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# THE GREAT RECESSION'S SIX CONTINUING CONSEQUENCES

## Introduction

More than a decade into the recovery that followed the Great Recession of 2008-09, many commentators and market participants believe we are in the late stages of the economic cycle that began as that crisis started to recede. To be clear, I am not offering any predictions about the timing of the next downturn or the outlook for global growth. But as financial markets watch for early indications of change on the horizon, one conclusion is inescapable: the economic environment in 2019 still bears the imprint of the events that unfolded in 2008-09. Far from breaking free of its effects, the global economy continues to be powerfully influenced by factors that either contributed to, or resulted directly from, the Great Recession.

Joe Brusuelas, chief economist at RSM, an audit and advisory firm, was quoted in the Washington Post last September, saying, “[The Great Recession] was such a shock to the economic system that it unleashed dynamics that we still don’t understand fully.” This is nowhere more obvious than in the low and zero interest rate environment that still dominates the world’s major economic blocs.

Highly unorthodox central bank policies intended to provide what former UK Chancellor Alastair Darling has called “short-term shock therapy” have evolved into our new normal. There is no doubt that the unorthodox monetary policies in the immediate aftermath of the crisis such as QE1 helped to stave off a potential depression.

But our inability to dispense with these crisis-era measures has become a major problem, undermining confidence in the strength of the recovery and encouraging a continuing sense of fragility.

Against this background, I would highlight six crucial ways in which the causes and consequences of the Great Recession continue to dominate our outlook and define the room for maneuver.

## 1. Debt Has Continued To Pile Up

Other than a brief pause during the worst of the crisis, the global stock of debt has carried on growing, aided by the sharp drop in interest rates by the major central banks from 2008 onwards and the introduction of quantitative easing.

Having reached around \$180 trillion on the eve of the crisis, it has since climbed to about \$250 trillion. If excessive debt was partly responsible for the Great Recession, there is no sign that this problem has been resolved. Rather, its focus has shifted from private to public sector balance sheets, leaving governments reliant on deficit finance and central bank balance sheets bloated. This will afford them very limited scope to act should they be required to come to the rescue again.

## 2. “Too Big to Fail” lives on

The term Too Big to Fail (TBTF) predates the Great Recession, having been popularized in 1984 during the takeover by the Federal Deposit Insurance Corporation of Continental Illinois. But TBTF gained a new lease of life during the financial crisis as it became clear that the banking system is so interconnected that a crisis in one area can easily engulf the whole. Today, governments and regulators have done what they can to manage the risks of TBTF – identifying systemically important institutions for additional oversight, mandating resolution plans for failing banks, and carrying out rigorous stress testing of assets and liquidity. But there is no end in sight for TBTF. In fact, in the US, for example, the largest banks have increased their share of deposits since the crisis, further concentrating the market.

TBTF is here to stay because the Great Recession reminded us that governments cannot allow major banks to fail.

## 3. Productivity and labor force growth have stalled

Since the Great Recession, productivity growth in developed economies has slowed sharply and weak labor-force growth has led to tight employment markets and skills shortages, which are a growing problem in Europe and Japan, and are particularly noticeable in the US. These two factors tend to impede consumption and encourage increasing leverage. If productivity performance fails to improve, monetary policymakers may have little choice but to intervene.

#### 4. China's influence over the world economy has grown

As China's economy has claimed a steadily larger share of world economic output, the rest of the global economy has become more sensitive to any slowdown in China's pace of growth. This matters because concerns have also grown over the country's spiraling stock of debt, which Mark Carney, Governor of the Bank of England and former Chairman of the Financial Stability Board, has identified as a major threat to financial stability. China protected its economic expansion during the Great Recession with the biggest stimulus package enacted in any country, largely channeled through its state-owned banks.

Banking assets almost doubled to 250% of GDP, and debt exploded from 248% of GDP to 441% by September 2018. China has never exerted greater influence over the direction of the global economy.

#### 5. Economic recovery left too many behind

As of mid-2019, the US economic recovery following the Great Recession is the longest on record, but it is also one of the weakest. In contrast, the US stock market has staged one of the strongest recoveries on record, benefiting owners of capital but contributing to worsening income inequality in the US. In 1970, family income at the 90th percentile was seven times higher than at the 10th percentile. By 2016, the gap had jumped to 13 times, with family incomes at the 10<sup>th</sup> percentile having shown almost no growth over that period. Growing income inequality across the developed world is likely to have contributed to the rise of populist politics around the world.

#### 6. Globalization has petered out

The coordinated global reaction to the Great Recession was a prime example of international co-operation through the multilateral organizations set up following the Second World War. That spirit of co-operation has vanished. Instead, nationalistic politics dominate, with countries such as China and Russia asserting their "great power" status increasingly aggressively and narrow self-interest dominating international relations. As a result, the globalization that drove much of the world's economic growth in the decades leading up to 2008 has ground to a halt. If another crisis were to take hold, it is not clear that countries would necessarily rekindle their former spirit of co-operation and connectedness.

These are some of the major legacies of the Great Recession that continue to dominate the global outlook more than a decade later. But with the advantage of hindsight, what lessons should we take from it for the future? One clear conclusion is that countries that took swift, decisive action to address their problems reaped big benefits. The US's enforced recapitalization of its banking system allowed it to recover quickly and increase its support for the real economy. The contrast with Europe is telling.

European banks are still gradually recapitalizing themselves more than 10 years later, leaving European companies, which are heavily reliant on bank finance, at an obvious disadvantage. The US's economic outperformance relative to Europe since the Great Recession is arguably due in part to its robust banking sector, which supports the real economy in a way European banks cannot.

A second conclusion is that well-intentioned regulation in response to a crisis can sow the seeds of problems in the future. The Volker rule reduced the willingness of fixed income market makers on Wall Street to carry inventory in the way they had before the Great Recession. Rules intended to make Wall Street banks safer have increased the risk that fixed income markets could see their liquidity dry up during periods of stress. Given sustained expansion in the stock of investment grade credit over the past decade, this has troubling implications.

The Great Recession may have given way to a period of sustained economic growth, especially in the US, but the crisis continues to cast a long shadow. As the world economy moves into its second decade of expansion, the effects of the previous crisis are still plain to see.

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