The Next Financial Crisis

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The theme of my talk today is the next financial crisis. The events of the past three years should suggest to all of us that we need to be thinking about topics like this. Too often we spend too much time fighting the last battles, de-constructing the last crisis and not enough time looking for the seeds of the next crisis. You might hope that I'm going to tell you exactly when the next crisis will occur and what will cause it. That presumes a lot. My crystal ball is a lot more cloudy than that and I think economists need to be a little modest about such things. I certainly have colleagues like Nouriel Roubini who make bold pronouncements about such things.

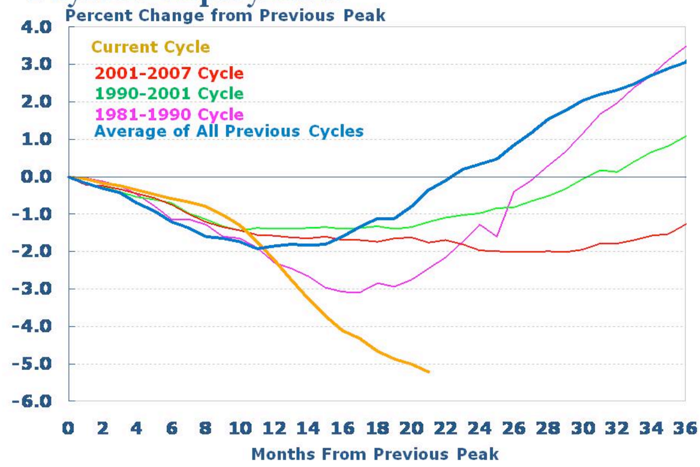
Before we launch into talking about the next financial crisis let me first talk about where we are in the current crisis. There may be a view in many parts of the world that the crisis is over; brisk economic growth has taken hold, equity markets are very optimistic – some would argue even bubbly in Asia– and people are buying risky assets again. They are buying a lot of them.

Economic growth has resumed in the U.S. and in the Euro Zone helped in part by stimulus packages but mostly helped by monetary policy. Although things are looking better I think it is pretty early to claim victory over the great recession. The pace of recovery is different across major markets but let me illustrate what it looks like in the United States.

I find the best way to illustrate where we are is to compare the current business cycle with previous business cycles on a common scale. The following pictures show where we are using an index that is defined to be 100 when the recession starts. The horizontal axis measures time from the beginning of the recession. Figure 1 shows the behavior of Employment, (by month) in the current cycle and for the three most recent recessions and the average of all previous post-war recessions. The units of measurement are the percentage change from the previous peak.

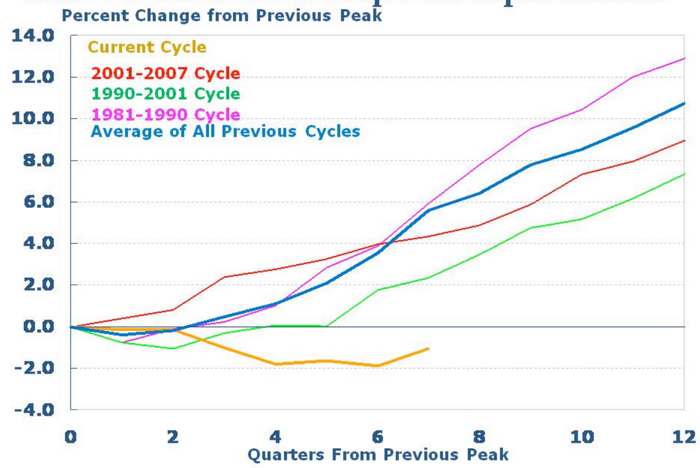
Immediately evident from these Charts is why observers have come to call this the Great Recession. It is clear a dramatic turndown in employment, consumption and investment beyond what we have experienced previously in the post-war period.

Payroll Employment

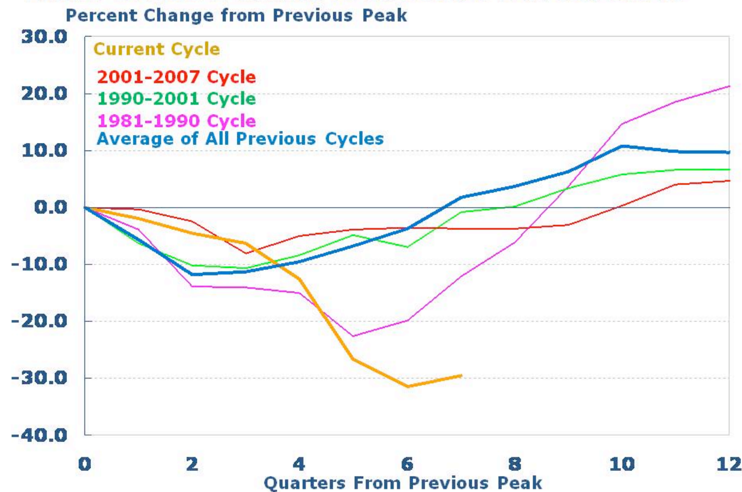


Source: Bureau of Labor Statistics

Real Personal Consumption Expenditures



Source: Bureau of Economic Analysis



I think the story being told here is of a very precarious recovery. Consumption has turned back up, investment has begun to recover but the labor market remains very depressed.

The recovery is fragile for several reasons:

- Credit markets are still weak. The demand for loans and the supply of credit for medium and small sized firms is very weak. Banks are reluctant to lend to them because of the dodgy loans they still have on their books. It is very difficult and very expensive to get letters of credit for new firms.
- For the reason cited above the supply of new jobs is very weak.
- The U.S. debt is increasing vary rapidly and that is going to serve as a drag on the economy in the years to come.
- The shadow banking system – the supply of securitized credit has not really recovered. Its role has been largely subsumed by the Federal Reserve that buys some like 70% of all the mortgage securities in the U.S.
- There is an enormous amount of debt that is going to have to be rolled over in the next few years and absorbed by the system.

Other things to note about the U.S. economy are that the savings rate has increased – something it very much needed to do - and the relatively weak U.S. dollar has made exports more attractive.

For all of these reasons the economic recovery may not be as robust as we might hope for. But there is one thing that we should note – think back to where we were one year ago. We were literally staring into the abyss. It was in many respects the darkest time of the economic crisis. World trade had ground to a halt.

The fact that we are growing again today is in many respects a triumph for economic policy making – largely monetary policy making. Both in Europe and the U.S. and in Asia we have avoided what could easily have been a worse collapse than the Great Depression. The financial system was so badly crippled that we were on the brink of a world where if you put your card in the ATM machine nothing would come out.

So we are recovering from those dark days and in that recovery lie the seeds of the next financial crisis. Economists have been roundly criticized for not having seen the financial crisis coming – although a few certainly did. But neither did policy makers, business folks and those who were supposed to keep watch over the soundness of the financial system. We should have seen the cracks forming for sure.

Financial crises, like business cycles, are mysteries. No one benefits from them, no one would choose to have them, but they happen. They are ubiquitous. So the one thing an economist can say for sure is there will be more recessions and there will be more financial crises. A recent excellent book by Ken Rogoff and Carmen Reinhardt, with the title ***This Time is Different*** documents the characteristics of over 150 financial crises and show that like business cycles they have many common characteristics. What we should be able to do is learn from past mistakes – and sometimes we do. Policies put in place in the 1930's – Glass Steagall, the creation of the FDIC and the SEC helped insure a relatively sound financial system in the U.S. that prospered for more than fifty years. They were policies that worked until they didn't any more.

But when cracks start appear we seem to suffer from collective myopia that leads us to ignore them. In some recent papers with a few of my colleagues I have argued that there were early warnings about the importance of systemic risk and the danger of un-priced guarantees for firms that are deemed too big to fail– the features more than anything else that brought the U.S. financial system down and hinder its full recovery. The collapse of Continental Illinois Bank in the 1980's and Long Term Capital Management in the 1990's contained important lessons that were articulated at the time but then ignored.

But this is all preamble – you are expecting me to talk about the next financial crisis. So let me talk about a problem that I think is a looming problem, one of the most difficult we have ever faced and it doesn't have an easy solution. The thing that has me most concerned, not just for the U.S. economy but for the world economy is the fiscal imbalance in the U.S.

Let me show you some more data.

The U.S. Treasury recently closed the books on fiscal 2009 and the news is not good. The fiscal deficit for the year was $1.4 trillion dollars an increase of more than $960 billion over fiscal 2008. In a $14 trillion dollar economy that represents nearly 10 of GDP. The last time we were this indebted was during World War II. These facts should seriously temper any euphoria over the third quarter turnaround in GDP growth and the improvements in the U.S. economy.

The administration has painted itself into a very difficult corner. It has dramatically increased spending and it has refused to acknowledge that it's commitment to not raise taxes on taxpayers earning $250,000 or less is not a sustainable commitment in the face of its ambitious programs and the unwillingness to cut spending. We are borrowing like crazy just as we have been for the past decade– the difference is that it is now the government that is levered to the hilt and not the private sector.

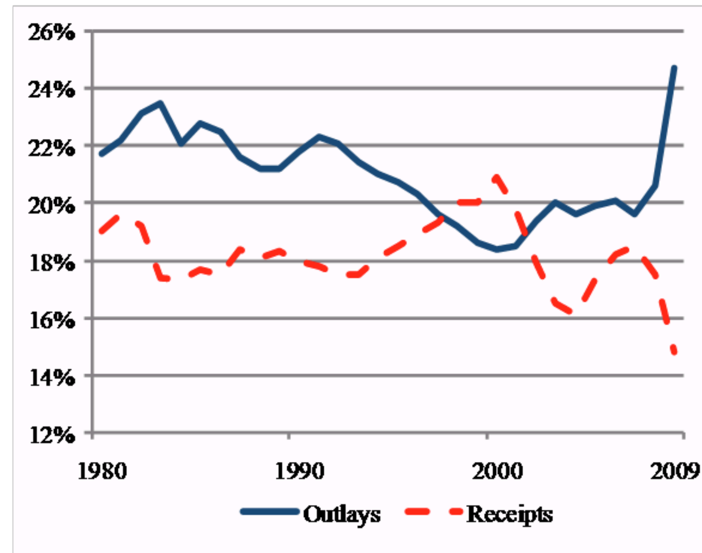
This is a bleak picture but there is good news that goes with it. As economic theory would lead us to expect, the savings rate in the U.S. has increased in response to the huge deficits. In the past year the savings rate has increased sharply to near seven percent. Private savings can offset the public dis-saving up to a point. Japan, for example, has been one of the largest deficit spending countries in the world for decades. Their debt to GDP ratio is about 200%. They can do this because Japanese households save at a very high rate.

The other good news is that the U.S. Dollar is and will continue to be the world's reserve currency. Why is that goods news? It means that the U.S. can run a persistent current account deficit because other countries need dollars for reserves. This is why we find it easy –even now with staggering deficits – to sell U.S. Treasuries at low interest rates. One distinct advantage the United States has is the depth and liquidity of its government securities markets.

Speculation that other currencies may replace it as the world reserve currency are, in my view, simply not credible. Not only is there is no likely alternative candidate but the response to the financial crisis last year caused a flight to the safety of U.S. Treasury obligation. That reaffirmed the world's belief in the long term credibility of the U.S.

But, here is the rub: that credibility is not insured to last forever. In order to continue to do this and fund our deficit we have to be perceived to be on a sustainable fiscal path. Exactly what constitutes a sustainable path can be hard to define. Market participants have to be confident that in the long run revenues and outlays are moving closer to one another and will not be characterized by a gap that is increasing ad-infinitum. Stated simply, in the government needs to spend less and collect more revenue.

The chart below from the congressional budget office (CBO) shows what the path looks like currently.



Clearly this is not a sustainable path. The administration recognizes explicitly that this is not sustainable and promises that sometime in the future it will begin to address the issue.

What are their options? As the economy improves, receipts will increase, but it will take a very robust recovery to make even a small dent in the gap. That leaves taxes and spending cuts as the main levers to restore sustainability. Unfortunately, the Obama administration refuses to take advantage of even likely efficient reforms to pay for its agenda. They have nixed the idea of charging for rights in their cap and trade policies to control emissions and they have refused to consider paying for increased health care coverage by eliminating the distorting tax advantage given to employer sponsored health care plans.

And, how credible is it to assume that they will confront the problem by decreasing spending? The feeding frenzy of special political interests that erupted around the stimulus package ought to answer that question.

If we assume that the public debt continues to grow because government spending increases rapidly and congress is unwilling to raise taxes, then the picture is not pretty. The current mantra is that the big imbalances were inherited and there is some justification for that. The Bush administration was irresponsible. But finger pointing doesn't fix the problem and the democrats have controlled the ball for eleven months now without any signs of a plan.

There are signs of wavering confidence everywhere in the world economy. Low interest rates, the weak dollar, and China's peg to the dollar has stimulated asset price bubbles around the globe and many countries – Brazil is one example - have had to respond by trying to limit hot money in-flows.

Right now there is a gigantic carry-trade financed with low US interest rates and driving investors into risky assets elsewhere. How much of that is a bubble as opposed to improving fundamentals I don't know.

But what happens if the world loses confidence in the US dollar in a big way? With no alternative reserve currency. It could once again put a huge damper on world trade. What happens if inflation spikes and the Fed has to unwind its massive balance sheet?

Now is the time to stem falling confidence by articulating a clear, credible plan for restoring fiscal sustainability once the worst of the recession has passed. Unless we can at least limit the growth in debt to the growth of the economy, the world will lose faith in Treasury obligations, increasing the government's borrowing costs and add to the fiscal drag on the economy as we try to service our massive debt. It is a very delicate balancing act indeed but it is not something we can postpone for long. The current policy stance is not credible because the administration supports many of the policies that they complain about inheriting - prescription drug benefits -- which Democrats also advocated -- and continuation of the Bush tax cuts for 95 percent of taxpayers.

We have the tools to deal with these issues if they arise but we have to be willing to use them. Putting the U.S. on a sustainable path could dampen even abort the recovery and everyone cites the example of 1937 as and argument for we should not suddenly raise taxes. In the U.S. there is currently a tremendous lack of political will to do the right thing.

Credibility is something that is very easy to lose with irresponsible fiscal policy and very very hard to rebuild once it is lost. Right now it is leaking away.