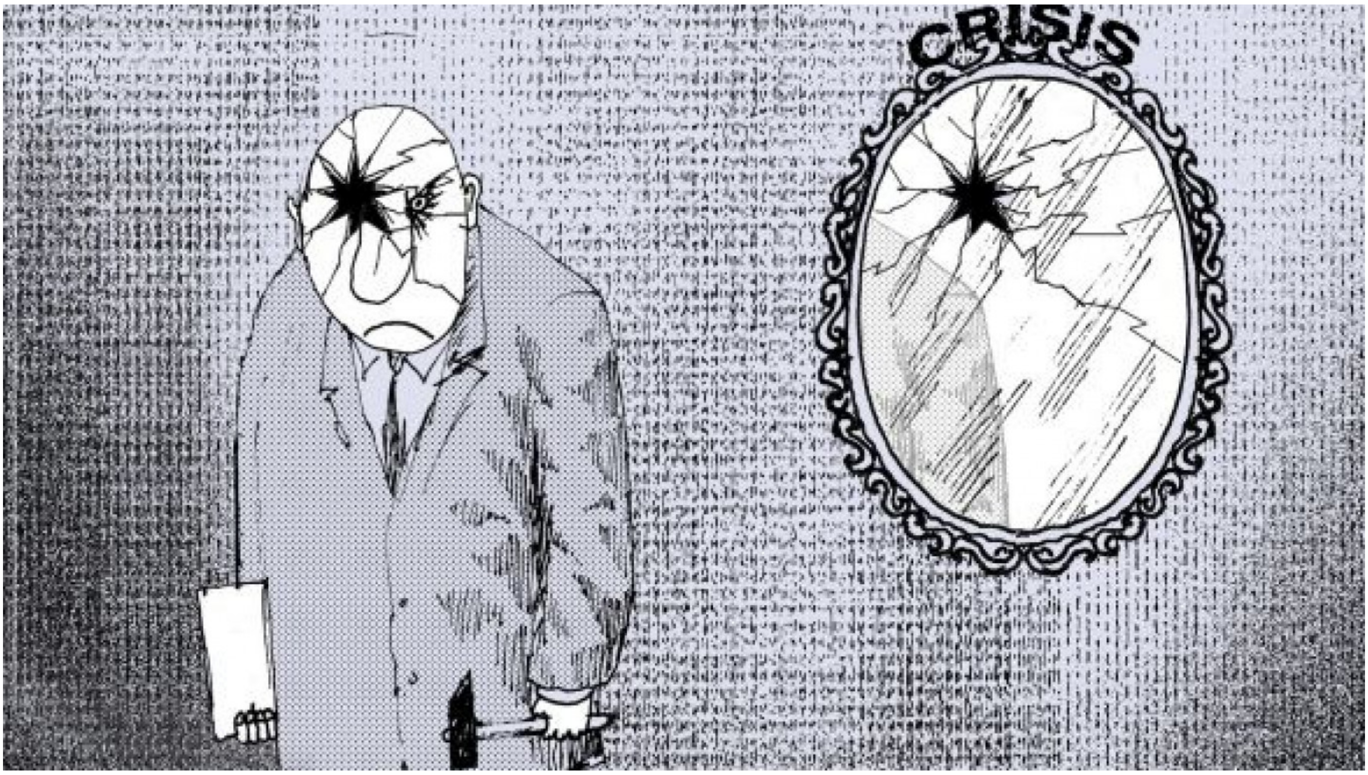
The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

7 More Years of the Great Recession

By Robert J. Shiller

September 22, 2010



Much of the talk emerging from last month's Jackson Hole Economic Symposium, attended by many of the world's central bankers and economists, has been about a paper presented there that gave a dire long-run assessment of the future of the world's economies.

The paper, "After the Fall," was written by economists Carmen Reinhart and Vincent Reinhart. According to the paper, when compared with the decade that precedes financial crises like the one that started three years ago, "GDP growth and housing prices are significantly lower and unemployment higher" in the subsequent "10-year window." Thus, one might infer that we face another seven years or so of bad times.

Economic theory is not sufficiently developed to predict major turning points based on first principles or mathematical models. So we have to be historically oriented in our method. History may be a "soft" social science, but we have to look at it — even at distant history — if we are to grasp other examples of major crises.

Moreover, we have to look at the entire world. Most economists study the recent history of their own country, which is easiest to do, and their results sound superficially important to most of their countrymen. But major financial crises are rare by the standards of any one country, and we have to range widely through history to get enough information about how such crises play out.

The Reinharts' research is an expansion and generalization of many people's informal economic thinking, which often compares the present to stories of major past episodes.

Ever since the current crisis began in 2007, many people have been wondering whether the Great Depression that followed the 1929 stock market crash and the banking crises of the early 1930s is relevant to our experience today. The troubling fact about the Great Depression is that it was severe, global and lasted more than a decade — and that it followed the collapse of an equity and real estate boom, roughly what happened before the current crisis.

Likewise, many people have been wondering whether the weakness that followed the equity and real estate crash in Japan at the beginning of the 1990s is relevant to our experience today. They used to refer to Japan's "lost decade." Now it is more appropriate to describe that experience as the "lost decades."

Are these examples models for our future? They certainly make one stop and think. But they do not stand as convincing evidence about what will happen — after all, two observations are hardly enough to prove the point.

But now the Reinharts have systematically studied many more examples in modern financial history. There is also the world financial crisis that surrounded the oil shocks of 1973 and 1979, and there are the country-specific financial crises in Spain in 1977; Chile in 1981; Norway in 1987; Finland and Sweden in 1991; Mexico in 1994; Indonesia, Korea, Malaysia, the Philippines and Thailand in 1997; Colombia in 1998; and Argentina and Turkey in 2001.

So there are many more than just two modern cases. From them, the Reinharts found, for example, that median annual growth rates of real per capita gross domestic product for advanced countries were one percentage point lower in the decade following a crisis, while median unemployment rates were five percentage points higher.

How did this happen? They note that, in general, debt levels and leverage rose during the decade preceding these crises, propelling increases in asset prices for a long time. The authors describe a "this time is different" syndrome during the pre-crisis boom, whereby these bubbles are allowed to continue for far too long, because people think that similar episodes in the past are irrelevant.

This seems to contain the germ of a new economic theory, but it remains ill-defined. It seems to have a behavioral-economics component, since the "this time is different" syndrome seems psychological rather than rational. But it is still not so sharp a theory that we can really rely on it for making confident forecasts.

Moreover, there are reasons to suggest that this time really might be different. I hate to say so, not wanting to commit the sin defined by their syndrome, but this time might be different because all of the modern examples of past crises came during a time when many economists worldwide were extolling the virtues of the "rational expectations" model of the economy. This model suggested that a market economy should be left alone as much as possible — so that is what governments tended to do.

According to “rational expectations,” bubbles simply did not exist, which meant that actual bubbles were allowed to grow. But that mind-set is waning, and government and business leaders now routinely warn of bubbles and adopt policies to counter them. So this time really is at least a little different.

In that case, perhaps all of those crisis-

induced bad decades are no longer relevant. But any such hopes that the aftermath of the current crisis will turn out better are still in the category of thoughts, theories and dreams — not science.

It is not true that if you break a mirror, you will have seven years’ bad luck. That is a superstition. But if you allow a financial market to spin wildly until it breaks down, it really does seem that you run the risk of years of economic malaise. That is a historical pattern.

Robert Shiller, a professor of economics at Yale University, is co-author with George Akerlof of “Animal Spirits: How Human Psychology Drives the Economy and Why It Matters for Global Capitalism.”