The U.S. Recession of 2007-201?

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- The U.S. recession of 2007-201? very serious, for us and for rest of world

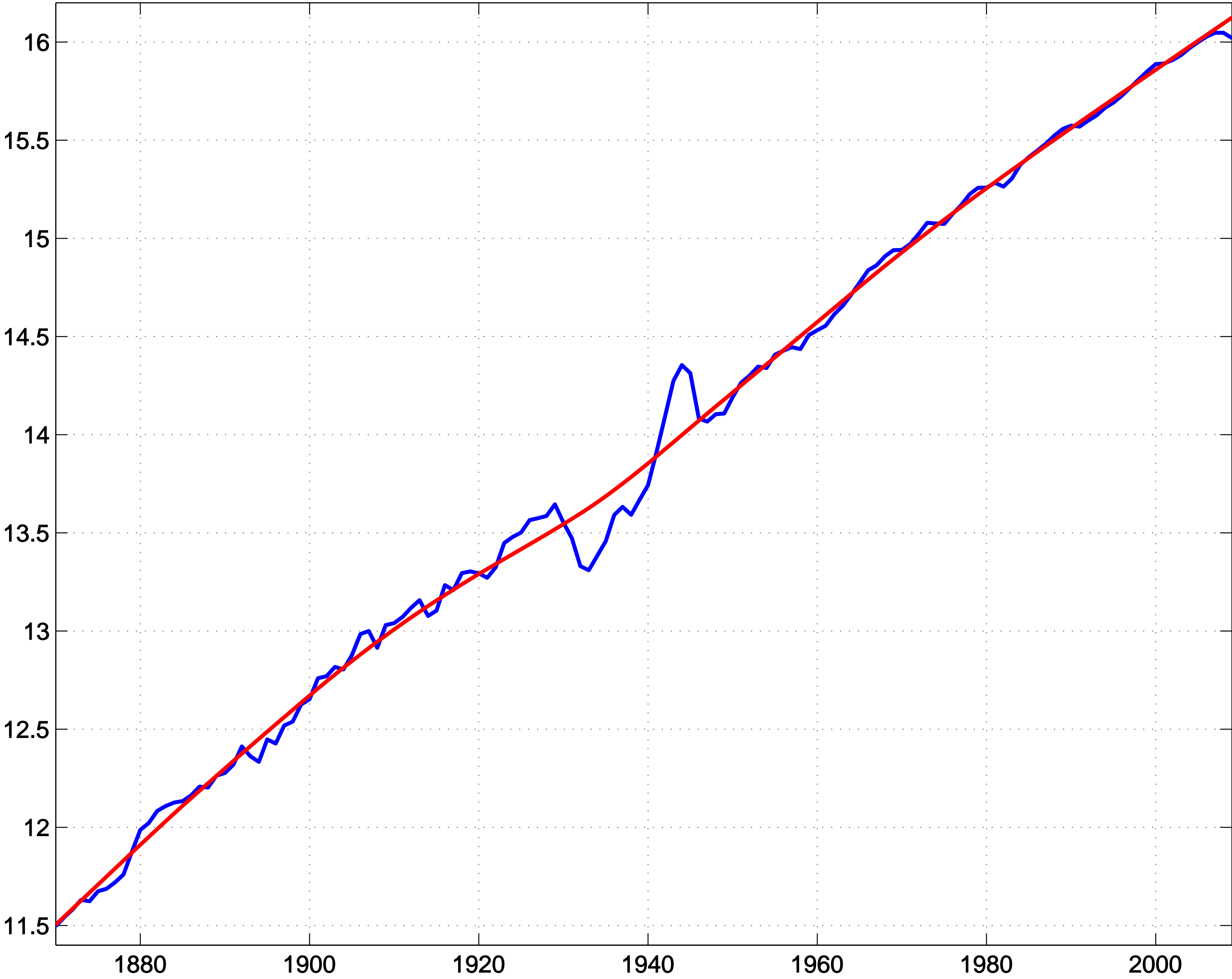
- Right to focus on policies to alleviate recession, aid recovery

- But other considerations important too:
  - long term growth in productive capacity
  - efficient use of resources

- Need to evaluate economy's performance on all three dimensions

U.S. Economy: Essential Background

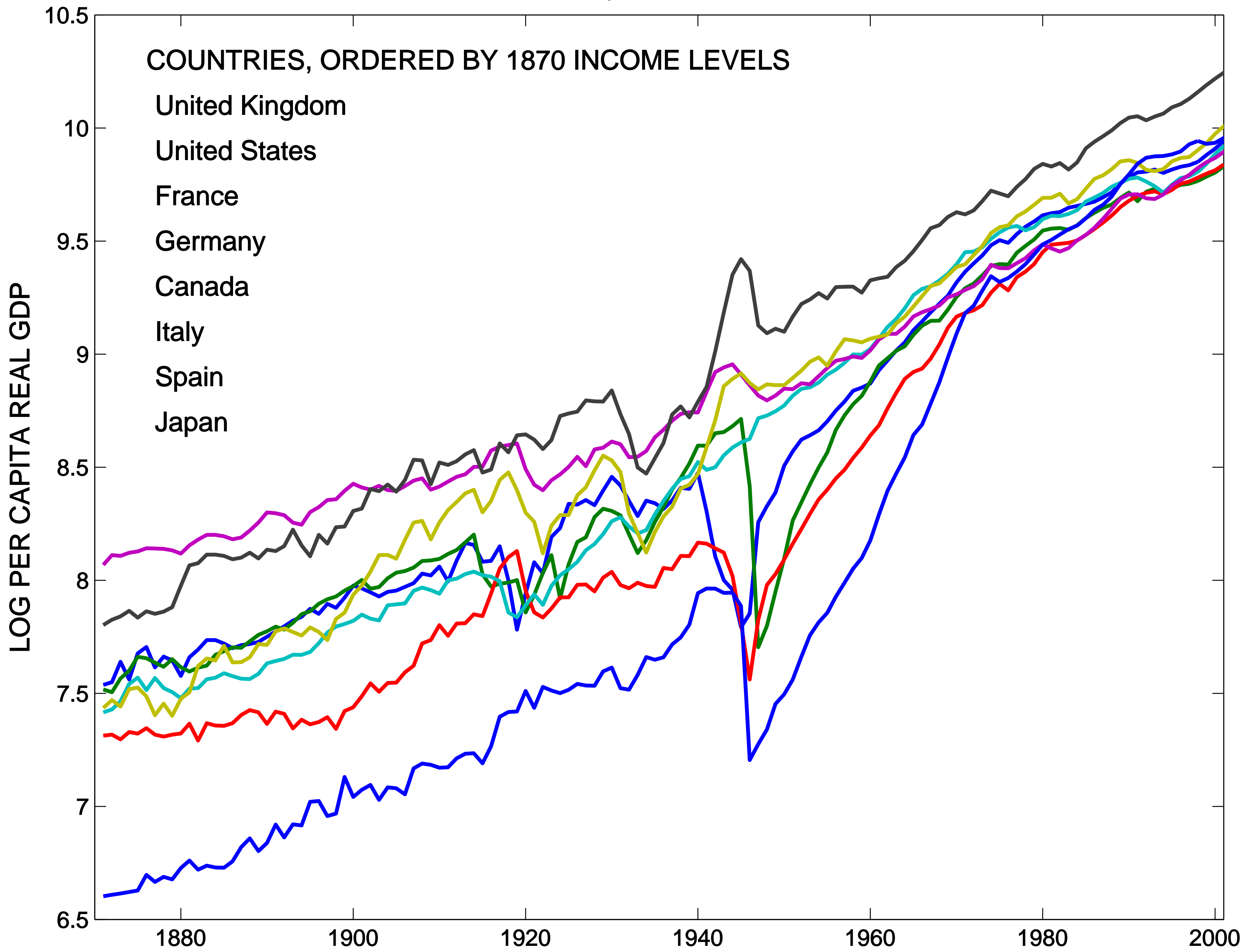
- In long run, U.S. production grows at about 3% per year. Per person, 2%
- Maintained for more than a century
- Occasional displacements—wars, depressions—then return to trend


U.S. REAL GDP, 1870-2008, LOG SCALE
16
15.5
15
14.5
14
13.5
13
12.5
12
11.5
1880
1900
1920
1940
1960
1980
2000

- Surely main feature of this graph is remarkable growth record
- Real income per person in U.S. increased by factor of 12 over the 1870 - 2010 period; factor of 4 in my lifetime (so far!)
- Government provided stable background for this achievement, good education for all: both centrally important
- But this ongoing miracle is mainly due to free-market capitalism

Other successful economies

- Nothing unique to U.S. in this long term growth miracle
- Next figure plots 1870-2008 real incomes in 8 large, successful economies
- These are **per capita** gdps (not total, as in U.S. graph)



LOG INCOME, EIGHT COUNTRIES
COUNTRIES, ORDERED BY 1870 INCOME LEVELS
United Kingdom
United States
France
Germany
Canada
Italy
Spain
Japan
LOG PER CAPITA REAL GDP
10.5
10
9.5
9
8.5
8
7.5
7
6.5
1880
1900
1920
1940
1960
1980
2000

- Thoughout period, US or UK leader: both grew at $\sim 2\%$

- Initially wide diversity in 1870

- Japan very poor; Spain, southern Europe poor relative to north

- But all these countries grew faster than US, UK on average

- Why not? A common civilization, technology. Backward learn from advanced: "catch-up growth"

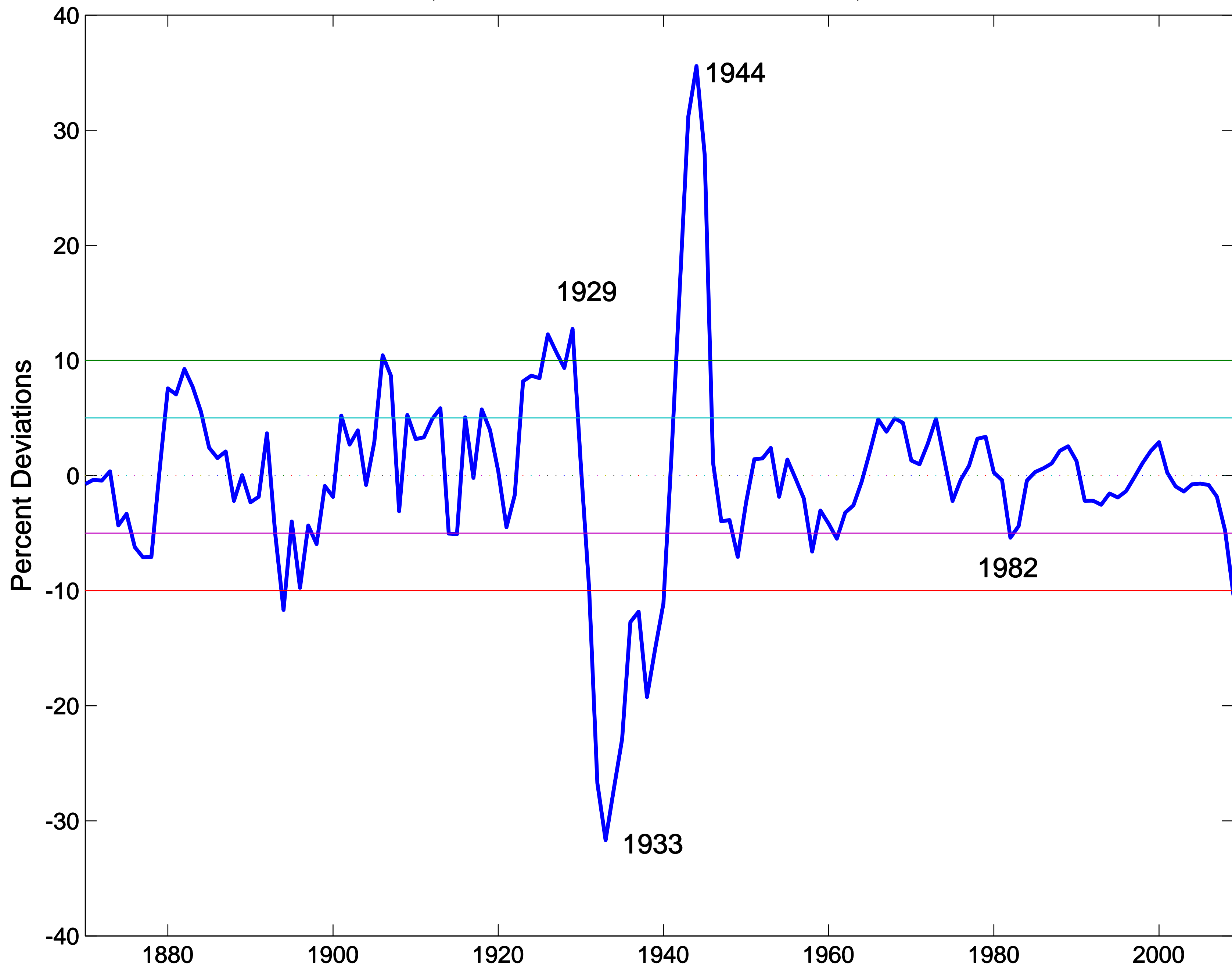
- Note that most of catch-up came after WWII
- For Europe, N. America, Japan an era of relative peace, free trade
- Through 1960s, every reason to foresee a common, high living standard for all of us
- But then—in 1970s—catch up stalled

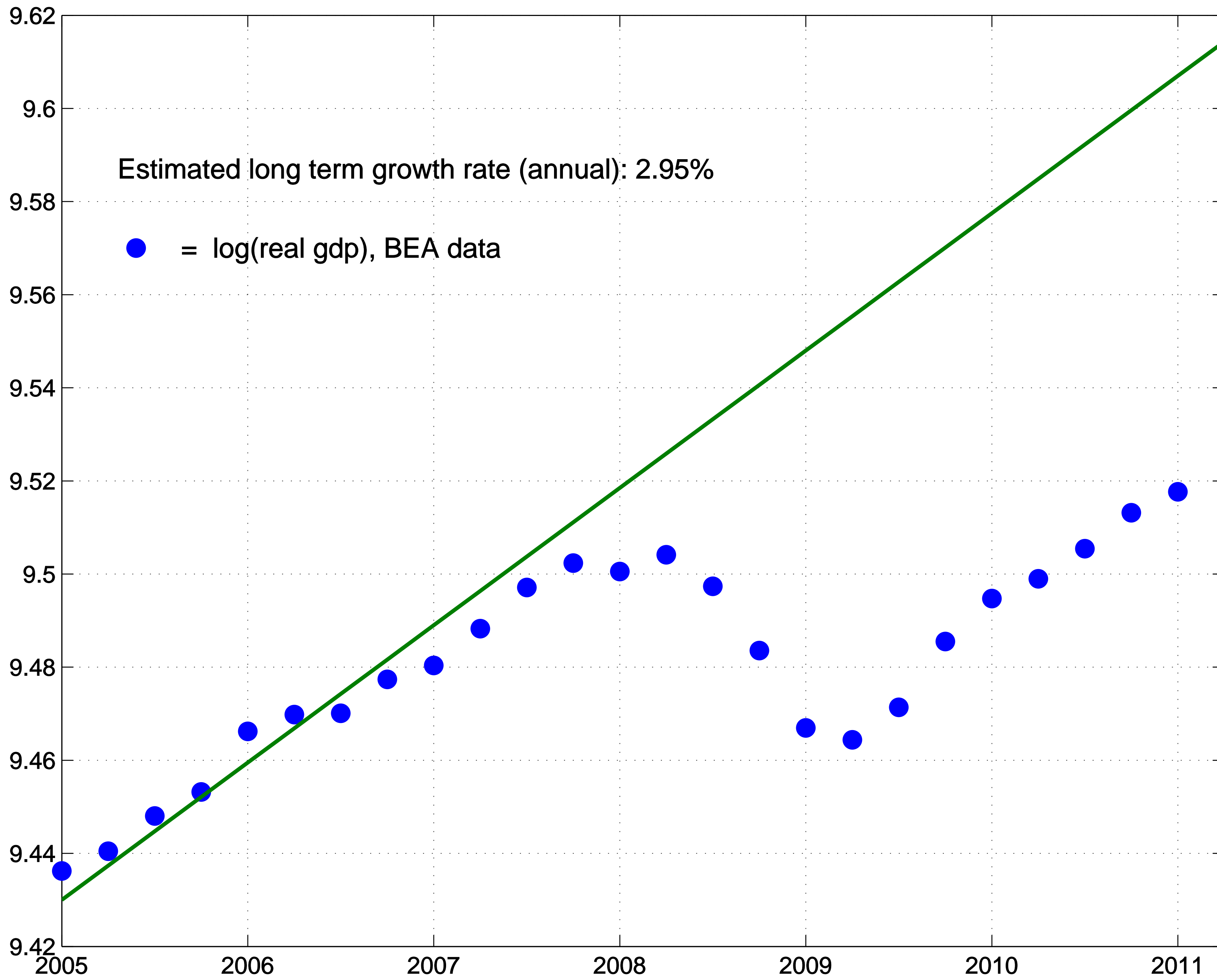
- Don't see this in growth rates—still $\sim$ 2% for all of the rich economies
- But — 20-40% gap has emerged, stabilized in income **levels**
- Why? Views differ.
- Mine is that European tax, regulatory structures discourage savings, work effort relative to U.S.
- If so, 20-40% gap represents cost of larger welfare state

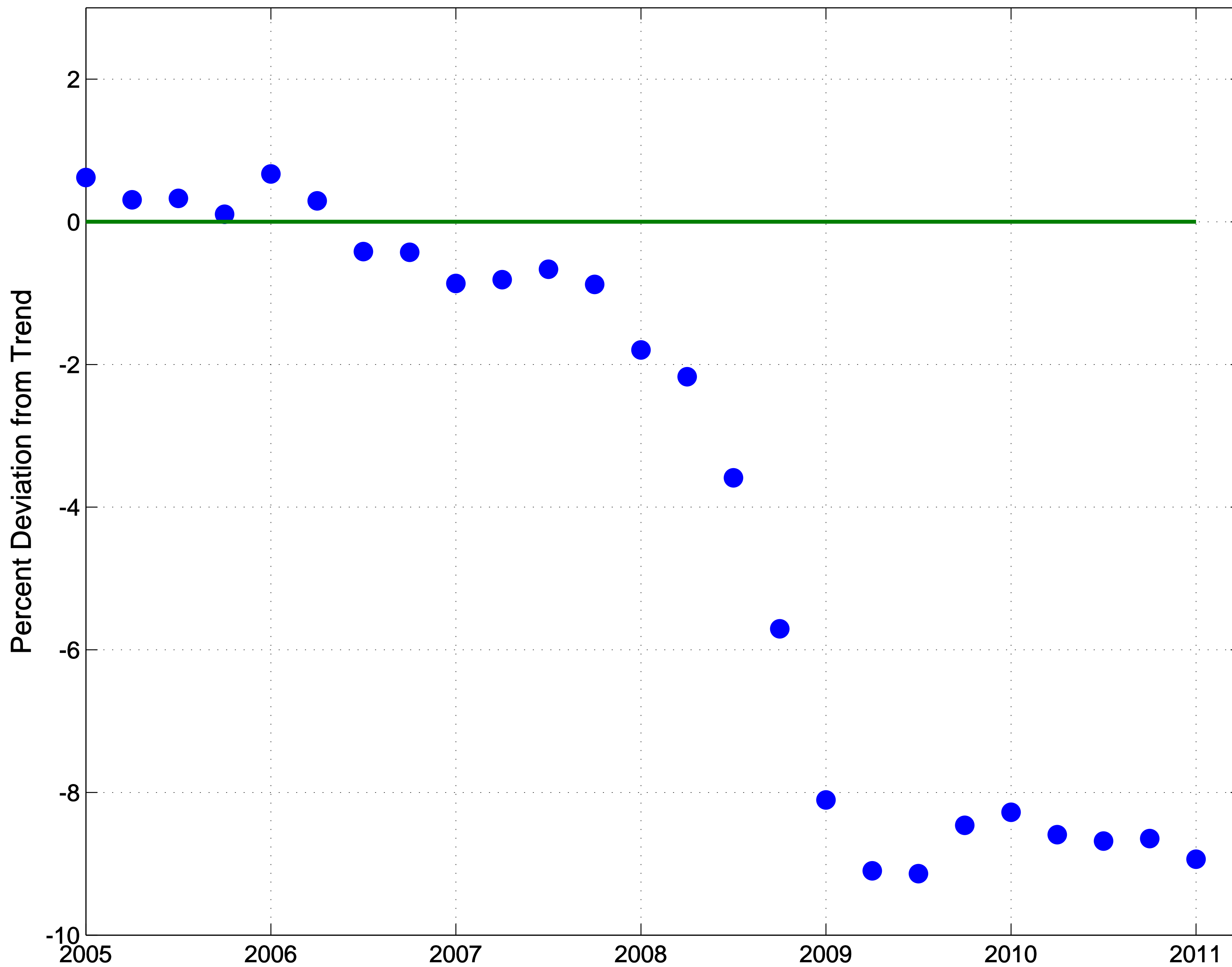
- Sum up: Two most important features of overall economic performance are:
  - long term real growth: essentially common to all successful economies
  - level of per capita income relative to “best practice”: substantial differences even among the advanced economies—policies do matter
- But announced topic was recessions, not growth
- These are important, too

Depressions and recessions in U.S.

- Show three figures:
  - Deviations from trend in long term annual data, 1870-2008
  - Current recession, quarterly U.S. data though 1st quarter of 2011
  - Deviations from trend in current recession


U.S. GDP, DEVIATIONS FROM TREND, 1870-2008
Percent Deviations
40
30
20
10
0
-10
-20
-30
-40
1880
1900
1920
1940
1960
1980
2000
1944
1929
1933
1982


U.S. RECESSION OF 2006 - 2011
Estimated long term growth rate (annual): 2.95%
= log(real gdp), BEA data
9.62
9.6
9.58
9.56
9.54
9.52
9.5
9.48
9.46
9.44
9.42
2005
2006
2007
2008
2009
2010
2011


U.S. RECESSION: GDP DEVIATIONS FROM TREND
Percent Deviation from Trend
2
0
-2
-4
-6
-8
-10
2005
2006
2007
2008
2009
2010
2011

- What does this history show?

- Most recessions—especially since WWII—are not every important events. Who remembers them?

- Depression of 1930s and the current one are both much deeper, more prolonged than typical

- In 1933, U.S,. GDP more than 30% below trend

- U.S. now almost 10% below trend

- These singular events have much in common: Useful to explore this

- Great Contraction of 1929-33: decline in real GDP of 34% between 1929 and 1933
- Average negative growth of 8% per year
- Economy remained more that 10% below trend until 1941—more than 10 years
- No war, natural disaster
- No change in American **ability** to produce
- What happened?

- Over same four years, price level fell 24%
- Average of 6% deflation
- Add these to get a 58% decline in dollar value of spending on goods and services
- These changes are far too large to be attributed to the stock market crash in October, 1929
- Comparable crashes before and after 1929 had no such effects

- What **did** change dramatically was bank deposits

- In 1929-33 three episodes of bank runs: 2 in 1930, one more in 1933

- Cumulative decrease over four years was 48%.

- Consider three questions in turn:

  – Why did deposits decline?

  – Why did this decline precipitate a depression?

  – What could have been done to reverse the decline?

Why the decline in deposits?

- Demand deposits are promises to pay cash—currency—on demand

- Banks hold currency plus reserves (government supplied credits, convertible into currency on demand). But reserves always much less than 100%

- A fractional reserve banking system will **always** be fragile, a house of cards

Why did the decline in deposits precipitate a depression?

- People, business firms like to hold certain ratio of cash to spending flows
- Bank failures, decrease in deposits, meant sudden decrease in liquidity—cash and cash substitutes—held by public.
- To rebuild balances, businesses, households cut back on spending, trying to restore comfortable ratio of cash/bank deposits to spending flows
- 48% deposit decline resulted in 58% spending decrease

$$\text{In 1929:} \quad \frac{\text{bank deposits}}{\text{GDP}} \cong 0.5$$

$$\text{In 1933:} \quad \frac{\text{bank deposits}}{\text{GDP}} \cong 0.5$$

- Balance restored, but at what cost?
- Played out as deflation and reduction in production and employment

What could have been done?

- Get more reserves—more cash—into the system
- Fed could have offset deposit decreases due to bank runs by increasing bank reserves, permitting/encouraging sound banks to expand deposits
- Instead, Fed stood by and watched
- Milton Friedman, Anna Schwartz argue that this Fed failure was the crucial policy mistake of the U.S. Great Depression.
- I agree.

Why the slow recovery?

- By 1934, banking crisis completely resolved
- Deposit insurance in place, deflation over
- Yet full recovery was still 7 years away: Why?
- Monetary theory no help here

- But recovery was retarded by number of harmful real policies
  - cartelization, price/wage fixing due begun in Hoover administration
  - Smoot-Hawley tariff of 1930
  - creation, support of large industrial unions
- Most important, in my view, but hardest to measure, were effects of demonization of business
- Businessmen were "malefactors of great wealth" (FDR)

The current U.S. depression

- Back to the present
- My view of 2007-08 crisis is based on parallels to 1929-33, but there are obvious differences between these situations that must be respected
- In 2008, there was much bank reorganization, but no bank runs, no deposits lost, no flight to currency
- Problem this time was not with commercial banks—now insured and safe

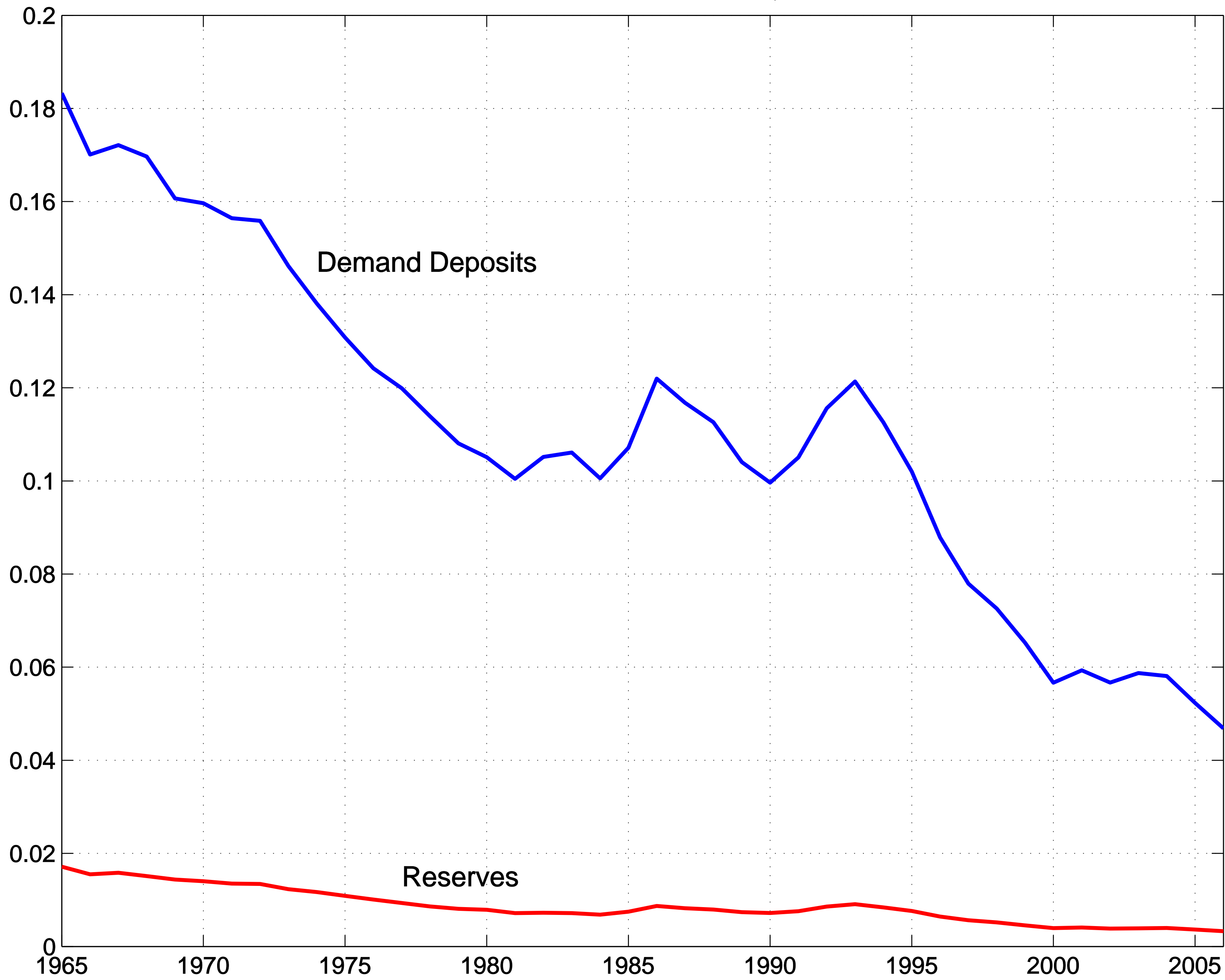
- But many banking services that were once provided by commercial banks have been taken over by investment banks

- Why?

- Until 1980s, commercial banks prohibited from paying interest on deposits

- Large depositors sought liquid assets with positive returns

- Motivation **greatly** intensified by inflation of 1970s



DEMAND DEPOSITS AND RESERVES, RELATIVE TO GDP
Demand Deposits
Reserves
0.2
0.18
0.16
0.14
0.12
0.1
0.08
0.06
0.04
0.02
0
1965
1970
1975
1980
1985
1990
1995
2000
2005

- By 1990s, then, businesses had moved most deposits out of commercial banks and into short run securities that are thought to (1) be safe from default risk, and (2) yield a better return

- Economically, the routine use of short term borrowing is identical to the issue of demand deposits: "you give me cash today, take it back (withdraw it, decline to roll it over) whenever you like"

- People extending short term credit to Lehmann and other investment banks to get a slightly higher return than the T-bill rate did not think (or did not admit) that they were taking on risk, and neither did those who extended credit to them, accepting their Lehmann paper as collateral

- Novel element is not issue of risky securities—need those as long as there are real risks to be shared

- It is increasing role that these played in the payments system

- In effect, “shadow banking system” was created, uninsured and unregulated

- The economics of the 2008 “credit freeze” following the Lehman Brothers failure were identical to the economics of the 1930s bank runs

- The effects of the credit freeze were also similar to the effects of the bank runs of the 1930s

- A part of the effective supply of liquidity supply had vanished, other money-substitutes now became suspect, everyone wanted to get into government-issued or government-insured assets: reserves, currency, and insured deposits

- Could see this in the widening spreads between treasury bills and commercial paper, between government and corporate bonds, etc.

- A flight to currency? Not exactly. But a flight to government promises of currency, current or future

- All of this similar to earliest stages of the Great Depression

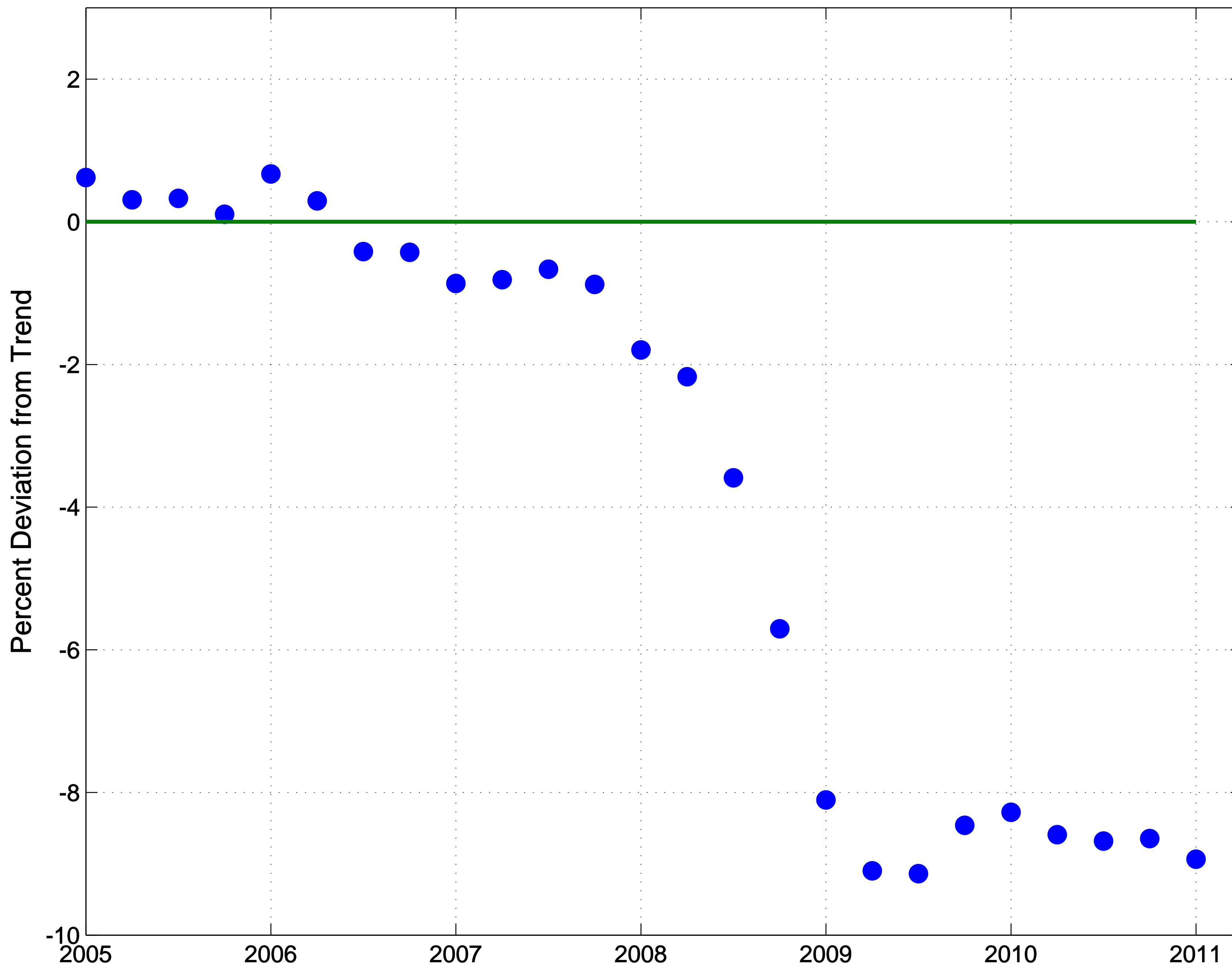
Policy responses to the current U.S. depression

- In 1930, the Federal Reserve stood by and watched as spending and production declined
- In 2008, the Federal Reserve did exactly the opposite
- In August, 2008, there were $45 billion of reserves in the banking system
- By the end of the year, there were $821 b.
- The Fed acted boldly as lender of last resort, just as it should have done in 1930s, but failed to do

- Financial panic was over by end of 2008

- Too late to prevent deep spending declines in GDP in 2008-4 and 2009-1

- But there is world of difference between two quarters of production declines and four years!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- Where do we go from here?

- Liquidity is no longer the problem:

  - banks have huge excess (above requirements) reserves

  - non-financial corporations are long on cash

- Yet business investment remains very low

- Unemployment retains very high

- Is this because government is not spending enough?

- Believe it is more accurate to say that the problem is government is doing too much

- Again, I see analogies to the U.S. of the 1930s

- Likelihood of much higher taxes, focused on the “rich”

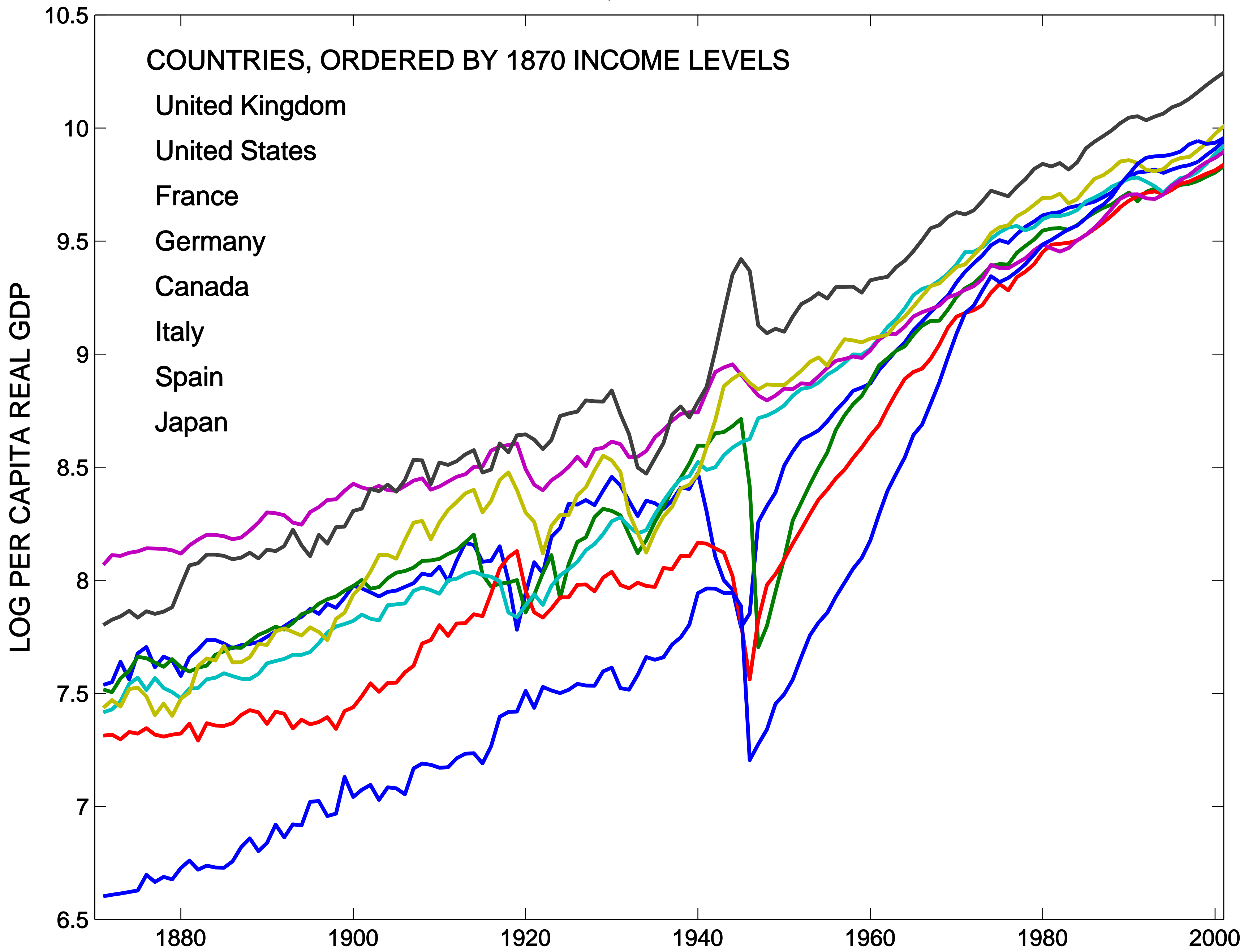
- Medical legislation that promises large increase in role of government

- Financial legislation that assigns vast, poorly-defined responsibilities to Fed, others

- Are these conditions that foster a revival in business investment, consumer spending?

Conclusion

- Throughout this talk, I have defined recession as deviation from a 3% growth trend
- Implicit assumption is that economy will get back to old trend line—only question is how long it will take
- Is this really the case?
- Know that European economies have larger government role and 20-30% lower income level than US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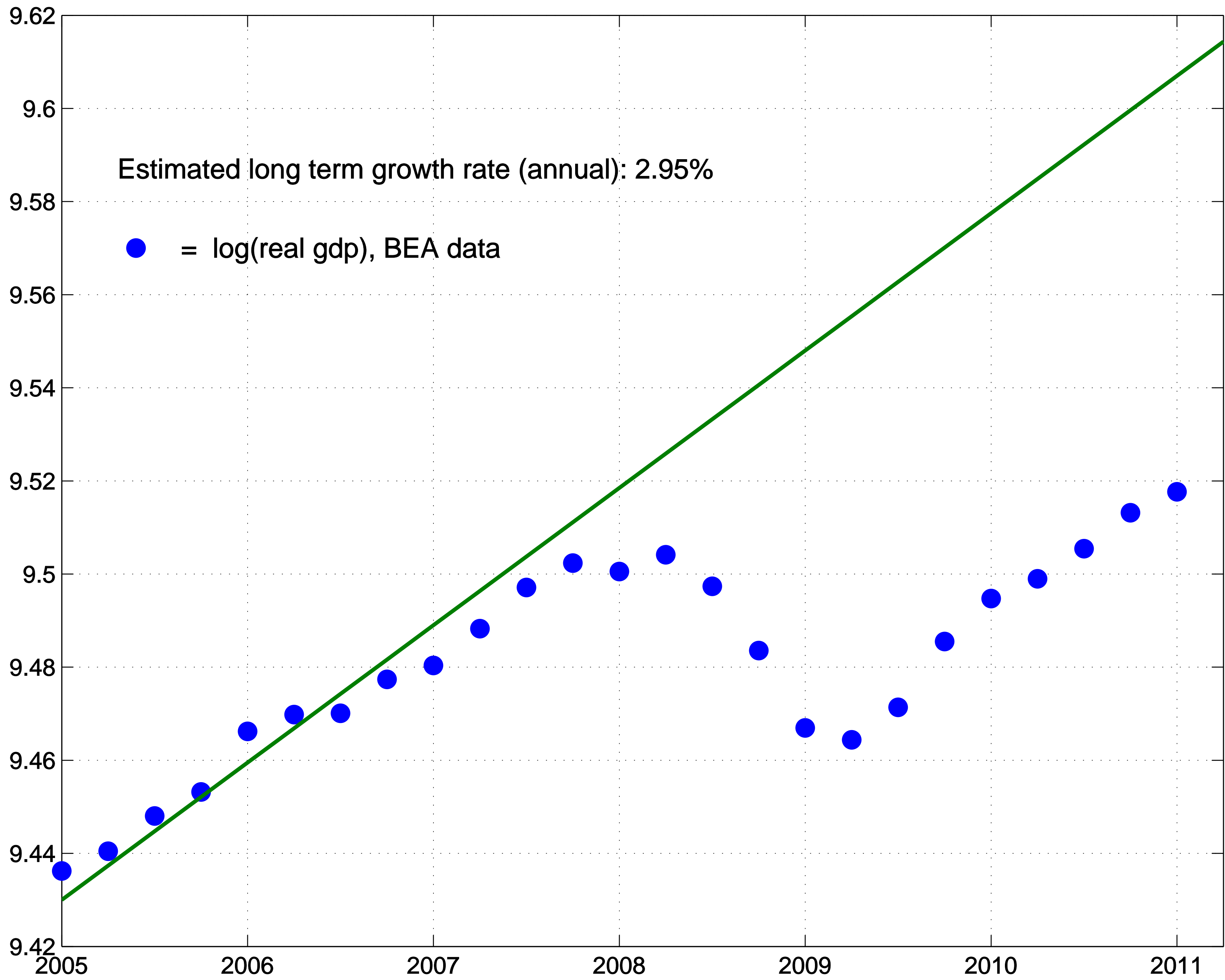
- Is it possible that by imitating European policies on labor markets, welfare, and taxes U.S. has chosen a new, lower GDP trend?

- If so, it may be that the weak recovery we have had so far is all the recovery we will get



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