The Recession of 2008: The Keynesian Moment

The worldwide recession of 2008 led to a dramatic revival of the Keynesian version of reform liberalism, which sees government as the guarantor of prosperity through its control over monetary and fiscal policies (interest rates and budgets). To understand this revival, and to assess how long it may last, we have to review some of the events of the recession.

Beginning during the Clinton administration in the 1990s, but supported by Republicans as well as Democrats, the United States government pursued a policy of making home ownership nearly universal. Banks and credit unions were pressured to give mortgages on easy terms, eventually with no money down and 40 years to repay. Financial institutions diluted the risk by reselling the mortgages in bundles with other loans (“Asset Backed Commercial Paper,” or ABCP), which were “securitized,” i.e., divided into smaller shares that could be conveniently traded. Although buyers often did not know what were the underlying assets, these shares were a good investment as long as the real estate market was buoyant, which it was for most of this century’s first decade, and they were purchased in quantity by investment houses around the world.

But the financial house of cards collapsed when housing prices started to decline in 2007. Overextended homeowners stopped making payments on their mortgages, banks were stuck with bad debts, and investors were left with piles of devalued ABCP. By the fall of 2008, many banks and investment brokers were threatened with bankruptcy. Meanwhile stock markets nosedived. The Toronto Stock Exchange index fell more than 800 points on October 2, 2008, in the middle of the Canadian election campaign. The situation was equally dire in the United States, which was in the midst of a presidential election.

By November, governments perceived a liquidity crisis, i.e., a squeeze on financial institutions that could spread throughout the world economy, as banks struggled to repair their balance sheets by

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1 www.cbc.ca/money/story/2008/10/02/markets-drop.html.
recalling loans. Borrowers, even large corporations, would be forced into bankruptcy as lenders required repayment, demand for products fell, and new capital was unavailable on depressed stock markets. Many commentators feared that the world was about to re-enact the Great Depression of the 1930s. Leading world governments—whether nominally socialist, liberal, or conservative—quickly agreed on a coordinated Keynesian response, built on three main policies:

1. Stem the emergency by bailing out financial institutions. This meant advancing huge government loans to threatened financial institutions, or even in some cases (e.g., the Royal Bank of Scotland) putting banks under partial or full public ownership. The goal was to stop the domino effect caused by bad loans and restore financial liquidity to the world’s economy.

2. Let the “automatic stabilizers” work. In an economic recession, government tax revenues fall because fewer people are employed, incomes fall, and sales volumes decline. Meanwhile, increase government expenditures for social assistance, unemployment insurance, and pensions for older workers forced out of the labour market. Rising expenditures and falling revenues produce budget deficits without needing to make an explicit decision to do so. The deficit is thought by economists to have a short-term stimulus effect because governments need to create money to fund it. Hence the concept of “automatic stabilizers.”

3. Budget for a “stimulus package” by deliberately increasing the deficit. The stimulus packages adopted in various countries in this recession involve temporary tax cuts; accelerated spending on infrastructure, such as roads and utilities; and subsidies to targeted industries (e.g., the “cash for clunkers” rebates adopted in the United States and Germany, designed to get people to trade in old cars for new ones). The theory is that deliberate deficit spending adds to the stimulus effect of the automatic stabilizers and helps keep workers employed who might otherwise be laid off.

As this is being written in late summer 2009, the recession seems to have bottomed out. Growth rates in most countries are less strongly negative than they were in the winter and have even turned
positive in Japan, France, and Germany. Many economic indicators are at least mildly encouraging. Stock markets in the United States and Canada have rebounded over 40% from the lows they reached in early winter 2009. Unemployment, however, is likely to keep increasing for some months, as the labour market is usually the last part of the economy to recover from recession.

With the growing consensus that the worst is over, attention has turned to analyzing how effective governments’ response to the crisis has been. Princeton University economist Paul Krugman, a Nobel Prize winner and an enthusiastic Keynesian, argued in a widely read essay that the three policies mentioned above had been important in the order in which we have listed them.\(^2\) Bailing out financial institutions was absolutely essential to restore liquidity, the automatic stabilizers kicked in smoothly and efficiently, and the stimulus packages helped, but not very much as yet, because of the time involved in approving new spending and getting “shovels in the ground.”

If Krugman’s early analysis is correct, many countries will be left with a policy overhang of stimulus spending larger than needed to restore prosperity. Canada is better off than most in this respect. The federal deficit in fiscal 2009-10, at about $50 billion, seems frighteningly large after ten years of balanced budgets but is only about 3% of gross domestic product (GDP). In contrast, deficits in the United States and in the United Kingdom are at about 13% of GDP, levels previously seen only in the emergency conditions of World War II. Some analysts fear that these deficits (particularly the American one, since the American economy is such a large share of the world economy and the American dollar is the world’s main reserve currency) will lead to a new round of inflation comparable to that of the 1970s.\(^3\) Governments, they say, are funding these deficits by creating new money, which will lead to general price hikes once prosperity and full employment return to soak up unused resources.

Deficit-spending is not the only policy legacy from the recession. Another is partial public ownership of the automobile industry, which arose when the governments of the United States, Canada, Canada is better off than most in this respect. The federal deficit in fiscal 2009-10, at about $50 billion, seems frighteningly large after ten years of balanced budgets but is only about 3% of gross domestic product (GDP). In contrast, deficits in the United States and in the United Kingdom are at about 13% of GDP, levels previously seen only in the emergency conditions of World War II. Some analysts fear that these deficits (particularly the American one, since the American economy is such a large share of the world economy and the American dollar is the world’s main reserve currency) will lead to a new round of inflation comparable to that of the 1970s.\(^3\) Governments, they say, are funding these deficits by creating new money, which will lead to general price hikes once prosperity and full employment return to soak up unused resources.

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and Ontario, plus the United Automobile Workers, bought Chrysler and General Motors to keep them from going bankrupt. Prime Minister Harper claimed that this was a temporary measure: “We don't intend to run automobile companies. In fact, we are seeking to exit our equity position in a reasonably short period of time, but obviously we will time that to ensure we get decent value in the marketplace.”

However, it is not easy for government to restore profitability and then privatize a nationalized industry. North American governments may be nursing their limping auto companies for many years to come.

Another policy legacy is protectionism, which was not supposed to be part of the orchestrated response to the recession but has been creeping onto the agenda in many countries. The United States, China, and many other countries have adopted protectionist measures as part of their stimulus packages, on the grounds that it would be unfair to tax their citizens to support industries owned in other countries. Canada is hardly innocent on this score, having always maintained local-purchase policies at the local and provincial levels. At the intellectual level, almost everyone is still defending free trade, but there is no doubt that protectionism is creeping back in at a pace accelerated by the recession.

Beyond debates about specific policies, the recession has also generated broader ideological debate. People always tend to see the meaning of unexpected events through the prism of previously held convictions. Not surprisingly, therefore, the political left (reform liberals, social democrats) and the political right (conservatives, classical liberals) have very different interpretations of what caused the recession. The left tends to see the financial collapse as proof of the folly of relying upon unrestrained markets. They indict investors for their “greed” in creating a speculative bubble, and suggest that much closer regulation of the economy will be required to avoid future recessions. Even more generally, they condemn the recent ascendancy of classical liberalism, as did former NDP leader ED Broadbent, when he called the recession the “disastrous consequences” of two decades of balanced budgets and tax cuts, pursued by Liberals and Conservatives alike. The right, on the other hand, believes the recession was

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caused by unwise government intervention (pushing banks to underwrite unsound mortgages for low-income people) plus a failure of government to create a proper regime of disclosure for the assets traded in new kinds of financial instruments (ABCP). This debate is bound to continue for a long time.

Initially, it seemed as if the recession might bring a long-term shift to the left, with more government regulation and Keynesian management of the economy; but as the downturn has leveled out, governments have been stressing that their bailouts and stimulus packages were temporary interventions, not long-term policy shifts. The recession does not seem to be favouring either parties of the left or right in terms of electoral politics. The Conservatives were re-elected in Canada in 2008, while the Democrats regained control of the White House and Congress in the United States in the same year. The National Party defeated Labour in New Zealand. A government of the right fell in Iceland, but the right is now back in power in Hungary. It is hard to see any tectonic shift in political alignments as a result of the recession.

The one exception—and it is hugely important—may be the United States, where the Democrats rode a wave of concern about the recession to control of both the White House and Congress. President Barack Obama and the Democratic Congressional leadership have reformist plans in many areas, especially energy and health care, going far beyond any stimulus package. But at the time of writing it is unclear whether their plans will get through Congress; and public opinion in the US, after being wildly enthusiastic for Obama, is starting to become more skeptical. Achievement of Obama’s policy goals would make the United States more similar to Canada and Western European countries, but would not shift the whole world’s policy environment.

- Tom Flanagan, August 2009.

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