In the Aftermath of the Financial Crisis of 2008: What Have We Learned?

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Editors: Luisa R. Blanco and Michael Crouch
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* Lecture transcribed by Lara Arsinian (MPP candidate ’12)
Message from the Editors

Dr. Luisa R. Blanco, Editor
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In the aftermath of the financial crisis and economic recession of 2008, it is important to reflect not only on its causes, but also on specific policies that can help countries to move towards sustained economic growth. This publication provides a compendium of lectures that intend to do this. The focus of the discussion is around the U.S. (first two chapters) and Latin America (last chapter), which enhances our understanding of the forces at play and the necessary policies that need to be implemented in different regions of the world.

Dr. Lee Ohanian points to the strange differences between the U.S. recession and other recessions around the world. The problems in the U.S. markets arose from misallocations of labor, rather than falling productivity around the world. His conclusion is that the data show that these errors were caused by policy, not a misshapen financial sector. Next, a case for the misalignment of the recession and the beginning of the financial crisis is made by Dr. Scott Sumner. The recession fueled the financial crisis, and not the other way around. While there was a misallocation of resources brought about by bad policy, smoother roads will be found when all, including policy makers, take the Efficient Market Hypothesis more seriously. Dr. Sumner concludes that a forward-looking monetary policy approach is needed. Finally, Álvaro Vargas Llosa gives a perspective of the effects of the recession in Latin America. While many have suffered, the region has done relatively well in terms of growth in comparison to other previous financial crises. However, this growth might prove ill-timed if it encourages bad policies to continue in some countries. He recommends specific policies for the region to avoid the mistakes from the past and provides a course of action for U.S.-Latin America relations.

Like it has with the Great Depression, the question of why this recession happened will be debated for years. We hope that this collection of thoughts will further the discussion of the cause of the Great Recession and the needed policy change for improving economic conditions in the future around the world.
The Great Recession:
A Comparison Across Time and Across Countries

Dr. Lee E. Ohanian
Professor of Economics, UCLA

Abstract

Many myths persist pertaining to the recent Great Recession, several of which are related to the Great Depression. The Great Recession looked different in the U.S. than it did in any other country. For the U.S., it was mainly a failure of the labor markets, and for other high-income countries there was a large drop in productivity. The data shows that the financial hypothesis does not fit well with the Great Recession, but rather goes along more with the policy hypothesis. The Great Recession was at its worst after many of the financial meltdowns occurred, but heated up with the Depression rhetoric of the White House.

I. Where Has the Crisis Left Us?

From 2007 to 2009, the U.S. and countries around the world experienced what economists call the “Great Recession.” Although in many respects, some features of the Great Recession continue, economists and policy makers are still trying to understand the three W’s of the Great Recession: 1) What happened? 2) Why? 3) The Way out. To help in the consideration of the causes of the Great Recession, two important questions must be answered, which several economists were asked to write about under the title “Macro after the Financial Crisis.” The first question was what view should be taken of the crisis, and the second is what is the future course of macroeconomic theory and how will it evolve following the crisis. In particular, what made the crisis and recession run so deep, why has it lasted for such a long time, and how and why does it differ across countries?

Looking at the Civilian Employment Rate, which is the number of workers per civilian in the working age population between 16 and 65 years old, we observe that the economy is fairly stable from 2002 until 2007. During this period, jobs were being created at roughly the rate of population growth. And then we see the Great Recession of 2008-2009, where employment drops significantly. The National Bureau of Economic Research, which is a nonpartisan collection of economists, has a business-cycle-dating committee, and their charge is to date the start and the end of recessions. The National Bureau of Economic Research dated the end of the Great Recession in the middle of 2009. However, the unemployment rate has not changed much since the Great Recession was termed to be officially over. So what we want to take away from this is that we had a remarkable rise in unemployment, and job numbers have yet to come back to pre-Great Recession levels.
II. “Who Dunnit?: Finding the Culprits of the Economic Crisis

By some measures, this recession is like a lot of other economic crises. It is a little bit of a murder mystery. What is meant by that is that when good economies go bad—good economies being the U.S. or Japan or other economies in Western Europe—it is a little bit like a “who dunnit.” The economy is like a novel where there is a victim and there are typically a lot of interesting, possible suspects. In terms of the current recession, there is a common view held by many that the Great Recession was caused by the financial crisis (the chief suspect in our novel) that came ahead of it in the fall of 2008. And it might certainly be the case, but no economic theory we have on the table, including economic models that feature financial market imperfections or financial market frictions, is at all consistent with the facts. The purpose here is to set out which theory is consistent with the facts and which theory is far away.

Consider real GDP, gross domestic production of final goods and services, on a proportional scale. The U.S. has been a remarkably stable and prosperous country, experiencing long run records of growth from 1800 up until around 2006.3 There has been remarkable growth enjoyed by citizens of the U.S. When the expected economic growth is compared to the actual economic performance of the past thirty years, the smooth economic trend line and the actual economic performance are remarkably similar to each other.4 This all came to an end with our most recent recession. While the Great Depression economy was about 35% to 40% below trend, the last 30 years has been almost zero. Zero means that the actual performance and the trend is the same, plus or minus 4%. So almost always the economy is within 2% to 3% of its trend behavior. There is remarkable stability and growth for the thirty years before the Great Recession.

Some would use this as evidence that the Great Recession is much worse than anything since the Great Depression. Yes, it is much worse, but it differs in a number of other ways that point out why the common thinking about the Great Recession has been wrong. To start, remember that real GDP per capita, which measures how much income is generated per person, depends on worker productivity and the total labor force. So any economic downturn, whether it is the Great Recession or any other, must be due to either lower worker productivity or lower employment. The percent change in real GDP per capita is equal to the percent change in economic activity in any point in time, and this is equal to the percent change in productivity and the percent change in the labor force. Almost all previous post-World War II recessions are largely due to fairly small drops in unemployment and fairly large drops in productivity, while the current recession is totally the opposite.5 In the current recession, there is almost no productivity change, and the drop in income and output is all due to a drop in employment.

Now, the Great Recession that hit European countries and other advanced countries such as Japan is exactly the opposite. Those recessions also had very large drops in income and output, but they were almost entirely due to drops in productivity, not drops in employment.6 Very similar financial crises hit all these countries, in which the values of mortgage-backed securities became impaired.7 So one question is that with all of these similar financial crises, why do these recessions look so different across countries?
In all post-war U.S. recessions, real GDP fell between peak and trough by about 4.5%. Employment, an alternative measure of the total output of hours worked, fell roughly 3% to 4%. Now in the Great Recession, the output drop is much larger, but the drop in labor input far exceeds in relation to any previous recession. This stands in contrast to the other G7 countries, where they had drops in output, production and income almost 3 percentage points higher that the U.S. However, they had relatively mild declines in employment. This allows for the assertion that the U.S. recession is all coming from drops in the number of people working. The European and Japanese recessions are not involving so much a decline in people working, but rather lower productivity on the part of those employed.

III. Diagnosing the Causes of the Crises

Recent research by economists provides a tool kit that helps identifying and understanding proximal causes of recessions, which works analogously to how physicians diagnose an illness. For example, if you are not feeling well, you go to see a doctor. What doctors do is measure deviations from normal patterns like heart rate, blood pressure, respiration, or body temperature. They use thermometers and different tools to determine whether any of your vital signs are substantially different than normal. So if you have a temperature of 103 degrees, they will say you have a fever because that is a substantial departure from normal 98.6 degrees. Having a fever points us in the direction of diagnosing an illness that is associated with producing a high fever as a symptom.

Economists go through the same process here with economies and, in place of thermometers, they use some different tools to help us understand departures from normalcy in labor markets, capital markets, and an economy’s ability to combine capital and labor to produce output. These are business-cycle diagnostics. What needs to be asked are three questions: 1) Is the labor market functioning normally? 2) Is the capital market functioning normally? 3) Is production functioning normally? And based upon the outcome of asking those questions, economists will get some hints of what might be going wrong with the economy. Much like a doctor gets a hint from understanding what is wrong with the patient that has a fever, high pulse rate, or otherwise.

This leads to the question: are the usual constructs of supply and demand being equated? When thinking about markets and the economy there is demand and there is supply, and the price of that market is what equates demand and supply and creates market clearing. Supply and demand become equal to each other because the price in that market moves to bring supply and demand into balance (the wage rate and return to capital are the prices of the labor and capital markets). During the recession, is that true? Is the labor market in equilibrium? Is the capital market in equilibrium? Have the efficiencies in production changed? Has the productivity declined? These questions are grouped into labor deviation (the extent to which supply and demand of labor are not coming together), investment deviation (the sense in which supply and demand of capital have not come together) and then the sense in which there is a disturbance or change in productivity.
Just like there are large differences in the sources of the drop in output across countries, in terms of employment in the U.S. and almost all in terms of productivity in Europe and Japan, we are going to see that these different changes are related to different departures from normalcy. If the percentage deviation from normal in the labor market and the capital market and in productivity is considered, it is easy to see that negative deviations mean that the market is not functioning correctly in such a way as to depress employment, output, and investment. In the average post-war recession, there is a fairly small change in the way that the labor market works. Very small recessions occur at about 2%. Comparing that to 13% during the Great Recession shows that there is a stark difference. To give a clearer idea, it has never been this big other than in the Great Depression. It is about 5 to 6 times greater than normal in terms of departure. For regular recessions, it is similar to walking in the doctor’s office when she has seen you a number of times before, and she says that, “I checked your temperature and it is 99 degrees. A little bit high, but nothing to worry about.” For the Great Recession, she says, “You have a fever of 103.5 degrees. We have to give you medication right away or check you into a hospital.”

The capital deviation is the extent to which the capital market is not functioning correctly. In past recessions, the numbers are positive meaning that, paradoxically, during recessions, capital markets seem to work a little better. And in the case of the Great Recession, it is very close to zero as well. So using this analogy, by going back to the doctor’s office, the economy has walked in and says, “I am not feeling well.” The doctor takes a temperature and she says, “I am measuring 98.6 degrees, so whatever is ailing you is not associated with a fever or any diseases that produce a fever.”

The third part is productivity, or how productivity changes. During recessions productivity falls at about 2.2% on average. That means that if everything in the economy is the same, all the same people with their usual jobs are producing 2.2% less output or less income. This average is quite large, but during the Great Recession, there was no drop at all, with no change in productivity. The same statistics produced for the other high-income countries show that the labor market seems to be working pretty well, but the culprit is lower productivity, the opposite of what is seen in the U.S. Whatever is ailing the U.S. economy seems to be very different than what seems to be ailing Europe and Japan. The problem is manifesting itself in the U.S. through a problem in the labor market, and it is manifesting itself in the other high-income countries through lower worker productivity.

Next, using the economic models that economists frequently use to study recessions, there are some interesting results. If we simulate those models in response to the labor market dysfunctions as the only problem, we see that what is predicted is very close to what actually happened. The model says there should have been a big drop in output and there was, there should have been a big drop in labor input and there was, and there should have been an extraordinarily large drop in business investment and there was. Using the analogy of the “who dunnit” novel, detectives are looking for clues and the clues are pointing to something funny going on in the labor market. In summary, the Great Recession in the U.S. has a labor deviation problem, whereas other
high-income countries have labor markets that seem to function a little bit better, but rather have a productivity problem.

IV. Varying Hypotheses Behind the Great Recession

There are two different hypotheses about the Great Recession on the table. The most popular one by far is the financial hypothesis, and the second is the policy hypothesis. Prominent economists have argued for both, including in favor of the policy hypothesis, like Edward Prescott who is a Nobel Laureate. The financial hypothesis is straightforward: the basic message is that the decline in the values of asset-backed securities (such as mortgaged-backed securities) and the near failures of important financial institutions reduced the amount of intermediation or banking services that were being provided, and this reduction in banking production reduced output employment.14 The argument for the financial hypothesis as the cause of the recession is that: 1) the crisis was very severe, 2) the timing seems to coincide fairly well, 3) economists often associate financial crises with economic downturns such as the Great Depression, and 4) that economists do have theoretical economic models in which imperfections reduce employment and output.

The evidence certainly seems very powerful. Many people are convinced of this. The financial hypothesis may ultimately be why there is such a severe recession. But there are some questions in relation to this hypothesis. How much did intermediation services fall at the aggregate level? Somewhat of a surprise is that consumer lending was largely unchanged, and banking credit did fall, but it did not fall until the crisis was over. Consider households, which are what should be looked at because they ultimately own businesses. The measures of the total liabilities of households in the non-financial businesses they own show that from 2007 to 2009, there is not much change. We do not see an aggregate drop in the liabilities of households; and the composition of these numbers is not very different for mortgages, corporations, loans, and other assets. Another way to think of this is to imagine that you are told that we are in the middle of a financial crisis; you would expect a large crunch in the total liability structure of households. Consumer lending actually rose throughout the recession, and when the National Bureau of Economic Research said the recession was over, only then did it decline.

Another measure of how much service is produced by the banking sector is the ratio of bank credit to total GDP. There is a remarkable run up in the 2000s reflecting partial financial innovation and partially the very popular practice of making subprime loans. The banking sector did not collapse in terms of the amount of services they were providing in the economy. This is something that is not very well known particularly among lay people. Looking at loans and leases through 2008, it is seen that through the failure of Bear Stearns (an investment bank), the failure of Lehmann Brothers, the bailout plan, TARP, the failure of Washington Mutual, and the Wachovia take-over, there is a small change in lending.15 Economists also use models to try to understand how financial crises can reduce employment output. Using the investment deviation from earlier, economists currently have to think about how financial crises or how a reduction in output of banking services contributes to a major recession through that investment deviation. The banking
V. Comparisons to the Great Depression

All of the comparisons have been between the Great Depression in the 1930s and the Great Recession. President Obama uses that analogy, and before him, President Bush did the same. The standard view about the Great Depression is that it started out as an ordinary recession and then, like the classic Jimmy Stewart movie *It’s a Wonderful Life*, there is a run on the savings and loans, and everyone goes to get out their deposits. That is a problem for a bank, because banks hold only a small fraction of deposits on reserve and invest those deposits in a variety of projects. And when the bank runs out of money, that spells trouble, which is the myth of the Great Depression.

There are two myths about the Great Depression: 1) that the crisis was quantitatively large and 2) the timing coincides with the financial crisis of that time. Both of those are not true. In 1930, the share of deposits in banks that either failed or suspended operations for a short period of time (what happens when a bank says, “Come back in a week, because we do not have the money now.”), is very small: 2% in 1930, 4% in 1931, and 2% in 1932. The way to think about that is that 98% of bank deposits are having no trouble whatsoever. Banking crises in the Great Depression were not quantitatively large, and the timing of these banking crises does not correlate with the time in which the Great Depression took place. It is important considering the number of hours worked or employment in the industrial sector from January 1929, before the Great Depression and the stock market crash to October of 1930. Nobel Laureate Milton Friedman argued that there was a banking crisis in November 1930. This crisis was located in Nashville, Tennessee, and it did not spread beyond that. Looking at how economic activity fell before the first banking crisis, we see the industrial sector declined 30% before that small first banking crisis. It is simply not true that we had a garden-variety recession that was then turned into a Great Depression via banking panics and large declines in the money supply. The money supply is what Milton Friedman liked to look at. There was no substantial decline in the money supply. So the punch line here is that the Great Depression was indeed great: it was great before any type of contraction in the money supply and indeed great before any type of banking difficulties.

VI. Myths of the Great Recession

There are other myths about the financial sector in relation to the Great Recession. One is that businesses have come to a standstill. The fact is that among major businesses, investment is almost entirely financed internally. What that means is that for major corporations such as Microsoft, 3M, and IBM, almost all the investment they do is from their internal cash. Those companies have enormous internal cash positions. For both large corporations and small businesses, 84% of investment is financed internally. In fact, 67% of firms do not even use external funds or external bank lending. Capital sector is not functioning well which means the capital market is not functioning well. Supply and demand are not being equated. That is how economic theories work, and it is not surprising if there is a substantial disruption in the financial system, which is going to have its biggest impact in the capital market.
spending and available funds, which are the cash within a corporation, allow corporations to very easily fund their own investment. What about smaller companies? If that is the case, then the corner mom-and-pop grocery should contract a lot more because they cannot get financing. What we see is that before the recession in the fourth quarter of 2007, at the height of the financial crisis of 2008, and then a year later, the smallest corporations did not decline in their share of the economy. Under the standard assumption, small corporations were just hammered. That is not true.

Another myth is that when economies go through financial crises, they take a long time to recover. It really depends on the types of policies they follow afterwards. Take for instance the GDP of Finland and Japan. They both had financial crises in the early 1990s. Japan propped up weak banks that in turn took government funds and loaned those funds out to their near insolvent customers. What happened to Japan was a 15-year period of stagnation and decline. On the other hand, Finland was very aggressive. They told the banking system to get their act together because they were not going to prop banks up. And Finland did have a serious, but quick recession, and recovered quickly. Japan's crisis was stretched out for a long period of time. Similar stories were told in Chile and Mexico. Mexico kept poor banks in business. Chile did not. Chile had a remarkable recovery. Mexico continued to stagnate.

**VII. Looking for an Alternative Hypothesis**

Any story that can help us understand the financial theory of the recession requires us to come to grips with the idea that many facts about the financial system and economy are simply out of line. And moreover, tax dollars were placed in those banks in the fall of 2008. That was almost two-and-a-half years ago, and Citibank and Bank of America have tons of cash now. If it was just the financial system, why have we not recovered by now?

What about the policy hypothesis? The idea there is that government policy makers panicked and put into place “crisis management policies.” There is always an enormous demand for “crisis management policies” that arises during any economic crisis in which politically important or politically connected constituents go to the government and say they need to be rescued. It certainly happened here. Banks were rescued. GM was rescued. Chrysler was rescued. They are all important. The mom-and-pop store down the street did not get rescued because they are not that important to the overall economy. Many economists say that many of these policies were not designed well. In fact, policies were not communicated well. Some economists talk about how in September 2008, Hank Paulson, Secretary of the Treasury, went to George Bush and said if TARP was not passed, the program in which the government was going to buy up subprime mortgage-backed securities, we might not have an economy in another week. The next day, every newspaper had the headline that George Bush said we are on the precipice of another Great Depression. There is something to be said about not crying fire in a crowded theatre, and this was a case of the government crying fire in a crowded economy because immediately after this period, the economy contracted significantly.
One reason economists have advocated this policy hypothesis is because some government programs did not work well. The economy really contracts when the American Recovery and Reinvestment Act that was advertised to keep unemployment from rising above 8%—it went to about 10%—and you see employment falling very quickly as we have TARP continuing and Cash for Clunkers. Employment just stays down. Also, these government programs are very expensive. If we were to pay off all the debt we owe, we would have to give up one year’s worth of GDP. With the exception of World War II, where the government spent a lot of money to fight the war, the debt-to-GDP ratio has never been this high.

Almost all economists agreed that temporary tax rebates do not work well. The government, both in 2008 and 2009, sent tax rebate checks primarily to low- and middle-income households. The idea was that consumers are not spending enough. If the government can just get consumers to spend more, then those dollars will go into businesses, and businesses will hire more people. However, Milton Friedman’s permanent income hypothesis emphasized that temporary transient changes in income are not going to be spent by consumers, because they are looking not at their income today but their prospects tomorrow and in the future. That is exactly what happened with the tax rebates of 2008 and 2009, consumer spending did nothing. Tax rebates just raised the federal debt substantially. John Taylor, Under Secretary of Treasury under both George W. Bush and George H. W. Bush, emphasizes that sales were hugging the trend line, and then it extrapolates the trend line. He observed that everything changed when Paulson and Bush start talking about the Great Depression in relation to the trend. People were uncertain of the future and the economy to come. Consumers were thinking about buying a car or a big ticket item at the time, but with policy makers talking about a Great Depression, consumers preferred to wait and see how the economy would evolve over time. Another indicator to look at is the spread between London Interbank Operator—the measure of short run operating costs—and interest rates in the U.S. The idea is that when the spread increases, that is a sign of some type of distress. There is a small increase after the Lehman bankruptcy, but a huge increase right after Paulson, Bernanke, and Bush start talking about another Great Depression. It begins to go down after the government completely reverses course and says that initially the plan was to think about TARP. Then the government said we are not going to do that. We are going take an equity position with banks, which most economists think should have been the practice from the beginning.

Also, we can remember Cash for Clunkers. The idea was that the consumer was going to get a new car, and the government was going to give the consumer a check for the old one. The effort here was to increase the demand for cars and help out Detroit. What happened: big increase in demand during Cash for Clunkers. Then car sales plummeted and, in fact, they were lower than what they were in the fall of 2008 when the crisis was at its peak. There is a similar picture for mortgage modifications and the tax credit for mortgage buyers. There was a big increase in demand during the period when the consumer received the tax credit and after that, a plunge. Again, home sales are much lower now than in the fall of 2008.
VIII. Conclusion

The Great Recession is all about a big and very persistent loss due to the labor market dysfunction, nothing like anything in any previous U.S. recession. If it is a financial crisis, why has it manifested itself in terms of labor markets? Why is there no rise in employment? Labor market distortions reflect on certain actions by employers and on government programs. Employers are saying, “I do not know what is going to happen with tax policy; I do not know what is going to happen with government regulation. I think I will increase the hours of work of my existing employees and not necessarily add new people.” That has been an important part of why we have not come back due to the loss of human capital. Half of the employment loss in this current recession is among workers who are relatively low skilled, workers that would be earning near the minimum wage. We know that during recessions, workers who are displaced suffer a loss in the value, the market value of their skill set. That means that they are no longer as valuable to an employer. Unemployment insurance can be very attractive. That is not going to make any normative statements about unemployment, but rather just say from a purely economic point of view if unemployment benefits are near the market value of your human capital then you certainly have an incentive to not take a job now, continue to search, or continue to look. Of course the problem with that is, as workers stay out of work longer, they suffer further deterioration of the value of their skill set.

What might we think about in terms of moving forward for policies? The government is trying to operate in the short run. Some might benefit from the programs derived from this approach, but some had large costs. The time is now to get away from the short-term fixes, forget the band aids, and focus on sensible, long-run fiscal changes. Every recent administration, whether it was Democratic under Clinton or Republican under Bush, has put together tax reform commissions. And every one of those commissions has said the same: change taxes to encourage new and higher investment. Another recommendation is to reduce government spending and address entitlements. Because of the baby boom and the subsequent baby bust, social security becomes a more looming issue. There is always an incentive for politicians to kick the problems down the road because none of them want to deal with it. It is politically unpopular. But the time has come to address social security and other unfunded government liabilities. If this is done, we can get back on the road to recovery and have a remarkable one. We will start to offer over 500,000 jobs per month rather than an average of 100,000, which is what we have been adding the first months of 2010.
4 Ibid.
5 Ohanian, “The Economic Crisis,” 51.
6 Ibid., 50.
7 Ibid., 49.
8 Ibid.
9 Ibid., 57.
10 Ibid., 58.
11 Ibid., 53.
12 Ibid.
13 Ibid.
14 Ibid., 55.
18 Ibid.
21 Ibid.
Market Efficiency and the Crash of 2008
Dr. Scott Sumner
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Abstract

Most people assume that the financial crisis caused the Great Recession. In fact, as with the Great Depression, the recent economic downturn began before the financial crisis, and indeed helped cause that crisis. The Great Recession caused many to question the “Efficient Markets Hypothesis” (EMH). However, it should be argued that the problem was that we did not take the EMH seriously enough. The correct policy would have been one that led markets to expect on-target nominal GDP growth.

I. The Efficient Markets Hypothesis and the Crash

The conventional view is that monetary policy was expansionary during late 2008, and that it was not up to the task of preventing a sharp decline in economic activity. In addition, the crash of 2008 is widely viewed as having discredited the Efficient Markets Hypothesis. But the exact opposite argument should be made; money was quite contractionary in late 2008, monetary stimulus might have been highly effective, and this crisis shows the importance of taking the EMH seriously.

Robert Hall recently led off a symposium on the financial crisis with the following observation:

The worst financial crisis in the history of the United States and many other countries started in 1929. The Great Depression followed. The second-worst struck in the fall of 2008 and the Great Recession followed. Commentators have dwelt endlessly on the causes of these and other deep financial collapses. Less conspicuous has been the macroeconomists' concern about why output and employment collapse after a financial crisis and remain at low levels for several or many years after the crisis.

This is certainly the conventional wisdom, but it is also almost entirely incorrect. The first financial crisis of the Great Depression occurred in November 1930, 15 months into the Depression, and it was relatively mild. Hall has reversed causation; it was the Great Depression that caused the later 1930 banking crisis, as well as subsequent crises. This should come as no surprise, as nominal GDP (NGDP) fell by half during the early 1930s. NGDP represents the total dollar income that people and businesses have available to repay their nominal debts. When NGDP falls sharply, debt crises usually follow.

Perhaps Hall was thinking about the famous stock market crash of 1929. But stock market crashes are not financial crises. Furthermore, the 1987 stock crash was almost identical in size and duration to the 1929 crash, and yet was not followed by even a modest slowdown in GDP growth.

In the more recent case there was a mild financial crisis before the onset of recession. However Hall mentions the severe crisis of the “fall of 2008,” and this occurred well after the recession began in December 2007. Indeed, as Figure 1 shows real GDP, even the most severe phase of the recession (June to December of 2008) was already well underway before Lehman Brothers failed in mid-September 2008.
Just as during the Great Depression, it is likely that much of the financial crisis was caused by a weakening economy.

**Figure 1: Real GDP for the U.S.: July 2007 to July 2010**

![Real GDP Chart](image)

*Source: Macroeconomic Advisers, online*

It is not clear that the Fed could have done anything to arrest this sharp decline in real GDP. However, most economists believe that monetary policymakers can control NGDP; and as Figure 2 demonstrates, NGDP also declined sharply in late 2008.

Any sharp decline in NGDP, sometimes called “aggregate demand,” will tend to produce a severe recession. That is because wages and prices are sticky in the short run, and hence a decline in nominal spending will initially show up as lower real output. By late 2008, however, the banking sector was also under severe stress. Thus in this case the decline in NGDP did not just increase unemployment; it also sharply reduced asset prices and increased the stress on the banking system.
II. The Lessons of Monetary Policy

Frederic Mishkin’s best-selling money and banking textbook lists three key “Lessons for Monetary Policy”:

1. It is dangerous always to associate the easing or the tightening of monetary policy with a fall or a rise in short-term nominal interest rates.

2. Other asset prices besides those on short-term debt instruments contain important information about the stance of monetary policy because they are important elements in various monetary policy transmission mechanisms.

3. Monetary policy can be highly effective in reviving a weak economy, even if short-term rates are already near zero.2

Many economists and pundits forgot these lessons in late 2008. Monetary policy was widely viewed as being “easy,” precisely because rates were fairly low. And once rates fell to near zero in December 2008, it was widely assumed that the Fed was “out of ammo,” and could do no more to stimulate the economy.

But perhaps we should not have been too surprised, as Milton Friedman complained about the exact same problem in 1997, when commenting on low rates in Japan:

Low interest rates are generally a sign that money has been tight, as in Japan; high interest rates, that money has been easy. . . . After the U.S. experience during the Great Depression, and after inflation and rising interest rates in the 1970s and disinflation and falling interest rates in the 1980s, I thought the fallacy of identifying tight money with high
interest rates and easy money with low interest rates was dead. Apparently, old fallacies never die.³

As during the Great Depression, and as in Japan during the past 17 years, the ultra-low rates in America since 2008 have reflected a weak economy, not easier money.

Some economists will argue that even if nominal interest rates are not a reliable indicator of policy, at least real interest rates can be used. There are two problems with this claim. First, even real rates are not always reliable, as tight money can depress real rates in the long run, by depressing real output. More importantly, if one is going to use real rates as a policy indicator, then money was actually quite tight during late 2008. Between July and early December 2008, the real interest rate on Treasury Inflation Protected Securities (TIPS) rose from just over 0.5% to more than 4%.

Mishkin recommends looking at other asset prices in order to gauge the stance of monetary policy. One such asset is TIPS. Here are some other asset markets during late 2008:

1. Commodity prices fell by more than 50 percent.
2. The trade-weighted value of the dollar soared from 96 to 111.
3. Stock prices crashed.
4. Commercial real estate prices began falling sharply.
5. Residential real estate prices began declining in many formerly stable heartland states, such as Texas.
6. TIPS/T-bond spreads fell sharply, a sign that inflation expectations were falling fast.

All these asset markets were signaling tight money. The real estate sector is especially interesting. In the so-called subprime states (Florida, Arizona, Nevada, and California) the market had already declined sharply by mid-2008. But the effect on the broader economy was surprisingly limited. The banking system was under stress, but the crisis was assumed to be manageable. Unemployment was still relatively low, and most economists forecast growth for 2009. Commercial real estate was still doing quite well.

After NGDP started declining sharply in late 2008, the crisis spread to all sectors of real estate, just as one would expect when nominal incomes are declining. Between mid-2008 and mid-2009, NGDP fell about 3%, which is more than 8% below the trend rate of growth. People and businesses had much less money available to repay debts than had been expected when the debts were contracted. The commercial real estate market soured, and the subprime crisis spread across the country.

III. The Symptoms of Misallocation

Some argue that a severe recession was inevitable, as major financial crises almost always lead to sharp downturns in the real economy, but late 2008 was not a typical financial crisis. The dollar actually became much stronger—a sign of tight money, not financial distress. In most financial crises the country’s currency will depreciate sharply, not appreciate. The previous cases where currencies appreciated in real terms during a financial crisis (the U.S. in 1930-1933, and Argentina in 1998-2001) were also attributable to tight monetary policies.
Others point to the problem of “reallocation.” Workers losing jobs in one sector are not easily able to switch over to other sectors. Often a long period of retraining and readjustment is required. While this is true in principle, it does not seem to have been a major factor in the recent recession. Most of the decline in housing construction took place between January 2006 and April 2008, and yet during those 27 months the national unemployment rate merely edged up from 4.7% to 4.9%. Unemployed workers got jobs in commercial real estate construction, or the booming export sector of the economy. Unemployment would eventually soar to over 10%, mostly due to the fact that the Fed allowed NGDP to fall sharply after mid-2008. But the sub-prime crisis, by itself, was nowhere near severe enough to cause a recession.

It is interesting to note that many other countries also saw sharp housing price run-ups between 2000 and 2005, and yet did not see the “bubble” burst, rather prices leveled off or rose even further. Australia is a particularly interesting case, the only major developed economy that did not experience a recession in this cycle. In Australia housing prices have continued to climb, despite already being at very lofty levels in 2005. NGDP growth is a very important determinant of the health of the housing markets. The Australian case also shows that “what goes up does not have to come back down.” It seems very unlikely that Australian housing prices will ever return to 2005 levels.

The U.S. economy during 2008 was like a patient who started with a common cold, and ended up with pneumonia. We started with a garden-variety banking crisis in 2007 and early 2008. In late 2008 the crisis became much worse, but for reasons unrelated to the original subprime fiasco. Instead, falling aggregate demand depressed output in almost all sectors of the economy. IMF (International Monetary Fund) data shows that expected losses to the entire U.S. banking system were highly correlated with expected NGDP growth during 2009 and 2010. Both NGDP growth expectations and expected banking losses soared in late 2008 and early 2009, and then both declined as the economic picture brightened in late 2009.

The government was still treating symptoms of a cold, not realizing that the problem had morphed into pneumonia. It was like bailing water from a boat, without first plugging the leak in the hull. No matter how much effort they put into rescuing the banking system, the problem just seemed to get worse. Falling NGDP worsened the asset side of commercial and investment bank balance sheets even faster than the government could repair the damage.

IV. Policy and Hindsight

So what could the Fed have done? The most effective policy during a fast-moving financial crisis is “targeting the forecast,” i.e. adopting a monetary policy stance expected to produce on-target growth. For instance, if the Fed wants to see 2% inflation they should ease or tighten monetary policy until they expect 2% inflation. But that is not what happened in late 2008. It was very apparent that both inflation and real growth were going to fall sharply, and come in well below the Fed’s implicit policy targets. Indeed the Fed actually asked for assistance from fiscal policymakers, something that would never happen if they were targeting the forecast during late 2008.
The policy recommendation should be to switch from an inflation target to a price level target, or better yet a NGDP target. Price level targeting means making up for any near-term under- or overshoots, with an off-setting action later. Thus after inflation fell below 2% during 2008-2009, the Fed should have aimed for higher than 2% inflation over the following few years, in order to return to the original trend line. This helps stabilize expectations and reduces the volatility of asset prices. Better yet would be a 5% NGDP target, a policy that would have called for aggressive easing in late 2008.4

A good example of the disadvantages of a backward-looking monetary policy occurred at the September 16, 2008 Fed meeting. The meeting occurred two days after Lehman failed, and the Fed decided to keep rates unchanged at 2%, citing an equal risk of recession and high inflation. There certainly was a risk of recession, but TIPS spreads suggest that inflation was actually expected to come in well below the Fed’s implicit 2% target over the following 5 years. The Fed’s mistake was to adopt a backward-looking monetary policy; they were reacting to the high headline inflation rates over the previous 12 months, not the sharply falling inflation expectations for the following 12 months. It was like trying to steer a car by watching the road through a rear-view mirror.

The logic behind “forecast targeting” is actually quite simple: policy should be set at a position that is expected to succeed. It would be very strange if a ship captain were to remark that he was hoping to reach New York, but that under current settings of the steering wheel, and taking account of wind and waves, he expected to reach Miami. In that case the obvious question would be: Why not turn the wheel? Similarly, one might reasonably ask why the Fed did not adopt a more expansionary policy in late 2008, when aggregate demand was clearly falling below their implicit target.

The Fed also made a major mistake in adopting a policy of “interest on reserves” in October 2008. This was done to insure that all the money being injected into the banking system did not leak out into the economy, potentially causing hyperinflation. However, the result was exactly the opposite of what was needed, as interest on reserves gave banks an incentive to hold on to “excess reserves” rather than move them out into the economy where they could boost aggregate demand.

In early 2009, I published a paper suggesting the Fed might want to consider a negative interest rate (i.e. penalty) on excess reserves, to encourage banks to be more aggressive. This proposal was adopted by the Swedish central bank in mid-2009, and (perhaps coincidently) Sweden has since had the fastest recovery of any European economy.

I also recommended a policy of quantitative easing (QE) in late 2008. Unfortunately, the Fed waited much too long, doing a largely symbolic QE program in March 2009, and then waiting until late 2010 to get serious about quantitative easing. The mistake was to depend on fiscal stimulus, which is not a reliable way of boosting aggregate demand. Only when fiscal stimulus failed to reduce unemployment did the Fed move toward QE2. As soon as rumors of QE2 began appearing in September 2010, asset prices began moving exactly as predicted by Mishkin’s textbook. Stocks rose sharply, as did commodity prices and inflation expectations. The dollar depreciated. It is too soon to know whether the economy will recover, but it is not too soon to know the impact of QE2 on
market expectations. That impact was positive, which is a necessary precondition for any economic recovery.

V. Conclusion

Macroeconomists ultimately need to move beyond a backward-looking “wait and see” approach to monetary and fiscal policy, where actions are taken and then we wait to see the results. The Fed needs to create a NGDP futures market, and subsidize trading to ensure liquidity. These market expectations of NGDP growth can provide immediate “real time” feedback as to whether policy is on the right track. A policy of stable 5% NGDP growth expectations is the best way to ensure macroeconomic stability and low inflation.

Some critics of my approach claim that falling NGDP was not “the real problem.” Rather (it is claimed) the real problem was the housing bubble and subsequent banking crisis, and falling NGDP was merely a symptom. This is wrong. falling NGDP is harmful to any economy, regardless of whether there is a banking crisis. Imagine someone with pneumonia who is walking to the hospital. On the way there he is stabbed by a mugger, after which he is rushed to the ER. The doctor says, “No need to patch that knife wound: the patient’s real problem is pneumonia.” Most people would ask for a second opinion. Both problems need to be addressed.

Similarly, it is a big mistake to claim that the banking crisis is the “real problem.” Yes, it is a real problem, but not the only problem. To a much greater extent than people realize the real problem was nominal—falling NGDP. And it is the Fed’s responsibility to prevent that from happening. In the 1930s, most people, even most economists, thought money was easy and therefore the Fed was not to blame for falling nominal spending. Years later, Milton Friedman and Anna Schwartz showed that money was actually too tight, relative to the needs of the economy. A similar reconsideration of the current recession should be promoted.

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Development in Latin America: How to Move Forward

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Abstract

Since the Great Recession, a noticeable rift has developed between the economic conditions of the U.S. and Latin American countries. Even though Latin American policies have been in the 2000s, many countries have seen growth. Positive growth in the short run hides the negative effect of these irresponsible policies. More emphasis should be placed on encouraging market-oriented policies that will better not only the people of Latin America, but also relations between the U.S. and Latin America.

I. Effects of the Great Recession on Latin America

The U.S. and countries around the world have been through a huge crisis in the last three years. There are many different ways of looking at the experiences of these countries and interpreting what happened. Although not all will ever be in total agreement as to what happened, there are helpful facts that can show the impact of the crisis on Latin America, and that might point the way forward for the region.

When looking at the U.S., it is evident that it forgot the roots of its greatness. The country has been living on borrowed money for too long, and it lost sight of the fundamentals. The U.S. is living beyond its means, and it forgot that savings and prudent investment are really the foundations of growth and prosperity. The personal savings rate was dismal and government saving rate was even worse in the U.S., both below zero. The only savings that were intact were corporations, some of which were in the financial sector, but the overall savings rate in the U.S. was about 13%, which compared to India's and China's 35-40% is very low.1 India and China were at the same time maintaining levels of investment of about 20%. This gap is the size of the bubble that built up over the years. Eventually this bubble was going to burst and have ripple effects all over the world. It did have an effect in Latin America, and the immediate effect was very strong. Latin America took a strong hit in the immediate aftermath. Trade and investment went down by about 30-35%. Stock markets went down by about 40-45%. GDP growth, which was maintained around 5% in this decade, dropped very dramatically to a negative growth rate of 2-3%.2

However, against all expectations, Latin America recovered very quickly, so much that in 2010 the region was experiencing very healthy growth across the board again. There are some differences from country to country, but generally speaking the picture is quite rosy. And this is very significant for two reasons: 1) because it is the first time in history that Latin America is doing well at a time when most prosperous countries in the world are not doing well, and 2) countries that have irresponsible policies are performing well by the numbers. Looking at the development of Latin America’s economies, you will see a definite link with what was happening in Europe and in the U.S. The U.S. had growth in the 1920s, in the 1950s, and in the beginning of the 1970s. Those were
periods in which there was growth in Latin America coming from what was happening in the U.S. and Europe. Today, this is the first time in history where Latin America is going through a bonanza decoupled from what is happening in the U.S. and in Europe. This means that there must be forces at work that were not there before, and it is important for the future to understand what they are and how to manage them. However, these forces are so powerful that they seem to be blurring the distinction between the countries that seem to be doing their homework and are headed in the right direction and the countries that are not headed in the right direction. The problem at the core of these issues is that with such growth, it becomes difficult to persuade these countries to adopt more responsible long-term policies and to create an environment in which those countries will move in the right direction. It is going to take a lot more persuasion and time than one would hope.

II. Clash of Ideologies

Latin America is going through a cultural confrontation, a cultural struggle. Some people like to think of it as an ideological struggle. There are broadly two sides. One side can be characterized as that of the modernizers. These are people that believe in liberal democracy as a political system and in the market economy. These people embrace globalization between Latin America and the rest of the world. In the other camp, you have exactly the opposite. In this side there are forces working against liberal democracy as a political system, against the market economy, and against globalization with the West. For them, Latin America does not belong in the West. People in this side will do everything in their power to decouple Latin America from those countries that are considered the leaders of the modern world.

On the side of the modernizers, there is an interesting mix of countries. Those countries led by governments of the center-right, such as Mexico, Columbia, and Chile, are part of this group. In relation to the left, there are two camps: the “vegetarians” and the “carnivores.” The vegetarian left would include those countries that take a more centrist and moderate approach in relation to policy and have moved towards liberal democracy and market economy, mirroring what happened in parts of Europe in recent decades. The carnivore left will include those countries that have taken a radical policy approach towards more government intervention in the economy. Many countries such as Brazil, Uruguay, Peru, Costa Rica, and the Dominican Republic are governed by the vegetarian left. It is this center-left that has evolved dramatically from what the left used to look like years ago. That group of countries has much more in common with countries that are governed by the center-right than with the others on the left. The others on the left include the carnivores: Cuba, Venezuela, Ecuador, Bolivia, and Argentina. This is again not only a political or ideological struggle; it really is a struggle for the soul of Latin America. It has to do with the vision of Latin America. Does it belong in Western civilization? Is it going to have institutions that support liberal democracy? Is it going to be a part of the global market economy? This struggle is going to be the defining moment in the next few decades for Latin America.
What makes this situation complicated is that there are generally healthy statistics across the board in Latin America. Just before the financial crisis of 2008, Latin America was growing at a rate of about 5%, which is very healthy for this region. Furthermore, about 40 million people were pulled out of poverty in the past five years. For the first time, there was the growth of a middle class that was not linked to the government bureaucracy, unlike what happened in the 1960s and 1970s. Government bureaucracy grew tremendously in those years under economic nationalism in Latin America, which fostered the emergence of a middle class. This time there is a phenomenon that is radically different; it is a middle class that is linked to the market economy. Small to mid-size enterprises have been able to sell to bigger companies, which creates an environment in which people’s aspirations for entrepreneurship and other forms of participation in the market economy have avenues available for the first time in some cases. This is what was happening before the crisis, but there was a short break during the crisis. In 2010, growth is expected to be at 5% on average, with countries like Brazil, Chile, and Peru doing much better. In 2009, Latin America has had an influx of foreign capital of about $160 billion—about 40-45% of this influx of capital was foreign direct investment. There is even a very stable financial situation with the debt, which used to be a problem in Latin American countries in the past. Debt is about 25% of the regions’ economy. Comparing that to the debt to GDP ratio in the U.S., which is reaching 90%, gives us an idea of how the tables have been turned.

In the financial sector, capital ratios are looking healthy at 12% across the board in Latin America. Some countries are doing better than others. There is a new phenomenon as well: the emergence of the “Multi Latinas”: Latin American originated multinational corporations. On the Forbes list of the top 2,000 companies in the world, for the first time there are a large number of Latin American companies. Brazil has 33 of those companies, which is more than what a fully developed country like Spain has. Mexico has 18 of those companies. Chile has eight, and Columbia, Peru, and Venezuela have three. The emerging Latin American corporations are able to play a role not only within the region, but also beyond the region. Latin American countries that used to rely heavily on countries outside of the region are now doing business with the rest of Latin America. That is the case with Bolivia; its main trading partners are within Latin America. This is a new phenomenon for the region.

This is a very novel environment for Latin America, and the fact that they are just coming out of a huge financial economic crisis makes this more interesting. Peru, for instance, will see its investment levels go up by about 10% in 2010, and Brazil at 20%. In fact, smaller countries that people do not usually talk about, like Panama, are doing very well also. Many large corporations are now headquartered in Panama: Heineken, 3M, and Adidas. Why is this happening? What are the reasons behind this change in the Latin American region? First, the reforms of the 1990s played a large role. Many tend to be very critical of them. They were flawed and, generally speaking, many of those reforms did not go far enough. In the 1990s, Latin American countries experienced the liberalization of the economy and monetary, fiscal, trade, and investment reforms. All of these changes created a positive environment in today’s world.
Furthermore, high commodity prices in this decade and high demand for those commodities around the world have clearly helped Latin America. Also the emergence of new players, such as India and China, is helping the region. The other reason is that with so much fiscal revenue coming in because of the sale of commodities, those governments are in a position to give a lot of handouts. Programs have been created in Latin America such as “Oportunidades” in Mexico and “Bolsa Familia” in Brazil. With all this revenue coming in, some of that redistribution has impacted people’s lives, and has helped to alleviate poverty.

However, there is a big danger and that has to do with the role that China and others are playing. The danger is that the distinctions between countries that are headed in the right direction and those that are not are being blurred. Many fail to notice the fundamental weaknesses that some of these countries have. They may be in for a big surprise somewhere down the line. One cannot underestimate the effect that China has had on the region. In the last 20 years, between 1990 and 2010, trade has increased by a factor of 40. China was buying about $10 billion worth of commodities from Latin America in the 1990s, and in 2010 it is around $400 billion. Many of these countries, including countries that are headed in the wrong direction, are in a position to satisfy that demand coming out of Asia and benefit from this.

China has been promising a lot of investment in the region in the last few years, and it has been slow in coming. They have committed about $20 billion related to oil in Venezuela. China is already playing a big role in Africa and in some parts of Central and Eastern Europe. Eventually something very similar to what has happened in the field of trade will take place in the investment arena as well. Prices on commodities have skyrocketed in a way that has helped countries like Bolivia, where they seem to be doing things wrong in such a way that it looks like they are doing everything right. Bolivia nationalized the hydrocarbon industries and has been establishing a system that looks like traditional Latin American populism, and yet the country is going through a huge boom. GDP growth in Bolivia has averaged about 4.6% in the last few years, and it is doing better than in the last 40 to 50 years.

Between 2003 and 2010, because of the commodities bonanza, fiscal revenue has grown by about 200%. It took the U.S. about 50 years to achieve the equivalent growth in fiscal revenue. The effect of globalization is through an increase in the demand on commodities is felt by countries in Latin America significantly. If you look at Argentina, another country where nationalization has taken place, there is high taxation, instability, unpredictability, and a very corrupt political system. Argentina seems to be headed in the wrong direction, but the boom that they are going through is quite amazing. Argentina has experienced average growth of 8-9% in this decade. The government keeps raising taxes on the agricultural sector, which is really the driver of Argentina’s economy right now. The more taxes they place on farmers, the better they seem to do. Money keeps coming in. Many predict that the end is near for Argentina because they are not going to survive this level of taxation. Then there are statistics that indicate they are doing even better. There is a huge distortion in this international environment affecting Latin America, which is helping everybody including the countries that seem
to be going in the wrong direction. That is a huge challenge for those trying to persuade these countries that they need liberal democracy, market economy, and globalization. It makes the case extremely difficult because governments have many statistics they can point at to justify what they are doing.

There are already signs of weakness in those countries that seem to be doing well, like Venezuela, Ecuador, Argentina, and Bolivia. In the case of Argentina, the socio-economic model that is in place is not sustainable and the government is having a hard time funding it. The pension system has traditionally been nationalized, then it went private, and it was nationalized again. Recently, the Argentina’s government took over the pool of savings that was part of the private pension system. They also took over part of the central bank reserves in order to fund some of their fiscal spending. Argentina’s government is desperate to be able to fund a system that is seeing fiscal spending grow even more than the revenues that are coming in from this bonanza. Those are signs that something is not quite right. In the case of Venezuela, it is even clearer. Venezuela is the only country in the region that will have negative growth in 2010. Those are signs of weakness. Oil production has gone down dramatically in Venezuela in recent years, despite the skyrocketing price of oil, so Venezuela’s government has had fiscal problems because it depends significantly from oil revenues. It is important to bear this in mind because the populist authoritarian model is one that was in place in Latin America for a long time. The period between 1930 and 1980 was a period of economic nationalism combined with authoritarian populism. These policies not only failed to develop Latin America, but they actually generated the crisis out of which the reforms of the 1990s came.

**III. The Search for Reform**

What kind of reform should be sought after in Latin America? What are the kinds of changes that need to take place in order for Latin America to ground its development and its growth on much firmer territory? This is a key question, because if the model that some of these countries are following is not sustainable, in a few years there will be a return to some of the conditions that prevailed before they came to the bonanza of the 2000s. Poverty rates will go up again, as will social conflicts. Some of the other countries are grounding their reforms on much firmer footing. Countries like Peru, Chile, and even Brazil are doing much better. However, in all of those countries, we are generally lacking a kind of consistent reform that would place Latin America on a firm path to development and would preempt the emergence of authoritarian populism somewhere down the line. Thus, it is important to generate conditions that will reach a critical mass of people, so that the emergence of these ghosts from the past is no longer possible. Latin America is not there yet. In my book “Liberty for Latin America,” five principles of oppression are discussed that underlie Latin America and its institutions since the colonial era and during the 200 years of Republican life. These five principles are corporatism, state mercantilism, privilege, bottom-up wealth redistribution, and political law.

Corporatism is when you allocate property rights based on group logic rather than based on the individual. In Latin America, corporatism meant that the property rights
were usually allocated on a group basis and people thought according to group logic rather than individually. State mercantilism is simply an environment in which competition takes place, not in the economic arena where it is supposed to take place, but in the political arena. People fight for control in the political process.

Privilege is self-explanatory. It is essentially an environment where there is not equality before the law, and social dislocation is created. Many conflicts from the past had to do with this. There is a clash between foreign investors, who invest in natural resources, and the indigenous communities that rise up against these investments. The way the property rights have been allocated in Latin America has been such that people who were sitting on resource wealth were never able to own it and use it. Because the subsoil was owned by the government, small indigenous communities that owned the land on the surface did not own what is under the soil. That was a source of great political trouble, because if you are sitting on wealth and the government says, “I own this,” and the government sells it to a foreign investor, you are clearly thinking that someone is stealing something important from you. This is just one example of many in which privilege rather than equality has come before the law.

Bottom-up wealth redistribution is very tricky because every time a populace politician offers redistribution, he is very popular and usually wins elections in Latin America. There is a bottom-up process of wealth redistribution, where wealth is being redistributed from people who do not have it to people who do have it. In fact, about 30% of social spending goes to the richest 20% in Latin America. When looking at the traditional forms of redistribution, such as pensions, health care, and education, about 80% of that is going to the top 40% of society. It is a system that is redistributing wealth, but it is not doing it in the way that was promised. It is doing it in exactly the opposite way. The only form of redistribution in recent years that is doing what it is supposed to be doing, at least as it is envisioned by those who have espoused those ideas, are those targeted conditional programs that were mentioned earlier, “Oportunidades” and “Bolsa Familia.” In these programs the government gives handouts, and the family that receives the money has to send their kids to schools and have them vaccinated. The whole social spending apparatus in Latin America is geared towards taking things from those who do not have anything and to channel it towards those who do, except for these very small programs. The social spending system clearly needs reform in Latin America.

Political law is the fifth principle of oppression. In developed countries, historically the law was a limitation on power. In many underdeveloped countries and developing countries, it played exactly the opposite role. The law was a tool for those who had power to be used for their benefit, and it did not place limits on power. Under a system where there is no limit on power, there is a delegitimization of official institutions. If individuals perceive that the law was the instrument of the powerful, then they are not going to believe in the law. That is why in the last four or five decades there has been a huge explosion of the informal economy in Latin America, where a whole underground society has developed outside of the law.

The reforms that need to take place in Latin America include spending cuts. The growth of the state in Latin America continues to be a big problem. Public spending
keeps going up by about 10% every single year. If you look at a country like Brazil, which is usually considered with China as a great emerging power, it has spending growing faster than economic growth. When looking at the ratio of consumption to GDP, ideally the economy should be growing at a faster rate than consumption. If the economy is growing faster than consumption, then there is more savings, which leads to more investment. That is what happened in India and China at the time when GDP growth took off and consumption did not grow as much, leading into a large pool of savings. As a result, there is a very interesting phenomenon: a huge drive for savings that is going to be invested and create returns. That is where development will eventually come from. That is not happening in Brazil. Brazil has had very healthy rates of growth, but consumption has been going up at the exact same pace. This environment does not allow for savings to take off. The ratio of consumption to GDP is flat and has been for many years in Brazil. The reason why this ratio has been flat is because of high government spending, which has led to a chronic fiscal deficit of almost 4%. The government in Brazil does not seem to be able to keep in check government spending, it is voracious. Generally speaking the government in Brazil seems to think that being a world player means the government needs to be spending a lot of money. Cutting government spending is one reform that needs to take place.

The state continues to own a lot of companies. If you look at the most important companies in Latin America, they are all owned by the state. In Brazil, Petrobras is semi-owned by the state. In Mexico and Venezuela, all of the big oil giants are owned by the state. The result is that they are heavily undercapitalized. Mexico is a dramatic case of undercapitalization, and this situation is going to affect the U.S. because Mexico exports oil to the U.S. Mexico is a huge oil producing country, where oil was nationalized in the 1930s, and oil cannot be privatized and cannot have any kind of participation from the private economy. Besides the oil sector in Mexico being completely undercapitalized, reserves are dropping fast in the country. Mexico will soon not be in a position to export oil to the U.S.; it will not even be able to produce oil. We have also seen a similar problem in Venezuela, where they are producing one million barrels of oil a day less than what they were producing five years ago. All these big-stake players are not only a drain on the economy, but they are having a terrible impact on the natural resources that Latin America is known for. Some people think that this is not a bad thing. Perhaps if Latin America realizes that it depends so much on its natural resources, then it will realize that it needs to start manufacturing, inventing, and innovating.

Taxation is a labyrinth in Latin America. If you want to do business in the region you are going to have to pay 61 different types of taxes. If you want to do business in Mexico and you are a mid-size company, you are going to spend 30% of your revenue on taxes. Latin America is now second in the world after central Asia in terms of how long and how complex the tax process is. Clearly that needs simplification and a reform. Looking at labor markets, Argentina’s labor code is copied right out of Mussolini’s labor code. Collective bargaining in Argentina is done not by each company but by trade, which makes collective bargaining very restrictive and inflexible. So if one company is producing submarines and another is manufacturing nails, both are subject to the
same rules regarding collective bargaining. This is hindering not only the process of wealth creation, but also job creation. A huge chunk of the economy is taking place underground and outside of the law. Furthermore, many of the tariffs in the region have come down, and there is a lot more exchange that is clearly benefitting Latin America. But, you can bring down tariffs on one side and they will go back up again through those regional trading blocs.

Innovation is another area in which corporatism is really hindering the process of wealth creation because many of these companies simply do not have enough resources and energy left to innovate. There has been some innovation in Brazil, in terms of bio-energy, and in Costa Rica, in terms of computer software. But generally speaking, Latin America is a region that does not innovate at all. The level of research and development is at 0.5% of the economy, which is about one fourth of what it is in China. The number of patents that are registered every year in Brazil is only 600, while in South Korea there are 80,000. South Korea is a tiny country compared to Brazil, and yet this country holds on the innovative process of the economy.

These are some of the reforms that need to be undertaken very soon. The consequences of not undertaking many of these reforms are economically troubling if you compare per capita income in Latin America today with what it was in the 1960s. Per capita income in Latin America in 1960 was about one-fourth of what it was in the U.S. Today, it is about one-sixth. So clearly the trend is going in the wrong direction. If we do not generate conditions for development soon in Latin America, there will be dreadful consequences for the political system from this cultural struggle. Those who have been struggling to prevent Latin America from playing their full role in today’s economy and from being a member of the family of liberal democracies are going to find themselves strengthened, and political institutions in the region are going to be further weakened. In those countries, there are forces at work trying to stop the trend towards strong liberal democracies under a market economy. If meaningful reforms that give a critical mass of the people reasons to turn a deaf ear to the siren song of populism are not undertaken, we will see a strengthening of these populist authoritarian currents and trends in Latin America. However, many countries are headed in the right direction, and the environment today is helping foster a new phenomenon, the growth of the middle class. What was really hurting Latin America historically was the huge disparity between the rich and the poor, which is not only ethically challenging, but also politically challenging for a liberal democracy. It has been very difficult for institutions to solidify and become predictable in an environment where so many people had many reasons to mistrust the political process. It is important that people have reasons to believe that the liberal democratic system and the market economy are to their benefit.

**IV. Conclusion**

In closing, what happens in Latin America is really for Latin Americans to decide. Many people believe that the reason for Latin American underdevelopment was because of exploitation from overseas. Latin American countries have had their share of exploitation. Clearly that is what happened in colonial times and in Republican times,
but Latin Americans are to blame for Latin America’s underdevelopment. However, the
U.S. can play a much more active role in the development of Latin America and it would
be to the benefit of the U.S. Unfortunately, what we have seen in recent years, and what
it seems like is never going to change, is certain disengagement from the region on the
part of the U.S. It is as if the U.S. does not really care. One can understand why the U.S.
is preoccupied with other parts of the world because of its security issues after 9/11. But
even so, the U.S. is a big enough country that it can handle all of these issues at once
and can continue to engage Latin America in a more meaningful way. Historically, the
relationship between the U.S. and Latin America has oscillated between hegemony and a
sort of condescension. Foreign aid and help from overseas was a way to cement a strong
relationship and to foster development. But in recent decades we saw the emergence of
a new vision, one that wanted to engage Latin America on an equal footing. One way to
do that was the creation of a free trade area across the hemisphere. That was frustrated
five years ago, because a few countries in Latin America opposed the idea even though
most countries in Latin America were in favor of it. After that, the U.S. simply lost all
interest. The trade between the U.S. and Latin America is not very sizable. It amounts
to about $650 billion, and it is small compared to its potential.

In fact, 75% of European trade takes place among European countries and most of
China’s trade takes place within Asia. Even though a lot of people in this hemisphere
complain about Chinese trade, the bulk of it is taking place within Asia. Clearly the
U.S. should be engaging with Latin America more. It is a more natural area for the U.S.
to enhance its trading relationship. The reasons for not doing so are entirely dema-
gogic and misplaced. There are many free trade agreements pending for ratification
in Congress: one with Colombia, another with Panama, and with South Korea. There
is a surplus in favor of the U.S. with 17 partners in which it has free trade agreements.
Unfortunately, voices have prevailed and they have paralyzed Congress, and many of
these treaties have not been ratified with Latin America. This disengagement on part of
the U.S. has had an effect in Latin America in terms of strengthening the position of the
carnivore left. The Organization of American States (OAS) has been severely weakened
and it has become ineffective. Every time in recent years that there has been a challenge
to liberal democracy, that organization has been entirely powerless. It is paralyzed by its
internal conflicts, contradictions, and a total lack of leadership. U.S disengagement from
the region has been the problem.

Another issue has been that when U.S. leadership disengages at the top level, the
bureaucracy takes over. The people who now control policy toward Latin America are
bureaucrats who would not be in a position to lead if it were not for this failure of leader-
ship at the top. What tends to happen when bureaucrats take over from leaders is that
issues that should not be playing a huge role come to the forefront. This allows for obses-
sion with narcotics and security as the overriding issue in terms of U.S. relationship with
Latin America. Not only has it not been effective, but it also has alienated many in Latin
America. The U.S. sees Latin America as a source of problems, and not as a potential
for mutually beneficial relationships. That has given way to anti-Americanism in Latin
America, which is not as strong as it used to be, but it has strengthened those voices.
Within the next few years, the U.S. must play a much larger role in Latin America, although some policy makers seem to think that countries such as Brazil will be playing that kind of leadership role in the region. Again, take into account the context of the great cultural struggle between modernizers and retrogrades, where Brazil belongs to the modernizers. Brazil is not taking a leadership role. Brazil is domestically doing a lot of things right, but in terms of foreign policy, it sees itself as sort of a counter weight to the U.S. in the region. In fact, Brazil has been tempted to establish an alliance with the unsavory regimes such as Venezuela and Iran. This is not helping the cause of the modernizers and the forces that favor the market economy and liberal democracy. We are missing a great deal of leadership from the U.S., but it does not mean that the U.S. should take a hegemonic role. It does not mean that the U.S. needs to come into Latin America and dictate matters, but something entirely different. It means engaging in Latin America in the way that some of the European countries are engaging each other and in the way that Asians are engaging each other.


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