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Three Lessons from the Financial Crisis

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More than two years have passed since the U.S. housing bubble burst. That event ushered in a financial crisis that was not only intense but also stunning. So stunning in fact, that in August of last year, just a month before the collapse of Lehman Brothers, the global economy was close to a crisis worthy of comparison with the Great Depression, yet neither the markets nor the Federal Reserve had much of an inkling of what was to come. The Standard and Poor's (S&P) 500 Index had come down to about 1,300 from its October 2007 high of 1,576. Positive growth had just been reported for the U.S. economy during the second quarter of 2008 at an annual rate of 2.8 percent (later revised down to 1.5 percent). Almost one percentage point of that growth came from U.S. consumption, and government spending also contributed. The wave of relief after the Bear Stearns scare in March 2008 had provided a nice boost to the economy and to markets. That boost was further enhanced by the substantial contribution to growth from net exports (2.9 percentage points) thanks to what was, then, continuing strength in the global economy, especially in China, which had reported blistering 10.1 percent year-over-year growth in the second quarter of 2008. These and other positive components more than offset a drag from inventories and residential investment. In short, the real economy had not shown much evidence of damage emanating from the chaos that was churning in the financial sector.

The Fed's Open Market Committee met on August 5, 2008, and decided to keep the federal funds rate at 2 percent. Its statement following the meeting was cautiously constructive about the economy while expressing concern about inflation. The statement concluded by suggesting, "Although downside risks to growth remain, the upside risks to inflation are also of significant concern to the Committee."

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Three Lessons

Given the relative complacency of markets, the Fed, and other central banks during the period running up to the collapse of Lehman Brothers and even in the midst of the July 2008 crisis involving Fannie Mae and Freddie Mac, it is worth asking what lessons have been learned over the last year and, in particular, as a result of the wrenching dislocations following the collapse of Lehman Brothers. I hope this will provide guidance for a quicker policy response in future crises.

Three lessons stand out. First, financial crises produce very powerful effects on the real economy. In a crisis, truly breathtaking dynamic and somewhat unpredictable causal connections, or nonlinearities, involving basic economic relationships come to light that policymakers need to appreciate more fully. The second lesson is that central banks tend to be slow to react, partly because their models—which broadly exclude a financial sector—are based on linear relationships, not the nonlinearities that emerge after a financial crisis. However, an ancillary lesson is that while central banks may be slow to respond, they possess great power to contain a financial crisis, as witnessed by the experience during the six months following the chaotic market response to the collapse of Lehman Brothers. Finally, a third lesson that needs to be taken seriously in the current environment is that China has become an even bigger player in the global economy and financial markets than most people have realized. China's actions—not least the massive fiscal stimulus package announced in November that equals about 14 percent of GDP—can play a big role in helping to stabilize the global economy and financial markets. Of course China has the potential to destabilize as well, but the increasing integration of Chinese policymakers with G7 policymakers over the past year is an encouraging sign that China can, on balance, be a stabilizing force in the global economy.

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Economic Harm from a Financial Crisis

The immense power of a financial sector disruption—such as the collapse of the housing bubble—to depress the real economy in a way that neither central banks nor financial markets anticipate was illustrated by the events following the September collapse of Lehman Brothers. That collapse, which symptomized the onset of the acute phase of the financial crisis, froze the global financial system and gave new meaning to the phrase "adverse feedback loop," whereby a paralyzed financial system causes real economic activity to contract sharply, which in turn further damages the financial system. That said, it is important to recognize, in retrospect, that the Lehman collapse resulted from stresses that had been accumulating in the financial sector for well over a year. The inability of the Federal Reserve to save Lehman was an indication of the fact that the financial crisis had reached a stage that could not be contained; saving Lehman would not have saved the system. If the Lehman Brothers failure had not triggered the panic phase of the cycle, some other institutional failure would have done so.

The financial markets responded almost instantly to the onset of the acute phase of the financial crisis. By early October, the S&P 500 Index had dropped by a third from its August level to a range between 875 and 900. The U.S. economy was already weakening rapidly during the third quarter. Growth was recorded at a –2.7 percent annual rate, mostly the result of a 2.5 percentage-point drag from sharply lower consumption. Residential investment subtracted 0.6 percentage points from growth during the third quarter of 2008, with many analysts suggesting, incorrectly, that would be the maximum drag from the housing crisis.

The fourth quarter of 2008 and the first quarter of 2009 were among the most severe quarters of contraction seen in the United States during the postwar period. Both consumers and businesses froze spending: consumption subtracted 2.2 percentage points from growth, and business fixed investment subtracted another 2.5 percentage points, with the overall growth rate at –5.4 percent. The slowdown accelerated into the first quarter of 2009 with a –6.4 percent growth rate, primarily reflecting an intensifying drop in investment spending that subtracted 5.3 percentage points from the total, while a deepening collapse in the housing sector subtracted another 1.3 percentage points. A panicky rush to reduce inventories in the face of collapsing aggregate demand subtracted another 2.4 percentage points from growth. The growth rate would have been far weaker had it not been for a 2.6 percentage-point positive contribution from net exports and a stabilization of consumption in the first quarter.

The nonlinear, negative response to the onset of the acute phase of the financial crisis was global. By the first quarter of 2009, the Japanese economy contracted at an extraordinary annual rate of –11.7 percent after falling at a 13.5 percent rate during the fourth quarter of 2008. Germany contracted at a similar pace of –13.4 percent during the first quarter of this year and –9.4 percent during the previous quarter. Capital flows to most emerging markets dried up, and growth fell sharply in those markets as well. The sharpness of the contraction was unprecedented and left policymakers scrambling to avoid a full-scale panic.

Alongside the collapse in investment spending, U.S. employment contracted at a pace of 700,000 jobs per month during the first quarter of 2009. The job losses in themselves and also the wider effects of the confidence-sapping rise in the unemployment rate from 6.7 percent to 9.5 percent between November 2008 and June 2009 further weakened consumption spending. During the second quarter, despite extraordinary contributions to U.S. household disposable income from government tax cuts and rebates, U.S. consumption contracted, accounting for about 0.9 percentage points to the 1 percent overall drop in U.S. GDP growth. In all, the government sector contributed a positive 1.1 percentage points to growth during the second quarter as a result of the stimulus package enacted in February 2009.

Central Banks: Slow but Powerful

The wave of policy measures enacted to stem the post-Lehman collapse was astonishing. Fiscal measures did not contribute much until the second quarter of 2009 because countercyclical fiscal policy measures need time to produce their effects. During the two quarters of the most intense contraction of the U.S. economy, the last quarter of 2008 and the first quarter of this year, the government contribution to annualized GDP growth was actually a modest 0.2 percentage points, substantially less than the average growth contribution from the government sector during the postwar period (0.6 percentage points). A financial crisis causes such a quick and powerful negative shock to the economy, raising the risk of further damage to the financial sector, that an extemporaneous response by the central bank—backed by fiscal authorities of the government—is the only viable option.

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Notwithstanding the extraordinary request from Federal Reserve chairman Ben Bernanke and Treasury Secretary Henry Paulson to Congress for $750 billion of Troubled Asset Relief Program (TARP) funds, the Federal Reserve and other central banks did most of the initial heavy lifting. On October 8, 2008, a joint central bank statement was issued that included widespread reductions in policy interest rates, including a reduction in the federal funds rate to 1.5 percent, which was still cautious—at least viewed retrospectively—in view of the crisis that was unfolding. The Fed may have been tempted to keep some of its powder dry. At its regular meeting on October 29, the Fed cut the fed funds rate by another fifty basis points to 1 percent. Meanwhile, the Fed's balance sheet expanded by nearly $1.5 trillion—that is, by nearly 200 percent—from its average level of $800 billion, while in October, as already noted, Congress passed the $750 billion TARP rescue package for banks. Of course other governments and central banks initiated substantial monetary easing and additional fiscal stimulus measures, including China's measure (enacted in November) worth an advertised 14 percent of GDP.

While, viewed retrospectively, the response of central banks, particularly the Fed, to the rapidly unfolding financial crisis was slow, it did prove effective. After a breathless wait for the extraordinary policy measures enacted in late 2008 and early 2009 to take hold, the adverse feedback loop running from the financial sector was broken during the second quarter of 2009. The reversal was all the more remarkable because the fall in home prices and equities through the first quarter of 2009 had already erased nearly $20 trillion of American wealth—about one-third of the total. A combination of the stress tests for which most U.S. banks received a passing grade in May and a second U.S. fiscal stimulus package, totaling $775 billion over several years, helped to calm investor psychology further. The appearance of less-than-disastrous first-quarter earnings reports—especially for U.S. financial corporations, whose results were somewhat flattered by additional forbearance resulting from changes in accounting rules—further aided the respite from financial panic.

There are additional reasons for the stabilization of investor attitudes that appeared by March 2009, tied largely to actions taken by the Fed. Wisely, the Fed moved aggressively to assure that there were no runs on banks and that no depositors at federally insured institutions lost any money, unlike during the Great Depression. The sharp rise in the value of risky assets, including stocks and lower-grade corporate bonds, that began in March resulted from a relaxation of investor panic that had been tied to the potential onset of a global depression. Such an outcome would have resulted from another round of the adverse global feedback loop that had been set in motion by the collapse of Lehman Brothers six months prior. Funds that had been deposited in safe-haven accounts (including the large FDIC-insured transaction accounts in the United States) that were earning very low rates of return began to be deployed opportunistically during the spring. Simultaneously, as it had done in 2008 during a rebound from the March Bear Stearns crisis, the weakness in the U.S. economy abated to "only" a 1 percent annual rate of contraction during the second quarter of 2009. The bulk of the slowdown in the contraction came from a sharp increase in government spending that contributed, as already noted, over a percentage point to growth. A sharp boost from net exports again came to the rescue, contributing 1.4 percentage points to growth during the second quarter.

The Importance of China

This year may be the first in which China's economy has played a substantial role in determining the path of the global economy. Until the collapse of Lehman Brothers in

2008, the Chinese authorities had been rapidly withdrawing liquidity from what appeared to be an overheating Chinese economy that was driving up commodity prices and energy prices in particular. The sharp nonlinear reversal in the path of the global economy that followed the collapse of Lehman Brothers forced a rapid reconsideration by the policymakers in China. Their response was among the quickest. In November they announced their massive public works program that would, over a period of about two years, be the equivalent of 14 percent of GDP—an extraordinary amount by any measure. Japan's largest stimulus packages during its "lost decade" seldom reached 4 percent of GDP, even when counted over periods of greater than a year.

Because of the unique way in which China measures expenditures (outlined in last month's *Economic Outlook*), the Chinese stimulus program produced immediate results. China's quarterly growth rate jumped from a 1.9 percent annualized rate at the end of last year to an 8.3 percent rate in the first quarter this year, and that was followed by a further acceleration to a 14.3 percent annual rate during the second quarter. Its volatile H-shares stock market, which had responded immediately to the announcement of China's stimulus package in November 2008, began a strong upward move early in March 2009, and by the end of July that market's index had doubled.

The sharp rise in Chinese shares was followed by a similar increase in Asian shares generally, and it could be said that China's aggressive stimulus measures and their positive impact on the export sector in Asia helped to lead financial markets and the global economy higher during the second quarter of 2009. Surely 2009 is the first year during which it is possible to say that aggressive Chinese policy measures and the attendant positive responses of China's and Asia's equity markets helped to lead global financial markets higher while boosting the global traded-goods sector. China's rapid expansion was aided by a very aggressive increase in money and credit, especially during the second quarter of 2009, which further excited speculation in equity and property markets. While there may be concern about bubbles in the Chinese property and equity markets emerging late in the summer of 2009, no one can still doubt the power of Chinese policy measures to boost the economy and financial markets of China, Asia, and the G7 economies.

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Looking Ahead

While the acute phase of the financial crisis has been truncated by aggressive measures of central banks and governments, and while economic activity in the traded-goods sector has stabilized, the outlook is somewhat uncertain. Coming full circle to the present, the consensus characterization of the real economy, especially in the United States, seems eerily similar to what it was a year ago. Most forecasts call for positive growth during the second half of the year, anticipating a substantial boost from the temporary surge in auto production tied to the federal government's $3 billion subsidy to encourage trading in older cars with poor fuel efficiency for new models. The Fed, having been chastened by the abrupt adverse turn of events during the fall of 2008, has signaled that it will hold rates low for a substantial period of time while maintaining an enlarged balance sheet. The large boost to U.S. disposable income resulting from enhanced tax cuts and transfer programs during the second quarter has ended. During June, the latest month for which data are available, real disposable incomes for U.S. households fell by 1.8 percent, while real consumer spending fell by 0.1 percent.

Going forward, further reductions in spending are both possible and likely. For the balance of 2009, financial markets will continue to rise if the real economy performs as expected and demonstrates that the U.S. recession ended in mid-2009. A tremendous relief from a policy-induced truncation of the financial crisis early in 2009 coupled with the slowdown in the rate of contraction in the U.S. and global economies has already been priced into most financial markets. The risk, however, is that the middle two quarters of 2009 could mark a temporary high point for the U.S. economy as annualized growth rates average a little bit above zero. Following that, flat to negative growth may emerge later in the year or early in 2010.

Another indicator that bears close watching is price levels. During the year ending in July, U.S. consumer prices fell at a 2.1 percent annual rate. Year-over-year deflation also appeared in the United Kingdom, Germany, Japan, and Canada during the year ending in the middle of 2009. Part of the year-over-year decline is due to the drop in energy prices since mid-2008, but one could argue that a sharp drop in energy prices is symptomatic of persistent and rising global excess supply in goods and services markets for the global economy.

An acceleration of deflation would be an unnerving development for both central banks and financial markets. Persistently falling prices mean weaker profits and higher real debt burdens. Profits for many U.S. firms increased during the first half of 2009 by virtue of aggressive cost-control measures, which included a sharp reduction in spending on capital equipment and severe cuts in the labor force that, in turn, sharply reduced disposable incomes. Those developments suggest that an adverse feedback loop may be emerging within the real economy in which efforts at cost reduction to increase profits ultimately depress demand growth and, in turn, further harm profits and growth.

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The other big question mark going forward concerns the increasingly important role of China in the global economy. We may well get a test of the "decoupling hypothesis," whereby Asia, and particularly China, is said to be able to keep growing even in the absence of growth in the United States, should U.S. growth slow toward the end of the year. While China's massive stimulus program should yield an 8 percent growth rate for China during the 2009 calendar year, sustained growth beyond that will probably require support for global aggregate demand from U.S., European, and Japanese consumers—each of which looks to be in doubt as we approach the autumn.

The global economy is at an important juncture. The story of the year to date has been, first, the substantial power flowing from collapsing markets to a collapsing real economy in the fall of 2008 and a reversal of that process in the spring of 2009. With financial markets likely to be playing a smaller role in determining the path of the real economy, it is prudent to consider how the feedback loop may run from the real economy back to financial markets. If growth resumes on a sustainable basis (as the consensus currently believes), financial markets will rise further, thereby providing additional reinforcement to positive growth in the real economy. Conversely, if aggregate demand fails to pick up and the real economy falters, financial markets will have a difficult time sustaining current levels and may even come to pose further downside risks to global economic activity.