The return of depression economics

Paul Krugman

Famous last words:

“The problem of depression-prevention has been solved, for all practical purposes.”

Robert Lucas, 2003

“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 and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again.“

Ben Bernanke, at Milton Friedman’s 90th conference, 2002

“If you want a simple model for predicting the unemployment rate in the United States over the next few years, here it is: It will be what Greenspan wants it to be, plus or minus a random error reflecting the fact that he is not quite God. ”

Paul Krugman, 1997

What we all believed, circa 1997:

1. Friedman and Schwartz had showed that the Fed could easily have prevented the GD

2. Monetary policy is always effective

3. Discretionary fiscal policy is unnecessary and usually counterproductive

Then came Japan …

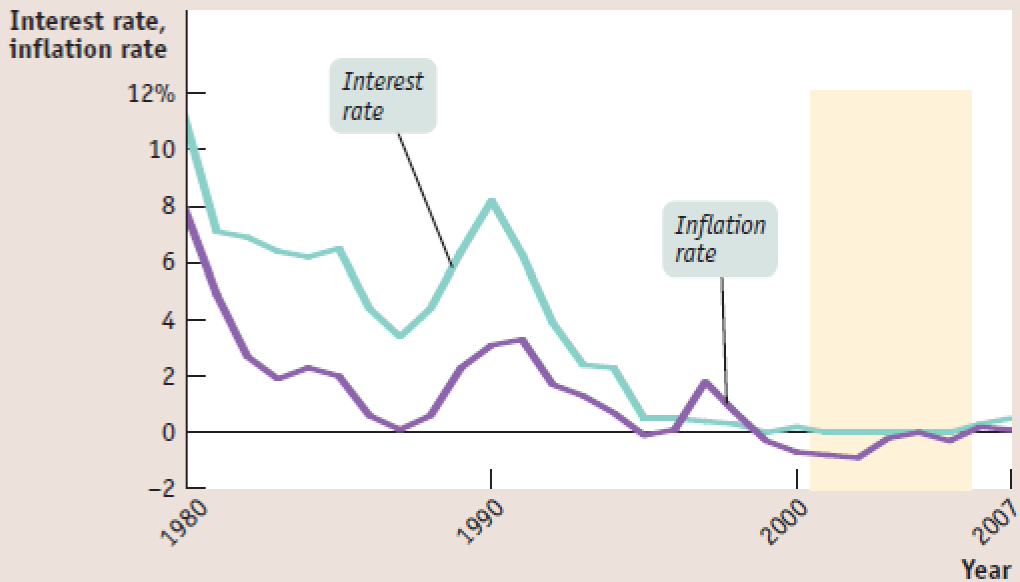
Maybe preventing deflation isn't that easy after all …

FIGURE 32-15

Japan's Lost Decade

A prolonged economic slump in Japan led to deflation from the late 1990s on. The Bank of Japan responded by cutting interest rates—but eventually ran up against the zero bound.

Source: OECD.



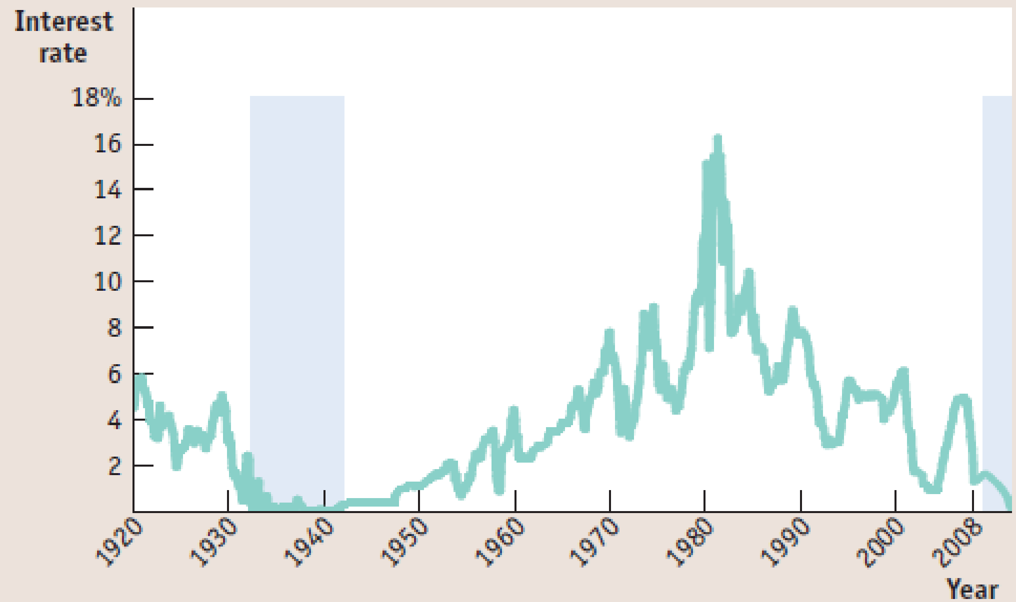
And we're no different

FIGURE 32-14

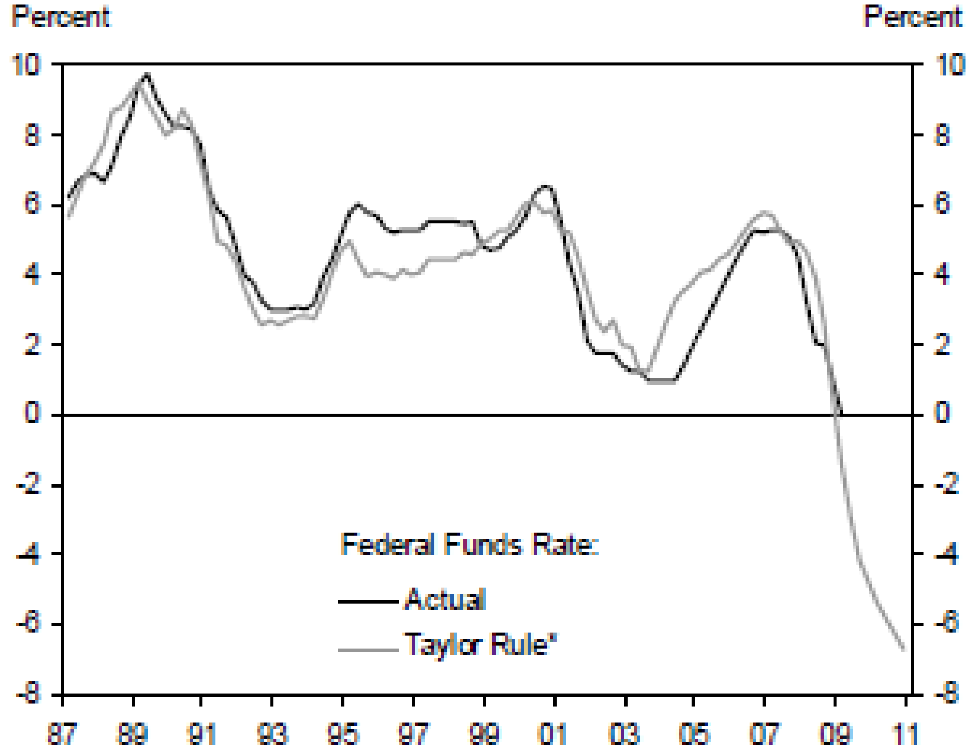
The Zero Bound in U.S. History

This figure shows U.S. short-term interest rates, specifically the interest rate on three-month Treasury bills, since 1920. As shown by the shaded area at left, for much of the 1930s, interest rates were very close to zero, leaving little room for expansionary monetary policy. After World War II, persistent inflation generally kept rates well above zero. However, in late 2008, in the wake of the housing bubble bursting and the financial market crisis, the interest rate on three-month Treasury bills was virtually zero.

Source: Federal Reserve Bank of St. Louis.



The Zero Bound Bites, Making Policy Tight



* GS forecasts beyond 2008Q4.

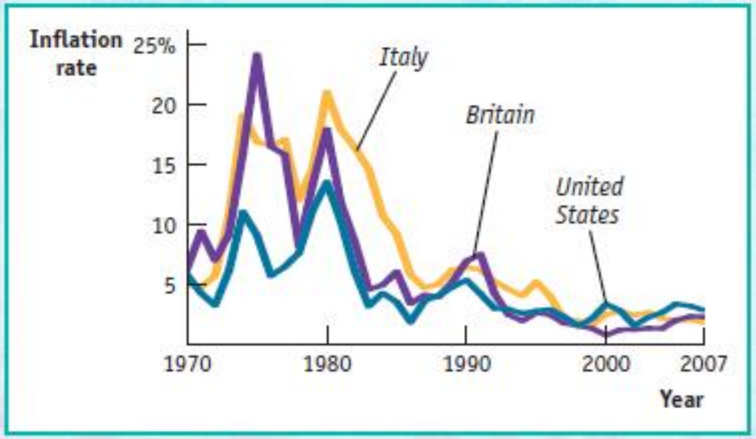
Source: William Poole, St. Louis Fed. CBO. Our calculations.

Maybe inflation wasn't such a bad thing …

GLOBAL COMPARISON

DISINFLATION AROUND THE WORLD

The great disinflation of the 1980s wasn't unique to the United States. A number of other advanced countries also experienced high inflation during the 1970s, then brought inflation down during the 1980s at the cost of a severe recession. This figure shows the annual rate of inflation in Britain, Italy, and the United States from 1970 to 2007. All three nations experienced high inflation rates following the two oil shocks of 1973 and 1979, with the U.S. inflation rate the least severe of the three. All three nations then weathered severe recessions in order to bring inflation down. Since the 1980s, inflation has remained low and stable in all wealthy nations.

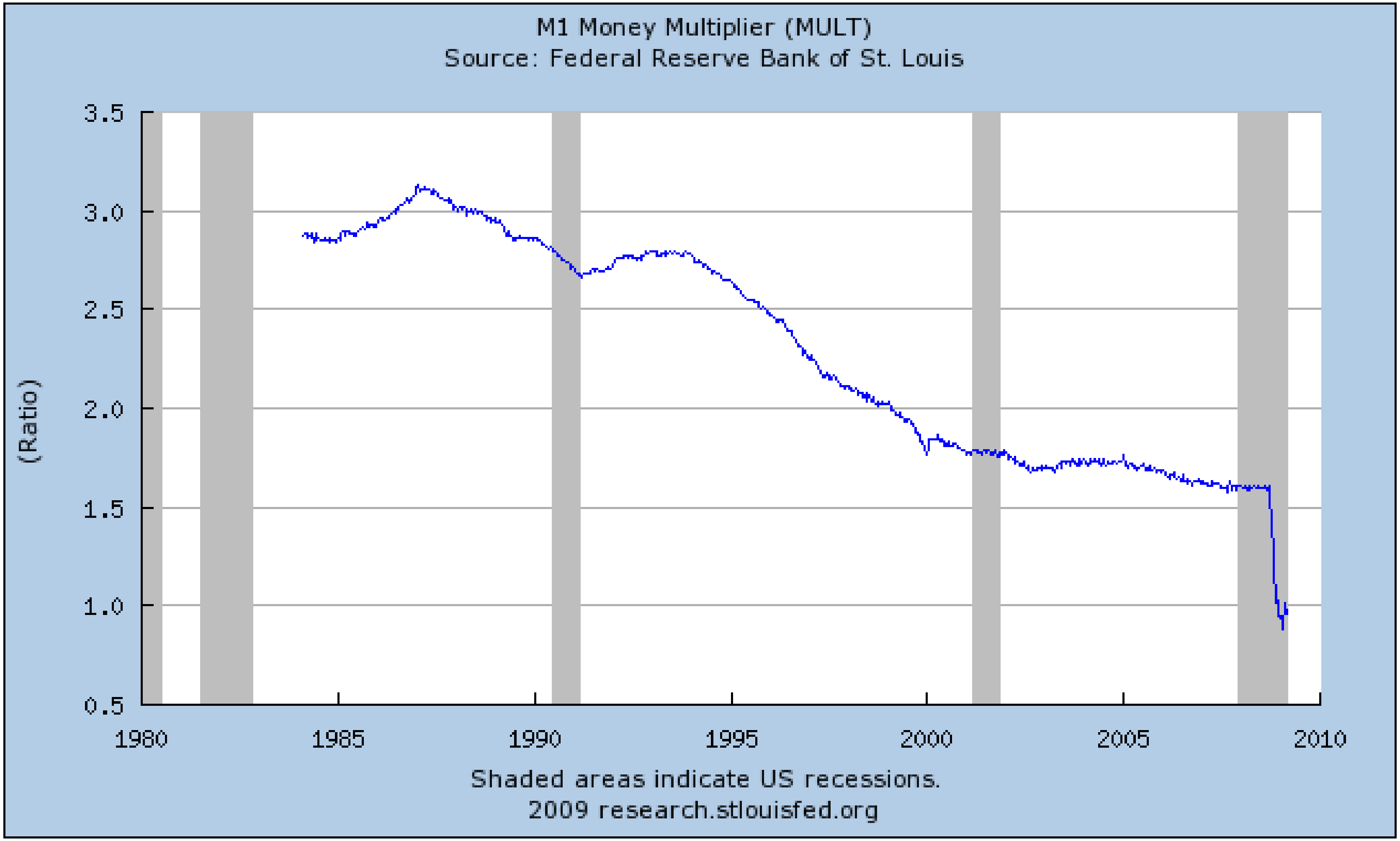


Source: OECD.

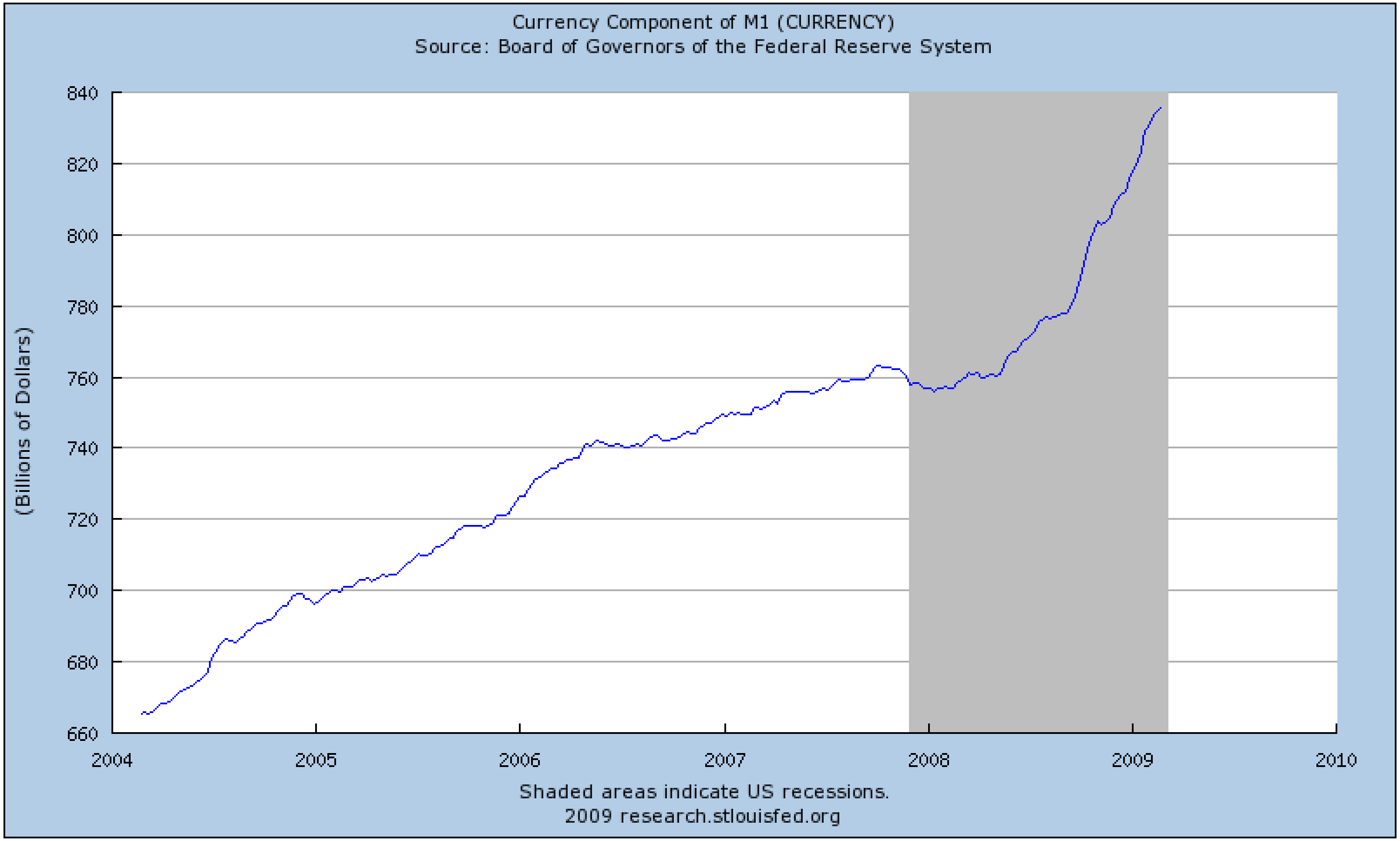
We used to think that the monetary mechanism was simple

Money is the essential channel that links the various parts of the modern economy.

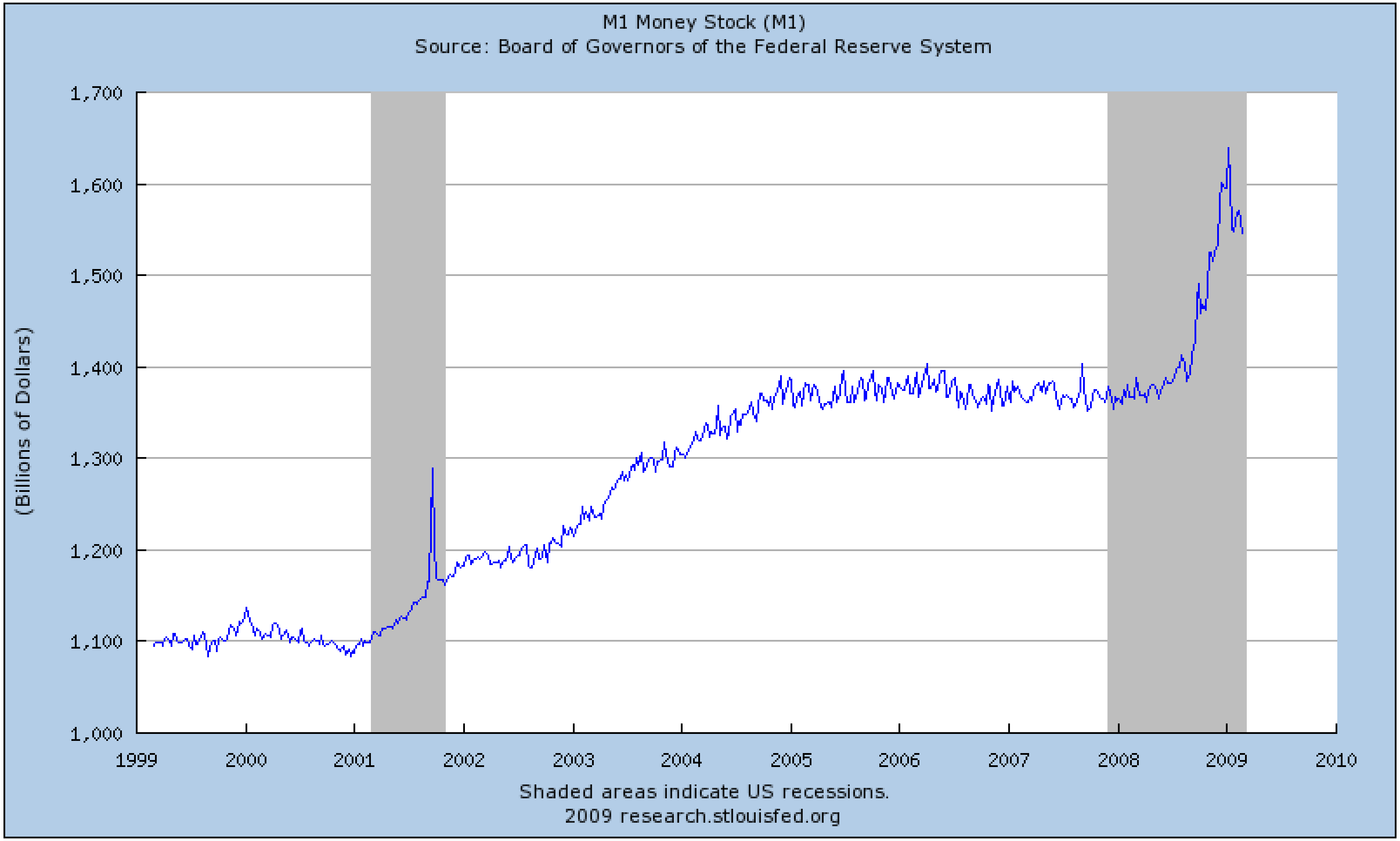
But things have been breaking down



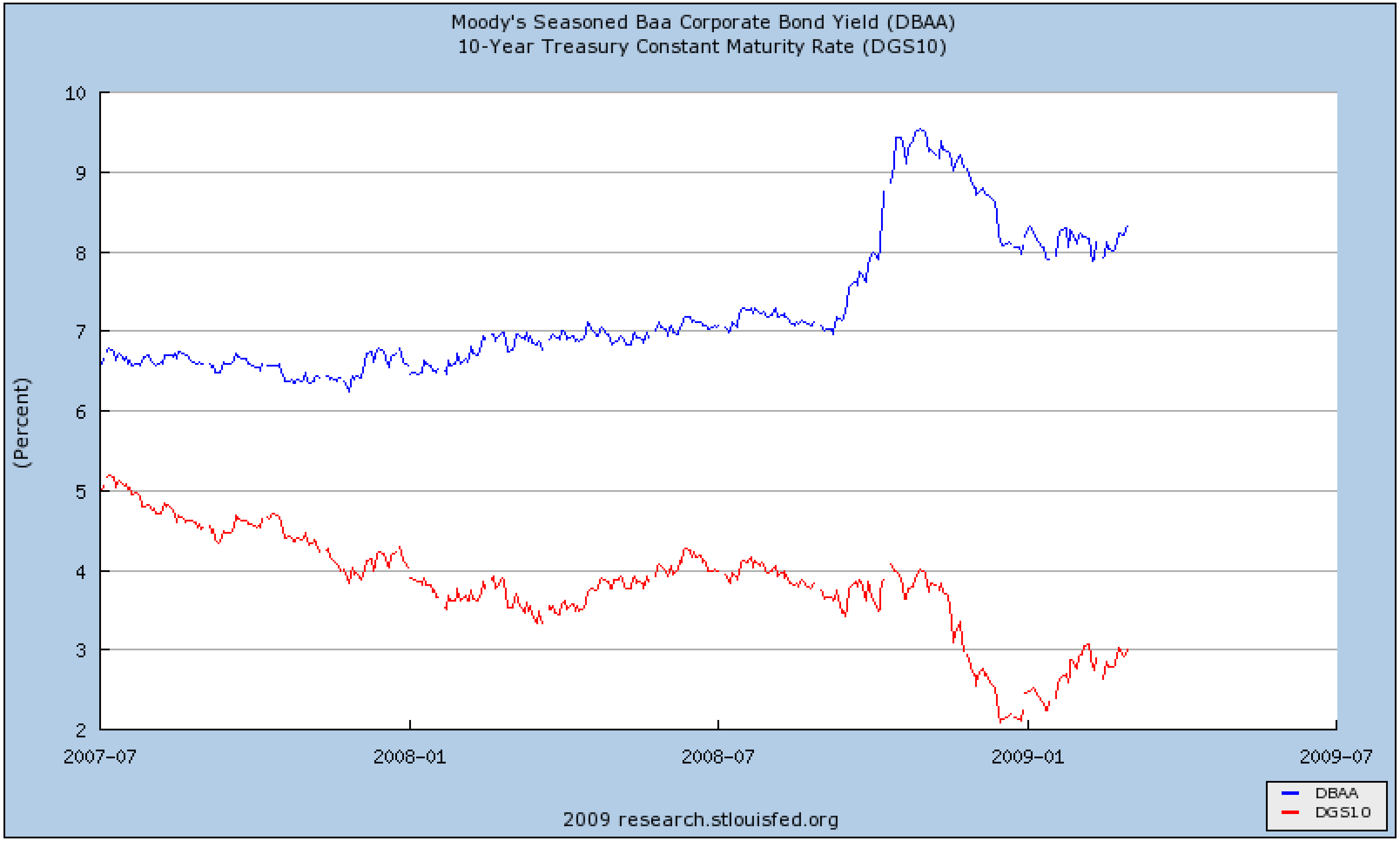
About those mattresses …



And anyway, M ain't what it used to be



There is no "the" interest rate



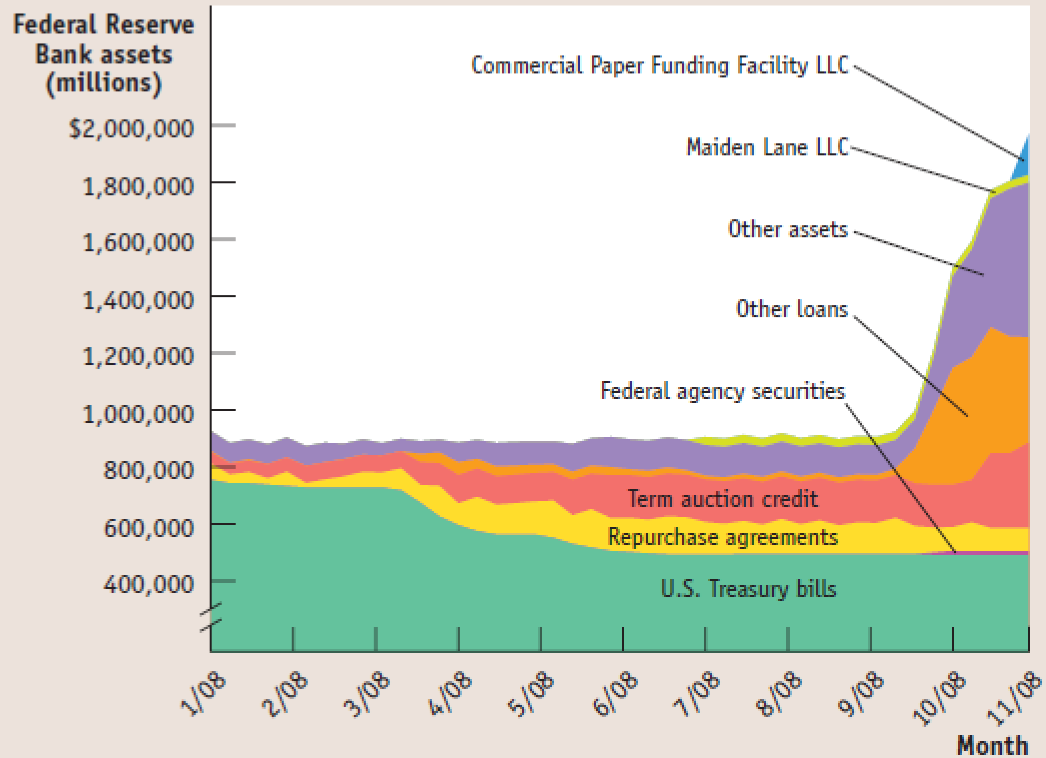
… which means that monetary policy has changed

FIGURE 30-11

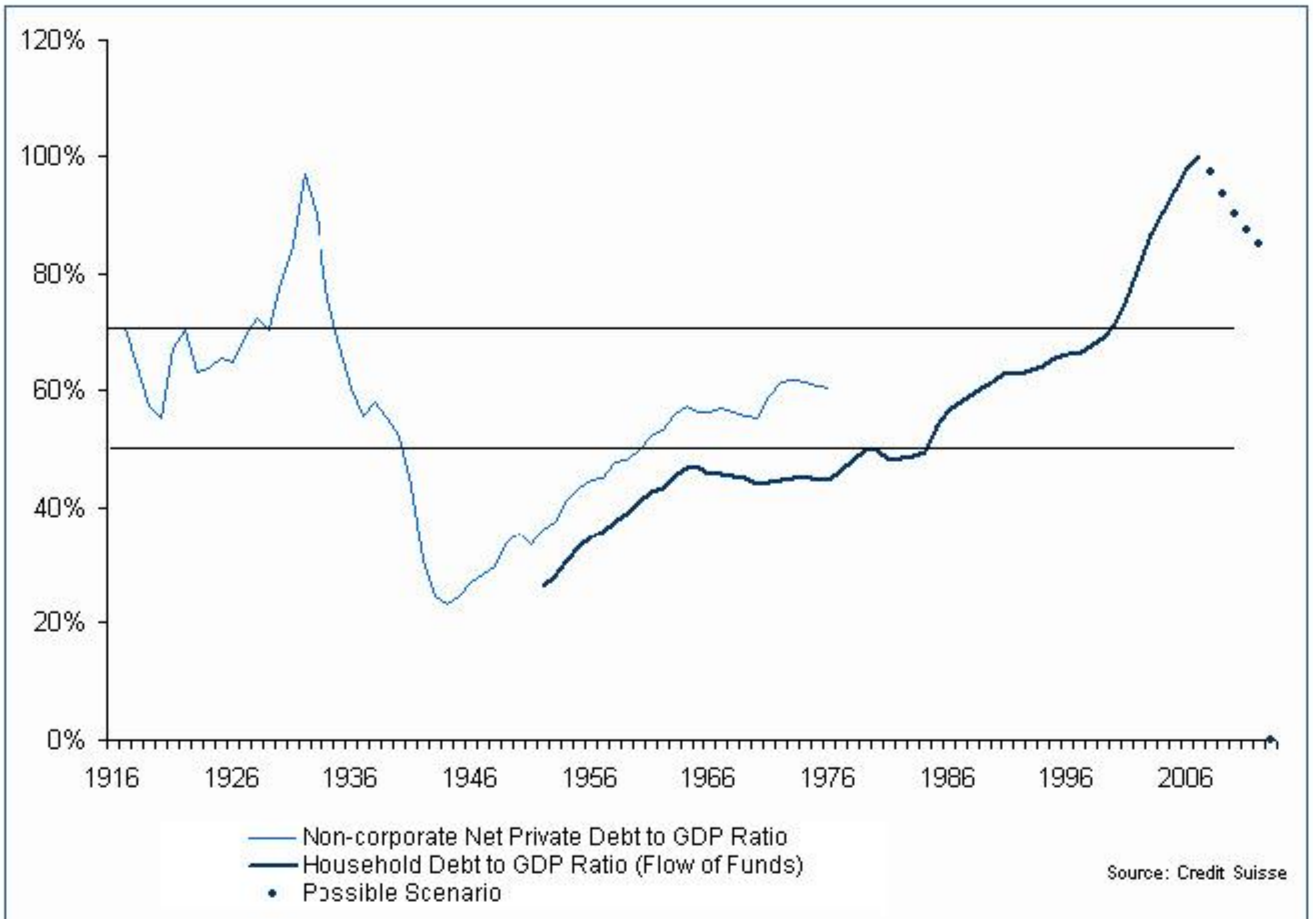
The Fed Responds to the Crisis

Normally, the Federal Reserve holds almost no assets other than U.S. Treasury bills. In response to the 2008 financial crisis, however, the Fed created an alphabet soup of special "facilities" to lend money to troubled financial institutions, leading to a dramatic shift in its balance sheet.

Source: Board of Governors of the Federal Reserve System.



And don't forget about balance sheets; Irving Fisher has his day



Some final words of reassurance:

"We're not making it up,“ Bernanke told the House Financial Services panel.

"We're working along a program that has been applied in various contexts," he said. "We're not completely in the dark."