Most economists think that macroeconomic disruptions, such as the current recession, can be understood in terms of aggregate economic variables such as total employment, the price level, and the money stock. Such views are misleading, however, as explained by Fischer Black’s Exploring General Equilibrium—particularly in the current economic situation.

Black’s view is that recessions are, at their core, matching problems and therefore cannot be captured by an aggregate model. At a fundamental level, what an economy does is to match the desires of the populace to available resources, and production technology. Black assumes that the matching is accomplished primarily through markets. My own take, though, is that much economic interaction is managed not through markets but through personal plans, commitments (such as career decisions), relationships, and contracts (including implicit contracts). Many of these plans, relationships, and contracts are specialized and long term. As a result, at their initiation they depend upon the expectations held at that time. Those plans, relationships, and contracts, furthermore, can be affected by asset prices. The immense increase in the asset value of the financial sector, for instance, drew far more young people into that industry than is now seen to be optimal. Whereas prices can presumably respond quickly to realign markets in response to a shock, the realignment of associated plans, commitments, relationships, and contracts is much more costly and time consuming.

When the economy is operating efficiently, expectations are largely fulfilled; desires, resources, and production technology are well matched; and economic agents are reasonably satisfied with their plans, relationships, and contracts. But the world is constantly evolving. If it evolves in a markedly unanticipated direction and expectations have to be significantly revised, the existing plans, relationships, and contracts will require revision, and the matching between desires, resources, and production technology will deteriorate. Depending on the extent of the revisions required, the resulting realignment
process can be lengthy and costly. While the transition is ongoing, resources are diverted from production and the production that does occur is less efficient and less well matched with consumer desires. The result is a reduction in the value of output, which macroeconomists refer to as a recession.

Let’s look at a brief history of the current recession from the standpoint of this realignment theory. During the period from 2000 through 2007, millions of American homeowners entered into debt contracts to finance their homes. Securities based on those contracts (which are simply more contracts) ended up, in part, in the hands of financial institutions. Unfortunately, the adequate servicing of the debt and, therefore, the performance of the securities, were based on expectations regarding the continued appreciation of housing prices that proved to be unrealistic. When housing prices started to decline, so did the value of the mortgages and the securities written upon them.

Because financial institutions held a substantial fraction of the housing-related securities, their market values declined as the performance of the securities deteriorated. This left the balance sheets of the financial institutions in need of restructuring, particularly given their highly levered capital structures. Awaiting that restructuring, it became difficult for financial institutions to perform as usual. As a result, financial intermediation was significantly impeded, calling into question the plans, relationships, and contracts that were premised on a continued flow of credit, such as any new corporate or residential investment that required external financing. Corporate borrowing strategies in which the borrower planned to pay off old loans by issuing new loans rather than paying them off entirely out of current earnings would be similarly affected.

In the meantime, consumers who held a substantial fraction of their wealth in the form of housing were forced to revise their consumption plans in the face of declining values. The change in consumption plans impacted all the producers, distributors and retailers whose plans and contracts were based on what were now obsolete expectations. And so it goes. Eventually, the required restructuring became so widespread that it impacted virtually every sector of the economy.

Given the long-term nature of specialized plans, relationships, and contracts, the required adjustment of the economy cannot be quick or cheap. Construction workers cannot become software developers overnight. Automobile companies cannot adjust immediately to a change in consumer preferences regarding how frequently they want to purchase cars or what type of cars they want to purchase. Similarly, people planning careers in finance cannot adjust those plans overnight. The current recession is particularly deep because the misalignment is particularly extensive.

**IMPLICATIONS FOR STIMULUS**

A n obvious question is whether the government can do anything to speed the restructuring process or reduce its cost. There are reasons to be pessimistic. If the government could identify how the economy needed to be restructured and provide incentives to move resources more quickly in that direction, then a properly designed program could alleviate and shorten the recession. But there is no evidence that the government has the proper information, or the proper incentives to behave in that fashion. If it did, central planning...
would be a good deal simpler. Viewed from a matching perspective there is no failure of ‘aggregate demand’—whatever that means. Instead, there is a complex misalignment problem which results in a decline in overall output. (Too many construction workers when no one wants new houses, for example.) Solving that problem requires restructuring and realignment, not indiscriminate government spending. Indeed, it is possible that increased government spending could add to the degree of misalignment.

Although the government’s ability to speed up the restructuring process is likely to be limited, the same cannot be said of its ability to impede it. For example, misguided monetary policy has the potential to impose added restructuring costs on an economy. If the Fed fails to provide a quantity of money equal to that demanded, the only way for the public to increase money balances is through falling prices. The path to falling prices is reduced demand for goods and services, accompanied by all the attendant realignment costs, as agents strive to increase money balances. In addition, the resulting deflation is likely to produce an artificially high real return on currency and short-term government bonds leading to further costly restructuring. This is basically Friedman and Schwartz’s interpretation of how the Fed turned the recession of 1930 into the Great Depression.

THE IMPORTANCE OF EFFECTIVE BANKRUPTCY PROCEDURES

Given the central role of financial intermediation in the current crisis, bankruptcy law suggests a way in which the government might possibly expedite the restructuring process. The key is to accept the bad news. There is no avoiding that losses have to be recognized before efficient recontracting can occur. That is why bankruptcy law needs to provide a transparent mechanism for forcing the recognition of losses.

This suggests the following solution to the banking crisis. To begin, the value of financial institution investments are immediately marked down to their market values. Based on those values, contracts with existing equity and debt holders are restructured. If the losses are large enough that existing equity and debt holders are wiped out, government insurers make up the difference to protect depositors. Following the government infusion to cover the losses of depositors, the restructured bank can be recapitalized by raising new debt and equity. From that point on, the bank should operate normally. Eugene Fama has recently made a similar point.

What makes the foregoing unrealistically optimistic is that it assumes away all the problems associated with the complex web of contracts and relationships that constitutes the financial system, the limited information of all the affected parties, and the incentive of each of those parties to protect their own self interest. As an illustration, there is not even agreement on the market values of the housing-related assets held by financial institutions—the determination of which is an important element of any restructuring. As a result, the actual restructuring has been time consuming, costly, and characterized by intense lobbying, rent seeking, stop-and-go policy making, and the continued failure of the credit markets to function efficiently. If the government could help break this logjam, in a fashion similar to the manner in which courts expedite corporate bankruptcy, the benefits could be large.
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THE BOTTOM LINE

The bottom line is this. The recession is due primarily to a widespread mismatch between current conditions and previous plans, relationships, and contracts. As a result, consumer desires, resources, and production technology are also misaligned. That misalignment has been greatly exacerbated by the collapse of financial intermediation. The best path for the government is to promote aggressive recognition of losses and a restructuring of the financial system. To the extent that the government becomes involved in restructuring financial institutions, it should avoid any unnecessary wealth transfers from taxpayers to the security holders of the financial institutions. Beyond that, the realignment process is best left largely to private agents. The government has neither the necessary information nor the proper incentives to do the job.

Just as a command and control economy is invariably less efficient at resource allocation and production than a market economy, a general stimulus program will, in all likelihood, lead to highly inefficient allocations, effectively burning resources at a time when they are particularly scarce and particularly vital to restart and re-align our beleaguered economy. To the extent that it is used to prop-up industries destined for decline, the stimulus could even prove harmful by delaying necessary adjustments or by potentially creating further misalignment.

Letters commenting on this piece or others may be submitted at http://www.bepress.com/cgi/submit.cgi?context=ev.

REFERENCES AND FURTHER READING