Continuing Threats from the Global Financial Crisis

Simon Johnson sees more rough weather, a recession that could last years, and more need for urgent action by the United States and its global partners.

Steven R. Weisman: This is Steven Weisman at the Peterson Institute for International Economics. Welcome to Peterson Perspectives. Our guest today is Simon Johnson, former chief economist of the International Monetary Fund and now a senior fellow at the Peterson Institute for International Economics, a professor at MIT, and author of the blog, baselinescenario.com. Thanks for joining us, Simon.

Simon Johnson: My pleasure.

Steven R. Weisman: There's been a series of actions over the last few days by the United States Treasury, the Federal Reserve, the IMF, the Europeans, and the G-7. Is there any sign at all that the global financial crisis is easing or at least bottoming out?

Simon Johnson: No, Steve, I'm afraid not. I'm afraid the crisis continues to widen. Some of the issues in the heart of the system, particularly in Europe, continue to intensify in really quite worrying ways.

Steven R. Weisman: Are there any bullets that they could shoot that they haven't shot yet?

Simon Johnson: Yes, there are always bullets. There are lots of bullets. A coordinated fiscal stimulus would be one of bullet. I think monetary policy in the United States could become a lot more aggressive, particularly. I do think right now, we're facing the risk of deflation—falling prices—given some of the global change and global conditions. I think within the eurozone, there are tremendous pressures and they need a big European stability fund so that the bigger members could help some of the smaller, weaker members. And in emerging markets, there are some things to be done, although the scale of that problem really threatens to overwhelm the resources both of the countries and of the IMF, so that's a very tough one.

Steven R. Weisman: What happens if the emerging-markets problem does overwhelm the resources of the IMF and other countries? Where do we turn for help?

Simon Johnson: Well, the IMF could get more money. There's about $200 billion right now, of which probably $50 billion is more or less penciled in for various programs. $200 billion seems like a fairly small drop in the bucket, but Japan has a trillion dollars in reserves. China has $2 trillion. The United States is still pretty good in terms of fiscal solvency. So, there is money out there. The question is what you do with it. What's the strategy? How do you use it? That's what people are really grappling with, and I think there are no clear, easy solutions right now for emerging markets. The policy actions are really needed. I think it's pretty clear what's needed in the United States and the eurozone, and that could help turn the world around. Emerging markets by themselves, if that's the space we're working on, trying to come up with creative, defensive solutions is going to be very tough.

Steven R. Weisman: There's going to be a summit of the G-20 in Washington. It sounds to me like you think there needs to be action before that.

Simon Johnson: Yes. They just announced the location will be the National Building Museum, which is a very nice museum. I go there with my kids all the time. It's going to be a November 14th dinner at Mr. Bush's house, I think, and then November 15 will be the big meeting. I'm actually very positive—OK, somewhat positive about that. I think the G-7 has shown itself to be having a rather hard time cooperating. We saw this with their somewhat weak announcement about currencies over the weekend. And then having the G-20 there, the big emerging markets could actually be very helpful. They hopefully will be saying: "Guys, we need to get serious. You have a lot of responsibility for what's happening. You have to really step up and put some sensible policies in place. Otherwise, other dramatic, drastic, not good things are going to happen, such as capital controls; there's a risk that capital controls will break out in a lot of the world unless you fix the system."

Steven R. Weisman: What are capital controls?

Simon Johnson: Capital controls are a way of preventing investors from taking their money out of your country. So, if people are in Icelandic bonds, for example—and there are a lot of people holding Icelandic bonds in Iceland—you put on a capital control or foreign exchange restriction and they have to stay on those bonds for much longer than they would like to stay in the country. Now, these capital controls come with a lot of difficult baggage and they create massive distortions. You really don't want to go there.

Steven R. Weisman: But it sounds like you think that the Europeans and the United States can do more on at least monetary policy between now and November 15th.

Simon Johnson: Absolutely. I'm surprised and shocked that the European Central Bank hasn't cut interest rates already. They're sending out signals that they're inclined to cut, but I don't see what they're waiting for, given the kinds of deflationary pressures we see around the world. The United States could also do a bit more on monetary policy. I think it's a combination of monetary and fiscal policy in both places, really counteracting the risk of prices and wages falling because you'd then get deflation, and deflation is terribly damaging when you have debts in nominal terms, as we all do in these countries.

Steven R. Weisman: So, you would like to see that before the G-20 meets?

Simon Johnson: Yes, and I think that meeting when they are, mid-November, puts pressure on everyone. Nobody likes to come to those kinds of meetings empty handed. You'd like to come and say, "Look, we just did some stuff, isn't that good? And we can do some more stuff; let's talk about it." So, I think the timing and that personal dynamic matters a bit.

Steven R. Weisman: What about doing more to elevate currency levels in the developing world. Should there be more intervention between now and then?

Simon Johnson: That's a very tough one. Obviously, the currencies are under regular pressure across most emerging markets. I think, in general, many of the countries, especially commodity exporters—commodity prices are going down—a lot of these commodity exporters do need to depreciate, and to the extent that countries are resisting depreciation—for example, in the case of Russia—I think that's probably a mistake. I think they should have some depreciation, get the exchange rate to a more defensible level, and then try to get around that. Instead, they tend to be losing their reserves, trying to hold an exchange rate that's probably overvalued for this global environment, and then they'll have to depreciate later with fewer reserves, trying to stabilize the situation. Not ideal.

Steven R. Weisman: You've written that the US government response has been fitful, poorly planned, and very poorly presented to the public. Do you think the record has improved at all in the last couple of weeks?

Simon Johnson: The US government has had some good moments. I think the bank recapitalization program that was announced a little bit over a week ago, that was quite good. That was quite well communicated and went over pretty well. In general, though, the response has been pretty piecemeal and the communication has been quite disappointing—but they've done better than the Europeans. The Europeans also had a good moment on bank recapitalization, but they came very late to the party there. They were in extreme denial up until, I would say, three weeks ago. It's extraordinary. And they still do a lot of finger-pointing and a lot of recriminations vis-à-vis the United States. They don't seem to understand that they created these vulnerabilities in their own economies and they're the only ones who could now sort this out for themselves.

Steven R. Weisman: Of course it's natural to blame somebody else.

Simon Johnson: Sure, absolutely. People do like to blame others. No question about it. I think, hopefully, governments in industrialized countries will get beyond that. And remember, we have been in this situation, Steve, for—as you said—over a year, right? And some of the initial problems were in German banks, second tier banks. They were in French banks, BNP Paribas, if you remember back to last August? I think there's been a lot of denial particularly from the Europeans all the way through this, and that's one reason why what we're facing right now looks so difficult and could be so severe.

Steven R. Weisman: Let's talk about the Germans and the French because they have an agenda going into the next summit that the United States is quite wary of. Is that true?

Simon Johnson: Well, it does seem that they—at least the French and the British—have some ideas about a so-called Bretton Woods II, and they want to restructure the global system and have a different kind of management of capital flows. Yes, the Americans are definitely skeptical. It's not really the case that the Europeans have a well-articulated proposal. I think there's a lot of political distraction going on here. They want to talk about the global problem because they want to say that they were run over by global traffic. There are some elements of truth to that, but they were standing on the highway even though people warned them to get out of the highway. So, I don't feel too sympathetic. I do think this G-20 summit should focus on immediate, cyclical policy responses and coordinate those—something for the United States, something for the Europeans, and something for everyone. Fixing the global system, designing a new Bretton Woods II, III, whatever you want to call it, we'll have plenty of time to do that while we're waiting for our economies to recover next year or the year after that.

Steven R. Weisman: In the United States, do you think that a stimulus program would be better enacted after the American election or can we wait until next year?

Simon Johnson: I wouldn't wait until 2009 if that's what you're talking about. I think Congress could come back in a lame-duck session and pass some legislation that everybody's comfortable with. I think it's becoming a bipartisan issue. I don't think people are going to fight about putting a big fiscal stimulus in. I don't think they should assume a fiscal stimulus is a magic bullet. I don't agree with that. I think you have got to have some pretty aggressive monetary action to make sure you don't get falling prices and falling wages. That's the critical priority right now. Mr. Bernanke gave a very famous speech four or five years ago about so-called helicopter drops of money into the economy. At that time, people said, "He's just an academic. This is fanciful stuff. This will never be useful." Now, people are reading that speech very carefully.

Steven R. Weisman: What is your prognosis for when the markets will stabilize and when the global economy will show the first signs of recovery?

Simon Johnson: I don't know when the markets are going to stabilize. In terms of the overall economy, I think we're looking at a three-year recession in the United States and something more than that in the rest of the world. It will depend on the policy responses and on whether the eurozone pulls itself out of it. But something like five years for the rest of the world, five years of lost growth, if you like, seems to me to be the baseline scenario.

Steven R. Weisman: Do you have anything to say that could end this conversation on a happier or more optimistic note?

Simon Johnson: Yes. I'm always reassuring. I'm always positive. I think that just because we messed up the global macroeconomic part of our lives doesn't mean that the rest of our lives are in big trouble. People still have the same human capital, same education, they are still the same resourceful people, and we'll figure this out. It's a bit of a mess, but people should not throw up their hands and assume that everything's going to be terrible.

Steven R. Weisman: Or that there's nothing we can do.

Simon Johnson: Absolutely. There's lots of things you can do at the policy level and at the level of your firm, at the level of your organization, and on a personal level. Absolutely, there's always a lot you can do.

Steven R. Weisman: Thank you very much, Simon, for joining us on Peterson Perspectives.

Simon Johnson: My pleasure.