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Drastic times

Jan 8th 2009
From The Economist print edition

Past crises inspire little confidence about the outcome of this one for America

THE good news, said Alan Blinder of Princeton University to a crowded hall on the opening day of this year's gathering of the American Economic Association (AEA) in San Francisco, is that the stockmarket rallied yesterday. The bad news, he joked, is that it bounced on hopes that the economy's problems would be solved at the AEA meetings.

No such luck. The prevailing mood at this year's event was one of despair, not hope. The tone of the three-day conference, which ran between January 3rd and 5th, was set on its first morning when Kenneth Rogoff of Harvard University outlined the results of new research conducted with Carmen Reinhart of the University of Maryland. The paper*, a sequel to work presented at the 2008 conference, looks at the aftermath of past financial meltdowns to gauge just how bad America's recession might be.

The analysis is based on 14 "severe" banking busts, including the Depression as well as the more recent "big-five" crises in the rich world—Spain in the late 1970s, Norway in 1987, and Finland, Japan and Sweden in the early 1990s. The sample also includes seven emerging-market crises that were left out of the earlier analysis for fear of appearing too alarmist. A year on, the authors have no such qualms. The hubristic belief in America that "we don't have financial crises" is now obviously false, said Mr Rogoff. In fact the authors find that banking crises have been almost as common in rich economies as developing ones (see table).

The main results of the research make depressing reading. Downturns that follow a financial crisis are typically long and deep (see table). On average, GDP per person falls by more than 9% from its peak and takes almost two years to reach bottom. The misery in the jobs market tends to last far longer. The unemployment rate increases by an average of seven percentage points after severe meltdowns and reaches a peak almost five years after its rise began. If that gauge is accurate, unemployment in America is set to rise to an alarming rate of 11-12% in coming years. The housing bust is unlikely to end quickly either. House prices take an average of five years to reach their nadir and fall by 36% in real terms. Equities take less time to reach rock bottom but lose more than half of their value by the time they get there.

A long, hard slog

Peak-to-trough changes in severe financial crises*

	Cumulative change, %	Duration, years
House prices	-36	5.0
Equity prices	-56	3.4
Unemployment‡	7.0	4.8
GDP per person	-9.3	1.9

Percentage of years spent in banking crises

	Advanced economies	Emerging economies
Since 1800 or independence	7.2	8.3
Since 1945 or independence	7.0	10.8

*Argentina (2001), Colombia (1998), Hong Kong (1997), Indonesia (1997), Korea (1997), Malaysia (1997), Philippines (1997), Thailand (1997), Japan (1992), Finland (1991), Sweden (1991), Norway (1987), Spain (1977), US (1929)
†Excludes Japan ‡Percentage points, trough to peak

Source: Reinhart and Rogoff, *The Aftermath of Financial Crises*, 2009

The most astounding result, said Mr Rogoff, is the effect on public finances. Real government debt rises by an average of 86% in countries afflicted by severe crises. The authors reckon the damage has little to do with the costs of bailing out banks. Rather ballooning debt reflects a collapse in tax receipts as a consequence of recession and, in most countries, a big increase in public spending to shore up the economy. It is chilling that such huge deteriorations in public finances are still not enough to prevent deep and prolonged downturns.

These numbers are not ideal guides to the future, as Mr Rogoff readily acknowledged. One obvious shortcoming is the range of outcomes. Whereas declines in home and equity prices were remarkably uniform after past crises, GDP per person fell—and unemployment rose—by much less than the average in some episodes, and by far more in others. America's recession could be milder than the average post-crisis downturn, but it could also be much deeper. Whatever their flaws, the Reinhart-Rogoff estimates are still likely to be a better guide to the downturn than the numbers spat out by standard forecasting models, which take as given that capital flows smoothly through the economy.

Mr Rogoff assured his audience that he was not trying to win the prize for gloomiest forecaster, and his sobering conclusions were not hotly disputed by delegates. A separate conference panel devoted to the crisis, which included Mr Blinder and Mr Rogoff as well as other heavyweight economists, was uniformly gloomy. Mr Blinder said the recession had barely begun and will be long and deep. Mr Rogoff fretted that "every time I hear a policymaker say 'we're not Japan', I feel it's more like Japan." The most hopeful assessment came from Olivier Blanchard, the IMF's chief economist, although he was hardly upbeat. With the right policies in place, he said, the economy might turn the corner in a year.

Spend to save

Nearly all were agreed that a massive fiscal stimulus was needed to stop a deep recession turning into something worse. But there was not much consensus about the form a package should take. According to Robert Hall of Stanford University, the drawback of tax rebates is that there is no guarantee they will be spent when the economy is at its weakest—indeed, worried consumers are likely to save the proceeds of any tax cuts. Direct government purchases may have a more immediate impact but much of the benefit risks being captured by producers. A reduction in some sales taxes, financed by the federal government, may be better.

If there is debate about the details, it is remarkable how unanimous economists now are that fiscal policy needs to be used actively to boost aggregate demand. One dissenting voice was John Taylor, also of Stanford University, who argued that there was scant evidence that tinkering with tax and spending policies does much to lift the economy. America's 2008 tax rebates are a case in point: they were designed to jump-start spending but had little discernible impact. Economists who believe public spending will have a more powerful effect, said Mr Taylor, are basing their analysis on the same models used to justify the tax rebates.

Mr Taylor's scepticism may well be shared by other academic economists but the scale of the economic

meltdown leaves them reluctant to rule out any options. Mr Rogoff likens the situation to that of a terminally ill patient who is offered a risky treatment that may cure the disease but is sure to have nasty long-term side-effects. The patient will always opt for the new drugs, even if they are more likely than not to fail.

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* "The Aftermath of Financial Crises", by Carmen Reinhart and Kenneth Rogoff

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