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 ...
And we’re no different
The Zero Bound Bites, Making Policy Tight

Federal Funds Rate:
- Actual
- Taylor Rule*

* GS forecasts beyond 2008Q4.
Source: William Poole, St. Louis Fed. CBO. Our calculations.
Maybe inflation wasn’t such a bad thing ...

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
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
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."