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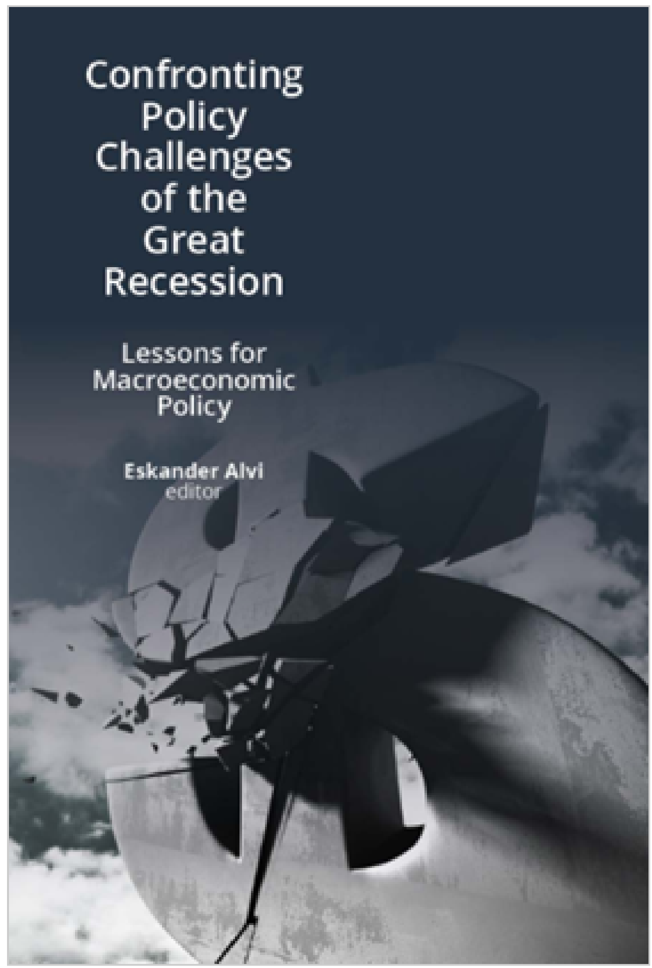
The Great Recession: in what ways did policymakers succeed and fail?

Confronting Policy Challenges of the Great Recession: Lessons for Macroeconomic Policy. Edited by Eskander Alvi. Kalamazoo, MI: W. E. Upjohn Institute for Employment Research, 2017, 137 pp., $28.32 hardcover.



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The collapse of the U.S. housing market in 2007 started a chain of adverse economic events—a financial crisis, soaring unemployment, a declining international economy, and, ultimately, the worst post-World War II economic disaster, the Great Recession of 2007–09. The burst of the housing bubble was due to aggressive lending by banks, easy access to credit, and securitization of mortgages. Securitization is the process of pooling and repackaging financial instruments, such as mortgages, and selling them to investors. After making loans to home buyers, lenders would securitize and sell the mortgages, thus acquiring additional funds for lending. The subprime mortgage crisis foreshadowed the subsequent banking industry turmoil, most notably the failure of Lehman Brothers. With many industries being affected by these developments—and given the tightly intertwined global economy—the results were devastating.

In *Confronting Policy Challenges of the Great Recession: Lessons for Macroeconomic Policy*, editor Eskander Alvi and his team of economists analyze the strategies used by policymakers to combat the Great Recession. In the book's opening chapter, Alvi previews the recession's severe economic effects, such as mass layoffs, volatile financial markets, declines in investment, and a sinking gross domestic product. In response to the crisis, which bore a resemblance to the Great Depression, policymakers sought to expand on what worked in the 1930s and to improve on what went wrong. Although the Great Recession never reached the depths of the Depression, it was followed by a slow recovery and missteps in both fiscal and monetary policy. In the course of the book, Alvi and his coauthors discuss the successes and failures of legislators who tackled the recession and its fallout, the reasons for the adoption of different fiscal and monetary policy measures, and the factors responsible for the sluggish recovery.

The Great Depression loomed large in the response to the Great Recession. Emergency assistance in the form of bank bailouts was a major priority, as was fiscal stimulus. Congress employed many common antirecessionary policies, such as tax cuts and increases in unemployment insurance and food-stamp benefits, and these measures prevented the crisis from spreading further. Although the unemployment rate reached an abnormally high 10 percent, it was still far lower than the 24-percent rate experienced in the 1930s. While the lawmakers' response to the recession improved in many areas, it also repeated some past policy mistakes. According to Barry Eichengreen, one of the book's contributors, the policymakers' decision to let Lehman Brothers fail was the "single event that most threatened the stability of global financial markets." The decision was comparable to that which allowed Henry Ford's Guardian Group of banks to fail in the 1930s, and both events wreaked havoc on the financial marketplace. Also, in an effort to regulate lenders and to protect consumers, Congress passed the Dodd–Frank Wall Street Reform and Consumer Protection Act in 2010, but this measure didn't go nearly as far as the Glass–Steagall Act that was passed during the Depression. The fact that the worst possible outcomes were avoided may have dissuaded Congress from taking further action to stimulate the economy and to regulate the financial sector. Another likely factor was the political pressure applied by the public as the country attempted to navigate through the recession. As noted by Eichengreen, it is through the "dominance of ideology and politics over economic analysis" that public criticism often affects policy decisions.

Fiscal stimulus came to a halt after repeated criticism of the bank bailouts and growing concerns about the national debt. The lack of appetite for additional fiscal policy intervention led to a much slower recovery, especially given the magnitude of the recession. In the words of Gary Burtless, who penned one of the book's chapters, this inaction was the "single worst error in macroeconomic policymaking following the financial crisis in 2008." In a similar vein, authors Laurence Ball, J. Bradford DeLong, and Lawrence H. Summers argue that a more aggressive fiscal policy—mainly additional tax cuts and government spending on public projects—was needed to supplement the Federal Reserve's (Fed's) efforts to boost aggregate demand. Contrary to public sentiment that expansionary fiscal policies add to the public debt and make the problem worse, the authors contend that, during a recession, such policies increase the national debt in the short term but have little effect in the long run, thanks to the increase in employment and output. Therefore, fiscal contractions in recessionary times make the debt problem worse, prolonging the economic slump. Ultimately, fiscal policy during the Great Recession was in many ways restrained by public pressure.

The Fed sought to fill in the gaps left by the ongoing debate about fiscal policy. Many economic observers believe that the initial financial threat faced by the country was greater during the Great Recession than during the Depression. Recognizing the gravity of the situation, the Fed deliberately sought to avoid the mistakes made during the 1930s. To keep credit flowing and increase consumer confidence, it lent great amounts of money, even to foreign banks and nonbank facilities, such as broker-dealers, money market funds, and buyers of securitized debt. With the federal funds rate already at zero, the Fed moved to further lower intermediate- and long-term interest rates with large-scale asset purchases—a process now known as quantitative easing. The Fed also used forward guidance, communicating its intent to keep interest rates at zero for the foreseeable future. These actions are generally believed to have been effective in lowering interest rates and raising asset prices. According to the authors, however, the Fed still faced, albeit to a lesser degree, the same pressures as those which prevented the adoption of additional fiscal policy measures. Some critics complained that central bankers didn't belong in the mortgage-backed securities market, and others brought up the possibility of hyperinflation. Ben Bernanke, the Fed chairman at the time, sought to explain the Fed's actions to Congress and the public, with mixed results. The Fed, seeking to assert its independence, started shrinking its balance sheet sooner rather than later, overlooking the lesson learned from the Depression. Still, in the authors' judgment, the Fed helped the country avoid the worst possible outcomes, introducing new monetary policy measures that can be relied on in future downturns.

Confronting Policy Challenges of the Great Recession: Lessons for Macroeconomic Policy will benefit any reader interested in learning about the Great Recession. The book outlines how Congress, the executive branch, and the Fed responded to the crisis, and the challenges they faced in the process. To make their case, the authors provide historical comparisons (mainly to the Great Depression), visual aids in the form of charts and graphs, and plenty of relevant data. While the book goes into many technical economic concepts, it is broad enough for anyone to enjoy.