



La Follette Policy Report

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Director's Perspective

Restoring Confidence, Economic Growth

With many Americans feeling as though the economic foundations of our society have been deeply shaken, careful policy analysis and management of public resources in responding to the economic recession are of the highest priority. To restore public confidence, our public and private sector leaders must balance the need to develop short-term policies to stimulate economic growth with longer term investments in the economic and social infrastructure of our nation that will reduce the likelihood of another severe recession.

President Obama has identified, in part, health care and education as key priorities for investment and reform, with the expectation that increased spending and greater accountability will enhance the effectiveness and efficiency of these sectors and long-run economic growth. In this context, this issue of the *La Follette Policy Report* offers perspective on the causes of the economic crisis that began in 2007, its ramifications, and on solutions offered to address it.

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Reflections on the Causes and Consequences of the Debt Crisis of 2008

By Menzie Chinn and Jeffrey Frieden

In late 2008, the world's financial system seized up. Billions of dollars worth of financial assets were frozen in place, the value of securities uncertain, and hence the solvency of seemingly rock solid financial institutions in question. By the end of the year, growth rates in the industrial world had gone negative, and even developing country growth had declined sharply.

This economic crisis has forced a re-evaluation of deeply held convictions regarding the proper method of managing economies, including the role of regulation and the ideal degree of openness to foreign trade and capital. It has also forced a re-assessment of economic orthodoxy that touts the self-regulating nature of free market economies.

The precise origin of this breathtaking series of events is difficult to identify. Because the crisis is such an all-encompassing and wide-ranging phenomenon, and observers tend to focus on what they know, most accounts center on one or two factors. Some reductionist arguments identify "greed" as the cause, while others obsess about the 1990s era amendments to the 1977 U.S. Community Reinvestment Act that was designed to encourage banks and other financial institutions to meet the needs of the entire market, including those of people living in poor neighborhoods. They also point to the political power of government-sponsored entities such as Fannie Mae and Freddie Mac, agencies designed to smooth the flow of credit to housing markets.

In our view, such simple, if not simplistic, arguments are wrong. Rather, we view the current episode as a replay of past debt crises, driven by profligate fiscal policies, but made much more virulent by a combination of high leverage, financial innovation, and regulatory disarmament. In this environment, speculation and outright criminal activities thrived; but those are exacerbating, rather than causal, factors.

History Repeats, Again

The United States has borrowed and spent itself into a foreign debt crisis. Between 2001 and 2007, Americans borrowed trillions of dollars from abroad. The federal government borrowed to finance its budget deficit; private individuals and companies borrowed so they could consume and invest beyond their means. While some spending went for physical commodities, including imports, much of the spending was for local goods and services, especially financial services and real estate. The result was a broad-based, but ultimately unsustainable, economic expansion that

drove up the relative price of goods not involved in foreign trade—things like haircuts, taxi rides, and, most important, housing. The key “nontradable” good was housing; that boom eventually became a bubble. And, when that bubble burst, assessments of assets and liabilities across the board became unbalanced.

This disaster is, in our view, merely the most recent example of a “capital flow cycle,” in which foreign capital floods a country, stimulates an economic boom, encourages financial leveraging and risk taking, and eventually culminates in a crash. In broad outlines, the cycle describes the developing-country debt crisis of the early 1980s, the Mexican crisis of 1994, the East Asian crisis of 1997-1998, the Russian and Brazilian and Turkish and Argentine crises of the late 1990s and into 2000-2001—not to speak of the German crisis of the early 1930s or the American crisis of the early 1890s. There are, to be sure, unique features of contemporary events, for the United States is not Argentina, but the broad outlines of the crisis is of a piece with hundreds of similar episodes in the modern international economy.

The United States

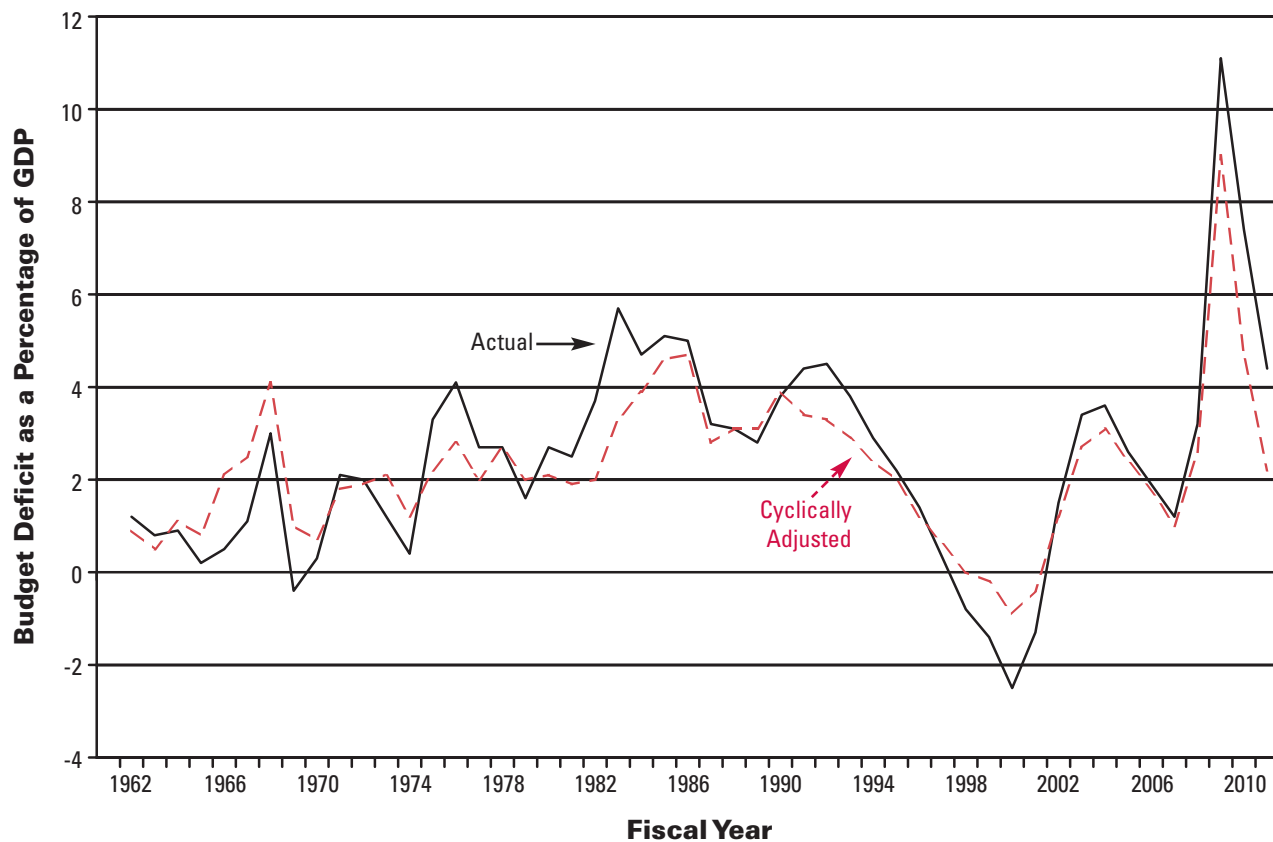
Ten years ago, few observers voiced concern about an impending debt crisis. In fact, the federal government registered substantial budget surpluses in 1999 and 2000, and surpluses were projected for the indefinite future. The recession of 2001, combined with the Bush administration’s tax cuts, quickly erased those surpluses and threw the federal budget into a substantial deficit of 1.5 percent of gross domestic product (GDP) by fiscal year 2002. National security spending after the September 11, 2001, attacks further increased the deficit.

By 2004, the federal budget deficit was more than \$400 billion, the largest in history. As shown in Figure 1, this deficit rivaled those of the Reagan deficits of the early and middle 1980s. The government ran these deficits with ease, for it could borrow just about as much as it wanted internationally. This ready access to capital funds was the new reality of globally integrated financial markets.

The result was a continual rise in America’s foreign debt, expressed as a share of GDP. This is most clearly seen in the size of the country’s current account deficit, the amount the country needs to borrow from the rest of the world to pay

Figure 1. Actual and Cyclically Adjusted Budget Deficits

The cyclically adjusted budget deficit is the deficit that would be incurred if the economy was at full employment.



Source: Congressional Budget Office, *Measuring the Effects of the Business Cycle on the Federal Budget* (June 2009). Note: 2009-11 are projections.

for the excess of its imports over its exports. In other words, a current account deficit means that the country is not covering its current expenses out of current earnings, so that it must borrow the difference from abroad. Between 2001 and 2007, the American current account deficit averaged between \$500 billion and \$1 trillion every year, resulting in a current account deficit equal to an unprecedented 6 percent of GDP in 2006, as Figure 2 shows. For a while, this borrowing failed to manifest itself in a corresponding degree of indebtedness to the rest of the world—largely because the dollar’s value fell over this period (and most of America’s assets abroad are denominated in foreign currency). However, that string of good luck ended in 2008, when America’s net indebtedness to the rest of the world deteriorated substantially (about \$1.3 trillion). This episode demonstrates that, in fact, there is no such thing as a free lunch, no matter how much things appear to change.

Facilitators of American Excess

Two other plausible causes have been forwarded for the current crisis. The first is the “saving glut” on the part of East Asia and the oil exporting countries. The other is an overly loose monetary policy. The first is, we believe, a red herring;

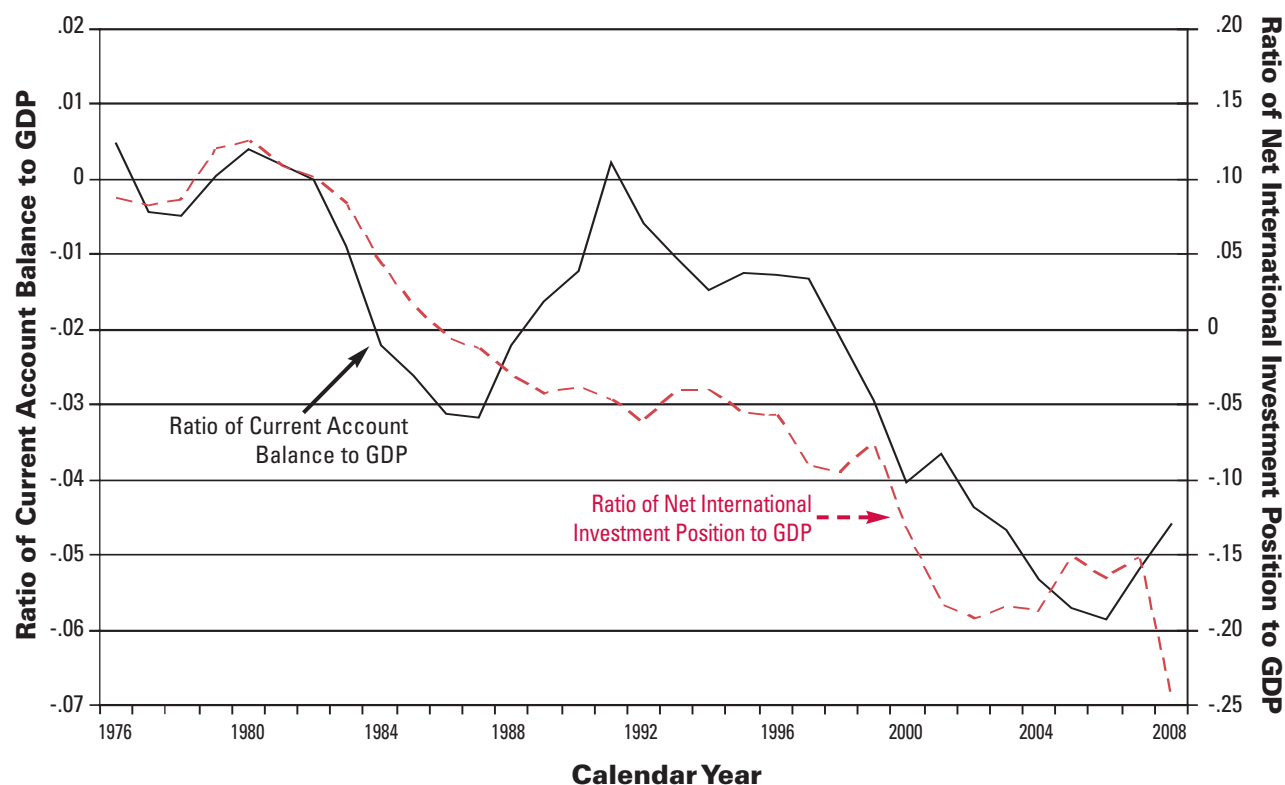
the second bears more blame, but is more of a contributor than a primary instigator.

The saving glut, a term coined by then Federal Reserve Board governor Ben Bernanke in a 2005 speech, argues that the U.S. current account deficit is better viewed as an East Asian capital surplus. Hence, one can think of incipient excess capital being pushed in the direction of America. More recently, several observers, including even the Bush administration in its *2009 Economic Report of the President*, have promoted the view that this capital flow to America is the root cause of the financial crisis of 2008, by inducing risk-taking behavior and the subsequent housing boom.

China is a central character in this drama. In the first decade of the 21st century, China’s saving rate surged even more than its incredibly high rate of investment, so that it too started running large current account surpluses, up to 10 percent of GDP in 2008, according to the International Monetary Fund. The oil exporting countries are also tagged as part of the capital flows to the United States. They were minor players until the oil prices began rising in 2004 and peaking spectacularly in 2008 (before dropping just as precipitously thereafter).

One point highlighted by the development of these

Figure 2. Current Account Balance, Net International Investment Position as Ratios of Gross Domestic Product



International investment position data is for year-end.

Source: Bureau of Economic Analysis, 2008 International Investment Position release, and 2009 first quarter final GDP release; and authors’ calculations

current account balances is the fact that these capital flows did not arise out of nowhere. Think about the oil exporters. They had such large surpluses because U.S. policy authorities had overstimulated the economy via a mixture of tax cuts, domestic and national defense spending, and lax monetary policy. This drove up demand for petroleum and resulted in the oil exporters' burgeoning trade surpluses. In other words, we think that narratives that place primary blame on the rest of the world for our troubles have the causality mixed up. To a large extent, America created its own misfortunes.

We stress this point because it is necessary to dispense with the view that all this excess saving from the rest of the world was "forced" upon us. The rest of the world's capital flowed to us, in part, because we wanted to borrow, and we wanted to borrow because of the Bush administration's emphasis from 2001 to 2008 on cutting taxes while still spending.

Turning to monetary policy, it is now clear—in retrospect—that the Federal Reserve Board pursued its low interest rate policy for too long. In the wake of the dot-com bust of 2001, the Fed dropped the interbank lending rate (the "Fed Funds rate") quickly—and kept it low for an extended period. By the end of 2002, the Fed's benchmark interest rate was approaching 1 percent, at a time when inflation was between 2 percent and 3 percent a year. Interest rates were kept at this extremely low level through 2004 and only went above 2 percent in early 2005. The long period of interest rates lower than the inflation rate—negative real interest rates—is thought to contribute to the remarkable increase in American borrowing.

Much has been made about the institutional aspects of

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the current crisis. We agree with the view that the presence of a large unregulated financial sector—what is sometimes called the "shadow financial system"—is a critical feature of the crisis. But we view this aspect as an exacerbating factor.

Essentially, the development of an unregulated financial sector has circumvented the entire panoply of banking regulation created in the wake of the Great Depression. This made the financial system vulnerable to traditional "bank panics," or "runs" on the financial system. The abdication of regulatory oversight (particularly in allowing high leverage) in the presence of too many institutions "too large to fail" meant the buildup of implicit financial liability on the part of the government. In this sense, the buildup of Treasury debt during the Bush administration understated the true liabilities of the government. This is a reality that people are only now coming to understand, as the debt to GDP ratio balloons, from the bank bailout and collapsing tax revenues (a phenomenon that is typical in the wake of financial crises, as Carmen Reinhart, a professor at University of Maryland, and Kenneth Rogoff, a professor at Harvard University and former International Monetary Fund chief economist, have pointed out).

Financial innovation and lack of regulation also play a role in allowing for the buildup of these governmental "contingent liabilities" on the part those institutions "too interconnected to fail." AIG represents the prime example of this phenomenon. AIG's financial products division was heavily involved in the trading of credit default swaps; the insolvency of AIG would have caused a cascade of defaults that would have threatened the entire financial system.

The debt crisis of 2008 would have occurred in the absence of credit default swaps and other exotic financial instruments (such as collateralized debt obligations, the sliced and diced securities based upon other securities backed by mortgages). But these factors greatly magnified the impact of the debt crisis and significantly complicated the policy response to the ensuing events.

Consequences

Not only did Americans borrow from the rest of the world, they borrowed from each other. Consider first households. Gross household debt rose rapidly. Many observers took comfort from the fact that at the same time, household assets—primarily houses and stocks—also rose, so that net assets were rising. As it turns out, household debts have turned out to be much more durable than household assets; and so as asset prices have plunged, individual asset/liability balances have deteriorated.

Consequently, during the foreign borrowing boom of 2001 to 2007, the federal government and households were the biggest borrowers. In a broad sense this is troubling;

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certainly, if this had been a developing country, red flags would have gone up, as the pattern of borrowing and spending would have suggested that most of the borrowed funds were going into consumption—which does not add to the future productive capacity of the economy—and not to investment.

Not only did the borrowing by the private sector not go to investing in new technologies, as in the dot com boom, but rather a large portion seemed to go to the financial and real estate sector. The central role of housing in the debt cycle that eventually collapsed into the crisis should not obscure the fact that real estate speculation of this nature is a common and predictable feature of such a capital inflow. The reason is straightforward: money borrowed from abroad has to go somewhere. Some of it is spent on goods that are readily traded across borders, “tradable goods.” Since there are ready foreign substitutes for domestically traded goods, much of this additional demand ends up sucking in imports from the rest of the world.

The run-up in housing prices was more spectacular than the yawning trade deficit but just as predictable. As Americans borrowed \$500 billion to \$1 trillion a year, they spent some of the increased resources on physical commodities that included imports but spent the rest on items not easily traded internationally. Such nontradable goods and services, which have to be consumed where they are produced, experienced rapid price increases because they faced no foreign competition. A universal result of a major capital inflow, then, is increased demand for and rising prices of nontradables, especially housing. And this is precisely what happened in the United States.

The capital inflow led to surging imports and rising home prices, and to a major expansion of financial activity. One reason is that financial services are also, largely, nontradable. It is also the case that much of the money coming into the United States flowed through the domestic financial system. American banks borrowed from abroad—taking deposits from foreigners, borrowing from other banks—in order to re-lend the money at home. Other financial institutions sold foreigners stocks and bonds on behalf of American issuers.

As capital flooded into the United States, imports surged, the housing market soared, and the financial sector boomed. These three results of the borrowing boom are typical of all such foreign debt cycles. Prices of such nontradables as housing rise, prices of tradables stay roughly the

same or fall, while imports rise. The financial, housing, and broader services sectors grow rapidly, while industries competing with imports are troubled.

The rise in housing prices had additional follow-on effects on consumption, contributing to the self-reinforcing nature of the bubble that developed. As housing prices rose, homeowners who regarded the price increases as permanent saw their family wealth rise. For example, a family with a \$200,000 house and a \$100,000 mortgage in 2000 might, by 2006, have a \$300,000 house and the same \$100,000 mortgage, so that its household wealth had increased by \$100,000. While this was “paper wealth,” there was nothing fictitious about it—a similar increase in the price of the family’s stocks would have been just as real. Indeed, the family could—as did millions of Americans—take advantage of newfound wealth to borrow and consume more, taking out a

home equity line of credit against their now more valuable home, which could then be spent on home improvements, new appliances, or vacations. So the housing expansion fed into a broader expansion of consumption, as debt fed housing price increases that, in turn, enabled more debt.

The Long-Term Prospect

We are now witnessing the unwinding of this process of debt accumulation. Households and firms are busily trying to reduce their debt loads, in the face of dimmer prospects for income and profits. For households, savings rates are rising, but at the cost of stagnant consumption. For firms, the reduction of debt load is consistent with a reduced rate of investment in plant and equipment.

In some sense, this process of retrenchment is necessary. For many years, the United States consumed more than it produced. We borrowed and for a while thought that the old rules had been suspended. But now it turns out that we do have to pay back what we have borrowed. The attendant higher saving rate and lower investment rate will lead to a substantial improvement in the current account balance, or in other words, the paying off of our debt.

More broadly, though, this also means that the United States cannot rely upon the driver of growth that has sustained it over the past three decades—namely consumption. But the consequences extend beyond the nation’s border. The world can no longer rely upon the American consumer. Who will take up this role remains to the next big question. ♦

Essentially, the development of an unregulated financial sector has circumvented the entire panoply of banking regulation created in the wake of the Great Depression. The abdication of regulatory oversight in the presence of too many institutions “too large to fail” meant the buildup of implicit financial liability on the part of the government.
