NEW YORK – This global economic crisis will go down in history as Greenspan’s Folly. This is a crisis made mainly by the United States Federal Reserve Board during the period of easy money and financial deregulation from the mid-1990’s until today.

This easy-money policy, backed by regulators who failed to regulate, created unprecedented housing and consumer credit bubbles in the US and other countries, notably those that shared America’s policy orientation. The bubble has now burst, and these economies are heading into a steep recession.

At the core of the crisis was the run-up in housing and stock prices, which were way out of line with historical benchmarks. Greenspan stoked two bubbles – the Internet bubble of 1998-2001 and the subsequent housing bubble that is now bursting. In both cases, increases in asset values led US households to think that they had become vastly wealthier, tempting them into a massive increase in their borrowing and spending – for houses, automobiles, and other consumer durables.

Financial markets were eager to lend to these households, in part because the credit markets were deregulated, which served as an invitation to reckless lending. Because of the boom in housing and stock market prices, US household net wealth increased by around $18 trillion during 1996-2006. The rise in consumption based on this wealth in turn raised house prices further, convincing households and lenders to ratchet up the bubble another notch.

This has all come crashing down. Housing prices peaked in 2006, and equity prices peaked in 2007. With the collapse of these bubbles, paper wealth of perhaps $10 trillion, or even as much as $15 trillion, will be wiped out.

Several complex things are now happening simultaneously. First, households are cutting back sharply on consumption, since they feel – and are – vastly poorer than they were a year ago. Second, several highly leveraged institutions, such as Bear Stearns and Lehman Brothers, have gone bankrupt, causing further losses of wealth (of these failed institutions’ shareholders and creditors) and a further loss of credit that these firms once supplied.

Third, commercial banks also lost heavily in these dealings, wiping out much of their capital. As their capital declines, so, too, do their future loans. Fourth, and finally, the failure of Lehman Brothers and near failure of the insurance giant AIG, incited a financial panic, in which even healthy firms are unable to obtain short-term bank loans or sell short-term commercial paper.

The challenge for policymakers is to restore enough confidence that companies can once again obtain short-term credit to meet their payrolls and finance their inventories. The next challenge will be to push for a restoration of bank capital, so that commercial banks can once again lend for longer-term investments.

But these steps, urgent as they are, will not prevent a recession in the US and other countries hit by the crisis. The stock and housing markets are unlikely to recover any time soon. Households are poorer as a result, and will cut back sharply on their spending, making a recession inevitable in the short run.
The US will be hardest hit, but other countries with recent housing and consumption booms (and now busts) – particularly the United Kingdom, Ireland, Australia, Canada, and Spain – will be hit as well. Iceland, which privatized and deregulated its banks a few years ago, now faces national bankruptcy, because its banks will not be able to pay off foreign creditors who lent heavily to them. It is no coincidence that, with the exception of Spain, all of these countries explicitly adhered to the US philosophy of “free-market” and under-regulated financial systems.

But, whatever the pain felt in the deregulated Anglo-Saxon-style economies, none of this must inevitably cause a global calamity. I do not see any reason for a global depression, or even a global recession. Yes, the US will experience a decline in income and a sharp rise in unemployment, lowering the rest of the world’s exports to the US. But many other parts of the world that still grow. Many large economies, including China, Germany, Japan, and Saudi Arabia, have very large export surpluses, and so have been lending to the rest of the world (especially to the US) rather than borrowing.

These countries are flush with cash, and are not burdened by the collapse of a housing bubble. Although their households have suffered to some extent from the fall in equity prices, they not only can continue to grow, but they can also increase their internal demand to offset the decline in exports to the US. They should now cut taxes, ease domestic credit conditions, and increase government investments in roads, power, and public housing. They have enough foreign-exchange reserves to avoid the risk of financial instability from increasing their domestic spending, as long as they do it prudently.

As for the US, the current undeniable pain for millions of people, which will grow next year as unemployment rises, is an opportunity to rethink the economic model adopted since President Ronald Reagan came to office in 1981. Low taxes and deregulation produced a consumer binge that felt good while it lasted, but also produced vast income inequality, a large underclass, heavy foreign borrowing, neglect of the environment and infrastructure, and now a huge financial mess. The time has come for a new economic strategy – in essence a new New Deal.

Jeffrey D. Sachs is Professor of Economics and Director of the Earth Institute at Columbia University.

Copyright: Project Syndicate, 2008.
www.project-syndicate.org