Kaleidic Economics

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Choose Your Own Financial Crisis

When I was younger I used to really enjoy the *Choose Your Own Adventure* book series. The premise is that there are a number of potential storylines, and the reader is able to create their own story by making choices at certain important moments. For example, in *The Abominable Snowman* you are at the Everest base camp when your friend Carlos goes missing.[1] After several pages of information (such as the fact that a foreign ministry official, Mr Runal, has arrived to help you look for him), you are presented with the following choice:

> If you and Runal search below the base camp in the valley, turn to page 9
>
> If you go above the base camp turn to page 13

There are 28 possible endings and the challenge is to find an agreeable conclusion. If things turn out badly, you have a choice of retracing your steps and making a different decision, or start all over. Although there is no real uncertainty in these books, they provide a nice way to think about scenario planning. There are some plotlines that are common to all possible stories. In the case of the Abominable Snowman, the Yeti itself acts as a thread that links together the action. We can think of these as the predetermined elements. But there are also some critical uncertainties, and the entire genre is built on the idea that the reader can navigate them for themselves.

When looking back through the historical record of the 2008 financial crisis, there are also predetermined elements, and critical uncertainties. On numerous occasions, policymakers had important choices to make about how to proceed. This paper will posit that we can reduce these infinite decisions, made by multiple decision makers, into a few key moments. Writing a "Choose Your Own Adventure" book that is based on the financial crisis would be a complex affair, and is beyond the ambition of this paper. But it can be done, and we will attempt to sketch out a means to approach it. Some economists might say the enterprise is a simple one. Put yourself in the position of the Governor of the Central Bank, in September 2008:

> If you commit to increasing the monetary base to whatever level is necessary to maintain NGDP growth expectations in line with the prevailing trend, turn to page 9
>
> If you fret about a temporary spike in CPI, turn to page 13

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[1] Montgomery, R.A., (1982) *The Abominable Snowman*, Chooseco

This of course poses an immediate problem, because it is contested as to whether or not the first option would have been optimal. It would be an oversimplification for page 9 to read:

Well done! Crisis averted **THE END**

But you get the point. This article intends to do two things that might serve as a starting point for this type of counterfactual analysis. Firstly, we will classify the period 2002-2012 into a few distinct phases. Secondly, we will list some of the key shocks that occurred and discuss whether they can be incorporated into a choice context.

Phases of the crisis

In order to reduce a decade of data into a few time periods, we can focus on the components of NGDP growth. The table below shows the periods selected, and the average values:

Period	**GDP Deflator** IHYU	**RGDP** IHYR	**NGDP** IHYO
"The build up" 2002 Q1 – 2007 Q1	2.5%	2.9%	5.4%
"The upper turning point" 2007 Q2 – 2008 Q1	2.5%	3.7%	6.2%
"The secondary recession" 2008 Q2 – 2009 Q4	2%	-3%	-1%
"Austerity" 2010 Q1 – 2011 Q4	2.6%	1.4%	4%
"BBQ recovery" 2012 Q1 – 2012 Q4	1.4%	0.3%	1.7%

It is important that we start relatively early, and permit several years of "The Great Moderation" to show up in the analysis. To paraphrase Hayek, before we can analysis why things go wrong, we need to understand how they work properly. The build up runs from 2002 to 2007 with +5% NGDP growth, moderate inflation, and good real GDP growth. Some Austrians would argue that this growth path is too high, and already sows the seeds of an unsustainable asset price bubble. Some might say the real problems occurred in August 2005, when the Bank of England cut interest rates and allowed broad money growth to reach double digits.[2] Others might say that right up until the summer of 2008 monetary policy was fine. I've attempted to merge aspects of all three by going from 2002-2007.

[2] Greenwood, J., (2009) "The successes and failures of UK monetary policy, 2000-2008" in *Verdict on the Crash*, Booth (Ed.), London: Institute of Economic Affairs.

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By mid 2007 problems were starting to emerge, with real GDP growth going way above what most people would consider to be the long run potential (i.e. that growth was unsustainably high), and inflation was spiking (although this is more evident in CPI data than the GDP deflator). This is the upper turning point that Austrians like to stress.

From 2008 Q2 to 2009 Q4 we then see a dramatic fall in real GDP growth, but a far milder impact on inflation. This implies that there were supply side problems as well as demand side problems (indeed it supports the view that pre crisis growth was unsustainable and actually coming at the expense of future growth).

NGDP growth had recovered by Q1 2010 but was subdued through 2011 Q4. Given the emphasis on policy decisions it seems wise to have a phase that looks at the coalition government and their controversial austerity plans.

The period of 2012 Q1 to 2012 Q4 could possibly be merged with the previous one, in that NGDP growth is reasonably stable but lower than the pre crisis rates. It might make sense to separate them into distinct phases though to draw emphasis to the height of the Eurozone crisis and what appears to be a "BBQ" recovery that is low and slow.

Key shocks

The table below attempts to list some of the key shocks that occurred in each of our phases of the crisis, and splits them up at to whether they are predetermined elements or critical uncertainties. It would be a mistake to treat the difference between the two as whether they are outside of one's control or not, although there is some truth in this. The extent to which something is predetermined is not only whether it is outside your control, but also whether it is hard to reverse. The key issue is that it is present in any conceivable scenario. For example, for UK policymakers in 2012 the Eurozone sovereign debt crisis was a predetermined element. There was uncertainty about how it would pan out, and a narrower shock such as "collapse of the Euro" might be more of a critical uncertainty. But the crisis itself, based on an existing high public debt burden, compounded by collapsing growth expectations, was something to be dealt with. By contrast, there were shocks that could have gone either way. This is obviously the case if it is a policy decision, and because the aim is to put the reader on the position of policymakers, this is how we shall proceed.

	Predetermined elements	**Critical uncertainties**
The build up	Excessive monetary growth in Europe Damage to potential growth due to public spending growth	Cut interest rates in August 2005?

Upper turning point	CPI goes above target	Abandon inflation target?
Secondary recession	Negative wealth shock Reduction in intermediation	Ensure stable NGDP growth? Adopt QE? Introduce regime uncertainty?
Austerity	Reduction in real GDP growth rate Reduction in capital formation due to previous fall in investment spending	Adopt austerity measures?
BBQ recovery	Eurozone crisis	

Obviously, the consequences of these critical uncertainties are going to be hotly debated. But that's one reason for stopping the analysis at this point. Why not have multiple *Choose Your Own Financial Crises*? Have an Austrian one, a monetarist one, market monetarist one, a New Keynesian one, a RBC one, a Post Keynesian one, etc. Indeed this switched the learning outcome away from "what should the central planners have done?" to "which school of thought provides a coherent narrative?" Ideally, the convincing aspects of each of the above would be merged such that the points of difference become obvious, and points of agreement used as a basis for solid counterfactual theorising.

Conclusion

There should be enough detail in the analysis above to see how a *Choose Your Own Financial Crisis* might proceed. The next steps would be to ensure that the shocks in "predetermined elements" make an appearance in all stories, whilst the "critical uncertainties" represent specific decision points. It's possible that the specific path chosen in terms of what action to take would result in dramatically different outcomes. Perhaps different decisions will cancel out and lead to fairly similar results. The really interesting element is hypothesizing – even with the benefit of hindsight – as to what proportion of possible endings are favourable and which are disastrous. Does this exercise simply demonstrate the absurdity of trying to control a complex economy? Can we identify path dependency (or dynamics of intervention) that suggest that what might be policy choices in some scenarios, become predetermined elements in (later phases) of other ones?

Kaleidic Economics is a business roundtable that meets each quarter in London. For more information: http://kaleidic.org

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