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Who’ll Stop the Pain?

By PAUL KRUGMAN

Earlier this week, the Federal Reserve released the minutes of the most recent meeting of its open market committee — the group that sets interest rates. Most press reports focused either on the Fed’s downgrade of the near-term outlook or on its adoption of a long-run 2 percent inflation target.

But my eye was caught by the following chilling passage (yes, things are so bad that the summarized musings of central bankers can keep you up at night): “All participants anticipated that unemployment would remain substantially above its longer-run sustainable rate at the end of 2011, even absent further economic shocks; a few indicated that more than five to six years would be needed for the economy to converge to a longer-run path characterized by sustainable rates of output growth and unemployment and by an appropriate rate of inflation.”

So people at the Fed are troubled by the same question I’ve been obsessing on lately: What’s supposed to end this slump? No doubt this, too, shall pass — but how, and when?

To appreciate the problem, you need to know that this isn’t your father’s recession. It’s your grandfather’s, or maybe even (as I’ll explain) your great-great-grandfather’s.

Your father’s recession was something like the severe downturn of 1981-1982. That recession was, in effect, a deliberate creation of the Federal Reserve, which raised interest rates to as much as 17 percent in an effort to control runaway inflation. Once the Fed decided that we had suffered enough, it relented, and the economy quickly bounced back.

Your grandfather’s recession, on the other hand, was something like the Great Depression, which happened in spite of the Fed’s efforts, not because of them. When a stock market bubble and a credit boom collapsed, bringing down much of the banking system with them, the Fed tried to revive the economy with low interest rates — but even rates barely above zero weren’t low enough to end a prolonged era of high unemployment.

Now we’re in the midst of a crisis that bears an eerie, troubling resemblance to the onset of the Depression; interest rates are already near zero, and still the economy plunges. How and when will it all end?

To be sure, the Obama administration is taking action to help the economy, but it’s trying to mitigate the slump, not end it. The stimulus bill, on the administration’s own estimates, will limit the rise in unemployment but fall far short of restoring full employment. The housing plan announced this week looks good in the sense that it will help many homeowners, but it won’t spur a new housing boom.

What, then, will actually end the slump?

Well, the Great Depression did eventually come to an end, but that was thanks to an enormous war, something we'd rather not emulate. The slump that followed Japan's "bubble economy" also eventually ended, but only after a lost decade. And when Japan finally did start to experience some solid growth, it was thanks to an export boom, which was in turn made possible by vigorous growth in the rest of the world — not an experience anyone can repeat when the whole world is in a slump.

So will our slump go on forever? No. In fact, the seeds of eventual recovery are already being planted.

Consider housing starts, which have fallen to their lowest level in 50 years. That's bad news for the near term. It means that spending on construction will fall even more. But it also means that the supply of houses is lagging behind population growth, which will eventually prompt a housing revival.

Or consider the plunge in auto sales. Again, that's bad news for the near term. But at current sales rates, as the finance blog Calculated Risk points out, it would take about 27 years to replace the existing stock of vehicles. Most cars will be junked long before that, either because they've worn out or because they've become obsolete, so we're building up a pent-up demand for cars.

The same story can be told for durable goods and assets throughout the economy: given time, the current slump will end itself, the way slumps did in the 19th century. As I said, this may be your great-great-grandfather's recession. But recovery may be a long time coming.

The closest 19th-century parallel I can find to the current slump is the recession that followed the Panic of 1873. That recession did eventually end without any government intervention, but it lasted more than five years, and another prolonged recession followed just three years later.

You can see, then, why some Fed officials are so pessimistic.

Let's be clear: the Obama administration's policy initiatives will help in this difficult period — especially if the administration bites the bullet and takes over weak banks. But still I wonder: Who'll stop the pain?