Foreseeable and Preventable

***Jeffry A. Frieden**, a professor of government at Harvard. He is the author of Global Capitalism: Its Fall and Rise in the Twentieth Century" and "and co-author with Menzie Chinn of the forthcoming "Lost Decades: The Making of America's Debt Crisis and the Long Recovery."*

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Many things contributed to the Great Recession of 2007-2010. Massive foreign borrowing, excessively loose monetary policy, reckless lending practices, lax regulation, and other factors all fed into the crisis. The relative importance of different causes is still open to debate.

Economists of varied ideological bents warned of dangers in the housing and financial markets long before the crash.

But there should be no dispute over the fact that there were major warning signals before the crisis. Nor should there be any dispute over the fact that more appropriate policies could have reduced the impact of the crisis, or avoided it altogether.

By 2003-2004, most analysts of international economic conditions were concerned by growing global macroeconomic imbalances, in particular, the fact that the United States was borrowing between a half trillion and a trillion dollars a year from the rest of the world. This huge capital inflow was fueling a financial and real estate boom, in ways typical of such borrowing experiences.

By 2005, most analysts agreed that these imbalances would cause serious problems, although the specific nature and timing of the problems were debated. All through 2005 and 2006, economists of varied ideological persuasions – from Raghuram Rajan and Ken Rogoff to Nouriel Roubini and Robert Shiller – warned of dangers accumulating in the housing and financial markets.

What could the government have done? The Bush administration could have reduced the outsized fiscal deficits that spurred foreign borrowing, and more generally could have acted to slow an overheated economy. The Federal Reserve could have raised lending rates to decelerate the credit boom. Regulators could have been more stringent about applying prudential principles to all of the complex financial operations in which financial institutions were engaging. But instead, none of these government agencies did anything.

Why was nothing done to heed the warnings? Electoral considerations may have mattered: no incumbent government wants to put the brakes on the economy before an election. Special-interest pressures undoubtedly mattered: real estate salesmen, homebuilders, financial institutions, and many borrowers had come to rely on a continuation of the boom. David Lereah, chief economist of the National Association of Realtors, whose 2006 book was titled "Why the Real Estate Boom Will Not Bust," explained to Business Week several years later, "I worked for an association promoting housing, and it was my job to represent their interests."

Ideology probably mattered. Larry Kudlow, economics editor of the conservative National Review, in 2005 dismissed "all the bubbleheads who expect housing-price crashes in Las Vegas or Naples, Florida, to bring down the consumer, the rest of the economy, and the entire stock market." Of course, the bubbleheads were exactly right, but the predictions did not accord with Kudlow's partisan commitments or his ideology.

And so it is with the post-mortems. Politicians, special interests, and ideologues all have their reasons to insist on a particular interpretation of the crisis. And those connected to the Bush administration have strong incentives to deny that the administration could have done anything differently. But they are wrong.

In the aftermath of every financial crisis I know of – and I have studied dozens – the policymakers in office at the time deny that anything could have been done. The cause was always elsewhere: irrational markets, foreign lenders, state and local governments, evil bankers. But this is almost never accurate.

National governments can act to avoid, or reduce the effects of, massive financial crises, if they are willing to act in time. There is plenty of responsibility to go around for the Great Recession, and for the very difficult times its aftermath will cause for America and the world. It is profoundly irresponsible – and demonstrably untrue – to pretend that the crisis could not have been avoided or lessened. If this kind of thinking persists, we will be setting ourselves up for another crisis of roughly the same type.

Topics: Economy, Politics, banks, finance, financial regulation

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