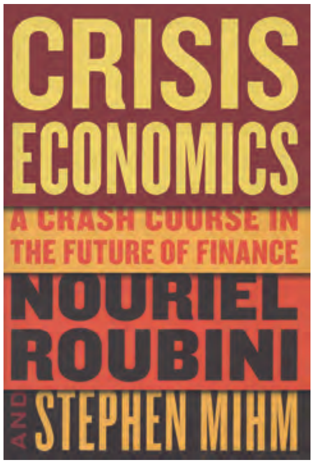
The Eye of the Hurricane

By Shayne C. Kavanagh



Crisis Economics:
A Crash Course
in the Future of Finance

By Nouriel Roubini
and Stephen Mihm

Penguin Press

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Nouriel Roubini is one of the economists who famously predicted the recent economic crisis. In *Crisis Economics*, he and his co-author, Stephen Mihm, trace the history of crisis economics, explore the origins of the recent crisis, propose solutions to these causes, and examine the prospects for the future.

FAULT LINES AND MORAL HAZARDS

A common view of the recent crisis is this: During the housing bubble, people took out mortgages they couldn't afford and then eventually defaulted on them. Because the mortgages were securitized, the bad mortgages went on to throw the entire financial system into crisis. The authors contend that this account is inaccurate because it pins the crisis on a few actors and events that occurred in the recent past. In fact, an economic crisis is like an earthquake, the authors say — over time, pressure on tectonic plates builds, eventually culminating in a crisis. For example, financial innovation in the 1970s saw mortgages securitized by the loan originator (e.g., a local bank) and sold to investors. As a result, originators now had less motivation to carefully examine the quality of the original loan — rather, their motivation shifted toward making loans and securitizing and selling them to investors to get cash to make more loans. Over time, the practice of securitization spread to other assets such as credit card debt, delinquent tax liens, and many others. As these products became more complex, they also came more difficult, if not impossible, to accurately value and assess for risk, and therefore illiquid when a deteriorating economy called into the question the optimistic assumptions these products were based on. Moral hazard is another of the authors' tectonic plates. Bonus systems in financial firms encouraged short-term thinking and excessive risk taking, and, hence, the interests of the shareholders of these firms were in many ways not aligned with those of employees. Government policies also contributed to the problem through "easy money" policies by the Federal Reserve and laws that created incentives for homeownership to the point where individuals were making choices that were not consistent with society's best interests. Eventually, these and other tectonic plates generated a pressure that created the conditions for the crisis.

Crisis Economics makes the point that there are broad similarities between all economic crises. In fact, they follow a fairly predictable path: Foreign investment flows into a country, fueling an asset bubble. Private consumption rises, investment booms, and a current account deficit widens (e.g., a trade deficit). A fiscal deficit may emerge, and leverage and debt accumulates. Then the bubble bursts, with the resulting fallout. As such, past crises have much to teach us about the present situation. In the past, the seeming end of the crisis was actually more akin to the "eye of the hurricane." In the current crisis, the federal government responded in ways that were, in the views of the authors, broadly consistent with what economic theory says should have been done, but the responses were implemented in such as way as to create conditions for future problems. For example, bailouts create a new moral hazard — an expectation among the finance sector that the federal government will ultimately absorb the fallout from risks gone bad — and a legacy of public debt that could eventually create serious concerns for the bond markets.

In fact, Roubini and Mihm believe that the status quo is unsustainable. The United States' national debt has been increasingly funded by foreigners, especially China. However, the willingness of other countries to buy U.S. debt has its limits, and they have already begun to slow down their purchases. As China continues its rapid rise, it may not remain content with an international financial system that is dominated by the dollar. Creditors may also become concerned with the United States' diminishing prospects of paying back its debt, especially if the U.S. political system resorts to monetizing the debt. In this situation, the U.S. economy would suffer severe repercussions.

PRONE TO CRISIS

As U.S. power declines, Roubini and Mihm believe the world will become more crisis-prone in the absence of a superpower to coordinate a response to emerging problems. In the more immediate future, they foresee a slow, U-shaped recovery. The reasoning behind the scenario is that, first, labor markets are weak and there does not seem to be an obvious path back to job growth. For instance, many manufacturing jobs have been sent off-shore and will not return. Many people who have kept their jobs have seen their income decline. Further, this recession is different from recent recessions because it was a "balance sheet" recession, not one born of monetary tightening. All sectors of the economy took on a great deal of debt, and it will take time for them to get out of it. Other factors that point toward a U-shaped recovery are:

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- Investment in capital spending has been weak, and firms have excess capacity. In this recession, capacity use bottomed out at 67 percent, while it was closer to 75 percent or 80 percent in other recessions.
- The financial system has been severely damaged. Many banks were shut down, and many more came close. A hobbled financial sector will be less able to finance future growth.
- The federal financial stimulus must eventually come to an end. While it offered some short-term relief, it increased the national debt, which will slow long-term growth.
- The traditional net consumer countries of the world (e.g., the United States and countries in Western Europe) are retrenching and spending less. The producer countries of the world (e.g., China) are not saving less and spending more. Hence, there is net decrease in global demand.

Looking beyond the trajectory of the current recovery, Roubini and Mihm explore a number of risks that could conceivably sow the seeds of the next crisis.

New Asset Bubbles. Prices for some risky asset classes have shot up more rapidly than their fundamental value would suggest is prudent. This is due to the high levels of liquidity central banks have created and also to a carry trade in the dollar. In a carry trade, investors borrow a currency with low interest rates in order to buy a higher-yielding one or invest in higher-yielding assets. Low interest rates and depreciating value make the dollar attractive for a carry trade. When the dollar stabilizes, the carry trade will end. If the dollar appreciates rapidly (as it might if there were a global crisis that sent investors to the safe haven of the dollar), the carry trade could end violently.

Defaulting on Debt. A number of industrialized countries have accumulated substantial public debt. As we have seen recently, there have been real concerns about some countries defaulting, creating instability in the markets. The United States has by far the largest debt, but unlike most other countries, it issues debt in its own currency and can therefore theoretically print money to pay its debt. This course of action could lead to significant inflationary pressures. Because of the severe consequence of debt monetization, Roubini and Mihm believe it is unlikely to happen, but they also think it is important to remain cognizant of the risk, given the polarization of the U.S. political system and the attendant difficulty in solving the federal government's structural budget challenges by raising taxes or cutting spending.

Inflation and Deflation. Deflationary pressures will persist in the short term as demand remains slack, the authors predict. Advanced economies could see the return of inflation in 2012 under three conditions: 1) governments monetize their debt; 2) easy money created during the crisis creates a bubble in commodities; or 3) the dollar continues to weaken, making commodities relatively more expensive.

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CONCLUSIONS

As Mark Twain said, "History may not repeat itself, but it rhymes a lot." This could sum up the essential message of *Crisis Economics* for local government finance officers. The recent economic crisis was not a "100-year event," but rather was consistent with the characteristics of previous crises. We can expect more volatility in the future as a result of the forces discussed above. Finance officers must remain aware of the possibilities and help build sufficient financial resiliency into their organizations to recognize changing conditions, adapt to them, and regenerate after negative events.

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