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FREEFALL

AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY

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FREEFALL

America, Free Markets, and the Sinking of the World Economy

JOSEPH E. STIGLITZ

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TO MY STUDENTS,
FROM WHOM I HAVE LEARNED SO MUCH,
IN THE HOPE THAT THEY WILL LEARN
FROM OUR MISTAKES.

Contents

PREFACE

IN THE GREAT RECESSION THAT BEGAN IN 2008, MILLIONS of people in America and all over the world lost their homes and jobs. Many m suffered the anxiety and fear of doing so, and almost anyone who put away money for retirement or a child's education saw those investments dwindle a fraction of their value. A crisis that began in America soon turned global, as tens of millions lost their jobs worldwide—20 million in China alone—a tens of millions fell into poverty.[1]

This is not the way things were supposed to be. Modern economics, with its faith in free markets and globalization, had promised prosperity all. The much-touted New Economy—the amazing innovations that marked the latter half of the twentieth century, including deregulation and finan engineering—was supposed to enable better risk management, bringing with it the end of the business cycle. If the combination of the New Economy a modern economics had not eliminated economic fluctuations, at least it was taming them. Or so we were told.

The Great Recession—clearly the worst downturn since the Great Depression seventy-five years earlier—has shattered these illusions. I forcing us to rethink long-cherished views. For a quarter century, certain free market doctrines have prevailed: Free and unfettered markets are efficier they make mistakes, they quickly correct them. The best government is a small government, and regulation only impedes innovation. Central banks sho be independent and only focus on keeping inflation low. Today, even the high priest of that ideology, Alan Greenspan, the chairman of the Federal Rese Board during the period in which these views prevailed, has admitted that there was a flaw in this reasoning—but his confession came too late for many who have suffered as a consequence.

This book is about a battle of ideas, about the ideas that led to the failed policies that precipitated the crisis and about the lessons that we ta away from it. In time, every crisis ends. But no crisis, especially one of this severity, passes without leaving a legacy. The legacy of 2008 will include n perspectives on the long-standing conflict over the kind of economic system most likely to deliver the greatest benefit. The battle between capitalism a communism may be over, but market economies come in many variations and the contest among them rages on.

I believe that markets lie at the heart of every successful economy but that markets do not work well on their own. In this sense, I'm in the tradit of the celebrated British economist John Maynard Keynes, whose influence towers over the study of modern economics. Government needs to pla role, and not just in rescuing the economy when markets fail and in regulating markets to prevent the kinds of failures we have just experienc Economies need a balance between the role of markets and the role of government—with important contributions by nonmarket and nongovernme institutions. In the last twenty-five years, America lost that balance, and it pushed its unbalanced perspective on countries around the world.

This book explains how flawed perspectives led to the crisis, made it difficult for key private-sector decision makers and public-sec policymakers to see the festering problems, and contributed to policymakers' failure to handle the fallout effectively. The length of the crisis will depend the policies pursued. Indeed, mistakes already made will result in the downturn being longer and deeper than it otherwise would have been. But manag the crisis is only my first concern; I am also concerned about the world that will emerge after the crisis. We won't and can't go back to the world as it w before.

Before the crisis, the United States, and the world generally, faced many problems, not the least of which was that of adapting to climate chan The pace of globalization was forcing rapid changes in economic structure, stretching the coping capacity of many economies. These challenges remain, in magnified form, after the crisis, but the resources that we have to deal with them will be greatly diminished.

The crisis will, I hope, lead to changes in the realm of policies *and* in the realm of ideas. If we make the right decisions, not merely the politically socially expedient ones, we will not only make another crisis less likely, but perhaps even accelerate the kinds of real innovations that would improve lives of people around the world. If we make the wrong decisions, we will emerge with a society more divided and an economy more vulnerable to anot crisis and less well equipped to meet the challenges of the twenty-first century. One of the purposes of this book is to help us understand better the po crisis global order that eventually will arise and how what we do today will help shape it for better or for worse.

ONE MIGHT have thought that with the crisis of 2008, the debate over market fundamentalism—the notion that unfettered markets by themselves c ensure economic prosperity and growth—would be over. One might have thought that no one ever again—or at least until memories of this crisis ha receded into the distant past—would argue that markets are self-correcting and that we can rely on the self-interested behavior of market participants ensure that everything works well.

Those who have done well by market fundamentalism offer a different interpretation. Some say our economy suffered an "accident," and accide happen. No one would suggest that we stop driving cars just because of an occasional collision. Those who hold this position want us to return to world before 2008 as quickly as possible. The bankers did nothing wrong, they say.[2] Give the banks the money they ask for, tweak the regulations a l bit, give a few stern lectures to the regulators not to let the likes of Bernie Madoff get away with fraud again, add a few more business school courses ethics, and we will emerge in fine shape.

This book argues that the problems are more deep-seated. Over the past twenty-five years this supposedly self-regulating apparatus, our finan system, has repeatedly been rescued by the government. From the system's survival, we drew the wrong lesson—that it was working on its own. Inde our economic system hadn't been working so well for most Americans before the crisis. Somebody was doing well, but it was not the average America

An economist looks at a crisis in the same way a doctor approaches disease pathology: both learn much about how things work normally seeing what happens when things are not normal. As I approached the crisis of 2008, I felt I had a distinct advantage over other observers. I was, i sense, a "crisis veteran," a crisologist. This was not the first major crisis in recent years. Crises in developing countries have occurred with an alarm regularity—by one count, 124 between 1970 and 2007.[3] I was chief economist at the World Bank at the time of the last global financial crisis, in 19 –1998. I watched a crisis that began in Thailand spread to other countries in East Asia and then to Latin America and Russia. It was a classic example contagion—a failure in one part of the global economic system spreading to other parts. The full consequences of an economic crisis may take years manifest themselves. In the case of Argentina, the crisis began in 1995, as part of the fallout from Mexico's own crisis, and was exacerbated by the E Asian crisis of 1997 and the Brazilian crisis of 1998, but the full collapse didn't take place until late 2001.

Economists might feel proud about the advances in economic science over the seven decades since the Great Depression, but that does mean that there has been unanimity about how crises should be handled. Back in 1997, I watched in horror as the U.S. Treasury and the Internatio

Monetary Fund (IMF) responded to the East Asian crisis by proposing a set of policies that harkened back to the misguided policies associated v
President Herbert Hoover during the Great Depression and were bound to fail.

There was, then, a sense of déjà vu as I saw the world slipping once again into a crisis in 2007. The similarities between what I saw then an
decade earlier were uncanny. To mention but one, the initial public denial of the crisis: ten years earlier, the U.S. Treasury and the IMF had at first den
that there was a recession / depression in East Asia. Larry Summers, then Undersecretary of Treasury and now President Obama's chief econor
adviser, went ballistic when Jean-Michel Severino, then the World Bank's vice president for Asia, used the R-word (Recession) and the D-w
(Depression) to describe what was happening. But how else would one describe a downturn that left 40 percent of those in Indonesia's central islanc
Java unemployed?

So too in 2008, the Bush administration at first denied there was any serious problem. We had just built a few too many houses, the presid
suggested.[4] In the early months of the crisis, the Treasury and the Federal Reserve veered like drunk drivers from one course to another, saving so
banks while letting others go down. It was impossible to discern the principles behind their decision making. Bush administration officials argued that t
were being pragmatic, and to be fair, they were in uncharted territory.

As the clouds of recession began to loom over the U.S. economy in 2007 and early 2008, economists were often asked whether anot
depression, or even deep recession, was possible. Most economists instinctively replied, NO! Advances in economic science—including knowlec
about how to manage the global economy—meant that such a catastrophe seemed inconceivable to many experts. Yet, ten years ago, when the E
Asian crisis happened, we had failed, and we had failed miserably.

Incorrect economic theories not surprisingly lead to incorrect policies, but, obviously, those who advocated them thought they would work. T
were wrong. Flawed policies had not only brought on the East Asian crisis of a decade ago but also exacerbated its depth and duration and left a leg
of weakened economies and mountains of debt.

The failure ten years ago was also partly a failure of global politics. The crisis struck in the developing countries, sometimes called the "periphe
of the global economic system. Those running the global economic system were not so much worried about protecting the lives and livelihoods of those
the affected nations as they were in preserving Western banks that had lent these countries money. Today, as America and the rest of the world struggle
restore their economies to robust growth, there is again a failure of policy *and* politics.

Freefall

When the world economy went into freefall in 2008, so too did our beliefs. Long-standing views about economics, about America, and about our hero
have also been in freefall. In the aftermath of the last great financial crisis, *Time* magazine on February 15, 1999, ran a cover picture of Federal Rese
Chairman Alan Greenspan and Treasury Secretary Robert Rubin, who were long given credit for the boom in the 1990s, together with their protégé La
Summers. They were labeled the "Committee to Save the World," and in the popular mindset they were thought of as supergods. In 2000, the best-sel
investigative journalist Bob Woodward wrote a Greenspan hagiography entitled *Maestro*.[5]

Having seen firsthand the handling of the East Asian crisis, I was less impressed than *Time* magazine or Bob Woodward. To me, and to mos
those in East Asia, the policies foisted on them by the IMF and the U.S. Treasury at the behest of the "Committee to Save the World" had made the cris
far worse than they otherwise would have been. The policies showed a lack of understanding of the fundamentals of modern macroeconomics, which
for expansionary monetary and fiscal policies in the face of an economic downturn.[6]

As a society, we have now lost respect for our long-standing economic gurus. In recent years, we had turned to Wall Street as a whole—not
the demigods like Rubin and Greenspan—for advice on how to run the complex system that is our economy. Now, who is there to turn to? For the m
part, economists have been no more helpful. Many of them had provided the intellectual armor that the policymakers invoked in the movement tow
deregulation.

Unfortunately, attention is often shifted away from the battle of ideas toward the role of individuals: the villains that created the crisis, and
heroes that saved us. Others will write (and in fact have already written) books that point fingers at this policymaker or another, this financial executive
another, who helped steer us into the current crisis. This book has a different aim. Its view is that essentially all the critical policies, such as those rela
to deregulation, were the consequence of political and economic "forces"—interests, ideas, and ideologies—that go beyond any particular individual.

When President Ronald Reagan appointed Greenspan chairman of the Federal Reserve in 1987, he was looking for someone committec
deregulation. Paul Volcker, who had been the Fed chairman previously, had earned high marks as a central banker for bringing the U.S. inflation r
down from 11.3 percent in 1979 to 3.6 percent in 1987.[7] Normally, such an accomplishment would have earned automatic reappointment. But Volc
understood the importance of regulations, and Reagan wanted someone who would work to strip them away. Had Greenspan not been available for
job, there were plenty of others able and willing to assume the deregulation mantel. The problem was not so much Greenspan as the deregulat
ideology that had taken hold.

While this book is mostly about economic beliefs and how they affect policies, to see the link between the crisis and these beliefs, one has
unravel what happened. This book is not a "whodunit," but there are important elements of the story that are akin to a good mystery: How did the larg
economy in the world go into freefall? What policies and what events triggered the great downturn of 2008? If we can't agree on the answers to the
questions, we can't agree on what to do, either to get us out of the crisis or to prevent the next one. Parsing out the relative role of bad behavior by
banks, failures of the regulators, or loose monetary policy by the Fed is not easy, but I will explain why I put the onus of responsibility on financial mark
and institutions.

Finding root causes is like peeling back an onion. Each explanation gives rise to further questions at a deeper level: perverse incentives r
have encouraged shortsighted and risky behavior among bankers, but why did they have such perverse incentives? There is a ready answer: problem
corporate governance, the manner in which incentives and pay get determined. But why didn't the market exercise discipline on bad corpor
governance and bad incentive structures? Natural selection is supposed to entail survival of the fittest; those firms with the governance and incen
structures best designed for long-run performance should have thrived. That theory is another casualty of this crisis. As one thinks about the problems
crisis revealed in the financial sector, it becomes obvious that they are more general and that there are similar ones in other arenas.

What is also striking is that when one looks beneath the surface, beyond the new financial products, the subprime mortgages, and
collateralized debt instruments, this crisis appears so similar to many that have gone before it, both in the United States and abroad. There was a bubl
and it broke, bringing devastation in its wake. The bubble was supported by bad bank lending, using as collateral assets whose value had been infla
by the bubble. The new innovations had allowed the banks to hide much of their bad lending, to move it off their balance sheets, to increase their effec
leverage—making the bubble all the greater, and the havoc that its bursting brought all the worse. New instruments (credit default swaps), allegedly
managing risk but in reality as much designed for deceiving regulators, were so complex that they amplified risk. The big question, to which much of
book is addressed, is, How and why did we let this happen *again*, and on such a scale?

While finding the deeper explanations is difficult, there are some simple explanations that can easily be rejected. As I mentioned, those w worked on Wall Street wanted to believe that individually they had done nothing wrong, and they wanted to believe that the *system* itself was fundament right. They believed they were the unfortunate victims of a once-in-a-thousand-year storm. But the crisis was not something that just happened to financial markets; it was manmade—it was something that Wall Street did to itself and to the rest of our society.

For those who don't buy the "it just happened" argument, Wall Street advocates have others: The government made us do it, through encouragement of homeownership and lending to the poor. Or, the government should have stopped us from doing it; it was the fault of the regulat There is something particularly unseemly about these attempts of the U.S. financial system to shift the blame in this crisis, and later chapters will exp why these arguments are unpersuasive.

Believers in the system also trot out a third line of defense, the same one used a few years earlier at the time of the Enron and WorldC scandals. Every system has its rotten apples, and, somehow, our "system"—including the regulators and investors—simply didn't do a good enough protecting itself against them. To the Ken Lays (the CEO of Enron) and Bernie Ebbers (the CEO of WorldCom) of the early years of the decade, we r add Bernie Madoff and a host of others (such as Allen Stanford and Raj Rajaratnam) who are now facing charges. But what went wrong—then and r —did not involve just a few people. The defenders of the financial sector didn't get that it was their barrel that was rotten.[8]

Whenever one sees problems as persistent and pervasive as those that have plagued the U.S. financial system, there is only one conclusio reach: the problems are systemic. Wall Street's high rewards and single-minded focus on making money might attract more than its fair share of ethically challenged, but the universality of the problem suggests that there are fundamental flaws in the system.

Difficulties in interpretation

In the policy realm, determining success or failure presents a challenge even more difficult than ascertaining to whom or to what to give credit (and who what to blame). But what is success or failure? To observers in the United States and Europe, the East Asian bailouts in 1997 were a success becau the United States and Europe had not been harmed. To those in the region who saw their economies wrecked, their dreams destroyed, their compar bankrupted, and their countries saddled with billions in debt, the bailouts were a dismal failure. To the critics, the policies of the IMF and U.S. Treasury h made things worse. To their supporters, they had prevented disaster. And there is the rub. The questions are, What would things have been like if ot policies had been pursued? Had the actions of the IMF and U.S. Treasury prolonged and deepened the downturn, or shortened it and made it shallow To me, there is a clear answer: the high interest rates and cutbacks in expenditures that the IMF and Treasury pushed—just the opposite of the polic that the United States and Europe followed in the current crisis—made things worse.[9] The countries in East Asia eventually recovered, but it was in sp of those policies, not because of them.

Similarly, many who observed the long expansion of the world economy during the era of deregulation concluded that unfettered markets worl —deregulation had enabled this high growth, which would be sustained. The reality was quite different. The growth was based on a mountain of debt; foundations of this growth were shaky, to say the least. Western banks were repeatedly saved from the follies of their lending practices by bailouts— just in Thailand, Korea, and Indonesia, but in Mexico, Brazil, Argentina, Russia…the list is almost endless.[10] After each episode the world continued much as it had before, and many concluded that the markets were working fine by themselves. But it was government that repeatedly saved markets fr their own mistakes. Those who had concluded that all was well with the market economy had made the wrong inference, but the error only beca "obvious" when a crisis so large that it could not be ignored occurred *here*.

These debates over the effects of certain policies help to explain how bad ideas can persist for so long. To me, the Great Recession of 20 seemed the inevitable consequence of policies that had been pursued over the preceding years.

That those policies had been shaped by special interests—of the financial markets—is obvious. More complex is the role of economics. Amo the long list of those to blame for the crisis, I would include the economics profession, for it provided the special interests with arguments about effici and self-regulating markets—even though advances in economics during the preceding two decades had shown the limited conditions under which t theory held true. As a result of the crisis, economics (both theory and policy) will almost surely change as much as the economy, and in the penultim chapter, I discuss some of these changes.

I am often asked how the economics profession got it so wrong. There are always "bearish" economists, those who see problems ahe predicting nine out of the last five recessions. But there was a small group of economists who not only were bearish but also shared a set of views ab *why* the economy faced these inevitable problems. As we got together at various annual gatherings, such as the World Economic Forum in Davos ev winter, we shared our diagnoses and tried to explain why the day of reckoning that we each saw so clearly coming had not yet arrived.

We economists are good at identifying underlying forces; we are not good at predicting precise timing. At the 2007 meeting in Davos, I was in uncomfortable position. I had predicted looming problems, with increasing forcefulness, during the preceding annual meetings. Yet, global econor expansion continued apace. The 7 percent global growth rate was almost unprecedented and was even bringing good news to Africa and Latin Ameri As I explained to the audience, this meant that either my underlying theories were wrong, or the crisis, when it hit, would be harder and longer tha otherwise would be. I obviously opted for the latter interpretation.

THE CURRENT crisis has uncovered fundamental flaws in the capitalist system, or at least the peculiar version of capitalism that emerged in the la part of the twentieth century in the United States (sometimes called American-style capitalism). It is not just a matter of flawed individuals or spec mistakes, nor is it a matter of fixing a few minor problems or tweaking a few policies.

It has been hard to see these flaws because we Americans wanted so much to believe in our economic system. "Our team" had done so m better than our arch enemy, the Soviet bloc. The strength of our system allowed us to triumph over the weaknesses of theirs. We rooted for our team i contests: the United States vs. Europe, the United States vs. Japan. When U.S. Secretary of Defense Donald Rumsfeld denigrated "Old Europe" for opposition to our war in Iraq, the contest he had in mind—between the sclerotic European social model and U.S. dynamism—was clear. In the 198 Japan's successes had caused us some doubts. Was our system really better than Japan, Inc.? This anxiety was one reason why some took s comfort in the 1997 failure of East Asia, where so many countries had adopted aspects of the Japanese model.[11] We did not publicly gloat over Japa decade-long malaise during the 1990s, but we did urge the Japanese to adopt our style of capitalism.

Numbers reinforced our self-deception. After all, our economy was growing so much faster than almost everyone's, other than China's—and gi the problems we thought we saw in the Chinese banking system, it was only a matter of time before it collapsed too.[12] Or so we thought.

This is not the first time that judgments (including the very fallible judgments of Wall Street) have been shaped by a misguided reading of numbers. In the 1990s, Argentina was touted as the great success of Latin America—the triumph of "market fundamentalism" in the south. Its gro statistics looked good for a few years. But like the United States, its growth was based on a pile of debt that supported unsustainable levels consumption. Eventually, in December 2001, the debts became overwhelming, and the economy collapsed.[13]

Even now, many deny the magnitude of the problems facing our market economy. Once we are over our current travails—and every recess does come to an end—they look forward to a resumption of robust growth. But a closer look at the U.S. economy suggests that there are some dee problems: a society where even those in the middle have seen incomes stagnate for a decade, a society marked by increasing inequality; a cou where, though there are dramatic exceptions, the statistical chances of a poor American making it to the top are lower than in "Old Europe,"[14] and wh average performance in standardized education tests is middling at best.[15] By all accounts, several of the key economic sectors in the United Sta *besides finance* are in trouble, including health, energy, and manufacturing.

But the problems that have to be addressed are not just within the borders of the United States. The global trade imbalances that marked world before the crisis will not go away by themselves. In a globalized economy, one cannot fully address America's problems without viewing th problems broadly. It is *global* demand that will determine global growth, and it will be difficult for the United States to have a robust recovery—rather t slipping into a Japanese-style malaise—unless the world economy is strong. And it may be difficult to have a strong global economy so long as part of world continues to produce far more than it consumes, and another part—a part which should be saving to meet the needs of its aging populat —continues to consume far more than it produces.

WHEN I began writing this book, there was a spirit of hope: the new president, Barack Obama, would right the flawed policies of the Bush administrati and we would make progress not only in the immediate recovery but also in addressing longer-run challenges. The country's fiscal deficit wo temporarily be higher, but the money would be well spent: on helping families keep their homes, on investments that would increase the country's long- productivity and preserve the environment, and, in return for any money that was given to the banks, there would be a claim on future returns that wo compensate the public for the risk it bore.

Writing this book has been painful: my hopes have only partially been fulfilled. Of course, we should celebrate the fact that we have been pu back from the brink of disaster that so many felt in the fall of 2008. But some of the giveaways to the banks were as bad as any under President Bush; help to homeowners was less than I would have expected. The financial system that is emerging is less competitive, with too-big-to-fail banks present an even greater problem. Money that could have been spent restructuring the economy and creating new, dynamic enterprises has been given away save old, failed firms. Other aspects of Obama's economic policy have been decidedly movements in the right direction. But it would be wrong to h criticized Bush for certain policies and not raise my voice when those same policies are carried on by his successor.

Writing this book has been hard for another reason. I criticize—some might say, vilify—the banks and the bankers and others in the finan market. I have many, many friends in that sector—intelligent, dedicated men and women, good citizens who think carefully about how to contribute t society that has rewarded them so amply. They not only give generously but also work hard for the causes they believe in. They would not recognize caricatures that I depict here, and I don't recognize these caricatures in them. Indeed, many of those in the sector feel that they are as much victims those outside. They have lost much of their life savings. Within the sector, most of the economists who tried to forecast where the economy was going, dealmakers who tried to make our corporate sector more efficient, and the analysts who tried to use the most sophisticated techniques possible predict profitability and to ensure that investors get the highest return possible were not engaged in the malpractices that have earned finance such a b reputation.

As seems to happen so often in our modern complex society, "stuff happens." There are bad outcomes that are the fault of no single individual. this crisis was the result of actions, decisions, and arguments by those in the financial sector. The system that failed so miserably didn't just happe was created. Indeed, many worked hard—and spent good money—to ensure that it took the shape that it did. Those who played a role in creating system and in managing it—including those who were so well rewarded by it—must be held accountable.

IF WE can understand what brought about the crisis of 2008 and why some of the initial policy responses failed so badly, we can make future crises l likely, shorter, and with fewer innocent victims. We may even be able to pave the way for robust growth based on solid foundations, not the epheme debt-based growth of recent years; and we may even be able to ensure that the fruits of that growth are shared by the vast majority of citizens.

Memories are short, and in thirty years, a new generation will emerge, confident that it will not fall prey to the problems of the past. The ingenuit man knows no bounds, and whatever system we design, there will be those who will figure out how to circumvent the regulations and rules put in place protect us. The world, too, will change, and regulations designed for today will work imperfectly in the economy of the mid-twenty-first century. But in aftermath of the Great Depression, we did succeed in creating a regulatory structure that served us well for a half century, promoting growth and stabi This book is written in the hope that we can do so again.

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