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An historical perspective on the Great Recession

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What started as a subprime crisis in the US soon spread to a global crisis resulting in what some have called the Great Recession. This column argues that economists spectacularly failed to take the prevention of financial crises seriously. But since then, economists have heeded the lessons from past crises and have helped avoid the worst.

The Great Recession of 2008/9 came as a big shock to economists as well as the general public. They had become accustomed to the serene conditions of the so-called Great Moderation—low inflation, smooth growth, and low unemployment. This led to triumphalist claims that "boom and bust" had been abolished. A complacent belief arose:

Inflation-targeting by independent central banks will inevitably deliver steady growth with low inflation.

Headlines claiming that the inflation targeting at the Bank of England had ushered in the most stable macroeconomic environment in nearly 400 years contributed to this belief—even though the studies cited did not attribute this outcome simply to the success of macroeconomic policy (Benati 2005).

Shattered dreams

These delusions were decimated by the financial crisis of 2007 and 2008. In the panic that ensued, there seemed to be a real possibility that there would be a repeat of the Great Depression of the early 1930s. Back then, real GDP and prices both fell by more than 25% in the US. One in three US banks failed. A seventh of bank deposits were wiped out—all coming as the catastrophic sequel to the rapid economic growth of the 1920s.

In late 2008, Queen Elizabeth II famously asked why no one in the economics profession had seen the crisis coming. The failure of economic forecasters to predict the crisis has been taken by some people to mean that economics as a discipline is totally discredited, as The Economist noted on 16 July 2009 before going on to say that this view was over the top. Certainly, there was an important failure in that, while economic analysis tells us why many banks may fail, economic forecasting is far from being able to say when. Indeed, current "early-warning" models suggested that the risks in 2007 in both the UK and the US were trivial.

Yet, at the same time, it has long been understood that market failures in the banking system entail risks of banking crises, which can then lead to big recessions. And it has also been long understood that there are appropriate policy responses (Mishkin 1991). This has allowed economic policymakers to prevent a re-run of the traumas of the 1930s and should inform the design of appropriate prudential regulation to reduce the risks of future banking crises.

Looking back

A look back at the Great Depression gives us a useful perspective on these issues. A recent issue of the Oxford Review of Economic Policy edited by Peter Fearon and me is designed to expedite this. That crisis also was not forecast, but economic analysis can easily explain the financial debacle of that period and its consequences.

Ex-post, there is no great mystery about what went wrong in the US in the early 1930s. We know that the US banking system was fragile; it was based on unit banking, undercapitalised, badly regulated, and had made too many bad loans. On average, the banks that failed had weak balance sheets, which were unable to withstand a recessionary shock (Calomiris and Mason 2003).

Bank failures led to a credit crunch and a collapse of the money supply. Monetary shocks and deflationary price expectations produced double-digit real interest rates and investment virtually ceased. In the absence of deposit insurance, there was a scramble to hold cash rather than bank deposits, putting further pressure on banks. The catastrophic outcome was the result of a passive response by the Federal Reserve and could have been largely averted by an aggressive lender of last resort (Bordo and Landon-Lane 2010).

Recovery after 1933 required regime change; the US left the gold standard, inflationary expectations were re-established, and expansionary monetary policy created strong demand growth, while banks were re-capitalised and re-regulated (Fishback 2010, Mitchener and Mason 2010). But to develop models to forecast sequences of events such as these would be extremely difficult if not impossible.

In 1929, the US had a badly regulated and under-capitalised banking system, an inexperienced and incompetent lender of last resort, and no federal deposit insurance. At the end of the crisis, responses were made both in terms of prudential regulation and crisis management. In 1933, ending the waves of banking crises was both an economic and a political imperative. As today, reliance on market discipline appeared unrealistic. The lender of last resort had failed. So, the solution was deposit insurance plus regulatory reform and the political attractions of the former meant that it would be a permanent feature of the US banking system (Crafts and Fearon 2010).

For this solution to work effectively, it is crucial that regulation is well designed. The lesson from the 1930s is that it most probably won't be because vested interests are likely to hijack the politics of regulatory design. In particular, it is clear that the 1933 Glass-Steagall Act introduced unjustified restrictions on universal banking while failing to address the real structural problem, namely, unit banking (Calomiris 2010). Nevertheless, given the scope for, and potentially large costs of, market failure in banking together with the unavoidable presence of deposit insurance, in principle, tighter regulation to contain moral hazard was appropriate and several decades of financial stability ensued.

Fortunately, banking crises are relatively rare in advanced economies. When they occur, a collapse of lending is typically associated with a severe squeeze on business investment. Banking crises are to be expected when there is excessive risk-taking leading to over-extended balance sheets, which are vulnerable to non-performing loans. This can reflect a failure to understand the risks but is more often the result of moral hazard.

A run on the bank

Fears about bank solvency in a world of imperfect (and asymmetric) information can lead to "bank runs" as depositors seek to withdraw their funds or inter-bank lending dries up. When bank balance sheets are impaired, restoring capital adequacy normally involves shrinking assets and attempts at de-leveraging imply a credit crunch. These problems are mitigated by banks maintaining high fractions of loss-absorbing equity to total assets. But in the absence of regulation, banks typically finance their operations with a socially sub-optimal amount of equity because this lowers their private cost of capital (Miles et al. 2011).

From the 1930s, the standard response to these problems of market failure was a combination of partial deposit insurance together with regulation of bank behaviour. After several decades of financial stability and with increasing international competition between financial centres, these costs seemed increasingly onerous.

The strict regulation that stemmed from the debacle of the 1930s was relaxed in countries like the US, notably with the repeal of the Glass-Steagall Act in 1999. But the idea that systemically important banks were too big to fail and would always be bailed out by government ensured that moral hazard was alive and well. In such circumstances, a banking crisis becomes more likely and, if it can't be prevented, then the requirement of policymakers is to make an effective response to contain the crisis and its impact on the real economy.

Since there are good reasons to fear that market failures will occasionally lead to banking crises with dire consequences, it is important that this is recognised, that attention is paid to developing better "early warning" models, that it is understood that inflation targeting does not guarantee financial stability and that prudential regulation is required. The real failure of economists as the Great Moderation came to an end was not one of forecasting but of not taking the prevention of financial crises seriously enough, perhaps encouraged in this by fashions in macroeconomics.

Two cheers for economists

It can be argued that from the autumn of 2008, economics and economic history had a good crisis. Some of the lessons of the 1930s had been well learned, especially by the Federal Reserve led by Ben Bernanke, a scholar who has made seminal contributions to research on the period. Aggressive policy responses prevented a collapse of the banking system and injected fiscal and monetary stimulus, which limited the downturn. Similar actions in 1930/1 would have averted the economic catastrophe that followed for the US, but then the economic analysis available to policymakers was not up to the task.

Two cheers for economists are in order. They were complacent before the financial crisis, but they did know enough to limit its impact so that the outcome was the Great Recession and not a Great Depression.

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