DEBTS, DEFICITS AND DILEMMAS

The Economist

DEBTS, DEFICITS AND DILEMMAS

A crash course on the financial crisis and its aftermath

Introduction by

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Introduction

MORE THAN HALF A DECADE has passed since the global financial crisis of 2007/08 plunged the world economy into its worst downturn since the 1930s. Yet the aftermath of the crash continues to cast a pall over the global economy. Growth has returned. But the recovery has been strikingly lacklustre, particularly given the scale of the recession. Many economies in the rich world are still operating well below their potential: factories sit idle and unemployment rates are high. For millions of people the economy is a long way from being "back to normal".

The same is true of macroeconomic policy. As the aftermath of the crisis has lingered, so it has transformed the landscape faced by finance ministers and central bankers, and in ways that few predicted five years ago. In 2008 and 2009 there was a remarkable consensus about how best to respond to the crash. Central banks slashed interest rates and flooded moribund financial markets with liquidity; governments bailed out banks, and tried to prop up their economies with tax cuts and spending. The world's 20 biggest economies introduced fiscal stimulus worth an average of 2% of GDP.

By 2010, however, the consensus around how best to support a recovery had begun to fracture. That was partly because some of the standard macroeconomic remedies were becoming exhausted. Once short-term interest rates had been cut to near zero, for instance, central banks could reduce them no further and had to try untested, and hence more controversial, ways to loosen monetary policy, such as "quantitative easing", or printing money to buy bonds. The weakness of the recovery also led to growing doubts about whether more fiscal and monetary stimulus made sense. And the contours of the debt crisis morphed, with the centre of panic shifting from America's subprime mortgage market to government debt in the euro area. Once governments themselves lost investor confidence, the calculus about how best to respond to the downturn changed. Greece's sovereign debt crisis, in particular, shattered the agreement in favour of fiscal stimulus.

As a result, the past few years have been marked by macroeconomic experimentation. Central banks have shown differing degrees of boldness: America's Federal Reserve and, more recently, the Bank of Japan embraced unconventional monetary tools most enthusiastically, while the European Central Bank has remained more conservative. Financial regulators have tried different ways to make banks safer, from ring-fencing deposits to prohibiting certain kinds of trading. Politicians have steered fiscal policy in quite different directions. Britain's coalition government embraced fiscal austerity early. So, too, did many countries in the euro area, largely at the behest of Germany. America's government kept budget conditions stimulative for longer, though by 2013 it, too, was raising taxes and cutting spending.

Economists have argued furiously about the wisdom of these choices. Some of these debates have obvious historical echoes. The divisions between those who push for continued Keynesian fiscal stimulus and those who argue that fiscal austerity will boost confidence, and hence bolster growth, could be taken straight from the 1930s. So, too, could the tensions between reformers who want to curb finance and those who worry that too many constraints on financiers will slow the recovery and lower future prosperity. Other controversies – over the benefits and risks of multi-trillion-dollar central-bank balance-sheets, or the usefulness of forcing banks to issue a tranche of debt that can be converted into equity – are new, because the innovations themselves are unprecedented.

Standard economics textbooks are of limited help in making sense of these debates. Many books still reflect pre-crisis norms, when monetary policy involved raising or lowering short-term interest rates, and where Keynesian fiscal policy had long gone out of fashion as a tool for countering the business cycle. Few pay careful attention to the macroeconomic consequences of financial regulation. Though the texts are being updated, they haven't kept up with the degree to which policy debates have shifted.

This book aims to help fill that gap. It is based on a series of briefs that appeared in *The Economist* in September and October 2013 to mark the fifth anniversary of Lehman Brothers' bankruptcy. The first chapter re-examines the debate about the origins of the crisis, assessing the relative role played by different causes, from financiers' distorted incentives to lax monetary policy, with five years' hindsight. Chapter 2 focuses on debt, the phenomenon at the heart of the crash and its aftermath, and one whose dynamics are too often given short shrift. It examines what makes debt dangerous, what drives debt cycles and what are the consequences of "deleveraging", a collective desire to pay down debt. Chapters 3–5 describe three of the biggest post-crisis policy controversies: what central banks should do once short-term interest rates are at zero; whether governments should be pushing fiscal stimulus or budget austerity; and how to make banks safer without undermining the recovery. In each case, the goal is to explain the theory behind different positions, and assess what the evidence to date suggests.

The Economist first published briefs specifically aimed at helping students and anyone interested in topical issues in 1975. Subsequent subjects have ranged widely, from American government to science. The last series before this one was published in 1999. It was on finance, and concluded:

> *Some of the new financial technologies are, in effect, efforts to bottle up considerable uncertainties. If they work, the world economy will be more stable. If not, an economic disaster might ensue.*

Alas, disaster did ensue, and the world of macroeconomic policy changed completely. The following chapters are a brief guide to that new world.