



Lost Decades

The Making of America's Debt Crisis and the Long Recovery

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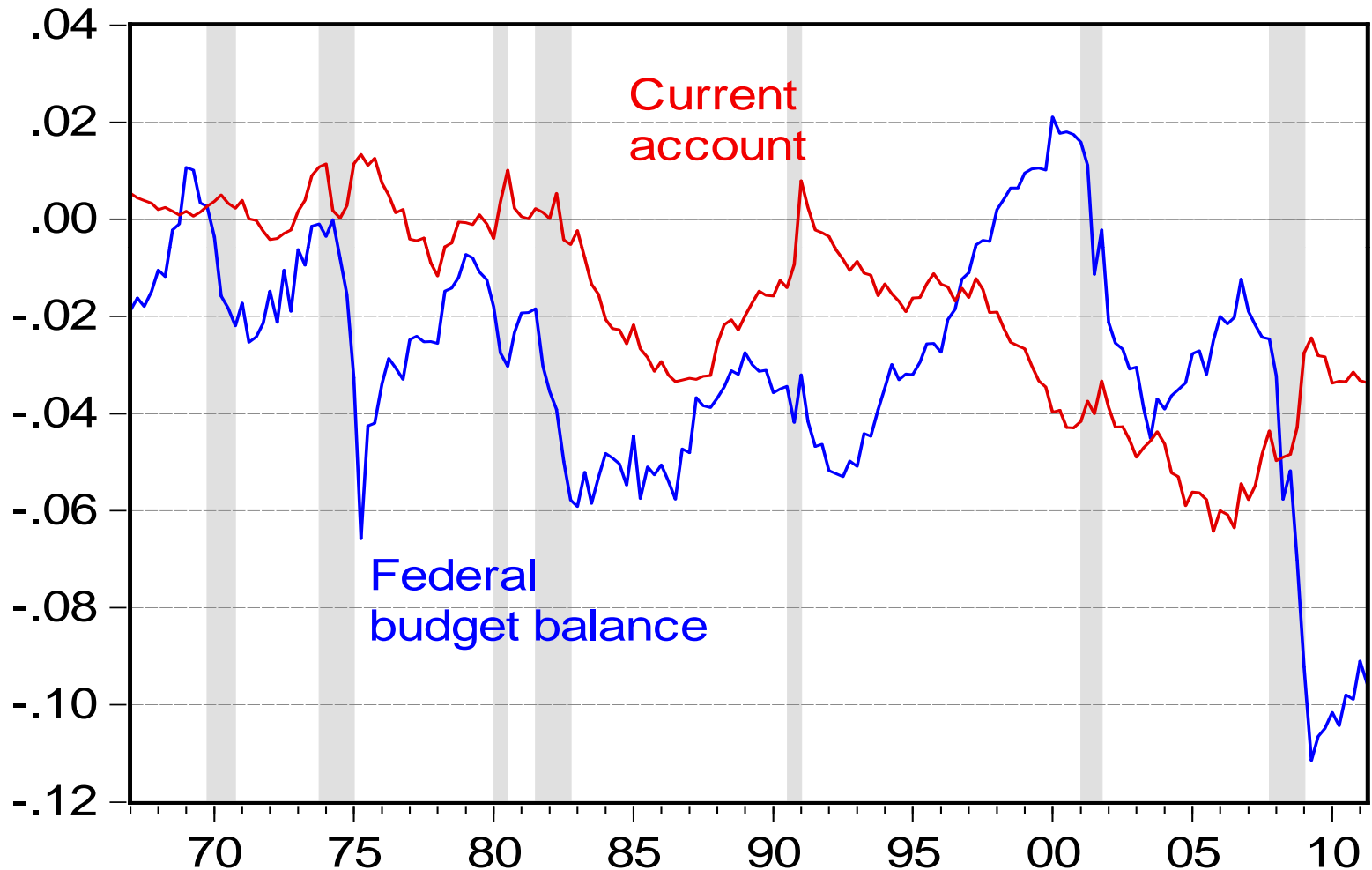
Rotary Club of Madison
January 4, 2012



An interpretation of the 2000's

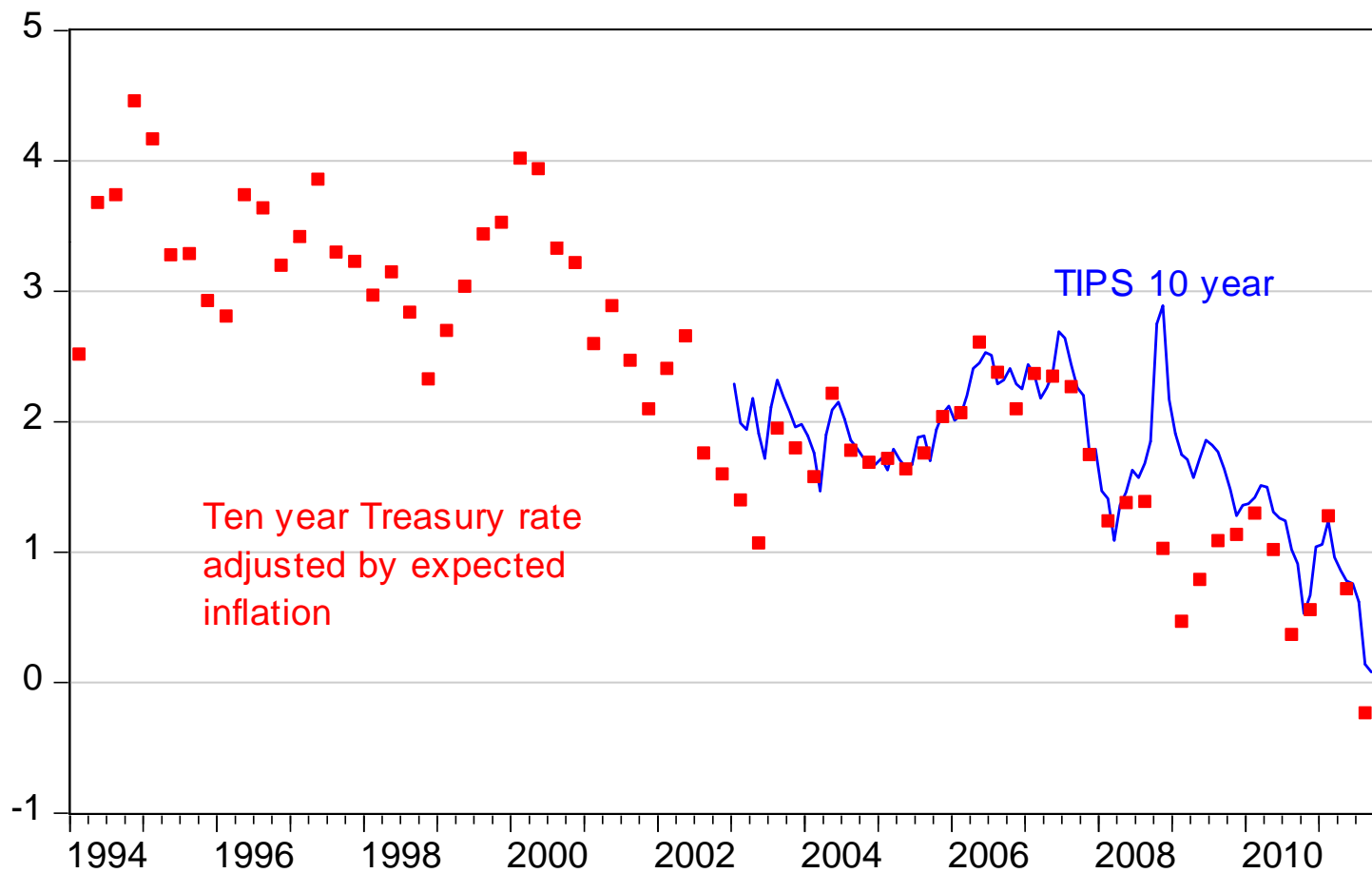
- Conventional capital flow cycle
- Excess saving abroad
- Low interest rates induce borrowing
- Borrowing by sovereign due to tax cuts, “global war on terror”
- Deregulation/non-regulation of the financial sector (incl. shadow banking system)
- Interaction with the tax system

Government and national borrowing



Note: Fed. Budget balance is net lending. Source: BEA

Real interest rates

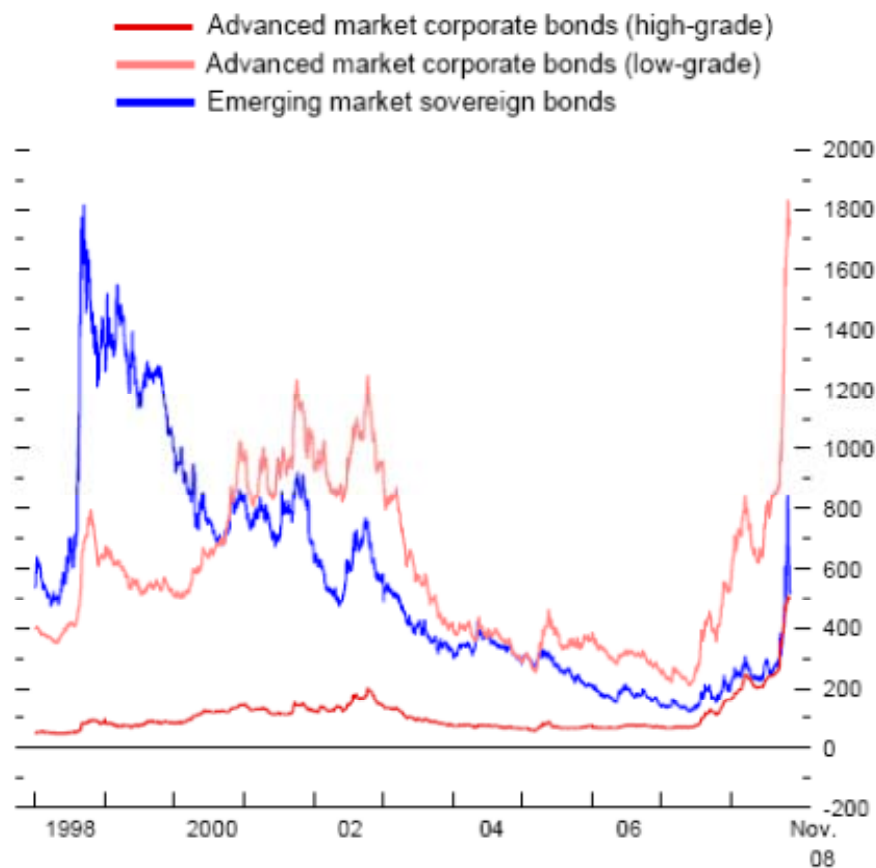


Source: Federal Reserve Board, Philadelphia Fed *SPF*

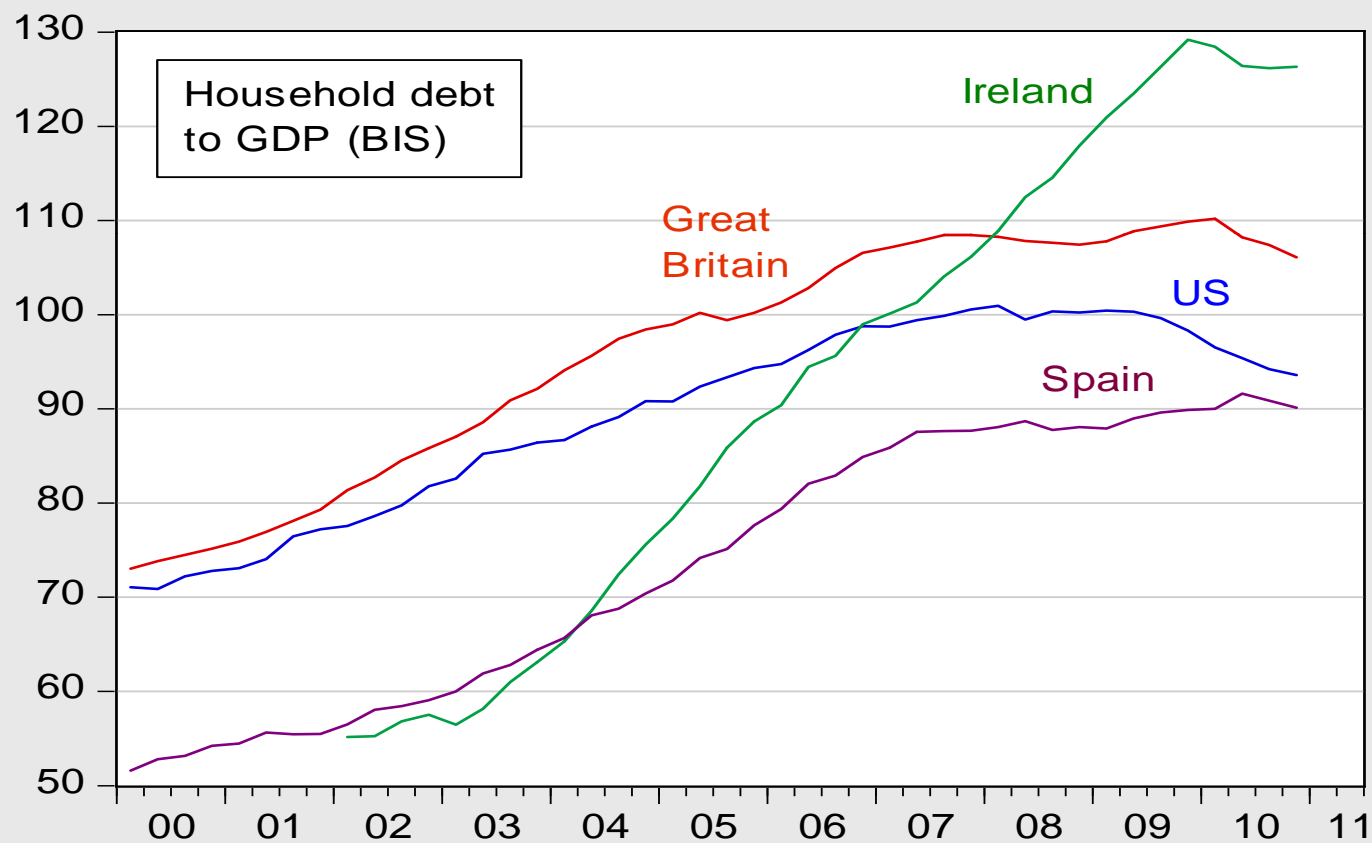
The “Disappearance” of Risk

Figure 3. Advanced and Emerging Markets: Sovereign and Corporate Bond Spreads, 1998–2008 ¹
(In basis points)

Source: IMF, *WEO* update, 11/6/08

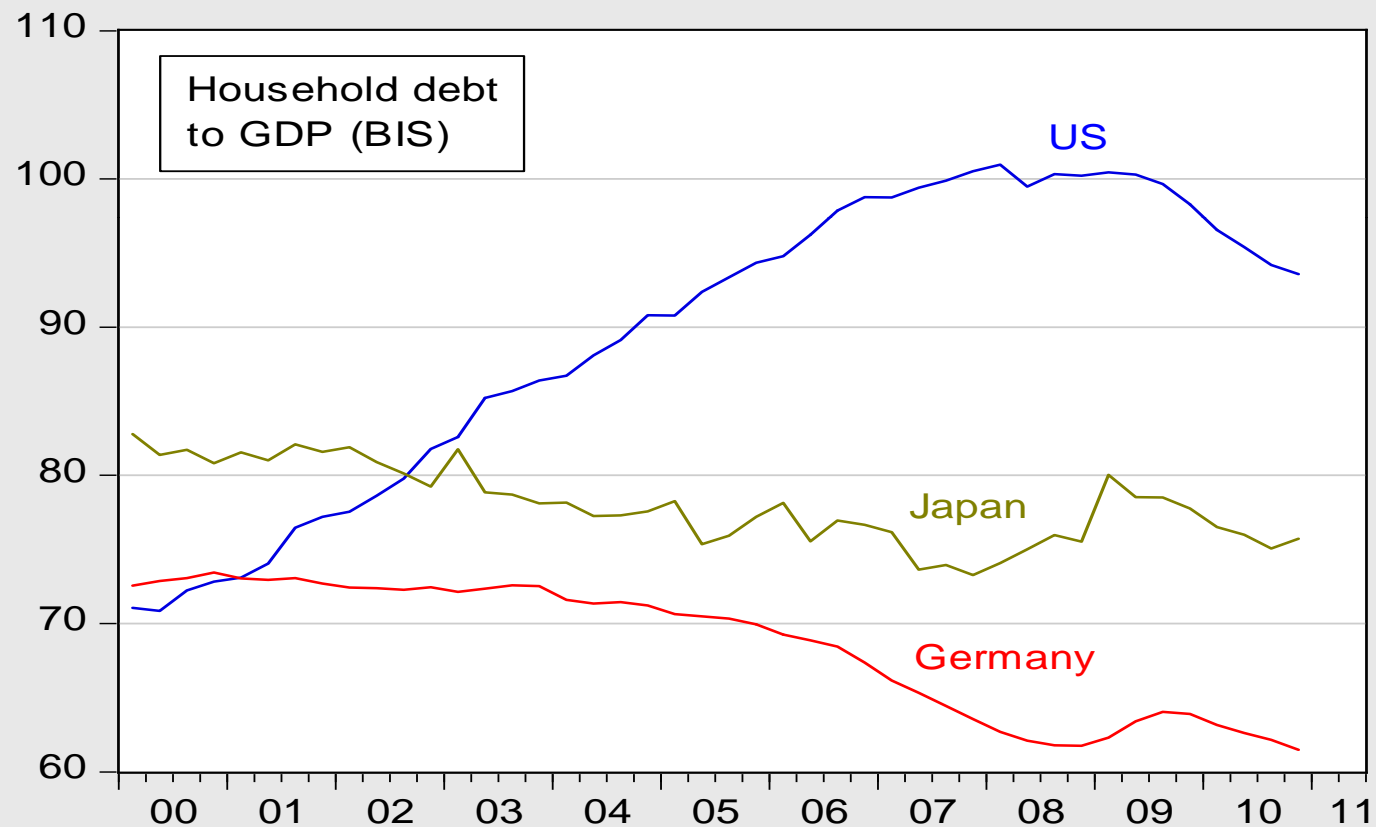


Household debt (I)



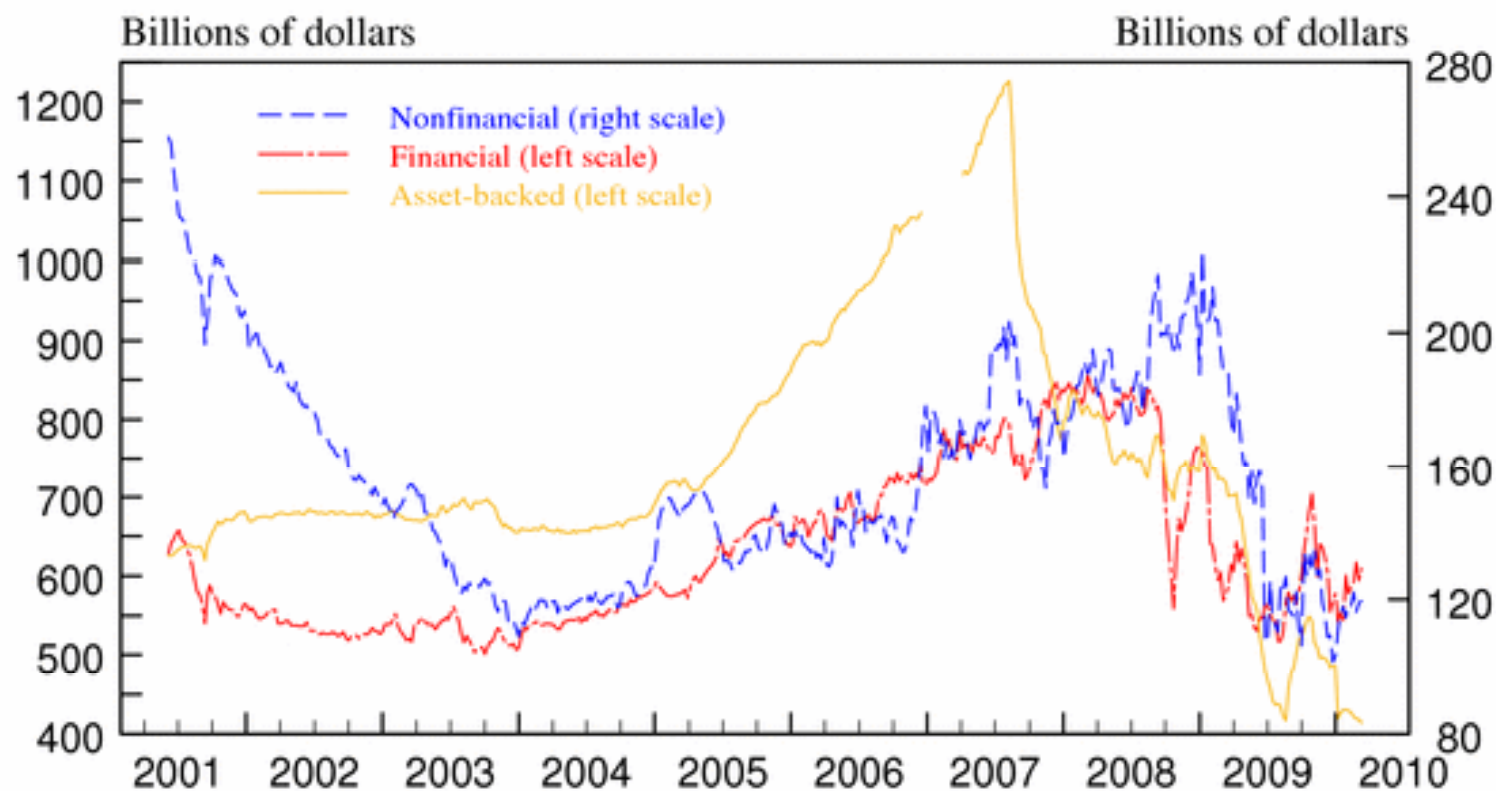
Source: BIS, *Annual Report* (2011)

Household debt (II)



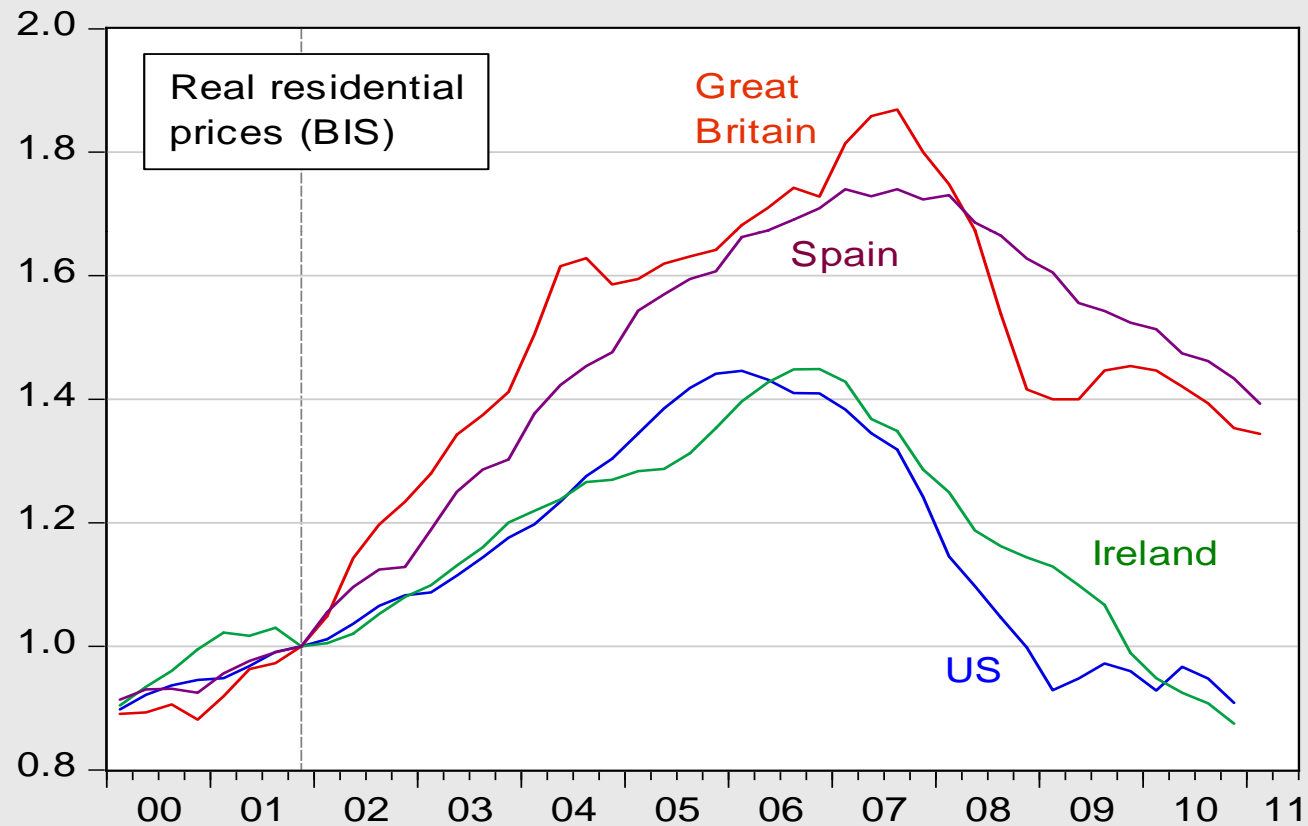
Source: BIS, *Annual Report* (2011)

Financial boom...and bust



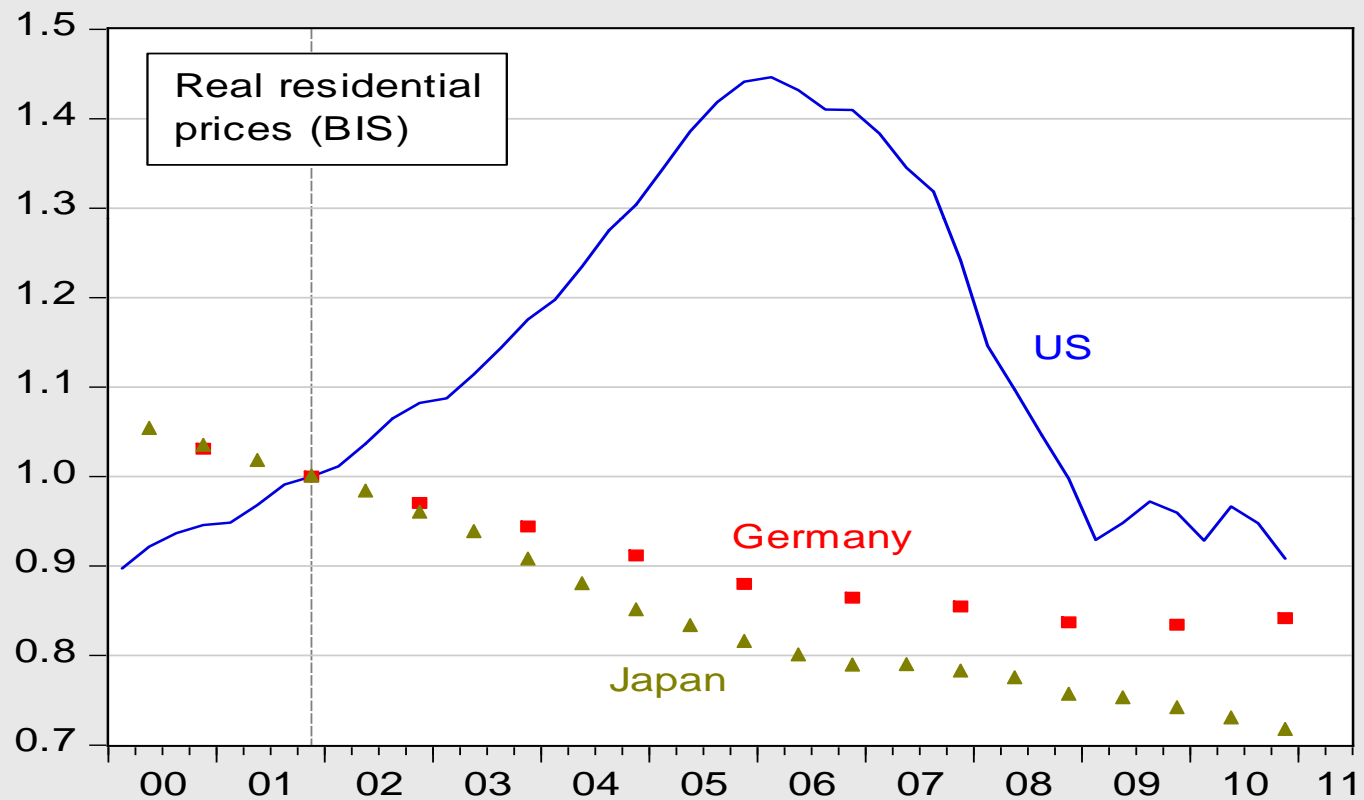
Source: Federal Reserve Board

Housing boom (I)



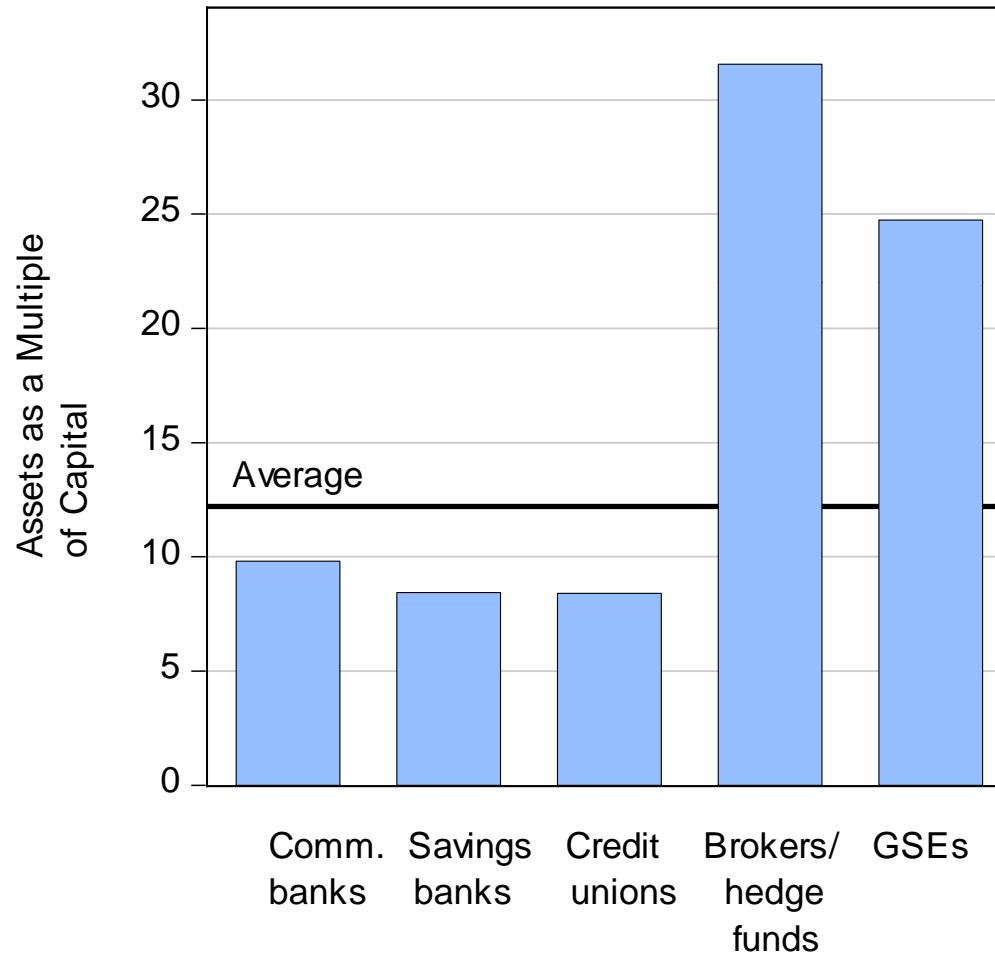
Note: Rescaled to 2001Q4=1.
Source: BIS, Annual Report (2011)

Housing boom (II)



Note: Rescaled to 2001Q4=1.
Source: BIS, Annual Report (2011)

Leverage (as of 2007)



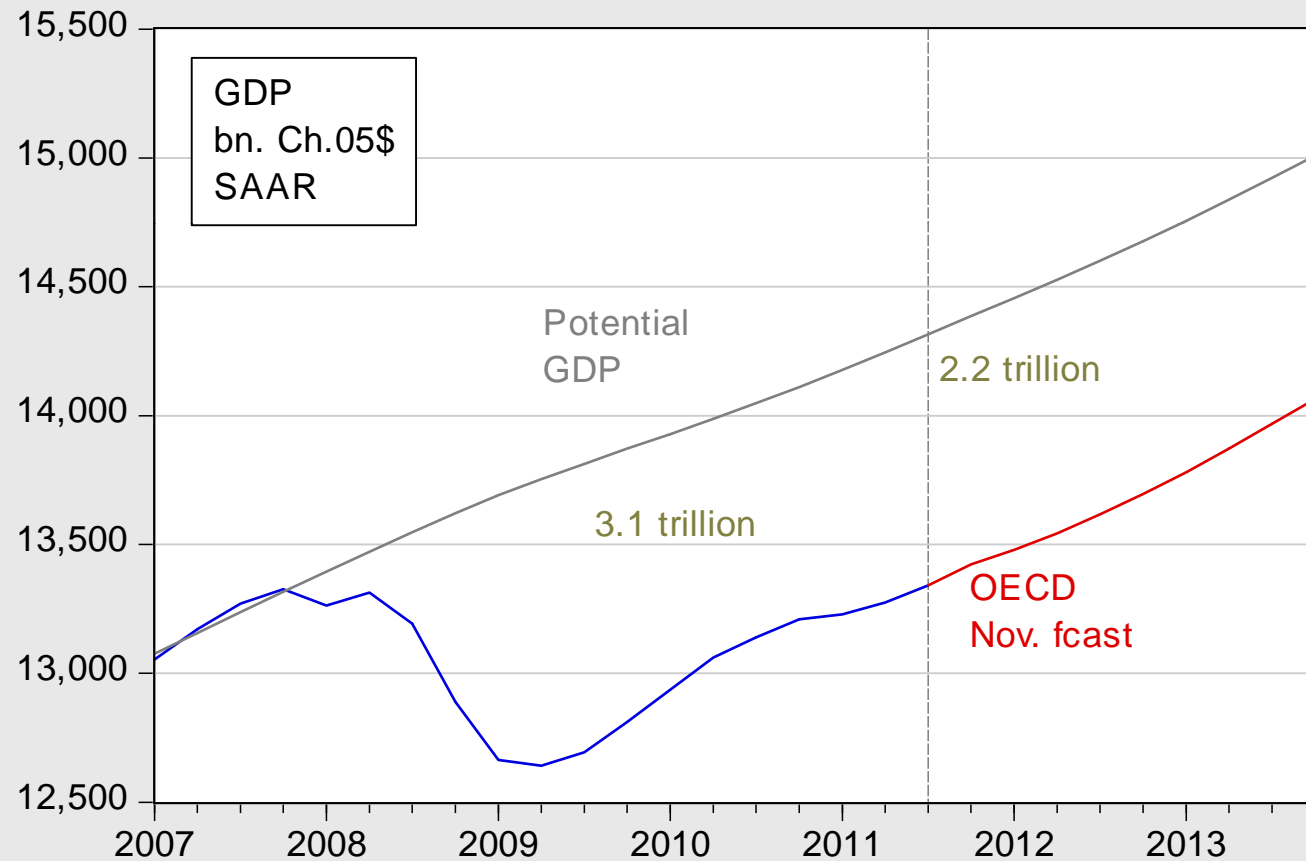
Source: Greenlaw, Hatzius, Kashyap, and Shin (2008)



And now, adjustment

- As with all debt crises, austerity
- Reduce consumption, increase savings
- Reduce imports, increase exports
- Reduce government spending, increase government revenue
- Reduce relative price of non-tradable goods and services
- Nothing pleasant

Economic Losses in the US



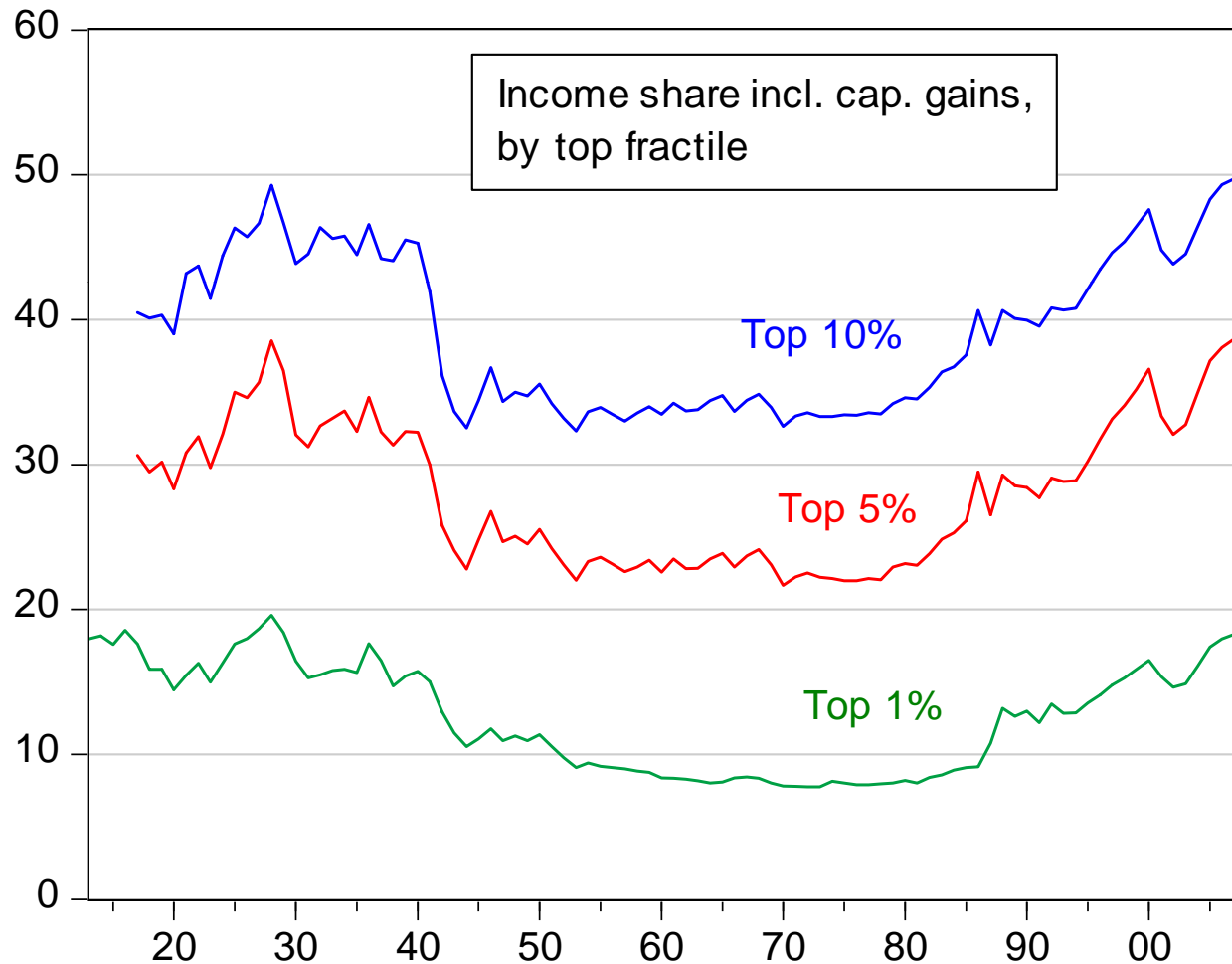
Source: BEA (2011Q3 2nd rel.), CBO, OECD



The politics of adjustment

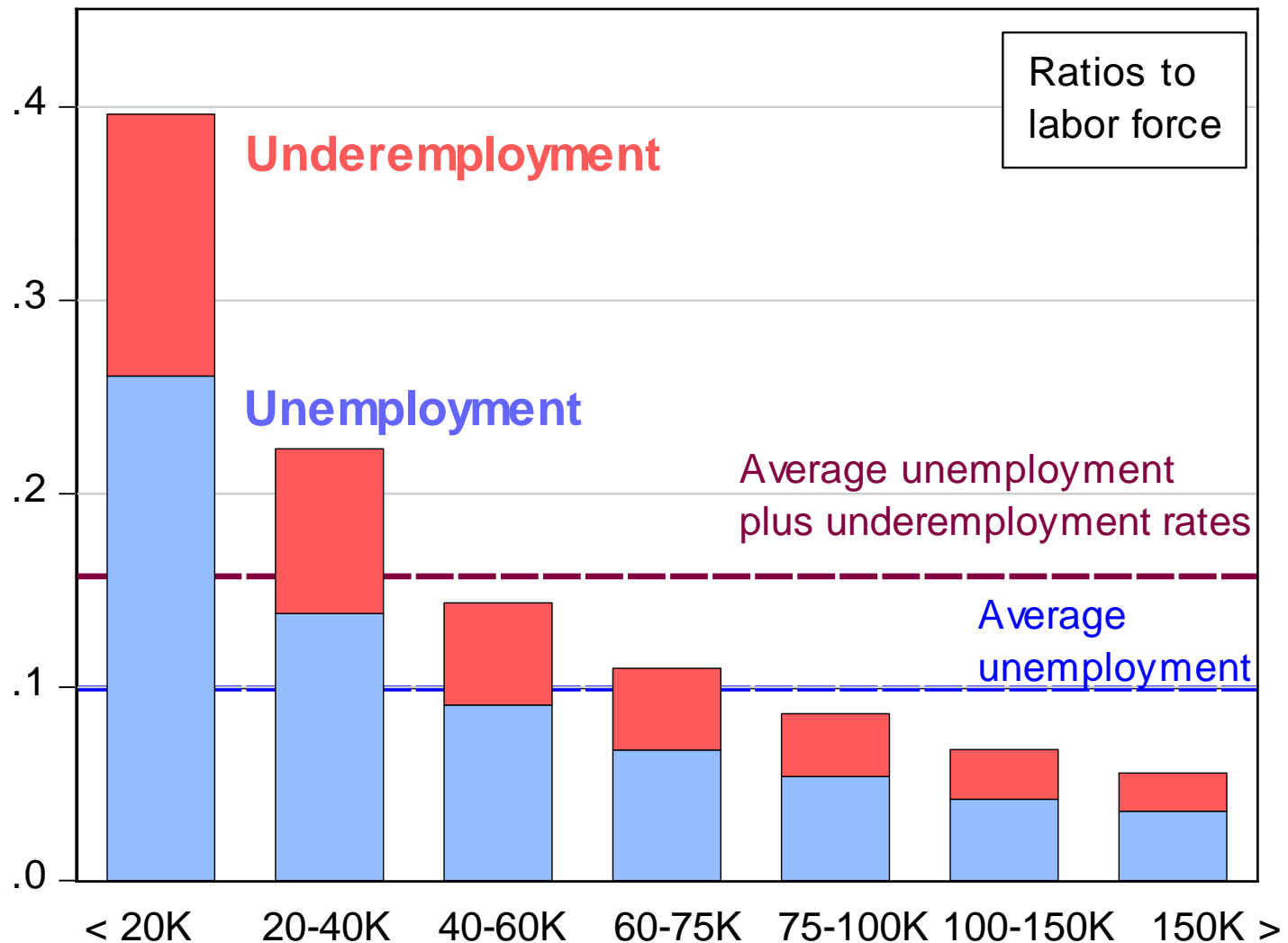
- Who will bear the burden of adjustment?
- Conflict among countries (cf. EU)
- Conflict within countries
- Heterogeneity of impact of the crisis
- Political economy implications: conflict at home and abroad
- The American example

Austerity amid increasing inequality

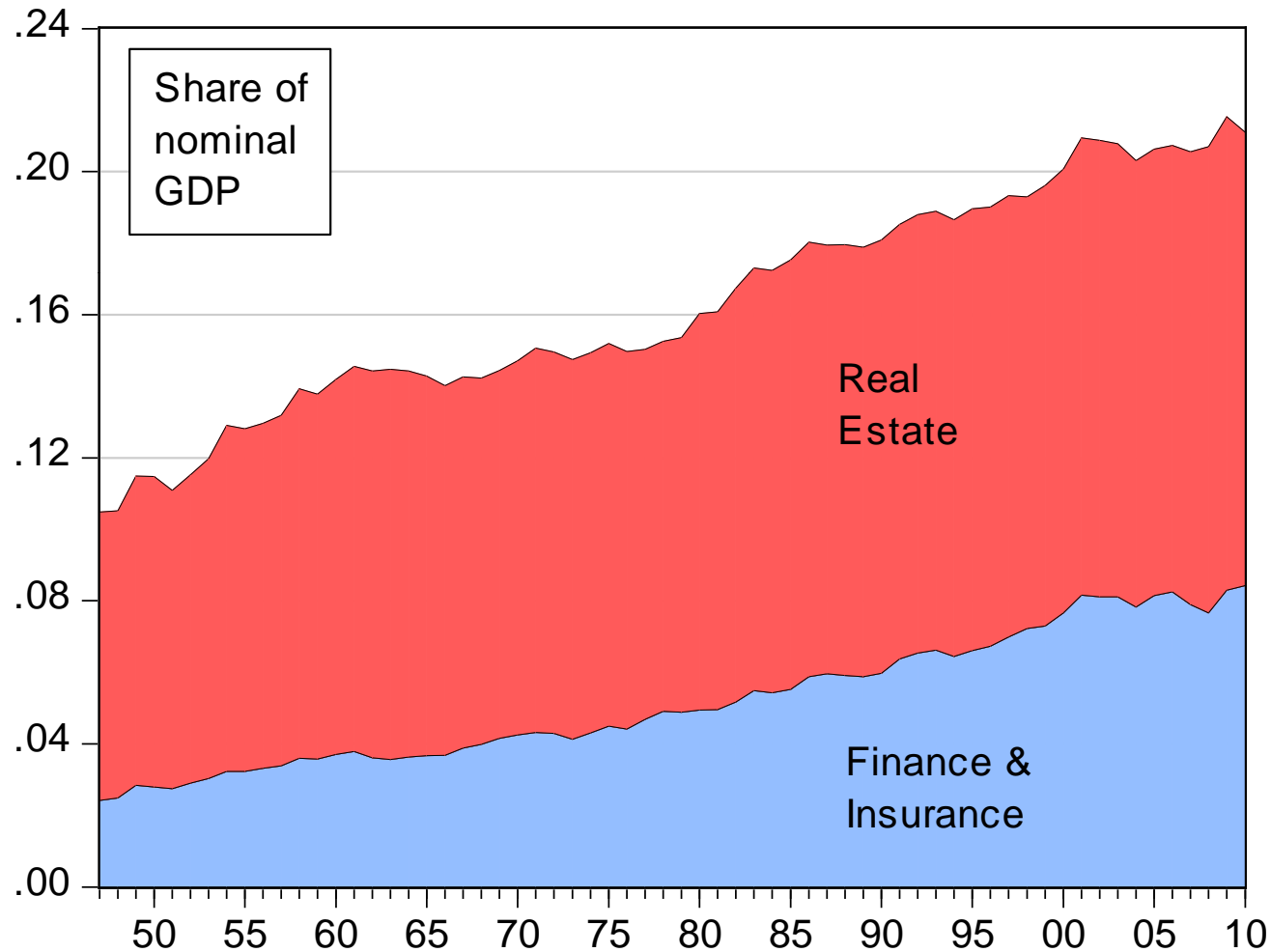


Source: Piketty and Saez

Incidence of unemployment, 2010



And a dominant role for finance



Source: BEA



Another lost decade?

- Adjustment will be painful, conflictual
- Policymakers and society resist facing consequences
- Problems not technical but political
- No resolution without burden-sharing, and little sign of willingness
- Delay increases cost



Summing Up

- Classic capital flow cycle: irresponsible lending, irresponsible borrowing
- Exacerbated by lax regulation
- Recovery impeded by bitter conflict over distribution of adjustment burden, within and across countries
- Resolution requires burden-sharing, at home and internationally – and little sign of this



More Information

- <http://www.ssc.wisc.edu/~mchinn/lostdecades.html>
- Macroeconomic outlook:
<http://www.econbrowser.com>
- CBO blog:
<http://cboblog.cbo.gov/>