Understanding the Economic Slump: Balance Sheets and Policy Uncertainty

The recovery after the financial crisis has been disappointing in the US and elsewhere. Not only in the public debate but also in the scientific community, there have been various explanations put forth as to why we haven’t witnessed a more speedy and robust rebound in economic activity and employment, and what policy makers should do to fight it now and avoid it in the future. The Julis Rabinowitz Center for Public Policy and Finance (JRC) hosted its second annual conference “Understanding the Economic Slump: Balance Sheets and Policy Uncertainty” that shed some new light on the debate, and is summarized here.

The starting point of the conference and many scientific enquiries into financial crises is a close look at the past - after all, the lab of macroeconomists is the real world, in which they study their subject “one disaster at a time” (The Economist). In “This Time Is Different”, Kenneth Rogoff and Carmen Reinhart argue that recoveries after financial crises usually take longer -- which immediately opens up the debate on what qualifies as a “financial crisis” and what the exact definition of “longer” is. Michael Bordo, Joseph Haubrich and Alan Taylor offered their interpretations.

Mr Bordo and his co-author Mr Haubrich showed that in the US at least, recessions that go hand in hand with broadly defined financial stress are followed, if anything, by steeper recoveries than those without financial stress. It seems that this is the complete opposite to what Ms Reinhart and Mr Rogoff have concluded. However, the difference comes from a different definition of financial crises, and a different measure of recovery (duration vs. steepness). Using the Reinhart/Rogoff method and definition, Mr Bordo and Mr Haubrich come to the same results as the previous literature.

"The conference has shown that the distinction between balance sheet recessions and uncertainty driven recessions is very intricate. Both channels are not only difficult to separate; they also feed on each other. Moreover, the type of uncertainty matters: aggregate uncertainty can have different implications than increases in idiosyncratic uncertainty, or higher belief disagreements. There is a fascinating research agenda out there, and we hope that the conference has helped to show where we are."

Markus Brunnermeier, Co-Director of JRC

There is an interesting finding, however, that is in fact different: the importance of the housing market. Messrs Bordo, Joseph Haubrich and Alan Taylor offered their interpretations.

Mr Taylor and co-authors, using an international dataset covering 14 countries from 1870 to 2008, focused on credit and its role in recessions and subsequent recoveries, that is often (though not always) related to housing booms. They showed that credit does affect the intensity of a recession and the likelihood of a financial crisis: excess credit before the crisis makes the recession deeper, and
the recovery longer. Given other, similar crises, they argued that the current recovery in the US is better than the estimation would predict, but that it is worse in the UK. It therefore seems that financial stress per se is not what leads to longer recessions and slower recoveries but credit and housing booms that burst.

Gary Gorton offered some insights into why exactly a credit overhang can lead to a full-blown financial crisis. He argued that the Lehman shock per se is not a satisfactory explanation, and that a financial crisis is a process: a buildup of fragility in the whole system – before and during the crisis – that shocks like Lehman exacerbate and expose. This process evolves when money-like instruments lose their “moneyness”, and financial firms rush to preserve this moneyness, for instance by cutting maturities of money market instruments, and later by increasing haircuts on the collateral.

Part of the buildup in financial fragility could be based on financial innovation, and Alp Simsek presented a model of how financial innovation, instead of reducing risk as is often argued, actually increases risk. One channel is belief disagreements, that is, large differences in beliefs on the return of an asset that, in combination with financial innovation, increases speculation. The other is that new assets open up possibilities for speculation in the first place.

Going one step further, Sebastian Di Tella presented a connection between balance sheet recessions and uncertainty shocks, or more generally, how the financial system amplifies aggregate shocks. In a nutshell, uncertainty shocks can lead investors to take on more aggregate risk, that is, risk that affects the whole economy rather than just individual investors. If this risk materializes, and leveraged investors lose net worth, they are less willing to hold assets. This in turn leads to the balance sheet recession that we can observe in many places around the world.

“Several aspects of the current recession were highlighted during the conference that are important for our understanding: first the importance of debt, and how debt amplifies ‘deep’ shocks, something that our current work horse models are not able to sufficiently capture, and were rightly criticized for it when the global crisis hit; second, how aspects from the realm of finance, broadly defined, can help mitigate balance sheet recessions. For instance how smarter mortgage contracts can reduce defaults, and that financial innovation in the derivatives market may increase risk via speculation in the economy.”

Atif R. Mian, Co-Director of JRC

Uncertainty itself has received increasing attention in recent years, and three presentations shed some light on the problem from various angles. Nicholas Bloom presented an attempt to measure economic policy uncertainty, and correlated it with other eco-
Pietro Veronesi presented a model of political uncertainty and its impact on the risk premium in markets. He argued that investors demand a risk premium for political uncertainty, and that this premium is largest when the economy is weak as policy makers have a larger incentive to change policies during those times— with unknown impact.

Casey Mulligan turned to the labor market, and how uncertainty increases the demand for social insurance because society has a demand for security. This increase in social insurance, in turn, increases the wedge of employers and employees between what the market can give them (wage, a productive worker) relative to what they have to give up (leisure, wage). This in turn can have negative consequences for the economy.

What does all that mean for policy makers? This question was addressed by Anne Krueger in her keynote address (which will be the focus in the JRC News April 2013) and a panel of four in the final session of the conference. All described the practical problems of exiting a recession or solving a crisis with strained balance sheets (public or private) and high uncertainty. And most importantly, what to do to avoid such situations in the first place.

Ms Krueger focused on the Euro Crisis and argued that the policy framework for solving sovereign debt crises is still not in place— despite clear recognition of what is needed. She described how crises usually proceed and that there are three key problems: First, policy makers tend to delay necessary macroeconomic adjustment underestimating the high costs of delay. Second, they fail to acknowledge the scale of the necessary macroeconomic adjustment. Third, they fail to appropriately evaluate whether a country’s debt burden is sustainable. Since a proper sovereign default procedure for countries is missing, an eventual solution is postponed, much to the detriment of that country’s economy. The adjustment in the Euro Crisis, Ms Krueger added, is of course made harder by the lack of exchange rate adjustments. Austerity could therefore lead into a vicious circle, but less austerity does not help if the rest of the economy is not reforming and adjusting, she added. Hence, the priority should be on more reform, and less austerity, but only in combination.

The Euro Crisis has also revealed how toxic the nexus between banks and their sovereign can be if the fiscal capacity of this sovereign is in question. This can lead to a double balance sheet recession, as both the sovereign and the banks cut back, moving each other deeper into a downward spiral.

Giovanni Dell’Ariccia presented a proposal for a banking union in Europe that aims to break that nexus. A banking union in his view must consist of three elements: a common safety net, a common regulator, and a common fund and procedure to unwind banks, particularly those that cross borders.
Jean-Pierre Landau addressed the issue of the helicopter drop, a metaphor of the current, massive amount of liquidity that central banks provide to support the economy. He highlighted the following policy contradictions: while monetary policy is very accommodative to support the process of deleveraging, banking and macroprudential regulation tightening is pushing in the opposite direction. He argues in favor of drawing a distinction between average and marginal requirements in order to distinguish between new and legacy loans.

The conference highlighted some of the most important aspects of the current recession: First, how strained balance sheets, both private and public, mattered for the crisis and still matter for the recovery; Second, which policies we need to understand better in order to exit the recession and ensure that the economy lands softly rather than abruptly. As Mr Landau put it: there is no such thing as a gliding helicopter; Third, how policy uncertainty is not yet fully incorporated into our thinking of recessions and recoveries; and Fourth, which policies need to be put in place to avoid a financial crisis as the one we have just witnessed, and a crisis in Europe that is still ongoing. Macroprudential tools are a key avenue for future research, not least because policymakers with a wealth of experience expressed concerns about their practical implementation and effectiveness.

The Dollar funding gap of foreign banks was the topic of Linda Goldberg’s presentation. She showed how foreign banks that relied on wholesale funding markets to fund longer-term dollar assets came under immense pressure - an important imbalance in the financial crisis. It was in the short term addressed by a concerted response by central banks, she concluded, but medium term challenges remain. One is to address global liquidity surges, as a subsequent squeeze can cause disruptions with spillovers into other regions.
Events

Public Lectures (co)sponsored by JRC during the Spring of 2013:

04/24/13  "Why This Time Was Different? Latin American and the Global Financial Crisis" - Jose De Gregorio, Former Governor, Central Bank of Chile

04/03/13  "Joining Up the Dots: Why Anthropoly Helps to Make Sense of the World" - Gillian Tett, Financial Times Assistant Editor

04/01/13  "The Banker's New Clothes: What's Wrong with Banking and What to Do About It" - Anat Admati, Stanford University

03/13/13  "A Fiscal Union for the Euro? Some Lessons from History" - Michael Bordo, Rutgers University

02/13/13  "The Role of Financial Markets in the Eurozone" - Ashoka Mody, Princeton University

02/11/13  "Europe's Steps Out of the Crisis" - Ursula von der Leyen, Federal Minister of Labour and Social Affairs of Germany