The recession will be over sooner than you think

A major source of today’s economic weakness is uncertainty that led firms to postpone investment and hiring decisions. Nick Bloom and Max Floetotto report that key measures of uncertainty have dropped significantly, so they believe growth will resume in late 2009.

Many pundits are warning that the current dire recession will persist well into 2010. We would have agreed with them three months ago: indeed, following an article on the likely impact of the credit crunch in the Spring 2008 CentrePiece, we wrote a VoxEU column in October 2008 predicting a severe recession in 2009.1 Based on the analysis of 16 previous economic shocks, we forecast a 3% drop in GDP and a three million increase in unemployment in both Europe and the United States (see Bloom, 2008, for details). We also worried about a far worse outcome: Europe and the United States slipping into another Great Depression due to damaging policy responses. But uncertainty appears to have fallen rapidly over the last couple of months and this outcome has hopefully been avoided.

Uncertainty is now falling

It now appears that the global policy response to the credit crunch has avoided repeating those mistakes. Instead, it has focused on delivering a massive dose of tax and interest rate cuts, and spending increases. Policies restricting free markets have so far been avoided. This has calmed stock markets as the fears of an economic Armageddon have subsided. At the same time, political uncertainty has dropped as world leaders have begun to clarify their stimulus plans. In fact, economic uncertainty is now dropping so rapidly that we believe growth will resume in the second half of 2009.

Figure 1 shows one measure of uncertainty – the implied volatility on the S&P 100 – commonly known as the ‘financial fear factor’. This jumped over threefold after the dramatic collapse of Lehman Brothers in September 2008. But it has fallen back by 50% since early December as both economic and political uncertainty has receded. Other measures of uncertainty have also fallen; this is even true for the frequency of the word ‘uncertain’ in the press.

As uncertainty falls, the economy will rebound

The heightened uncertainty after the credit crunch led firms to postpone investment and hiring decisions. Mistakes can be costly, so if conditions are unpredictable the best course of action is often to wait. Of course, if uncertainty has dropped as world leaders have begun to clarify their stimulus plans. In fact, economic uncertainty is now dropping so rapidly that we believe growth will resume in the second half of 2009.

Good news: Great Depression II avoided and growth resumes in late 2009

Much like today, the Great Depression began with a stock market crash and a meltdown of the financial system. Banks withdrew credit lines and the interbank lending market froze up.

What turned this from a financial crisis into an economic disaster, however, was the compounding effect of terrible policy. The infamous Smoot-Hawley Tariff Act of 1930 was introduced by desperate US policy-makers as a way of blocking imports to protect domestic jobs. Instead of helping workers, this worsened the situation by freezing world trade. At the same time, policy-makers were encouraging firms to collude to keep prices up and encouraging workers to unionise to protect wages, exacerbating the situation by strangling free markets.

In brief...

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every firm in the economy waits, economic activity slows down (see Bloom et al, 2008). To twist President Roosevelt’s well-known phrase from the Great Depression, there is nothing to fear but uncertainty itself.

But now that uncertainty is falling back, growth should start to rebound. Firms will start to invest and hire again to make up for lost time. Figure 2 shows our predicted impact of the spike in uncertainty following the credit crunch. This is based on our detailed analysis of 16 previous financial, economic and politically driven uncertainty shocks. After falling by 3% between October 2008 and June 2009, we forecast GDP will start to rebound from Autumn 2009 onwards.

So it’s now or never for expansionary policy

Many economists make the case for a stronger policy response. That might be right, but policy-makers need to act fast. Economic stimulus measures – such as spending packages, quantitative easings or a couple of rounds of liquidity injections – have to be enacted quickly. Dithering over different courses of policy will actually make things worse by adding uncertainty. This is exactly what happened in the United States after 9/11 when the Federal Reserve Board criticised Congress for creating unnecessary uncertainty with its lengthy debates on investment tax credits.

Delaying an economic stimulus package until the summer may mean that it is too late. The economic medicine will be administered just as the patient is trying to leave the hospital.

Nick Bloom is an assistant professor of economics at Stanford University and a research associate in CEP’s productivity and innovation programme. Max Floetotto is a PhD candidate in economics at Stanford University.

Further reading
