DEBTS, DEFICITS AND DILEMMAS

The Economist

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A crash course on the financial crisis and its aftermath

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Introduction

MORE THAN HALF A DECADE has passed since the global financial crisis of 2007/08 plunged the world economy into its worst downturn since the 1930s. Yet the aftermath of the crash continues to cast a pall over the global economy. Growth has returned. But the recovery has been strikingly lacklustre, particularly given the scale of the recession. Many economies in the rich world are still operating well below their potential: factories sit idle and unemployment rates are high. For millions of people the economy is a long way from being "back to normal".

The same is true of macroeconomic policy. As the aftermath of the crisis has lingered, so it has transformed the landscape faced by finance ministers and central bankers, and in ways that few predicted five years ago. In 2008 and 2009 there was a remarkable consensus about how best to respond to the crash. Central banks slashed interest rates and flooded moribund financial markets with liquidity; governments bailed out banks, and tried to prop up their economies with tax cuts and spending. The world's 20 biggest economies introduced fiscal stimulus worth an average of 2% of GDP.

By 2010, however, the consensus around how best to support a recovery had begun to fracture. That was partly because some of the standard macroeconomic remedies were becoming exhausted. Once short-term interest rates had been cut to near zero, for instance, central banks could reduce them no further and had to try untested, and hence more controversial, ways to loosen monetary policy, such as "quantitative easing", or printing money to buy bonds. The weakness of the recovery also led to growing doubts about whether more fiscal and monetary stimulus made sense. And the contours of the debt crisis morphed, with the centre of panic shifting from America's subprime mortgage market to government debt in the euro area. Once governments themselves lost investor confidence, the calculus about how best to respond to the downturn changed. Greece's sovereign debt crisis, in particular, shattered the agreement in favour of fiscal stimulus.

As a result, the past few years have been marked by macroeconomic experimentation. Central banks have shown differing degrees of boldness: America's Federal Reserve and, more recently, the Bank of Japan embraced unconventional monetary tools most enthusiastically, while the European Central Bank has remained more conservative. Financial regulators have tried different ways to make banks safer, from ring-fencing deposits to prohibiting certain kinds of trading. Politicians have steered fiscal policy in quite different directions. Britain's coalition government embraced fiscal austerity early. So, too, did many countries in the euro area, largely at the

behest of Germany. America's government kept budget conditions stimulative for longer, though by 2013 it, too, was raising taxes and cutting spending.

Economists have argued furiously about the wisdom of these choices. Some of these debates have obvious historical echoes. The divisions between those who push for continued Keynesian fiscal stimulus and those who argue that fiscal austerity will boost confidence, and hence bolster growth, could be taken straight from the 1930s. So, too, could the tensions between reformers who want to curb finance and those who worry that too many constraints on financiers will slow the recovery and lower future prosperity. Other controversies – over the benefits and risks of multi-trillion-dollar central-bank balance-sheets, or the usefulness of forcing banks to issue a tranche of debt that can be converted into equity – are new, because the innovations themselves are unprecedented.

Standard economics textbooks are of limited help in making sense of these debates. Many books still reflect pre-crisis norms, when monetary policy involved raising or lowering short-term interest rates, and where Keynesian fiscal policy had long gone out of fashion as a tool for countering the business cycle. Few pay careful attention to the macroeconomic consequences of financial regulation. Though the texts are being updated, they haven't kept up with the degree to which policy debates have shifted.

This book aims to help fill that gap. It is based on a series of briefs that appeared in *The Economist*

in September and October 2013 to mark the fifth anniversary of Lehman Brothers' bankruptcy. The first chapter re-examines the debate about the origins of the crisis, assessing the relative role played by different causes, from financiers' distorted incentives to lax monetary policy, with five years' hindsight. Chapter 2 focuses on debt, the phenomenon at the heart of the crash and its aftermath, and one whose dynamics are too often given short shrift. It examines what makes debt dangerous, what drives debt cycles and what are the consequences of "deleveraging", a collective desire to pay down debt. Chapters 3–5 describe three of the biggest post-crisis policy controversies: what central banks should do once short-term interest rates are at zero; whether governments should be pushing fiscal stimulus or budget austerity; and how to make banks safer without undermining the recovery. In each case, the goal is to explain the theory behind different positions, and assess what the evidence to date suggests.

The Economist first published briefs specifically aimed at helping students and anyone interested in topical issues in 1975. Subsequent subjects have ranged widely, from American government to science. The last series before this one was published in 1999. It was on finance, and concluded:

> *Some of the new financial technologies are, in effect, efforts to bottle up considerable uncertainties. If they work, the world economy will be more stable. If not, an economic disaster might ensue.*

Alas, disaster did ensue, and the world of macroeconomic policy changed completely. The following chapters are a brief guide to that new world.

1 Crash course: the origins of the financial crisis

The effects of the financial crisis are still being felt, five years on. This chapter looks at its causes

THE COLLAPSE OF LEHMAN BROTHERS, a sprawling global bank, in September 2008 almost brought down the world's financial system. It took huge taxpayer-financed bail-outs to shore up the industry. Even so, the ensuing credit crunch turned what was already a nasty downturn into the worst recession in 80 years. Massive monetary and fiscal stimulus prevented a buddy-can-you-spare-a-dime depression, but the recovery remains feeble compared with previous post-war upturns. GDP is still below its pre-crisis peak in many rich countries, especially in Europe, where the financial crisis has evolved into the euro crisis. The effects of the crash are still rippling through the world economy: witness the wobbles in financial markets as America's Federal Reserve prepares to scale back its effort to pep up growth by buying bonds.

With half a decade's hindsight, it is clear the crisis had multiple causes. The most obvious is the financiers themselves – especially the irrationally exuberant Anglo-Saxon sort, who claimed to have found a way to banish risk when in fact they had simply lost track of it. Central bankers and other regulators also bear blame, for it

was they who tolerated this folly. The macroeconomic backdrop was important, too. The "Great Moderation" – years of low inflation and stable growth – fostered complacency and risk-taking. A "savings glut" in Asia pushed down global interest rates. Some research also implicates European banks, which borrowed greedily in American money markets before the crisis and used the funds to buy dodgy securities. All these factors came together to foster a surge of debt in what seemed to have become a less risky world.

Start with the folly of the financiers. The years before the crisis saw a flood of irresponsible mortgage lending in America. Loans were doled out to "subprime" borrowers with poor credit histories who struggled to repay them. These risky mortgages were passed on to financial engineers at the big banks, who turned them into supposedly low-risk securities by putting large numbers of them together in pools. Pooling works when the risks of each loan are uncorrelated. The big banks argued that the property markets in different American cities would rise and fall independently of one another. But this proved wrong. Starting in 2006, America suffered a nationwide house-price slump.

The pooled mortgages were used to back securities known as collateralised debt obligations (CDOs), which were sliced into tranches by degree of exposure to default. Investors bought the safer tranches because they trusted the triple-A credit ratings assigned by agencies such as Moody's and Standard & Poor's. This was another mistake. The agencies were paid by, and

so beholden to, the banks that created the CDOs. They were far too generous in their assessments of them.

Investors sought out these securitised products because they appeared to be relatively safe while providing higher returns in a world of low interest rates. Economists still disagree over whether these low rates were the result of central bankers' mistakes or broader shifts in the world economy. Some accuse the Fed of keeping short-term rates too low, pulling longer-term mortgage rates down with them. The Fed's defenders shift the blame to the savings glut – the surfeit of saving over investment in emerging economies, especially China. That capital flooded into safe American-government bonds, driving down interest rates.

Low interest rates created an incentive for banks, hedge funds and other investors to hunt for riskier assets that offered higher returns. They also made it profitable for such outfits to borrow and use the extra cash to amplify their investments, on the assumption that the returns would exceed the cost of borrowing. The low volatility of the Great Moderation increased the temptation to "leverage" in this way. If short-term interest rates are low but unstable, investors will hesitate before leveraging their bets. But if rates appear stable, investors will take the risk of borrowing in the money markets to buy longer-dated, higher-yielding securities. That is indeed what happened.

From houses to money markets

When America's housing market turned, a chain reaction exposed fragilities in the financial system. Pooling and other clever financial engineering did not provide investors with the promised protection. Mortgage-backed securities slumped in value, if they could be valued at all. Supposedly safe CDOs turned out to be worthless, despite the ratings agencies' seal of approval. It became difficult to sell suspect assets at almost any price, or to use them as collateral for the short-term funding that so many banks relied on. Fire-sale prices, in turn, instantly dented banks' capital thanks to "mark-to-market" accounting rules, which required them to revalue their assets at current prices and thus acknowledge losses on paper that might never actually be incurred.

Trust, the ultimate glue of all financial systems, began to dissolve in 2007 – a year before Lehman's bankruptcy – as banks started questioning the viability of their counterparties. They and other sources of wholesale funding began to withhold short-term credit, causing those most reliant on it to founder. Northern Rock, a British mortgage lender, was an early casualty in the autumn of 2007.

Complex chains of debt between counterparties were vulnerable to just one link breaking. Financial instruments such as credit-default swaps (in which the seller agrees to compensate the buyer if a third party defaults on a loan) that were meant to spread risk turned out to concentrate it. AIG, an American insurance giant