees led to irresponsible home purchases—is an article of faith on the political right. It's also a central theme, though not the only one, of Raghuram Rajan's *Fault Lines*.

In the world according to Rajan, a professor of finance at the University of Chicago business school, the roots of the financial crisis lie in rising income inequality in the United States, and the political reaction to that inequality: lawmakers, wanting to curry favor with voters and mitigate the consequences of rising inequality, funneled funds to low-income families who wanted to buy homes. Fannie Mae and Freddie Mac, the two government-sponsored lending facilities, made mortgage credit easy; the Community Reinvestment Act, which encouraged banks to meet the credit needs of the communities in which they operated, forced them to lend to low-income borrowers regardless of risk; and anyway, banks didn't worry much about risk because they believed that the government would back them up if anything went wrong.

Rajan claims that the Troubled Asset Relief Program (TARP), signed into law by President Bush on October 3, 2008, validated the belief of banks that they wouldn't have to pay any price for going wild. Although Rajan is careful not to name names and attributes the blame to generic "politicians," it is clear that Democrats are largely to blame in his worldview. By and large, those claiming that the government has been responsible tend to focus their ire on Bill Clinton and Barney Frank, who were allegedly behind the big push to make loans to the poor.

While it's a story that ties everything up in one neat package, however, it's strongly at odds with the evidence. And it's disappointing to see Rajan, a widely respected economist who was among the first to warn about a runaway Wall Street, buy into what is mainly a politically motivated myth. Rajan's book relies heavily on studies from the American Enterprise Institute, a right-wing think tank; he doesn't mention any of the many studies and commentaries debunking the government-did-it thesis.[5] Roubini and Mihm, by contrast, get it right:

> The huge growth in the subprime market was primarily underwritten not by Fannie Mae and Freddie Mac but by private mortgage lenders like Countrywide. Moreover, the Community Reinvestment Act long predates the housing bubble…. Overblown claims that Fannie Mae and Freddie Mac single-handedly caused the subprime crisis are just plain wrong.

As others have pointed out, Fannie and Freddie actually accounted for a sharply reduced share of the home lending market as a whole during the peak years of the bubble. To the extent that they did purchase dubious home loans, they were in pursuit of profit, not social objectives—in effect, they were trying to catch up with private lenders. Meanwhile, few of the institutions engaged in subprime lending—such as Countrywide Financial—were commercial banks subject to the Community Reinvestment Act.

Beyond that, there were the other bubbles—the bubble in US commercial real estate, which wasn't promoted by public policy at all, and the bubbles in Europe. The fact that US residential housing was just part of a much larger phenomenon would seem to be presumptive evidence against any view that relies heavily on supposed distortions created by US politicians.

Was government policy entirely innocent? No, but its sins were more of omission than commission. Fannie and Freddie shouldn't have been allowed to go chasing profits in the late stages of the housing bubble; and regulators failed to use the authority they had to stop excessive risk-taking. But as much as conservatives would like to put soft-hearted politicians at the center of this story, they don't belong there. And Rajan's endorsement of the conservative story line, without even an acknowledgment of the problems of that line, comes across as slippery and evasive.

The Bubble as a White Swan

Whatever the precise causes of the housing bubble, it's important to realize that bubbles in general aren't at all unusual. On the contrary, as Yale's Robert Shiller explained at length in his justly celebrated book, *Irrational Exuberance*, they are a recurring feature of financial markets. (Not coincidentally, Shiller warned early on that we were experiencing a massive housing bubble.) Bubbles have happened in small economies and large, in individual nations and in the global economy as a whole, in periods of heavy public intervention and in eras of minimal government. The North Atlantic housing bubble, as Roubini and Mihm say, was a "white swan"—a common sort of event, not a highly unusual one, albeit much bigger than most.

Our guess is that the bubble got started largely thanks to the global savings glut, but that it developed a momentum of its own—which is what bubbles do. Financial innovations such as the securitization of mortgages may have made it easier for the bubble to inflate—but European banks managed to extend too much credit without such frills. However, it is clear that there were major failures in oversight. In particular, Ben Bernanke has admitted that the Fed failed to use its regulatory powers to rein in the excesses of the mortgage lenders—a tragic oversight. Greenspan disregarded the clear warning by a member of the Fed board that mortgage lending had become dangerously excessive. And the widespread securitizing of mortgage loans has made the mess much harder to clean up.

In a housing market that is now depressed throughout the economy, mortgage holders and troubled borrowers would both be better off if they were able to renegotiate their loans and avoid foreclosure. But when mortgages have been sliced and diced into pools and then sold off internationally so that no investor holds more than a fraction of any one mortgage, such negotiations are impossible. And because of the financial industry lobbying that prevented mortgages from being covered by personal bankruptcy proceedings, no judge can impose a solution. The phenomenon of securitization, created in the belief that a large-scale housing crash would never happen, has trapped investors and troubled borrowers in a mutually destructive downward spiral.

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What happens when bubbles burst? Invariably, a lot of paper wealth disappears. But that, in itself, isn't enough to turn a burst bubble into a catastrophe for the economy as a whole. The stock crash of 2000–2002 was a $5 trillion hit to US household wealth. It created a lot of pain for people counting on capital gains for their retirement, but it didn't trigger any broader systemic crisis. The housing bust was an $8 trillion hit—not all that much bigger than the stock crash, once one takes into account both inflation and economic growth in the interim. But it produced the worst global crisis since the 1930s. Why?

Most of Roubini and Mihm's *Crisis Economics* is, in effect, devoted to that question. In view of Roubini's reputation as a wild man and doomsayer, their book breaks surprisingly little new ground. But it is a very good primer on how finance gone bad can wreck an otherwise healthy economy.

There are two main answers to the question of why some asset bubbles do so much damage when they burst. The narrow answer focuses on the financial sector; the broad answer argues that debt and leverage among nonfinancial players such as corporations and home owners are equally important. Which one you subscribe to has major implications for your view on how we should respond to the economy's continuing woes.

Let's talk first about the financial sector—banks and bank-like institutions. Even Adam Smith knew that banks are peculiarly subject to crises of confidence. It's in the nature of their business: a bank may promise you that you have access to your money whenever you want it, but since most of the funds put in any bank's care are invested in long-term assets, no bank can actually meet that promise if a large fraction of its depositors simultaneously demand their money back. So banking depends on confidence: as long as people believe their money is safe and withdraw funds only when they have a personal or business reason to do so, their money probably is safe. But if a bank's customers develop doubts about the institution's soundness and decide en masse to pull their money out—that is, if there's a run on the bank—fear that the bank will fail can turn into a self-fulfilling prophecy.

The global real estate bust, unlike the bursting of the dot-com bubble, raised justifiable concerns about the soundness of banks. Financial institutions, by and large, weren't exposed to technology stocks. They were, however, very much exposed to losses from mortgage defaults. So it's not surprising, at least in retrospect, that the real estate bust triggered a run on large parts of the financial system. Or to use an old-fashioned term that has come back into common use, it triggered a financial panic.

But how could an old-fashioned panic happen in the modern world? Generations of economics instructors have told students that bank runs—like the famous scene in the movie *It's a Wonderful Life*—are a thing of the past, because modern depositors know that their money is insured by the FDIC. Why were they wrong? The now-familiar answer is that by 2007 the financial system had evolved to a point where both traditional bank regulation and its associated safety net were full of holes.

In the United States, conventional banking was increasingly supplanted by a variety of alternatives, these days usually grouped together as "shadow banking." For example, many businesses began parking their money not in bank deposits but in "repo" (repurchase) agreements—very short-term loans to hedge funds and investment banks. Repo yielded higher interest rates than ordinary deposits, because its issuers weren't bound by the reserve requirements or other rules that applied to conventional banks. But it wasn't government-guaranteed, and it was therefore subject to crises of confidence. Runs on repo brought down Bear Stearns and Lehman Brothers. And by many estimates, by 2007 repo and other forms of shadow banking accounted for about 60 percent of the overall US banking system—yet shadow banking remained largely unregulated and unsecured. "It's little wonder," write Roubini and Mihm, "that the shadow banking system was at the heart of what would become the mother of all bank runs."

In Europe, the breakdown of the traditional banking safety net took a somewhat different form. First of all, banks in the bubble areas of Spain, Ireland, Iceland, and the UK made loans that far exceeded their deposits, which they supplemented with wholesale funding—basically, borrowing from other banks and investors. This wholesale funding could and did dry up when the soundness of the original lenders came into question.

Beyond that, European banks were backed by their national governments, not by a pan-European safety net—which meant that when really major banking problems arose in some countries, the ability of those nations' governments to backstop their banks came into question. Iceland, where a handful of runaway bankers ran up a debt many times the country's GDP, is the famous example. But similar if less severe doubts about the government's ability to deal with banking debts have arisen in Ireland and Spain.

So the real estate bust created a crisis of confidence in much of the world's financial system and eventually paralyzed crucial parts of that system. Signs of strain began appearing in the late summer of 2007; all hell broke loose after the failure of Lehman in September 2008. During the winter of 2008–2009 borrowing costs for almost everyone except governments soared, if they could get credit at all. And the world economy looked dangerously close to a complete meltdown.

Policymakers rushed in to prevent that outcome. Financial institutions were bailed out at taxpayer expense; guarantees were extended to restore confidence—Ireland, for example, took the extraordinary step of guaranteeing all Irish bank debt; central banks and government agencies stepped in as "lenders of last resort," providing credit where banks could or would not. These measures were successful in stemming the panic: by the early summer of 2009, most measures of financial stress had subsided to more or less normal levels. And as we noted at the beginning of this review, the world economy ended its headlong plunge and began growing again.

But as we also noted, it hasn't been much of a recovery. If the fundamental problem lay with a crisis of confidence in the banking system, why hasn't a restoration of banking confidence brought a return to strong economic growth? The likely answer is that banks were only part of the problem. It's curious that only one of the three books surveyed here so much as mentions the work of the late Hyman Minsky, a heterodox, long-neglected economist whose moment has come—in more ways than one. However, Roubini and Mihm give a good overview of Minsky's views—and Richard Koo, whether he knows it or not, is very much a Minskyite.

Minsky's theory, in brief, was that eras of financial stability set the stage for future crisis, because they encourage a wide variety of economic actors to take on ever-larger quantities of debt and engage in ever-more-risky speculation. As long as asset prices keep rising, driven by debt-fueled purchases, all looks well. But sooner or later the music stops: there is a “Minsky moment” when all the players realize (or are forced by creditors to realize) that asset prices won’t rise forever, and that borrowers have taken on too much debt.

But isn’t this new prudence a good thing? No. When one individual tries to pay down debt, that’s all well and good—but when everyone tries to do it at the same time, the consequences can all too easily be destructive for everyone involved. The process of destruction is easiest to see in the financial sector, where everyone’s attempt to pay off debt by selling assets all at the same time can lead to a vicious circle of plunging prices and rising distress. But the problem isn’t necessarily restricted to finance.

Richard Koo’s *The Holy Grail of Macroeconomics* argues, in fact, that the biggest problem facing economies in the aftermath of a Minsky moment (although he never uses the term) lies not in the financial sector but in nonfinancial sectors with too much debt on their balance sheets. Koo is the chief economist at the Nomura Research Institute. Much of his book is devoted to Japan’s long era of stagnation from the early 1990s onward. This stagnation, he argues, mainly reflected the balance sheet problems of nonfinancial corporations, which were stranded with high levels of debt after the Japanese real estate bubble of the 1980s burst. He argues that the United States now faces a similar problem, with debt problems concentrated not among corporations but among home owners, who ran up large debts both in the course of buying houses and through using them as ATMs—that is, using refinancing to extract cash from rising home values, and spending that cash on higher consumption.

In Koo’s analysis, simultaneous attempts by many private players to pay down their debts lead to a “fallacy of composition” that’s closely related to the famous (but too often overlooked) “paradox of thrift.” Each individual corporation or household cuts back on spending in an effort to reduce debt; but these spending cuts reduce everyone’s income and keep the economy persistently depressed.

These broader problems of debt and deleveraging arguably explain why the successful stabilization of the financial industry has done no more than pull the economy back from the brink, without producing a strong recovery. The economy is hamstrung—still crippled by a debt overhang. That is, the simultaneous efforts of so many people to pay down debt at the same time are keeping the economy depressed.

So what’s the answer? In the short run, the only way to avoid a deep slump when almost everyone in the private sector is trying to pay down debt simultaneously is for the government to move in the opposite direction—to become, in effect, the borrower of last resort, issuing debt and continuing to spend as the private sector pulls back. In the heat of a Minsky moment, budget deficits are not only good, they are necessary. Indeed, the surge in budget deficits around the world between 2007 and 2009 was arguably even more important than the financial rescue in keeping the real estate bust from triggering a full replay of the Great Depression.

This surge in budget deficits, by the way, wasn’t mainly the result of deliberate efforts to stimulate the economy. Instead, the main factors were a collapse in tax receipts as economies slumped, and secondarily a rise in automatic payments like unemployment insurance benefits. In the United States, the two-year federal deficit over 2009–2010 will be around $2.5 trillion; the Obama stimulus plan accounts for less than a quarter of the total.

So budget deficits kept us from falling into the abyss. But how will the economy recover? This will be the subject of a second article.

—*August 31, 2010*

LETTERS

How the Fed Failed November 25, 2010

1. Ben Bernanke, "The Global Savings Glut and the US Current Account Deficit," March 10, 2005, available at www.federalreserve.gov.↩
2. See, for example, Robert Shiller, *Irrational Exuberance*, second edition (Princeton University Press, 2005); Paul Krugman, "That Hissing Sound," *The New York Times*, August 8, 2005. ↩
3. Ben Bernanke, "The Economic Outlook," Testimony before the Joint Economic Committee, October 20, 2005, available at www.house.gov.↩
4. Hyun Song Shin, "Securitization and Financial Stability," VoxEU.org, March 19, 2009.↩
5. See, for example, Barry Ritholtz, *Bailout Nation: How Greed and Easy Money Corrupted Wall Street and Shook the World Economy* (Wiley, 2009), and David Goldstein and Kevin G. Hall, "Private Sector Loans, Not Fannie or Freddie, Triggered Crisis," McClatchyDC.com, October 12, 2008.↩