Retirement Income
JOURNAL

The Great Contraction

By Kenneth Rogoff *Tue, Aug 23, 2011*

'The global economy is badly overleveraged, and there is no quick escape without a scheme to transfer wealth from creditors to debtors, either through defaults, financial repression, or inflation,' writes Harvard economist Kenneth Rogoff.

Why is everyone still referring to the recent financial crisis as the “Great Recession”? The term, after all, is predicated on a dangerous misdiagnosis of the problems that confront the United States and other countries, leading to bad forecasts and bad policy.

The phrase “Great Recession” creates the impression that the economy is following the contours of a typical recession, only more severe – something like a really bad cold. That is why, throughout this downturn, forecasters and analysts who have tried to make analogies to past post-war US recessions have gotten it so wrong. Moreover, too many policymakers have relied on the belief that, at the end of the day, this is just a deep recession that can be subdued by a generous helping of conventional policy tools, whether fiscal policy or massive bailouts.

But the real problem is that the global economy is badly overleveraged, and there is no quick escape without a scheme to transfer wealth from creditors to debtors, either through defaults, financial repression, or inflation.

A more accurate, if less reassuring, term for the ongoing crisis is the “Second Great Contraction.” Carmen Reinhart and I proposed this moniker in our 2009 book *This Time is Different*, based on our diagnosis of the crisis as a typical deep financial crisis, not a typical deep recession. The first “Great Contraction” of course, was the Great Depression, as emphasized by Anna Schwarz and the late Milton Friedman. The contraction applies not only to output and employment, as in a normal recession, but to debt and credit, and the deleveraging that typically takes many years to complete.

Why argue about semantics? Well, imagine you have pneumonia, but you think it is only a bad cold. You could easily fail to take the right medicine, and you would certainly expect your life to return to normal much faster than is realistic.

In a conventional recession, the resumption of growth implies a reasonably brisk return to normalcy. The economy not only regains its lost ground, but, within a year, it typically catches up to its rising long-run trend.

The aftermath of a typical deep financial crisis is something completely different. As Reinhart and I demonstrated, it typically takes an economy more than four years just to reach the same *per capita* income level that it had attained at its pre-crisis peak. So far, across a broad range of macroeconomic variables, including output, employment, debt, housing prices, and even equity, our quantitative benchmarks based on previous deep post-war financial crises have proved far more accurate than conventional recession logic.

Many commentators have argued that fiscal stimulus has largely failed not because it was misguided, but because it was not large enough to fight a “Great Recession.” But, in a “Great Contraction,” problem number one is too much debt. If governments that retain strong credit ratings are to spend scarce resources effectively, the most effective approach is to catalyze debt workouts and reductions.

For example, governments could facilitate the write-down of mortgages in exchange for a share of any future home-price appreciation. An analogous approach can be done for countries. For example, rich countries’ voters in Europe could perhaps be persuaded to engage in a much larger bailout for Greece (one that is actually big enough to work), in exchange for higher payments in ten to fifteen years if Greek growth outperforms.

Is there any alternative to years of political gyrations and indecision?

In my December 2008 column, I argued that the only practical way to shorten the coming period of painful deleveraging and slow growth would be a sustained burst of moderate inflation, say, 4-6% for several years. Of course, inflation is an unfair and arbitrary transfer of income from savers to debtors. But, at the end of the day, such a transfer is the most direct approach to faster recovery. Eventually, it will take place one way or another, anyway, as Europe is painfully learning.

Some observers regard any suggestion of even modestly elevated inflation as a form of heresy. But Great Contractions, as opposed to recessions, are very infrequent events, occurring perhaps once every 70 or 80 years. These are times when central banks need to spend some of the credibility that they accumulate in normal times.

The big rush to jump on the “Great Recession” bandwagon happened because most analysts and policymakers simply had the wrong framework in mind. Unfortunately, by now it is far too clear how wrong they were.

Acknowledging that we have been using the wrong framework is the first step toward finding a solution. History suggests that recessions are often renamed when the smoke clears. Perhaps today the smoke will clear a bit faster if we dump the “Great Recession” label immediately and replace it with something more apt, like “Great Contraction.” It is too late to undo the bad forecasts and mistaken policies that have marked the aftermath of the financial crisis, but it is not too late to do better.

Kenneth Rogoff is Professor of Economics and Public Policy at Harvard University, and was formerly chief economist at the International Monetary Fund.