Stabilization Policy, Part II

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As promised last week, this post provides a thumbnail description of the GEM Project's explanation of extreme instability. Such instability is defined as contractions in total nominal spending that are too powerful to be reversed by automatic fiscal stabilizers and central-bank reductions in short-term interest rates. The damaging class of massive market failure most recently occurred in the 2007-09 Great Recession. The complete GEM model can be found in the papers section of this website.

Understanding extreme instability. In order to get a handle on the core mechanics of the Great Recession, three facts must be kept in mind. First, in modern, highly specialized economies, many wages and prices adjust very slowly in response to market disruptions. As a result, contractions in total demand necessarily generate involuntary job loss and underutilized capital. Adverse demand movements are *always* at the heart of actual recessions and depressions.

The second fact is more particular to extreme instability. In the wake of the 2008 bankruptcy of Lehman Brothers, it was readily observable that many investors/lenders became uncertain about the nation's ability to avoid near-term depression and, as a result, paused in their acquisition of assets. They became rationally inactive,. Asset prices reacted to hesitant buyers with a sickening collapse. Recall that the S&P 500 equity index lost nearly a third of its value in the month following the Lehman failure. In the GEM analysis, sidelined buyers were sensibly waiting for credible asset-market bottoms to emerge.

Third is the destabilizing feedback between cumulating damage to the financial system's capacity to recycle saving into investment/consumption and collapsing aggregate demand. A lesson of both history and logic is that unchecked contractions in nominal spending in highly specialized economies result in depression. The collapse in living standards, massive permanent job loss, widespread private debt default, widespread destruction of wealth, and other predictable costs of a 21st century depression would make its 1930s predecessor look like a walk in the park. In one of its relatively minor outcomes, government debt would quickly swell by many trillions of dollars, saddling taxpayers with an unmanageable increase in liabilities.

The 2008-09 collapse in asset prices and the damage to business and household creditworthiness quickly ate up (mark-to-market) bank capital. Facing industry-wide drops in capital-asset ratios, bank managements rationally sought to reduce assets, cutting back on lending and greatly aggravating the on-going contraction in total spending. Moreover, as inactive investors cut back on short-term funding to banks (and nonbanks), even more financial-institution asset sales were needed to balance their books. Inactive investor/lenders had set off a phenomenon that economists have named "contagion". The term describes an indiscriminate reluctance to provide short-term funding to financial institutions, forcing the sale of assets at depressed prices. (See Hal Scott (*Connectedness and Contagion*, Cambridge: MIT Press, 2016.)

In acute-instability crises, the effective policy response to adverse feedback dynamics has long been understood to include temporary injections of public funds to help mitigate the effects of rapidly deteriorating bank capital on total spending. But wait. As noted last week, Sheila Bair has a different idea. No bailouts, put the banking system into bankruptcy, liquidate assets, and push investors/lenders deeper into retrenchment. Such a policy response would super-charge any brewing collapse in in aggregate demand and help motivate descent into depression. Bair appears focused on the short-term political benefits available from exploiting the broadly held myth of taxpayer losses from big-bank "bailouts". She either does not understand or does not care that such political expediency makes future crises much more dangerous.

Superior policy. A better-designed policy to prevent future Great Recessions is not complex. It begins by being mindful of the two fundamental characteristics of highly specialized economies that have already been emphasized:

- Given the rational inability of many wages to contract (absent long lags) in response to rising unemployment and excess capacity, effective stabilization policy must pay close attention to the behavior of total nominal spending. In the perilous circumstances of an unchecked demand collapse (e.g., what was spontaneously organizing itself in the second half of 2008), authorities cannot dawdle. Their response must be on-target (focusing on reversing contracting demand), big and quick. There are no policymaker do-overs when confronting gathering depressions.

- Financial institutions exist to channel saving into spending on investment and, to a lesser extent, consumption. A substantial persisting breakdown in financial markets assures an unchecked contraction in total nominal demand. The GEM Project has identified the key to those dynamics to be the credibility of stabilization authorities' trend full-employment objective. (By federal law, the Fed's full-employment goal is co-equal with its trend low-inflation target.) Investor/lender uncertainty with respect to authorities' capacity to achieve their real-side objective rationally motivates asset-acquisition inaction and consequent debilitating feedback between financial-sector disruption and collapsing total spending.

Building on those facts, GEM analysis provides a compelling alternative to the current consensus sink-all-boats approach to managing instability crises. The focus shifts to concerted government action – on all fronts, in size and with speed – to halt and reverse contracting nominal demand. The explicit objective must be to restore, especially with respect to investors and lenders, the credibility of the trend real-side (full-employment) objective of stabilization authorities. Such credibility is the antidote to investor/lender uncertainty that rationally induces inaction. Effective stabilization policy crucially features rapid, large-scale interventions to unfreeze financial markets. That focus is, of course, not exclusive. In episodes of extreme instability, stabilization authorities properly pull out all the stops, undertaking a broad range of actions to boost total spending. This alternative to the current policy consensus describes, in a nutshell, Ben Bernanke's successful approach in 2008-09. It is not surprising that he titled his memoir *The Courage to Act.*

With the reversal in total spending in mid-2009, real activity began to improve and asset markets quickly bounced back to near pre-recession levels. Banks' mark-to-market insolvency melted away. Effective all-in demand-management policies bailed the entire country out of a bleak future that included saddling taxpayers with multiple trillions of dollars in federal-deficit liabilities. By contrast, potential Troubled Asset Relief Program (TARP) losses in 2008-09, which are the moral focus of today's public-policy consensus, are the smallest of small potatoes. Throwing away effective stabilization tools (capital injections as well as other classes of intervention that support total spending), either out of ignorance or for temporary political gain, is unconscionable. Instead, policies to prevent future Great Recessions should focus on constructing the most credible, powerful toolkit for intervening in aggregate demand and convincing investors/lenders globally of the power of that toolkit and authorities' determination to use it in future instability crises.

Some evidence. A couple of additional facts are instructive. First, as noted above, taxpayer losses from large-bank bailouts during the Great Recession are a myth. Instead of losses, the Treasury made a handsome profit on TARP capital injections to the biggest banks. Indeed, large-bank (above-market) interest payments and warrants eased the burden on taxpayers by largely paying for the below-the-radar multi-billion-dollar TARP losses from other defaulted loans, most substantially to the auto industry. The facts reveal the first policy-consensus pillar to be no more than a politically expedient fabrication. This essay, however, makes a more important point. The big-bank capital injections helped prevent the multi-trillion-dollar taxpayer losses that would have occurred if the 2008-09 demand contraction had had been allowed to morph into a 1930s-class depression.

A second class of evidence should help seal the deal. If the public-policy problem is the prevention of future episodes of extreme instability, consensus thinking should be informed by what worked to stabilize the economy in 2009. The successful Fed policy had a single objective: To halt and reverse the collapse in total spending. In designing how to accomplish that, Bernanke understood that financial markets, suffering from sidelined buyers who had become uncertain about trend macro prospects, had to be unfrozen. Once that was accomplished, the contraction in total demand was halted and reversed. Production, employment, and income began to gradually recover. Meanwhile, and this is important to understand, asset prices rebounded rapidly. The pattern of that real post-crisis recovery is uniquely consistent with confidence-centric dynamics, along the lines presented above.

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