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# The Great Contraction of 2008-2009

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CAMBRIDGE – A popular view among economic forecasters and market bulls is that “the deeper the recession, the quicker the recovery.” They are right – up to a point: immediately after a *normal* recession, economies do, indeed, often grow much faster than usual over the ensuing twelve months. Unfortunately, the Great Recession of 2008-2009 is far from being a normal global recession.

The Great Recession was turbo-charged by a financial crisis, making it a far more insidious affair that typically has far more long-lasting effects. As Carmen Reinhart and I argue in our new book *This Time is Different: Eight Centuries of Financial Folly*, the Great Recession is better described as “The Great Contraction,” given the massive and simultaneous contraction of global credit, trade, and growth that the world has experienced.



Fortunately, despite a hobbled recovery in the developed world, emerging markets in Asia, Latin America, and the Middle East have enormous latent growth potential. Most should be able to grow strongly, despite the challenging global environment.

Nevertheless, the legacy of the huge contraction in credit is not likely to go away anytime soon. Yes, if you are a bank, particularly a big one, you can raise money easily enough, thanks to sweeping explicit and implicit government guarantees. But, for everyone else, particularly small and medium-size firms, the credit environment continues to be very challenging. Even firms in established industries such as energy report facing great difficulties in raising capital.

The optimists say not to worry. Credit will soon come to everyone else as easily as it has to the banks. After all, credit also dried up during the 1991 global recession, and yet funds were flowing briskly within 18 months.

But this parallel fails to recognize the fact that balance sheets remain far more impaired this time. Housing prices are being propped up temporarily by myriad subsidies, while a commercial real-estate tsunami looms. Many banks' weaknesses are simply being masked by government guarantees.

Indeed, G-20 governments now face the daunting prospect of trying to rein in the monster they have created. It is now very clear that the taxpayer will always be there to guarantee that bondholders get paid. Unchecked, large financial firms will be able to tap bond markets for decades to come at rates just above what the government pays, regardless of the inherent risk of their asset positions. Lenders to banks will not bother worrying about what kinds of gambles and investments financial institutions are making, or whether regulation is effective.

The good news is that most governments do see the need to implement significant new regulation on financial firms. But here's the rub: financial regulation is enormously complicated, all the more so given that there must be some degree of international consistency. It would be a disaster if countries were to rush in individually to implement their own new system.

On the other hand, if regulators take their time to “get it right,” there will be a huge shadow of uncertainty hanging over the financial system. Banks know that they face higher capital requirements, which will force them to scale back lending relative to their resources). But how much higher? There is much discussion of breaking up banks that are too big to fail. But what will actually happen?

Given this environment, no wonder credit is still contracting in the United States, Europe, and elsewhere. If banks don't know what the rules of the game are going to be, they have to be very cautious about over-extending their balance sheets.

So government regulators – and ultimately all of us – are caught between a rock and a hard place. Regulate in haste, repent at leisure. Overly strict regulation could seriously impair global growth for decades. But if regulation is too soft, the next monster global financial crisis could come within a decade. And even if regulators take their time to try to get it right, as most of us think they should, the world may have to live with weak credit expansion as banks hold back, awaiting a clearer verdict on their future.

And here is another painful thought that Harvard historian Niall Ferguson often emphasizes: many of the leaders and legislators who are passing judgment on new rules for banks are the same leaders and legislators who oversaw the regulation in the run-up to the financial crisis.

I am often asked why economies get themselves into such a bind again and again throughout economic history. Unfortunately, as Reinhart and I document empirically for hundreds of financial crises, covering 66 countries and eight centuries, the answer is all too simple: arrogance and ignorance. Investors and policymakers are often altogether ignorant of the myriad historical experiences with financial crises. And the few that are dimly aware of what has happened in other times and other places all too often say, “Don't worry, this time is different.”

Perhaps the Great Contraction of 2008-2009 *will* be different from other deep financial crises, and we will see a sustained sharp recovery worldwide. But G-20 policymakers are best advised not to bet on it, and to counsel patience, particularly in epicenter countries.

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