Covid-19 recession: lessons from past severe recessions

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The covid-19 pandemic could lead to the most severe recession since World War II. The ‘COVID-19 Recession’ of 2020/2021 will be deeper than the ‘Great Recession’ in 2009 after the financial crisis in 2007/2008 and can be compared with the ‘Great Depression’ in the 1930s.

The danger of deep recessions is that they are not only harmful in the short-term but can lead to long periods of stagnation with mounting economic and social problems. Whether such recessions can be dampened or will deepen and what will happen after the acute crisis very much depends on the policies followed. This contribution will discuss which mistakes can be made and what can be learned from severe recessions in the past. This leads also to policy conclusions for the COVID-19 Recession.

Three dangers

There are three areas of danger during and after severe recessions: a) the danger of falling wages and deflation, b) the danger of a lack of a lender of last resort and high debt stocks which prevent a recovery, and c) the danger of a lack of stimulation.

Falling wages and deflation: In deep crises, unemployment explodes and bargaining power of trade unions and workers erode. This can lead to such a pressure in labour markets that nominal wages, and with them wage costs, decrease. This risk is increased as a number of mainstream economists see wage cuts as a remedy to fight against high unemployment. And the microeconomic logic suggests that wage cuts can help firms in a crisis to survive. However, when the nominal wage level in a country decreases, the price level will also decrease and a deflationary development is triggered. A good example is the Great Depression. At that time, in almost all industrial countries, a falling nominal wage level led to a cumulative deflation. Japan after the mid-1990s is a second example. Moderately falling wage costs kept Japan in a stagnation which has not been overcome until today.

In a deflation, investment is hampered. Which company will buy a machine today when it expects that a competitor can get the same machine in one year much cheaper? A wage cut does not only make it harder for households to pay back mortgages or other debt, it also reduces consumption. But the main point is that deflation increases the real debt burden. Nominal debt services do not decrease but revenues do. The outcomes are widespread financial problems, stagnation or even cumulative shrinking of the economy.

Liquidity shortages and high debt: Recessions almost automatically lead to liquidity problems in the private sector. When revenues shrink because of less demand for goods and services, many firms are not able to service their debt, pay their suppliers or pay wages. Following the logic of markets, financial institutions will stop giving credit to such units as they do not want to throw good money after bad. The fear that new credits cannot be paid back leads to strict credit rationing. In such a situation, the central bank has to take over the function of a lender of last resort. It has to finance economic units’ liquidity needs. Without a comprehensive intervention of central banks, the financial crisis of 2007/08 and the following Great Recession would have led to the same disaster as the Great Depression in the 1930s. Nowadays, the need for a lender of last resort, at least for the domestic financial system, is widely accepted.

One of the key problems of severe recessions is that they inevitably lead to high stocks of debt which choke recovery. High stocks of debt, combined with debtors’ problems in fulfilling their debt-service, block credit expansion and GDP growth. Traditional monetary policy does not work in such a situation, as low refinancing rates for banks will not stimulate credit expansion. Needed in such a situation is a cleaning of balance sheets in the form of solving the non-performing loan problem and policies to reduce the debt burden.

There is a national and international dimension to the problem. The accumulation of high domestic debt, which is usually in domestic currency, can become a heavy burden, but it can, at least theoretically, be solved by national policies - for example
by nationalising over-indebted financial institutions, as during the Great Recession. More complicated is international debt. Severe world recessions lead almost automatically to massive capital flight from countries with weak currencies to hegemonic capitalist states which issue the world’s leading currencies. Big and small wealth owners in the former follow their asset protecting strategy and try to hold wealth in world-dominating currencies such as, today, the US dollar or the Euro. At the same time, international capital flows dry up for countries whose currencies are already weak. In such a constellation it becomes extremely difficult or impossible for countries with weak currencies to service or restructure their foreign debt, which is almost always denominated in foreign currency. To make matters worse, exchange rates of these countries collapse. This triggers a disastrous real debt effect as, for domestic agents in these countries, it becomes more difficult to service their foreign debt. This exchange-rate driven real-debt effect is much faster and more violent than deflation as exchange rates can move much faster than wages and price levels. Looking at the present situation of the world economy, most emerging and developing countries suffer from the described effects.

Charles Kindleberger, a famous historian, stressed that the Great Depression could only become so deep because a) there was no international lender of last resort and this means that there were no institutions and no cooperation to help countries with external problems; b) there was no anti-cyclical, politically driven capital flow from countries with no external problems to countries with severe external problems; c) countries with no external problems followed protectionist policies to stimulate their employment and reduced their imports.

**Lack of demand - need for stimulation:** During severe recessions, fiscal stimulation and demand stabilisation by governments is needed. There are many cases which show that fiscal austerity in recessions does not work – from fiscal austerity by US President Hoover (1929-1933) or German Chancellor Brüning (1930-1932), through the Latin American crisis in the 1980s to austerity in Greece after 2010.

But the problem is more fundamental. Besides high stocks of debt, a high level of uncertainty and pessimistic expectations can lead to long term stagnation which keeps countries on a path of low growth and high unemployment. In 1936, John Maynard Keynes, having the Great Depression in mind, argued that only a socialisation of investment, meaning a big public sector with high investment plus non-profit oriented institutions such as housing cooperatives, could stabilise investment sufficiently to prevent long-term phases of insufficient economic dynamic. In most countries, the Great Depression only could be overcome when preparations for World War II started to dominate the economies.

Lessons for the COVID-19 Recession

The COVID-19 Recession has the potential for a severe world recession with long term stagnation with disastrous economic and social effects and unpredictable political outcomes. Especially the escalation and duration of the crisis in a large number of emerging and developing countries can create fundamental problems for the affected countries and the world economy as a whole. To overcome the danger, not only short term liquidity help in the framework of an international lender of last resort is needed, but also cancelation of foreign debt of countries which become over-indebted. But also debt stocks in developed countries will explode and can hamper recovery of the private sector. Also this debt problem has to be solved to pave the way for new sustainable development.

A strong and long term stabilisation of demand is needed. The best option seems to be a long-term-oriented global Green Deal with massive public and private investment to support the ecological transformation. Wage increases according to productivity growth trends of the last decade plus a low inflation rate (this can be the target inflation rate of central banks) is essential to prevent breaking the nominal wage anchor.

History shows that good and bad policies decide how deep recessions become and when they can be overcome. Policies needed seem to be clear: defend the nominal wage anchor, establish national and international lenders of last resort, clean non-performing loans quickly from balance sheets, reduce debt burdens, and implement a huge long-term-oriented stimulation program in the framework of a Green Deal.

However, many of the positive policies needed have massive distributional effects. For example, if massive debt is cancelled, somebody has to pay – the tax payer in the form of increasing the value-added tax or via a property tax, all or only rich depositors in banks, and so on. To implement rational and needed policies these distributional conflicts have to be overcome as part of a vision of how societies should develop.

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