

THE ROAD TO GLOBAL ECONOMIC RECOVERY, 2009*

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RESUMEN

Este documento se enfoca inicialmente en las lecciones aprendidas a partir de los sucesos que provocaron la crisis de la economía mundial de los años 2008-2009 y la forma como se ha manejado por parte de las autoridades económicas en los Estados Unidos y a nivel mundial, planteando la importancia de la intervención del Gobierno y los obstáculos de la política monetaria como fuentes de crecimiento y recuperación en este período. La segunda parte interpreta los acontecimientos actuales y discute la tesis de que Krugman acepta que ya ha habido una salida a la crisis ocurrida en el verano de 2009, pero todavía estamos lejos de una economía en expansión. Por último el artículo se ocupa de la situación de América Latina y Colombia en particular y señala que esta crisis no surgió de malos manejos económicos sino de los efectos que tuvo sobre el comercio, las materias primas y los flujos de capitales la reducción en la actividad económica en los países del primer mundo. Por el contrario se evidencia una fortaleza en las economías emergentes.

PALABRAS CLAVE: Crisis, recuperación, política fiscal, política monetaria, economías emergentes.

CLASIFICACIÓN JEL: E20, E32, E63.

ABSTRACT

These document contains three parts: the first part focuses on the lessons that have been learnt from the 2007-2009 crisis and how economic authorities handled the shock suffered in most variables. The conclusion is that Government intervention through fiscal policy is the only way to offset the weakness of households and firms. Monetary policy on the other hand can help, but it has limits in its ability to become a real source of economic growth. The second part makes a short review on current economic affairs including a discussion on whether the crisis has ended. Krugman accepts that the crisis is over, but he believes that we are still far from an economic expansion. Finally, the article analyzes the economic situation of Latin America and Colombia in particular. It points out that this crisis did not start in our countries and it did not happen because of bad economic policies as it used to happen in previous crisis in emerging economies. The crisis had an impact on these countries because of its effects on trade, commodities and capital flows due to the lower economic activity in developed countries. However we have evidence of strength in developing countries.

KEYWORDS: Crisis, economic recovery, fiscal policy, monetary policy, emerging economies.

JEL CODES: E20, E32, E63.

What we are really going to talk about is of three things. First I want to talk about the crisis. What is this that we have learned in this global crisis that is extraordinary, that has swept the world over the past year? Second, I want to talk about the current outlook. What I think is going to happen on the world economy, broadly. What I think are the prospects for the major nations, for the world economy as a whole. And then at the end I am going to talk a little bit about this region, a little bit about Colombia on which I am no expert, but I did hear some interesting things yesterday, so I am a bit stronger in being able to talk about this situation in this country.

1. LESSONS FROM THE CRISIS

Well, let me begin with the crisis, with what we have learned. And I think that the first thing that we have learned is that the world is not a safe place; that the world economy can, in fact, have very severe crisis. And now you might say “we knew that. We had the Great Depression in the 1930s. We knew that a global crisis was possible”. But I think it is worth to say people had written off the possibility that something like that would ever happen again. We looked at the world, and people said, these were things that happened 75 years ago, but that was a different world and t we are smarter than our grandparents were. We are not going to make those mistakes. We are not going to have anything like that. But what we have had in the past year and a half is a crisis that is actually fully comparable to the first year of the Great Depression and we do not want to have any illusions as just how bad it has been. I can give you a few numbers. There was a decline in real GDP for some of the major economic regions or advanced regions. On the

one hand between 1929 and 1930, and on the other between 2008 and what we think will be the outcome for 2009. So, if we look at the United States, this one has not been as severe as the first year of the Great Depression, but in Europe it has substantially been worse. In Japan it has been about the same and in the advanced countries as a group, it has been similar. This is really as bad as the first year of the Great Depression. I do not have developing countries as we do not have good data for 1929-1930, but as it appears it is again a comparable blob. We can do comparisons of industrial production. This is a huge shock to the world economy and is a shock for which there is no excuse. This is not like the slump of 1979, where there was this political event in the Middle East that disrupted the supply of oil, leading to a sharp economic retraction. This is a purely internally generated shock. In 1930, the great economist John Maynard Keynes wrote about this slump of his time and said that we are involved in a colossal model, that we have blundered in the operation of a machine that we do not understand and you can say exactly the same thing this time. We built ourselves a world economy that we did not understand. We did not know how to run it and the result has been this one year of catastrophe. And one more thing I should say: the whole world has been caught up in this crisis. There was a widespread view before the crisis that really took hold, that you would have decoupling, that emergent nations would be able to continue growing even in the face of a severe slump, That you would have recession in America, even in Europe, but this would not be very much felt in Brazil or China. That has turned out to be wrong. The reason that it has turned out to be wrong is globalization. We have a world with a great deal of trade, which is a good thing. I do not want to say that

that is a bad thing. Actually, opening us to the world economy is the best path we know towards sustained growth. But in a crisis like this, you will have a sharp decline in trade which is what we see here.

The rate of change in total world exports. Simply fell off a cliff. The slump in the United States and Europe led to a collapse of imports, particularly of imports of durable manufactured goods and the result was a catastrophic decline in world trade from which no country has been immune. There have been no safe harbors in this storm Worldwide contraction. I suppose I should say in advance I will show more evidence, that this does not mean that we are about to fully replay the Great Depression. In fact it seems that we have had a repeat of the first year of the Great Depression, but we are managing to avoid the second, third and fourth years. So, it is not as bad as the first year might have indicated, but it has been a terrible year and the way forward is not at all clear.

So, we have this tremendous global slump. What did we learn from it? I believe there are five really important lessons that we have learned from this slump. Lessons that contradict what many economists, many leaders had come to believe. And there it is, the world has become a different, more frightening place, than most people imagined. So, this is one of the lessons.

Over the course of the last thirty or so years, there has been a growing tendency, a growing belief that you can trust financial markets, that investors, make mistakes, but they do not make systematic mistakes, that the price of assets on financial markets is reasonable, that we should think markets as being more sensible, more or less stable. The strong form for the economists in the room is the “efficient markets” hypothesis, but, even if you did not totally believe in that, there

was a tendency to discount the possibility of a really massive mispricing of assets. That now looks foolish. In fact, back to the mid 1980s, it was a period of relative stability in the real economy around the world. There were recessions, but except in some countries, they were not very severe. It was a period when policy makers felt pretty good. They thought they were running things pretty smoothly. But what we actually saw over that period is that there were a series of enormous bubbles in the financial markets. We saw a very high valuation of stocks. Lots of people buying stocks in companies that had no realistic prospect of earning a profit, a huge bubbling of stock which then burst. the ratio of housing prices to rental rates of rented housing and there was an enormous bubble both in stocks in the 1990s and then in housing in the middle years of this decade. People came to believe that because prices had been rising in the recent past, they would continue to rise in the future and the result was that prices lost all touch with reality. Major bubbles followed by major collapses. At this point you just have to consider a fact: financial markets will get carried away. The prices of assets will often be completely unrealistic and there will be drastic, painful corrections in those prices. And I should mention it. We now have an estimate of how much value was destroyed or how much value apparently disappeared with the collapse of the housing bubble and falling of the stock prices. It is about 13 trillion dollars for the United States. It is about one year GDP disappeared from the decline in assets value; probably a number on the same order for the world. All of a sudden, abruptly, the world found itself poorer by an amount equivalent to roughly one year's production, because it was never that rich. The wealth was an illusion. It was an illusion created by a bubble and financial markets.

The second lesson involves the safety of the financial system. Now we know that at the beginning of the Great Depression in the 1930's bank failures, a panic in the banking system was a crucial element of the crisis. The waves of bank runs in the United States in 1930 and 1931 and runs on banks in Europe. Kredit Anstalt in Austria and many other European banks. We had convinced ourselves that this would never happen again, that our banks were safe. That is apparently that they were safe because they had government guarantees, apparently that they were safe because they were regulated by the government, apparently they were safe because financial leaders had apparently mastered the art of controlling risk. That has turned out not to be all true. I have a personal anecdote. My local bank, the bank at which I do my own checking, is Southern Bank, a regional bank in the Northeastern United States. Southern now has signs on the windows of all its branches saying "part of one of the world's strongest and safest banks" and underneath that, the logo for Santander, the Spanish bank, because Southern turns out to be owned by Bank Santander in Spain now. Think about that, a US bank now boasting to its depositors, reassuring them saying "don't worry we are not really a US bank, we are Spanish" . so that is the state we are in. But more important than that, I do not worry about my deposits at Southern, because Southern is a regular commercial bank with insured deposits. Even if it goes under, the American government will stand behind them. But most banking is not like that, not any more. We fell into a major error, which was that we mistook surface appearances with reality. We said, well a bank is something that has a marble building and a line of tellers and offers you deposits. That is okay. Deposits are a guarantee because banks like these are regulated. We have that under control. But of

course, if you are serious about economics you must know that something matters not for what it looks like, but for what it does and it turns out if you think about it that any institution that borrows short and lends long, any institution that says to people, leave your money with us, it is safe. You can have whenever you want, but use most of that money to invest in things that are risky, that might not be liquid, and that might not be easy to sell in a crisis. Anything like that is a bank.

What we had starting with the summer of 2007, but extremely acute beginning in the fall of last year, what we have is the collapse of non-bank banks, the “shadow banks” as we call them. It was bankrupt. It was the equivalent of 1930 in the United States. The bank run did not consist of mobs of people standing outside the banks demanding cash, it was electronic online mobs demanding repayment on internet of their overnight loans, but it had the same effects: financial collapse fully comparable to the Great Depression.

Third lesson. We came to believe that the major Central banks could always solve our problems. That even if we did have a bubble, even if we had a banking problem that Alan Greenspan could always solve the problem by cutting down interest rates, printing more money, that Jean Claude Triché could do the same thing, that the central bankers were always able to repair whatever damage might have been done. That turned out to be wrong for reasons that our grandparents would have understood quite well, namely central banks have a powerful influence on interest rates. They can push interest rates down. But they cannot push them below zero. Try to push interest rates below zero and people will just hang on to cash, and zero is the lower bound and sometimes zero is not low enough. A long time before this did actually happen. But it happened

again. In the 1930s the Federal Reserve could not end the Great Depression because interest rates were zero. There was nothing more the Fed could do. Then we went to loan time. People forgot about the problem. Technically the problem is a liquidity trap. People forgot that there was a limit on policy. It happened again in Japan in the 1990s but not enough people paid attention. And now it has happened all around the world. All of the major world economies are now, more or less at zero interest rates. No abilities of the central banks to cut interest rates any further and that is a really serious constraint. In the United States we sometimes talk about something called the Taylor's Rule, which is a rule of thumb for setting interest rates. It reflects inflation and unemployment basically. If inflation is high, interest rates should be high too to control inflation. If unemployment is high, interest rates should be low to try to fight unemployment. Historically that fits what the Federal Reserve does in the United States pretty well. Right now, the Taylor's rule says that the interest rate should be minus 5%. But what can you do?. so, right now interest rates in the United States are five points too high, five hundred basis points too high and we cannot do anything. And that is not because the Fed is stupid, it is because it ran out of room. And therefore we are unable to have an effective monetary policy to fight the crisis and this is at the core of what is going on. It is not only that we are at a world recession, it is that we are at a world recession and we have run out of the ammunition to fight it. We no longer have a list of conventional tools for fighting the recession. What we do have are government budgets and over the years with many problems of government finance, with persistent problems of deficits, we were tempted to say that

deficits are always a bad thing. And the truth is that most of the time, deficits are bad things, but they are not always.

And so, my fourth lesson right here is that in a crisis like this one, it is actually a good thing to run deficits. Households, people are not buying houses, so they are not borrowing. People are paying down their credit card debts. Businesses have slashed investment and have stopped borrowing. The private sector has actually become a net lender in the United States after many years of borrowing. If that were the only thing happening we would now be in the second Great Depression, because that is a cut back in spending. The trouble is that if everyone tries to cut back in spending at the same time, well, my spending is your income and vice versa. So if everyone tries to cut spending at the same time you have a very severe depression. Basically if people's income falls until people cannot cut their spending anymore. Fortunately, we have governments that have been able, for the most part, to maintain spending, have been able to supply basic services and their revenue has dropped because of the slump. But because the government has been there, the governments are sources of stable demands; they act as stabilizers for the economy. There have been some deliberate action as well, but the most important function has been simply that the governments are there as a stabilizing factor. If you want to ask why are we not heading to a full grade depression. Well in 1929, the federal government was 3% of GDP, and furthermore it tried to balance its budget in the face of the slump. Today the federal government is around 20% of GDP and it did not try to balance its budget and that extra stability has been a crucial support with the same thing happening all around the advanced world. That is the automatic role of government. What about a more deliberate efforts to

stimulate?. The concept here comes from John Maynard Keynes and Keynes in economics is experiencing a great revival now. Many people who sort of not paid attention to him, who thought he was wrong are saying: well he told what to do to avoid a depression and that now seems very relevant.

And my last lesson from this crisis is that it works. Lots of different evidence here. Many countries have pursued some kind of stimulus plans this year. Life is complicated, many things happen, but what has become quite clear is that the countries that have been most aggressive about stimulus are the ones that have performed better than forecasts expected. China is the biggest example, but Japan has done better, Korea has also been aggressive; the United States, we are just starting to see the results of the stimulus, but it is helping. There is no real question that this Keynesian policies work. A very different world. My last book was called “The return of depression economics”. And we really are. We are now in a depression. But we are in a world where the lessons from the depression are relevant. And all of this depression economics results in depression economics strategies are appropriately extremely relevant.

2. HOW IS THE WORLD ECONOMY DOING?

And now I come to the second part of this talk. How are we doing in today’s world economy? The worst is probably over. Most indications are that the world economy has hit bottom, has stabilized. Manufacture seems to be expanding rather than shrinking around the world and there is a bunch of other evidence suggesting the same thing. Slight economic growth in Japan, Germany, France. Probably this quarter we will see

significant growth in the United States. And people ask me when the recession will end. And I would say that the recession ended more or less yesterday. It may have been even a little bit earlier than that. When they go around, when they back date to figure out when the official end of the recession was. It will be in July or August. The recession ended this summer. That is good. That means that we are not headed to a second Great Depression. Basically we have had 1930 all over again, but it does not look like we are going to have 1931, 1932 and 1933, which is a good thing. I think we can say that the rescue efforts of central banks/ central governments have been the reason why. Without those we would have had in fact a fall, a second Great Depression, but we have sorted that. Unfortunately, there is a very big difference between not falling off a cliff, between not having total collapse and having a total recovery. I think you want to think of the world economy as someone who was badly injured in a car accident and who was rushed to the hospital and was on the critical list. And now he is off the critical list. He is not going to die, but we do not have an idea when he will be able to walk again. We have avoided the worst, but recovery is by no means assured and there are a number of reasons to fear that this is going to be a very troubled, slow recovery in the world. So let me give you those reasons.

First of all, we have actually been seeing a pattern in modern recessions, which is that they tend to drag on for a very long time. They tend not to end when they end. My best interpretation is that we have seen a change in the nature of the business cycle. Before the 1980's, before the 1990's more exactly, recessions were typically the result of an inflationary problem. Recession was starting to run ahead, central banks, whether they were the federal reserve or the Bank of Japan or

the European banks would respond to high inflation by rising interest rates, squeezing the economy. They tried to deliberately induce recession to bring inflation under control. High interest rates would squeeze spending, especially spending on housing and then, when inflation was under control, they would relax again and that relaxation would bring a surge of the demand because there was plenty of demand. In 1981, 1982 interests in the United States were 18%, 20%. Nobody was buying houses. When the interests dropped to normal levels again, everybody wanted to buy a house. And so you had a roaring fast recovery. We brought on inflation under control in a way we are the victims of our own success. So we have not had inflation problems over the past twenty-five years. Instead we had booms that ran along, that led to a bubble that led to overextension by businesses, that led to too much investment capacity, and then, one day everyone looks around and like the cartoon character that walks off the cliff five paces and then looks down and realizes there is nothing under him and plunges to the ground, people looked around and realized they have over invested, they set assets prices too high and the bubble burst. It is much harder to generate a recovery from that. Traditionally in the United States economic recoveries come because low interest rates lead to a housing boom. We are not going to have that housing boom again. We cannot. We just had an enormous housing bubble. We have too many houses. People have been badly burned. So we cannot have the rapid recovery we had before. These bad times tend to linger for a long time, even after the recession is over. That is the first thing that leads me to believe this is not going to be an easy answer. The second thing is that historically, financial crisis are much worse in their effects, much more prolonged in their

effects than other kinds of recessions. It is one thing if you have recession like the terrible world recession of the early 1980's which was caused in first place by inflation and oil prices; it is another if you have got inflation because your financial system fell apart. Those are very hard to recover from.. Typically it takes a year and a half to even get to the level of output you had before. So, since this is a world financial crisis, history tells us that the recovery will be slow, painful, that it will take a long time to get back.

And there is one more thing. Countries have had financial crisis and they have recovered, even terrible financial crisis. There was a terrible financial crisis in East Asia in 1997, 1998. The economies of the region came roaring back in 1999 and 2000. There was a terrible crisis in Argentina, 2002. 2004, 2005 were years of fast growth in Argentina. So financial crisis are all often followed by dramatic recoveries. And these recoveries have something in common. They are all led by exports. Countries that have had financial crisis almost always recover first by having a big increase in exports. A big increase in their trade surplus. That is usually what drives the balance back. That is even true for Japan. Japan had its "lost decade". They had a huge bubble in stocks and real estate. In the 1980s when the bubble burst they had a decade of slow growth alternating with recessions and then finally in 2003, they had a convincing recovery. What was that recovery driven by? Exports to China, exports to the United States. Big exports led recovery. Countries that had financial crisis in general, or on average moved from roughly balanced trade to a surplus, trade surplus of 3% of GDP, which really drives the recovery. Fine. There is nothing wrong with that, except this time we have a global financial crisis. It has affected everybody. The whole world

has been caught up in the crisis. The whole world cannot have an export led recovery. We cannot have everybody running a trade surplus of 3% of GDP, unless we can find another planet to export to. So, the route to recover from financial crisis, the route that has been the dominant route out for decades, is simply not available. We simply do not know what recovery at world level from this financial crisis will look like.

Well, you ask me, where is there any good example of economies that experienced a financial crisis and then had a strong recovery that was not based on running a trade surplus? The answer is that you have to go back to the Great Depression. The Great Depression was also a global crisis and there was also global recovery. The global recovery was a result of a public spending program known as World War II. So we hope we do not have to go that route again. But, actually it is very hard to see where a convincing recovery comes from. Everything suggests that this ought to be a prolonged, difficult period for the world economy.

3. LATIN AMERICAN AND THE WORLD FINANCIAL CRISIS

So now, let me talk a bit about this region. I have been doing the economics of crisis for 30 years. I wrote my first paper on that subject in 1979 and much of that period was spent analyzing crisis in Latin America. First the debt crisis of the 1980s, then the Tequila crisis of the mid 1990s, then the Argentina crisis. This time, Latin America is not playing any role in creating the crisis. There was nothing wrong in this region. The crisis had nothing to do with Latin America. The whole results were not at all driven by something going on here. If I can return to my car crash metaphor, what has happened to Latin America is

like you were driving down the highway and someone fifty cars ahead of you had a traffic accident and you are caught in the traffic jam that follows, but you did not cause the accident. You were not even part of the major accident. Overall, although all Latin America has suffered a significant slowdown it is one of the less affected regions of the world. The crisis has been worse in Asia, has been worse in Eastern Europe than it has in Latin America. So, this time Latin America has been a bystander suffering collateral damages from a crisis that had its origin in the wealthy nations, but that has been unpleasant, for Colombia has been hit both by declining the volume of exports and because this is still a country that relies on commodity export, has been hit by a decline of the price of commodities: oil, gold and agriculture products. A fairly nasty external shock, but it is purely an external shock and the recession has not been that severe by comparison with the rest of the world. And, I would say something else, which I think is a hopeful sign. As I said, I have spent basically my entire adult life studying crisis in Latin America. And we have a standard view of what the trouble of Latin America economies is when faced with an external shock, which is that, historically, countries in this region have not been able to deal with these crises very well. As soon as something goes wrong there is a loss of confidence in the sustainability of finances. So bond spreads rise enormously, huge risk premiums. Countries are unable to pursue counter cyclical policies. They are not able to cut interest rates, because if they cut interest rates, the currency will depreciate and because they are so dependent on foreign currency borrowing, they have no room to do that. A fall in the currency will produce terrible balance sheet effects. We have a whole set of doctrine known picturesquely as the “original sin” about countries that

are unable to borrow in their own currency and they are of course very vulnerable to external shocks and the doctrine was devised largely with the experience of Latin American countries in mind. We can see all of this happening right now, but not here. You can see it happening in Eastern Europe. If you look at what is going on right now in Lithuania, Estonia, Latvia, Ukraine, you see all the syndromes which we have traditionally associated with crisis in Latin America happening there. They have large external debts in Euros and they are unable to cut interest rates. They have on the contrary, been forced to rise interest rates in order to face economic slump to defend their currencies, their risk spreads are enormous. They are suffering a terrible, terrible crisis. The truth of all, looking at Latvia right now is like looking at Argentina 2002. Latin America does not look like that. Colombia particularly, does not look like that. What is amazing to me, we had a discussion of the economy yesterday in Bogotá, is looking at some of the charts that were being presented. My thought was that, if the charts had not been labeled, I would have said that Colombia looks kind like as Australia in 1998. That is, it looks like a normal country facing a nasty external shock, major hit to the price of its exports, but with enough freedom of maneuver to have a flexible exchange rate, ability to cut exchange rates, ability to cut interest rates. It is not... I do not want you to get too overconfident. It is not a magnificent performance. It is not just the most wonderful thing you have ever seen. It is normal. It is a response you would have expected from an advanced country faced with similar external problems; which is suggesting there has been a sort of graduation. That Colombia and to an important extent the other countries of this region have got a degree of security in their financial sector, a degree

of maturity in their financial markets that makes it possible to respond much better to this kind of crisis.

So, any terrible world crisis like this produces at least some relative winners. Some parts of the world that do better than you might have expected and in this case that is Latin America in general, including Colombia has done better than you might have expected facing the crisis.

That is it. It is a terrible, terrible crisis. I believe weakness will last for a long time in the world economy. People ask me how long do I think the troubles will last and I always say I have no idea because I am finding it hard to see where the drivers for a full recovery come from. So it is probably a period of prolonged weakness but that does not mean that growth has to stop everywhere, it is just a worse external environment. The prices of commodity exports will probably be relatively low for a while. The export markets will not be growing as rapidly as you would like, so it is going to be more difficult. It will be a less stable environment than those of the last five six years, but still plenty of room for economic growth in countries that were not caught up in the economic crisis. Plenty of room for progress.

The world did not end this year. For a while we thought it might have; but it did not. And although it is still a very troubled world and difficult time, I think we are going to make it through this. I think that is my last word.