Normalcy is Just a Few Bold Policy Steps Away

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The current financial crisis was built in steps, but it took a dramatic turn for the worse during the third quarter of 2008 after the Lehman-AIG events. Since then, gloom has taken over. Economic agents of all sorts, from creditors to consumers, are frozen waiting for some sense of normalcy to be restored. The main purpose of this article is to make the case that normalcy is much closer —just a few bold policy steps away— than is the conventional wisdom.

Implicit in my perspective is that the system we had before the crisis is not permanently broken, but rather that it mostly needs to be made more resilient to aggregate shocks, especially panic-driven ones.

I build my analysis and policy prescription on three premises and observations: First, before the crisis the world economy had an excess demand for assets, especially AAA assets, and this will not change significantly once the crisis ends. Second, and contrary to what investors thought at the peak of the boom, the (private) financial sector in the U.S. is not able to satisfy this demand for AAA assets when large negative aggregate events take place. However, the U.S. government does have the capacity to fill this gap, especially because it is the recipient of flight-to-quality capital, even when the core of the global financial crisis is located in the U.S. Third (and with the benefit of hindsight), the main policy mistakes were made during rather than before the crisis. In particular, policy has not adequately addressed, and sometimes has exacerbated, the extreme Knightian uncertainty that has paralyzed asset and credit markets.

These observations hint at a policy framework for the crisis and the medium run. For the latter, we can go back to a world not too different from the one we had before the crisis (real estate prices and construction sectors aside), as long as the government becomes the explicit insurer for generalized panic-risk. That is, while monolines and other financial institutions can lever their capital for the purpose of insuring microeconomic risk and moderate aggregate shocks, they cannot be the ones absorbing extreme, panic-driven, aggregate shocks. This must be acknowledged in advance, and paid for by the insured institutions. Reasonable concerns about transparency, complexity, and incentives can be built into the insurance premia. Collective deleverage, as currently being done, should not constitute the core response; macroeconomic insurance should.

The structural policy framework for the medium run also carries over to the crisis-policy itself. The essence of a solid recovery should build not from deleveraging and a forced brutal contraction of the financial sector, but from the explicit and systemic insurance provision against further negative aggregate shocks to their balance sheets caused by panic or predatory

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actions. The recent intervention of Citi, with a mixture of (paid) insurance and capital, is promising, and so is the second intervention of AIG (see the recent FT-forum articles by Caballero and Krishnamurthy, and Kotlikoff and Merheling 2008 for similar assessments). These interventions need to be scaled up to the whole financial system (banks and beyond), and it is better to do it all at once, for in this case the likelihood of the government ever having to disburse funds for its insurance provision becomes negligible.

The good side of panic-driven contractions (as opposed to those driven by more structural factors) is that the potential for a strong recovery is always around the corner. Although the current crisis has already caused enough collateral damage to add persistence to the recession, there are still plenty of resources waiting on the side to make a sharp rebound possible. With this I do not mean to say that this recession is an imaginary one. On the contrary, I believe it is a very serious recession. My point is simply that good policy has an opportunity to bring the recession back to familiar turf by defeating the extra gloom, and if this happens, the recession will become a manageable one from which current asset prices, on average, will look like once-in-a-lifetime deals.

Along the ideal recovery path described earlier, the real interest rate would remain at record low levels for a long time; risk-spreads and the VIX would decline gradually but consistently; asset prices and financial leverage would rise rapidly; the yen and dollar would depreciate vis-à-vis most other currencies, helping net exports in Japan and the U.S.; commodity prices would recover but not to record levels; postponed non-residential investment, inventory accumulation, and durable expenditures would snap back, joining and leveraging on the fiscal and monetary expansions; global imbalances would stabilize and build back a bit; unemployment would peak at single digit levels and then begin to turn around; and inflation would rise only gradually in the developed world, creating the needed space for a recovery consolidation.

There is no way out of a dreadful last quarter of 2008 and well into the first quarter of 2009. But the big difference with the consensus forecast is in the sharp recovery after that. The source of this difference is in the assessment of the dominant nature of the recession. Slow recoveries follow the typical credit crunch, as financial resources have to rebuild for growth to resume. But while I think this was the nature of the mild recession preceding the Lehman/AIG events, the dominant recession now is very different in nature. It is a systemic run on all forms of explicit and implicit insurance contracts, but with no shortage of resources on the side. If confidence recovers, the resources to support the recovery are abundant and ready. Nick Bloom, from Stanford, provides the best available evidence of how an economy is likely to react to a temporary bout of uncertainty. He estimates that such a shock causes a sharp contraction for two quarters, which is then followed by abnormally high growth. I think this is the correct way to view the current recession, as long as bold policy actions are undertaken.

Of course many things can go wrong to cause a disastrous outcome, but enough has been written about these negative scenarios. It is time to, at the very least, begin to sketch what the good scenarios may look like.