

The Great Recession



Garett Jones

BB&T Professor for the Study of Capitalism

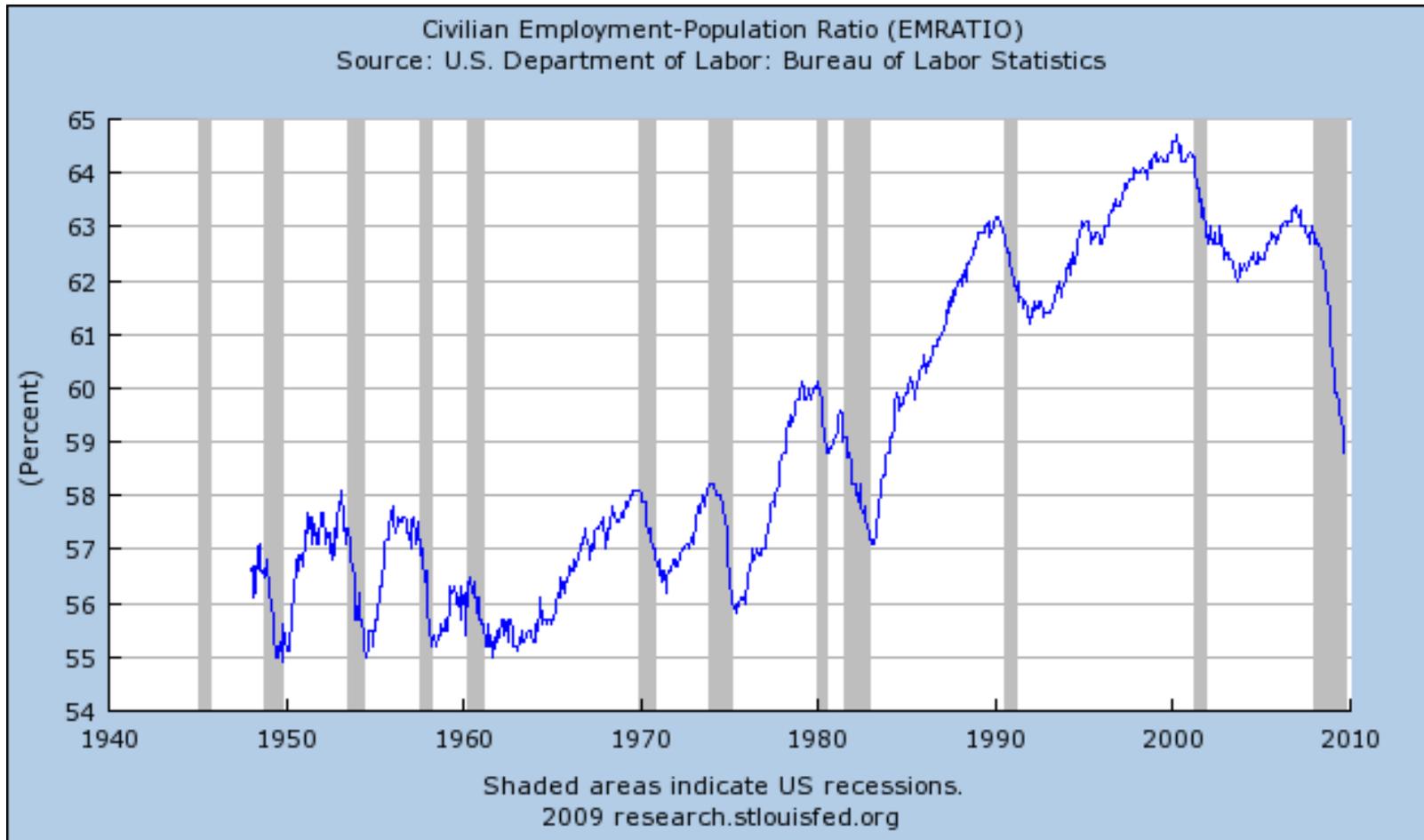
The Mercatus Center

and

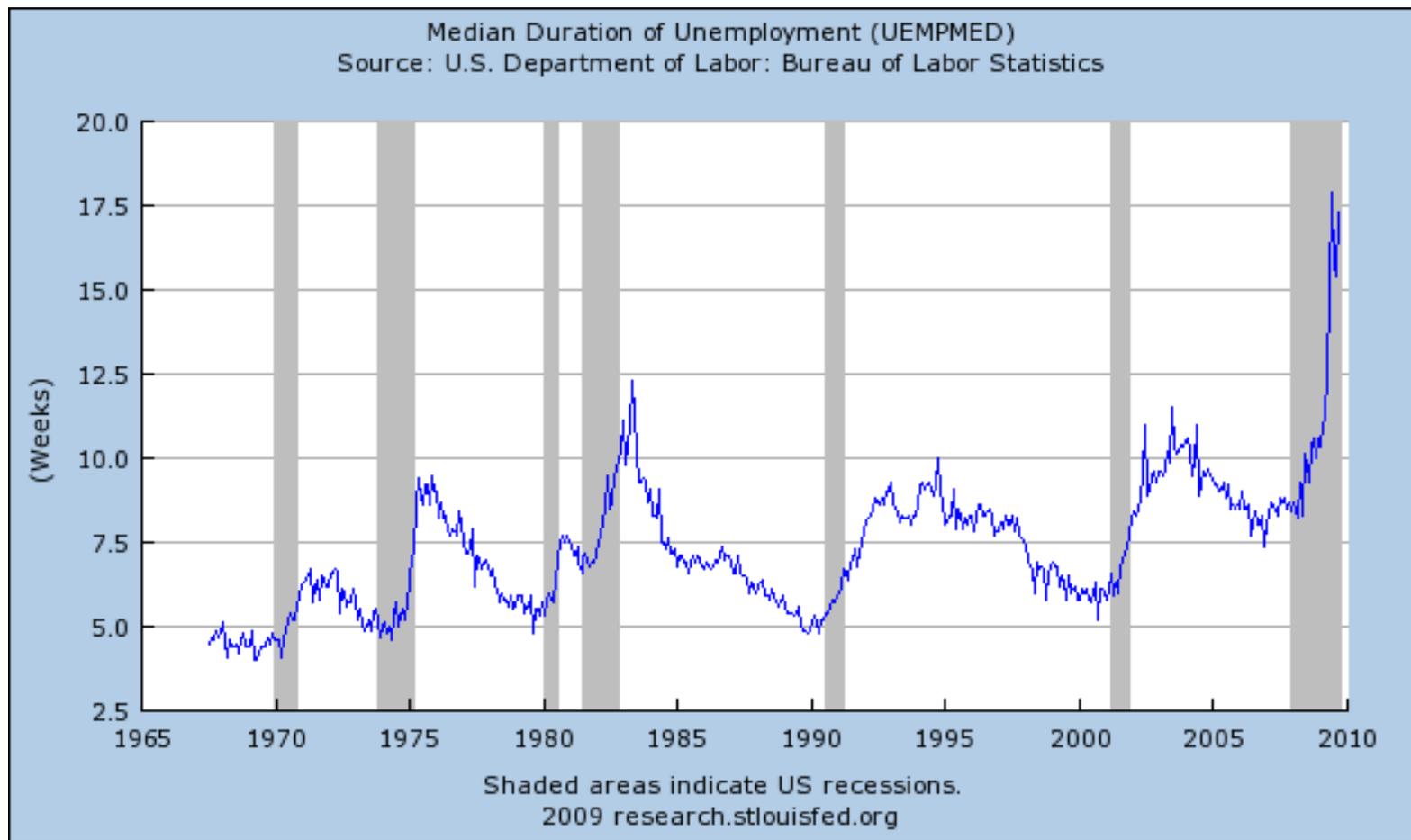
Assistant Professor of Economics

George Mason University

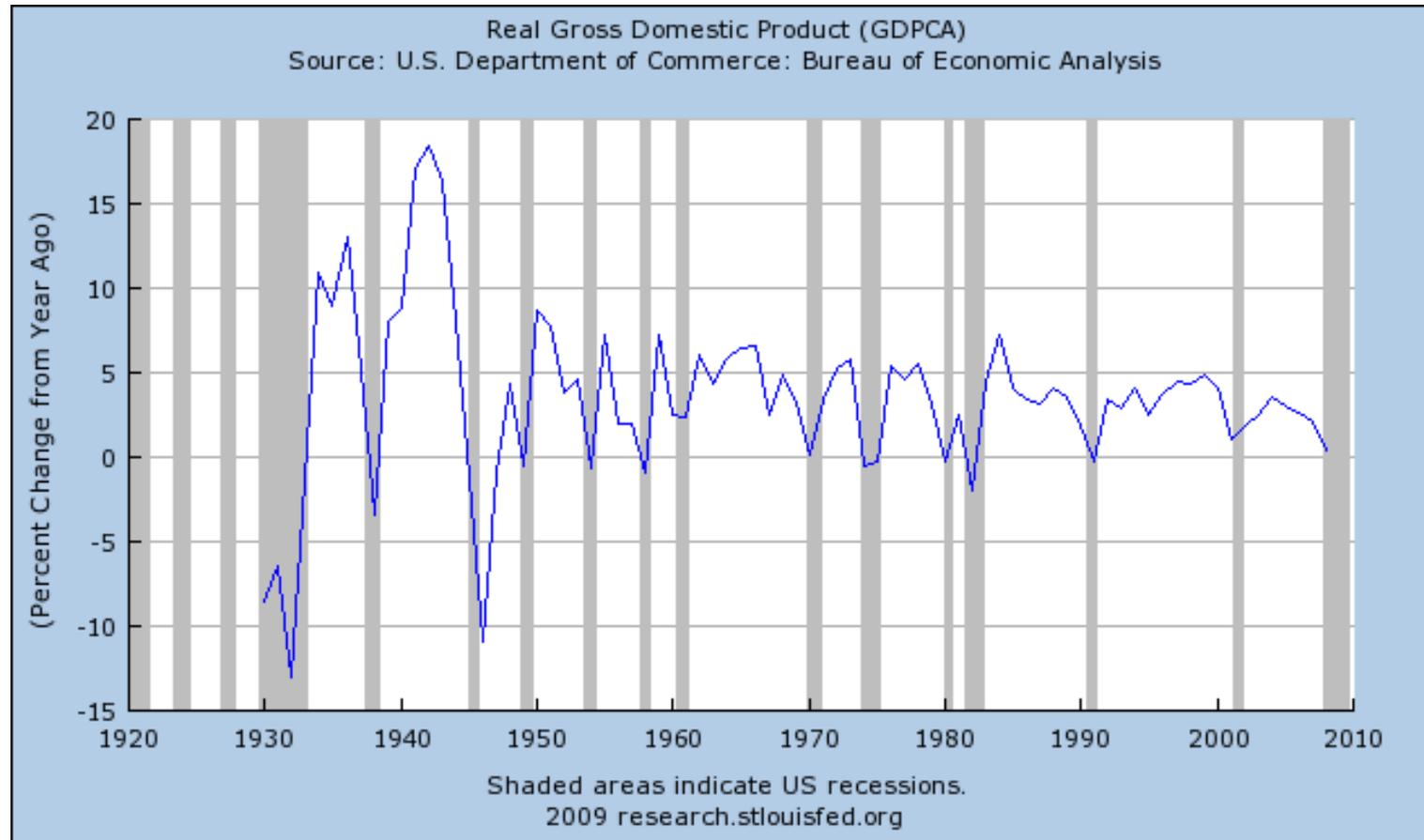
The worst job recession since WWII



Half of unemployed searching > 17 weeks



But nothing like the Great Depression



The Great Depression vs. The Great Recession



1929-1932

- 25% fall in output
- 25% unemployment
- 33% fall in money supply
- 25% fall in prices
- Stock collapse, then bank collapse, then bailouts

2007-2009

- 0% fall in output
- 10%+ unemployment
- 10% increase in money supply
- 5% rise in prices
- Housing collapse, then bank collapse, then bigger bailouts

What Economists Learned about the Depression



- Mostly from Milton Friedman and Anna Schwartz's *Monetary History of the United States*
 - *Don't let the money supply fall by 1/3*
 - *By "money" we mean cash + checking + savings accounts*
 - *Don't let average prices and wages fall dramatically*
 - ✦ *Too hard to repay old debts when you earn less & sell less.*
 - *Irving Fisher, "Debt-Deflation Theory of Great Depressions," 1935*
 - ✦ *Workers resist wage cuts—get laid off instead*
 - *Loose money helps private sector heal itself*
 - ✦ *Different from government spending approach=Taking up slack*

Bernanke's Promise: Never Again



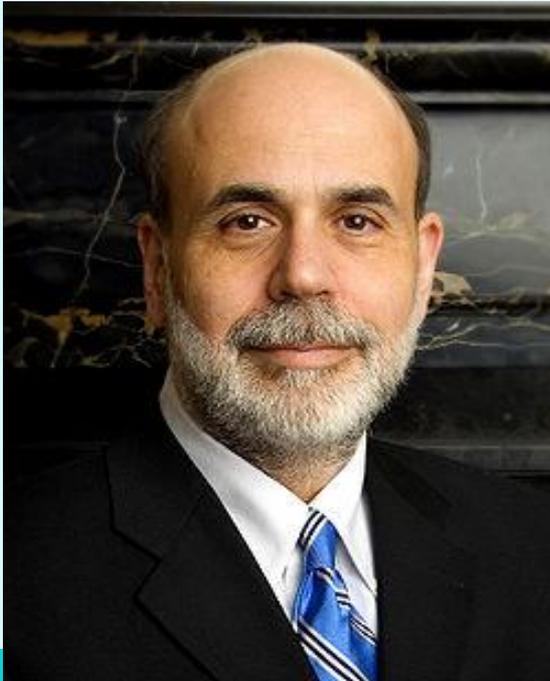
“Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton [Friedman] and Anna [Schwartz]: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again.”

--November 8, 2002, celebrating
Friedman's 90th Birthday

Two scholars who led the charge

- **Ben Bernanke**

- Harvard undergrad
- Ph.D. MIT
- Played key role in fighting “Great Depression 2.0”



- **Lawrence of Arabia**

- Oxford educated scholar of Arab world
- Played key role in fighting Ottomans in WWI

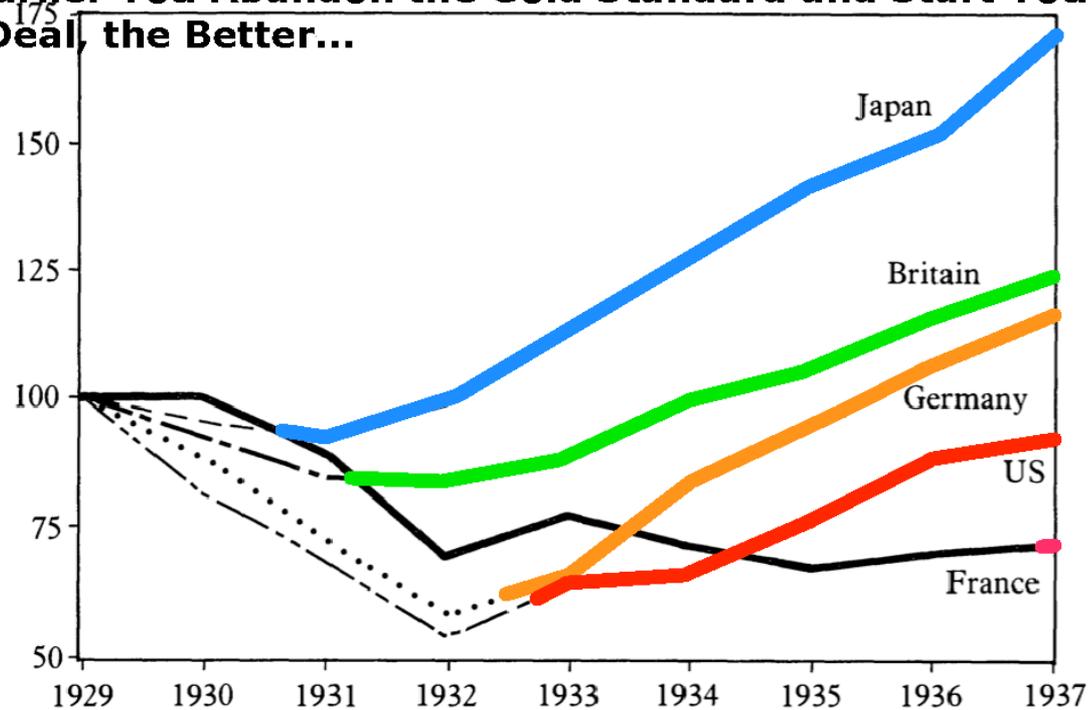


Bernanke: He changed our minds



- What did he teach (most of) us?
 - How well-intentioned tight money (i.e., the Gold Standard) made the Depression Great
 - How countries that quit the Gold Standard earlier recovered faster (e.g., Sweden)
 - Why healthy banks matter
 - How bank destruction worsened the Depression

The Earlier You Abandon the Gold Standard and Start Your New Deal, the Better...



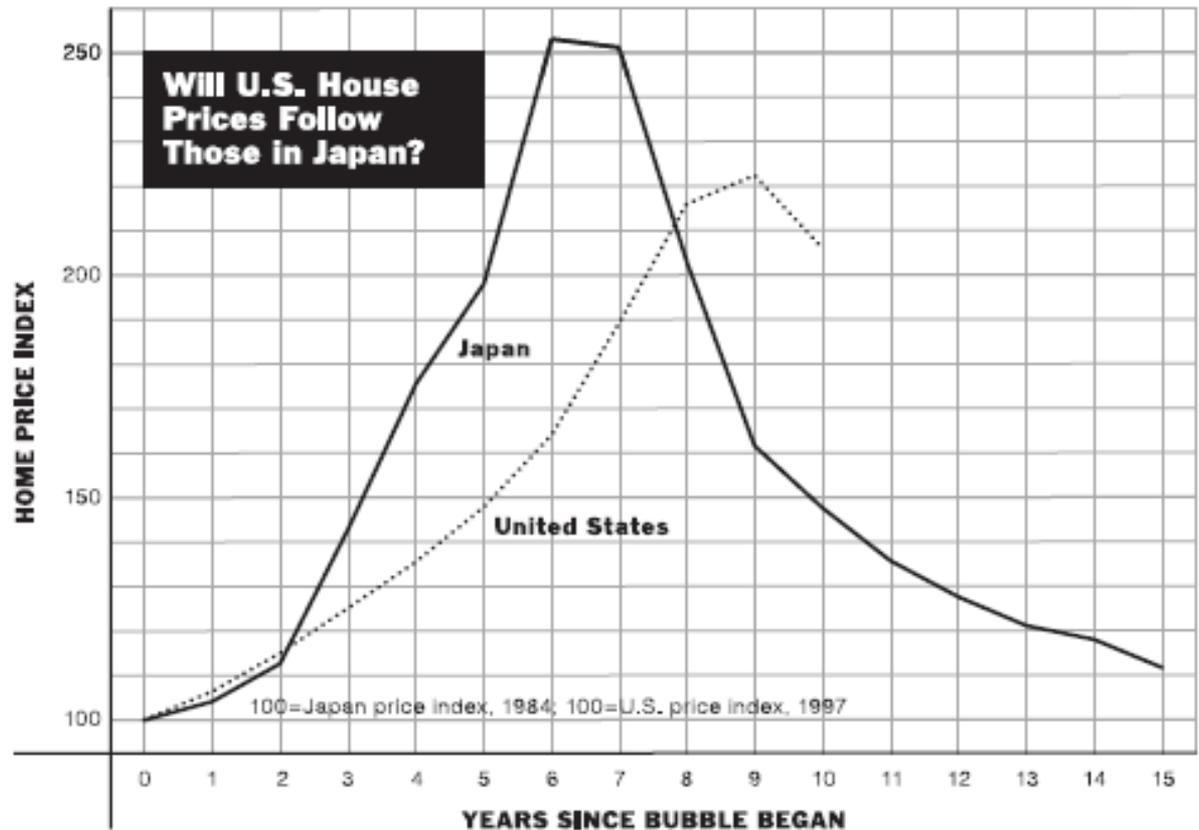
Eichengreen (1992), "The Origins and Nature of the Great Slump Revisited"

Figure 5. *Indices of industrial production, 1929-1937* (1929 = 100)

Source: League of Nations, *World production and prices, 1937/8*, p. 44.

From delong.typepad.com, based on Bernanke and Barry Eichengreen's research.

A closer analogy: Japan's Real Estate Bubble



Source:
Alex Tabarrok,
GMU Economics,
New York Times,
March 2008

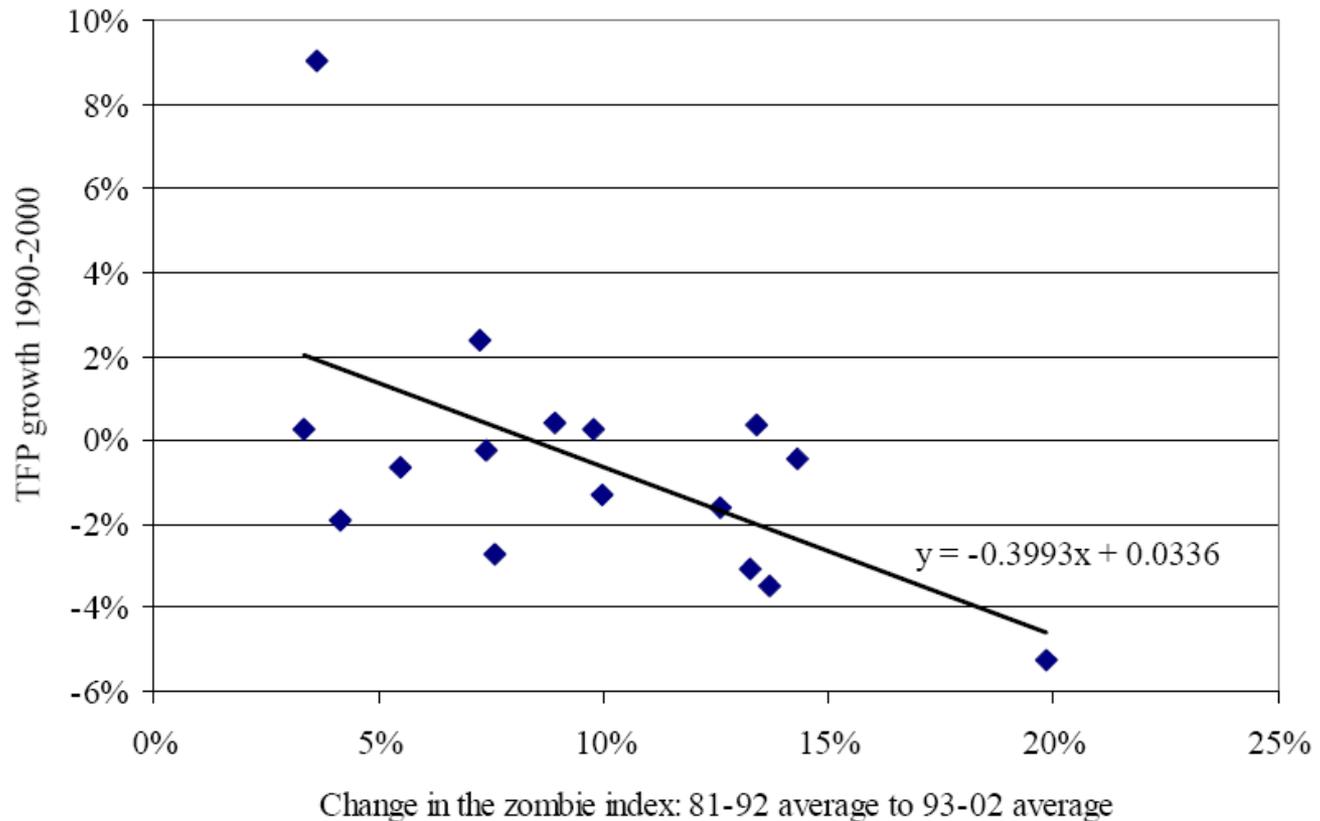
Source: Statistics Bureau Japan, S.&P./Case-Shiller Home Price Index

Japan: Bursting Bubble → Zombie Banks



- A too-common financial crisis story
 - Banks lend based on a “New Era” story (Robert Shiller)
 - New Era collapses
 - Bank borrowers don’t repay
 - Government keeps “zombie banks” alive
 - ✦ Rolling over bad loans → Avoid bad news
 - ✦ Banks “make” lots of loans, but they are loans to old, bad risks
 - Result: Lost Decade of slow growth after crisis

Japan: Zombie sectors less productive a decade later



Lessons I thought economists learned from Japan



- Make sure money supply grows
 - (Japan: 0% to 1% for too long)
- Don't let debt-heavy “zombie banks” limp along
 - A major research area in 1990's
- Extra government spending yields little benefit
 - Might work if politicians were saints, spending on best projects
 - But in real world, spending goes to connected (or needy)
 - ✦ Less job growth: Overtime for a lucky few

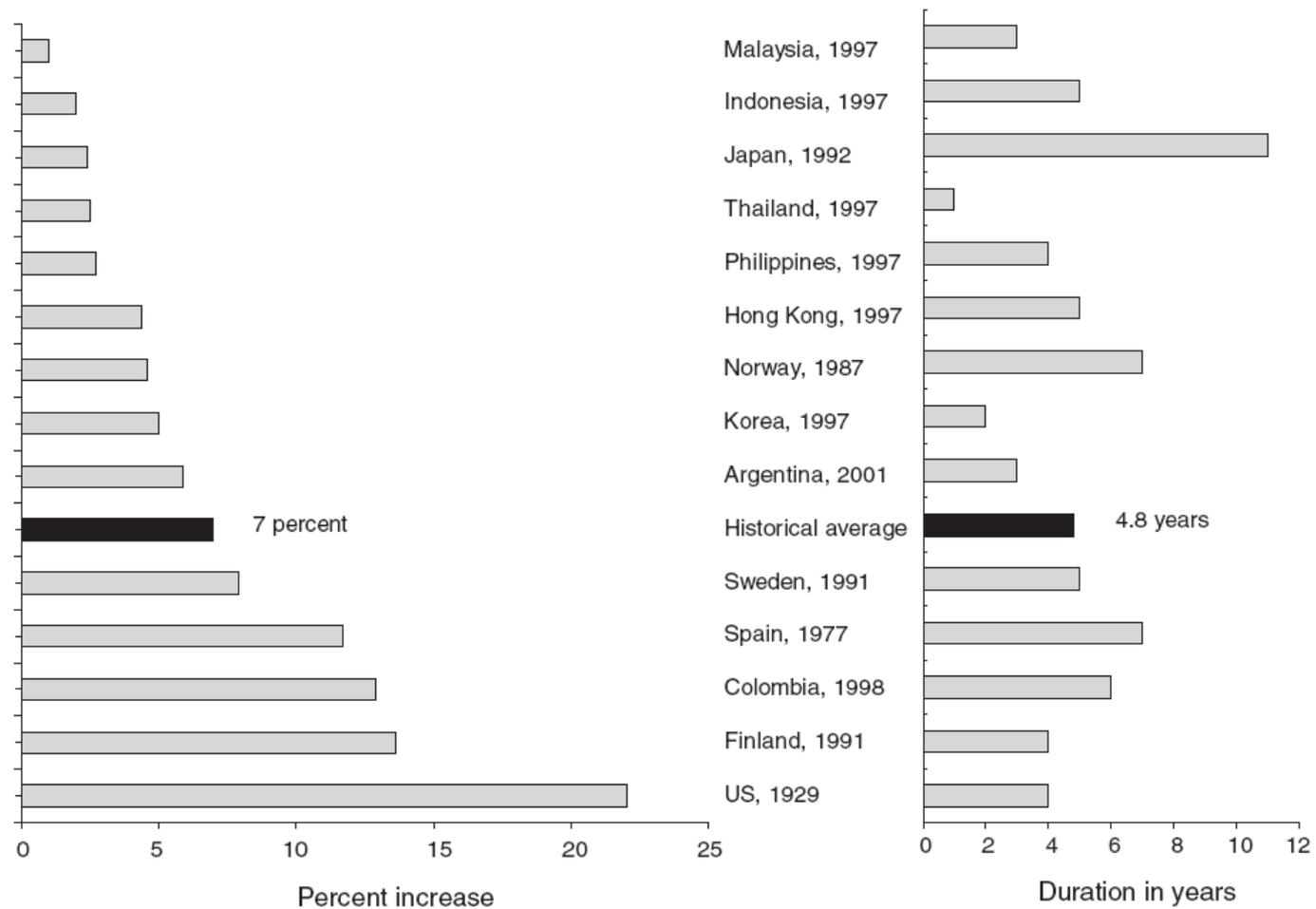


FIGURE 3. PAST UNEMPLOYMENT CYCLES AND BANKING CRISES: TROUGH-TO-PEAK PERCENT INCREASE IN THE UNEMPLOYMENT RATE (left panel) AND YEARS DURATION OF DOWNTURN (right panel)

Reasonable Predictions?



- From my interview with CNNMoney.com, April 14, 2009:

“Ben Bernanke has taken Friedman and Schwartz's lesson to heart, and so he's grown the broad money supply - currency, checking, and savings accounts - by 10% over the last year.

“Friedman always taught that money impacts the economy with 'long and variable lags' of a year or more, so we won't start seeing the effects until this fall, at the earliest. But that's well before most of the Obama stimulus will be hitting the economy anyway.

“So even as we debate and discuss the pros and cons of a fiscal stimulus designed by Congress, Bernanke and his colleagues at the other end of the Mall are already creating a more reliable stimulus: Money growth.”

Why a weak recovery?



- **Zombie banks**
 - Plus we just lost all our big investment banks → Broken bridges
- **Zombie households**
- **Other possible explanations**
 - Fed's fear of acting too aggressively
 - ✦ Political and economic consequences
 - “Option value of waiting” (Dixit/Pindyck/Bernanke)
 - ✦ In a time of political and economic turmoil, waiting can be the best decision, for firms and families

Final Question: Would you lend to this family?



Annual Growth in Net Worth of U.S. Families
1953Q1 to 2009Q2

