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- Where are we in the global crisis?
- How did we get here?
- What are the lessons—and how do we get to a more stable and prosperous economy?

Towards a Global Malaise

- The world has pulled back from the brink where it was in September 2008
- But the world is not yet on the course of a robust recovery
- In fact, prospects are that growth will slow down towards the end of the year/early next year
 - Only source of strength is in Asia
 - Europe and America heading to slow growth—or a double dip

Key problem

- Before the crisis, global growth was supported by bubbles—the largest in the United States
 - Financial innovation and deregulation had allowed bubbles to grow bigger
 - For all the innovation, this crisis is much like the crises that have plagued capitalism throughout history—except in the short period after World War II when most countries adopted good financial regulation
 - Mistaken view that markets, on their own, were efficient, self-correcting, and stable
 - Markets worked well in decades after Great Depression because of good regulation,
 - After deregulation, because governments repeatedly bailed them out
 - During past quarter century, economic theory has explained why markets are often not efficient or stable
 - Led to mistaken view that regulations weren't needed
 - And appointment of regulators that didn't believe in regulations

- Bubbles allowed everyone one to live beyond their means
 - Especially America and its consumers (household savings rate of zero)
 - America’s spending spree helped support a global boom
 - Governments had become use to spending fake income generated by bubble
- Globalization and financial and capital market liberalization allowed , “toxic assets” to be spread around the world
 - Securitization based on “greater fool theory”
 - Globalization had opened up a global market place for fools
 - America is thankful—were not so many of the toxic assets sold abroad, its problems would be even worse

The problem in a nutshell: bringing the world back to reality

- What will fill the gap in aggregate demand left by the bursting of the bubble
 - Consumption won't, shouldn't return to where it was
 - Not everyone can export themselves out of a crisis
 - US had been engaged in competitive devaluation
 - Exchange rates like negative beauty contest
 - US had been winning
 - Europe is winning now
 - Uncertainty makes this a negative sum game

- When consumption and exports are weak, investment will be weak
- The only answer: government

Global Keynesian Stimulus

- Worked—without out the world would have faced a global depression
- But US stimulus package was too small, and not well designed
 - Too much spent in ineffective tax cuts
 - Too little in aid to states and localities in US
- The one country with a large stimulus –China—has resumed strong growth
 - China and India have managed (temporarily) to have growth even when the rest of the world is weak
 - But they are too small (economically) to save the rest of the world
- Australian stimulus was timely and one of the best designed in the world

Big economic and political mistake

- Leaving those who had created the mess in charge (both in politics and in banks)
 - Couldn't admit easily that magnitude of the mistakes
 - Couldn't change mindsets quickly enough
 - Had incentives to hide their mistakes, through continuing faulty accounting and hidden bailouts
 - Wanted to believe that the bubble was reality, economy going through a temporary bump
 - Give the economy a little assistance, don't change too much, and world could go on as before

We can't go back to world as it was before 2007

- Distorted economy—40% of profits in finance
 - Confused ends with means
- Financial sector not only bloated, had failed to perform its essential functions—allocating capital and managing risk, at low transactions costs
- Innovation directed at circumventing tax, accounting, and financial regulations, not at enhance productivity of the economy

The slow train wreck

- Consequences of bubble predictable, and predicted (though not by those who believed markets always work)
- Economic meltdown
 - Weaknesses in aggregate demand
- And financial meltdown
 - Banks didn't know who to trust—credit stopped flowing
- Two were related, but distinct
 - US made crucial mistake focusing on financial sector, assuming that that would “solve” the broader economic problem
 - But didn't “save” the banks in a way which helped restore broader economy to strength

Saving the banks

- Focus was originally on saving not just the banks, but the bankers and their bondholders and shareholders
 - Broke ordinary rules of market economy (should have put banks into conservatorship)
 - Ersatz capitalism: System of socializing losses, privatizing gains
 - Distorts incentives
 - No conditions were put on bankers

The Result: Flow of Credit Not Resumed

- Though that was the intent of the mega-bailouts
- Banks paid out money in bonuses and dividends
 - *It was in their incentives to do so*
- And country's fiscal position is worse than it otherwise would have been
 - Much of assistance was hidden
 - Availability of cheap money
 - Restructuring of mortgages took bad mortgages off books and put them on that of the government
 - Losses will be realized over years to come

Beyond the financial crisis: the economic crisis

- Even if we had fully fixed the banks we would have a problem from lack of aggregate demand
- Vicious circle
 - High unemployment—one out of six Americans who would like a full time job still can't get one; long term unemployment highest on record—run out of unemployment benefits
 - Low property values, high foreclosure rates—even higher than in 2008, 2009

- Weak banks, with large losses, not just on residential mortgages but all commercial mortgages (problems may be worse, and just coming out into the open)
- With weak banks, credit flow impaired
- States and localities revenues plummeting, and they have to cut back or raise taxes, in either case, a negative stimulus

The Next Blow to the Global Economy

- Worries growing about large public debts created to save the global economy
- Leading to cutbacks in spending in many European countries
- In the U.S., likelihood of second round of stimulus small—even though the economy is very weak
- Effects of cutbacks will be to dampen global growth, possibly leading to a recession in some countries

Myth of Austerity

- Long standing debate—back to Great Depression
- When economies go into recession, deficits rise
- Conservatives: Cutting deficits through austerity will restore confidence and economic growth
- But “confidence fairy” never seems to appear
- This is a theory that has been debunked over and over again
- If Europe follows this route will have adverse effect both on it and the world

Monetarist response

- Don't worry—monetary policy can fill the gap
- But monetary policy has already reached its limits
- Has not been able to restore economy to full employment
- And in the U.S. has left the U.S. government with large amounts of implicit liabilities

There is an alternative

- Fiscal policy—shifting more spending towards high return investments, that lead to growth in short and long run
- Tax policies—shifting taxes to encourage investment and towards individuals with high marginal propensity to consume
- Credit policies—focus on creating new financial institutions rather than pouring money into old institutions bogged down by legacy of bad debts and bad business practices and mentality (banks who are no longer banks)

- Such a policy can lower national debt in long run (and possibly in the short); create a more dynamic and fairer economy

Global challenge

- We live in a global economy, so what matters is global aggregate demand
- Big short run challenge is increasing global aggregate demand
 - Global market economy not working as it should
 - Large unmet needs (addressing problems posed by climate change and global poverty) and large underutilized resources
 - Irony: most of the waste of resources occurs after the bubble breaks
 - In trillions of dollars
 - A result of mistaken economic policy
 - But again demonstrating that markets are not self-correcting (at least in the relevant time frame)

Sources of weak global aggregate demand

- The bubble had artificially supported demand
 - With bursting of bubble, weakening of demand
- Large accumulations of reserves, partially in response to mismanagement of East Asian financial crisis by US Treasury and IMF in 1997-1998
 - Money not spent leads to lower aggregate demand
- Growing inequality in most countries around the world

Some hope America's consumer will return

- But that would be a mistake—growth will not be sustainable
- Goal should be to prevent the emergence of another bubble, through better financial regulation
- Bill passed by US gets a grade of B- : better than nothing, but not good enough to prevent another crisis, riddled with exemptions, and with key decisions left to regulators—including the same regulators who got the economy into the mess

Global imbalances and global reserves

- Long worry that disorderly unwinding of imbalances would lead to global crisis
 - Imbalances didn't lead to this crisis, but could well contribute to the next
- Some countries are producing more than they are consuming—contributing to weak global aggregate demand
- G-20 framework (US consume less, China consume more) unlikely to solve problem
 - China already expanding consumption rapidly
 - But spending is not going to goods produced in the United States
 - World cannot survive if everyone consumes in profligate manner as the US

What is needed

- A new economic model
 - Innovation focusing on saving resources, not labor, or financial innovations circumventing regulations, taxes, and accounting standards
 - Investments to respond to the challenges of global warming and poverty
 - But that requires a high carbon price
- A new global reserve system
- A new global regulatory system

A new global reserve system

- Peculiar for the currency of a single country to play the central role that it does, especially as confidence in its economic and political management weakens
- Could contribute to restoration of global aggregate demand, a more stable global financial system, and it would be more equitable
 - Peculiar for poor countries to borrow from the US at high interest rates, and lend to US at close to zero interest rates
- Growing support for this new global reserve system

New Global Regulatory System

- Finance is global, and without a global regulatory system, there is risk of arbitrage, circumvention
- Basic principles clear: transparency, incentives (not to engage in excessive risk taking), restraints (against excessive risk taking, including through derivatives), structures (like Glass Steagall, Volcker rule, to reduce scope for conflicts of interest, excessive risk taking, etc) and consumer/investor protection

- But power of banking lobby, especially in US, too strong to get adequate regulation
 - Though Goldman Sachs, through its various exposed practices proved best lobbyist for reforms
- Each country has a responsibility to protect its own citizens and economy
 - Global coordination being used as a delaying device
 - Each country adopt its own protective rules
 - Then a period of harmonization

The Big Picture

- Markets failed miserably—and we are all paying big price
- Government came to the rescue—but in ways that were not as effective as they could have been and left a greater legacy of debt
- Choices many governments are making today are likely to make the global downturn last longer

- There were alternatives, though would have stimulated the economy more and left less of a legacy of debt
- There are alternatives today that can set the global economy on a course for a return to a stronger recovery and a more stable future

- While we have been focusing on the short run, long run problems have not gone away
- But the resources available to deal with them have been greatly diminished
- There are strategies for dealing with the short run problems that will simultaneously address the long run
- Success in dealing with both will require getting a better sense of the appropriate balance between markets and government
- We lost that balance in the run-up to the crisis
- Now is the time to restore it