No. 09-32
August 2009

# WORKING PAPER

## PROJECTIONS PAST AND FUTURE:
## Economic Imagination and the Financial Crisis 2007–2012

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MERCATUS CENTER
GEORGE MASON UNIVERSITY

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# **Projections past and future**

Economic imagination and the financial crisis 2007-2012

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June 2009

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# Introduction

The UK economy is in a state of flux.

Try to think back to 2006; back when my students hadn't heard of "quantitative easing" (and neither had I), when I mystified colleagues for teaching such antiquated and irrelevant topics as "what ended the Great Depression," and back when the Labour government had "ended" boom and bust and delivered low interest rates, low inflation, and economic growth.

We have since moved from an illusion of steady growth to the reality of catastrophe. It was not growth; it was indebtedness. The housing market was a bubble and the entire banking system was perilously over-leveraged. Even prior to the bank bailouts, the UK budget deficit was approaching £200 billion. UK net sovereign debt (which was £353 billion in 2001) was around £700 billion at the beginning of 2009 and could well exceed £1 trillion. Times are tough and promise to get tougher.

Whether or not economists could, or should, have predicted this mess, there is an unprecedented urgency and demand for us to make ourselves a little more useful than we currently are. In this article I shall argue that we have two main tools at our disposal, both of which are shockingly under-utilized. The first is **counterfactual analysis**—the ability to construct alternative histories to robustly assess what has transpired to be. The second is **scenario building**—the creation of alternative futures to interpret and respond to what is to come.

It is the art of imagination that provides economists with our contribution to the public debate. This is my attempt to add to that debate.

# Part 1: Projections past

It is somewhat frustrating for a skeptic of fiscal stimulus programs (such as myself) to debate with their advocates.

> Economist 1: What explains the scale of the recession?
> Economist 2: We didn't have a big enough fiscal stimulus.
> Economist 1: Really? Obama is spending $800bn.
> Economist 2: But as a fraction of GDP it is quite small.
> Economist 1: But Japan spent over $6 trillion on construction projects, around 3 percent of GDP in all.
> Economist 2: Well, their depression would have been even worse if they had not spent the money.

Apparently, if the economy recovers, it is due to the stimulus. If it does not, it is because the stimulus was not big enough. What we can—and should—agree upon is that reconciliation and a genuine advancement in our understanding lies in the space of counterfactual analysis. If the common response is, "It would have been even *worse* if X had no have happened," the debate need not stop there. Indeed, we have a responsibility to pursue this line of thinking and use the established practice of counterfactual analysis to make projections about the past.

*Alternative histories should not cut debate short; they should be the starting point of serious enquiry.*

The starting point of this exercise is crucial. There is an old joke about someone who is lost and stops a passing stranger to ask which was the right way to the train station. "I wouldn't start from here," came the response. It is perfectly valid for economists to use a similar reply when journalists clamour for a "get out of jail free" card; there is nothing wrong with saying, "We are in a mess, and before we discuss ways to get out of it we need to understand why it happened in the first place." But often this evasiveness simply reflects apathy towards solutions. To build effective counterfactuals, we first need to establish our starting point. For purposes of this discussion, we should begin at some point in history before we became "locked in" to a particular rescue passage, but not so far in the past that we lose focus of the overriding problem.

I suggest we go back to the summer of 2007. This is when the subprime mortgage market collapsed, but before the state had fully launched into its strategy of bailouts, nationalizations, and ad-hoc interventions. To recap, the first real "moment" of the crisis, and the first signal that trouble was truly brewing, was the bankruptcy of Merit Financial Inc. in May 2006. From February to March 2007, several more U.S. mortgage lenders declared bankruptcy as the subprime industry imploded. On September 14th, Northern Rock secured an emergency credit line from the Bank of England (leading to the first bank run in the country since 1866). March 16, 2008 saw JP Morgan Chase use a Federal Reserve loan to take over Bear Sterns, and the defining moment came on September 15, 2008 when Lehman Brothers filed for bankruptcy. Throughout September, companies such as Fannie Mae, Freddie Mac, Merrill Lynch, AIG, and Washington Mutual (and in the UK Bradford & Bingley) were either taken over or nationalized. The following month saw stock markets enter

free fall and the true scale of the crisis became apparent. Looking back to the summer of 2007 (after the subprime industry collapsed, but before the response strategy was implemented), I wish to imagine what would have happened if we had followed the following three paths.

**Counterfactual 1: "A glass of wine by his own fireside"**
*As the Drury Lane Theatre went up in flames, passers-by noticed a man who stood in the street with a drink, simply watching. Richard Brinsley Sheridan—the owner—was reported to have said, "A man may surely be allowed to take a glass of wine by his own fireside."*[1]

Imagine if policy makers had responded to the brewing credit crunch in a similar vein of passive detachment. What would have happened? Catastrophe?

Firstly, on what grounds do we judge catastrophe? Despite the bailouts, Bush stimulus, Obama stimulus, etc., the Dow Jones lost 35 percent of it value between September 2008 and March 2009. Is this success or failure? The economist Steve Horwitz cites Bryan Caplan as asking the following question:

> Suppose for the last six months both administrations had responded to the crisis by adopting a strong laissez-faire position. On 9/3/08, the Dow stood at 11,533. Monday it was around 7300. Unemployment has gone up by 2 percentage points. Does anyone think that laissez-faire as a policy would not have been absolutely savaged by the media and others given the economy's performance since then? If not, then why haven't we rejected the activism as vigorously, given that performance?[2]

While this needs to be born in mind when *appraising* policy responses, the fact remains—what would have happened if a laissez-faire response was enacted? According to Democratic Representative Paul Kanjorski, the following:

> On Thursday (Sept 18 [2008]), at 11am the Federal Reserve noticed a tremendous draw-down of money market accounts in the U.S., to the tune of $550 billion was being drawn out in the matter of an hour or two. The Treasury opened up its window to help and pumped a $105 billion in the system and quickly realized that they could not stem the tide. We were having an electronic run on the banks. They decided to close the operation, close down the money accounts and announce a guarantee of $250,000 per account so there wouldn't be further panic out there . . . If they had not done that, their estimation is that by 2pm that afternoon, $5.5 trillion would have been drawn out of the money market system of the U.S., would have collapsed the entire economy of the U.S., and within 24 hours the world economy would have

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[1] The Oxford Dictionary of Quotations, OUP (1999)
[2] Cited by Steve Horwitz, http://myslu.stlawu.edu/~shorwitz/gsutalk.htm

> collapsed. It would have been the end of our economic system and our political system as we know it.[3]

Glossing over the inflammatory rhetoric, what would have happened if this guarantee wasn't put into place, and the extra liquidity not injected? Tyler Cowen posits the following:

> My personal guess—and guess is the right word—is that if nothing had been done on this day, a disaster would have resulted, though not on the scale postulated here. In my view there would have been an immediate bank holiday, partly improvised, plus complete insolvency for some very large financial institutions, followed by rapid nationalization. There would have been a much tougher whack to the commercial paper market than what we saw. Many businesses would have had problems meeting short-term payroll requirements. The downturn in the real sector would have been much steeper than it has been. In short, it would have been very bad but not the end of the world economy or democratic capitalism.[4]

In the "glass of wine by his own fireside" alternative, these insolvencies would lead directly to a large downturn in the real sector and a shut down of credit markets. Investors would lose money (on risky assets) and businesses without sufficient reserves would become insolvent. In summary, the following would occur:

- Housing market collapses
- Major financial institutions go bankrupt
- Major restriction on cash-flow for SMEs
- Large-scale unemployment
- Major currency devaluation
- Loss of faith in policy makers
- Threat of widespread public disturbances

Does this sound familiar? Robert Murphy points out that:

> Paulson and Bernanke chickened out and didn't simply let a bunch of banks fail back in September 2007. It would have been painful—there would have been billions in losses, house prices would have plummeted, the dollar may have fallen, etc. But guess what? All those things happened anyway, and the fundamental problems in the economy merely festered.[5]

Essentially we'd see the process of "creative destruction" in the banking industry. If there are no bailouts then efforts will be on wealth creation, not wealth redistribution.

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[3] See 2 min 20s of here: http://www.youtube.com/watch?v=pD8viQ_DhS4. This has been confirmed by Paulson himself, see 1hr 50min 48sec of here: http://financialserv.edgeboss.net/wmedia/financialserv/hearing092408.wvx

[4] http://www.marginalrevolution.com/marginalrevolution/2009/02/did-the-world-almost-come-to-an-end-sept-18th.html

[5] http://consultingbyrpm.com/blog/2008/09/free-market-bush-administration.html

As Robert Reich says, "If they're too big to fail, they're too big period."[6] It is important to point out that not all banking chiefs were in favour of state intervention. For example, the Chief Executive of a Kansas City bank wrote the following on the bank's Web site: "When the siren song of the subprime-mortgage market came along we took the long view and turned a deaf ear."[7] BB&T, the 14th-largest commercial bank in the U.S. (with revenues of $136.5 billion), avoided subprime lending and complex debt securities. Its chairman & former CEO, John Allison, opposed the bailouts. In a letter to Congress he said, "It is important that any rules post-'rescue' punish the poorly run institutions and not punish the well-run companies . . . [Congress should] hear from well-run financial institutions."

In this version of the past, the public would acknowledge that bankruptcy isn't the end of the world. What happened to Lehman? Assets moved to companies that could employ them more productively. Thomas Woods wrote, "The earth did not break free of its orbit and go tumbling toward the sun. Washington Mutual, or WaMu, was the largest American savings and loan bank, and it had to liquidate in September 2008. JP Morgan Chase bought some of its good assets. Life went on."[8]

There is evidence in the UK of this process of creative destruction occurring. Private sector buyouts (the norm in the baking industry prior to central banks) included the Derbyshire and Cheshire Building Societies being taken over by the Nationwide Building Society in September 2008;[9] Alliance & Leicester being taken over by Santander on October 10, 2008; and Yorkshire Building Society merging with Barnsley Building Society (£376 million assets December 2007) on December 31, 2008. However, in a demonstration of the lack of political support for the "do nothing" approach, the majority of takeovers and buyouts were being done behind closed doors, with the state in the driving seat (in particular, the shotgun marriage on January 19, 2009 when HBOS was taken over by Lloyds TSB).

The deeper "problem" is that many of these falling assets (U.S. dollar and high-rated corporate bonds in particular) had been tacitly insured by the U.S. government. Imagine if the Treasury had not stood behind and supported mortgage agencies debt. According to Tyler Cowen:

> The Chinese bought over $300 billion of that stuff and they were told that it is essentially riskless. The flow of capital from them and from other central banks, sovereign wealth funds, and plain old ordinary investors would shut down very quickly. The dollar would fall say 30–40 percent in a week, there would be payments system gridlock, margin calls at the clearinghouses would go unmet, and only a trading shutdown would stop the Dow from shedding half its value. Most of the U.S. banking system would be insolvent. Emergency Fed/Treasury action would recapitalize the FDIC but we would lose an independent central bank and setting the money supply would be a

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[6] http://robertreich.blogspot.com/2008/10/if-theyre-too-big-to-fail-theyre-too.html
[7] cited by Frederick Holmes in a letter to *The Economist*, http://www.economist.com/opinion/displaystory.cfm?story_id=13097517
[8] Thomas Woods (2009) *Meltdown*, Regnery
[9] http://news.bbc.co.uk/1/hi/business/7603411.stm

> crapshoot. The rate of unemployment would climb into double digits and stay there. Many Americans would not have access to their savings. The future supply of foreign investment would be noticeably lower. The federal government would lose its AAA rating and we would pay much more in borrowing costs. The deficit would skyrocket.[10]

And Cowen also says, even more melodramatically, "When it comes to the mortgage agencies, there is no real choice but to bail out the debt holders. The alternative is a run on the dollar and collapse of faith in U.S. government securities and the end of the world."[11]

But would a refusal to bail out U.S. financial assets devastate foreign investors' confidence in the U.S. economy? Not if it signalled that U.S. Treasuries were not tied to toxic assets. If the "worst-case scenario" is a government default, are we sure that this should be left off the table?

On this, Jeff Hummel makes two arguments. The first is on ethical grounds:

> Treasury securities represent a stream of future tax revenues, and investors have no more just claim to those returns than to any investment in a criminal enterprise. I favor total repudiation of all government debt for the same reason I favor abolition of slavery without compensation to slaveholders. [12]

The second argument is more technical:

> The economic argument depends on whether Ricardian Equivalence holds. Repudiating government debt eliminates future tax liabilities. To the extent that people correctly anticipate those liabilities, the value of private assets (including human capital) should rise over the long run by the same amount that the value of government securities falls. Thus, people will gain or lose depending how closely their wealth is associated with the State. If on the other hand, people underestimate their future tax liabilities, they suffer from a fiscal or "bond illusion" in which Treasury securities make them feel wealthier than they actually are. Debt repudiation will bring their expectations into closer alignment with reality, which should increase saving.[13]

In conclusion, a liquidationist, laissez-faire approach would undoubtedly look bad. But two points remain. First, none of the efficiency losses due to regime uncertainty and the arbitrary shifting of policy would occur. Second, even the worst-case scenario—government default—has a silver lining.

**Counterfactual 2: Let markets flourish**

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[10] http://www.marginalrevolution.com/marginalrevolution/2008/09/could-you-clari.html
[11] http://www.marginalrevolution.com/marginalrevolution/2008/07/the-cost-of-mor.html
[12] http://hnn.us/blogs/entries/53544.html
[13] http://hnn.us/blogs/entries/53544.html

It would be wrong to subscribe counterfactual 1 to free-market, classical liberal, or libertarian economists. On the contrary, there is a "positive program for laissez faire" which would involve concerted policy reforms built around markets being allowed to flourish. I will assume some cultural differences under this scenario, namely that the general public accepts that a recession will occur and understands the basic coordinate function of the price system. We would see several key outcomes:

*(i) Insider trading would be legalized, allowing whistleblowers to reveal information.*

Although the share price of banks such as HBOS would drop immediately, we would know very quickly how many assets are truly "toxic" and where they are. Either there are more than we thought (but at least the truth is out in the open and can start the recovery phase), or there are less than we thought (even better). Instead of relying on the long and bureaucratic process of regulatory oversight, allowing those in the know to trade on their knowledge would shed light on banks' balance sheets. Another policy would be to abolish "Fair Value Accounting" (FVA) and allow auditors to make estimates of market value, rather than state "current" market value.

*(ii) Let the private sector lead expectations management—price deflation is mild and temporary.*[14]

The biggest policy concern about falling prices is that they encourage consumers to put off spending, leading to an economic slowdown. But there are examples of the private sector deliberately attempting to manage customers' expectations. Consider the justification by Tesco for their large pre-Christmas price cuts:

> Tesco's commercial director, Richard Brasher, said the price cuts were in response to surveys it had done, which found that customers were reluctant to spend early on certain items in case they were later discounted. He said: 'Customers are telling us that they are delaying their main Christmas purchases as they wait for bargains. Some say that a bit of the pleasure they usually get from buying gifts has gone in the current climate . . . Our Half Price Sale reassures customers that we're not making them wait.'[15]

*(iii) Allow labor markets to adjust to mitigate unemployment.*

A primary cause of the Great Depression was that markets (and the labor market in particular) were not allowed to clear. And while they are more flexible today, there

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[14] Note: There's a distinction between monetary deflation (primary cause of Great Depression) and price deflation (a possible outcome). We still buy consumer electronics, despite an assumption that nominal prices fall over time. And we expect real price deflation across a broad range of products . . . *but still buy them*. Technological innovation *should* lead to falling prices, and an increase in living standards. By propping up prices we are denied the welfare-enhancing effects of innovation.

[15] "Tesco slashes prices 50% in pre-Christmas sale" The Times, December 11th 2008, http://business.timesonline.co.uk/tol/business/industry_sectors/retailing/article5323997.ece.

are still rigidities that prevent wages from changing and curtail the adaptability of business. Some possible remedies:

- Eliminate corporation tax (revenues are expected to fall anyway, this may not be devastating for public finances and would be a simulative).
- Raise retirement age (to reduce pension obligations).
- Repeal minimum wage laws .
- Ease restrictions on migrant workers.

One outcome might be the fact that workers accept that there's a downturn and are willing to take pay cuts to safeguard their jobs.

*(iv) Reduce the size of government.*

If markets are to be given room to flourish, government needs to scale back. One policy might be a balanced budget amendment to actually prevent government from inflating the money supply. This might finally do what independent central banking has failed to accomplish—create a credible commitment that the monetary authorities will not monetise their debts. Indeed a reduction in the size of the state would give scope for new industries—currently illegal—to flourish. There would be a fiscal stimulus and immediate boost to tax revenue through the legalization of trade in the following industries:

- Drugs
- Guns
- Prostitution

In addition, the immediate withdrawal from Iraq and Afghanistan and a drastic reduction in military spending would restore the public finances.

The key outcomes of this counterfactual would be an immediate and drastic reduction in economic activity, but laden with possibilities for future growth. It is well known that recessions fuel new company creation, and if the economic system is altered to be more friendly to entrepreneurship, these will be the drivers of growth. There would be a clear shift in benefits from debtors to savers, and although debt burdens might push many into negative equity, savers will accumulate sizable deposits and move into the housing market when house values better reflect earnings. There would be a rise in personal bankruptcy, but a greater ability to accumulate wealth in the future.

**Counterfactual 3: The opportunistic act**

The final counterfactual imagines what would have happened if the UK government pursued opportunistic policies to guarantee UK financial accounts and seize control of the financial industry. This would pre-empt the credit crunch by (a) slowing down the growth of credit and exposure to over-leverage (the government would have entered the crisis increasing interest rates and reserve requirements to restrict credit growth); (b) once the crisis hit, intervening opportunistically in the banking industry, creating a "bad bank" to ring fence toxic assets, nationalizing Bradford & Bingley, Northern

Rock, etc., and then swiftly returning them as mutually owned building societies,[16] while others remain in the public sector (the government also exploits its access to capital to undercut commercial and foreign lenders); and (c) underwriting all new loans to small businesses (in the expectation that some will pay off and it will generate a return—i.e., the state speculates about the long-term viability of the economy).

The main outcomes of these policies might be:

- Inflow of foreign capital
- Exchange rate appreciates
- Bad relations with foreign countries
- Bad relations with the city

Although this is written as a counterfactual, it is important to touch upon the events that have resembled this particular strategy. For example, the UK government nationalized Northern Rock and guaranteed all deposits (even above the £50,000 limit at other banks). The bank then began to offer highly competitive savings rates, directly competing with remaining private banks. In September 2008, over £1 billion of new savings were deposited.[17] While EU competition laws restrict Northern Rock from holding more than 1.5 percent of all British savings, it came close to achieving this.

In addition, consider the following countries experiences over the last several years:

Croatia:

- In 2005, reserve requirements went from 50 percent to 75 percent.
- In early 2007, the central bank put a threshold of 12 percent on the lending growth of commercial banks.
- In 2008, the bank increased the discount rate by 4.5 percent points to 9 percent.
- The Governor of the National Bank, Željko Rohatinski, was *The Banker's* "Best Central Bank Governor of Europe" and the "Best Central Bank Governor of the World" in 2008.

Ireland:

- Unlimited guarantee of bank deposits at 6 main banks for up to 2 years (September 2008).
- €2 billion ($2.57 billion) in public-spending cuts.

Poland:

- A contingency plan to trim public spending by $5.65 billion.

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[16] http://www.guardian.co.uk/business/2009/feb/08/bradfordbingley-northernrock
[17] See "The six safest places for your savings," The Times, September 30, 2008

Germany:

- According to an article in the *Wall Street Journal*,

  Ms. Merkel lectured her party on financial discipline on Monday, praising the famously thrifty inhabitants of Swabia, the region around Stuttgart where the Christian Democrats' conference is being held . . . “The root of the global financial and economic crisis is known to every Swabian housewife,” Ms. Merkel said. “You can't keep on living beyond your means. A lack of thrift in advanced economies caused the crisis and can't be its cure.”[18]

[18] December 2nd 2008, see “Germany’s Merkel Calls for Caution in Spending,” Marcus Walker, *Wall Street Journal*, http://online.wsj.com/article/SB122816734631570097.html

# Part 2: Projections future

As a profession, economists have a poor reputation for making predictions. But it *is* sometimes possible to look back and identify those who got it right, and also recognize that in *some* cases this was not due to random luck, but the result of a sophisticated theory of the world around them.[19]

The Austrian school of economics provides a theoretical apparatus to explain how an expansion in the money supply can interfere with the information signals being provided by prices (such as the interest rate). In short, it suggests that excess credit creation creates unsustainable growth, which at some point will inevitably lead to credit tightening and a crash. The utilization of this theory for forecasting stems from combining the knowledge that there must be bubble activity somewhere in the economy with a reasonable judgment about where the bubble is occurring. Indeed, many Austrian economists pointed to the housing market as the manifestation of a boom-bust cycle and to the regulatory mistakes that were inflating the housing bubble. For example, in September 2003, U.S. Representative Ron Paul said the following to a House Financial Services Committee:

> Ironically, by transferring the risk of a widespread mortgage default, the government increases the likelihood of a painful crash in the housing market . . . This is because the special privileges granted to Fannie [Mae] and Freddie [Mac] have distorted the housing market by allowing them to attract capital they could not attract under pure market conditions.[20]

But while there is evidence that Austrian economists foresaw the recent economic collapse and forewarned about the policies that contributed to the unsustainable boom, the greatest strength of the Austrian's school's broader theoretical foundations is to warn about the difficulties in exercising such judgment. In short, Austrians offer the best model with which to predict the future, but also the best reasons for being cautious about those predictions.

This is best demonstrated in Ludwig Lachmann's infamous slogan, "The future is unknowable, though not unimaginable."[21] Economic theory provides the necessary toolkit to foresee what might happen, but cannot act as a crystal ball. Economic forecasting is difficult (and perhaps foolish) because, unlike in the hard sciences, the phenomena economists observe in the social sciences are not characterised by constant relationships and are not independent of our actions. Consider three levels of economic analysis:

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[19] In February 1929, Freidrich von Hayek warned that "the boom will collapse in the next few months" (Austrian Institute of Economic Research Report), while that summer Ludwig von Mises said "a great crash is coming, and I don't want my name in any way connected with it." (Margit von Mises My Years with Ludwig von Mises, Arlington House, 1976, p. 31).

[20] Speech to US House of Representatives, July 16, 2002.

[21] Lachmann. Ludwig M., (1976) "From Mises to Shackle: An Essay on Austrian Economics and the Kaleidic Society," *Journal of Economic Literature* Vol. 14, No.1, p. 59.

1. "**Economic fundamentals**" are the direct causal relationships between variables like inflation, interest rates, and output. Economists have a reasonably sound theoretical explanation for why a rise in the interest rate will reduce inflation, and we can treat this as a fundamental relationship.

2. The interest rate is also a policy tool—it is a politicized instrument. Therefore, we cannot, as economists, forecast interest rates without recourse to political considerations. *Ceteris paribus*, if inflation is low, we would expect the interest rate to fall. But this assumes that the monetary authorities are engaged in inflation targeting (and at a particular rate). Indeed one of the biggest causes of the Great Depression was "**regime uncertainty,**" where the changing rules of the game undermined entrepreneurs' ability to plan.[22] During the present economic crisis, not only do economists have to work with notoriously unreliable macroeconomic models, they must also factor into their analyses the completely arbitrary and inherently unpredictable possibility that the government will bail out one company or nationalize another.

3. On top of this, but of far stronger relevance, is the subjective nature of economic variables. Whether a fiscal stimulus is used for consumption (in which case it will have a multiplier effect on the economy) or to pay off debt (in which case it will not) depends not on stable economic relationships, but the "**expectations**" of the general public. If the public is concerned about future debts, the stimulus is doomed to failure. If the public suffers from money illusion, or has an exceptionally high rate of time preference, the stimulus money is more likely to be spent. While economists can model this behaviour, the final outcome is the result of the actions of individuals. Whether monetary priming succeeds in staving off deflation is a self-fulfilling prophecy based on consumer confidence, and confidence is notoriously difficult to predict.

At a very simple level, it is simply anti-intellectual to give credence to economic predictions. Economics is not predisposed towards generating robust forecasts and a host of compounding factors make the only attainable goal to be the "least worst" forecaster. The most difficult task for the economist right now is to resist the invitation to make predictions about the future state of the economy.

Their inability to predict should not, however, force economists to remain silent. While we have no special authority to say *when* economic growth will return, we can still contribute to the public debate.

*In order to do this, economists should move away from offering predictions and towards building scenarios.*

Scenarios are "a tool for ordering one's perceptions about alternative future environments in which one's decisions might be played out."[23] Rather than "select" a

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[22] See "Wartime Prosperity? A Reassessment of the U.S. Economy in the 1940s," March 1, 1992, Robert Higgs, The Journal of Economic History
[23] Schwartz 1998, p.4

future that appears most likely, one constructs a range of alternative futures. For each scenario, one creates a plan to judge which scenario is emerging and to cope with it as it does so. The idea is not to predict the future, but to anticipate the future as it emerges.

In devising a scenario, the first question to ask is, "What are the driving forces"? The second question is, "Are these driving forces predetermined, or are they critical uncertainties?"

| **Driving forces** | |
|---|---|
| **Predetermined elements** | **Critical uncertainties** |
| Housing markets characterized by a growing population and limits on supply | The real value of "toxic" assets that still exist on banks' balance sheets |
| People borrowing too much (as a factor of income) relative to average incomes | Whether there will be a new government in 2010 |
| Rising construction costs as China and India increase global demand for resources | Whether we will experience deflation or inflation |
| Increased attention to environmental regulations that raise housing costs | Whether new technologies are discovered to mitigate increasing depletion of natural resources |

Based on the above table, here are four scenarios:

**Scenario 1: Policy triumph (V)**
Giving politicians the benefit of the doubt, what if their appeals for calm and self-confidence regarding their stewardship turn out to be correct? The main implication of this is that the economic recovery would look like a "V"—a severe downturn followed by a return to growth. By "growth," we typically mean GDP, the figures for which are not available in real time. There is, therefore, an incentive to look at other indicators to tell if we are on the path to recovery. Indictors such as:

- Manufacturing output
  This is the largest component of industrial production and was up by 0.2 percent (month on month) in April (but note this is still down 13.2 percent year on year). Additionaly, the Office for National Statistics revised a previously estimated drop of 0.1 percent in March to a 0.2 percent increase.

- Index of Production
  ONS showed a 0.3 percent increase in production after a series of falls that began in March 2008.

- IMF global growth estimates
  In April 2009 the IMF estimate for 2010 went up from 1.9 percent to 2.4 percent.

- FTSE 100
  Stock markets have the benefit of being forward looking, but what is good for stocks and shares is not necessarily what is good for the economy. After all,

two of best years in U.S. stock market history occurred during the Great Depression, and it was a storming market that resulted in the financial crisis in the first place!

A word of caution: While the above are necessary conditions for scenario 1 to be accurate, they might also be suggestive of competing scenarios.

**Scenario 2: The Weimer syndrome (VL)**
This scenario focuses on the primary policy instrument to deal with the financial crisis—the drastic reduction in interest rates combined with unprecedented quantitative easing—and considers where monetary expansions typically lead: inflation. Thus far, the Bank of England has injected an immense amount of new money into the financial system, but banks have been reluctant to lend it out to businesses. What if this £125 billion stockpile of liquidity is unleashed? If the printing press spigot is turned off too late? The implication would be hyperinflation, of the same sort (and for largely the same reasons) as befell Weimer Germany, post-communist Yugoslavia, and contemporary Zimbabwe. The collapse in the price mechanism would lead to large-scale misallocation of goods, economic chaos, and stagflation. Key indicators for future inflation include:

- Inflation expectations
  The Financial Times/GfK NOP survey showed that people expect inflation to be 2.4 percent over the next year (as of June 12th).

- Gilt yields
  The long-term value of gilts are eroded by inflation, leading to a sell-off by investors concerned about inflation. A falling price leads to rising yield, and for 10-year gilts this became 4.01 percent on June 11, 2009 (a 10-year high[24]).

- Oil prices
  $72 a barrel, June 11th, 2009 (8-month high)

- Gold
  Gold is the ultimate inflation hedge since it stores its value. If gold becomes more popular it suggests investors are concerned about future inflation. Current prices are up from $870 in April to $950 on June 12th. According to the World Gold Council, "Retail investors around the world bought 131 tonnes of gold in the first three months of this year, an increase of 33 percent."

**Scenario 3: The next Great Depression (L)**
The reason for so much monetary priming is the general fear of another "Great Depression," which brings the possibility of a "Debt-Deflation spiral." More debt, high interest rates, and a cataclysmic fall in output and employment. Aside from the output indicators, we can also look out for:

- Rising interest rates

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[24] "Buyers face hike in mortgage rates as inflation fears mount," *The Guardian*, 11 June 2009

New debt being issued by governments has put upward pressure on interest rates, thus "crowding out" private spending and investment. Three-month LIBOR has fallen from over 2 percent in March 2009 to 1.3 percent in June 2009.

- Higher taxes
  If the government fails to curtail spending, then given the amount of borrowing and money printing already in place it will be forced to increase taxes. This would reduce economic activity and lengthen any recession, as what happened when Hoover and then FDR increased taxes in the 1930s.

- Failure of gilt auctions
  Governments spending plans rest largely on the issuance of new debt. In March 2009, Britain experienced its first failed gilt auction since 2002. Many commentators believe this reflects the ambiguity of the plans rather than serious concerns about credit standing, but further auctions will be monitored closely.

- Reduced credit rating
  The public finances would be even more severely tested if the UK's rating is downgraded. In May 2009, Standard & Poor revised its outlook for Britain's AAA debt from "stable" to "negative."

**Scenario 4: The double dip recession (W)**
This occurs when the initial "recovery" is curtailed by a second downturn and depends on the fragility of the upturn (which involves digging deeper into GDP figures to see whether the recovery is merely an illusion). To some extent, a "double dip" recession would manifest the fact that Britain's strategy has thus far been inconsistent. While monetary policy has been aiming to reduce interest rates as low as possible, fiscal policy is borrowing heavily and raising rates. There are a number of factors that might cut short a recovery and send the economy back into a recession:

- The timing of the fiscal stimulus
  If a high proportion of economic growth is the consequence of government spending, growth will subside when spending falls.

- Rising interest rates
  If we focus on the epicentre of the financial crisis—the housing market—we can see signs that the recovery could be temporary. Thus far, low interest rates have offset falling house prices, which does not solve problem but only delays the inevitable reckoning.[25] Recently, Nationwide increased mortgage rates (fixed rates) by up to 0.86 percentage points (12th June 2009); Cheltenham & Gloucester increased by up to 0.3 percentage points June 12th (3-year fix for 75 percent LTV has risen to 5.59 percent); Northern Rock 0.2pp (June 12th).

[25] "When a few lenders start raising rates, the rest of the market are quick to follow." (David Hollingworth at mortgage broker London & Country, quoted in "Buyers face hike in mortgage rates as inflation fears mount," *The Guardian*, 11 June 2009)

- Mortgage lending
  According to the Council for Mortgage Lenders, there was a 16 percent increase in April 2009 month on month (but a 28 percent decrease year on year).

- Mortgage defaults
  Bank of England: 1.1 million in negative equity

# Conclusion

Economists have an important voice to add to the public debate, but we need to recognize that we are not oracles and should not pretend to be. If the media ask us to forecast when the upturn will truly arrive, we should resist. We should also resist sweeping generalisations about the effect of policy. Rather, we can assess the policy response based on considered counterfactuals about what might have happened otherwise. And we can offer projections of how the economy will progress should alternative futures emerge. In the same way that you do not expect a mountain guide to tell you what will *happen* at the summit, you can expect insightful commentary during the ascent. Economists need not consign themselves to ex-post analysis masquerading as insight. We should build projections past and future, and in doing so help make a complex economy a little more intelligible.