Three Lessons

With unemployment still at 7.6%, the effects of the Great recession are still not quite behind us. But housing and financial markets are back to normal, and we've had steady but slow growth for four full years now. So perhaps now is a good time to step back and ask, what has the Great Recession taught us?

I think the answer is, three things. First, fiscal stimulus works. The Obama stimulus was definitely effective at kick starting our economy, turning us from a -8% real growth rate in late 2008/early 2009 to a +4% real growth rate by the end of 2009. Since then however, the sequester and other government spending cuts have slowed real growth down to about +2% annually.

But we have done far better than Europe, where a single-minded focus on balancing budgets has been the rule. The Euro area unemployment rate is above 12%, and the EU has experienced negative economic growth in six of the last seven quarters. As any good Economics textbook will tell you, trying to balance the government's budget during a recession is a self-defeating policy. And that includes the textbooks written by Greg Mankiw and Glenn Hubbard, top economic advisors for George W Bush and Mitt Romney.

The second lesson is, monetary stimulus works too. Businesses need access to credit to operate, and when the banking system collapsed in 2008, so did the economy. Since then, the Federal Reserve has worked aggressively to recapitalize our banking system, through both direct bank loans and "quantitative easing", that is, buying government and private long term bonds.

Again, Europe provides a stark contrast. There, the Central Bank has been reluctant to follow the Fed's lead. So, wherever banks continue to be undercapitalized – Spain, Italy, and Ireland, for example – businesses still can't get loans, and unemployment rates are in the double digits.

The European Central Bank's justifies its inaction by pointing to its political mandate. Its charter mandates only that it keep prices stable, saying nothing about encouraging growth. Ironically, the Rep. Kevin Brady, the Republican Chair of the Joint Economic Committee, has proposed changing the Fed's mandate to match the ECB's. But is 12% unemployment really something we should aspire to?

The third lesson is, we need strong regulation of the whole banking/financial system. Our economy relies on working credit markets to operate, which means when the financial "wizards" take on excessive risks, as they did repeatedly in the years before the crash, they put all of us at risk as well. Yes, bailing them out was the right thing to do, for our own sake, not for theirs. But we should never again let them put us into the position where we had to choose between bailing them out, or going down with them.

We had strong banking regulation, 30 years ago. But the drumbeat of "government regulation is bad" eroded those rules, and we've been paying the price for that for 5 years now. The Dodd-Frank Act was a step in the right direction, but it was probably not enough. There is growing sentiment in favor of reinstating the Glass-Steagall Act, which was the cornerstone of the old regulatory system, a sentiment I support.

We also need the Fed and the other bank regulators to adopt rules that act to shrink the biggest banks. That rules could increase capital reserve requirements as banks grow bigger, or they could outright cap bank size. Because if a bank is "too big to let fail", that really just means it is too big. Otherwise the ones held hostage will be, once again, you and me.