

Comment on:
“From Great Depression to Great Credit Crisis: Similarities,
Differences and Lessons”
by Miguel Almunia, Agustín Bénétrix, Barry Eichengreen, Kevin
O’Rourke and Gisela Rua

Fabrizio Perri*

University of Minnesota, Federal Reserve Bank of Minneapolis, NBER and CEPR
fperri@umn.edu

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If, as it seems, the 2008 global recession is over and it has not been as severe and as prolonged as the great depression who or what should we thank?

Has this happened because we have been just lucky this time or because now we make better and more aggressive use of counter-cyclical policies?

Could have the great depression been avoided had we used these policies more aggressively at the time?

These are the provoking and policy relevant questions raised in this paper. The answers (and key messages) in the paper can be summarized as following. Fiscal policy was not used during the great depression but that does not mean it was not effective. Indeed VAR analysis suggest the possibility that government spending multiplier at the time was large, so had the governments at the time use fiscal policy more aggressively the great depression could have been milder. Since the current crisis is so similar to the great depression it is possible to think that the multiplier is large now as well, hence the use of aggressive fiscal stimulus in this recession is an option that should be taken. In this note I will briefly comment on two points

*The views expressed herein are those of the author and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.

related to these argument. The first concerns the estimates of the size of the multiplier during the great depression. The second qualifies the importance of fiscal policy in the current crisis.

Multiplier uncertainty

The debate on the size of the fiscal multiplier, i.e. the impact of an independent increase in discretionary public spending (such as defence spending) on GDP, is an old one but not one that, unfortunately, the profession is close to resolve. Theoretically the range spans from values around 0 (in the case of neoclassical fully Ricardian models) to values well above 2 (In the textbook IS-LM model). Empirical studies (see the recent surveys by Spilimbergo et al., 2009 and Hall, 2009) also find a wide range of possible values depending on the country, the period under consideration, or the empirical methodology followed. This uncertainty reflects the attempt of estimate a linear and time invariant relation in an obviously non linear and non stationary world, as in some countries/situations the multiplier is likely to be large while in others is likely to be small. Also there is a classic identification problem as both public spending and output are endogenous variables and it is hard to sort out the pure effect of one on the other. The current study represents a welcome addition to the literature as the role of fiscal policy has not been central in recent studies of the great depression (see Kehoe and Prescott, 2007) but at the same time it does not really help resolve the overall uncertainty. Indeed the range of estimates reported in this study alone is extremely large as values of the multiplier starting from 0.43 (section 4.1.2), to 1.1 and 2.2 (section 4.2.1), to end with 2.5 (section 4.1.1), are reported. So although I really praise the authors for conducting an extensive sensitivity in estimating multiplier during their depression, it is exactly their carefulness in the analysis that confirm to the reader that the substantial uncertainty around the size of the multiplier remains a serious issue even during the great depression. Certainly the authors make the case that the multiplier *could* have been large during the great recession but they do not make the conclusive case the multiplier was not small. And, *a fortiori*, they cannot make the case that multiplier during the current recession is not small.

Fiscal policy during the current crisis

One of the many interesting figures in the paper is figure 11, which shows how fiscal response during the current crisis, measured as budget deficit as a percentage of GDP, has indeed been much larger in the current recession than in the great depression. I find it interesting to delve a bit deeper into the reason of the current fiscal response. In table 1 I do that using US data (from the Congressional Budget Office)

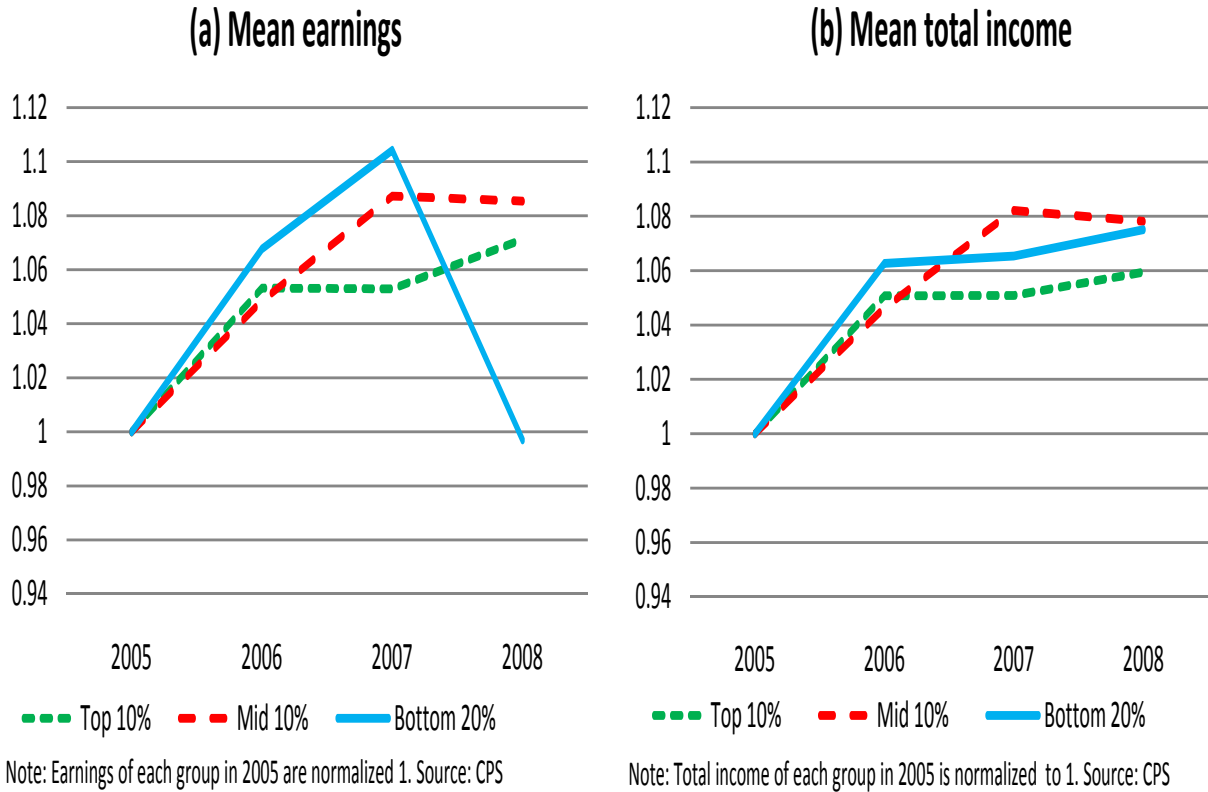
Table 1. Change in US budget 2008-2009

	Percentage of GDP			
$\Delta B/Y =$	$\Delta R/Y$	$-\Delta G_D/Y$	$-\Delta G_M/Y$	$-\Delta I/Y$
-6.6	-2.7	+0.8	+3.6	-0.5

The table breaks down the large (6.6% of GDP) increase in the US budget deficit $\Delta B/Y$ from 2008 to 2009 in four components: change in government revenues $\Delta R/Y$, change in discretionary spending $\Delta G_D/Y$, changes in mandatory spending $\Delta G_M/Y$ and change in interest payments $\Delta I/Y$. The table shows that the large part of the increase in the US deficit is due to "automatic stabilizers" such as reduction of government tax revenues and increase in mandatory spending. In particular about 2/3 of the increase in $\Delta G_M/Y$ are due to increases in social assistance program such as social security, medicare, medicaid and unemployment insurance, while the remaining 1/3 is basically due to the financial sector bail-out. Focussing more on the role of income assistance program in figure 1 I use micro data from the Current Population Survey (CPS) to assess the impact of the 2008 recession on three classes of working age households¹: households in the bottom 20% of the earnings distribution, the 10% of households around the median earnings and households in top 10%. The left panel of the figure plots the average earnings for these three groups and clearly shows how the bottom earners (the solid line) are the hardest hit by the recession: this is due, quite mechanically to the fact that unemployment increases in recession and that households with an unemployed member are most likely to end up in the bottom 20% of the earnings distribution. The right panel plots, for the same three group of households, instead of earnings average total income, which includes government income assistance programs. Notice that although income assistance programs make little difference for the top and median earners (the dashed and dotted lines are very similar across graphs), they make a substantial difference (around 8% of mean income) for the bottom earners (the solid line) in 2008, the year the recession started. In particular it

¹Working age households are defined as households containing at least one member of age between 25 and 60.

Figure 1: MEAN EARNINGS AND TOTAL INCOME IN THREE GROUPS OF HOUSEHOLDS



is the presence of income programs such as social security and unemployment insurance that stabilizes the income of households who experienced a severe drop in earnings.

Unfortunately similar data are not readily available for the interwar years but, since the great depression came in a time of almost non existent social programs (no social security, unemployment insurance, welfare), and at a time where the safety nets of rural society were dissolving, I strongly suspect that during that time there was very little difference between earnings and total income even for the bottom of the distribution. One lesson that can thus be learned from this analysis of government spending during the recession is that the key difference between fiscal policy now and then is not so much a current stronger discretionary response, but rather the current presence of significant "automatic stabilizers". These auto-

matic stabilizers play, in my opinion, two important roles: first by redistributing resources to low earners implicitly support aggregate demand in a faster and more efficient way than simple discretionary spending, and that can work as a stabilizer of macroeconomic fluctuations.² Second by easing the pain for the fraction of the population hardest hit by the recession, they reduce economic inequality and poverty and this probably reduces the urge of policy makers of adopting misguided policies, as we have seen in the years immediately following of the great depression.

Conclusions

The paper asks what saved us from the great depression in 2009 (and in the past 60 years). It is obviously a very important question, and studying history can help us answer it. The conclusion of the paper is that fiscal policy is playing a important role in this. In this note I have provided some arguments that qualify this conclusion a bit; it is probably not so much discretionary fiscal policy (for example the stimulus program) that saved the day for the US economy but the presence of a large and long lasting system of "automatic stabilizers", which was virtually absent during the great depression and put in place right after it. Looking forward the key decisions policy makers will have to make, especially if unemployment remains high, is for how long to keep these stabilizers in place, i.e. for how long to extend unemployment insurance and how long keep taxes low, as the key tradeoff here is between demand stabilization and poverty reduction on one side, v/s large budget deficits and poor incentives on the other.

References

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²For a theoretical argument on the importance of automatic stabilizers for macro stability see Christiano and Harrison.