Crisis Economics!

A return to the abyss.

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One interpretation of financial crises is that they are, in Nassim Taleb's phrase, "black swan" events—unplanned and unpredictable occurrences that change the course of history. But, in my new book on financial crises, *Crisis Economics* (Penguin, 2010)—which covers not only the recent crisis, but also dozens of others throughout history and across both advanced economies and emerging markets—I show that financial crises are, instead, predictable "white swan" events. What is happening now—the second stage of the global financial crisis—was no less predictable.

Crises are the inevitable result of a build-up of macroeconomic, financial, and policy risks and vulnerabilities: asset bubbles, excessive risk-taking and leverage, credit booms, loose money, lack of proper supervision and regulation of the financial system, greed, and risky investments by banks and other financial institutions.

History also suggests that financial crises tend to morph over time. Crises like those we have recently endured were initially driven by excessive debt and leverage among private-sector agents—households, banks and financial institutions, corporate firms. This eventually led to a re-leveraging of the public sector as fiscal stimulus and socialization of private losses—bail-out programs—caused a dangerous rise in budget deficits and the stock of public debt.

While such fiscal stimulus and bailouts may have been necessary to prevent the Great Recession from turning into Great Depression II, piling public debt on top of private debt carries a high cost. Eventually those large deficits and debts need to be reduced through higher taxes and lower spending, and such austerity—necessary to avoid a fiscal crisis—tends to slow economic recovery in the short run. If fiscal imbalances are not addressed through spending cuts and revenue increases, only two options remain:

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inflation for countries that borrow in their own currency and can monetize their deficits; or default for countries that borrow in a foreign currency or can't print their own.

Thus, the recent events in Greece, Portugal, Ireland, Italy, and Spain are but the second stage of the recent global financial crisis. The socialization of private losses and fiscal laxity aimed at stimulating economies in a slump have led to a dangerous build-up of public budget deficits and debt. So the recent global financial crisis is not over; it has instead reached a new and more dangerous stage.

Indeed, a practical definition of a financial crisis is an event that forces policy officials to spend a long weekend trying desperately to announce a new bailout package in order to avoid national and global panic before the markets open on Monday. In the past years, such weekend all-nighters dealt with the needed bailouts of private firms—Bear Stearns, Fannie Mae and Freddie Mac, Lehman Brothers, AIG, bank rescues, and so forth.

And of course, such weekend dramas are still with us, as EU and eurozone policymakers recently spent a desperate weekend developing a rescue package not only for Greece, but also for other weak eurozone members. The progression is clear: first came rescue of private firms, and now comes the rescue of the rescuers—that is, governments.

The scale of these bailouts is mushrooming. During the Asian financial crisis of 1997–98, South Korea—a relatively large emerging-market economy—received what was then considered a very large IMF rescue package of $10 billion. But, after the rescues of Bear Stearns ($40 billion), Fannie Mae and Freddie Mac ($200 billion), AIG (up to $250 billion), and the Troubled Asset Relief Program for banks ($700 billion), we now have the mother of all bailouts: the $1 trillion European Union-International Monetary Fund rescue of troubled eurozone members. A billion dollars used to be a lot of money; now one trillion is the "new normal" or—to paraphrase the novel and film *The Devil Wears Prada*—a trillion is the new ten billion!

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Governments that bailed out private firms now are in need of bailouts themselves. But what happens when the political willingness of Germany and other disciplined creditors—many now in emerging markets—to fund such bailouts fizzles? Who will then bail out governments that bailed out private banks and financial institutions? Our global debt mechanics are looking increasingly like a Ponzi scheme.

While the right medicine needed to avoid fiscal train wrecks is well known, the main constraint to fiscal consolidation and discipline is that weak governments around the world lack the political power and willingness to implement austerity. Political gridlock in Washington and in the U.S. Congress demonstrates the absence of the bipartisanship needed to address America's fiscal issues. In the United Kingdom, a "hung" parliament has resulted in a coalition government that will have a hard time implementing fiscal discipline.

In Germany, Chancellor Angela Merkel lost a key state election after the rescue of Greece, and Japan has a weak and ineffectual government that seems in denial of the scale of the problem that it faces. In Greece itself, there are riots in the streets and strikes in the factories; in the rest of the PIIGS (Portugal, Ireland, Italy, and Spain), fiscal discipline will be politically and socially painful. So political constraints may prevent fiscal austerity and structural reforms from being implemented.

As a result, "crisis economics" is likely to be with us for a long time. Indeed, the recent financial crisis is not over, and, worse, the medicine used to treat it may have been partly toxic. It seems to have made the patient weaker and more addicted to dangerous drugs, as well as more susceptible to new strains of the virus that may, in some cases, eventually prove fatal. ◆