The recession tracks the Great Depression

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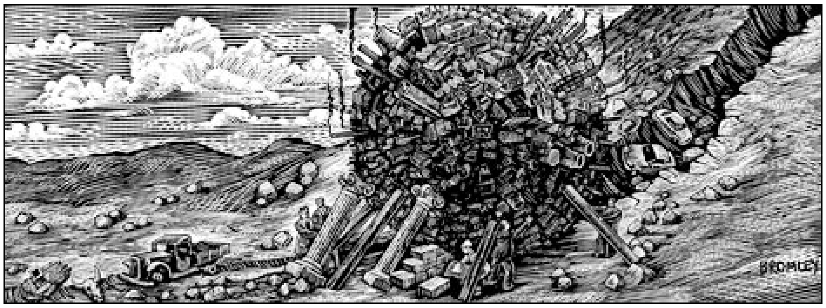


Green shoots are bursting out. Or so we are told. But before concluding that the recession will soon be over, we must ask what history tells us. It is one of the guides we have to our present predicament. Fortunately, we do have the data. Unfortunately, the story they tell is an unhappy one.

Two economic historians, Barry Eichengreen of the University of California at Berkeley and Kevin O'Rourke of Trinity College, Dublin, have provided **pictures** worth more than a thousand words (see charts).* In their paper, Profs Eichengreen and O'Rourke date the beginning of the current global recession to April 2008 and that of the Great Depression to June 1929. So what are their conclusions on where we are a little over a year into the recession? The bad news is that this recession fully matches the early part of the Great Depression. The good news is that the worst can still be averted.

First, global industrial output tracks the decline in industrial output during the Great Depression horrifyingly closely. Within Europe, the decline in the industrial output of France and Italy has been worse than at this point in the 1930s, while that of the UK and Germany is much the same. The declines in the US and Canada are also close to those in the 1930s. But Japan's industrial collapse has been far worse than in the 1930s, despite a very recent recovery.

Second, the collapse in the volume of world trade has been far worse than during the first year of the Great Depression. Indeed, the decline in world trade in the first year is equal to that in the first two years of the Great Depression. This is not because of protection, but because of collapsing demand for manufactures.

Third, despite the recent bounce, the decline in world stock markets is far bigger than in the corresponding period of the Great Depression.

The two authors sum up starkly: "Globally we are tracking or doing even worse than the Great Depression . . . This is a Depression-sized event."

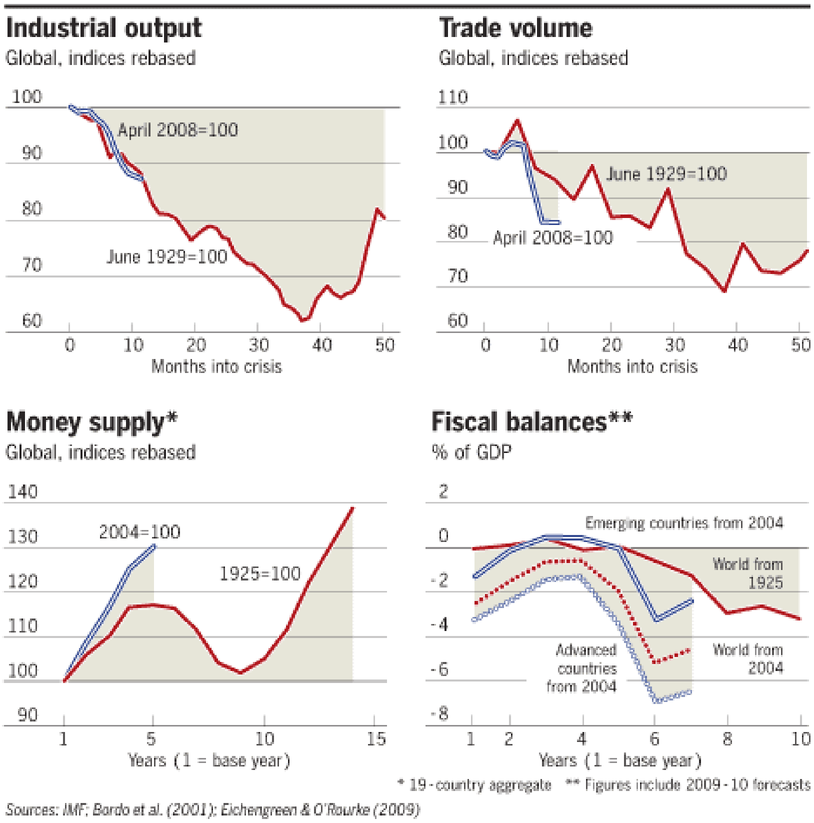
Yet what gave the Great Depression its name was a brutal decline over three years. This time the world is applying the lessons taken from that event by John Maynard Keynes and Milton Friedman, the two most influential economists of the 20th century. The policy response suggests that the disaster will not be repeated.

Profs Eichengreen and O'Rourke describe this contrast. During the Great Depression, the weighted average discount rate of the seven leading economies never fell below 3 per cent. Today it is close to zero. Even the European Central Bank, most hawkish of the big central banks, has lowered its rate to 1 per cent. Again, during the Great Depression, money supply collapsed. But this time it has continued to rise. Indeed, the combination of strong monetary growth with deep recession raises doubts about the monetarist explanation for the Great Depression. Finally, fiscal policy has been far more aggressive this time. In the early 1930s the weighted average deficit for 24 significant countries remained smaller than 4 per cent of gross domestic product. Today, fiscal deficits will be far higher. In the US, the general government deficit is expected to be almost 14 per cent of GDP.

All this is consistent with the conclusions of an already classic **paper** by Carmen Reinhart of the university of Maryland and Kenneth Rogoff of Harvard.** Financial crises cause deep economic crises. The impact of a global financial crisis should be particularly severe. Moreover, "the real value of government debt tends to explode, rising an average of 86 per cent in the major post–World War II episodes". The chief reason is not the "bail-outs" of banks but the recessions. After the fact, runaway private lending turns into public spending and mountains of debt. Creditworthy governments will not accept the alternative of a big slump.

The question is whether today's unprecedented stimulus will offset the effect of financial collapse and unprecedented accumulations of private sector debt in the US and elsewhere. If the former wins, we will soon see a positive deviation from the path of the Great Depression. If the latter wins, we will not. What everybody hopes is clear. But what should we expect?

We are seeing a race between the repair of private balance sheets and global rebalancing of demand, on the one hand, and the sustainability of stimulus, on the other.



Robust private sector demand will return only once the balance sheets of over-indebted households, overborrowed businesses and undercapitalised financial sectors are repaired or when countries with high savings rates consume or invest more. None of this is likely to be quick. Indeed, it is far more likely to take years, given the extraordinary debt accumulations of the past decade. Over the past two quarters, for example, US households repaid just 3.1 per cent of their debt. Deleveraging is a lengthy process. Meanwhile, the federal government has become the only significant borrower. Similarly, the Chinese government can swiftly expand investment. But it is harder for policy to raise levels of consumption.

The great likelihood is that the world economy will need aggressive monetary and fiscal policies far longer than many believe. That is going to be make policymakers – and investors – nervous.

Two opposing dangers arise. One is that the stimulus is withdrawn too soon, as happened in the 1930s and in Japan in the late 1990s. There will then be a relapse into recession, because the private sector is still unable, or unwilling, to spend. The other danger is that stimulus is withdrawn too late. That would lead to a loss of confidence in monetary stability worsened by concerns over the sustainability of public debt, particularly in the US, the provider of the world's key currency. At the limit, soaring dollar prices of commodities and rising long-term interest rates on government bonds might put the US – and world economies – into a malign stagflation. Contrary to some alarmists, I see no signs of such a panic today. But it might happen.

Last year the world economy tipped over into a slump. The policy response has been massive. But those sure we are at the beginning of a robust private sector-led recovery are almost certainly deluded. The race to full recovery is likely to be long, hard and uncertain.

** 'A Tale of Two Depressions', June 2009, **www.voxeu.org**; ** 'The Aftermath of Financial Crises', Working Paper 14656, **www.nber.org**.*

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