



CENTRE for ECONOMIC  
PERFORMANCE

*Lionel Robbins Memorial Lectures*

# The Return of Depression Economics Part 2: The eschatology of lost decades

**Professor Paul Krugman**

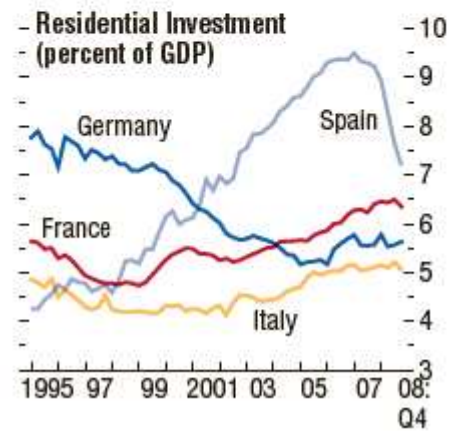
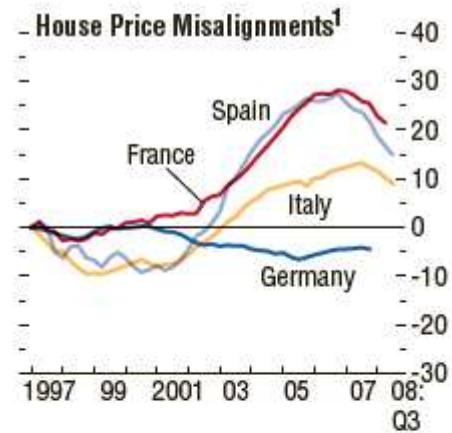
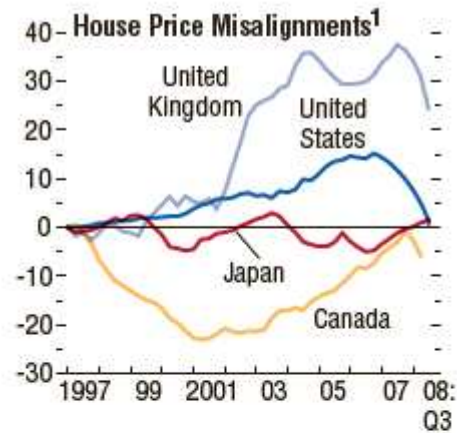
*Centenary Professor, LSE and Professor of Economics and International Affairs,  
Woodrow Wilson School, Princeton University*

**Professor Lord Richard Layard**

*LSE, Chair*

# Lecture 2: The eschatology of lost decades

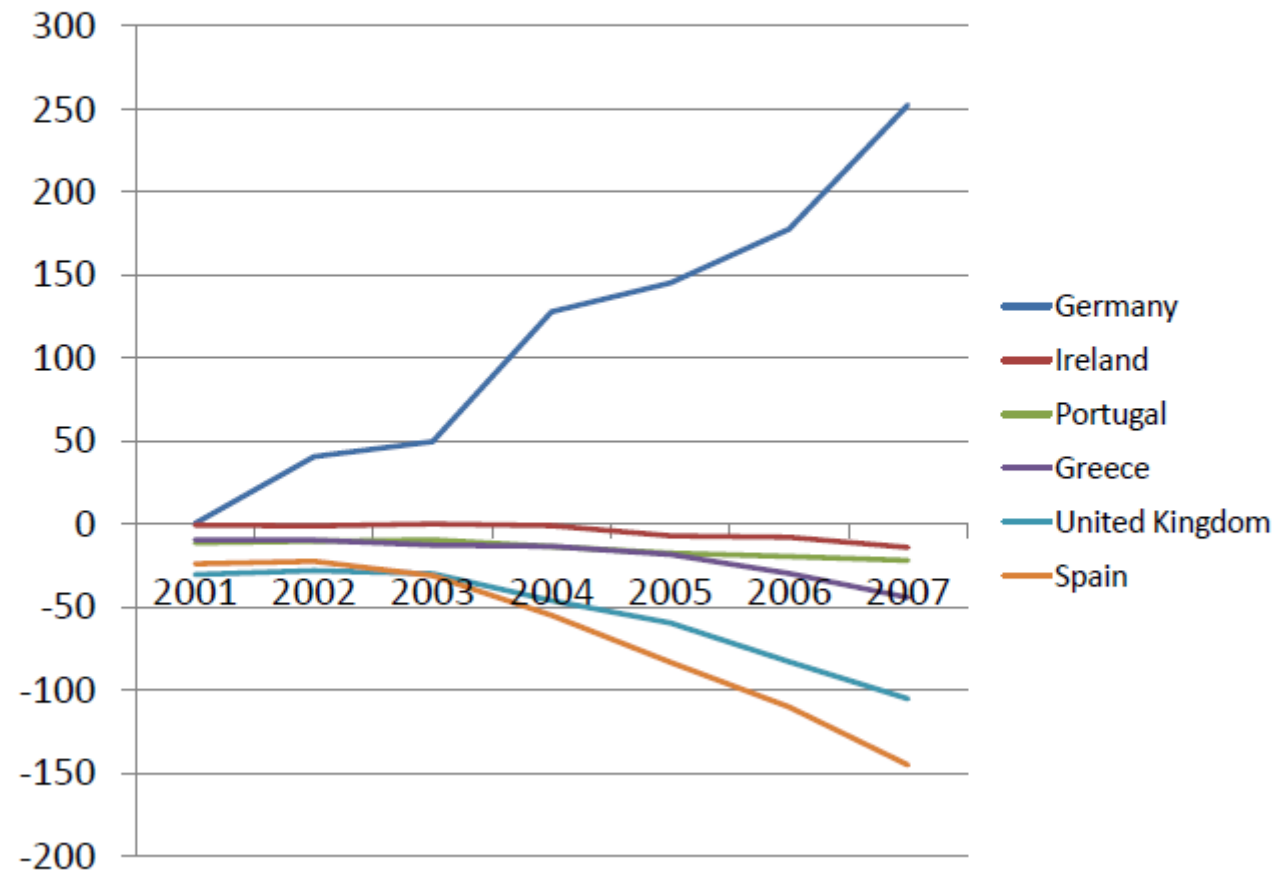
Paul Krugman

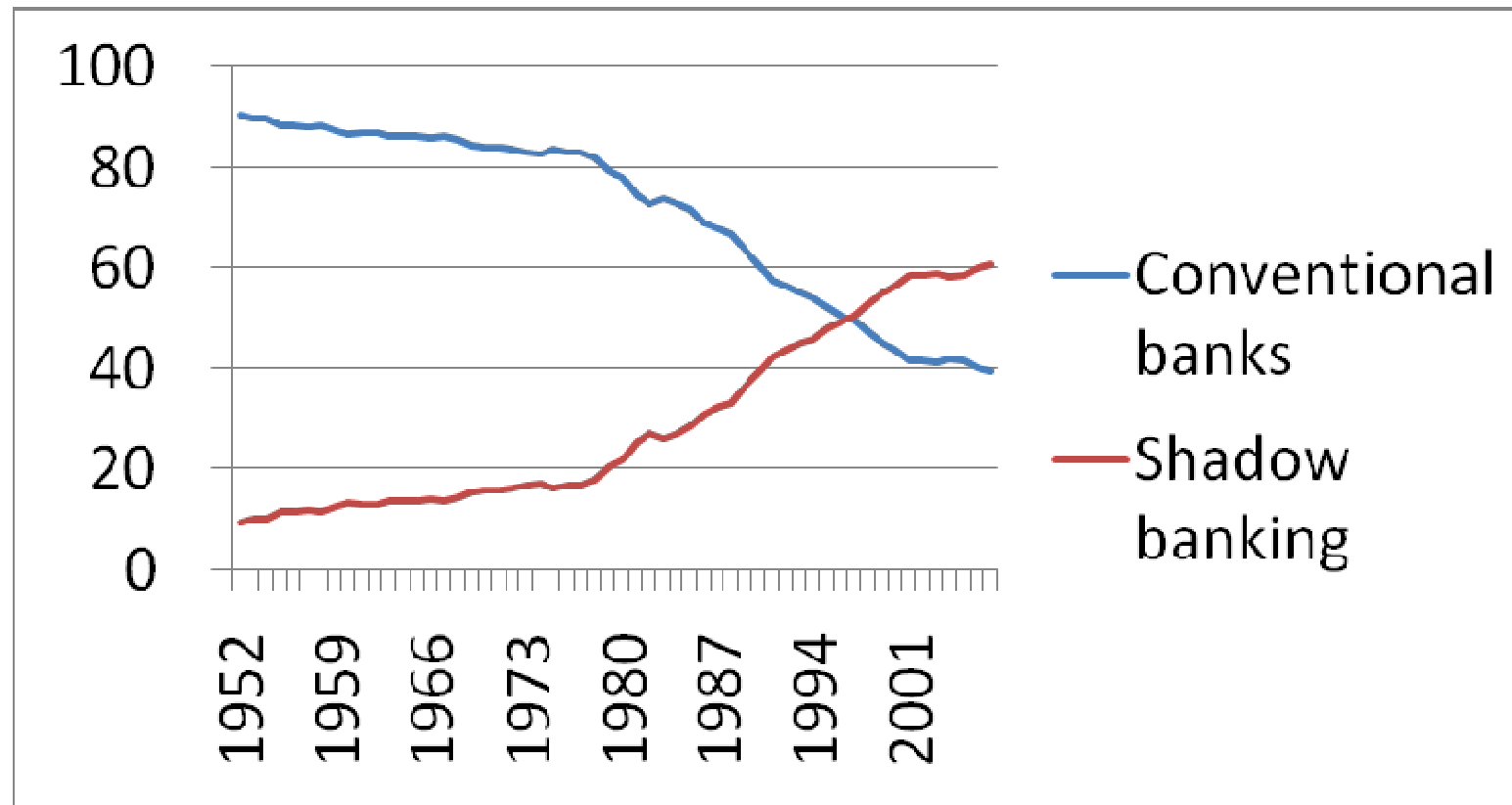


## Growing surpluses

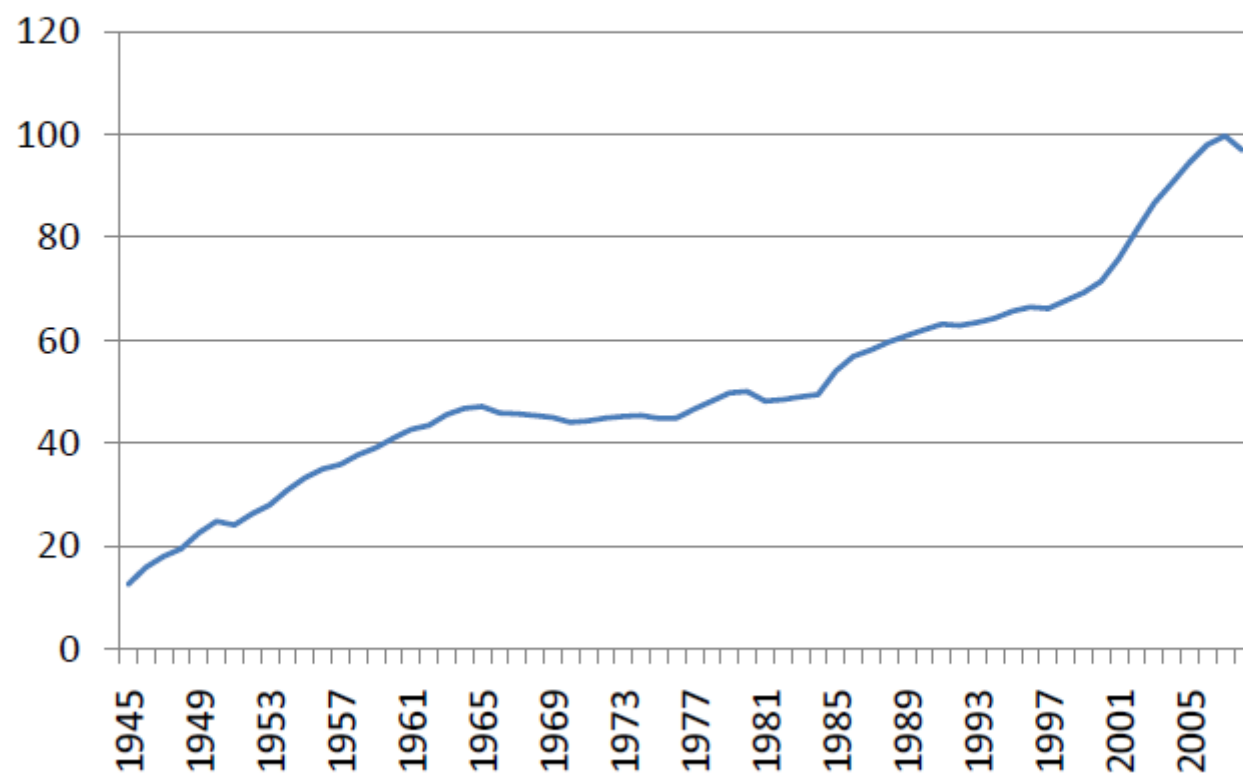
	2000	2007
Developing Asia	38.6	406.5
Newly Industrialized	38.9	103.6
Middle East	71.9	254.1
Japan	119.6	211
Germany	-32.6	250.3
Total	236.4	1225.5

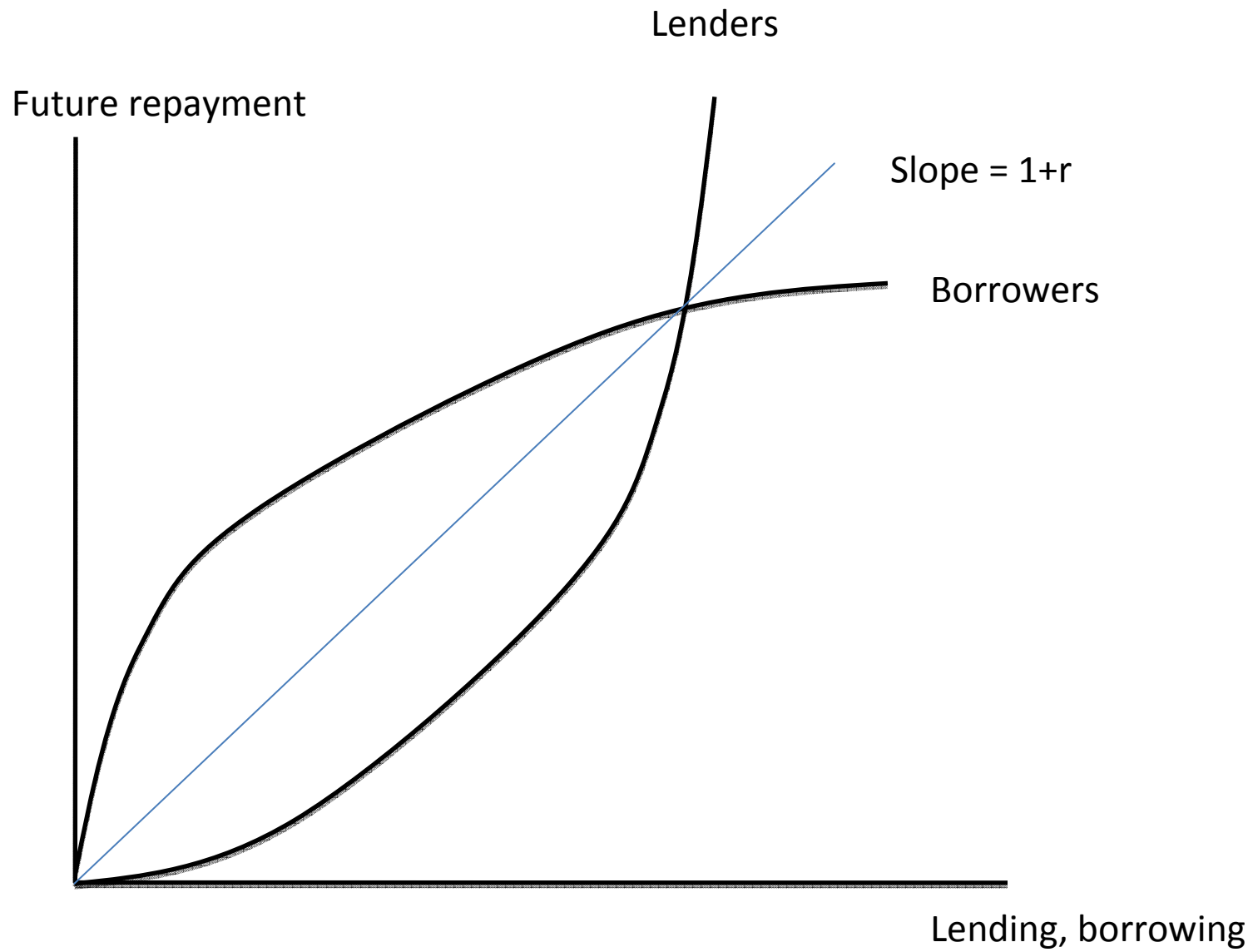
## European current accounts (\$billion)



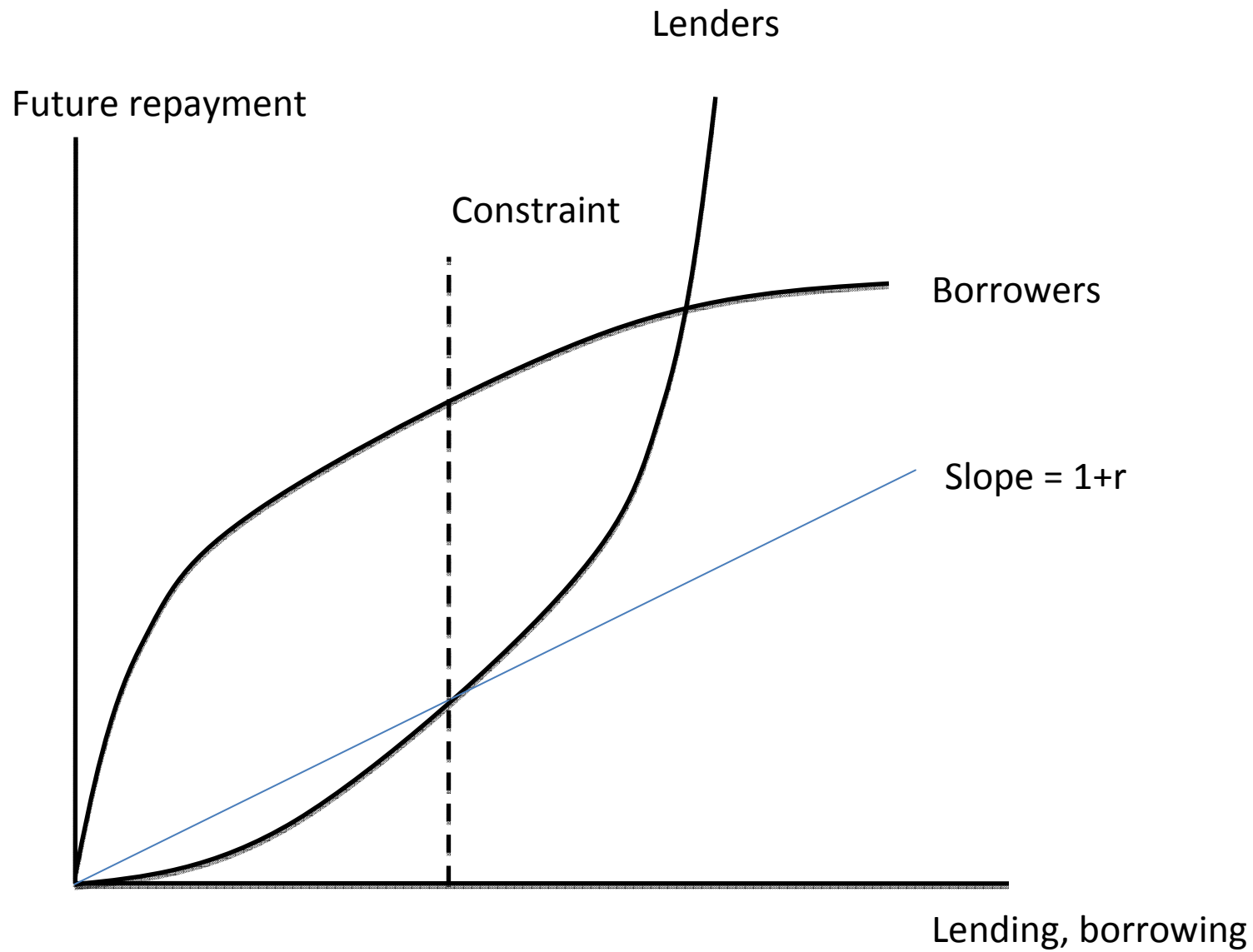


## Household debt as % of GDP

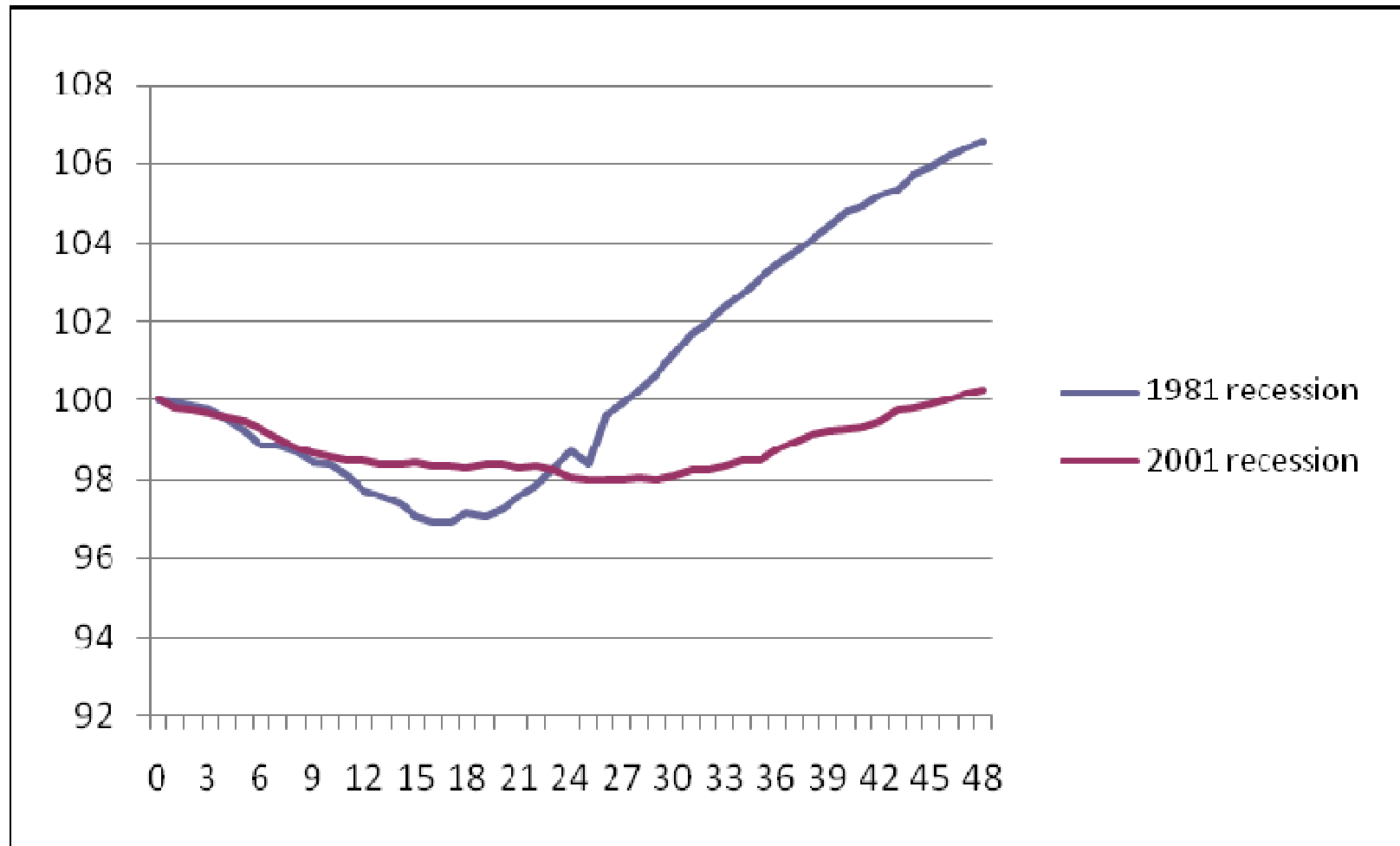




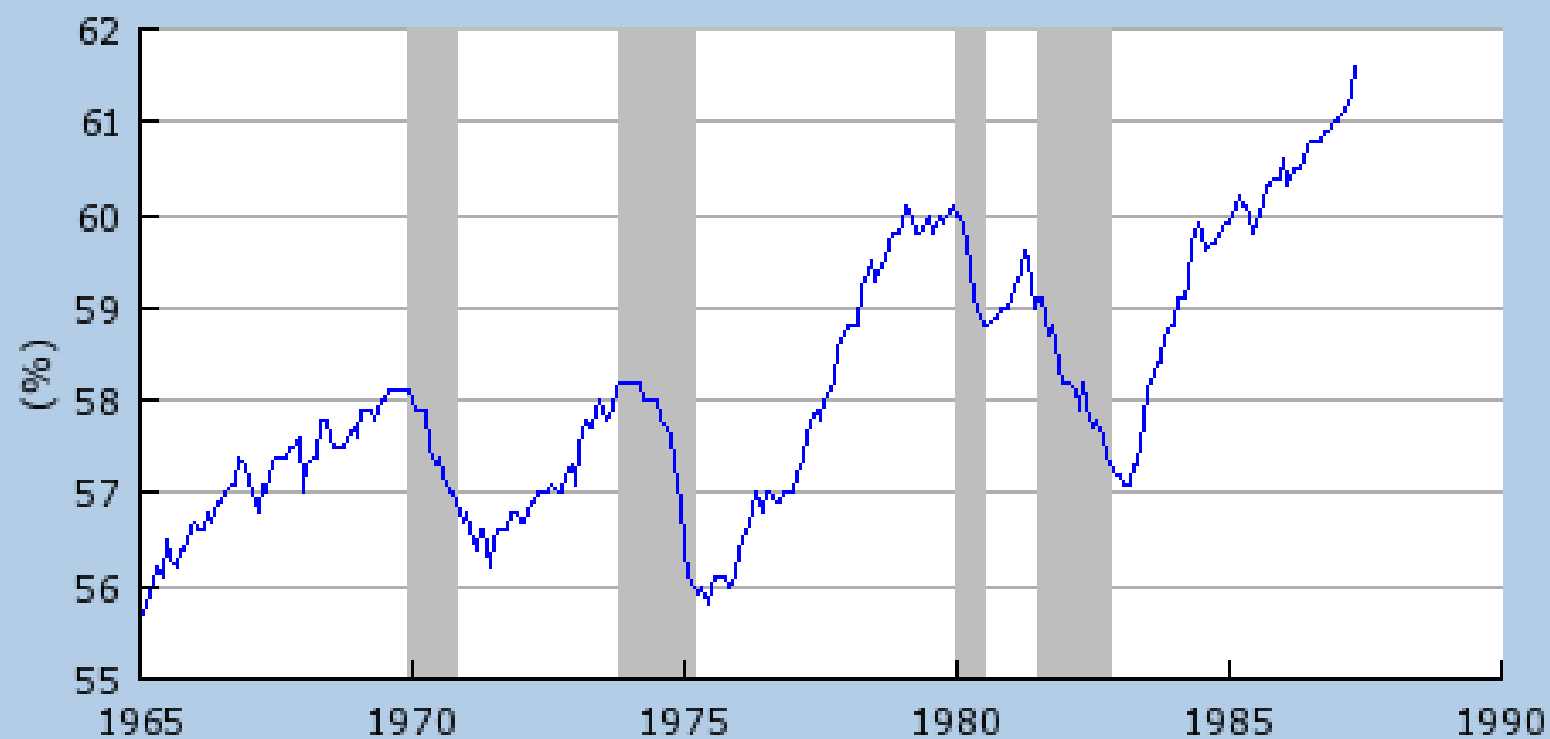




## Employment cycles

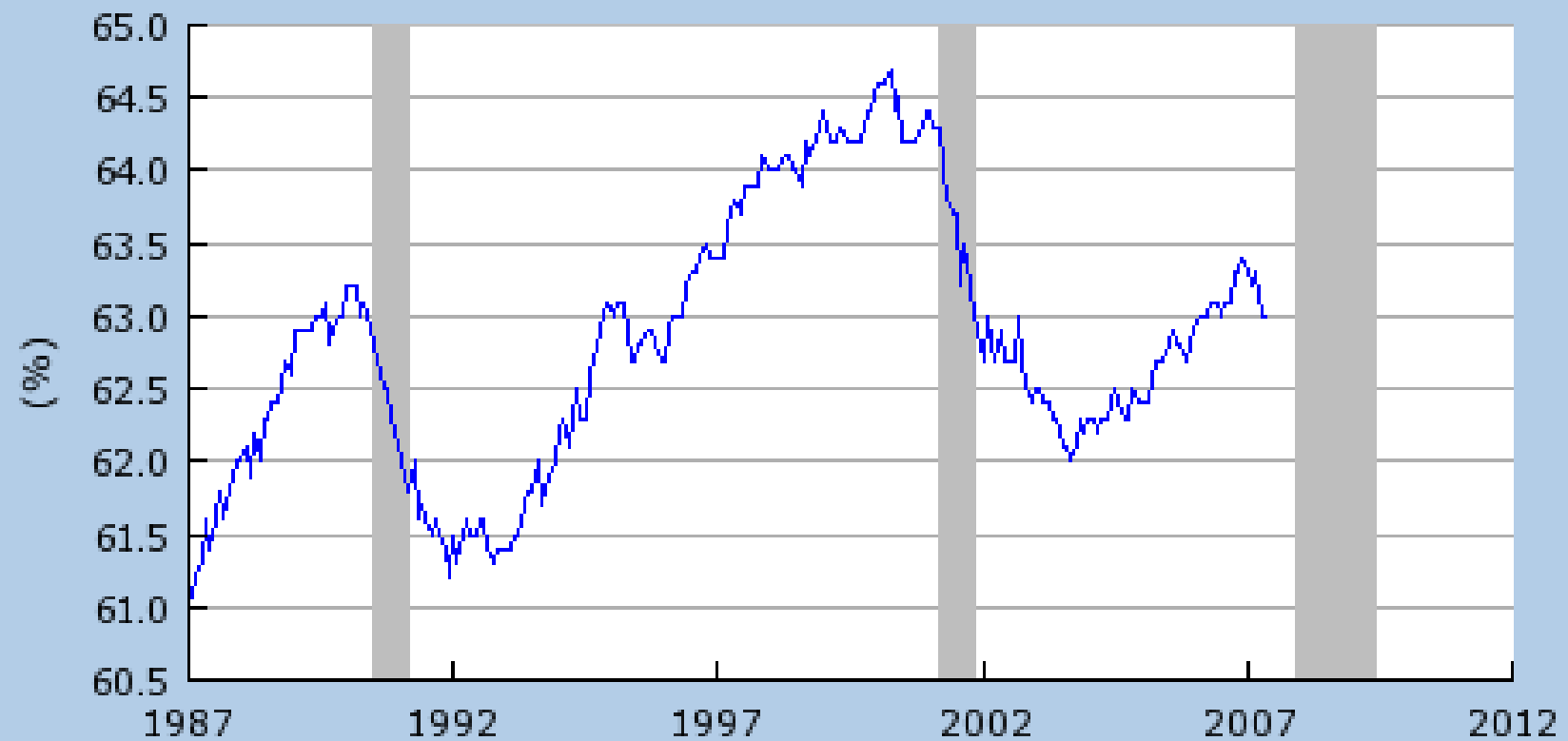


Civilian Employment-Population Ratio (EMRATIO)



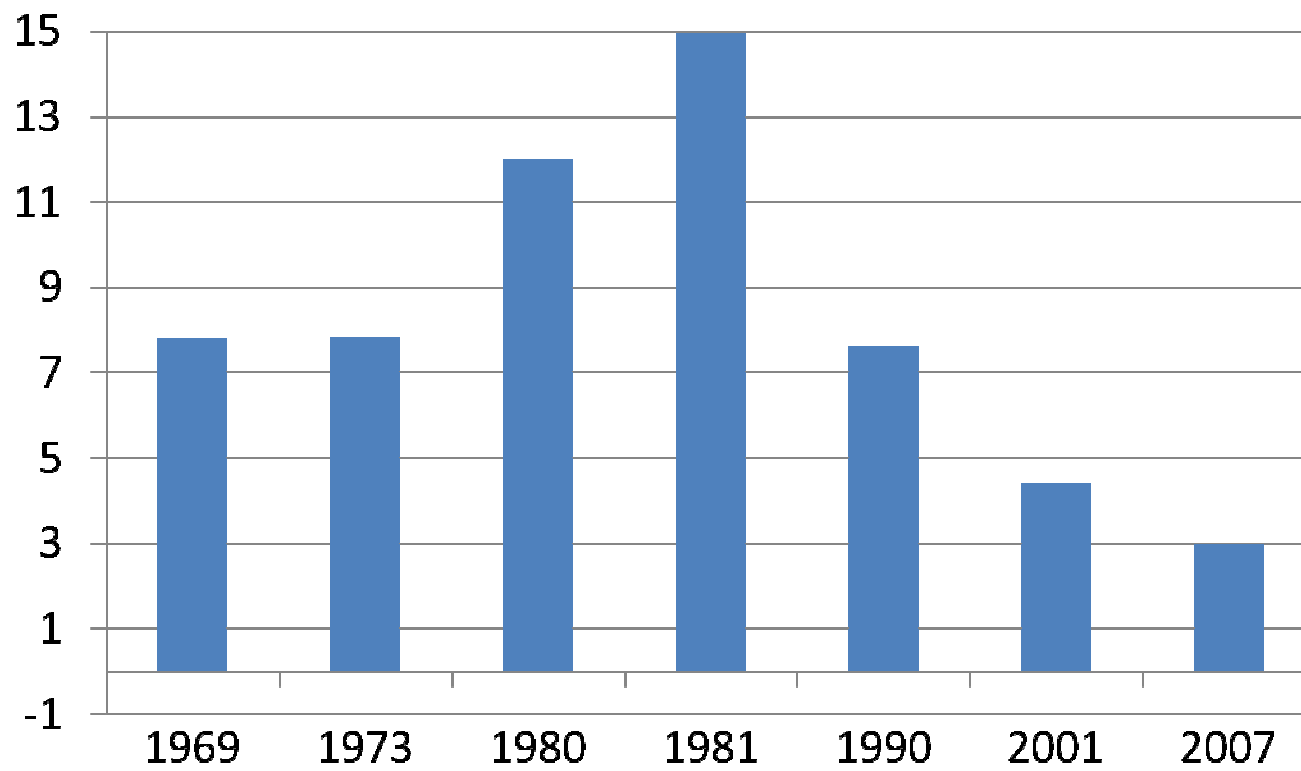
Shaded areas indicate US recessions.  
2009 [research.stlouisfed.org](http://research.stlouisfed.org)

Civilian Employment-Population Ratio (EMRATIO)

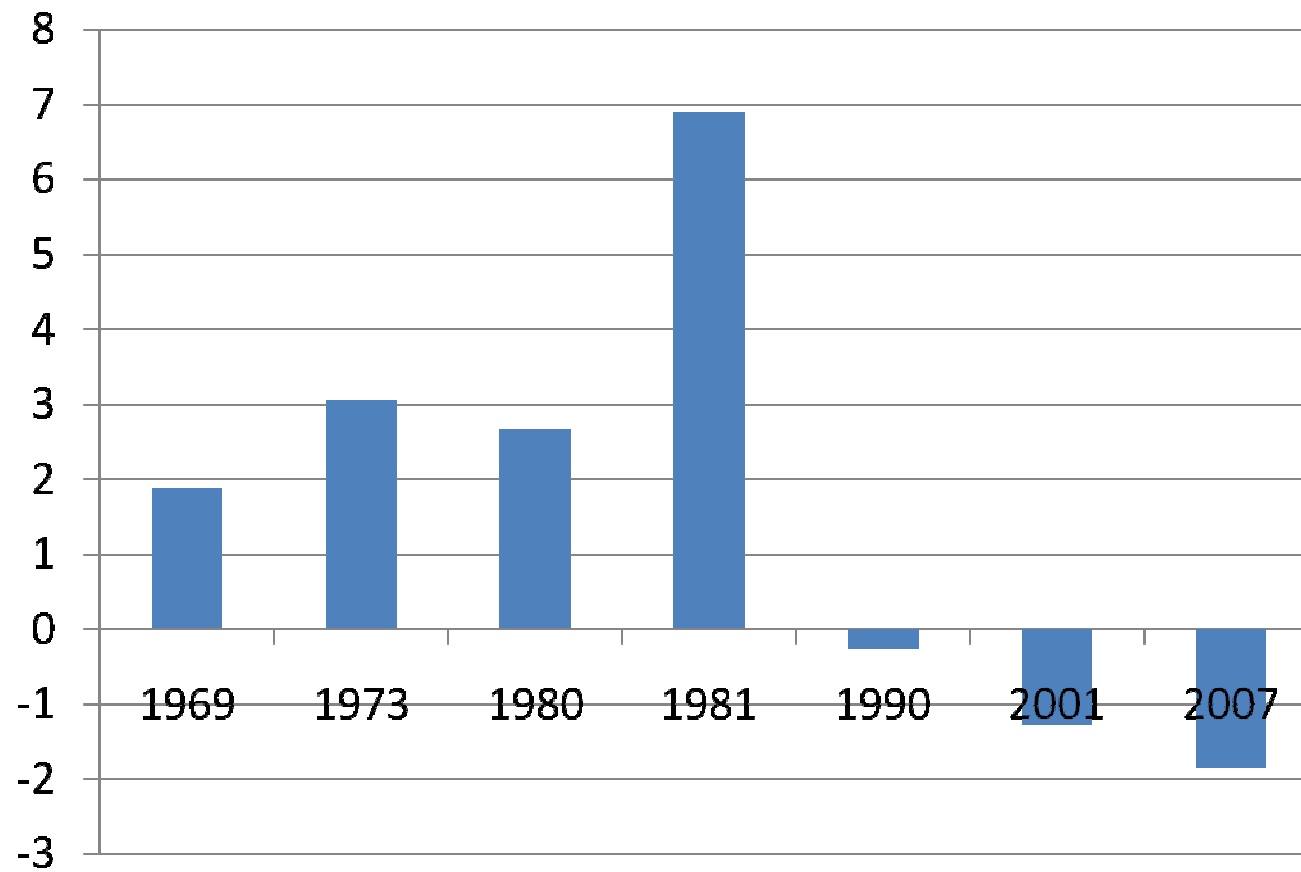


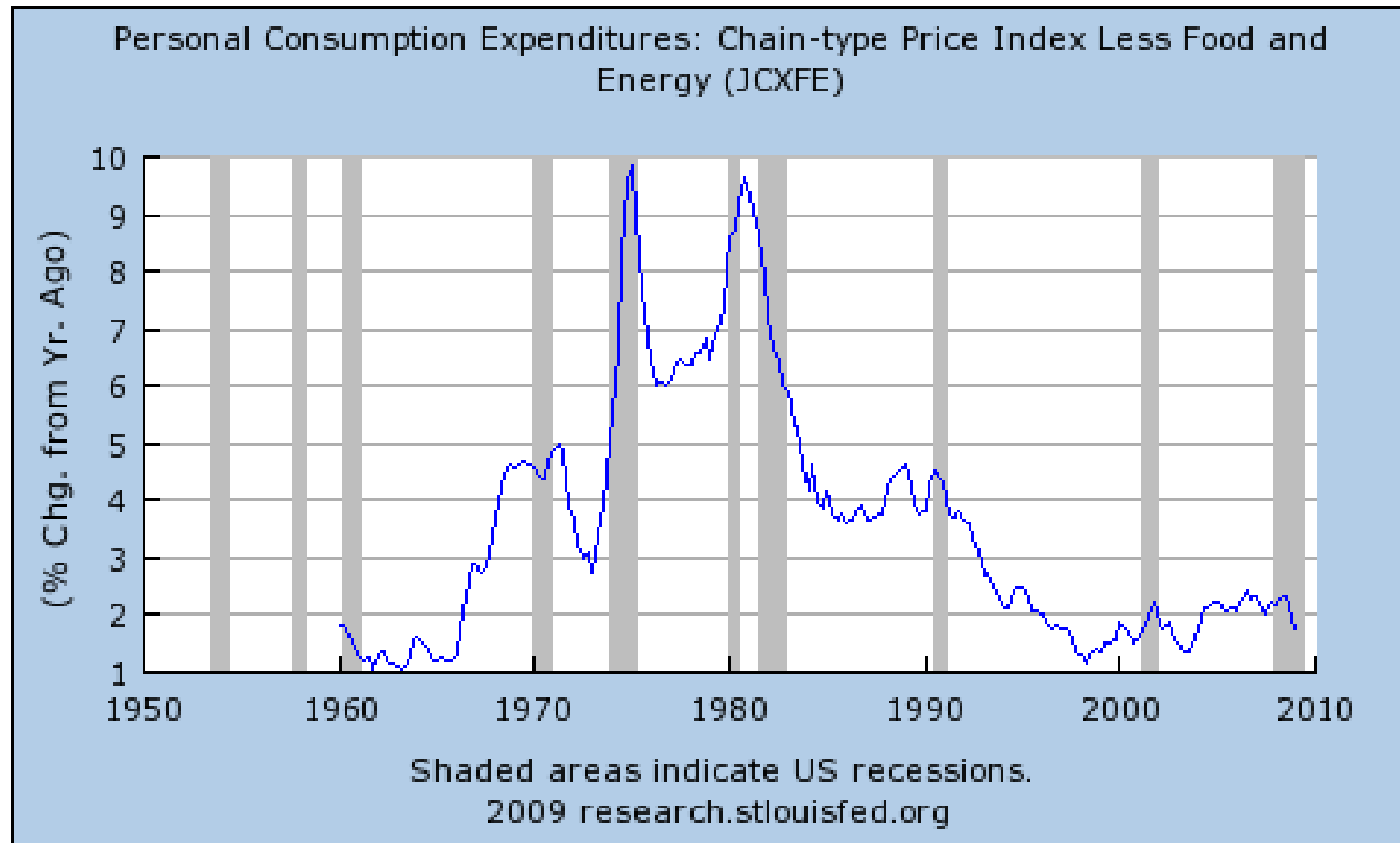
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**Interest rate at start of recession**

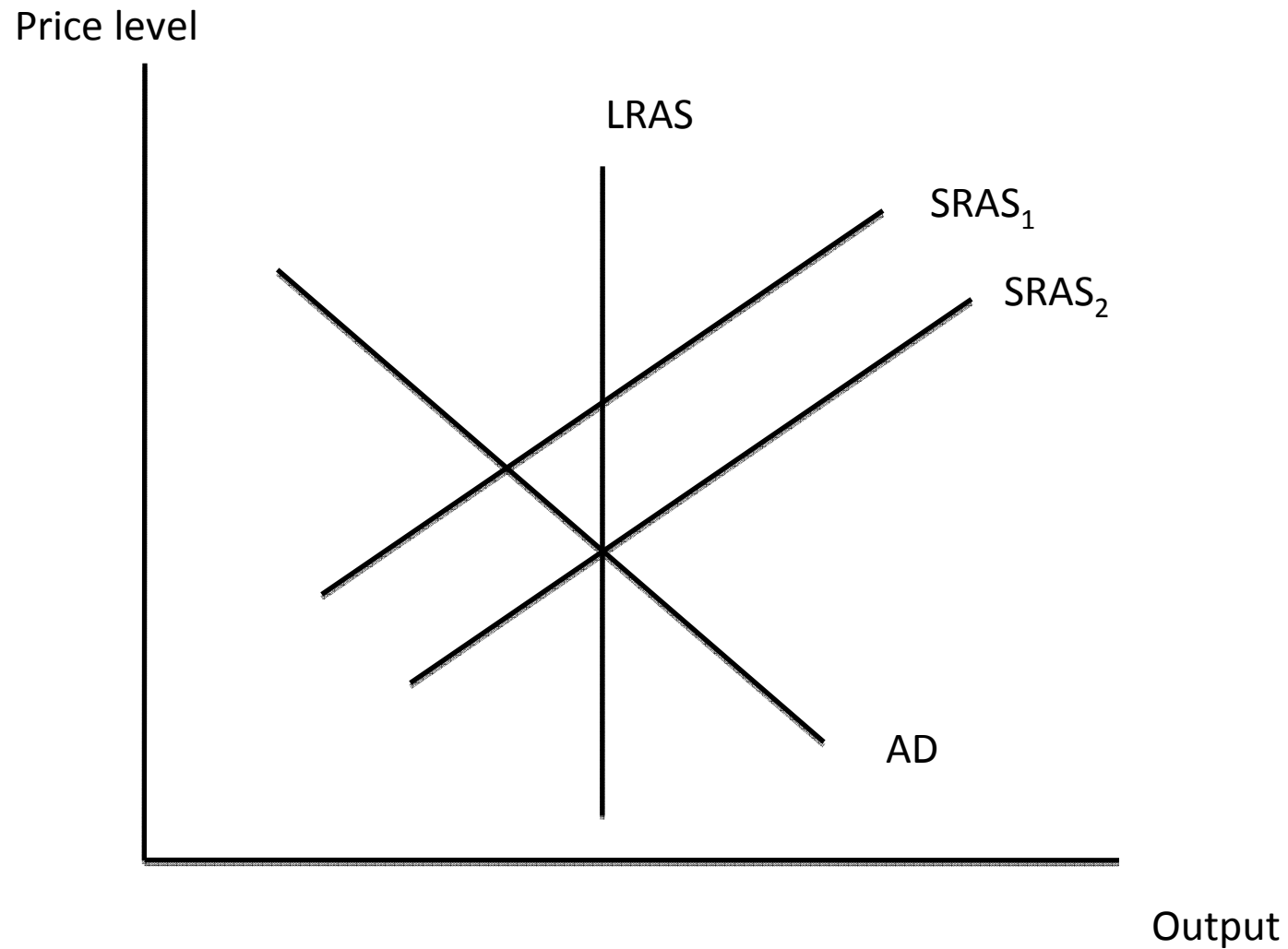


**Runup change in interest rate**



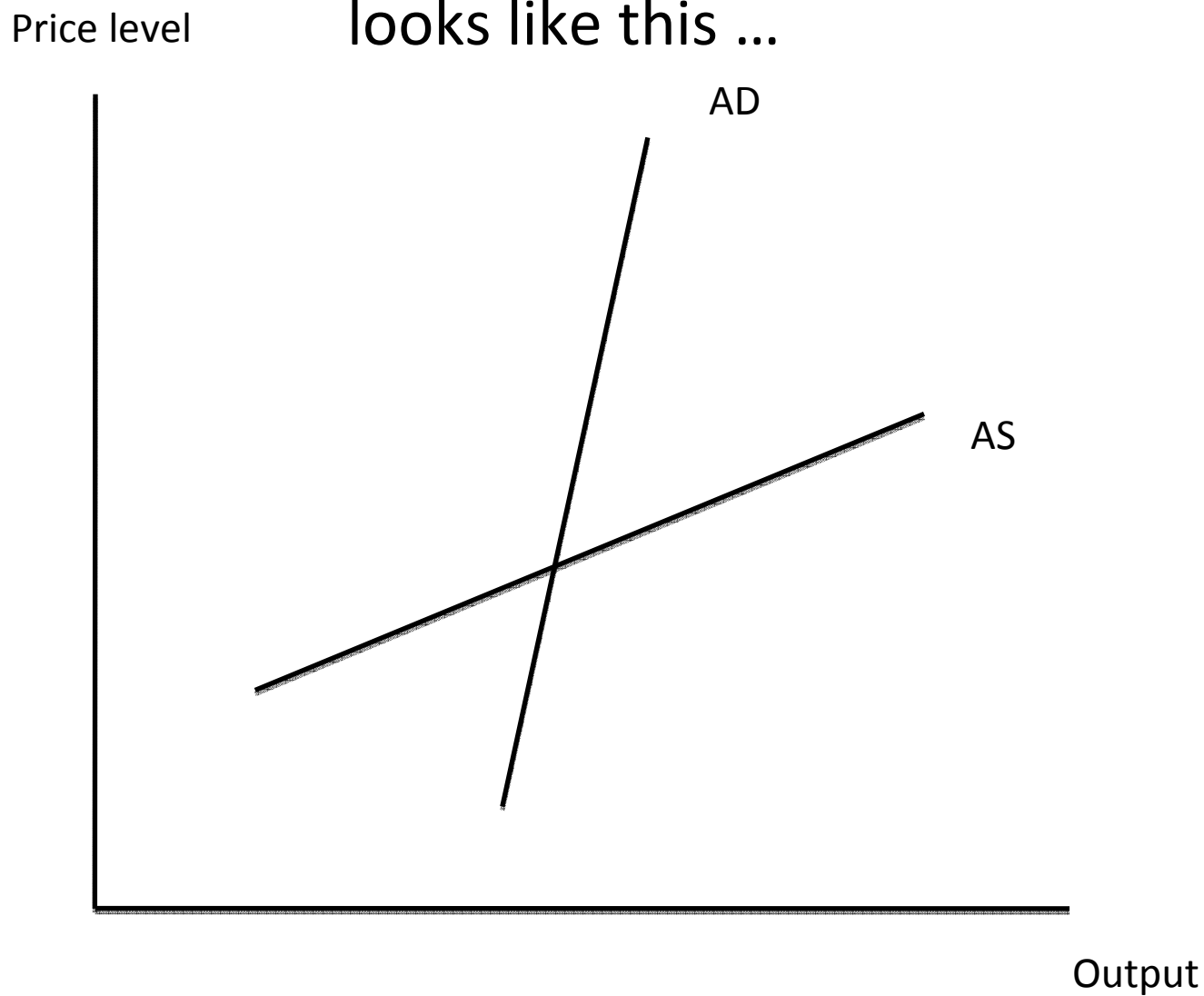


# The textbook adjustment process

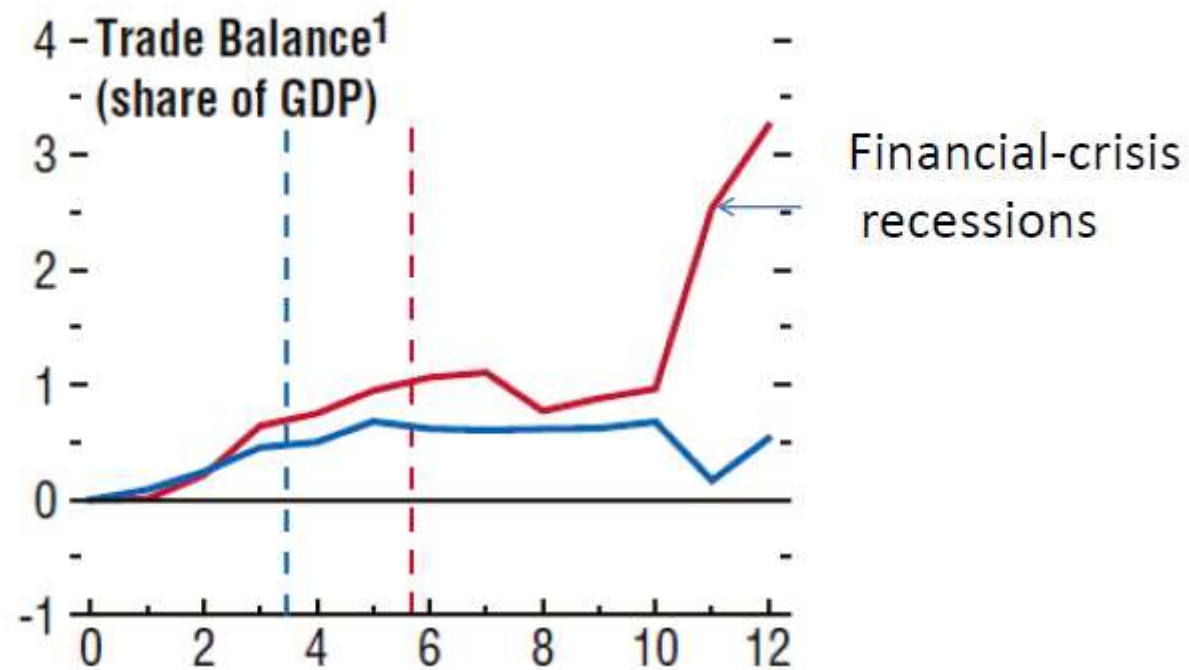




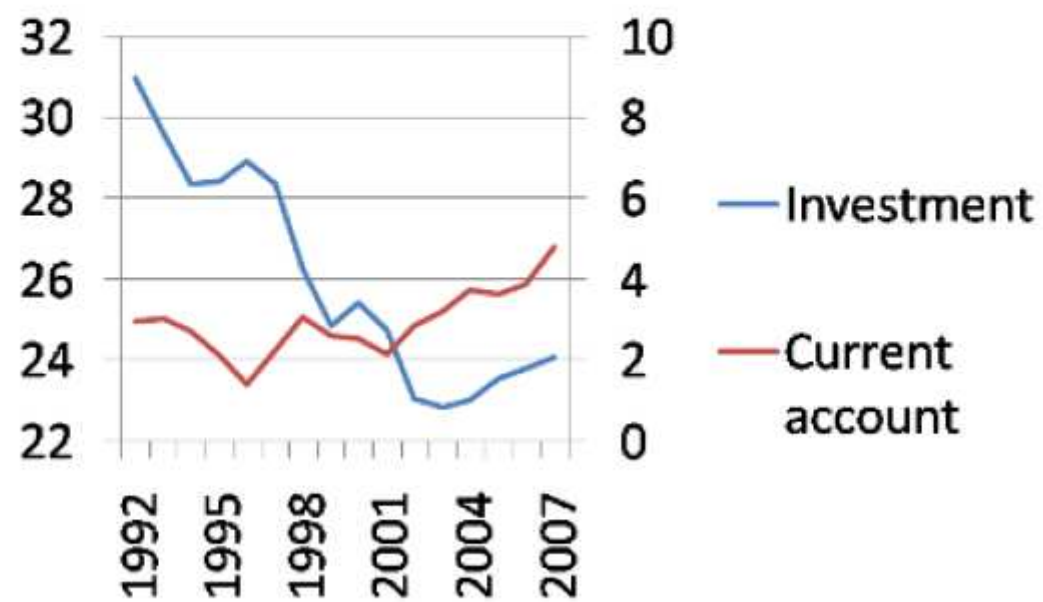
But in the liquidity trap, it probably  
looks like this ...



Historically, recovery from financial-crisis-led recessions has been export-led



## Japan's recovery: export-driven



# THE RECOVERY FROM THE GREAT PANIC OF 1873

Our Nation's Four Great Business Epochs  
After the Recovery from the Panic of 1873.

BY ROGER W. BABSON  
of Wellesley Hills, Mass.

**A**t the close of the last article we left our Nation in the throes of the severe depression of 1873. It will be remembered that the real panic began with Black Friday in the Fall of 1869, and continued into 1870; but this was so sharp and sudden that there came a quick rebound in 1871, which lasted into 1872.

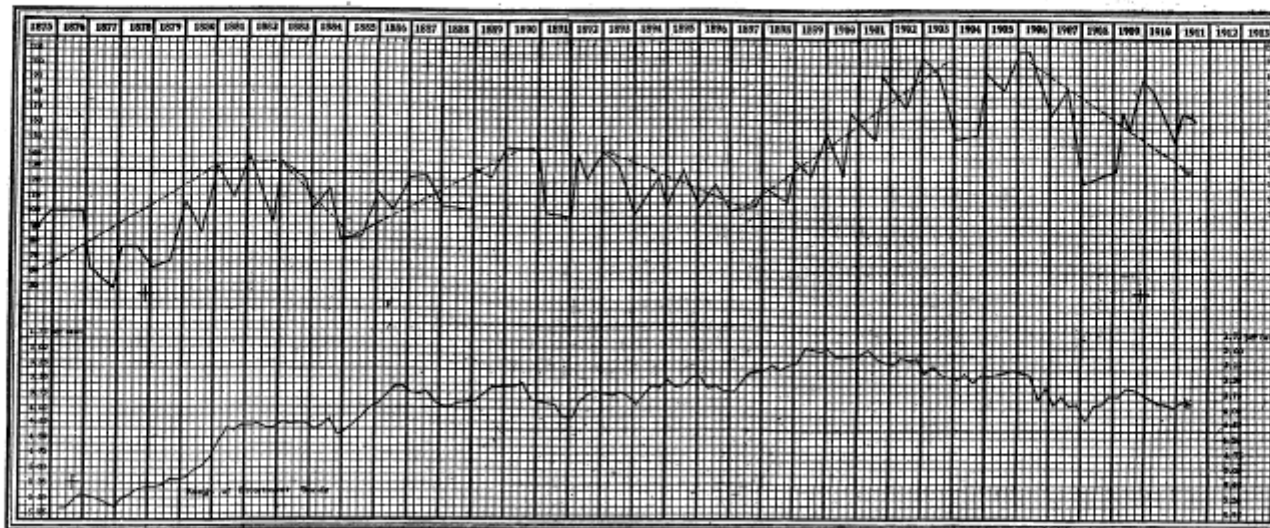
As stated in this previous article, all of our severe crises have consisted of two sharp movements about three years apart, followed by about three years of depressed business. Therefore, although the first and in many ways the severest blow of the "Panic of 1873" came in 1873 and 1874, the second and final blow did not come until 1893, which completed the third liquidation begun three years previous.

Although the second blow is often not as severe as the first, yet the business is less able to withstand the second pressure, and the apparent disaster is much greater. Therefore the year 1893 was one of great financial and industrial hardships.

In the Fall of 1892 the trouble really began, but it was first brought to an acute stage on April 26, 1893, when the Atlantic Bond failed. A flood of stocks was sold on the New York Stock Exchange, prices fell with great rapidity, and the market showed an almost continual decline until the Fall of the year. In the late summer there was a slight rally, but this was shortly the fall before a storm; and in September, 1893, the New York Warehouse Company, a large and apparently prosperous concern, went to the wall. The New York Millroad failed on the 15th of September, and Jay Cooke & Co., a great banker house of that day, closed on the following day.

The entire financial community was then in a state of great excitement, and confidence seemed to vanish. The New York Stock Exchange closed its doors on the 26th and did not open them until the 30th, while about 50 per cent. interest was charged for the money for a short period during the worst of the trouble.

Roger W. Babson, the Well-known Statistician, Tells of the Business Epochs That Followed That Period of Depression.



Prices of Investment Stocks and Bonds from 1875 to 1911.  
This is a plot of relative price movement of ten representative high-grade stocks and five representative high-grade bonds. The bonds law that action and reaction are equal, when prices are considered, is well illustrated here. Especially does it show that while the stock market sometimes discounts conditions, it does not always do so. The dotted line shows the major cycles. On account of the maturing feature of bonds the bond line shown in the plot of bond yields inverted, which indicates the varying cost to the investor. Note that the bond market does not rise and fall simultaneously with the stock market except in rare instances.

of gradual recovery. It is true that Stock Exchange transactions were very small, failures large, and clearings continued to decline; but the setback in business was comparatively short, and by 1868 everything was going again at full speed. As is usual, after even a semi-panic, money is cheap, which condition eventually prepares a foundation for a general uplift. Although Mr. Vanderbilt did all he could to stay the break of prices during 1888 and 1889, yet he saw that it was unprofitable and decided to let go and sell the market short, as he is with whatever happened. Moreover, he made the best of his opportunities in 1894 and 1895 by purchasing the securities of several coal, oil, and other roads, which resulted in the acquisition by the New York Central of the West Shore and allied lines.

As is always the case following a semi-panic, later troubles again crept into and 1898 stands out in the memory of all as the year of the fierce strikes by New York, Chicago, and other cities. It was on May 4, 1898, that the bomb-throwing outrage was perpetrated in Chicago, which served as another illustration of the unprofitable means which the public can to withstand the laws of nature. However, later was not long out of work, as the wheels of industry again began to turn, and all the country was blessed with abundant crops, which resulted in gold imports and a general revival of business of all kinds. Moreover, although our civil legislators in Washington at this time again attempted to tinker with the tariff, "in order to bring back good times," yet there was enough interest in conservation to prevent this move, and the nation held steady at a lower tariff and railway-rate regulation were defeated. Under the stimulus of cheap money and favorable legislation, there were nearly 20,000 miles of new railroad constructed in 1897, which, according to my figures, is the greatest number of miles ever constructed in any one year. Eighteen hundred and eight-eight was another year of good business, and although St. Paul passed its dividend yet earnings continued to increase, and on Jan. 18, 1899, J. P. Morgan came to the front through the reorganization of the famous "trusts" agreement between the trust line officials. In fact, financial conditions continued to improve.

So how does it end?

Keynesian business cycle theory:

“use, decay, and obsolescence”

Koosian theory: rebuilding the balance sheets

Use, decay, and obsolescence:

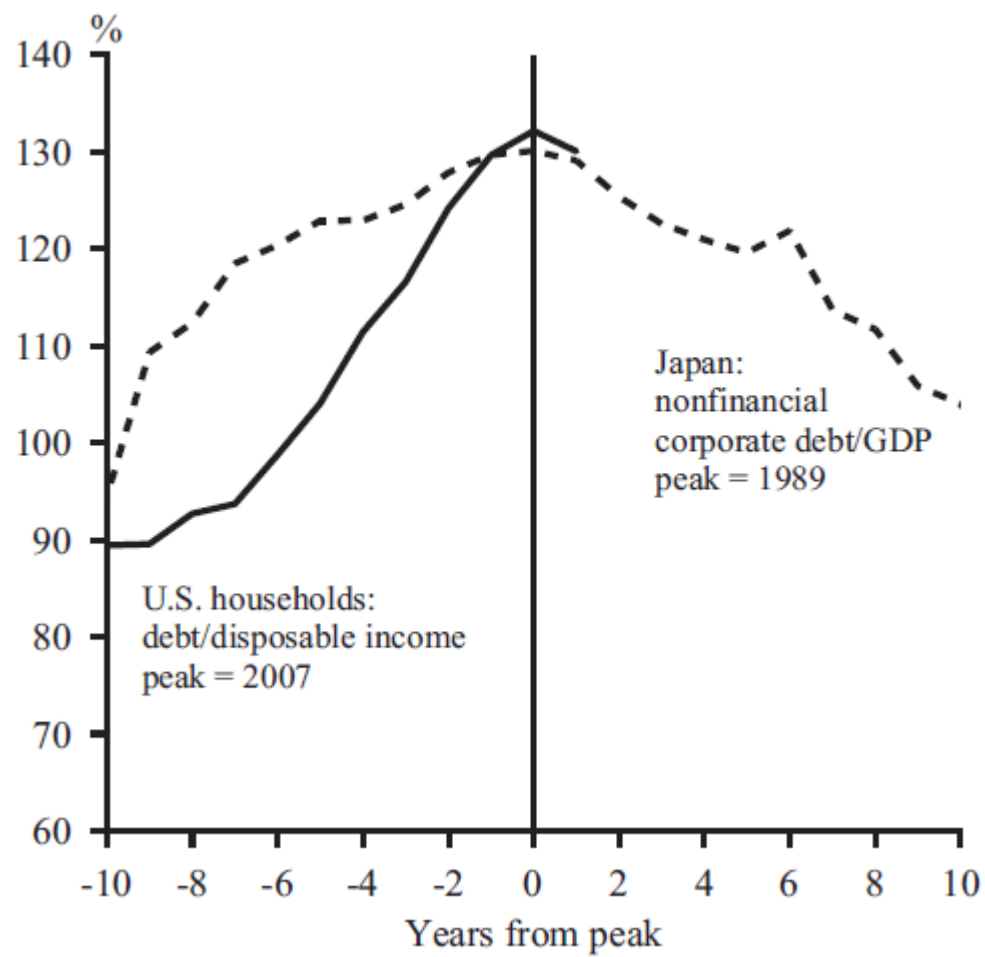
US stock of autos: 135 million

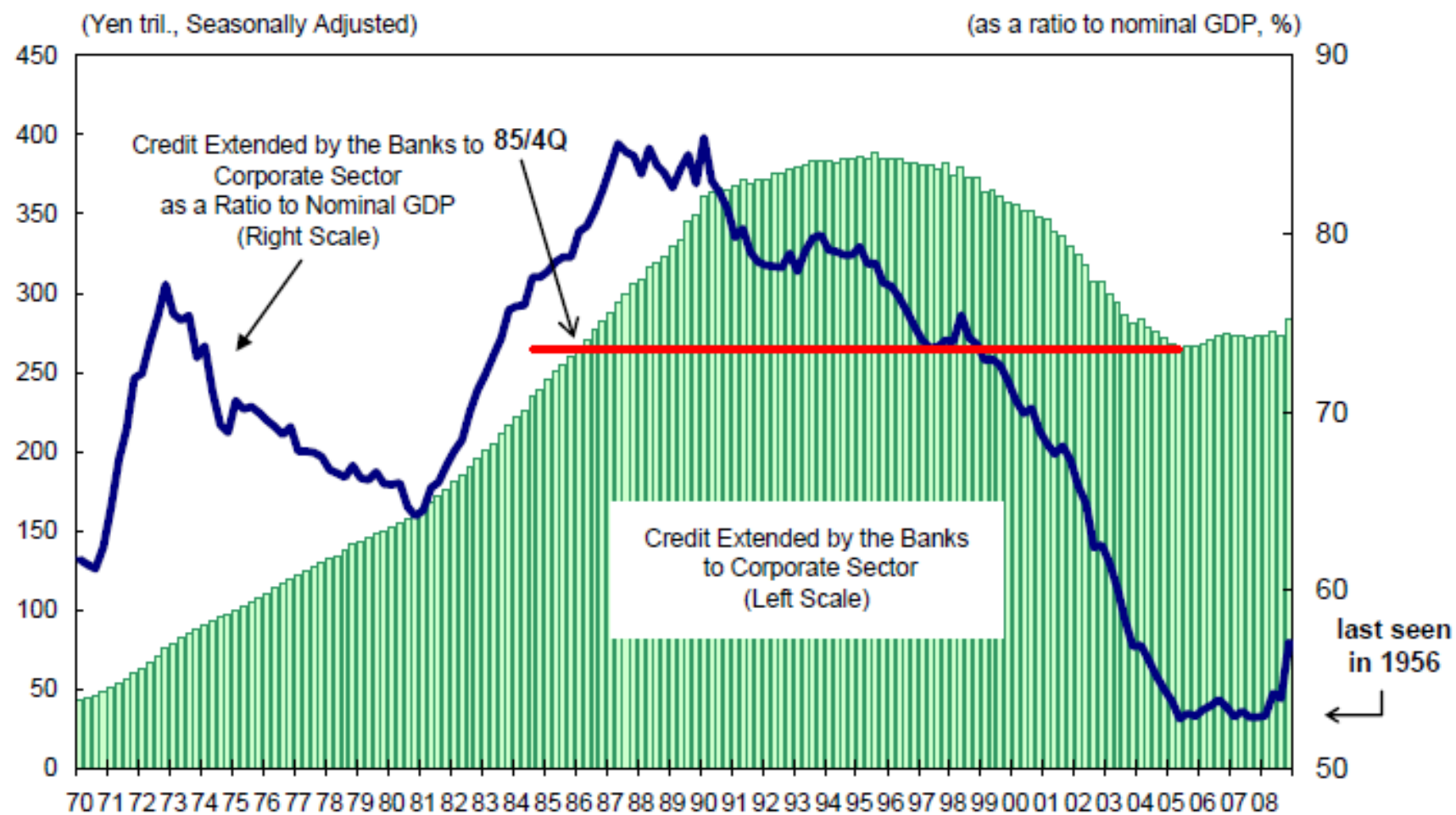
May 2009 auto sales: 484,000

Annual rate of 6 million?

If so, more than 20 years to replace stock ...

## Leverage ratios

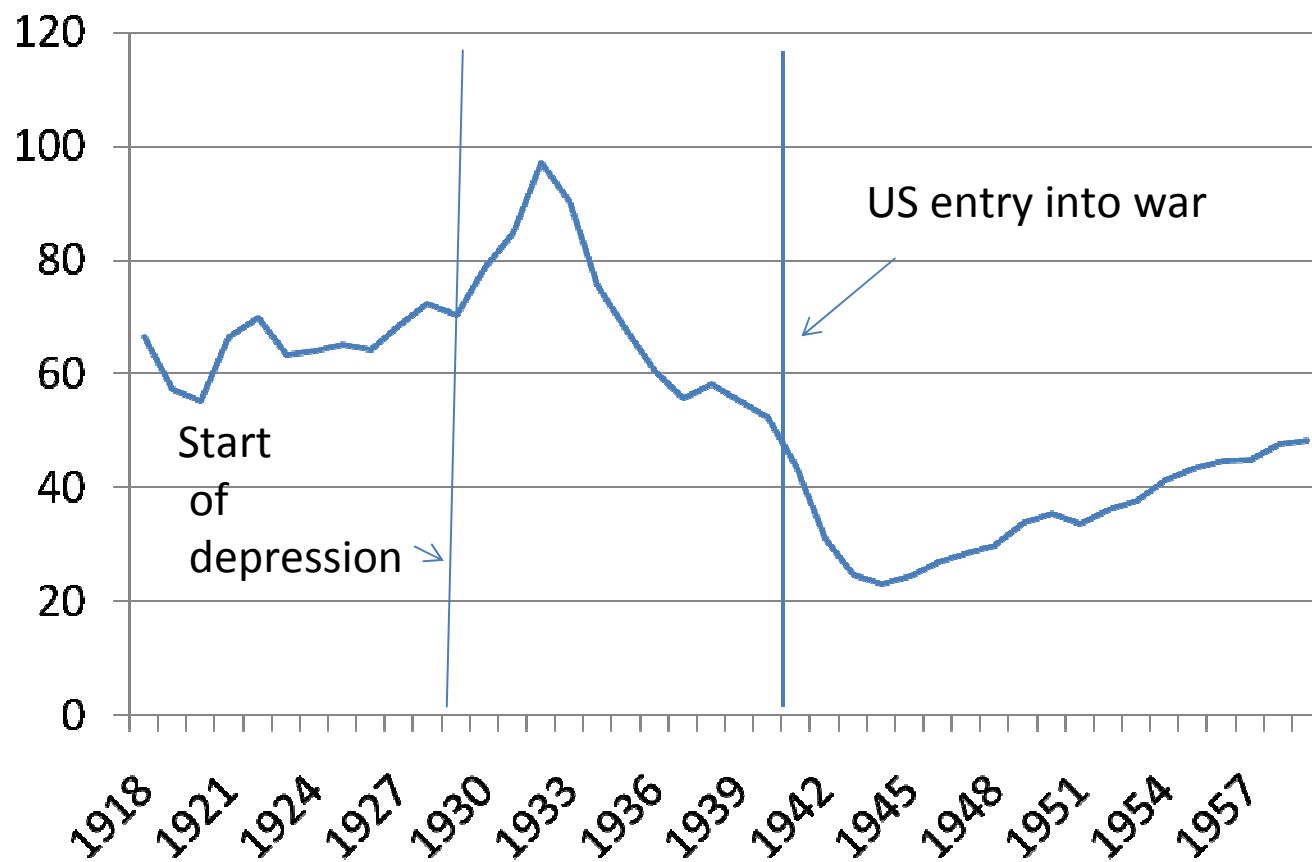




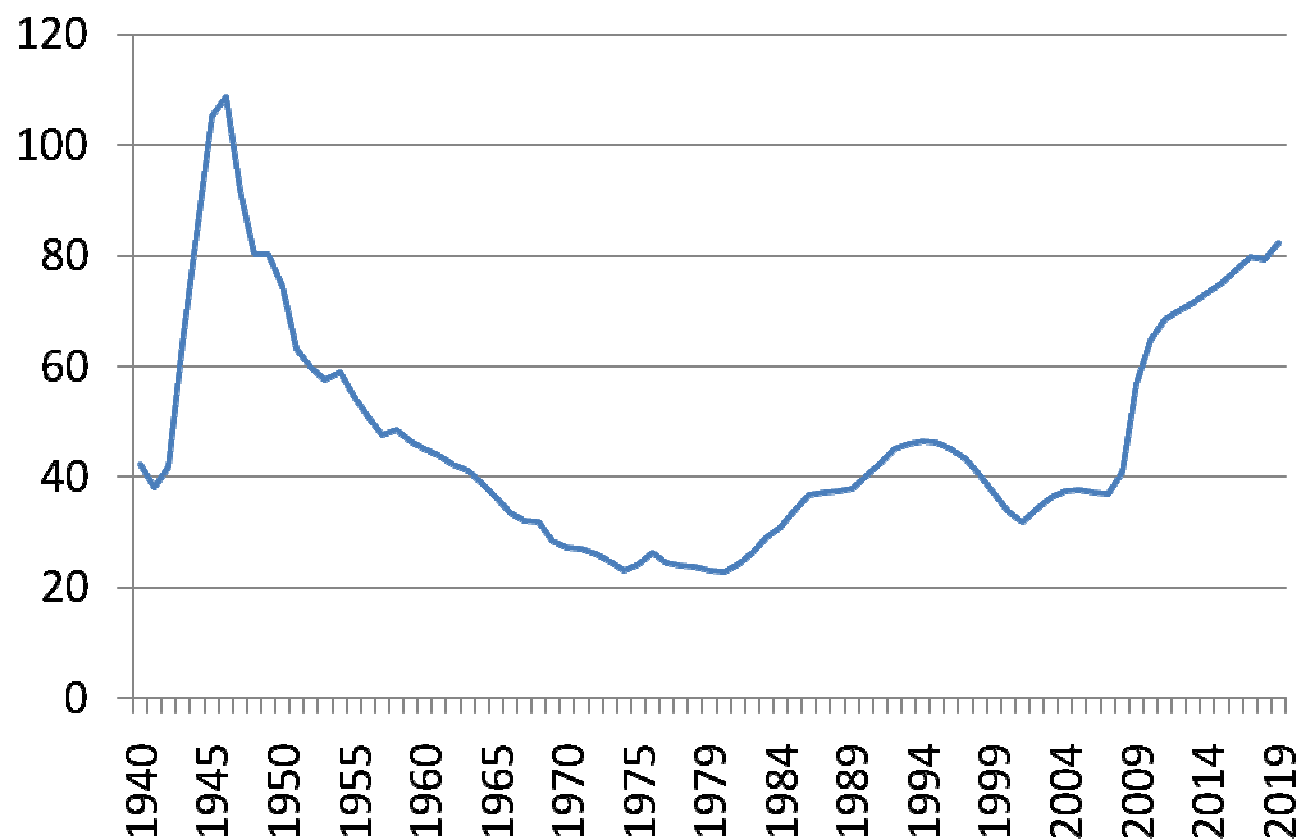
Source: Richard Koo



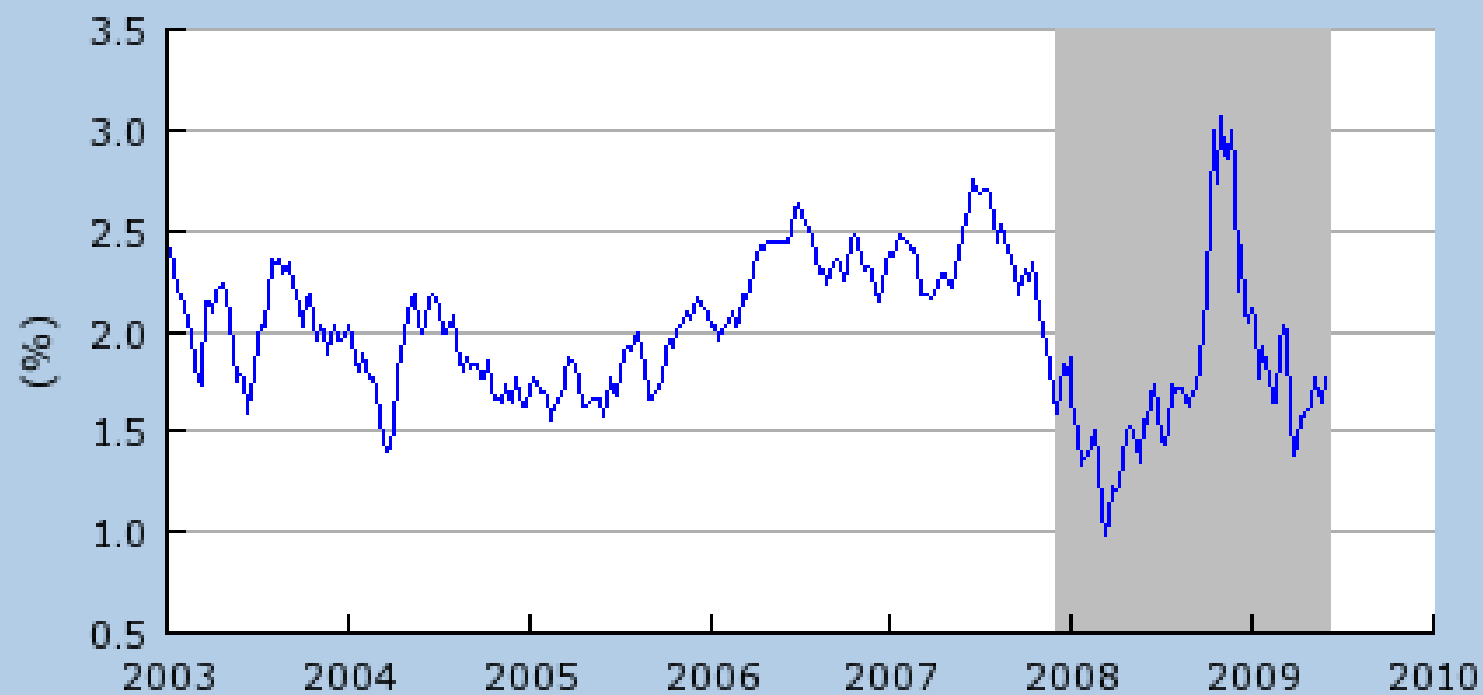
**Noncorporate debt as % of GDP**



**Federal debt as % of GDP**

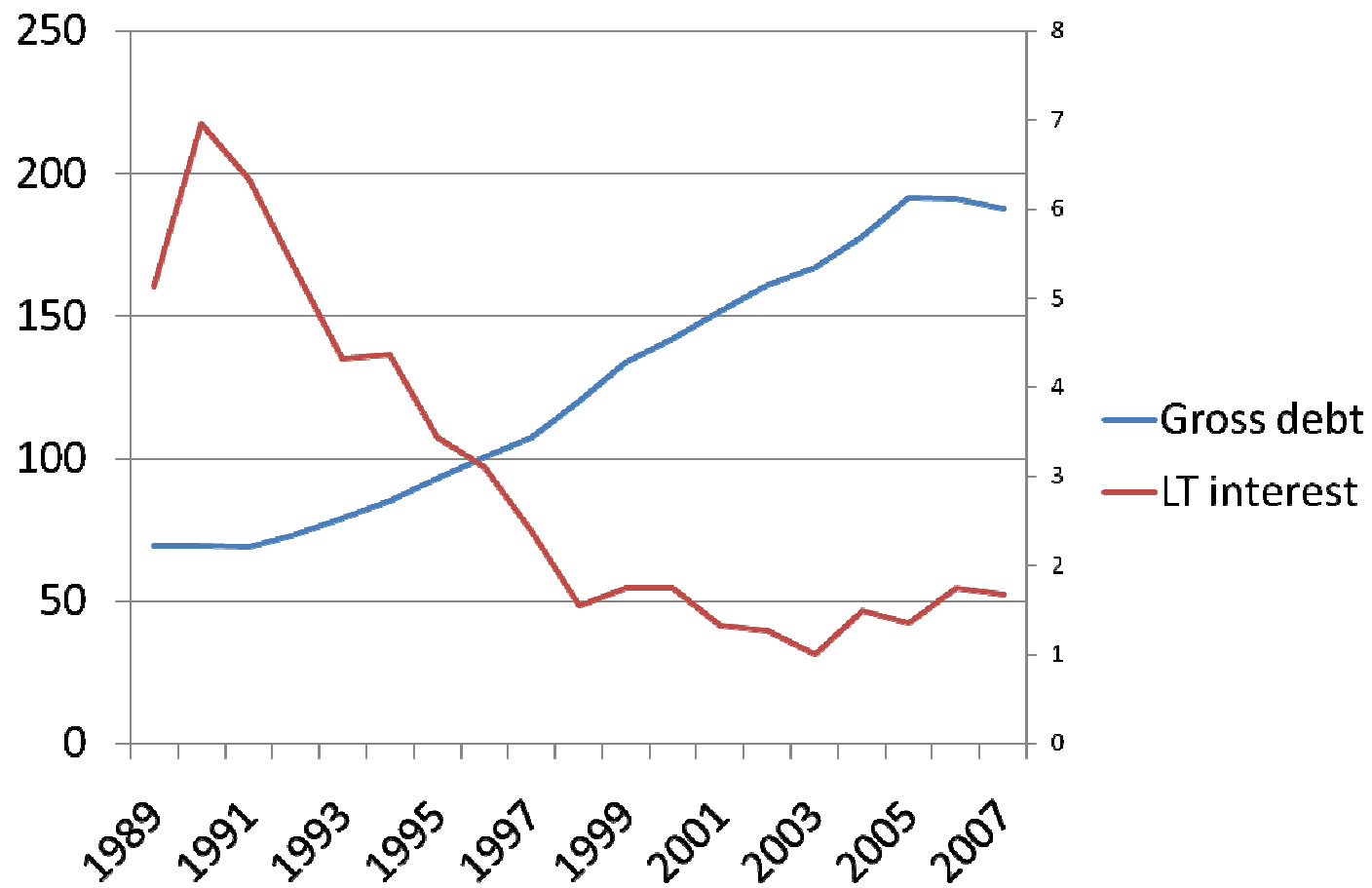


10-Year Treasury Inflation-Indexed Security, Constant Maturity (WFII10)



Shaded areas indicate US recessions.  
2009 research.stlouisfed.org

Japanese debt and interest



Source: OECD