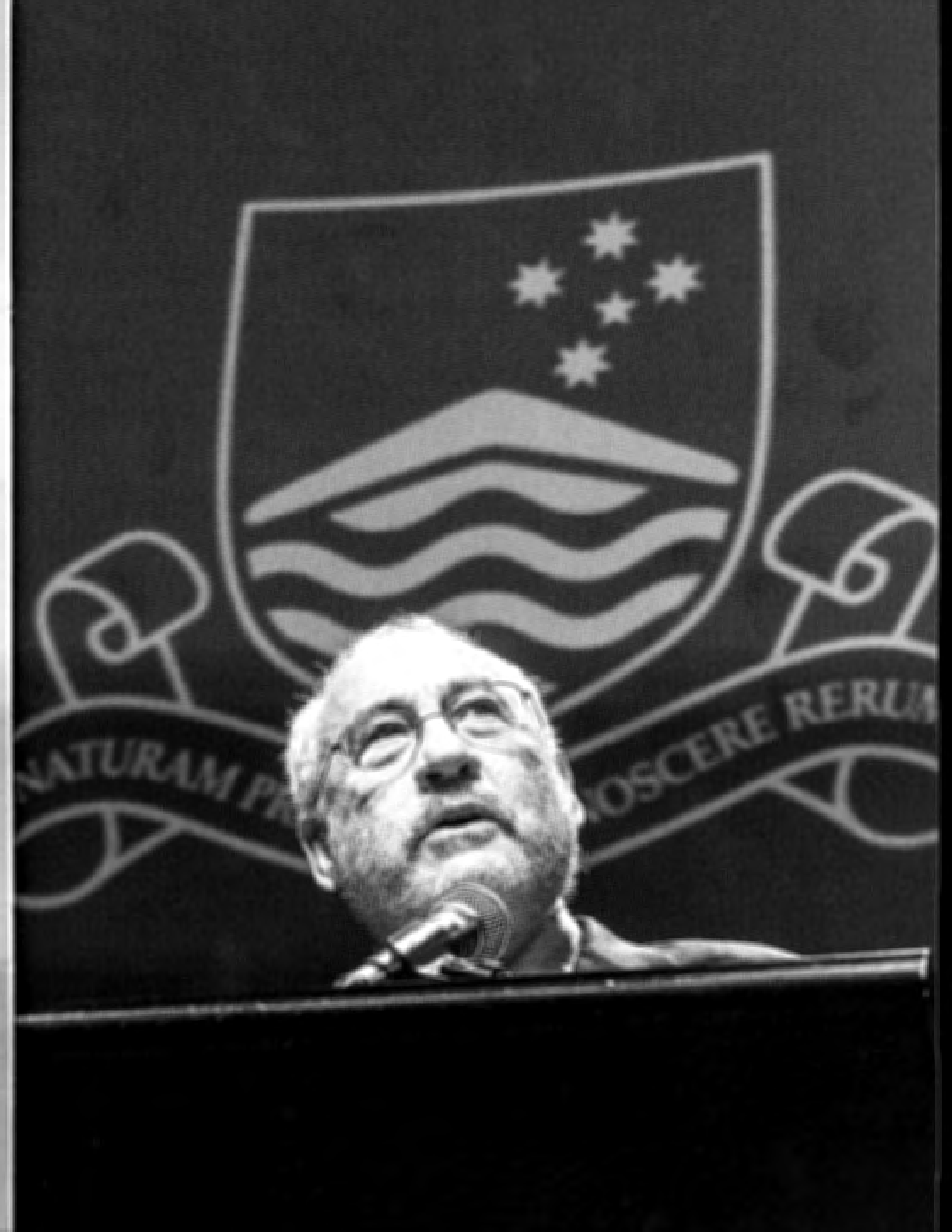


Crisis averted?

Nobel Laureate Professor Joseph Stiglitz on why the world didn't see the Global Financial Crisis coming, and what lessons we should learn from it.



The Global Financial Crisis that began in 2008 is the worst crisis that we have had in more than three quarters of a century and, yet, the economics profession did not predict it.

Far worse than that, the standard models said it could not happen. On the basis of these models, economists and central banks argued that markets were efficient and more stable. And they said that, obviously, efficient markets do not have bubbles.

But those models were wrong. The crisis should have spurred some rethinking, and an attempt to understand why the models were wrong and how we can make them better.

For example, take Adam Smith's idea of an invisible hand. The idea was that individuals in the pursuit of profits would be led as if by an invisible hand to outcomes that would maximise the wellbeing of society as a whole. Well, now we understand that the reason that the invisible hand couldn't be seen was that it actually wasn't there.

I don't think anybody should or would claim that the pursuit of self-interest—also known as greed—led to improved wellbeing for society. On the contrary, it led to a global calamity.

Ben Bernanke, after the crisis, went so far as to say there was nothing wrong with the models that were used—just the implementation. Even after the bubble broke, he was asked: "will it have effects on the economy?" And he said, in effect, "No, we've diversified risk; we spread risk in such a way that our economy is protected and more stable".

Even putting aside the actual outcome of that 'diversified risk', the very logic of this argument is obviously wrong. Just think about it; say 100 people arrived in New York with a disease and

you asked "What are you going to do about these people, all carrying smallpox?" The economists following these models would say: "Let's spread the risk. Let's send two of the people into each of the states around the country and that would diversify the risk".

It's obvious that economists have the wrong model. In this particular case, spreading America's toxic mortgages around the world made what would have been an American disaster into a global pandemic.

The flaws in the reasoning of our central bankers and our economic officials had many dimensions. One was a kind of incoherence. After the crisis, officials and academics I spoke to always talked about the risk of contagion—but before the crisis they always talked about the benefits of diversification. They never put those two sides of the same coin together.

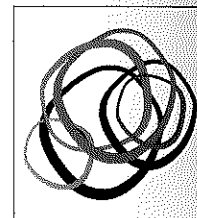
An example of the kind of intellectual incoherence was Alan Greenspan's observations after the crisis. He was asked to testify about what had happened and he said he was 'surprised'. He thought banks would be able to better manage risk.

But I was surprised that he was surprised, because if you looked at the incentive structures that bank managers had, it was evident that they encouraged short-sighted action and excessive risk taking. If the bank managers hadn't behaved badly we would have had to rewrite our microeconomics textbooks.

We won't have to rewrite our microeconomics textbooks after all. But the consequence of ignoring these perverse incentives, of course, is that the global economy has suffered enormously.

When it comes to the question of who is most to blame for the crisis, I think it's the banks. They engaged in excessive risk taking, they engaged in predatory, discriminatory lending, and they engaged in a host of other really bad practices.

The regulators also carry blame and should have stopped banks from doing all this. There is a 200-year history of banks behaving this way. Why regulators would think that they would suddenly stop behaving badly is a mystery, especially because they had already learnt these lessons the hard way. After the Great Depression, we passed good regulations to stop the bad behaviour of banks. And it worked. We had 35 years of economic stability; not a serious bank crisis around the world.



Nobel Laureate Professor Joseph Stiglitz is a distinguished Fellow of the Asia and the Pacific Policy Society. To join the society: <http://bit.ly/APPSociety>

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And then because we hadn't had any crises for 35 years, the idea spread that we didn't need regulation, when the reason we didn't have crises was *because* we had regulation. As a result, since 1980—since the Reagan-Thatcher era began—we've had more than 100 financial crises. So deregulation worked in the way one would expect—or in the way one should have expected—and created more volatility.

I also blame economists. They propagated ideas that both banks and regulators used that led them to deregulate and to adopt the policies that added to our economic problems.

And the result is that the crisis has been long-lasting. We've now had a weak economy for more than half a decade. In the United States the recession officially began in 2007. In 2014 nobody would say we're back to health.

One way to think about where we are today is to go back to the Great Depression. We didn't get out of the Great Depression until World War II. We had to spend the money on armaments to protect the US but it was the government's spending that got us out.

The period after World War II was a period of shared prosperity where every group in our country saw their incomes increase, but the people at the bottom saw their incomes increase the most. It was also the period in which the US growth was at its highest. Since 1980, with the era of deregulation, growth slowed and instability increased. But though growth was limited, what growth there was was not shared; only the top have seen their incomes significantly grow. Today, median household income in the United States is actually lower than it was in the mid-1990s.

Even looking at that slow growth after 1980, we are more than 15 per cent below where we would have been had we not had the crisis that began in 2008—and the gap is still increasing.

The total loss for the United States is in excess of \$5 trillion. If anybody talks to me about government waste, I say no government has ever wasted resources on the scale of America's private financial markets.

We still now have almost 20 million Americans who would like a full-time job and cannot get it. That's like having almost the entire population of Australia wandering around jobless.

If we look at the growth that has occurred in the last seven years after the crisis, across the countries of the North Atlantic, Europe and America, what you see is that among the large countries, only the US and Germany have had any economic growth and that economic growth has been truly paltry. In any other circumstance, paltry growth would be considered disappointing, if not a disaster.

But making things even worse is how it's distributed. In the United States, since 2009, 95 per cent of all the increase in income has gone to the top one per cent, which means the bottom 99 per cent haven't heard about recovery.

And things are worse in some social demographic groups. American males have a median income that is lower than it was 40 years ago.

So the question is: why have the United States, and many other countries in Europe, not recovered? The answer is fairly simple; it's a lack of aggregate demand.

There are several reasons for this lack of aggregate demand.

Firstly, austerity and government cutbacks. Even the United States has had a mild form of austerity. We have roughly 650,000 fewer public sector employees than we did in 2008 before the crisis. If we had normal growth with the growth of our population, we'd have some two million more employees.

With this magnitude of cut-backs, it's no wonder the economy is not performing, particularly because we haven't fixed the financial system. We not only have cut-backs on the public side, we also have weaknesses on the private side.

Secondly, we have a growing and high level of inequality.

Inequality profoundly affects economic performance, in many ways. One is very simple—those at the top don't spend as much money as those at the bottom. Those at the bottom have no choice and they tend to spend 100 per cent of their income. Those at the top are able to save 10, 15, 20 per cent of their income. And so, when there is redistribution from the bottom to the top, as has occurred in the United States, where inequality has reached a level not seen since 1928, right before the Great Recession, aggregate demand decreases—or would do so in the absence of something else happening. That is, with that kind of inequality, we're going to have weak aggregate demand unless the government and other authorities do something about it.

Bernanke and Greenspan *did* do something about it; they created a bubble. It was a short-term palliative, but it was clearly not sustainable. Because of that bubble—and the easy access to cheap credit that was both cause and consequence—the bottom 80 per cent of Americans were consuming 110 per cent of their income.

Thirdly, the lack of aggregate demand is also related to the need for structural transformation. Every economy constantly needs structural transformation but the challenges right now are particularly great and, in some ways, are similar to those that faced the global economy 80 years ago, before the Great Depression.

At that time, the structural transformation was a movement from agriculture to manufacturing. We were the victims of our own success. In the 19th century, some 70 per cent of the population had to be engaged in agriculture and related activities

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in order to produce the food that we needed to survive. Now in the United States, two to three per cent of the workforce produces more food than even an obese population can consume.

That's a great success but it poses a problem. All those people that were working in agriculture had to move somewhere else. And the problem is that the markets don't do that kind of structural transformation very well on their own. And when incomes in the agriculture sector go down—and in the United States between 1928 and 1932 they went down by more than 50 per cent—people don't have the resources to move to cities, or to learn new skills that non-agricultural jobs require. So they were trapped in their own sector.

The United States is now engaged in another kind of structural transformation, but it's an even more difficult one; we're going from manufacturing to a service sector economy.

Within the service sector, the key areas are going to be education and health—two sectors largely associated with government finance. But this is just the time we are cutting back government finance, so government policy, rather than facilitating the structural transformation, is actually impeding it.

In a way, the recession has exacerbated all the problems that we have noted; it led to greater inequality, and the austerity that followed the recession impeded the ability of the government to facilitate structural transformation. The result of this is that we are experiencing a prolonged economic downturn.

The following may help crystallise the nature of our problem.

Back in the 2008 Obama Administration, a lot of people thought: "well, we've had a bump, our banks are a little sick—all we need to do is give the banks a few trillion dollars, to help them heal and make them feel better. Don't scold them too much—that would upset them, impede the healing process, and might lead them not to lend—and in 18 months the banks will be healthy and we can pick up where we left off in 2007".

That was obviously wrong. We gave the banks a lot of money. The banks are now healthier—but not perfect.

The government is still underwriting more than 90 per cent of our mortgages, but the profits are pretty good; they're paying big dividends, even bigger bonuses.

But our economy is not back to health.

As I've explained, we had simply papered over our deeper problems with a bubble. The economy in 2007 might have seemed good when you looked at GDP and the stock market, but without the bubble, we would have had a weak economy—which is exactly where we are. The difference now is that our banking system—our financial system—is still not healthy, and inequality has gotten worse, as is the ability of the government to deal with structural transformation. Austerity has exacerbated the problem.

To conclude: the market economy is not working the way it's supposed to. It's not delivering for most citizens.

This dramatic failure is not an inevitability. These failures of growth and inequality are not a result of inexorable economic forces. They are a result of politics and policies.

We used to say: "Yes, inequality is bad but if we were to get rid of inequality it would reduce our growth and impede our economic performance".

Now we realise that inequality, to the extent that it has grown, is imposing a cost. We are paying a high price for this inequality. This is a view that is now becoming mainstream.

The lesson of this is that we ought to be working for shared prosperity, the kind of shared prosperity that the United States had in the decades after World War II.

And I hope that, as one looks back on these experiences of the Global Financial Crisis and what we've learned in the last seven years, that we take to heart the lessons of the crisis; that we try to create an economic framework that will lead to more stable, more prosperous, and more shared economic prosperity.



This article is a modified and condensed transcript of Professor Stiglitz's Crawford Oration at ANU on 30 June. Watch the video of the lecture at <http://bit.ly/crisisaverted>