

FIVE EASY PIECES ABOUT THE CRISIS

by Andreu Mas-Colell*

I would like to take the opportunity offered to me in this article to express a few, in fact five, ideas about the current crisis in the world economy. They will be somewhat disconnected and not particularly deep or technical, as I cannot claim to be a specialist on financial or monetary matters.

1. The first observation is that when facing an economic crisis, policy reactions are bound to be strongly influenced by **history**. Over the last year a dark fear has taken hold of the world's conscience: the fear that 1929 could be repeated. The current crisis has many unexpected features but some of its characteristics take us back to 1929. As a consequence we have reacted (which is to say the world economic leader, the US, has reacted) and I daresay we will continue to react, by doing what we feel worked then and by avoiding what did not work then. More explicitly: with a fiscal expansion, an extremely expansive monetary policy (that was not implemented after 1929) and, up until now (and I would be optimistic in this respect), by avoiding the protectionist temptation. In addition, of course, there has been an understanding that, in some respects, we are moving in uncharted territory, especially in that which concerns the financial sector. However, for now I'm referring to the real impact of the crisis.

OVER THE LAST YEAR A DARK FEAR HAS TAKEN HOLD OF THE WORLD'S CONSCIENCE: THE FEAR THAT 1929 COULD BE REPEATED

The avoidance of protectionism is not controversial by any means. No sensible economist would recommend it. Maybe I should say no sensi-

ble economist taking into account the general interest. There may be some economists inclined to recommend to their national governments measures bordering on protectionism, but they are rare. The disaster brought about by an escalation in protectionism in the 30s was of such magnitude that its avoidance has become almost a moral principle among economists.

The expansive monetary policy and, more pointedly, the expansive fiscal policy have raised some eyebrows, although not with sufficient force to make a serious dent on policy, especially in the USA. The concerns are two-fold: Concerns as to what these measures may hold in store for tomorrow and doubts as to whether they will work. As for monetary policy it is argued, for example, that the creation of liquidity may have inflationary consequences in the future. Also, there have been experiences where an exclusive reliance on easy monetary policy has failed. As for fiscal policy history should make us, in principle, more optimistic, but the present situation is quite unique. Expectations have received a tremendous jolt and it is possible that people realise that current deficits will need to be absorbed in the future (this is known as the Ricardian equivalence argument), leading to a shift towards placing more probability weight on the anticipation of higher taxes in the future (perhaps because people are sceptical about fu-



ture growth). The consequence is an increasing propensity to save, thus nullifying the effects of increased expenses.

These are legitimate worries and they are having an effect, more in Europe than in the US. Nevertheless, I believe we are duty bound to try the expansionary policies. If the world comes out of recession in a relatively short time, central banks and economic authorities have the means to control in-

flationary dangers (for example, expect quick increases in interest rates, driven by the European Central Bank, as soon as we get out of recession. Not good news for those European countries with a slower recovery). If the recession persists it is certainly true that we will have added difficulties (some countries more than others) with public debt. However, and this is a key question, can we really afford not to try? Can we really contemplate a situation where no

fiscal expansion is attempted and there is no recovery? Maybe the recovery is unrelated to these policies. Nevertheless, how can we be sure? Economists make educated judgments but they are always probabilistic. You would be wise not to trust an economist (or any social scientist, for that matter) who is full of certainties. On this point, my own opinion is that it would have been irresponsible not to have tried. As of this date (May 09) I remain optimistic about its effects.

BANKS WHICH ARE NOT PERCEIVED TO HAVE THE TAXPAYERS OF A COUNTRY THAT IS STRONG ENOUGH BEHIND THEM, AS A SAVIOR OF LAST RESORT, WILL NOT BE SUFFICIENTLY TRUSTED

2. Let me now move to my second observation, which relates to **expectations**. After the so-called 'great moderation' (a very long period of growth in the advanced, and many non-advanced, countries) the current crisis has come as a shock. It would constitute an extreme form of naïveté to believe that it should not affect how we think about the future. To me it reasserts a lesson that we should never have forgotten: every period of expansion is followed (but not deterministically with respect to the moment) by a recession, at least. This applies to all countries, advanced and non-advanced. I wish that this lesson did not apply to the less advanced countries because they are in sore need of growth, but it does. It is to be desired, therefore, that the economic leaders of these countries do not operate under institutional systems that require sustained and permanent growth, because if so, the unavoidable crisis may be much worse, in itself and in its social and political impact. It is imperative that the institutional environment be adaptable, ideally self-adaptable (auto-

matic). To be more explicit: currently I'm more optimistic about India than about China.

3. The third observation has as a starting point the remark made above as to the extent to which economists, and other social scientists, can make educated judgments. In fact, very educated judgments. Nevertheless, if the situation is new, one cannot be sure, as I have also indicated, how things will work out exactly, or perhaps if they will work out at all. This means that one should be willing to **experiment**. To try measures (I am referring here to the famous structural measures so often mentioned, among others) and to abandon them if they do not have the desired effect. Of course, this should be done with care because we are dealing with real people. However, in matters such as the average, long-term unemployment rate it could be sad if there was a measure out there that would reduce it and we did not give it an opportunity.

4. In fourth place let me ask to what extent the current crisis has a **technological nature** (as was the case, for example, with the dot-com crisis or with many others associated with major innovations in the past). A major characteristic of this type of crisis is that overoptimistic expectations built around the possibilities opened up by a new technology fuel a bubble that eventually bursts, as every bubble is bound to do. With it go extravagant claims about the technology, but typically the technology itself, and the new industries that support it or are supported by it, remain. After the party they are valued for their true worth and incorporated into the natural flow of the economy, so to speak. At first sight the current crisis is not like this, but in a sense it is: the new technologies have been the new financial instruments.

The derivatives, in other words. These are useful tools for the diversification of risks and they are here to stay but, as happens in the script of technological crises, there has been too much of a belief that they could work miracles, leading to the development of credit with very little collateralization and to excessive leveraging.

5. My final remark takes as its starting point the observation that, in some respects, the current crisis has enhanced the significance of the State. It has underlined a role whose importance had lain dormant, unappreciated and perhaps forgotten: the State, and not just the Central Bank, as guarantor of the stability and viability of the financial system, including the banks. Indeed, it has been the institution of the State that in the present crisis has saved the financial system from collapse. This has an immediate and far-reaching consequence: the **increased role of states**. The fact is that history has delivered us a world that, while highly interconnected, does not constitute a single state. The increased relevance of individual states in the regulation and sustenance of the structure of guarantees of the financial and, more specifically, the banking system, will condition, perhaps dramatically,



the shape of the international financial system. The concept of an international bank loses strength: banks will need to be supervised by a state. What is more: banks which are not perceived to have the taxpayers of a country that is strong enough behind them as a savior of last resort will not be sufficiently trusted (incidentally, this is a reason why international cooperation and organisations will be of help, but not decisively). In partial contrast with the past, banks will seek a solid home base and therefore the size of the country will matter a great deal in terms of the size of the banks it can support. Indeed, we have already witnessed in the current crisis several instances of the lack of congruence between the size of some countries and of their banks.

*ANDREU MAS-COLELL



PROFESSOR OF ECONOMICS AT THE *Universitat Pompeu Fabra* AND PRESIDENT OF THE BARCELONA GRADUATE SCHOOL OF ECONOMICS. HE WAS A LECTURER IN ECONOMICS AT HARVARD UNIVERSITY (1981-96) AND PROFESSOR OF ECONOMICS AND MATHEMATICS AT THE UNIVERSITY OF CALIFORNIA (BERKELEY) (1972-80). HE HAS BEEN A SLOAN FELLOW AND A GUGGENHEIM FELLOW. HE HAS BEEN EDITOR OF THE JOURNAL OF MATHEMATICAL ECONOMICS (1985-88), AND *Econometrica* (1988-92). PROFESSOR MAS-COLELL IS A FELLOW OF THE ECONOMETRIC SOCIETY AND WAS ITS PRESIDENT IN 1993. IN 1997 HE WAS ELECTED FOREIGN ASSOCIATE OF THE AMERICAN NATIONAL ACADEMY OF SCIENCES AND FOREIGN HONORARY MEMBER OF THE AMERICAN ECONOMIC ASSOCIATION. HE HAS BEEN A MEMBER OF THE EXECUTIVE OF THE INTERNATIONAL ECONOMIC ASSOCIATION AND PRESIDENT OF THE SPANISH ECONOMIC ASSOCIATION (2006). FROM 2000 TO 2003 HE WAS MINISTER FOR INNOVATION, UNIVERSITIES AND ENTERPRISE FOR THE *Generalitat of Catalunya*. HE HAS BEEN NAMED FUTURE SECRETARY GENERAL OF THE EUROPEAN RESEARCH COUNCIL (ERC) FOR THE PERIOD (JULY) 2009-2011. IN 2005 HE WAS CHOSEN TO BE A MEMBER OF THE INSTITUTE OF CATALAN STUDIES AND OF THE ROYAL ACADEMY OF MORAL AND POLITICAL SCIENCES, IN 2008. HE HAS BEEN A MEMBER OF THE ADVISORY COUNCIL OF THE RESEARCH DEPARTMENT OF *La Caixa* AND PRESIDENT OF *Telefonica's* RESEARCH AND DEVELOPMENT SCIENTIFIC ADVISORY COUNCIL. CURRENTLY HE IS A MEMBER OF THE BOARD OF DIRECTORS OF THE *Cercle d'Economia*. MAS-COLELL HAS WRITTEN MORE THAN 100 STUDIES ON TOPICS THAT RANGE FROM THE ABSTRACT THEORY OF GENERAL EQUILIBRIUM AND STRUCTURE OF FINANCIAL MARKETS, TO PRICING POLICIES FOR PUBLIC COMPANIES AND GAME THEORY.