Journal of Economics and International Finance Vol. 4(6), pp. 131–136, 22 March, 2012
Available online at http://www.academicjournals.org/JEIF
DOI: 10.5897/JEIF12.006
ISSN 2006-9812 ©2012 Academic Journals

Review

Lessons from the great recession: Need for a new paradigm

Salman Ahmed Shaikh

Business and Economics Research Center, Institute of Business Administration, Karachi, Pakistan. Tel: +9221-38104701, Ext: 1624. E-mail: salmanashaikh@iba.edu.pk or salmanahmed_hyd@hotmail.com.

Accepted 6 March, 2012

The ongoing sovereign debt crisis in Europe and U.S. is challenging the conventional wisdom and is creating fears of a double dip recession in 2012. Massive levels of debt and consumption beyond means and speedy financial innovation with lax regulation has put major economies in a deep hole. Monetary policy with ease in rates had been ineffective, to say the least, in generating new jobs in the last few years when interest rates were kept at near zero level since 2008 in United State. Fiscal stimulus again targeted the undisciplined financial sector which did not use the stimulus for extending credit to the private sector as much as was required. With business cycle fluctuations, mounting consumer and fiscal debt is unsustainable and one lesson of the crisis is that business cycles are for real and here to stay. The securitization of consumer debt magnified the losses and created negative unjust effects on savers and taxpayers which had nothing to do with the mess in the first place. Against this backdrop, a new paradigm is needed which will put the focus back on productive enterprise, bring recovery with job creation, limit and regulate speculative financial institutions and instruments, and improve corporate governance by influencing the incentives more deeply and proactively.

Key words: Great recession, great depression, financial crisis, credit crunch, subprime mortgage crisis, housing market bubble, securitization, leveraging, shadow banking.

INTRODUCTION

What triggered the crisis in United State was the asset bubble in U.S. House market. House prices rose sharply after dot com bubble burst and touched the peak in 2005. When the house market bubble burst, house prices declined even sharply than the incline seen previously as shown in Figure 1.

Bubble in house market was created after the steep decline in interest rates following recession in 2000/2001. Sharp decline in interest rates and predatory lending to sub-prime borrowers founded the beginning of the crisis as shown in Figure 2.

With the repeal of Glass Steagall act, the distinction between commercial and investment banking became ever more blurred. Commercial banks were able to mitigate risk by packaging risky consumer debt receivables and selling them to the investment banks. The investment banks securitized them and sold them to insurance companies, other investment banks, hedge funds etc. The underlying loans making up those securities were very risky. In some instances, loan was sanctioned at a loan to value ratio of 125%. Adjustable rate mortgage, interest only mortgage etc and other luring schemes were offered to lend as much as was possible. Low interest rates provided the liquidity needed to keep the credit flowing.

With the rise in interest rates from 2005 onwards, many consumers could not pay their loans. Defaults increased and this had effects felt by all financial players who were part of this by way of insuring and holding securitized financial assets whose underlying assets were the same toxic loans.

On September 15, 2008, when Lehman Brothers filed for bankruptcy, its assets totaled $639 billion. But, it also had $619 billion in debt. The balance sheet size was larger than the GDPs of several dozen African and Asian countries combined. Lehman's bankruptcy filing was the largest in history and it exposed the fact that with excess leveraging, no institution is too big to fail.

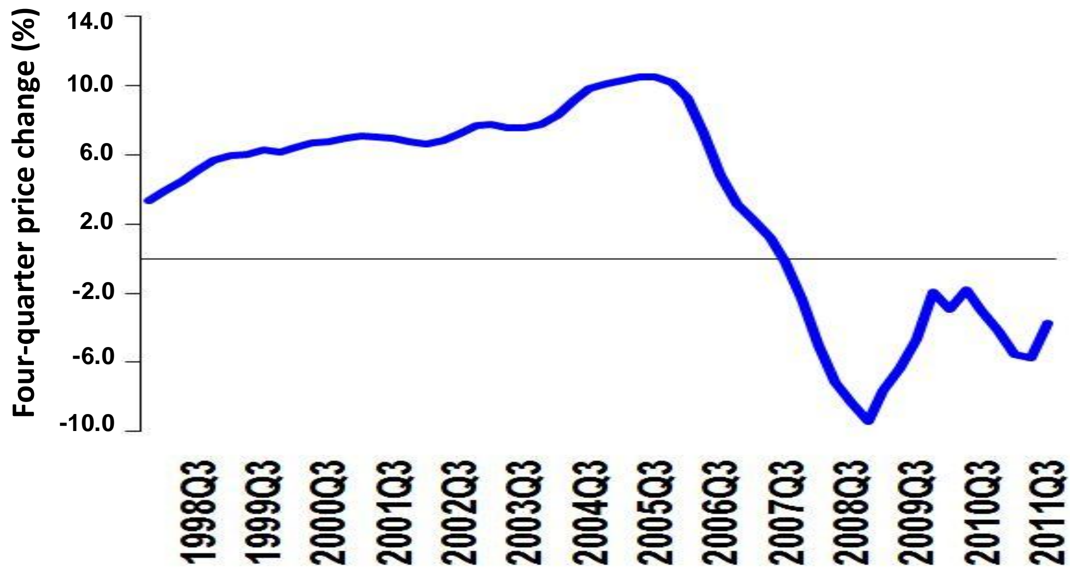

Figure 1. U.S. house price index.

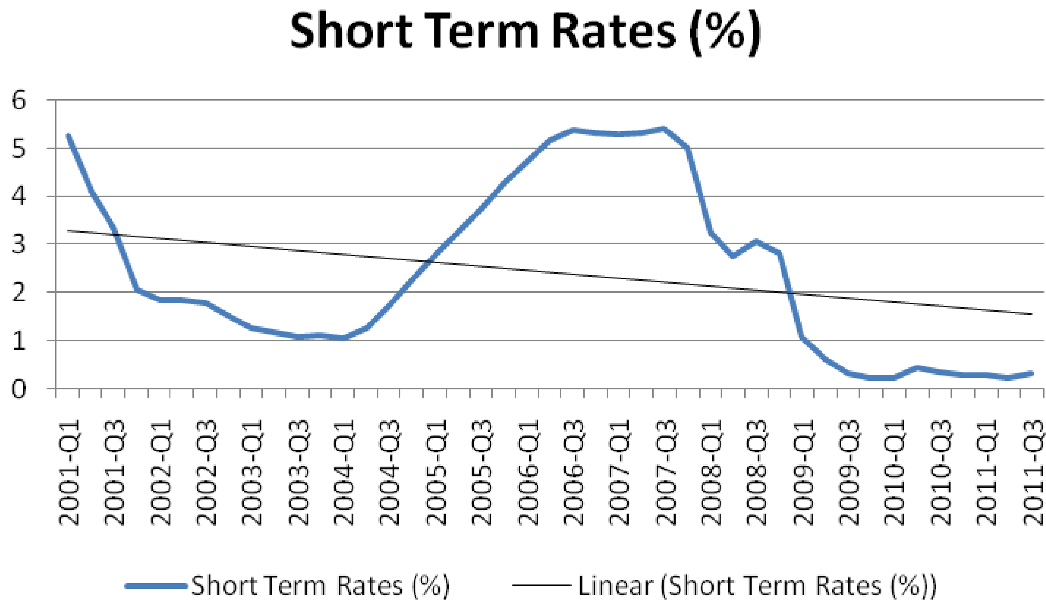

Figure 2. U.S. house price index. Source: OECD Stats.

Now, the ongoing sovereign debt crisis in Europe and U.S. is challenging the conventional wisdom and is creating fears of a double dip recession in 2012. Massive levels of debt and consumption beyond means and speedy financial innovation with lax regulation has put major economies of the world in a deep hole.

U.S., the world's biggest economy, recently witnessed lowering of credit rating by Standard and Poor's (S and P). In 1980, the U.S. national debt stood at around $2 trillion. By 2011, it stood at a staggering $15 trillion. Debt to Gross Domestic Product (GDP) ratio in U.S. has climbed over 100% of GDP. This debt may become more costly as the riskiness of the treasury securities increase further.

After the great recession, there are 7 million fewer jobs in the United States than there were four years ago. Some 25 million Americans who would like to work full-time cannot get a job at the moment. Hurd and Rohwedder (2010) found that the effects of the recession were widespread: between November 2008 and April

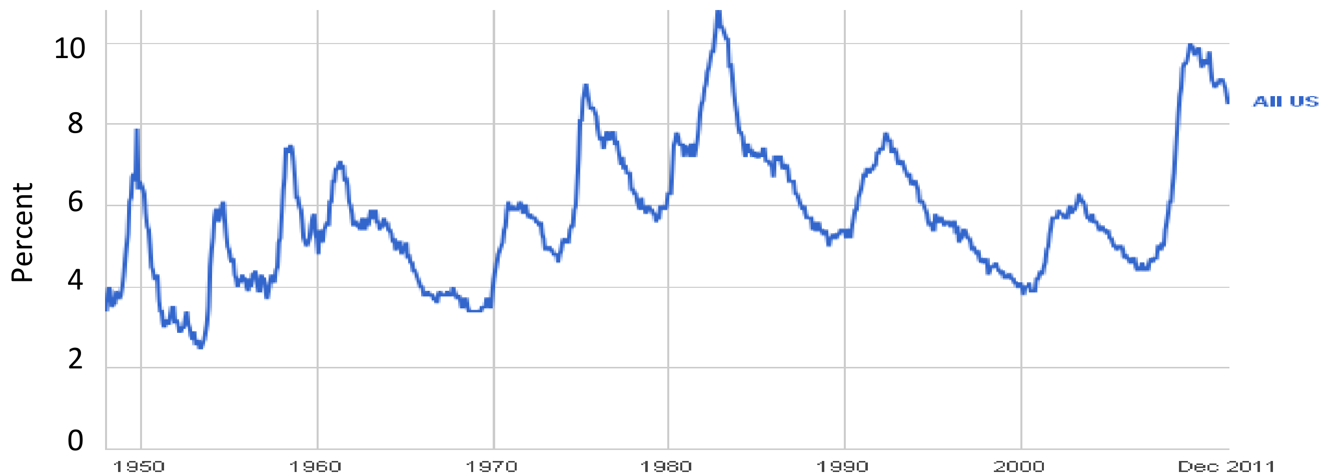

Figure 3. U.S. historical unemployment rates. Source: U.S. bureau of labor statistics.

2010, about 39% of households surveyed had either been unemployed, had negative equity in their house or had been in arrears in their house payments. Reductions in spending were common especially following unemployment. Figure 3 shows that unemployment rose steeply during the crisis years (2006 to 2010) and is still on the higher side.

Jagannathan (2009) explaining the structural reasons causing the crisis criticized the neoliberal trade paradigm of growth. They opined that as firms economize in the downturn, there will be increasing pressure on them to outsource jobs to foreign workers who are willing to work for a fraction of the domestic wage. This only adds to the underlying structural problem accentuating the recession.

Along the same lines, Palley (2009) argued that current financial crisis was a result of a faulty U.S. macroeconomic paradigm. One flaw in this paradigm was the neo-liberal growth model adopted after 1980 that relied on debt and asset price inflation to drive demand in place of wage growth. A second flaw was the model of U.S. engagement with the global economy that created a triple economic hemorrhage of spending on imports, manufacturing job losses, and off-shoring of investment.

With up-rise of BRIC, America's manufacturing and even technological edge has migrated across the border and overseas. In the long run, this is decreasing U.S. national wealth, and also de-industrializing it. Indeed, in last thirty years, U.S., then the global manufacturing super power after the Second World War has now become the global super consumer of the cheap imported goods. (Katkov, 2010)

Coming to the policy response to the crisis, Greenspan (2004) favored following a "strategy of addressing the bubble's consequences rather than the bubble itself." He based his idea on the fact that it is difficult for policymakers to identify a bubble in real time. But, Krugman (2008) mentioned that some economists indeed identified the house market bubble like Robert Schiller among others.

Fed's response to the crisis using monetary policy with ease in rates had been ineffective to say the least in last few years when interest rates were kept at near zero level since 2008. Fiscal stimulus again targeted the undisciplined financial sector which did not use the stimulus for extending credit to the private sector as much as was required. This led to the credit crunch and sluggish economic activity and which has persisted even after the severity of the crisis subsided.

Subsequently, we point just a few factors that have been prime cause behind much of the economic problems being faced by U.S. or had been bad response to the crisis.

I. The long-term habit of consumption beyond means. U.S. consumer debt has soared by 1700 percent over the past 40 years. With business cycles fluctuations, this is unsustainable. The securitization of consumer debt magnified the losses and created negative unjust effects on savers and taxpayers which had nothing to do with the mess.

II. U.S. fiscal deficit exceeded $1.3 trillion in Fiscal year 2011. Taking on credit was made extraordinarily easier for consumers, but the promised yet unsustainable and inefficient welfare spending showed recklessness on government's part and encouraged public at large to be taking the same route.

III. Share of U.S. gross domestic income accruing to finance and insurance, according to the Bureau of economic analysis, had risen fairly steadily from 2.3% in 1947 to 7.9% in 2006 (Greenspan, 2010). These earnings are transaction costs for the productive sector. Amidst these highest earnings, the financial sector still could not do its job of matching credible business sector investors with limited number of savers. This failure resulted in injustice

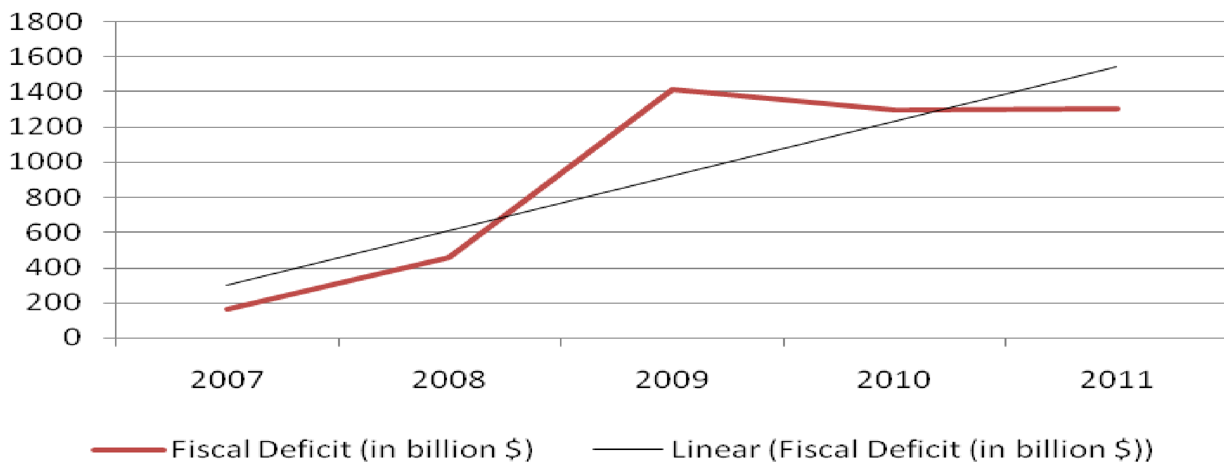

Figure 4. U.S. fiscal deficit (in billion $). Source: usgovernmentspending.com.

to the savers and to the productive sector that was not part of the mess in the first place to lose credit lines amid credit crunch in post-crisis scenario.

IV. Quantitative easing adopted time and again to rescue the economy discouraged savings, created even more fluctuation in real asset prices, and encouraged more speculation to profit from correct anticipation of inflation and financial asset prices rather to take the pain of productive enterprise which increases employment opportunities.

V. Financial intermediation growing in massive proportion and delinked with productive sector. In the financial crisis of 2007 to 2009, the huge bail-out package to the few financial tycoons basically encouraged 'socialize losses and privatize gains' as remarked by Nobel laureate, Joseph Stieglitz. Financial institutions that were just supposed to be playing a supportive role to the productive economy got much bigger and unregulated through shadow banking practices.

SOVEREIGN DEBT CRISIS DEFIES CONVENTIONAL WISDOM

In 1980, the U.S. national debt stood at around $2 trillion. By 2011, it stood at a staggering $15 trillion. For the first time, debt to GDP ratio in U.S. has climbed over 100% of GDP. Fiscal deficit has touched $1.3 trillion in fiscal 2011 as shown in Figure 4.

Likewise, Japan has a gross public debt which is 220% of its GDP. Similarly, the crisis hit European countries have debt to GDP ratio exceeding well over 100%. Though, everywhere, we see quantitative easing policy adopted by monetary authorities and rates touching zero bound. But, with sovereign default risk a very likely possibility, yield on treasury securities is climbing by each passing day.

Is there any validity left in the concept of risk free rate? The interest rate on a treasury bill is often used as the risk-free rate. But, the ongoing sovereign crisis in Europe and U.S. is challenging conventional wisdom. The bonds of Portugal and Cyprus have already been categorized as 'junk' meaning having no value. United States has also seen a downgrade of its credit rating by S and P. Recently, France and Austria were stripped of their triple-A credit rating. Three smaller euro-zone countries (Malta, Slovenia and Slovakia) also suffered a one-notch downgrade. Italy and Spain had their ratings knocked down by two notches (to BBB+ and A, respectively) (The Economist, 2012).

In Greece, youth unemployment has reached 42.9% making it very difficult to go more deep down the road of introducing further austerity measures. In Spain, the new government announced a radical package of austerity measures, but the youth unemployment rate is now touching 45%. It seems very hard to avoid social unrest unless the problems are fixed soon.

The crisis in Greece and much of Europe and even in North America had been caused by massive levels of debts. Excess leveraging is most dangerous in economic slowdowns. With the financial sector growing much larger in proportion to the productive sector and with lax regulation, the consequences were bound to be severe and they had been severe.

In most monotheist religions, taking on excess level of debt and ‘interest’ had always been prohibited. The unbridled pursuit of greed also requires some external source of guidance than mere reliance on material animalistic instincts of a human soul. Religion provides the ethical check and call to balance material pursuits

with attention to misery of the underprivileged people.

The world of today may have financial tycoons and large corporations having asset base exceeding the GDPs of dozens of African and Asian economies combined, but it also has unprecedented poverty, inequality and unemployment.

Financial system which was supposed to compliment productive sector has overgrown in importance and made the productive economy enter deep in slump too. Taxpayer's money has been used to save undisciplined and highly leveraged financial institutions. Quantitative easing would increase inflation in the long run and act as a tax. Plus, the future generations will now inherit in each of the crisis country, the massive levels of debts and the consequent problems of unemployment, austerity measures, cut in welfare spending without having a say in the policies that led them to be inheriting such unprecedented problems.

EFFICACY OF MONETARY POLICY

Interest rates in U.S. reached the zero bound in December 2008. Recently, amid fears of double dip recession, the Fed has shown commitment to keep the policy rates low for at least the next two years.

Great recession (2007 to 2009) compelled the Fed to keep the rates low. Economists especially from Chicago School (from where Milton Friedman belongs too) analyzing Great depression criticized the central bank for having not adopted monetary easing and thereby worsening the sentiments through inaction.

In the 'Great Recession', the central bank in U.S. did not adopt tight monetary policy because inflation is tackled through non-market forces (subsidies and political influence in resource rich countries to meet demand at affordable prices) because U.S. did not have that financial capacity nor the political influence at the time of Great depression unlike today. But, this monetary easing has still not caused private investment and private sector borrowing to increase.

Krugman (September 02, 2009) in his New York Times article titled "How Did Economists Get It So Wrong?" analyzed the current financial crisis and Fed's response in following words:

"But zero, it turned out, is not low enough to end this recession. And the Fed cannot push rates below zero, since at near-zero rates, investors simply hoard cash rather than lending it out. So by late 2008, with interest rates basically at what macroeconomists call the "zero lower bound" even as the recession continued to deepen, conventional monetary policy had lost all traction."

Therefore, the question again arises that how effective is the monetary policy in recession and depression times. The bearish sentiments in economic downturns, as Keynes said, can only be revived by public investment either through increasing government expenditure in public sector enterprises or by providing subsidies to private sector enterprises. No matter how hard one tries to deny it, when one considers the bail-out package for financial sector as well as for producing sector in U.S and the huge subsidies provided by OECD countries to their farmers, one cannot say government has no role to play in an economy.

But, rather than promising unsustainable and inefficient welfare spending in healthcare and other heads, the first and foremost duty of the government was to improve governance and oversight. As the crisis unfolded, it became explicit that the regulation could not keep pace with financial innovation and that unfettered financial system currently dominated by few big players seeking unbridled self-interest is not to be completely relied upon. If the current crisis leads to stagflation, then in those circumstances, monetary stimulus fails and further exacerbate the situation with output decreasing and capital scarcity due to eventual increase in interest rates.

It remains to be seen whether the expansionary monetary policy approach will pay rich dividends, but it cannot be denied that developed world in general including Europe and U.S. in particular are far away from coming out of crisis even after the great recession.

THE WAY OUT OF THE CRISIS

Unrestrained chase of self-interest, moral relativism, incentive-led economic choices and indifference to collective responsibilities has led to engender societies where economic interests have become the solitary basis of establishing and maintaining relationships.

This inner void of identity and purpose at individual level and social void in the form of a polarized society bound together only for economic interests can be better studied and dealt with incorporating religion.

Humans are much more than utility maximizing species. They are capable of using both instrumental (material rationality) and critical reasons (moral rationality) to differentiate right from wrong and need reinforcement to adopt virtues influenced by an inner urge other than just material interests.

This inner urge can be reawakened by looking beyond utility maximization models to re-acknowledge the principal fact that humans are moral being than just an instrument for maximum material advancement for self. Some may argue that current paradigm can be fixed and this great recession is an anomaly and an exception, not a general consequence and failures of certain capitalistic principles. But, it must be noted that only at this time, developed world was caught in a crisis, else the developing world and emerging countries have faced far too many crises after 1970s. The phrase 'Trickle up' was famously used by Nobel laureate Joseph Stieglitz in his

response to how current mainstream institutions and policies had failed to provide benefit to masses.

Even the success stories of China and India exhibited the fact that high growth rate consistently even for a longer duration in last two decades has not resulted in decrease in inequality of income. Hence, even institutions like IMF and World Bank had now finally realized and decided to combat poverty with a direct approach. Problem seems to be deep rooted and not restricted to a particular choice of policy, but a choice of institutions that can work for sustainable growth and development and moderate the business cycles.

A new paradigm is needed which put the focus back on productive enterprise, brings recovery with job creation, limit speculative financial institutions and instruments and improve corporate governance by influencing the incentives more deeply. This will require direct incentives to productive sector through expansionary fiscal policy, public investment in infrastructure, rationalizing inefficient public welfare spending and improved governance and oversight of financial institutions and instruments. In the post crisis scenario, jobless recovery is no long term cure.

Fundamentally, there is also a need to revisit the indicators and barometers of progress and development. GDP alone is not the single most important indicator anymore. Belief in unfettered markets and rational behavior also needs to be revisited, rather than taught and preached as some sacred value judgment.

The basic postulates of a new paradigm will be that less is better if it is distributed fairly equally than more wealth distributed unequally. Efficiency measures need to include social objectives. Priorities need to be set right and we must seek worldwide consensus on the following issues:

1. Growth is important but development is pivotal.
2. Growth that does not result in development is less desirable.
3. Reducing inequality is more important than increasing the growth rate.
4. Social optimization is more important than profit optimization.
5. Achievement of social optimization if not possible solely through the private sector, must be brought about through government intervention, whenever necessary. Horizontal as well as vertical equity are both important.

To get out of this mess, the long-term habit of consumption beyond means needs to change. It is not just the government who consumes/spends beyond means, but people in general and in vast majority too in U.S., where changing habits is important. It brings again the question of what could be governed and what societies implicitly and intentionally need to change themselves permanently. This is where the social sciences and comprehensive doctrines like religion can come in to shape and improve habits and expand the worldview.

Tax cuts and public sector projects of capacity building can induce investment when labour supply is elastic as in current times. This is important as fiscal bleeding cannot occur incessantly which either burdens the taxpayer or the general masses through inflation tax with quantitative easing. Easing policies to get inflow of foreign investment is very important especially with the crisis in Middle East and in Euro zone.

CONCLUSION

The project to enable consumers realizing 'The American Dream' through predatory lending and encouraging leverage at all levels of society proved fatally unsustain-able. The unsustainable promised welfare spending also did not help in restraining recklessness and only increas-ed the size of fiscal deficit and misery of populace.

Quantitative easing and fiscal bleeding is going to bring inflation and will be detrimental to savers, taxpayers and future generations. This paper also argued that response to the crisis requires revisiting the value judgments which led to cornering of any thoughtful consideration of the fact that regulation and oversight is necessary to control and avoid crisis in today's complex economic world which is in bad shape now in terms of rising inequality of income, wealth and limited public access to influence and benefit from policy making.

REFERENCES

Alexander, Katkov A (2010). The Great Recession of 2008-2009 & Government's Role, Proc. ASBBS, 18: 1.

Greenspan A (2010). The Crisis, Greenspan Associates LLC. April 15.

Greenspan A (2004). Risk and Uncertainty in Monetary Policy." Am. Econ. Rev. Papers. Proc., 94(2): 33-40.

Hurd, Rohwedder (2010). Effects of the Financial Crisis and Great Recession on American Households, Working. National. bureau. Econ. Res., p.16407. http://www.nber.org/papers/w16407.

Jagannathan (2009). Why are we in a Recession? The Financial Crisis is the Symptom not the Disease! Natl. Bureau. Econ. Res., Working paper 15404. http://www.nber.org/papers/w15404.

Krugman P (2009). How Did Economists Get It So Wrong, Op-Ed Page, NY Times, September 6.

Palley TI (2009). America's Exhausted Paradigm: Macroeconomic Causes of the Financial Crisis and Great Recession. Working. Institute, Int. Polit. Econ. Berlin. 13(30): 06.

The Economist (2012). France goes soft-core, The Economist Newspaper Limited. January 14.