EG Technical Briefings
Volume VI No. 2, May 2009

Technical Brief on the Global Recession

Review:
This technical brief is a review of “Financial Crash, Commodity Prices, and Global Imbalances” by Ricardo Caballero, Emmanuel Farhi, and Pierre-Olivier Gourinchas (hereafter, CFG) presented in Douglas Elmendorf, N. Gregory Mankiw, and Lawrence Summers (eds.) *Brookings Papers on Economic Activity, Fall 2008* (The Brookings Institution: March 2009), p. 1-68.

CFG believe that “the persistent global imbalances of recent decades, the sub-prime crisis, and the volatile oil and asset market are tightly interconnected.” CFG also believe that the core cause of these inter-connections is a world-wide misallocation between secure and liquid financial assets compared with the demand for such assets. CFG believe there are highly significant large-scale and long-term adverse consequences for the world economy, unless these major inter-connected problems are addressed successfully.

The circumstances addressed by CFG arise as follows: Very substantial new wealth has been created in developing countries as a result of the exploitation of commodities (oil, bauxite, gold, etc.) and successful development. The owners of this wealth have not been satisfied to invest their wealth in their home countries, as financial market assets in their home countries are not necessarily secure and stable.

CFG believe owners of this newly generated wealth in developing countries focused their demand for secure and stable assets on U.S. financial markets, as the most secure of such markets and a much better option than other available choices. The resulting strong demand for U.S. assets reduced the rate of return on investment for housing and other especially interest-rate-sensitive sectors. As a result, prices in the U.S. housing, other sectors, and financial markets have risen unsustainably and led such increases world-wide. For example, the enormous rise in crude oil prices and the financial market consequences were effectively one shock rather than two. The result was generation of, initially in US, housing and financial bubbles. Moreover, the bubbles persisted and thereby weakened global economic activity to the point that a full blown world-wide recession was generated.

The critical broader point is that these problems are not a one time event. Once recovery has occurred, the world economy has a continuing very significant excess demand for safe and

EG Technical Briefings is published by USAID/EGAT Office of Economic Growth (EG) in Washington, D.C. This publication aims to share technical and analytical information with USAID field missions, especially with economic, private sector, and agricultural development officers. Any views, interpretations expressed in *EG Technical Briefings* are those of the author(s) alone and do not represent any official view of USAID or the U.S. government. If you have feedback or suggestions about *EG Technical Briefings*, please contact Stu Callison (ccallison@usaid.gov) or Danielle Dukowicz (ddukowicz@usaid.gov). This briefing was authored by Robert H. Aten, Team Leader, EGAT/EG Economic Policy & Governance.

secure financial assets. So long as developing countries remain financially underdeveloped, it is likely that a massive global shortage of financial assets will arise again and persist.

CFG note that this is a comprehensive theoretical model. CFG find that the data, especially those regarding the commodity markets, are consistent with the interconnections they model among imbalances, the subprime crisis, and volatile oil and asset markets.

Views of other commentators:
Kathryn Dominguez points out that there is no role for government policy in this model, which may overstate the role of the private sector in the current crisis. There is no money, there are no banks, and therefore there is no role for monetary and exchange rate policy in this model. Moreover, the implications for commodity prices follow a standard model by Harold Hotelling that has been known since the early 1930s. **Carmen Reinhart** generally agrees with Ms. Dominguez and adds that there is no role for risk in the model. **Larry Summers** suggests that we would be more likely to believe the insights of the model if it were to be estimated fully, as CFG have not yet done. **Fredrick Mishkin** recommended that CFG consider their model in historic context, and also consider the role of financial market innovation. He also believes that Federal Reserve actions have mitigated the crisis significantly. Separately, **Bruce Bolnick** notes the CFG model is just a formalization of Federal Reserve Chairman Bernanke's older analysis, and observes that the model is not "a good guide to understanding the *implications* that follow from the observed global imbalances." The low U.S. saving rates is unexplained by the model.

Reviewer comments:

1) CFG's is clearly only a partial if helpful analysis. The technical debate among economists/financial analysts over time reflects how little technical agreement there is about the overall causes and projected cures for the current worldwide recession.
2) The last two US recessions were principally financial in nature. Traditional inventory recessions have become rare as US manufacturing has waned and manufacturers have become better at managing inventories. Such recessions are generally short. However, financial recessions tend to have a longer "tail" of lengthy unemployment and slow recovery as occurred after 2000. Moreover, such a longer "tail" is predicted for this recession. Both the asset bubbles and the misallocations between assets and the demand for them have extraordinary implications for likely and persistent future world financial recessions. (See the IMF website for its views on these matters, including that this will be a long recovery)
3) Thus, it might be a substantial benefit to the US and the world economy, if USAID (and other donors) were to help developing countries more effectively resolve their economic/institutional problems regarding financial markets and exchange rates.
4) It is possible that the global recession has caused huge losses world-wide in financial assets. In the wake of those projected losses, perhaps it is unnecessary to worry so much about what may be somewhat more modest flows of excess wealth assessed by CFG. However, the destruction of assets may not have been so extensive. A simple adding up of losses across the globe may not be appropriate, as, for example, measured currency losses. In the world-wide calculation of such losses, one country's depreciation is probably offset by another country's appreciation.

.