Paul Krugman - New York Times Blog

October 19, 2012

1933 And All That

Noah Smith continues the debate about recoveries after financial crises, and rightly dismisses John Taylor's work; the serious contention is with Bordo-Haubrich (pdf). My take, like Noah's, is that B-H have simply misidentified financial crises. In their postwar table (p. 26 of their paper), they identify 1973-5 and 1981-2 as "banking crisis" recessions, which seems just wrong; while there may have been banking troubles, both were very clearly "Fed recessions", generated by sharp interest rate hikes intended to curb inflation. That is, they're nothing like 2007-2009.

One paper that should be cited here, by the way, is Schularick-Taylor, which uses pre-crisis credit growth rather than a binary division to identify financial-crisis slumps — and finds that such slumps are indeed characterized by slow recovery.

But what about 1929-33? This clearly was a financial-crisis slump, and was followed by four years of fast growth. Reinhart-Rogoff are right to say that the key point should still be that unemployment remained far about pre-crisis levels. Still, why was growth fast in the aftermath of this crisis?

Well, I have a hypothesis — not necessarily excluding other stories. Here it is: growth was fast after 1933 because policy was so bad, specifically because the banking system was allowed to implode. This set the stage for fast catch-up growth as a functioning financial system was reconstructed, although the lingering overhang of private-sector debt prevented a full recovery. But that's the contrast with 2007-2009, where the banks were rescued, avoiding complete collapse but also and therefore obviating the possibility of a fast bounceback.

What evidence can I present? One piece of evidence would be the old Friedman-Schwartz data on money supply, which was allowed to collapse in 1929-33 but not this time around. Here's another piece of evidence: bond spreads. We have data on lower-grade corporate bonds and more or less safe government securities over the long haul (the government series changes, but as you can see the two different measures were very close when they overlapped):

From this data we can calculate spreads between Baa bonds and government debt around the troughs of the Great Depression (in March 1933) and the Lesser Depression (in June 2009):

As I read this, it tells us that the disruption of financial markets in the 30s was bigger and went on much longer than the disruption this time around. So a return to financial stability gave a much bigger boost in the 30s.

What all this also tells us is the folly of using growth from the recession trough as a measure of success: the worse you screw up the original response to the crisis, the better this measure looks!

And the bottom line remains the same: a weak recovery was only to be expected given the kind of crisis we experienced in the waning months of the Bush administration.

October 18, 2012, 3:02 pm180 Comments
Understanding Romneynomics

I've been delving a bit into what the Romney campaign and its economist fellow-travelers have been saying, and I think I have figured out the true economic doctrine Romney and his inner circle have in mind. It is, needless to say, not what the campaign has claimed.

The official line has been that the five-point program will create scads of jobs. This has a couple of problems. First, the program is vacuous — for the most part it's a statement of desired outcomes, not policies. Second, as Glenn Kessler points out, the studies claimed as justification for the 12-million jobs number actually don't say at all what the campaign asserts.

Actually, one point that should be made: Kessler isn't quite right in his critique of the (not-Peter-nor-Doug) Diamond paper claiming big employment gains from the Romney tax plan. The time horizon is not, in fact, a big deal. What is a big deal is that the Diamond paper is an analysis of an economy that is assumed to be continually at full employment. The "job gains" the paper estimates are supply-side, not demand-side — they represent an increase in the number of people who want to work, not an increase in the number of jobs available. If you like, Diamond is claiming (implausibly) that there would be a big jump in the labor force participation rate.

And this, of course, has nothing to do with the problems of an economy where people who want to work can't find jobs.

So the Romney campaign is lying about the rationale for its boasts about jobs. But what's the real story?

The answer is actually pretty clear: CONFIDENCE. The Romney notion is that we'd be having a rip-roaring recovery right now, except that Job Creators feel that Obama is looking at them funny. And so all Romney has to do is show up, and happy times will be here again. No, seriously: in Boca Raton Romney declared that simply by being elected he could start a boom, "without actually doing anything".

Now, the obvious riposte here is that we know why we have a weak recovery, and it's not Obama's evil eye — it's the normal hangover from a severe financial crisis, which could only have been averted by much stronger fiscal and monetary stimulus. But that's not a story the Romney people want to hear. Hence the determined effort by people like John Taylor to dismiss everything we've learned — and I don't just mean me, I mean Rogoff-Reinhart, the IMF, Alan Taylor, and more — about the macro effects of financial crises.

So there you have it. The true plan is to provide an economic stimulus in the form of Romney's awesome awesomeness; the cover story is the pretense of having an actual program.

Are you feeling confident?

Well, Reinhart and Rogoff, who literally wrote the book on crises and their aftermath, have weighed in, and they're not happy. They have two main complaints, both of which are completely valid.

The first is that looking at the rate of recovery from the trough is a very peculiar criterion — especially when, as Taylor does, you look only at the first year (!) of recovery. By this standard, the New Deal was a tremendous success story, because growth was fast in 1933-4. Never mind the fact that pre-crisis per capita GDP wasn't restored for more than a decade. As R-R say, surely the relevant comparison is with the pre-crisis peak, especially given the fact that post-crisis economies often suffer periods of relapse (as is happening in Europe now).

The second is that Taylor is awfully free in designating recessions as the result of financial crisis. He counts

1973 and 1981 as financial crises, to which the only answer if you know your history is, what on earth is he talking about? These were both disinflation recessions, caused more or less deliberately by the Fed; the Fed pushed interest rates very high to calm prices, and a V-shaped recovery took place once the Fed decided we had suffered enough. This isn't hindsight: the contrast between those kinds of recessions and the slump following the bursting of a housing bubble was the reason many of us predicted a long, slow recovery well in advance. (It's been even slower than I predicted back then, but in early 2008 I didn't realize how bad the debt overhang was).

Call this another example of how politicization is hurting economics. The proposition that financial crises change macroeconomic outcomes is surely one of the big things we've learned in recent years. Yet here we have well-known economists refusing to listen and throwing out misleading studies, which just happen to be convenient politically.