Lost Decades
The Making of America’s Debt Crisis and the Long Recovery

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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

Ten year Treasury rate adjusted by expected inflation

Source: Federal Reserve Board, Philadelphia Fed SPF
The “Disappearance” of Risk

Figure 3. Advanced and Emerging Markets: Sovereign and Corporate Bond Spreads, 1998–2008

Source: IMF, WEO update, 11/6/08
Household debt (I)

Household debt (II)

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

Income share incl. cap. gains, by top fractile

Source: Piketty and Saez
Incidence of unemployment, 2010

Average unemployment plus underemployment rates

Average unemployment
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](http://www.ssc.wisc.edu/~mchinn/lostdecades.html)
- Macroeconomic outlook: [http://www.econbrowser.com](http://www.econbrowser.com)