Lingering Effects of the Financial Crisis and US Growth

Presentation to the NY Federal Reserve Economic Advisory Committee, 11/21/14

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Six years since the onset of the global financial crisis, how has the world economy fared compared to past recessions marked by deep financial crises? What crisis-related factors might still be influencing the economy going forward, on top of secular factors such as an aging population?[1]

Taking stock of the recovery to date, there is a wide divergence of performance among advanced economies. The United States recovery is very much line with the benchmarks for past post-war financial crises, including the depth and duration of the housing crisis and unemployment. In some respects the US has in fact done somewhat better, as the *Economic Report of the President* has documented. Though low investment and prolonged unemployment, particularly among youth, may carry lasting scars, domestic demand is strong and economy appears to be in solid recovery mode. However, the recession in the Eurozone has been more severe by many measures and, for the periphery of Europe, brooks comparisons with the Great Depression, albeit Europe is vastly richer today than it was 75 years ago. Many of the countries that experienced banking crises still have per capita real GDP well below where it was at the start of the crisis. Indeed, out 12 countries that experienced systemic financial crises, only Germany and the United States have reached and surpassed pre-crisis peaks in per capita GDP.

Table 1 (from Reinhart and Rogoff, 2014) lists the 35 worst recessions since 1857 that were marked by systemic banking crises. The simple measure of severity used in the table (others can be constructed) is based on cumulative decline in output per capita peak to trough (parallel to the measure Barro's (2006) measure for "rare disasters," but on a per capita basis) plus years until the previous peak is recovered. Figure 1 gives a simple illustration of the severity index for the US crisis of 1893.

As the crises are still ongoing in the Eurozone, we base estimates on IMF growth forecasts.[2] As the table illustrates, several countries are experiencing crises that are very severe, even weighed against past deep financial crises. There are many reasons why the US recovery has been stronger than in Europe, ranging from a more aggressive monetary response to much earlier implementation of meaningful bank stress tests to the shale gas revolution. But policy paralysis in the Eurozone has certainly been instrumental in the outcome. The Eurozone remains a nascent federal state with a weak central government, and this has made much more difficult to fund needed transfers between the stronger economies of the north and the weaker economies of the south. There has also been grossly inadequate structural adjustment in some of the Eurozone's largest economies, notably France and Italy.

Going forward, recovery prospects remain worryingly asynchronous. While the US and UK appear to be enjoying relatively solid recoveries, growth in the Eurozone hovers near zero; Italy looks set to have a triple dip recession (by the older conventional definition, anyway). Elsewhere, Japan is

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[1] This note draws heavily on Reinhart and Rogoff "Recoveries from Financial Crises: Evidence from 100 Episodes," , American Economic Review May 2014, and also draws on Reinhart, Reinhart and Rogoff "Deal with Debt" (International Seminar on Macroeconomics, June 2014), and Lo and Rogoff "Secular Stagnation, Debt Overhang and Other Rationales for Sluggish Growth Six Years on," (Bank for International Settlements conference, June 2014).

[2] Table 1 is based on the October 2013 IMF World Economic Outlook. Updating the table to the October 2014 WEO will not have a dramatic impact because the IMF forecasts have generally been too optimistic, with the notable exception of the UK which has outperformed.

experiencing a technical recession, in part because a rise in the consumption tax has more than offset monetary stimulus, but – importantly -- also because of a failure to deliver structural reforms.

Another very important factor in overall global picture is China, which is experiencing a significant slowdown, arguably even greater than suggested by official data. Indeed, the overall slowdown in emerging markets has been dramatic, accounting for almost half of the IMF's persistent forecasts errors in projecting global growth (WEO, October 2014). The slowdown in the BRICs (Brazil, Russia, India and China) has been particularly steep since 2010. The IMF notes that a good part of its large forecast errors over the past several years, for both emerging markets and advanced countries, comes from an overestimate of how quickly global investment would bounce back after the crisis. Correspondingly, the IMF (April 2014) also attributes a large share of the drop in global real interest rates to a sharp downward shift in investment demand.

Over the course of a long crisis, many secular factors have now become cumulatively more important. For example, the advanced countries are now six years further into an era of an extremely difficult demographic cycle. To the extent inequality has persistently risen more rapidly than expected, there has probably also been a drop-off in demand that will eventually be equilibrated through price and wage adjustment, as well as through accommodation of political calls for greater income redistribution. Some would argue that innovation has tailed off, reducing long-term productivity growth, though this claim is highly debatable.

But there are also factors that may be more directly attributed to the aftermath of the crisis. If one looks integratively at the overall debt picture in the economy (as Reinhart and Rogoff, 2010 and Reinhart, Reinhart and Rogoff, 2012 forcefully argue one should) the deleveraging picture is quite mixed. As Lo and Rogoff (2014), the Geneva Report (2014) and the IMF Fiscal Monitor (April 2014) show, the US and UK have made considerably more progress than the Eurozone. The Eurozone approach of attempting to deleverage mainly through orthodox Washington consensus policies (as opposed to more heterodox policies involving debt restructuring and inflation) has not been especially successful to date, though as already noted, weak structural reform efforts in some countries have also been a major contributing factor. High debt overhang creates a negative feedback loop between debt and growth that is not helped by persistently low inflation. Another important factor may be lingering fear of a relapse in the crisis, a factor that might have held back both consumption and investment.

Overall, at this stage, we are still simply too close to the onset of the crisis to clearly separate out long-term secular from more transient factors. Although there seems good reason to believe that the US economic recovery is well grounded and lingering effects from the financial crisis are fading, albeit scars remain. However, the asynchronous recovery in advanced economies, substantial pockets of debt overhang, the slowdown in China, as well as lasting post-financial crisis trauma, all cast a cloud that make it difficult to confidently infer how much of today's trend growth malaise is temporary versus permanent.

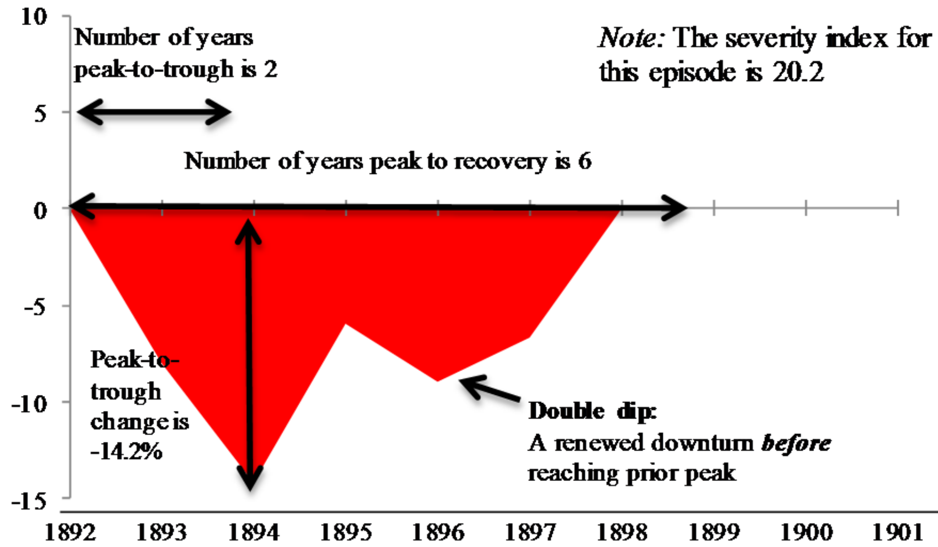
Table 1. Crisis Severity: Percent Decline in Per Capita GDP, Duration of Contraction, and Years to Full Recovery in 35 of the Worst Systemic Banking Crises, 1857-2013

			% change	Number of years			
			Peak to	Peak to	Peak to	Severity	Double
	Year	Country	trough	trough	recovery	index	dip, yes=1
1	1926	Chile	-46.6	3	16	62.6	1
2	1931	Spain (Civil War)	-34.6	9	26	60.6	1
3	1983	Peru	-32.0	11	25	57.0	1
4	1931	Uruguay	-36.1	3	17	53.1	1
5	1893	Australia	-28.0	8	20	48.0	1
6	1929	Mexico	-31.1	6	16	47.1	1
7	1921	Italy	-25.5	3	21	46.5	1
8	1890	Brazil	-21.7	4	21	42.7	1
9	1923	Canada	-30.1	4	10	40.1	0
10	1890	Uruguay	-21.0	2	19	40.0	1
11	1981	Philippines	-18.8	3	21	39.8	1
12	1980/1985	Argentina	-21.8	11	18	39.8	1
13	1929	India	-8.2	9	31	39.2	1
14	1929/1933	US	-28.6	4	10	38.6	1
15	1994	Venezuela	-24.2	11	14	38.2	1
16	1939	Netherlands	-16.0	6	21	37.0	1
17	*2008*	*Greece*	*-24.0*	*6*	*12*	*36.0*	*0*
18	1931/1934	Argentina	-19.4	3	15	34.4	1
19	1931	Poland	-24.9	4	9	33.9	0
20	1929/1931	Austria	-23.4	4	10	33.4	0
21	1981	Mexico	-14.1	7	17	31.1	1
22	1920	UK	-18.7	3	11	29.7	1
23	2001	Argentina	-20.9	4	8	28.9	0
24	1980	Chile	-18.9	2	8	26.9	0
25	2002	Uruguay	-18.9	4	8	26.9	0
26	1930	France	-15.9	3	10	25.9	1
27	*2007*	*Ireland*	*-12.9*	*3*	*12*	*24.9*	*1*
28	1931	Germany	-17.8	4	7	24.8	0
29	*2008*	*Italy*	*-11.3*	*6*	*12*	*23.3*	*1*
30	1890	Argentina	-18.3	2	5	*23.3*	0
31	*2007*	*Iceland*	*-12.2*	*3*	*11*	*23.2*	*0*
32	1997	Indonesia	-15.1	2	8	23.1	0
33	1866	Italy	-8.8	1	14	22.8	1
34	*2008*	*Ukraine*	*-14.4*	*1*	*8*	*22.4*	*0*
35	1931	Romania	-10.1	11	12	22.1	1
	Memorandum item:						
	Share of crises having a *double dip*						65.7

Source: Table 1 from Reinhart and Rogoff (May 2014 AER).

(1) *Severity index = –Peak-to-trough % change + Number of years from peak to recovery of prior peak.*

Figure 1. Basic Concepts: An Illustration with the US Banking Crisis of 1893



Sources: Figure 1 from Reinhart and Rogoff (May 2014 AER)