

KENNETH ROGOFF: Rogoff on why this recession lasts so long

13/10/2012 |

Interview Kenneth Rogoff, economics professor at Harvard University and author with Carmen Reinhart of *This Time is Different: Eight Centuries of Financial Folly*

Emerging Markets: The global economy remains in a parlous state several years after the onset of the crisis. What went wrong?

Kenneth Rogoff: I'm not so sure that something's gone wrong. It's rather that the early assessments of what was going on might have been overly optimistic. When you have a deep systemic financial crisis it takes years just to go from peak to trough and it takes years more to heal again. The reason that you can't shortcut this process is that the boom was exaggerated. So what happens afterwards has to reflect some return to normality.

The larger issue is that there's a big overhang of debt – public, private, external –and it'll take a long time to work its way down. That's especially the case when policymakers choose to bail everything out and not to find ways to restructure the debt. It's also the low inflation environment: it takes longer to whittle down [the debt]. So we have this big overhang of debt – we're still a long ways from being normal again.

EM: In terms of the misdiagnosis of the problem, what specifically was not understood at the outset?

KR: The basic misdiagnosis is that for most post-World War II recessions in advanced countries the bigger the fall, the larger the rise. Recessions usually only last a year or less, with even two years being a rarity. Once the recovery begins, you quickly make up lost ground and even get back to trend, certainly within two years, often just within one year.

That is absolutely not the case after a deep financial crisis. After a deep financial crisis it takes almost five years to get back to the starting level of GDP per capita. It takes a whole different time period.

Wall Street and central bank economists during the crisis again and again once there was a little bit of good data they'd say 'we're off to the races, if we're going to start booming now'. At first they said the economy was going to grow very fast then, after a year or two, that it was slow. Every time the data got a little bit better they'd say it was going to be a V-shaped recovery.

Of course it's possible: there are uncertainties here. But they've been repeatedly overly sanguine, just as some of the doom-and-gloom types have said every time there's some bad data, that we're about to have a giant recession. That's an overstatement too.

EM: We see that again in some respects – the past few weeks have been cast by many as having been a turning point for risk sentiment. There's been a sustained rally on the hopes that the economic outlook will now not get worse. How wrongheaded is this?

KR: You have to distinguish between policies that really build growth organically and policies that remove tail risk. That's not easy to do, but tail risk has remained a big concern, especially in Europe.

So, to the extent global central banks are not only easing monetary policy but, in the case of Europe, effectively easing fiscal policy – the ECB is playing a quasi-fiscal role in its guarantees – that helps reduce tail risk. There are many research papers that show that tail risk is a huge driver of risk premia; to the extent that central banks can remove tail risk, that can have a big effect on financial markets. But that doesn't necessarily mean that normal growth is around the corner.

EM: How long will it take for anything resembling a sustained recovery? And are we likely to see pre-crisis growth rates when it comes?

KR: Based on my work with Carmen and Vincent Reinhart, it wouldn't be surprising if global growth was a percent lower than normal for another six or seven years at least. It's possible that growth in the emerging markets will make up for that, but there are big headwinds from the overhang of debt. It's not going to happen in a year. We're way out in the future here.

If Governor Romney gets elected and we have a gigantic tax cut, that's going to temporarily boost growth but it'll also balloon the deficit, so that's not necessarily self-sustaining, although it might - you don't know. But there's still scope for expansionary policy in many countries but in a territory where debt is so high that it's taking bigger and bigger risks with the long term.

I can't predict that we wouldn't get a year where we had solid growth or even better than solid growth, especially with very expansionary policy. But I think the fundamentals of the deleveraging wouldn't change – that's going to take many years to undo. So if policymakers do chose that there could be some payback later on.

EM: How does this post-crisis period compare with similar post-crisis episodes?

Carmen Reinhart and I have been very careful to frame our work as looking at historical benchmarks and not making predictions. We haven't made predictions. But we can say that we're tracing the historical benchmarks in this crisis if you look an array of statistics from unemployment to housing, equity, debt – and you look at the crisis centre countries, some have done a bit worse, some have done a bit better. But it's very, very typical to the benchmarks.

The big thing people got wrong was in thinking you couldn't have a financial crisis like this in advanced countries. That was not only a misreading of the economies, it was also a misreading of history where the advanced countries had plenty of crises like this. So if you extend over a long enough period, there certainly was a period after WWII where things were very quiet because the Great Depression and the war just devastated financial markets. It was kind of hard to work your way up to a financial crisis, clearly.

So that was a big mistake – a 'this time is different mistake' – to think that we're advanced countries, that we can't have banking crises, that we can't have profound financial crises. That's a complete misreading of the history. A lot of people made that mistake, a lot of financial economists did too. They focused on just a couple of decades of data, theses very technical models that weren't all that critical and which seemed to support the idea that deeper and richer financial markets somehow made things more stable.

But neglecting to see just how huge in the real world debt was as a percentage of financial instruments and therefore that the risks were there.

EM: Where in the world do you see that 'this time is different' type mistake being made again?

KR: Most of the 'this time is different' thinking now remains that this time is different, that the recovery will be good. But if you had to pick a place it would be China, where a lot of the world believes it's just impossible to have

a financial crisis in China.

The Chinese have done a great job, but it's not impossible to have a financial crisis in China. The pinnacle of 'this time is different' is exactly where people think something is impossible that the crisis can hit the hardest.

EM: In China, it's becoming a fairly established view that Chinese growth is slowing fast. What's your sense, how bad can it get?

KR: The mainstream view is more that growth will slow to 7% instead of 9%. But not really recognising the magnitude of what a 3% growth year would do to a lot of investments, banks and other overstretched parts of the Chinese economy.

EM: How probable is a 3% growth year in China?

KR: It's a pretty low probability in the near term, but if you're going over five years, it's a distinct possibility. It's very hard to deleverage an economy that's growing in the way China does it, despite very thoughtful efforts by Chinese officials, there are still tremendous pressures to produce fast growth – and to take risks.

EM: In terms of the structural problems facing the economy what do you pick out as key? And what can Chinese policymakers do now to avert this scenario?

KR: The classic problem that hits countries in the world is that growth through heavy investment just stops to work after a while. That's what we saw in Latin American in the 1960's when things just started slowing down.

China has obviously had a very heavily investment oriented growth strategy, much like Japan did or even point to the Soviet Union. But you eventually hit diminishing returns, though it's hard to know when that is. Then countries start to seek out other ways to get fast growth, financial liberalisation being a leading one, which in theory is a very good idea but when you start doing it in too rushed or panicked a way, it's risky. That's classic political economy.

I don't know how it will unfold in China. They're clearly very cautious. These things aren't easy to calibrate. When you do monetary tightening in China, given their very controlled, repressed financial markets, it's not necessarily easy to do tightening in a calibrated way, advanced countries certainly don't find it easy.

EM: How much awareness of these issues do you think there is among Chinese top economic leadership?

KR: Well, when officials were deciding to form the euro in the early '90's they had an awareness that there was a large segment of the economic community that thought you needed fiscal union at the same time you did monetary union but they decided to go ahead anyway.

EM: What does all this mean for the capacity of willingness of the authorities to offer the kind of stimulus they undertook in 2009? Is that either feasible or desirable in any sense?

KR: I think everyone understands that they need to recalibrate and change their growth model and at the same time that's very painful to do. I don't know about the capacity and willingness, they clearly have a lot more capacity to do more stimulus.

But on the other hand, if you look at investment as a percentage of GDP, if you look at how China has become bigger and bigger in world markets, basic arithmetic shows you have to change your growth strategy and it's not always easy to calibrate that. It's hard to know what the timing of things will be and obviously there are political uncertainties too.

EM: One of the consequences of the China slowdown is the breakdown of the BRICS growth thesis – that the high growth emerging market economies would continue unabated. What's your assessment on the slowdown?

KR: There's still a lot of room for growth in the BRICS through market liberalisation and reforms. There has been a piece of what's going on, though sometimes overstated, when countries are just drafting off of China's growth.

Of course, there will be ups and downs and volatility though my strong assumption is that over the next fifteen years emerging markets will have vastly higher average growth than the advanced countries.

EM: But over the next five years, are we likely to have a vastly different reality to what we've seen over the past decade?

KR: It seems like the trend is slowing slightly. Oil prices have a big effect on Russia, Brazil slowed down. But we're talking about the longer term trend and it's not clear that that has changed dramatically.

EM: Coming to the US economy, top on most people's mind is the fiscal adjustment we may see in the imminent future. How worried are you about the so-called fiscal cliff?

KR: I don't think we should be too worried about the fiscal cliff itself. What we should be worried about is the gridlock in Washington, the complete lack of an agreement on what course the country should take.

It's very clear that there's a stark disagreement between the various parts of the Republican party, which are very concerned that government is expanding too much, that debts are being run up too much, that regulation is becoming too onerous, and the Democratic party that has a more benign view of government and wants to expand it in a number of dimensions with health being the most dramatic. Because they're so evenly balanced at the moment, it creates a lot of uncertainty. It's not that we won't veer before we get to the fiscal cliff, it suggests we have no idea which direction we'll turn.

If you look at Governor Romney's proposals, they're for a giant tax cut and a lot of spending. Let me put it this way: certainly a lot of the heavy lifting is going to get done by spending cuts and it's clear that President Obama is raising taxes and intends to raise them more because he thinks you shouldn't, for example, be cutting future scientific research. He has his arguments, as Governor Romney has his. But they are very different visions – and it's that uncertainty that I think really makes it hard for businesses at the moment.

If you go clearly in either direction, certainly resolving the uncertainty would be helpful. Over the longer term I think there are real questions about strategy, are you going to care more about equality or about growth? And if you care more about equality you're probably not going to get as much growth.

EM: Do you see any evidence at all that lawmakers are willing to reach an agreement on tackling the debt?

KR: We have to hope the election leads to some movement and to a change one direction or the other and that then makes it very clear which direction we're going to turn. At the moment, there's broad intellectual agreement that the Simpson-Bowles ideas were the right direction to go to reduce deductions and to try to keep marginal rates as low as possible.

But everyone is cautious about getting as specific as Simpson-Bowles was. We may see something like that, that would be really quite good for the United States if we could go that. But I think the elections will be very important in resolving how that plays out. You've gone through this period of gridlock and if the voters can't resolve it then we're going to have more gridlock.

EM: What's the most likely outcome on the fiscal cliff?

KR: In the very short term the most likely outcome is that Congress does something to temporize again while the

hammer out the harder issues because they seem so far from any agreement. But it's hard to see that they're going to do anything before January, but hope springs eternal.

EM: Even if they reached an agreement, how vulnerable is the US economy over the coming year?

KR: I don't think it's that vulnerable at all. It's like the rock of Gibraltar compared to a lot of the rest of the world. The US has these long term problems that need to get resolved. It doesn't have 30 years to resolve them but it might have five or 10. It would really take sustained chaos in Washington for the US to seem more unstable than Europe in the near term. I don't think we're about to collapse, but on the other hand you can't turn these things around quickly, so let's say we have a giant tax cut and we don't get the growth to materialize that certainly some people believe that if we just followed the right policies the US would boom and suppose for example Governor Romney wins and we get a giant tax cut then the economy booms and we'll all but fine. But it's certainly a distinct possibility that we just get giant deficits for a while even with growth and it's not that easy to turn these ships around. I think it would be better to wrestle with the tax system sooner rather than later. I don't think the US – it may get a downgrade or something – but that's just something that the ratings agencies have to do because of how the US is behaving, but it doesn't mean it translates into anything quickly. The odds of a significant recession I don't think they're any more than 15%. It's not that easy some months to distinguish between 0.3% and 0.5% but to get a really significant recession the odds are just normal. That's what it is in a normal year at this time in the cycle.

EM: Clearly the Fed is doing the heavy lifting. What sort of impact if QE3 actually likely to have?

KR: I think it will have a marginal positive effect, the big thing being that they're now saying that they're putting a big weight on unemployment, whereas before they were saying we're going to do QE and as soon as inflation starts to rear its ugly head we're quickly going to backtrack. And they've said something very different. I think that these changes probably have further to evolve. But I think what they've done will be modestly helpful. Bernanke gave a forecast that it would knock 0.4% off unemployment after a couple of years, that seems like the right order of magnitude. It's not a game changer.

EM: Are there likely to be more changes ahead in monetary policy and in the QE programme?

KR: But we didn't just have QE3 we had a big qualitative change and I think they'll probably be more changes ahead. For quite some time I've been saying that when you're in a once-in-a-75-year-financial-crisis having elevated inflation for a few years is the least of your concerns and that that fear has been overstated. And I think in fact that they'll probably move more in the direction of indicating that if inflation was elevated for a while it wouldn't be the end of the world. I think they'll say that more clearly, it's been implicit, they'll make it clearer.

EM: The big players in Europe now seem to understand – albeit belatedly – that some commitment to fiscal union is now needed. Has the crisis entered its final phase, is it almost over?

KR: I think the ECB's transition, the fact that it said it would now buy bonds of the periphery countries potentially in unlimited amounts is certainly a major change and reflects no doubt a major change in Berlin also, who has to have approved that I would think. Everything Mario Draghi is saying doesn't solve the longer term problems, it obviously doesn't.

Everyone points the finger at Germany as being that one that's holding things back. I think you could just as well – or better – point the finger at France because I think at least in the public rhetoric Germany well recognises that you're going to need a powerful centre in the European Union or it just isn't going to work. And the French seem to believe that if just Germany would use its resources to guarantee everyone – potentially France as well – there's no need for bigger changes. The banking union is a little bit of a discussion because again it's a question of

how much Germany is going to pay for it.

I think that in the long run the only stable equilibrium – the only stable equilibrium – is a much deeper political union among the euro countries that remain. I say that because once you admit that it has to be a country, the eurozone really has to become a country to look more like a country in order to survive, it raises questions for some of the periphery countries when they would join that union. I don't think we're anywhere remotely near the end game. They've made very important steps but there are still long ways to go and huge question marks. For example, the idea that no country could ever leave the euro doesn't necessarily square with the idea that you need very substantial political union eventually. I don't know how they're going to work all that out, they still seem to have a long way to go.

But certainly the ECB actions are very helpful medium term, but they don't solve the longer term – two to five year problems – of the eurozone that require just revolutionary changes in the political landscape. It might be coming, but it's still a long way off.

EM: How likely is a break-up of the single currency?

KR: I think more likely is that Germany and France work things out. If they can work things out then the rest can follow but they seem to have very different visions at the moment of what's needed and what it could look like. I do think that the eurozone, the core eurozone would be smaller, at least for an extended period. They might never officially have anyone leave the euro, they might just allow some countries to have massive capital controls, we never reintroduce another currency but you have a big differential of what the euro's worth in the peripheral countries versus what it's worth elsewhere. That option is a distinct possibility, but it's just a long ways to go.

The basic idea that Robert Mundell has outlined – that you can have completely different countries in a union and have the same currency is just overstated. In his classic article he mentions the idea of labour mobility, that's important. But a lot of subsequent research forcefully makes the point that it's hard to work without fiscal union. It's hard to have fiscal union without political union, you need political legitimacy. And the banking union is part of fiscal union. And obviously there's a big fiscal component to that.

There is a very high probability that Germany and France stick together and work things out. I say that maybe out of blind optimism that's what I think. A very low probability that all of the current members are still a full equal member 10 years from now.

EM: How likely is a Greek exit at this stage?

KR: There are many ways to put a country in another tier, for example by allowing it to have capital controls. That might be sufficient to ringfence Greece. There are many ways to go but all of them involve the creditors getting less than full repayment in real terms from the debtors so even if Greece is somehow ringfenced it still leaves Portugal, Ireland, Spain – potentially Italy – to work something out with. And there are a lot of ways to go.

It's partly a political question but I think the economic piece of it is that the debts, austerity alone is not going to work and policies which emphasise forbearance and stimulus are not going to work either because they'll just make the debt problems even worse. They have to have some form of restructuring and if they continue, some way of controlling deficits.

There's a high probability that France and Germany work it out, there's a huge political commitment notwithstanding the hugely different visions of what's needed. But when European officials say it's unthinkable that anyone's going to leave the eurozone, that's going to be a tough trick to achieve.

EM: What are the chances that France could be the next in the firing line?

KR: The commitment between France and Germany to make things work is very, very high. They might still screw up. France could have problems, but I think it would not necessarily undermine expectations about the French-German connection which is just very powerful and transcends a lot of the economic short term issues.

EM: On banking union, does year-end sounds implausible?

KR: It involves huge fiscal transfers and you need political legitimacy. It has the same problem given the big fiscal transfers and it's hard to see how you have the banking union without creating a more powerful centre. You might be able to have it for a couple of years if people don't fully understand its implications. But the banking union is a transfer mechanism, it's a potentially a very large transfer mechanism.

EM: But it hasn't been sold as such

KR: I think everyone sees that.

EM: What should the role of the IMF be in all this? Still concerns about the IMF's relationship to Europe and its control by Europe. Should the IMF be more or less involved in Europe at this juncture?

KR: Everyone would be better off if the European representation in the IMF were reduced much further despite all the positive governance qualities they bring. It's almost ludicrous that they insist on being treated as the eurozone but then for purposes of the IMF, each of the countries get a different seat – that has to change. The sooner the better. I think it's better for everyone, it would be better for Europe. There are times when you need tough love and that's better for you, to be told this isn't going to work and we have to walk away from you if you don't have a programme. It would certainly be better if the governance issues were fixed.

I've thought all along and I feel strongly that the IMF should not be putting money into Europe. Europe is a rich region and the IMF shouldn't be putting its own resources in – it then becomes a hostage. It plays an enormously valuable role in technical advice generally, it has an indispensable role. But by putting in large amounts of cash it risks making itself a hostage for example having to oppose restructuring because it's afraid to lose its own money. So I don't think that should be the role in the advanced countries of the IMF. Even though it's obvious as you watch the crisis unfold that oftentimes the IMF is saying much more sensible things than some of the national and even European officials.

EM: Does the IMF need more firepower to deal with the crises?

KR: I don't think it needs further firepower. I think the IMF's main role should be giving technical advice, synthesising best practice and the need to have the IMF as this giant pool of money, both the benefits are overstated and the risks are understated, it causes moral hazard problems even though they're subtle it may not be obvious at first sight. I don't think expanding the IMF size would be good. And I think this is very obvious – Europe is a real case in point. We should be glad they didn't have \$3 trillion to put into Europe because it really would have compromised the whole future of the IMF. If they had a big pot of cash, it would have been very hard to avoid getting gamed into using it. I think we should be glad that they didn't.

EM: What's your judgment of IMF managing director Christine Lagarde after her first year?

KR: She certainly deserves positive reviews. It's complicated. She'll ultimately be judged by what happens in Europe. Given that it was very hard to avoid getting drawn in and giving money, they've certainly been much tougher than the European Commission or the ECB. When you talk about the troika, the one that's the hardest to convince is the IMF. Not necessarily harder than the Germans, but the IMF is definitely consistently been the one to say this isn't working. On the other hand they don't necessarily have the power to say it's not working, it's not

going to work and that you have to do something completely different. The IMF is never in a strong position anywhere to do that.

EM: Are we any closer to an actual move towards a single seat for Europe?

KR: I'm aghast that they haven't figured out how to change the World Bank and IMF presidency and managing director situation – this is a painful anachronism and serves both institutions badly and needs to change. I wouldn't predict that it's necessarily going to change but there are certainly some great developing country candidates out there when the time is right.

EM: Has this undermined the credibility of the institutions?

KR: I don't know. I hesitate to say that although let's say when there's a crisis in Latin America or Asia in five years, one can well imagine that the countries that are receiving programmes are going to say well look what you did in Europe – it's completely different, you have no legitimacy. But at the end of the day if you're doing a good job it makes up for a lot of sins and so if things go well I don't think it will undermine them as much. It's a long run point but it's not just about the IMF. It's about the IMF and more broadly world governance.

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