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MITIGATE THE EFFECTS OF THE FINANCIAL CRISIS TO ENSURE LONG-TERM WELL BEING

The Context

It is no surprise that public attention world-wide is focused on the financial market crisis: the future of capitalism as we know it is at stake, our markets are in turmoil, and even the safety of individual bank accounts is in question. The U.S. economy is mired in recession. Latin America, a region with a trajectory of weathering crises, is now poised for the spillover effects, which threaten to undermine its hard won gains from the economic reforms of the 1990's. What are the implications for individual welfare in the region? For public support for free trade, market reforms, and democracy? Will the crisis result in a new round of public support for Chavez and Morales style populists? Can we even begin to answer these questions?

Happiness surveys are increasingly being used to assess the welfare effects of phenomena ranging from cigarette smoking and obesity (bad for happiness) to participating in democracy and getting a promotion (good for happiness). They are based on interviews with hundreds of thousands of individuals across countries and over time. The welfare effects can be quantified in income terms. A typical individual in the U.S. or Britain, for example, would need roughly $60,000 (in 2004 dollars) to make up for the stated changes in happiness that stem from losing his or her job—in *addition* to the forgone employment income. Instability in income flows, meanwhile, has a stronger negative effect on happiness than does the positive boost that comes from income gains.

Financial crises are terrible for happiness. This is not a surprise. We know that individuals are loss averse and do not like uncertainty. Crises bring about significant amounts of both. Not surprisingly, they bring changes in happiness of unusual magnitude: national average happiness levels do not move much for the most part, but they surely do at times of crisis. During the crisis in Latin America in 2001-2002, individuals in the crisis countries had above average happiness levels before the downturn, and below average levels after (controlling for the usual socio-economic and demographic factors). The effects were temporary and in subsequent years, as growth recovered, happiness in most of these countries returned to the pre crisis level.

In those same countries, *satisfaction* with democracy and with how the market was working went down significantly. Yet *preference* for *democracy as a system* of government and for *market policies* went up. The majority of citizens in the region were able to distinguish between the poor performance of particular governments and the more general economic and governance systems they live under.

The Challenge

The 2008 financial market collapse has made 2001-2002 in Latin America, or even the 1998 collapse of the ruble in Russia, pale in terms of magnitude and reach. While the extent, duration, and magnitude of the current crisis is not yet clear, it surely will have effects on the welfare of billions of individuals for the foreseeable future. Those effects are due as much to the welfare losses incurred in incomes and jobs, as to the uncertainty surrounding the crisis and its causes and possible cures. Our experience with a crisis of this magnitude, and with such strong global inter-connectedness between the markets and countries involved, is limited, with only the Great Depression to point to as an example. Yet that example is one in which global information and technology could not transmit problems—and perhaps solutions—as quickly as they can now.

In order to estimate the effects of the financial crisis on happiness where it began—in the United States—the income equivalent required to compensate for such a loss in reported happiness for the average individual was calculated (based on the coefficient on income in the standard happiness regression for the U.S.). The conclusion is that it would be comparable to a 75 percent decline in income, or $45,000 for a person earning $60,000 (for detail on the method, see Graham and Chattopadhyay, 2008). Even if this estimate is high, it suggests that the well being losses for the average person associated with the crisis are very large.

What are the implications of generalized happiness falls of such magnitude? Our research shows that happier people are more likely to support markets and democracy; to perform better in the labor market and to be healthier; and to have positive attitudes about future mobility for themselves and their children. While happiness levels typically recover along with economies, one cannot tell if short term but significant drops erode these positive associations over the long term; they surely could.

Related to this, the strong belief in opportunity and upward mobility is the explanation that is often given for Americans' high tolerance for inequality: the majority of Americans surveyed believe that they will be above mean income in the future (even though that is a mathematical impossibility). Will the crisis erode the long-standing belief in the fairness of the market system, not least because the costs of the crisis will be paid for by the average citizen, while its roots lie in weak regulation and excessively compensated executive mismanagement?

What are the implications for Latin America? On the one hand, happiness drops could be larger than in the U.S. as most citizens in the region have less of a margin to absorb income losses. On the other hand, the uncertainty effects might be smaller, given that they are far more accustomed to economic uncertainty. Assuming a similar 10 percent drop in happiness for the region as in Argentina in 2001, and a median income of $18,000 (2008 figures), the income equivalent loss in well being for Latin America would be 53 percent or roughly $10,000. The effects on public attitudes and faith in the market system, meanwhile, are harder to assess at this point. While faith in the system actually increased during the 2001-2002 crisis, the fundamentals of the system as we know it, beginning in the U.S., were not in question at that juncture.

Hemispheric Opportunity

The Summit of the Americas brings an opportunity for the countries of the region to discuss a coordinated effort to deal with the welfare losses associated with the crisis, as well as the potential effects it could have on public attitudes. Policymakers should therefore focus their efforts on the following actions

- Preserve the positive trend in public attitudes. Citizens in the region are able to distinguish between the poor performance of particular governments and the more general economic and governance systems they live under. With all of the public attention that Venezuelan President Hugo Chavez and Bolivian President Evo Morales have gotten, the large majority of the region's citizens continue to live under—and support—market friendly democracies: 57 percent of respondents in the 2008 Latinobarometro poll preferred democracy to any other system of government, for example. It is essential to preserve this positive trend in public attitudes by managing the financial crisis as pro-actively as possible.

- Make visible efforts to demonstrate commitment with the average citizen. The welfare losses associated with the crisis are difficult to predict and likely to be significant. As insecurity and uncertainty are as detrimental to well being as are actual income losses, governments in the region would do well to make visible efforts to demonstrate their commitment to mitigating the negative effects for the average citizen. The countries in the region that are able to take counter-cyclical fiscal measures to buffer those effects should do so, providing important lessons for the rest of the region going forward.

A positive commitment to mitigating the effects of the crisis at the summit level will hopefully generate positive momentum for necessary adjustments to national and international systems of economy and governance rather than in a dramatic refutation of those systems.

Want to Know More?

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