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The Great Recession, Fallout, and What We Learned

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The Great Recession (December 2007–June 2009) roiled financial markets around the world and caused significant damage to the global economy on a scale that is comparable only to the Great Depression. Starting in the United States with the collapse of housing prices, its reach expanded quickly to financial markets inside and outside the country and soon swamped the international economy. The outsized losses in the broader financial sector and the rapid deterioration of the pace of aggregate economic activity posed extraordinary challenges on many fronts. Not since the 1930s have policymakers been confronted with such near-catastrophic events.

This volume presents five chapters on macro policy challenges in the Great Recession from some of the country's most distinguished economists who came to Kalamazoo, Michigan, as part of the fifty-first Werner Sichel Lecture Series (2014–2015), which was sponsored jointly by the Department of Economics at Western Michigan University and the W.E. Upjohn Institute for Employment Research. The chapters included here follow from their presentations. The idea is that confronting the policy challenges will encourage more discussion and research to better instruct future policy in dealing with comparable adversities.

It is now well understood that the Great Recession was caused by a housing bubble that was enabled by easy access to credit and a belief that housing prices would not fall. On the supply side, lenders secured additional funds by selling their mortgages, which fed into strong incentives to lend. Securitization of mortgages became common and created an aggressive lending cycle that started with lending to home buyers, followed by selling the mortgages, which were then securitized and sold to investors, leaving lenders with more funds to advance to other home buyers. Since the loan originators would pass on the mortgages, they had little interest in making sure that the borrowers were financially sound. Subprime mortgages that resulted were often bundled with prime ones in complex ways, which made the risks less transparent. Furthermore, the credit rating agencies deemed the securities worthy, giving them a seal of approval as a safe investment product. The near-collapse of the financial system wreaked havoc on itself and the larger global economy. As Reinhart and Rogoff (2009) note in their well-known research, output losses associated with financial crises can be dreadful and persistent. The 2008 recession lived up to that description.

The authors in this book describe the unprecedented events and the often-extraordinary policies put in place to limit the damage and turn the economy around. Not surprisingly, some policies worked well while others barely made a dent. An analysis of the many lessons and encounters, successes and failures, will surely offer fresh perspectives on how to manage the economy in a future crisis of comparable proportion. While some research has been conducted on the lessons of the Great Recession, an appreciation of the accompanying challenges adds value and enriches policy content. The hindsight afforded by the Great Recession is invaluable, and in the following five chapters we hope to underscore the main issues policymakers faced.

When beset by a crisis, we are prone to look for precedents in judging what kinds of policies are likely to be effective. Barry Eichengreen offers that viewpoint by drawing analogies between the Great Depression and the Great Recession and the lessons learned. He also makes a connection between politics and fiscal policies, drawing on historical precedence. Even in the case of monetary policy, though the central bank has much autonomy, the Federal Reserve worries about any potential compromise of independence if it is at odds with Congress or the prevailing political sentiment. The challenges arising from the political direction is a common theme in the book, a view that is well positioned by Gary Burtless. No discussion of the Great Recession is complete without the extraordinary policies taken by the Federal Reserve. Donald Kohn, who was the vice chair at the central bank from 2006 to 2010, provides an explicit description of how the Federal Reserve dealt with the crisis. Another common theme is the sluggish recovery. Laurence Ball and his coauthors take on the lower trend path of potential GDP following the 2008 recession and suggests fiscal stimulus to close that gap, arguing that this could be achieved without increasing the public debt. The effects of the Great Recession quickly went international, with financial crises outside the country often appearing to be worse than in the United States. Kathryn Dominguez looks at the financial and trade connections to ask if the foreign shocks were responsible for the slow recovery in the United States.

In Chapter 2, Eichengreen presents a historical perspective on lessons learned from past crises and how they are applied—and often misapplied—in subsequent periods of turmoil. The major precedent—the Great Depression of the 1930s—offered a variety of guidelines for policymakers, from preventing bank runs to providing emergency lending and allowing stimulus on the fiscal side.

Policy did succeed in applying some lessons learned on many fronts—on the financial side, it prevented a large-scale bank run, aggressively lowering the federal funds rate and provisioning plenty of liquidity through both quantitative easing when rates could not go any lower and two fiscal stimulus packages to prop up spending. But there was also failure in a few critical areas, the most notable being the failure of Lehman Brothers. This seriously compromised the lender of last resort obligation that the Fed normally maintains and in turn created an extraordinary degree of uncertainty regarding which financial institution might fail next. Both Eichengreen and Burtless point to the political climate of blame that may have been partly responsible—the public perceived that the Federal Reserve was bailing out large banks responsible for bringing about financial chaos, while homeowners with bad mortgages and folks on Main Street were left in the lurch.

The central bank's large-scale purchase of mortgage-backed securities was also viewed with apprehension in some quarters. There was concern that it looked much like the elements leading up to the housing bubble. To be sure, the housing market after the collapse did benefit from the injection of direct liquidity, money that would normally not flow in that direction because of extraordinary risks. Restoring supply offered a much-needed lifeline to the mortgage and refinance market. Political disenfranchisement aside, it is also hard to deny that a recognition of moral hazard was at play, that the Federal Reserve would not try enough to corral a potential buyer for Lehman Brothers. Following the purchase of Bear Stearns by JP Morgan Chase with a $30 billion loan from the Federal Reserve, one wonders how much more a prospective buyer would require and whether that amount would be forthcoming.

The second shortcoming both Eichengreen and Burtless refer to is that policymakers did not gauge the magnitude of the missteps. Once Lehman Brothers failed, the financial sector entered a renewed vicious phase of panic and uncertainty, the extent of which policy formulators had not anticipated. After the fact, though, central banks in the United States and Europe worked hard to restore confidence, sparing no resource to shore up the ailing institutions, which suggests they may have miscalculated the fallout from Lehman's demise. Perhaps because Lehman was not a depository bank, the lessons from the Great Depression did not quite instruct policy in the Great Recession. A related deficiency, though on a different scale, was that while a housing bubble was recognized early on, the scope and magnitude of the damage it would bring to the real economy was not. The common policy view was that any macro damage from the housing debacle would be limited. It was not fully appreciated that extensive securitization of mortgages had spread the risks well beyond the housing market. Because of the ease of securitizing, lenders had an incentive to lend aggressively and pass on the risks to buyers and holders of mortgage-backed securities. Such risks were not properly priced, which became apparent only after the collapse of house prices. In sum, policymakers had underestimated the risks of their own missteps, as with the failure of Lehman, and did not properly identify the broadening macro risks arising from the housing market.

The third shortcoming was that although averting a disaster on the scale and enormity of the Great Depression was reason for gratification, that success planted the seeds for policy reversion. Once the economy had stabilized with 10 percent unemployment and growth resumed, although tepid, policymakers breathed a sigh of relief and eased their policy efforts too soon. Eichengreen and Burtless argue that at this juncture the urgency for a continuation of policy receded and deficit and debt worries surfaced. In the United States, a $1.2 trillion spending cut over 10 years was approved in 2011, the Bush tax cuts elapsed, and the sequester—8.5 percent cut in federal spending across the board—was put in place in 2013. Eichengreen argues that the turn to austerity was even more pronounced in Europe, with euro area deficits falling sharply in 2012, despite the return to a recession, while in the U.K. its government turned to fiscal consolidation. Central banks also became reticent after the first stint of victory. The Federal Reserve was cautious in expanding its unconventional measures, waiting until its third round of quantitative easing to make open-ended asset purchases. In 2010 the European Central Bank began to phase out unconventional measures, followed by two premature interest rate increases in 2011.

In Chapter 3, Burtless considers the political fallout from the recession and the subsequent challenges for policy in generating an appropriate pace of recovery. He argues that while monetary policy was active, the fiscal side was rather restrained. Following two fiscal stimulus packages, one in late 2008 and the other in early 2009, there were heightened concerns of unsustainable government debt and a severe public backlash. The perception was that the dollars were being misused to bail out large banks and that the large deficits would be ruinous to the economy. To be sure, the Troubled Asset Relief Program did involve the Treasury buying stocks of distressed financial corporations, but the amount was a fairly small percentage of the overall fiscal stimulus, and in fact, the Treasury did not lose money on this particular undertaking. Nonetheless, political sentiment did not support any additional stimulus even though it gradually became clear that the recession was more severe than originally thought. Burtless also observes that once the financial sector stabilized, with the panic there retreating, the willingness to pass any additional stimulus to reduce unemployment simply dissipated. This reaction is not unusual, Burtless notes in comparing with events in some Western European countries that had high but stable unemployment rates in the 1980s. Once the threat of layoffs ebbs, the motivation to pass new measures to prop up employment also withers.

The institutional setup of fiscal and monetary policies is different. With monetary decision-making delegated to mostly seven voting members of the Federal Reserve Board, policy actions are usually swift. Fiscal policy, in contrast, is determined in the political arena with wider debate and requires approval of both houses of Congress. This often leads to delays and lags. The mix of fast-acting monetary policy with unhurried fiscal policy is generally a good balance. When a major shock like the Great Depression or the Great Recession strikes, however, monetary policy alone may not suffice, and promptness on the fiscal side may be warranted. With interest rates at zero, this was clearly such a scenario. Burtless argues that, with fiscal policy passage subject to political jostling, even in times of great need, as in the Great Recession, the prospect of stimulus can be tardy and unreliable. Additionally, the window of action is often short and closes once the peril of rising layoffs has passed, even though the unemployment rate can remain high. This challenge that Burtless identifies clearly bears recognizing as a constraint on policy timing and possible options for fiscal action.

Monetary policy played a key role in stabilizing the economy. In Chapter 4, Donald Kohn describes the new and not-so-new policies that were put in place. One of the challenges he describes was that institutions in the financial maelstrom were not banks. Securitization, often involving subprime mortgages, had drawn in a variety of financial institutions that did not take deposits and therefore were not subject to close supervision. With subprime mortgages packaged in obscure ways, it was difficult to know where the losses would ultimately accrue following the collapse of the housing market. The feedback between the financial and the real sectors meant financial institutions under stress needed to sell assets, often at fire-sale prices, which would drive down asset prices, including house prices, and increase foreclosures, which would further adversely impact the financial sector. Kohn notes that the central bank was not particularly equipped to deal with such a crisis. Under the Federal Reserve Act of 1913, the Fed is not able to directly lend to households and businesses, but it could act in the financial market to reduce the stress and end the fire sale of assets, which would be a relief to both Wall Street and Main Street. To stop the financial implosion, in 2008 the Fed started to lend to nonbank institutions, something it had not done since the 1930s. This broad provisioning included broker-dealers, money market funds, issuers of commercial paper, and buyers of securitized debt.

Securitization also spread the risks to foreign banks through their purchase of securitized debts that were funded by short-term deposits and borrowings in foreign currencies that were later converted to dollars in swap markets. With the crisis deepening, access to swaps became difficult so they had to bid directly for dollars, which put upward pressure on interest rates. To ease the situation the Fed created central bank foreign currency liquidity swaps—it directly lent dollars to foreign central banks so that they could lend where appropriate to their banks. The extension of risks to nonbanks and foreign financial institutions posed particularly acute challenges for policymakers.

A well-known special challenge facing the central bank was posed by having reached the zero lower bound—the federal funds rate could not be lowered. This was possibly the biggest hurdle for monetary policy. In late 2008 and early 2009, the Fed purchased long-term assets composed of government bonds and mortgage-backed securities. This came to be known as quantitative easing. The Fed first bought mortgage securities in 1971, following legislation that amended section 14(b) of the Federal Reserve Act, which allowed the central bank to buy and sell in the open market mortgage securities that were fully guaranteed by an agency of the U.S. government. When Congress passed that legislation, essentially to ease funding in the housing market, the central bank was uncomfortable in that role, and in 1981 made the last purchase of agency debt before the Great Recession (Haltom and Sharp 2014). The size of asset purchases in the Great Recession, including that of mortgage securities, is unprecedented. However, as Kohn points out, this was an example of a policy that was in the books but long remained dormant, and was put to vigorous use in this recession. It could be argued, by comparison with the 1970s, that the central bank was easing from a situation of exigency rather than normalcy and was evidently less reluctant in exercising that option.

The Federal Reserve also introduced forward guidance—promising to keep the Fed funds rate near the floor for prolonged periods, or until certain inflation and unemployment targets were met. This effectively tethered the future Fed funds rate and removed any perceived upward bias from the central bank's actions going forward. The combination of asset purchase and forward guidance kept longer-term interest rates low and favorably impacted asset prices, including house prices, and encouraged consumer and business spending. Some of the monetary policy measures discussed here started under Fed Chair Ben Benanke and continued under the stewardship of Chair Janet Yellen.

It is useful to note that in the variety of efforts to stabilize the economy, the Fed did not deviate from its usual inflation and unemployment targets—2 percent and full-employment, though it has been argued by some economists that a higher inflation target would provide a stronger boost to aggregate demand. Perhaps the Fed was not comfortable altering the key anchor of monetary policy, an action that would signal a different policy regime and risk confusion about its commitment to low inflation. On the unemployment side, with the natural rate being strictly unknown, the Fed showed a willingness to continue with low interest rates until inflation reached its threshold, rather than raise rates once the unemployment rate reached a predetermined level. This approach let the actual unemployment rate reach 4.3 percent in May 2017.

Kohn argues that communicating the purpose and scope of the policies turned out to be a serious challenge—it was difficult to explain that the Federal Reserve was not bailing out failing institutions but rather providing liquidity to keep the banking and the larger financial system functional. Confusion among the public and in Congress created suspicion and made it difficult to execute policy as needed. It would have been helpful to have had a process to explain the scope of the problem and what has to be done and why, possibly along the lines of the Fed chair directly communicating to the public via the media, something Bernanke had done on a couple of occasions.

In the aftermath of the Great Recession, GDP growth remained sluggish. The disappointing recovery is central to Chapter 5, by Laurence Ball, J. Bradford DeLong, and Lawrence H. Summers. The authors focus on potential GDP and note that its revision was noticeably below the counterpart based on pre-2008 trends, about 7 percent lower, and that estimates by Reifschneider, Wascher, and Wilcox (2013) and the Congressional Budget Office (2014) suggest that about two-thirds of the loss was permanent in nature. In the face of high unemployment and the economy's infrastructure in need of upgrade and repair, the authors propose closing this potential GDP gap by use of fiscal measures. Their choice of fiscal makes good sense given that monetary policy had reached the zero lower bound. In that liquidity trap scenario, an argument is made that a properly designed stimulus would likely reduce rather than increase the debt burden, the logic being that a stimulus would directly raise revenue and in turn lower the debt/GDP ratio, create positive supply effects of public investment, and possibly lead to reductions in real interest costs arising from an increase in expected inflation. Additionally, the debt problem that is normally associated with tax cuts would be mitigated by the hysteresis effects of rising output and employment. Thus, Ball and his coauthors make the forceful argument that with interest rates so low, crowding out would not dilute the expansionary effort and a tax cut would pay for itself.

Referring to some simple calculations by DeLong and Summers (2012), Ball et al. reason that a hysteresis parameter of 0.05 (a $1.00

increase in current output having a positive effect of $0.05 on potential output) via investment, employment, and other favorable effects would suffice in leaving the national debt unchanged in the face of a tax break. The policy challenge here is that with interest rates at their historic lows, this would be a great opportunity for the government to cut taxes and borrow to fund infrastructure. But the political process that is essential to the tax and spend changes may not cooperate, leaving the central bank to continue to assume almost singlehandedly the task of lifting the economy.

The Great Recession started in the United States but spread to other countries through financial and trade linkages. A high degree of financial integration between developed countries meant a synchronous effect of the U.S. financial fallout on other countries. Trade was a second channel that transmitted the adverse consequence across nations. In Chapter 6, Kathryn M.E. Dominguez also notes that the recession was especially severe because of its financial origins, pointing to research by Reinhart and Rogoff (2010), who document the vicious effects on the economy compared to other kinds of recessions. In an integrated system, this can be disastrous both in the size of the downturn and its duration, as exemplified by the Great Depression. Fortunately, in the Great Recession both fiscal and monetary policy were aggressive, which limited the downside. However, on the issue of recovery, she notes, the Great Recession seriously lagged compared to its predecessors (recoveries across the past 11 recessions).

Dominguez maintains that one reason for the weak revival was unfavorable transnational effects. Whereas the United States was weak, the rest of the world was weaker. What appeared to be the beginning of a healthy rebound near the end of 2009 proved to be too optimistic. Europe's financial and fiscal difficulties were becoming full blown, and by 2011 the tsunami and earthquake in Japan and the fiscal impasse in the United States led to considerable revisions of growth forecasts. Japan's return to recession in 2013 and again in 2014, combined with the Russian ruble crisis, created enough downside momentum to limit growth in the United States. To examine the reasons for the slow recovery, Dominguez and Shapiro (2013) use forecast revisions and narrative information from contemporaneous news reports. They find that shocks originating from Europe were the cause between 2010 and 2012. Updating the narrative evidence through 2014 and including a broader group of countries, Dominguez finds that the focus shifts from the United States in 2008–2009 to the Eurozone in 2010, Asia in 2011, and Russia in 2014.

Transmission of shocks across borders creates a special kind of vulnerability and poses a challenge for policy. During the recession, there was some cooperation between the Federal Reserve and major central banks. An example, as mentioned earlier, was the establishment of swap lines, which several foreign banks used. But more general coordination is tricky, since shocks have diverse origins and require different policy responses that are not easy to complement. The tsunami in Japan in 2011 required a very geographically targeted fiscal response by the Japanese government, while bank bailouts in Southern Europe involved the European Union, the European Central Bank, and the International Monetary Fund. The low interest rate policy in the United States clearly helped, but it would be difficult to argue that Federal Reserve should lower rates because of the negative external events, though perhaps the timing of any change in interest policy can be amenable.

The chapters presented here offer an account of the lessons and concurrent challenges faced by policymakers in the 2008 recession. While the lessons discussed are mostly economic, they are almost always seen by both policymakers and the public through the lens of history, politics, and institutions. This often made navigating the course difficult in the recession and presented additional hurdles. One of the contributions of this book is not only a better understanding of the lessons but also of their nuances, limitations, and boundaries. This balance, it is hoped, will better guide future policy in situations of similar distress.

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