1. This is a report of the Institute of Policy Studies and Economic Society of Singapore Breakfast Seminar titled ‘2009, Another Annus Horribilis’. Prof Bradford Delong said that 2009 was not going to be a horrible year like 2008, and the world could avoid another Great Depression because we now understood the factors that led to it and could successfully avoid them.

2. Admittedly, the current financial crisis was likely to be the worst financial distress since the Great Depression of the 1930s, and according to current forecasts, would be close to the worst global economic downturn since World War II. In the United States (US), the fall in the civilian employment-to-population ratio in this recession was already greater than in three of the other eight post-World War II economic recessions. As demand in the US fell, the US would no longer be able to play its role as the global economy’s importer of last resort and safe haven for finance, which meant that the US recession could bring the global economy down with it.

3. The current US recession was different from the ones since World War II. Six of the nine past US recessions were caused by the actions of the Federal Reserves. These actions included a shift in policies from putting first priority on maintaining near-full employment to maintaining its credibility as guardians of price stability which had the effect of “taking away the punchbowl” just as the party got going. In contrast, the primary factor leading to the current economic crisis was not due to a tightening of monetary policy but a collapse in the risk tolerance of global financial markets.

4. In the 1800s, the Bank of England would customarily intervene in financial markets whenever asset prices plunged too far, serving as the lender of last resort to keep universal bankruptcy at bay. This resulted in a dilemma where speculators would view this measure as a safety net and not restrain their greed. In 1844, Sir Robert Peel, then Prime Minister of the United Kingdom put in place the principle where “the existence of a lender of last resort should always be doubted in advance, [so that the fear that there would be no safety net would discourage excessive speculation], but the lender of last resort should always arrive when necessary”. Sir Peel did so by making it illegal for the Bank of England to support the market in a financial crisis, but at the same time reassuring the central bank that the government in power would not prosecute if the bank did so. Central banks had been trying to apply this principle in the current economic crisis to avoid unjustly rewarding and encouraging speculation.

5. In the past 15 months, in order to keep the global economy near full employment, central banks and governments had taken steps to reduce the magnitude of this collapse in financial wealth and to try to prevent it from having major consequences for global production and employment. These included:
i. Reassuring investors that the risks were not that great by announcing and standing ready to lend to every financial institution that needed a larger short-term cash cushion to feel secure.

ii. Pushing up financial asset prices by making longer-term safe bonds scarce and short-term immediate cash abundant by reducing the price of long duration financial assets and risk.

iii. Reducing the amount of risk in the marketplace by guaranteeing and, when necessary, nationalising organisations thought to have taken on excessive risk and on the verge of default.

iv. Recapitalising the financial system by having the government take and fund minority ownership shares in financial institutions.

As these first four steps had not worked, central banks and governments were now moving on to the following steps:

i. Massive purchases of risky assets by governments in order to reduce the quantity of such assets that the private sector had to hold thereby bringing the amount of risk the private sector had to bear back in proportion with the (diminished) risk tolerance of the global private financial system.

ii. Temporary nationalisation of large chunks of the global financial system (to be followed by privatisation at some point in the future).

iii. Major government spending programs where the private sector was too shell-shocked to finance investment for the next several years.

Prof Delong said that these measures would almost surely work because the world did not face any insurmountable technocratic problems in policy design and would not repeat the mistakes made in the Great Depression and Japan in the 1990s. Nonetheless, there were political and intellectual problems such as Germany's unwillingness to tolerate a large increase in the total debt of the European Union and the US Republican Party's engagement in the politics of obstruction for potential gains at the ballot box. Prof Delong shared the comments of Martin Wolf, the Associate Editor and Chief Economics Commentator at the Financial Times, London. The problem, in the 1930s, was that too many were treating the economy as “a morality tale”. This included economists of the Austrian school who “argued that a purging of... excesses... was required [and]...Socialists [who] argued that socialism needed to replace failed capitalism”. Martin Wolf advocated approaching the economic system “not as a morality play but as a technical challenge”. Prof Delong saw that governments across the globe understood that the financial situation at hand called for strong government intervention, and for this reason, 2009 would not be another annus horribilis.

Open Discussion

Dr Khor Hoe Ee, President of the Economic Society of Singapore started the discussion session by asking Prof Delong to elaborate on the factors resulting in the loss of US$17 trillion in financial assets. Prof Delong explained that there were four possible channels that led to this loss - the collapse of risk tolerance when financial professionals took on huge losses, herding
behaviour of investors, an increase in uncertainty, and the expectation of massive losses in the corporate sector as the real economy turned down.

9. A participant asked if the role of fiscal policy could be exaggerated, and felt that fiscal policy was not necessarily the panacea unless problems of the financial system were first fixed, in the light of Japan’s experience in the 1990s. Prof Delong related the views of Adam Posen, deputy director of the Peterson Institute for International Economics who observed that fiscal policy measures did not work in Japan in the 1990s because they were not carried out on a sufficiently large scale. The Japanese government was compounded by a limited debt carrying capacity because of low productivity and low population growth rates. In contrast, the debt carrying capacity of the US had been rising because of its faster growing population, which meant that the fiscal policy actions taken by the Obama government would not have much long term fiscal drag. Banking and bank regulation policies were required on top of prudential monetary and fiscal policies to keep banks in check.

10. On the risk of a collapse in the US dollar, Prof Delong said that the US was still two to three decades away from a situation in which external debt was large enough to raise concerns about a possible serious dollar crash. Capital flight in terms of risky capital and investment in government debt had not yet occurred, and global events appeared to have left the dollar if not stronger, at least stable.

11. A participant referred to Prof Delong’s presentation and asked if the political problems of the world could become too large to be solved by technocratic and financial methods. Prof Delong saw that “financial band-aid” solutions appeared to have worked so far and were likely to continue to be effective, although there was no guarantee of this. Prof Delong commented that the current financial and central bank officials including Tim Geithner, Ben Bernanke and Henry Paulson would do better if they were less concerned about being viewed as ‘obsequious servants of Wall Street’. Geithner, Bernanke and Paulson were trying to rescue those institutions which needed to be rescued in order to keep the economy afloat, while punishing equity holders (of, for instance, with Bear Stearns and Fannie Mae and Freddie Mac) as harshly as they could. This approach had failed as it had discouraged potential investors from investing in banks. A participant said that the key issue in efforts to restore the economy was really about trying to find the right balance and asked if the world would at some point be at danger of hyperinflation due to over-compensatory fiscal and monetary measures taken to stave off the recession. Prof Delong saw that this was a danger, but a remote one which would occur only if the economic situation turned out better than predicted.

12. In response to a closing question on the prospects of the economy in 2009, Prof Delong said that there were worst-case scenarios being thrown up, some, for instance, pointing to a looming US current account deficit. On the positive side President-elect Obama had shown himself to be a good legislative tactician with the use of tax cuts that Republicans could not refuse in order to push through the rest of his economic stimulus package. This was likely to help promote an economic recovery in the US.

* * * * *

Notes recorded by Ms Debbie Soon, Research Assistant, IPS.

Lee Kuan Yew School of Public Policy

NUS