EconoFact Chats: What We've Learned from Recent Recessions

Karen Dynan, Harvard University

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Michael Klein:

I'm Michael Klein, executive editor of EconoFact, a nonpartisan web-based publication of The Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

The last 20 years have been rocked by two major economic crises. The great recession; the financial and economic crisis that began with the financial meltdown in September, 2008. And the great lockdown; the pandemic induced recession that started in March, 2020. Recessions are for economists what earthquakes are for seismologists; terrible events with high human costs that offer an opportunity to learn. And not only to learn, but also to teach. My guest today is Karen Dynan, a professor of the practice in the Department of Economics at Harvard University. Karen developed and teaches the course at Harvard College called Financial Crises and Recessions of the 21st Century. Karen is especially well positioned to teach this course.

Michael Klein:

Along with being a prolific and influential scholar and having directed the economic studies program at The Brookings Institution, Karen has had high level policy experience. She served as Assistant Secretary for Economic Policy and Chief Economist at the U.S. Department of the Treasury from 2014-2017. Before that experience and her work at Brookings, she worked for almost two decades at the Federal Reserve Board. Karen, welcome once again to EconoFact Chats.

Karen Dynan:

Thanks, Michael. It's great to be here again.

Michael Klein:

It's nice to have you on again. I've looked at the webpage you posted for your course the last time you taught it, which was in the spring of 2021. And it looks like a great course and a really wonderful compliment to macroeconomic courses. It also looks like it was a lot of work on your part. What prompted you to develop this course?

Karen Dynan:

Well, I wanted to teach the course because one of the important things we've learned is just how damaging these crises can be. It can take years after a bad financial crisis or recession for the economy to normalize again. For example, it took almost a decade to restore labor markets in the United States to where they were before the Great Recession. And I have a whole class about the human cost of recessions. I think we all understand that recessions come with job loss and other things that create immediate hardship for households. But an important related point is that the scars can be very long lasting.

Karen Dynan:

For example, job loss can lead people to get wiped out financially, and then they struggle for years to get back on their feet. Workers laid off for a long time can lose their skills. They can also get so discouraged that they drop out of the labor force altogether. Appreciating the size and potential persistence of these costs underscores to the students why it's so important that we have macroeconomic policy tools we can use, both to mitigate crises and also to try to avoid them in the future.

Michael Klein:

Yeah. We have a number of EconoFact memos about the costs of recession. We have, for example, one by Jesse Rothstein on labor market scarring. How, if you're entering the labor market for the first time during the recession that sort of shadows you for your whole life. One of the features of your course that I found interesting is you teach it like a history course. You go through the events chronologically, you start with the developments in the housing market in the first years of this century, then you cover the financial meltdown in 2008 and the great recession that occurred in the wake of that. And so on and through the effects of COVID on the economy in the most recent period as well. A more standard approach in economics is to organize the material by topic, not chronologically. Why did you choose to do it chronologically, Karen?

Karen Dynan:

Well, first of all, the specifics of these periods are very interesting and it's a fair bet that we haven't seen our last mortgage crisis, nor unfortunately our last pandemic. So I do think it's important for people to understand the specific economics underlying these particular episodes. But more generally one can view these crises as case studies of how challenging it can be to make good economic policy in real time. For example, when we're analyzing the period leading up to the great recession, I talk about how bubbles can be hard to recognize in real time. I also discuss the difficulties associated with trying to monitor risk taking in the financial system, particularly given how complex it is and how it's changing all the time.

Karen Dynan:

And as we're talking about how the market meltdown unfolded in 2008, I try to get students to think about how they would weigh the trade offs associated with rescuing large financial firms, as opposed to letting them fail. I teach it this way because I think recognizing the challenges associated with understanding these events as they're unfolding in real time, and also just appreciating the messiness of crafting an effective policy response, can help us do better in the future.

Michael Klein:

Yeah. One thing that I've always found is there's a lot of 'Monday morning quarterbacking' in response to these crises. And people say, "Well, why don't you do that?" And it's a little bit like if a fireman goes in and there's a terrible fire, and then the house owner says, "Well, you got my antique chair really wet when you're putting the fire out." It doesn't seem like quite fair criticism. I recently had a chat with John Cassidy, the economics columnist for The New Yorker. He was a guest on EconoFact Chats. And we discussed his book, When Markets Fail. He spoke how macro economists were blindsided by the financial meltdown in 2008 and the subsequent great recession. One of the sessions in your course I noticed is called, Changes In The Way Macro Economists See The World. How have macroeconomic frameworks changed as a result of that experience? And what real world aspects are now part of the standard macroeconomics toolkit that were not there, or at least not as prominent before the great recession?

Karen Dynan:

Yeah. Probably the most important rethinking had to do with the linkages between the financial system and the macro economy. Before the financial crisis, most macroeconomic models had relatively limited roles for financial variables. And you need to remember that models are simplified frameworks that help us understand a more complex reality. So the whole point is ignoring features of the real world that don't seem to matter much. And I think people thought a limited treatment of financial channels was okay at that point because we'd gone decades in the United States without a financial disruption causing significant macroeconomic fallout. Even the bursting of the dot com bubble in the late 1990s had resulted in just a mild recession.

Michael Klein:

Yeah. In the macroeconomics course that I teach, I have a slide with a quote from Einstein that says, "models should be as simple as possible, but no more so than that."

Karen Dynan:

Yes, that's exactly right.

Michael Klein:

He was a smart guy.

Karen Dynan:

Yes, that's right. But we realized models were too simple. Basically the events of the early 2000s made us realize that we need to do a lot more thinking about the linkages between the real side of the economy and the financial part of the economy. And now there are many more academic researchers focused on these issues as well as many more people in government thinking about the issues. And I think that thinking is going to benefit us going forward.

Michael Klein:

A previous guest I had on EconoFact Chats, your colleague, Jeremy Stein. I remember him always telling me the plumbing is important. And the events of 2008 really showed that.

Karen Dynan:

Yeah. I think you don't realize how important the plumbing is until the plumbing breaks.

Michael Klein:

Right. I guess we could take this metaphor further, but let's not. What you're discussing in the way that there's this rethinking in the light of the events of 2008 and the financial meltdown reminds me of the same kind of rethinking that occurred back in the 1970s when I was first studying economics. There was a sea change at that time in the way macro economists thought about the world and the way in which macroeconomics was taught, with the recognition that recessions weren't always the result of weak aggregate demand, but could be caused by supply shocks to the economy. Of course, this was prompted by the primary economic event of the early 1970s, the dramatic rise in oil prices. Do you think that this framework that was first of a developed and taught in the 1970s, is that a sufficient way to think about supply shocks now with what's going on with COVID, and ships being backed up at the port of Los Angeles and not enough truckers and so on?

Karen Dynan:

Sure. There are in important similarities between what happened in the 1970s and what's going on today. Right now, underlying demand in the economy is strong because people have lots of pent up demand after being constrained by the pandemic for so long, but we're seeing supply not keeping up. It turns out it's just complicated to fully open the economy after such a long time, particularly when the virus is still out there. And I know you've covered that before with EconoFact. But the result has been that inflation has risen. So it really is a supply shock story, like what we saw in the 1970s. I do think the current supply shock is of a somewhat different nature than in the 1970s, because it has to do with bottlenecks, it has to do with supply chain problems. And it also has to do with things going on with labor supply. People being reluctant to rejoin the labor force and take jobs. So there are these differences in the nature of the shock, but it's still a supply shock. So the experience in the 1970s helps us think about it.

Michael Klein:

One of the key insights that we gained by including the supply side was a better understanding of the sources in the dynamics of inflation when faced with disruptions. For example, like an oil price shock, or today, a pandemic. Inflation today is high compared to the last three decades, but we're still below the experience of the 1970s. I would guess that there are lessons from that period that the people at the Federal Reserve have learned, which make it much less likely to have the high inflation period like we had in the 1970s. Would you agree with that?

Karen Dynan:

Yes. First of all, let me say that supply shocks, they no doubt complicate life for monetary policy makers. Most of the recessions we've seen since the 1970s have been driven by weak demand. So not driven by supply shocks. With the results being in a weak demand recession that you get both unemployment and you get disinflationary pressures, inflation is trending down. And these sorts of situations, these demand driven recessions, they're relatively straightforward for monetary policy makers because easier policy helps both to restore labor markets in to bring inflation back to more normal levels. But when you have supply shocks, it's a different situation. The trade offs are much harder because easier monetary policy will support labor markets that are still weak like they are now, but it might come at the cost of aggravating the inflationary pressures.

Karen Dynan:

Turning to what we learned in the 1970s. The most important lessons for monetary policies were, first of all, watch supply and demand imbalances and think about how they're likely to evolve. And we see monetary policy makers doing that now. Secondly, to watch measures of inflation expectations. And the latter is really important because you don't want inflation to take on a life of its own with high expected inflation getting built into wages and prices, and then leading to some sort of spiral upwards. So the Fed is also watching inflation expectations in addition to those supply and demand imbalances, and has signaled it will act if needed to tighten policy before inflation spirals upward.

Michael Klein:

We have a memo by Menzie Chinn that we posted back in May. And Menzie talked about that; the way in which inflation expectations, if they become embedded, makes the whole game much more difficult. I was just looking at the data on that. The Michigan Survey now has expected inflation at about 4.2%, I think, which is well below where we are. But it's also dramatic if you look at the chart that it's spiked up over the last few months. So this is something to watch carefully, I suppose.

Karen Dynan:

Yeah, I think so. There are a lot of different measures of inflation expectations and different views about which measures are the best measures. I think the one thing people do agree on is that it is a really hard thing to measure and none of our measures are really, really good. But we are seeing some increase in inflation expectations in a lot of measures now. Although, these increases are small, like the increase in inflation to date. They're small relative to the increases we saw in the 1970s, which really led to double digit inflation.

Michael Klein:

Yeah, so I think that's important that historical context is important as well. That we remember we're not in hyperinflation. What's happened with inflation, I guess before this period was a bit of a puzzle because inflation remained quite low, even when the economy and this long period of growth. I talked to Greg Mankiw about this some time ago. But there are other puzzles as well. And one of them is that we have very high levels of government debt right now. And in the models that you and I teach that would prompt higher interest rates as government borrowing competes with borrowing by the private sector. You were recently quoted in The New York Times. And you said, "The long term downward move in interest rates is the most important macroeconomic development that has occurred over the last couple of decades." Can you explain what you meant by that and why you think it's so important?

Karen Dynan:

Sure. We were talking about the long term trend in interest rates. There are a variety of reasons why interest rates are so low right now and some of them have to do with the business cycle and what central banks are doing. But looking over the long term, one important thing is that various factors have changed the supply and demand for saving over the last couple of decades in a way that has reduced interest rates, which you can think of as the price of these funds that people are saving; quite considerably. Interest on 10-year treasury securities, for example, has declined about six percentage points from its early 1990s level. And that was just going through the pre-pandemic era. It's declined further since then. This downward trend in interest rates, it's complicated our lives in various ways.

Karen Dynan:

It's created challenges for savers who are dependent on interest income. Some people think it makes the financial system more prone to bubbles. And it has reduced the space available for monetary policy makers to cut rates in response to a recession. So there are various complications, but one way in which the lower interest rates have made life easier is that it's helped governments because it's helped lower their borrowing rates. So that's made it less costly for governments to finance the spending they've done, for example, to support their economies during the pandemic. The lower rates, they imply a lower budget cost in the sense that future interest payments are lower because of the lower rates. But they also imply what economists refer to as a lower economic cost. In the sense that these low rates are a signal that the private sector doesn't have highly profitable alternative uses of that money at the moment. So that's really what I was talking to Neil Irwin about.

Michael Klein:

In your course, when you taught it in the Spring of 2021, you ended it with a session in which you discussed the to-do list for economic of policy makers. What were some of the items on that list? And have you seen any progress made to enact those policies since the time you taught the course?

Karen Dynan:Yeah. Some of the items have to do with how we can do better at fighting future crises. For example, I talk about how many economists think we need more automatic fiscal stabilizers. Meaning, fiscal support that kicks in automatically without Congress having to act when economic conditions deteriorate, and then turns off automatically when economic conditions improve again. And just to contrast this, the government has done a lot of discretionary fiscal policy over the last 20 months, but it's taken a great deal of political energy to pass these measures and resulted in fiscal support that's been delivered in a go, stop, go, way. That probably hasn't been ideal.

Michael Klein:

Yeah. We have a memo by Jay Shambaugh about automatic stabilizers. I imagine he's one of the people you've been thinking about as advocating it.

Karen Dynan:

Yeah.

Michael Klein:

And the important part of that is that it takes the politics out of it. And when politics become more difficult, then there's less of a response, even though there could be sort of broad agreement, but it becomes a very politicized thing.

Karen Dynan:

Yeah. I think that's an important point. And it's also just distracting. Congress has a lot of things that it needs to be doing. There are a lot of different priorities in this country, and spending so much time debating these fiscal packages has distracted them from that.

Michael Klein:

What about in the financial area, Karen, have you seen progress made in that dimension?

Karen Dynan:

Yeah. There are a bunch of things on the to-do list when it comes to financial policy. We certainly did do significant financial reform after the financial crisis. But a lot of that regulation; or a lot of the kind of better regulation has been done with respect to the banking system, with relatively little changes in the shadow banking area. So some people think we have more work to do along those lines. As for recent progress, I think particularly in the financial area there certainly has been ongoing thinking about how we can improve regulation and better identify the risks out there. We see kind of new papers all the time on it. In terms of taking concrete steps. Not much over the last couple of years. I would say that's because policy makers have been pretty distracted with other things since the beginning of 2020. But hopefully attention will turn back to these items once the economy is more back to normal.

Michael Klein:

Karen, are you going to teach your course, Financial Crises and Recessions in The 21st Century, again this coming Spring, in 2022?

Karen Dynan:

Yeah. I'm planning to teach it again in the Spring of 2022.

Michael Klein:

When you teach a course, the first time it's a lot of work. When you teach it the second time, it's a lot less work because you have a lot of materials. But I guess that isn't necessarily the case for this course because you're always updating it. Is that right?

Karen Dynan: Yeah. I'll definitely be updating it for the events of the last year. It's the hard part about teaching a course on timely macroeconomic developments, but it's also the fun part.

Michael Klein:

What will you change in what you teach this coming semester in the Spring of 2022 that wasn't there in the Spring of 2021?

Karen Dynan:

Well, I did have a few slides in my final lecture in the Spring of 2021 about overheating and what that might imply for inflation and monetary policy. But we really didn't know much at that point about the nature of the supply shocks we were seeing or how long they would persist. So I anticipate that students will want to hear more about that and hear more about inflation generally. As for other new material, we'll have to see how things go. Given how things have gone over the last 20 months, I suspect there'll be other surprising developments by next spring that we'll need to talk about.

Michael Klein:

Well, it sounds like a great course. Is there any chance that maybe in the back of your lecture hall, there's a seat that I could fill because I'd really love to hear what you're about to say in the spring about all these really interesting things?

Karen Dynan:

There'll always be a seat for you in my classroom, Michael.

Michael Klein:

Do I have to take the test as well?

Karen Dynan:

It's recommended, but not absolutely necessary, if you don't want to do that.

Michael Klein:

All right. Maybe I'll take it pass/fail. Karen, thank you very much for joining me once again on EconoFact Chats. It's always great to talk to you and I always learn a lot in our conversations. So thanks very much.

Karen Dynan:

You're very welcome. I enjoyed it.

Michael Klein:

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