PREFACE

The financial crisis has prompted a vigorous outpouring of books from economists, journalists, and financial commentators who have analyzed it from a variety of perspectives. From beginning to end, they tell a complete story of why the American economy spiraled into a devastating financial mess, how the financial crisis evolved into a global phenomenon, and how policymakers sought to put out one fire before turning to the next one. The economists stay away from a personalized narrative, stick with the economic features, explain them engagingly, and occasionally suggest an alternative policy framework that provides a more promising outcome. The journalists create entertaining narratives around the decision making and the personalities involved in the process without providing an analytical model of the origin of the crisis and the policy handling. The financial commentators do set out a rigorous analytical underpinning of the turmoil's origin and its evolution, but without explaining brain twisters such as over-the-counter derivatives and credit default swaps, which are beyond the grasp of most economics students. Even the difference between quantitative monetary softening by the Federal Reserve and discretionary easing via a change in the federal funds rate needs to be spelled out for beginners.

This book is different. I have written it for my undergraduate students who plan to major in economics or financial economics. I have also used some of the material for my lecture course on emerging market economies, which attracts graduate students from the political science department and from the Columbia Schools of Education, Journalism, and International Affairs. Given their diversity of interests and background, I have chosen to develop a story in each chapter, with an anecdote or two and with newspaper citations. Each chapter has charts and the occasional picture or cartoon so that my argument makes a concrete appeal to the reader. Each chapter begins with an introduction that summarizes its content. Most important, I provide an analytical framework in each chapter in order for the reader to go beyond the story, the facts, and the pictures and think rigorously.

In chapter 1, I trace the origin of the crisis to a combination of the easy monetary policy of the Federal Reserve that began in 2001 and a weak regulatory environment, which drove Americans into out-of-bounds home acquisition based on mortgage financing. These mortgages, which were acquired by major Wall Street banks and other financial institutions, turned subprime when the housing boom collapsed as interest rates began moving up from mid-2004. In order for the reader to fully grasp the magnitude and coverage of the government's bailout effort, the chapter also unfolds the rescue programs that were launched by the policy makers in late 2008.

Of particular relevance here, and discussed in chapter 2, is the decisive implementation of the stress tests of major U.S. banks by the Federal Reserve that in turn was followed by financial funding for the needy banks from the Troubled Asset Relief Program legislated by Congress in late 2008. This early restoration of the financial health of major U.S. banks differed from the delayed adoption by EU regulators of a stress test of European banks in the summer of 2010.

In chapter 3, I discuss U.S. economic recovery in terms of precise indicators, among them real GDP growth, the unemployment rate, and the inflation rate, and argue that given the severity of the recession, employment recovery during the current recession will lag sharply behind GDP recovery, more so than in the recessions of 1981 and 2001. Therefore, the White House economic policy team and the Treasury should not be faulted for running a budget deficit aimed at forestalling sharp declines of real GDP and employment. However, as a prudent Keynesian, I argue that although the budget deficit is necessary in the short run for countering the gaps in consumption and investment spending, deficit reduction will remain the biggest challenge for the government and lawmakers in the medium term. By contrast, the Federal Reserve may end up successfully devising a timely exit strategy of monetary policy tightening if inflationary expectations appear in 2011.

In chapter 4, I rank a number of countries from North America, Europe, Asia, and South America in terms of the impact of the crisis on their GDP growth rate in 2009 and its recovery prospects in 2010. The explanatory variables in the exercise relate to the health of an economy's banking sector, the country's export dependence, and finally its inflation rate combined with a continuing budget deficit, which will restrict policy makers' ability to undertake a stimulus. At the top of the ranking hierarchy are the Asian economies, led by China and India, followed by Brazil and Chile in South America. The United States, Germany, and France are in the middle. Among the major economies, Russia and Japan turn up almost at the bottom in terms of the latest GDP growth rate indicators in 2009 and 2010. This ranking, based on these dual GDP growth rates for a select group of countries, is also adopted for the book's cover.

In chapter 5, I describe the financial activities of security traders and hedge fund managers who employ over-the-counter derivatives and credit default swaps via fast electronic trading and flash orders. The details from the get-go provide the necessary background to my readers for understanding the essential features of the financial overhaul that will emerge from the Dodd-Frank Wall Street Reform and Consumer Protection Act, which President Barack Obama signed on July 21, 2010.

Chapter 6 is on the regulatory proposals and provides a blow-by-blow account of the 18-month-long legislative process in Congress that was marked by energetic debates, back-and-forth trade-offs, and softening, by lawmakers, of some regulatory provisions, evidently for minimizing their negative impact on the functioning of the U.S. financial sector. In my view, the enforcement of adequate reserve requirements by banks against their risky assets and the regulation of over-the-counter derivative trading are critical for striking a balance between maintaining an active banking sector in the United States and warding off the impact of the next crisis. At the same time, the regulatory agencies will have to stay ahead technologically in monitoring the activities of the increasingly complex financial vehicles, including fast electronic trading, that are here to stay. In conclusion, the U.S. regulatory stance appears more selective and less restrictive than the regulations being deliberated by EU lawmakers that I discuss in the chapter.

Chapter 7 on the dollar's role as a reserve currency has a complete story of the dollar's emergence in that role and the requirement for it to remain reasonably stable in order for foreign holders of dollar assets, among them the People's Bank of China, to continue amassing these assets. I also provide the background for the Chinese policy makers' resolute determination against raising the yuan-dollar exchange rate at our bidding while the U.S. economy continues posting a massive budget deficit combined with an easy monetary policy that lowers the greenback's value. "The dollar is your currency, but it has become our problem," Chinese policy makers emphasize.

Chapter 8 discusses the contrasting features between the Great Depression and the current financial crisis, narrating the differences in both origin and policy response. A major policy lesson is invoked by Federal Reserve Chairman Ben Bernanke, who referred to the relevance to the current situation of the Fed's premature policy tightening in 1937 in the middle of a fragile recovery of the U.S. economy. The chapter's details provide the readers with a balanced view of the relative seriousness of the current crisis in terms of the worst features in each episode, consisting of GDP growth decline, the stock market plunge, inflation moving into deflation, and the unemployment rate.

As for the future of American capitalism, I argue in the final chapter that it will retain its innovative spirit and entrepreneurial vigor and that the best that regulators will manage in the future is moderating the impact and volatility of a crisis episode. In my judgment, the overhaul of financial rules is intended to provide regulatory guardrails against excessive risk taking by American banks rather than cutting their size and curbing their competitive prowess against foreign banking rivals. As for the role of the proposed Consumer Financial Protection Bureau in protecting Americans' interest with regard to credit and debit cards, checking accounts, and mortgage lending, I believe that American banks will keep ahead of their customers' choices and decision making.

The analytical framework and the major conclusions relating to the current crisis were written up toward the end of October when the manuscript was completed. Indeed, I faced a continuing challenge in keeping ahead of the evolving details and not being overtaken by them in my focus as an economics analyst. These details related not only to the forecasts and actual outcomes of GDP, unemployment, and inflation from quarter to quarter and the stock market and manufacturing sector ups and downs, but also to the state of the housing sector and the on-again, off-again benefits for the unemployed. These features continued to be energetically invoked in the context of the U.S. budgetary and monetary policy making. The mid-November 2010 congressional election results, in which the

Republicans gained control of the House of Representatives, will undoubtedly reshape these policies amid a contentious legislative environment. Across the Atlantic, the recurring sovereign debt problems in the peripheral eurozone economies and their impact on the future of the euro will continue to engage EU policymakers in the months ahead.

In the following paragraphs, I briefly update the major features of the evolving economic scene in the United States and in the eurozone with a view to suggesting that they do not affect the book's conclusions.

With regard to U.S. GDP growth prospects in the second half of 2010, I had ruled out a double-dip recession in the third quarter. Anticipating the November congressional election outcome, I had also suggested that all the Bush tax cuts should be extended for a year in the interest of a bipartisan consensus on the issue. On December 17, 2010, President Obama signed into law the $858 billion tax cut compromise he had reached with congressional Republicans. It extended the Bush tax cuts by two years. The tax cut would temporarily reduce employees' payroll taxes by 2 percentage points and thereby put extra cash in consumer wallets. The long-term unemployed got an extension of unemployment insurance. Prompted by the proposed tax incentives, businesses would release their cash into new investment and equipment purchases.

On the eve of the bipartisan tax compromise, U.S. GDP had already risen 2.6 percent at a seasonally adjusted annual rate in the third quarter, higher than the 1.7 percent of the second quarter. A vigorous growth in consumer spending had lifted retail sales, industrial production, and factory orders. In the last week of December 2010, companies released reports of higher corporate profits, and the Dow industrial average hit a two-year high.

As before, however, the job market lacked decisive momentum in new hiring. The unemployment rate had remained at a high 9.4 percent of the workforce. The high unemployment rate weighed on homeowners' ability to hold on to their properties. At the same time, sales of new homes remained at historically low levels in November 2010, lower by more than 20 percent compared with their level a year earlier. Finally, the fragile balance sheets of state and local governments posed a continuing problem with regard to their economic health and financial maneuverability.

Amid these massive uncertainties in the housing and labor markets and the tortuous bipartisan fiscal wrangling over the Bush tax cuts following the results of the mid-November congressional elections, the Federal Reserve, as before, displayed a consistent policy stance. On December 14, 2010, the Federal Open Market Committee (FOMC) kept the short-term interest rate on hold at near-zero and stayed with its decision (announced on November 3) of purchasing long-term Treasury bonds worth $600 billion by mid-2012. The core consumer price index was up a scant 0.8 percent in November from a year earlier. Including energy and food, it was up 1.1 percent. Inflation, in the Fed's judgment, was not of imminent concern, and December would provide a forward momentum to the economic recovery going into 2011. But the unemployment rate would remain high, close to 9 percent toward 2011-end, even if real GDP grew at 4 percent. It was necessary to undertake a significant quantitative easing of monetary policy and bring down long-term interest rates so that businesses would undertake investment spending as consumer outlays kept apace.

Perhaps the improved growth prospects following the December tax deal would drive investors away from long-term Treasury bonds and their yields would rise. Will the positive feedback work against the Fed's expectation of declining long-term interest rates? In its December decision making, the FOMC announced that "it will regularly review the pace of its securities purchases . . . and will adjust the program as needed to best foster maximum employment and price stability."

How did the year-end policy making among European leaders in Brussels compare with the positive tax compromise and the steady-as-you-go monetary policy stance of the Federal Reserve in Washington?

In late November 2010, the government of Ireland was provided a bailout funding of up to €90 billion ($119 billion) for financing its budget deficit and supporting Irish banks that held government debt. Sovereign debt restructuring that would have unnerved bond investors was thus avoided. But the Irish bailout raised the possibility of similar rescues for Spain and Portugal. That in turn raised the question: Shouldn't the size of the current €440 billion ($559 billion) EU bailout fund be increased? However, despite calls by leading officials of the European Central Bank (ECB) and the International Monetary Fund (IMF) for a larger and immediate European response to such a crisis, the suggestion was opposed by a core group of senior officials from the fiscally prudent northern countries, among them Germany, Finland, the Netherlands, and Sweden. They resisted suggestions for short-term changes in the EU-wide response system. These officials insisted that the Economic and Monetary Union (EMU) operating in the eurozone reemphasize fiscal austerity in the peripheral economies and quickly pass new budgetary rules that would punish its profligate members.

However, the EU leaders adopted an easier option at the December 16, 2010, summit. They approved an amendment to the EU treaty for creating a new bailout system for debt-ridden countries and for setting up a permanent rescue fund in 2013. The amendment must be ratified by all 27 EU member states. It would seem that a here-and-now resolution of the urgent, short-term bailout issues was postponed to a future date.

Can the recurring bailouts of the peripheral members that issued their respective sovereign bonds for financing their budget deficits be held back if the eurozone authorities were to issue common euro bonds, similar to U.S. Treasury bonds? But a common euro bond would require a fundamental change in the treaty that formed the EMU. A common euro bond must be backed by closer economic and budgetary integration. It might even mean minimum standards on pay and welfare policies and corporate taxation. European leaders are not ready for such a great leap forward. It would seem that at the end of 2010, the common bailout fund of €440 billion ($559 billion) supplemented by the IMF funding of €250 billion ($318 billion) that I discussed in chapter 4 would provide the resources for near-term bailouts. No more than that was the response of the better-off EU members.

This implies that the near-term tool at the EU disposal, short of full-scale bailout for troubled peripheral economies, will be the ECB's program of using its own balance sheet for buying sovereign debt (as discussed in chapter 2). The ECB announced on December 24, 2010, that it would nearly double its capital, from €5.8 billion ($7.66 billion) to €10.8 billion ($14.27 billion) by the end of 2012. It will acquire an additional financial cushion for buying distressed bonds of countries such as Greece, Ireland, Portugal, and Spain. The extra funding will flow to ECB coffers from the profits of the national central banks.

It would seem that the policy debates and decisions in Brussels tend to lag behind the urgent requirements for eurozone stability. Every time a bailout is negotiated, the doomsayers raise the possibility of the euro's demise and the breakup of the eurozone. These concerns reflect the formidable challenges of forming a single economic and political union among a diverse group of countries. The issues facing Washington policy makers, by contrast, appear manageable. Perhaps the December 2010 tax compromise will lay the groundwork for tomorrow's badly needed overhaul of the tax code by Congress. Perhaps the Republican-dominated Congress will also stop short of undertaking a major overhaul of the Dodd-Frank Act that I discuss at length in chapter 6. Again, the quantitative easing launched by the Federal Reserve will work out despite the fact that the interest rate on the 10-year Treasury bond went up following Fed purchases. The discussion of these issues, however, belongs to another project.

From Financial Crisis to Global Recovery follows my earlier book *Financial Crisis, Contagion, and Containment: From Asia to Argentina* published by Princeton University Press in 2003. It dealt with the massive destabilizing impact that several emerging market economies experienced when their policy makers prematurely opened up their financial systems to short-term capital inflows in the 1990s. The present book has a well-rounded story with the analytical focus and major conclusions of each chapter firmly in place. I deliberately stayed away from working up a new idea or a novel explanation of this or that aspect of the crisis. I designed it as a textbook. Despite this ostensibly limited goal, I faced an uphill task in managing its comprehensive coverage and analytical rigor amid continuously unfolding data and policy details. In finally accomplishing it, I have profited enormously from classroom discussions and responses from my students. I am immeasurably grateful to Edmond Horsey, my research assistant, for pushing the manuscript from its provisional shape to a successful completion. He collected the necessary information for each chapter and converted it into charts that are uniformly attractive and readily accessible. He tracked down the cartoon sources and persisted with round-the-clock reminders to the copyright holders till he got the necessary permission for their publication in the book. At my request, he located suitable quotations from the works of Robert Triffin, Adam Smith, and John Maynard Keynes that I hope the readers will savor for their current relevance despite their cumbersome prose. I also thank Maria Konovalova and Yuan Wang for their assistance in collecting some information for chapters 3 and 5. I acknowledge partial financial support from the Harriman Institute of Columbia University.

I invite my readers to undertake an exploration of the causes and consequences of the destabilizing financial turmoil with an American origin and a global reach. It is a continuing story that I hope will end soon with a positive outcome for the millions of people who lost their livelihood from its destructive impact.

December 29, 2010, Padma Desai

FROM
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TO
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