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Double dip, or just one big economic dive?

By Ezra Klein, Published: August 5

Lately, everyone seems to have his own prediction for whether we're entering double-dip recession. Former Obama adviser Larry Summers says there's a "1-in-3 chance." Ex-Reagan adviser Martin Feldstein pegs it at "50-50." Matt Yglesias, a fellow at the Center for American Progress, cheekishly pegs the probability at "precisely 31.22 percent."

The White House is more sanguine. "We do not believe that there is a threat there of a double-dip recession," press secretary Jay Carney said.

This is a conversation that frustrates Ken Rogoff to no end. Rogoff, a Harvard economist, is co-author, with the Peterson Institute's Carmen Reinhart, of "This Time Is Different: Eight Centuries of Financial Folly." Their book is perhaps the finest study of financial crises ever published. And when Rogoff hears economists talking about recessions and double-dips, when he sees the markets panic because it just realized we're not returning to normal anytime soon, he wishes they would have read him more closely.

"The whole mentality of thinking of this as a recession leads to bad forecasts and bad policy," he says. "It's just not the right framework."

Recessions, he argues, imply a very particular economic phenomena: a business-cycle recession, in which the drop is quick, and the recovery is usually similarly swift. That is not what we're in. That is not what financial crises are. And mistaking one for the other has, in his opinion, cost us a fortune.

Financial crises are not about the business cycle falling out of whack. They're about debt. Lots of it. And that's why they're so resistant to efforts to speed a recovery. Whereas you normally get out of a recession by lowering interest rates and persuading consumers to spend, the period after a financial crisis is marked by consumers trying to dig out from under a mountain of borrowed money. You can accelerate that process, but it's hard to do. But first you must correctly diagnose the problem.

Rogoff has suggested we call this period the "Great Contraction" in order to distinguish it from more normal recessions. You may or may not like the name, but consider this: When we talk about double-dip recessions, that implies, as the National Bureau of Economic Research has said, that the recession ended in summer 2009, and we've been recovering ever since. The Great Contraction, conversely, suggests we have been, and remain, mired in an ongoing financial crisis. Which better describes the economy you see?

In a paper co-authored with her husband, the economist Vincent Reinhart, Carmen Reinhart looked at the aftermath of the 15 post-World War II financial crises. “The monetary policies in these episodes were quite different. The fiscal policies were quite different. And the exchange rates were all over the place,” she says. But wherever there was a substantial overhang of private debt, there was a long road to recovery.

“Debt de-leveraging takes about seven years. That’s the essence,” she says. “And in the decade following severe financial crises, you tend to grow by 1 to 1.5 percentage points less than in the decade before, because the decade before was fueled by a boom in private borrowing, and not all of that growth was real. The unemployment figures in advanced economies after falls are also very dark. Unemployment remains anchored about five percentage points above what it was in the decade before.”

Can policy help? Both Rogoff and Reinhart think it can. But it needs to focus on eroding the mountain of debt that’s smothering the economy.

Since 2008, Rogoff has recommended that the Federal Reserve commit to an extended period in which it will seek to set inflation at 4 percent. That would effectively make debt worth less. That’s anathema to central banks, which have spent the past few decades building their credibility as inflation fighters. But Rogoff is unimpressed. “All the central banks of the world have been fighting the last war,” he says. “This is a once-every-75-years great contraction where you spend your credibility. This is what that credibility is for.”

Reinhart focuses on the housing market, where much of the debt is concentrated. “I ultimately think we have to wind up with some form of debt forgiveness,” she says.