

OCTOBER 2011

McKinsey Quarterly

Understanding the Second Great Contraction: An interview with Kenneth Rogoff

The economist and coauthor of *This Time Is Different* explains what history can teach us about the global downturn and why climbing out of it is still rife with risks.

Bill Javetski and Tim Koller



Continued economic stagnation in Europe and the United States, along with renewed uncertainty about the health of the debt-ridden global financial system, has been raising fresh concerns about the prognosis for economic recovery and even the potential for a relapse into crisis. A big part of the problem, as Harvard economist Kenneth Rogoff pointed out in *This Time Is Different: Eight Centuries of Financial Folly* (Princeton University Press, September 2009), the best-selling academic book he coauthored with fellow economist Carmen Reinhart, is that we are working through a recession linked to a deep financial crisis—a powerful amplifying mechanism with long-lasting effects. Reinhart and Rogoff’s work, based on investigations of empirical data from 800 years of financial crises, shows that such downturns are exceptionally deep and long lasting, as well as unprecedented in the United States since World War II. McKinsey’s Bill Javetski and Tim Koller recently visited Rogoff in his Cambridge, Massachusetts, office to ask where we are in the recovery time line and why Rogoff thinks that a bout of moderate inflation may help the world regain economic health. Rogoff’s outlook—that the balance of current economic risks tilts “more to the downside than the upside”—is sobering but essential reading for business leaders and policy makers trying to make sense of today’s uncertain environment.

The Quarterly: *What does history tell you about where we are on the time line of the economic contraction we’ve been living through?*

Kenneth Rogoff: The historical experience gives a very clear view that the aftermath of a financial crisis brings slow and halting growth, sustained high unemployment, and surging public debt—with the overhang of public and private debt being the most important impediment to a normal recovery from recession.

It has been utterly remarkable how the United States has been tracking the averages of postwar deep financial crises across a broad range of indicators. On average, it takes four and a half years to get back to the same per capita GDP where you started out and about the same amount of time for unemployment to stop rising.

Indeed, we haven’t yet gotten back to the same per capita GDP where we started. Our perspective is that we have never left the recession; we’re still very much in it. I hope in another two or three years things will be feeling more normal. But there are a lot of difficulties to traverse before we get there.

The Quarterly: *You distinguish between normal recessions and those accompanied by a deep financial crisis. Are there many recessions marked by such a crisis?*

Kenneth Rogoff: There have been many across the world, but for the United States this is the first one since World War II. A financial-crisis recession is a very different animal from a normal recession. At least quantitatively, it’s not as bad now as it was in the Great Depression. Nevertheless, Reinhart and I argue that the right name for this downturn

is the “Second Great Contraction,” building on the title of Milton Friedman and Anna Schwartz’s famous book about the Great Depression.¹

The Quarterly: *Is there any way to accelerate our pullout from this contraction?*

Kenneth Rogoff: It’s not easy, because a postfinancial-crisis recession is characterized by an overhang of private and public debt that is much more severe than it is after a normal recession. There are many mortgages still under water—perhaps 25 percent—and people are more cautious about extending their borrowing than they were before 2007. That leads to slower consumption growth. Businesses in turn invest more slowly.

In 2008, policy makers placed too much confidence in the Keynesian idea that you can jump-start the economy with a big temporary stimulus and then step back and watch the private sector take over. Of course, Reinhart and I argued otherwise, based on the results of a seven-year research project, and our results certainly were acknowledged by practitioners, academics, and policy makers. Nevertheless, most policy makers and markets still insisted, “Well, yes, maybe that is how things always were in the past, but this time it’s different because the policy response was so aggressive.” In fact, the policy response is always very aggressive. Every country does everything it can to claw its way back from a deep financial crisis.

So, unfortunately, there is no easy out. Perhaps the best chance would be to find a way to get ahead of the mortgage defaults—that is, to have restructurings and debt forgiveness, albeit with some kind of quid pro quo. That is very hard to do. But if there were a way to write down and forgive some of the mortgage debt, that would be money well spent. In ten years, we will probably end up forgiving a big chunk of it. As Carmen has noted, this is a little like Third World debt that was carried on the books forever, even though it was a joke.

The Quarterly: *What other policy responses would make sense?*

Kenneth Rogoff: Beyond that, we need to think about long-run structural reform. Most financial crises have at their root very, very high leverage. To hit the nail on the head, I think we have to do something about the prevalence of nonindexed debt instruments. I would start with changing our corporate-tax law and any overt incentives that favor debt. Obviously, the US home mortgage tax deduction makes no sense, given the risk that debt entails. I understand the political imperative, but let’s not subsidize debt in an overt way. I think public-finance experts need to methodically go through the system and strip debt subsidies out.

And then I’d say governments need to find ways to spark market innovation in indexing debt instruments. If we had housing loans indexed to, say, regional housing prices, as

¹ Milton Friedman and Anna Jacobson Schwartz, *The Great Contraction, 1929–1933*, Princeton, NJ: Princeton University Press, 1964.

Bob Shiller has advocated, it would have helped a lot and provided better incentives to borrowers and lenders.² If in 200 or 300 years, we're experiencing fewer and milder financial crises, it will be because we figured out how to put some basic indexation clauses into debt that make it a little less vulnerable to systemic risk.

The Quarterly: *Financial innovation, in the form of derivatives, credit default swaps, and other instruments, was supposed to make the world a safer place. Did they have a role—good, bad, or neutral—in creating the crisis?*

Kenneth Rogoff: Financial innovation is always a piece of financial crises, and financiers are always ahead of the regulators. In *This Time Is Different*, we discuss how in the 1300s and 1400s the Catholic Church—which was the regulator at the time, of course—had very strict usury laws. The financiers got around them by thinking of very clever devices, including denominating loans to be repaid in a foreign currency. You give the money in a weaker currency and require the repayment in a stronger currency, which, of course, everyone perfectly well understood to be equivalent to paying interest.

There are countless examples over the ages. The transatlantic cable led to huge financial innovation. Innovation is always ahead of the regulators.

²Robert Shiller is a professor of economics at Yale University and cocreator of the Case–Shiller House Price Index, one of the most widely used methods of measuring performance in that industry.

Kenneth Rogoff



Vital statistics

Born March 22, 1953, in Rochester, New York

Married, with 2 children

Education

Graduated with a BA in economics in 1975 from Yale University

Earned a PhD in economics in 1980 from the Massachusetts Institute of Technology (MIT)

Career highlights

Harvard University
(1999–present)

- Professor, economics and public policy

Princeton University (1992–99)

- Professor, economics and international affairs

University of California at Berkeley (1989–91)

- Professor, economics

University of Wisconsin at Madison (1985–88)

- Professor, economics

Fast facts

Awarded Deutsche Bank Prize in Financial Economics in 2011

Served as economic counselor and director of the research department of the International Monetary Fund (August 2001 to September 2003)

Elected member of the American Academy of Arts & Sciences and the Econometric Society

Earned life title of international grandmaster of chess by World Chess Federation in 1978

The Quarterly: *Does that mean we should be cautious about the supposed benefits of financial innovation?*

Kenneth Rogoff: I think financial innovation has been overly blamed for everything. Financial-sector *lobbying* is another matter—regulators of the financial sector lost sight of the risks.

The Quarterly: *Is the size of the banks an important factor? Can they get too big?*

Kenneth Rogoff: I believe that size is overrated as the issue. There is this view that if we can just break up the big banks into smaller ones, we won't have a problem. But if you look at systemic crises, usually a lot of banks are doing the same thing. So if we take one big bank and break it up into ten smaller banks that act similarly, I'm not sure how much we really would have bought ourselves. The incentives that would make a big bank go whole hog in one direction would probably make ten smaller banks do the same thing.

The Quarterly: *You've advocated allowing inflation to increase as one kind of remedy. Can you explain?*

Kenneth Rogoff: There are no quick fixes. But I do think that this is a period when we shouldn't be worried about raising inflation slightly. Indeed, moderate inflation, I would say, is exactly the prescription for a Great Depression-type scenario or a Japan-type scenario. It lowers real interest rates, helps facilitate housing price adjustment (the real price still needs to come down in many places), and modestly shortens the typical long post-crisis deleveraging period. I've pushed the idea, for some time, that we're in a Great Contraction, not in a typical recession, and one has to analyze the problem differently. Unfortunately, there is still a risk that this thing could get much, much worse. The biggest problem is the global overhang of debt. After publishing our book, Carmen Reinhart and I did a study that looked at the impact of public debt on growth. When debt gets over a certain level—a good marker is 90 percent of GDP—it is linked to lower growth.

If elevated inflation—I've suggested 4 to 6 percent for a few years—somewhat reduces real debt levels, that would be welcome. Of course, I do get a knee-jerk reaction from many people saying that even slightly elevated inflation is anathema; we'd be going back to the bad old days of the '70s. And my answer is that this could still be much worse than the '70s. I've worked my whole career on designing central banks and promoting tools and institutions for containing inflation. But right now, given a once-in-80-years downturn, you have to balance the risks.

Related thinking

“The growing US jobs challenge”

“Surveying the economic horizon: A conversation with Robert Shiller”

“Jobs and US economic recovery: A panel discussion”

“The looming deleveraging challenge”

The Quarterly: *Is that the right approach for Europe as well?*

Kenneth Rogoff: Absolutely, though of course they have a political tightrope to walk. Still, how much should they worry about whether inflation is under 2 percent right now when the euro could fall apart in the next year or two?

Please understand, the European Central Bank is under tremendous political pressure, and they’re not the main source of the problem. But I don’t see how they would want to be in a situation where they’d go out of business in a year and say, “Well, the euro may have fallen apart, but we never had inflation expectations go above 2 percent.” Inflation is not a panacea, but this is a once in eight or ten decades situation where it would be helpful.

The Quarterly: *Is it naive to pretend that some or much of this debt isn’t going to have to be restructured at some point?*

Kenneth Rogoff: By any historical benchmark, Greece, Portugal, and probably Ireland are way over the line. Their debts should be dramatically reduced—for Greece by at least 60 percent or 70 percent. Portugal probably 40 to 50 percent. Ireland is more complicated because it’s difficult to disentangle what’s government debt and what’s bank debt. The big problem is Ireland’s bank debt. But the government has guaranteed it.

Had the eurozone officials done all this a year ago and, importantly, cast an ironclad safety net over the remainder, perhaps we would be looking at this in the rear window.

The Quarterly: *What indicators would you look to for signs that we’re finally starting to get out of this?*

Kenneth Rogoff: Job growth and unemployment. I don’t expect unemployment to come down again to 4 or 4.5 percent until the next time the economy overheats. That level was never normal. More likely, when this is all over, unemployment will settle down at around 6.5 or 7 percent. Until we’ve seen unemployment come down to a level like that, things will remain precarious. I should note that the most reliable measure, though, isn’t unemployment; it’s employment. In addition to unemployment rising, the participation rate in the economy has fallen, and that too needs to come back. ○

Bill Javetski is a member of McKinsey Publishing and is based in McKinsey’s New Jersey office; **Tim Koller** is a principal in the New York office. This interview will also appear in *McKinsey Quarterly*’s first print issue of 2012, to be published in January. Copyright © 2011 McKinsey & Company. All rights reserved.