What I Got Wrong: Bailing 2 for 8

• I thought subprime was too small to take down the U.S. economy, even if the housing bubble did crash hard

• I thought, after Bear-Stearns, that we were in liquidation-quasinationalization mode rather than uncontrolled bankruptcy

• I thought the TBTF institutions knew they had a government backstop, and would use it aggressively

• I thought higher inflation would follow rather than precede strong recovery

• I thought no run on Treasuries possible until higher inflation appeared

• I thought that the Federal Reserve would make stabilizing nominal GDP growth in order to avoid prolonged high unemployment its principal priority

• I thought the Obama administration would apply the lessons of the RTC and the S&L crisis

• I thought the Obama administration would husband its resources to act--via Reconciliation, FHFA, TARP, infrastructure banks--if needed, even if Congress proved dysfunctional
Global Challenges

• How to rebalance U.S. Housing market?
• How to avoid transformation of U.S. unemployment from cyclical to structural?
• How to rebalance costs between southern and northern Europe?
• How to allow foreigners to invest on a large scale without deranging domestic capital markets?
• How to deal with a possible major China growth slowdown?
• Can expansionary monetary policy alone cure a balance-sheet recession?

• This last, at least, we are about to find out…
Let's Back Up to Early 19th Century

• Say (1803): Merchants know how to create means of payment

• Malthus (1819): But if excess supply in one sector is balanced by excess demand in another, where is the other?

• Mill (1829) (and Say): What if everybody wants to hold more cash—or something else—and people don’t trust private credit?

• Then pressure for spending to fall below income

• But, for the economy as a whole, spending is income
The U.S. Financial Crisis

Nominal Risky Bond Yields
The Spending Slowdown

The Slowdown in Spending Growth
The Housing Bubble
Drivers of U.S. Spending

Deviation from 2007:I Shares of Potential GDP
The Housing Bubble and Its Collapse

Deviation from 2007:1 Shares of Potential GDP

- Gross Exports
- Equipment Investment
- Government Purchases
- Residential Construction
Long-Run: 2005-08

Deviation from 2007:1 Shares of Potential GDP

- Smooth sectoral rebalancing: full-employment
Long-Run: 2005-08

Deviation from 2007:I Shares of Potential GDP

- Housing down; exports, equipment
The collapse of exports and equipment.
The collapse of exports and equipment
The Long Short-Run: 2009

Deviation from 2007:I Shares of Potential GDP

- Depressed housing and fiscal austerity

- Where is the economy's natural bounce?
The Long Short Run: 2009

Deviation from 2007:I Shares of Potential GDP

- Depressed housing and fiscal austerity
And the Fed Acts...

Now: open-ended quantitative easing
Is OE QE Important?

• Yes
  • Portfolio-balance effects: at some point the risk-bearing capacity freed-up is put to use
  • Expected-inflation effects: cash is expensive to hold when its purchasing power declines

• No
  • OE QE is just a continuation of the policy of the past four years
  • Rises in expected inflation do not trigger but follow recovery
  • Operating businesses focus on cash flow and capacity
  • Housing is broken
Risks

• Confidence?
  • The Confidence Fairy and the Inflation-Expectations Imp
  • Inflation?
  • No signs of inflation
  • And it would be a boon
    • Exports
    • Incentives to spend
    • Creates an unwinding problem
• Fiscal cliff?
• International: Europe and China?
• Transformation of cyclical unemployment into structural?
Transformation of Cyclical into Structural Unemployment

Stagnant Employment/Population and Collapsing Participation

- Participation Rate
- Adult Employment/Population
