MENZIE D. CHINN
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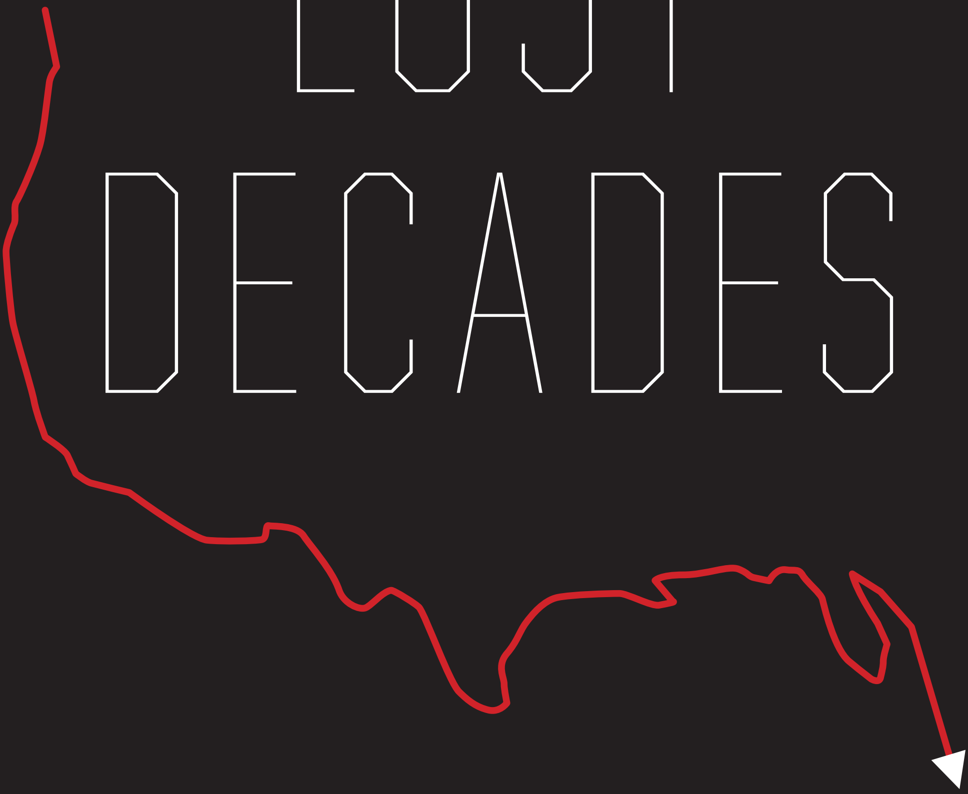
LOST DECADES



The Making *of* America's Debt Crisis *and the* Long Recovery

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PREFACE

The midterm elections were over, and the Republicans had made stunning advances. The GOP had picked up over seventy seats in the House of Representatives and seven seats in the Senate. Perhaps just as important, the Republicans had taken a number of crucial governorships from the Democrats, including the pivotal states of Michigan, Ohio, and Pennsylvania. The election was a dramatic reversal of the Democrats' landslide victory two years earlier, and was a particular blow to the president, who had swept into office in the midst of a devastating economic crisis.

Certainly the Democrats could be satisfied with some major legislative accomplishments, passed with their previous majorities. But now, a disappointing economy and stubbornly high unemployment rate had brought back to life a Republican Party that had appeared moribund two years earlier. For the foreseeable future, the Republicans, together with allies among conservative Democrats, would be able to block or force changes in just about any initiative the president had in mind.

The year was 1938, and the economic recovery from the Great

Depression was in deep trouble. Back in 1933, when Franklin D. Roosevelt became president, the country was in the fourth year of the deepest depression in its history. The Roosevelt administration had moved quickly and aggressively to try to bring the country's economy back to life. Roosevelt and his fellow Democrats in Congress purged the nation's banking system and imposed stringent new regulations. They created an ambitious array of federal programs to put the millions of unemployed to work. And they initiated the first serious federal social program in American history, Social Security.

By 1936 the economy was recovering. The unemployment rate had fallen to 14 percent, still high but down from where it was, 25 percent, when Roosevelt took office. Both national income and the stock market were rising rapidly. In light of the upturn, the Roosevelt administration resolved to tackle the federal government's budget deficit, which in 1936 had reached nearly 5 percent of gross domestic product (GDP), a level unprecedented in peacetime. Delivering on promises to trim the deficit, the administration cut spending by 20 percent and raised taxes by even more; within a year the budget was practically back to balance. Meanwhile, the Federal Reserve tightened monetary policy, apparently to avoid a resurgence of inflation.

In the aftermath of the fiscal and monetary retrenchment, in the summer of 1937 the American economy collapsed into a steep recession. Industrial production dropped by one-third, the stock market plummeted more than 40 percent, and the unemployment rate shot back up to 19 percent. As the American economy slumped, the administration's popularity faded rapidly. And the result of the 1938 midterm election reflected this loss of confidence in the federal government's ability to bring the nation out of the Depression.[1]

Today the United States and the world are slowly recovering from the most serious international economic crisis since the Great Depression of the 1930s. As was the case in the late 1930s, the causes and consequences of the crisis are hotly debated. And just as then, a great deal rides on an appropriate understanding of why and how the United States got to where it is today. How could the world's richest economy go broke? How did the world's most powerful banks collapse? Why would the most conservative government in modern American history nationalize enormous portions of the U.S. economy? Why did millions of American families lose their homes, and millions more their jobs? Whose fault is it all?

We have a unique perspective on these debates. We have spent, between the two of us, more than fifty years working on debt crises. We have lived through and studied financial and currency disasters in Europe, Latin America, Asia, and Russia. We have witnessed firsthand, and analyzed in detail, the human, social, and political wreckage of irresponsible borrowing. We have watched country after country lose decades of economic progress to the austere aftermath of financial crises. But we never feared that we would see a classic debt crisis in our own homeland. And we never imagined that our country could face the prospect of almost two decades lost to misguided policies, an unnecessary crisis, and a daunting task of economic reconstruction. Nonetheless, there is value in our ability to compare the current crisis to those we have known and investigated. As we examine the events of the past decade, and look toward the decade to come, we can draw on a wealth of comparative and historical experiences to guide our analysis.

The United States is in the midst of the greatest failure of economic policy, and of financial markets, of recent times. This is the story of how and why it got there, and of what the nation must do to repair a wounded economy.

The crisis

The most serious economic crisis of the past seventy-five years began as the summer of 2008 ended. In August and September, credit markets everywhere entered a downward spiral that spun faster and faster until, in the first two weeks of October, it seemed that the world economy might be coming to an immediate end. During those dark weeks and months, an international economic order that had inspired faith bordering on rapture around the world appeared to have turned on its creators and strongest supporters. The United States, the very center of economic globalization, was gripped in a panic that threatened to destroy the world economy. The collapse seemed to surge out of nothing and nowhere. One week there was mild concern about a sluggish housing market in the American Sunbelt, the next week the whole world was staring over a precipice into the end of global capitalism. The world's strongest economy turned into the sick man of international capitalism. The American paragon of capitalist virtue, protector of the free-market faith, took over huge swaths of the private sector. What happened? How could this come to pass?

The United States 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; households borrowed to allow them to consume beyond their means. As money flooded in from abroad, Americans spent some of it on hard goods, especially on cheap imports. They spent most of the rest on local goods and services, especially financial services and real estate. The result was a broad-based economic expansion. This expansion—especially in housing—eventually became a boom, then a bubble. The bubble burst, with disastrous effect, and the country was left to pick up the pieces.

The American economic disaster is simply the most recent example of a "capital flow cycle," in which capital floods into a country, stimulates an economic boom, encourages high-flying financial and other activities, 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—and, in fact, the German crisis of the early 1930s and the American crisis of the early 1890s. We can best, and most fully, understand the current debt crisis by understanding the dozens of debt crises that have come before it. What causes such crises? What can we learn from the paths to them, through them, and out of them?

To be sure, the most recent American version of a debt crisis was replete with its own particularities: an alphabet soup of bewildering new financial instruments, a myriad of regulatory complications, an unprecedented speed of contagion. Yet for all the unique features of contemporary events, in its essence this was a debt crisis. Its origins and course are of a piece with hundreds of episodes in the modern international economy.

For a century American policymakers and their allies in the commanding heights of the international financial system warned governments of the risks of excessive borrowing, unproductive spending, foolish tax policies, and unwarranted speculation. Then, in less than a decade, the United States proceeded to demonstrate precisely why such warnings were valid, pursuing virtually every dangerous policy it had advised others against.

Most analysts of the crisis miss this central point. Each of the many accounts published since 2008 has focused on one or another limited aspect of the crisis. Some follow the financial meltdown and response blow by blow, yielding vivid insights into the personalities and institutions involved. Other accounts emphasize the role of financial regulators in the collapse, documenting the influence of Wall Street over the deliberations in the halls of Washington, D.C. Yet others explain how the financial crisis caused so deep a global recession. Our analysis starts with the macroeconomic drivers of the experience, includes the political pressures, incorporates the regulatory enablers, and puts the crisis into a comparative and historical context, drawing parallels and lessons from the dozens of similar episodes from the past.

The American crisis immediately spread to the rest of the international economy. The world learned a valuable lesson about global markets: they transmit bad news as quickly as good news. The American borrowing binge had pulled much of the world along with it—drawing some countries (Great Britain, Ireland, Iceland, Spain, Greece) into a similar debt-financed boom, and tapping other countries (China, Japan, Saudi Arabia, Germany) for the money to make it possible. The collapse dragged financial markets everywhere over a cliff in a matter of weeks, with broad economic activity following within months.

Impact and implications

The global crisis raises the specter of global conflict. As governments scramble to protect their citizens, their actions can be costly to their neighbors: a bailout favors national over foreign firms, devaluation puts competitive pressures on trading partners, big deficits suck in capital from the rest of the world. The 1929 recession became a depression largely because of the collapse of international cooperation; the current crisis may head in that direction if international collaboration similarly fails.

With or without broader international complications, the United States faces hard times. The country lost the first decade of the twenty-first century to an ill-conceived boom and a subsequent bust. It is in danger of losing another decade to an incomplete recovery and economic stagnation.

In order to not lose the decade to come, the United States will have to bring order to financial disarray, gain control of a burgeoning burden of debt, and re-create the conditions for sound economic growth and social progress. None of this will be easy. The tasks are made more difficult by the fact, which we have learned to our alarm, that all too many policymakers and observers cling to the failed notions that got the country into such trouble in the first place. If Americans do not learn from this painful episode, and from others like it, they will condemn the nation to another lost decade.