Financial Panics vs. Recessions

Perhaps one of the most important points to understand in the current economic environment is the difference between a recession and a financial panic. What's the difference? In the US, the National Bureau of Economic Research (NBER) is responsible for determining when a recession begins and ends. It defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales" (NBER). A financial panic or crisis is the result of excessive speculation that results in a bubble of some asset (increase in price not justified by the economic fundamentals) accompanied by a rise in debt. When the bubble bursts, the wealth is gone but the debt remains. Panics were a common occurrence in the US up through the Great Depression (panics took place in 1819-1821, 1837-1843, 1857-1858, 1873-1878, 1893-1897, 1907-1908 and 1929-33). While the average recession since WW2 has lasted 10 months, contractions following financial panics lasted about 4 years. Why the difference?

"Typical" Recessions

Typically, during the latter part of economic expansions, excesses tend to develop in an economy. Individuals and/or companies begin to become less diligent. Businesses become less efficient as demand remains strong; even weak firms may do well. Consumers take on more debt as they expect the good times to continue. However, something comes along to put an end to economic growth (a shock such as a rise in energy prices; policy changes such as higher interest rates by the Fed, etc.), resulting in a recession. Recessions perform a cleansing role in the economy, helping to eliminate excesses. Many times, the economy overheats resulting in higher inflation. The central bank raises interest rates to try to slow down the economy, often resulting in a recession. As the recession proceeds and excesses are corrected, consumers begin to spend again due to pent-up demand (they postponed purchases for awhile and are now ready to spend again); businesses become more efficient and reduce costs and thus are better prepared to respond to increased sales; inflation comes down allowing the central bank to lower interest rates and the economy starts to grow again (obviously, it gets more complex than this). This process is referred to as the business cycle.

Financial Panics

During a financial panic, excessive speculation takes place as credit and/or lending becomes too easy. The prices of a particular asset (or many assets) increase and people take out more debt. One reason is that they may borrow more in order to speculate by purchasing more of the asset. Also, they think they have more wealth and that it will continue to rise, thus they think they will be able to finance a higher debt load. In the 1800s, the speculation was on railroads (1870s), land, etc. Though asset prices may have originally rose for legitimate reasons, it gets out of control as excessive speculation takes hold, causing asset prices to increase beyond what is justified by market conditions. Eventually, the bubble bursts and the wealth declines, but people are left with high debt that they can't pay, resulting in a bust. The economy takes a long time to recover since consumers and/or businesses cannot resume their normal spending until they deleverage (reduce their debt). Banks who engaged in loose lending practices tighten their lending to correct for past excesses and because of losses incurred on previous loans.

By now you can probably understand that the financial crisis of 2008 is a panic, not an ordinary recession, and it is likely to take years for a strong recovery to take place. Economists who considered it a deep recession predicted a V-shaped recovery while those who viewed it in the context of previous financial panics predicted a U-shaped recovery or a "long slog" (Paul Volcker).

The best account of financial crises is a new book called "This Time is Different" by Ken Rogoff and Carmen Reinhart. Here's a link to a research paper they released in Feb 2008, "Is the US Subprime Crisis So Different? ", in which they compare the US subprime crisis to previous severe financial crises (this is fyi, no need to delve into all the details). What stood out to them prior to the crisis? I'll quote their follow-up paper, "We showed that standard indicators for the United States, such as asset price inflation, rising leverage, large sustained current account deficits, and a slowing trajectory of economic growth, exhibited virtually all the signs of a country on the verge of a financial crisis—indeed, a severe one." The follow-up paper, "The Aftermath of Financial Crises" describes the contraction and recovery following a financial panic (this is fyi, no need to get into all of the details). They show that aftermath of severe financial crises share three characteristics: real housing prices decline by 35% over 6 years and equity prices decline by 55% over 3.5 years; the unemployment rate rises by 7 percentage points during the contraction; and government debt rises by 86%, primarily due to collapse in tax revenue but also due to fiscal stimulus. Though the US may not experience the same exact result as others, these indicators show the deep and prolonged effects of financial crises. If you want a more comprehensive analysis by Reinhart and Rogoff, go here to read a 124-page paper that provides a "panoramic analysis of the history of financial crises from England's 14th century default to the current US sub-prime financial crisis." Finally, here's a nice interview with Rogoff and Reinhart from PBS (once again, fyi).

How does the experience of the US compare to the average severe financial crisis based on the finding of Reinhart and Rogoff?

	US Great Recession	**Average Severe Financial Crisis (Reinhart/Rogoff)**
Decline in Housing Prices	35.1% (Case-Shiller)	35%
Decline in Stock Prices	54% (Dow), 57% (S&P)	55%
Increase in unemployment rate	5.6 percentage points	7 percentage points
Increase in government debt held by public	90%	86%

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