Andrew Ross Sorkin on the Great Recession

Author : James Annable

Date : Sep 14, 2018

It was ten years ago that Lehman Brothers declared bankruptcy. The GEM Project has identified that as the point at which the 2008 total demand disturbance pivoted from its stationary to its nonstationary phase. That's a big deal. As readers of this Blog know, only the latter threatens the huge cost of depression.

Andrew Ross Sorkin, a journalist at the *New York Times*, has been a leader in defining the consensus narrative explaining the nature of and how best to respond to the Great Recession. He took an anniversary victory lap on the front page of the NYT business section (September 11, 2018). He clearly remains unaware that his explanation of crisis macrodynamics is badly incomplete; worse, his policy recommendations on how to prevent repetition of the Great Recessions are simply wrong. What he has failed to do, because he does not know how, is identify the practical cause to the 2007-09 Recession. The GEM Project defines a "practical cause" as one that implies an effective cure.

For Sorkin, other journalists, and many economists, the practical cause of the Great Recession was the deregulation of the financial industry, especially large banks, that Robert Rubin and Alan Greenspan helped engineer during the Clinton presidency. The Sorkin *et al.* effective response is the reregulation of large banks in pursuit of sharply reduced financial risk. Emphasis was placed of the housing sector, especially the prevention of a mass default of subprime mortgages. Sorkin accepts as fact that low-income families (lured into too-expensive purchases) stopped paying on their loans, igniting the 2008 financial crisis.

There are at least two critical errors in Sorkin's consensus story. First, in the lesser problem, there was no mass default of subprime mortgages. The Sorkin fact is false. From *The Financial Crisis Inquiry Report* (2011): "For 2005 to 2007 vintages tranches of mortgage-backed securities originally rated triple-A, despite the mass downgrades, only about 10% of Alt-A and 4% of subprime securities had been 'materially impaired' – meaning that losses were imminent or had already been suffered – by the end of 2009." (pp. 228-9)

Authors ignoring facts and actual macrodynamics in order to focus on a more exciting fable of greed and criminal behavior could never explain why mark-to-market prices of all non-Treasury financial assets, not just bundled residential mortgages, fell so sharply. Broad equity indexes fell a mind-boggling 50 percent. Playing the Sorkin blame game will never explain how a relatively minuscule amount of nonstandard home loans pushed the U.S. economy to the brink of depression. Contrary to the consensus narrative, the practical cause of the brewing 2008 nonstationary demand contraction was neither subprime mortgages nor their seedy underwriting. Their packaging into CDOs and subsequent distribution were based on analysis, which turned out to be true, that they were relatively low-risk assets.

The second error is much more fundamental. Sorkin's story pays no real attention to the nature and consequences of the investor attack on Lehman Brothers that quickly morphed into a widespread market route that had little to do with subprime mortgages. Understanding the collapse of investor confidence is essential to adequate modeling of the Great Recession. While such a model was apparently beyond Sorkin's grasp of, it is provided in the GEM Project. The following summary focuses on three features of the GEM model.

First, microfounded meaningful wage rigidity uniquely motivates causality from adverse demand disturbances to involuntary job loss and evidence-consistent contractions in employment, output, and income. Aggregate demand now plays the starring macrodynamic role in both stationary and nonstationary instability. Second, the analysis of total spending disturbances is separated into two types. *Stationary demand disturbances* (SDD) reflect the contained, temporary weakening of spending associated with garden-variety recessions. *Nonstationary demand disturbances* (NND) are unchecked spending collapses associated with acute instability that threaten depression. NDD overwhelms the automatic stabilizers and central-bank purchase of short-term treasury debt that effectively ameliorate SDD.

Third is the most critical difference between the two classes of demand disturbances. NDD induces uncertainty in investor/lender perceptions of the trend real-side macro future; SDD does not. Nancy Stokey's (2009) insightful examination of rational investor/lender behavior demonstrates that, with rising uncertainty, simple *inaction* becomes increasingly rational. Buyers of financial assets respond to uncertainty inherent in NDD circumstances by moving to the sidelines, waiting for the emergence of a credible floor under prices. (A maxim of veteran traders is not to try catching a falling knife.) Such inactivity provides critical fuel for contracting investment and total spending.

The most basic version of the NDD model emphasizes investment outlays, the most volatile component of total spending:

I(t)=ƒ[Ƈ(t)И(t), (1-Ƈ(t))₡(t)],

such that ΔI/ΔИ>0, ΔI/Δ₡>0, 0