The Great Recession in Historical Perspective

Peter Temin

Economics

MIT

My Themes

- Keynes: “Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist.”
- Marx: History repeats itself, “the first time as tragedy, the second as farce.”
- Tip O’Neill: “All politics is local.”

My methodology

- Keynesian Open-Economy Macro
- DSGE Model is a fine for the long run
  - But it generally assumes flexible prices
  - And a closed economy
  - Used to analyze depressions in Kehoe and Prescott, 2007
- It is hard to apply to the short run
  - It ignores price rigidities, international aspects
  - See my review essay, JEL 2008, and below

Plan of my narrative

Topic	1920s	2000s
Causes	1	2
Spread	3	4
Recoveries	5	6
Current Events	7	8

Imbalance and Ideology I920s

- Imbalance was the residue of the First World War
  - Britain was exhausted by the war
  - Germany was defiant, despite its loss
  - The US was unready for leadership
- International capital flows were reversed
  - Britain went from largest lender to borrower

The Gold Standard

- Hume: price-specie-flow mechanism
  - Formulated in the mid-18th century
  - Explained how fixed exchange rates work
- Fall in exports leads to gold outflow
  - Less gold leads to lower prices
  - Lower prices lead to increased exports
- Assumes competitive markets and flexible prices—no longer true in the 1920s

Early 1920s

- Policy makers assumed Hume was right
  - Fixed exchange rates when flexibility was needed
  - Went back on gold, tried to lower wages
- Italy and Britain deflated
  - Mussolini marched on Rome in 1922
  - Britain had a general strike in 1926
- France and Germany did not deflate
  - Lots of conflict within and between them

Prelude to a Crisis

- Germany had a boom in municipal spending
  - US had booms in housing and then stocks
- Recessions started in both countries
  - Internal and external deficits increased
- Hume's mechanism works for single countries
  - But not when many countries have deficits
  - (When risks are systemic, not idiosyncratic)

Imbalance and Ideology 2000s

- End of the Cold War brought new capital flows
  - US became the largest borrower
  - China became the largest lender
- US had a housing boom (like Weimar's)
  - Larger and more serious than the US housing boom of the 1920s

The Washington Consensus

- Adaptation of the Gold Standard mentality
  - Supported minimal government
  - Free competition in finance and industry
  - Stable exchange rates
- Promoted 18th century conditions
  - Instead of assuming they were present
  - Applied to the US as well as developing countries

Structured Finance

- Mortgages were bundled and divided into "tranches"
  - CDOs, CMOs, etc.
- Higher tranches were safe; lower, risky
  - Investors could hold the risk they wanted
- But restrictions of Hume's mechanism held
  - Good for idiosyncratic (independent) risks
  - Not for systemic (macroeconomic) risks

Parallels

- Great Depression and Great Recession both caused by nostalgia
  - Ideology ignored economic changes
- Formally, people miscalculated risks
  - Calculations dealt with idiosyncratic risk
  - Misleading for systemic risk
- Excesses led to crises in both periods

Keynesian theme

- Practical men rely on Hume and Smith
- Atomistic competition praised
  - Markets are efficient
  - Regulations only reduce efficiency
- But large enterprises are now important
  - Oligopolies have replaced competition
  - Governments are large parts of economies
  - Wages are not flexible (downward)

Spread of the first crisis

- Countries held onto gold in the 1930s
  - Deflated their economies
  - Led to currency crises in summer 1931
  - Germany said it might not pay reparations
    - Chancellor Bruening announced this in May
    - For domestic consumption
  - Dried up international lending
  - Produced a currency crisis in July 1931

More currency crises

- Britain announced a big government deficit
  - Led to a run on the pound
- Britain abandoned gold in September
  - Kept Bank rate high at first to regain gold
- US raised the discount rate sharply in October 1931 from 1.5% to 3.5%
  - Saved the dollar and destroyed the economy

Spread of the second crisis

- US has a flexible exchange rate now
  - Had a banking crisis instead of a currency crisis
- BNP Paribas actions in August 2007 increased interest-rate spreads
  - Bear Stearns rescued in March 2008
  - Fannie Mae and Freddie Mac saved in August
  - Lehman Brothers bankrupt in September
  - AIG nationalized two days later

Financial market froze

- All sellers, no buyers
  - Government policy unclear
  - All tranches looked alike
- Risks were dependent on housing prices
  - They were highly correlated
  - The end of the boom made ratings irrelevant
- Fire sales of assets wrecked balance sheets

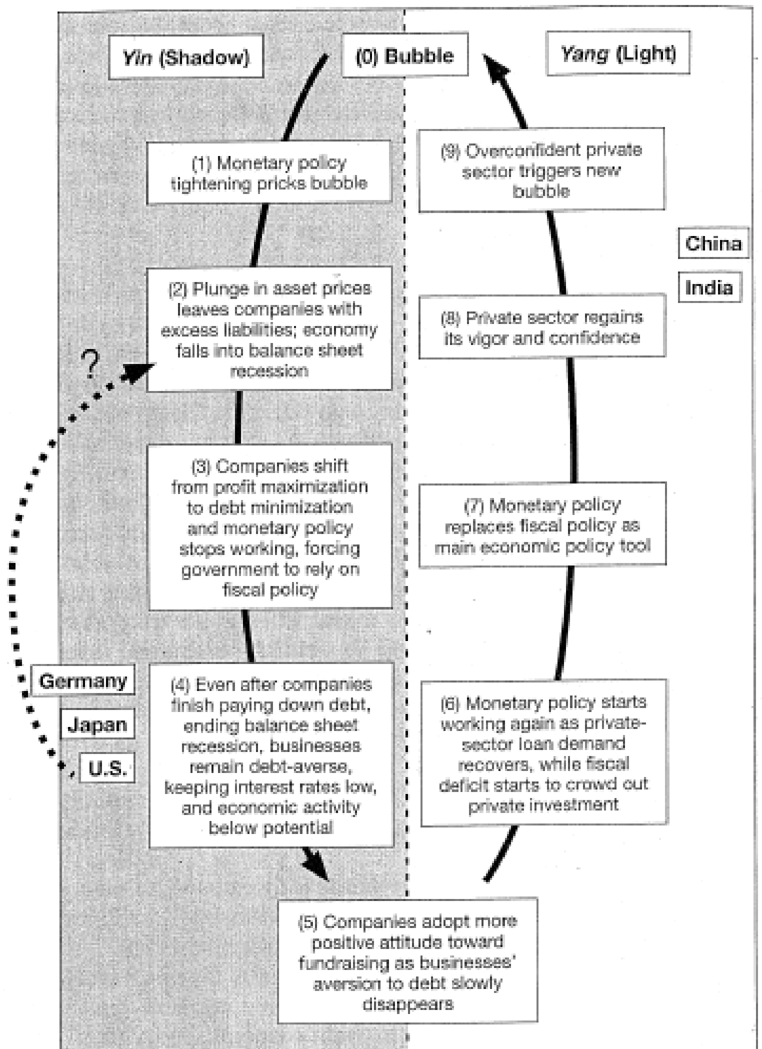
Koo (2008), Chapter 5

- Yin (shadow) and Yang (light) economics
  - Yin phase follows a balance-sheet recession
- Fallacy of composition dominates the invisible hand in Yin phase
  - Assets < Liabilities in many companies
  - Debt minimization replaces profit maximization
  - Fiscal policy replaces monetary policy

The Holy Grail of Macroeconomics

- The economy has two phases, yin and yang
  - Keynes did not understand
  - He analyzed a *yin* economy as if it was *yang*
- His followers emphasized *yin* policies after the war
  - Fiscal policies; not effective in *yang* economy
  - Brought Keynesian thought into disrepute

Exhibit 5-2. The *yin–yang* cycle of bubbles and balance sheet recessions



Source: NRI

Minsky, Marx

- Minsky argued for cycles in the 1970s
  - Booms lead to over-optimism
  - Then a crash
  - Recovery starts the process over
- Koo follows Minsky in his picture
- Marx said history repeats itself
  - Farce comes because we have been here before

Recovery 1930s

- FDR introduced a new policy “regime”
  - Restrained competition, raised wages
- Did high wages prolong unemployment?
  - GDP growth was very rapid; more growth would have generated inflation
  - Policy reversals led to recession in 1937
  - Unions were the result of the Depression, not its cause

Eggertsson (AER, 2008)

- Recovery was “driven by a shift in expectations”
  - Theory: Sargent (1983)
  - Application: Temin and Wigmore (1990)
- Eggertsson “formalizes Temin and Wigmore’s argument in a … DSGE model”

Eggertsson’s DSGE model

- Consumers “maximize expected utility over the infinite horizon”
  - Continuum of firms is linear in labor
  - No capital
- Rudimentary financial side
  - Based on a zero interest rate
- Equilibrium “defined without any reference to the money supply”

Eggertsson's Summary

- Removal of constraints "provides a formal explanation of why Roosevelt's reflationary regime was credible."
- Summary comes before section V
- It ignores the gold standard (added in V)
  - A necessary part of the New Deal
  - Allowed expansionary policies

Gold standard (section V)

- “We extend the model explicitly to account for the gold standard.”
- M $\leq$ constant times gold reserves
  - Inequality lets Hoover sterilize gold inflows in 1920s to avoid inflation
  - But forces contraction after gold outflows in early 1930s
- “Eliminating the gold standard was a *necessary*—but *not a sufficient*—condition for the Roosevelt regime change.”

DSGE Limitations

- Eggertsson modeled a closed economy
  - No exchange rate
- No financial intermediaries
  - No bank failures
- No monetary policy—only fiscal policy
- Fiscal policy measured by actual deficits
  - Lack of monetary policy implicitly assumed by fixed exchange rate

Post-war Prosperity

- New deal set up stability and prosperity
  - Glass-Steagall Act, SEC, etc.
- Combined to give decades without crises
  - And a stable distribution of income
  - Stability brought impatience with regulation
- Washington Consensus arose
  - Distribution of income widened
  - Glass-Steagall repealed in 1999

Asian crises, 1997

- Powerful elites overreached and took big risks
  - They invested in ways that helped their countries and also enriched themselves
- They acted like Koo (and Minsky) predicted, taking bigger and bigger risks
  - They relied on their friends in government to bail them out if gambles fail

Recovery 2010s

- The Fed was slow to see the crisis
  - But Bernanke expanded rapidly in early 2009
  - Fed bailed out the largest banks
- Obama passed a stimulus bill
  - Enough to keep us from another depression
  - Not enough to restore prosperity
  - Little financial reform

Why not Great Depression 2?

- US Presidential election came soon after the crisis in 2008
  - Came after 3 years of decline in the 1930s
- Obama had the opportunity to change
  - But not the political mandate to do much
  - Nor the Congress to help
- Now we are worried about Europe
  - We thought we avoided the worst in 2009

Marx again

- We are not yet in a world depression
  - Safety nets, less unemployment
  - Farce rather than tragedy
- But recall the path of the Depression
  - Initial contraction in 1929
  - Currency crises in 1931
- New contraction in 2008
  - Will we avoid currency crises in 2012?

Keynes in the War

- Negotiations on post-war exchange
  - Keynes wanted symmetry
  - US opposed it
- Keynes argued for a “GE system”
  - Seeing exchange rates as connecting countries
- Now largely forgotten

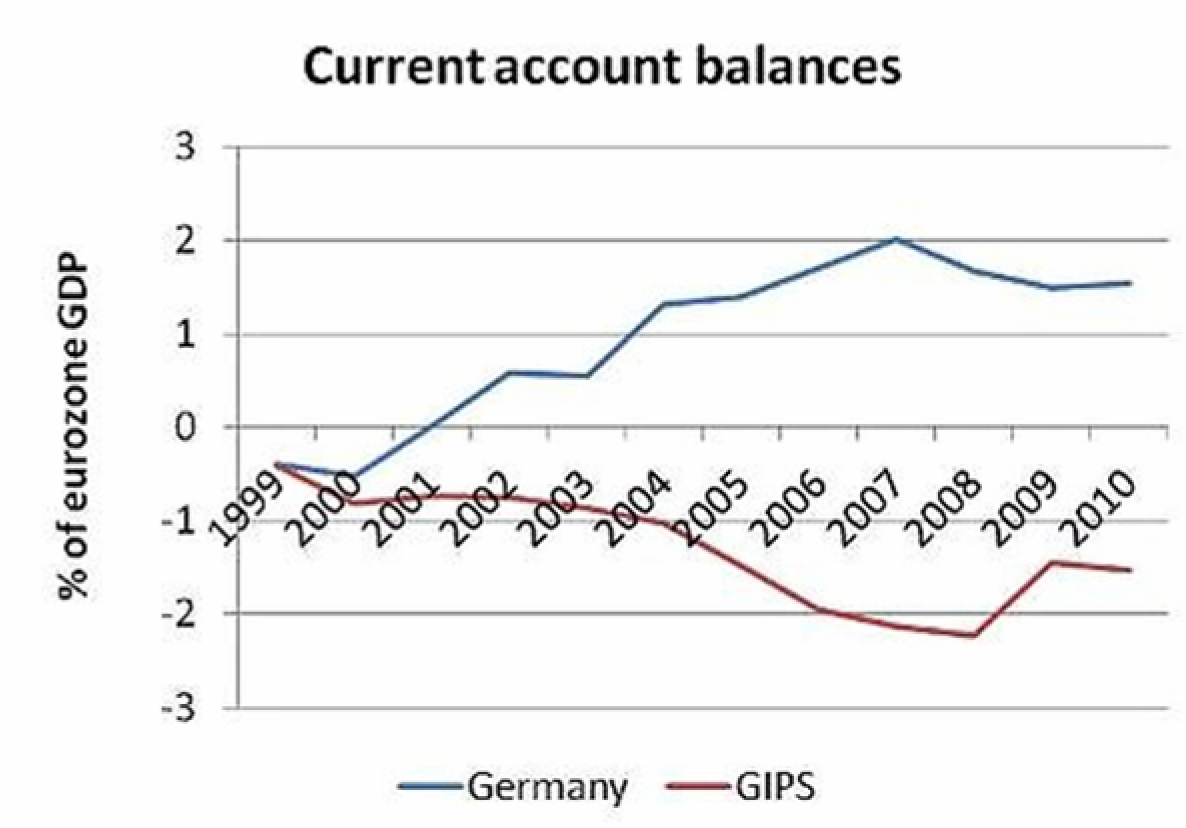
Current Exchange Regimes

- Euro and dollar-renminbi stability
  - Analogs of the gold standard
- Euro by treaty without an escape clause
  - Also without fiscal coordination
- Renminbi rate set by China
  - Many consultations; no decisions

Germany and Europe

- Germany is like US in the 1920s
  - It is running large surpluses
- German surpluses affected Southern Europe (GIPS)
  - They had booms with high wages
- Now they need lower wages to recover
  - They cannot devalue
  - They must deflate; “austerity” is the motto

EMS (euro) History



German influence

- Merkel has exported her views
  - Promotes austerity everywhere
- Prevents countries from paying their debts
  - Inflation rejected
  - Growth rejected
- No good path to euro stability

O’Neill’s theme

- Merkel speaks to her domestic supporters
  - Advocates austerity, even for Germany
  - Does not support devaluation
- She is like Bruening in 1931
  - He spoke to his supporters
  - Generated a currency crisis

China and the US

- China has large surpluses, like Germany
- Imposes a burden on other countries
  - The US is like Southern Europe
  - We cannot devalue relative to China
- China needs to reorient demand
  - To enable the US to recover
  - Recent wage rises in China may help

Germany and China

- Both surplus in fixed exchange rates
  - Worse than the Gold Standard
  - No good way for countries to opt out
- Deficit countries face limited options
  - Greece cannot devalue in euros
  - The US cannot devalue relative to the renminbi

What should be done?

- International: Keynesian “system”
  – Impose penalties on surplus countries
- Domestic: Bailouts make us equity investors in large banks
  – Government now provides all the capital, but has not taken control
  – We should get info and returns like other stockholders

Lessons

- World economy is prone to collapse
  - Recovery measures are only temporary
  - Memories fade, a new cycle begins
- Only a Great Depression produces reform
  - Keynes (slaves of defunct economists) was right
  - So was Marx (tragedy and farce)
  - And also Tip O'Neill (local politics)