

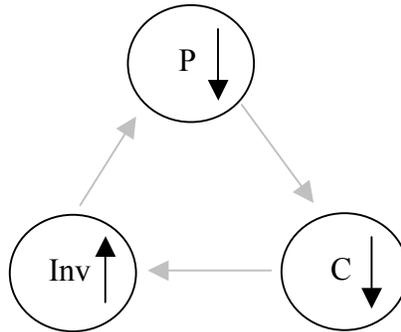
The Great Depression

In this case we saw how the fall in asset prices and consumer prices can be devastating for an economy. Indeed, most of the recessions that are accompanied by deflation have this characteristic. USA in the 1930's, Japan in the 1990's and Argentina now are only some of the examples we will see where this mechanism is at work.

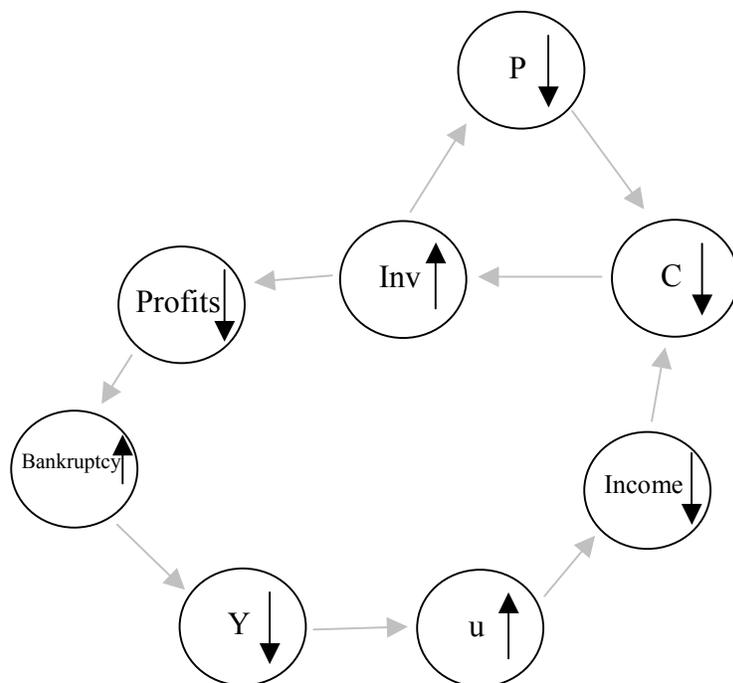
Let me go over the deflationary mechanism instead of summarizing the specifics of the case. You should take a look at the handout of the babysitter cooperative (The Multiplier) because a lot of the intuition is there too.

The first channel is the one that comes from the standard multiplier. A drop in prices delays consumption that increases inventories. In the end, the firms are forced to sell their stock at a lower price, further reducing prices.

Note that if consumers get depressed and think there is a chance that prices might fall, then consumption is delayed and prices drop, confirming the consumer's fears. In other words, this is a multiple equilibrium model. If consumers are excited, consumption is high and there are incentives for consumption to remain high. If consumers are depressed, consumption is low, and there are incentives to keep it low.



This is not the end of the story given that if the drop in prices persists, then firms have lower profits, bankruptcy goes up. Therefore, output falls and unemployment increases.

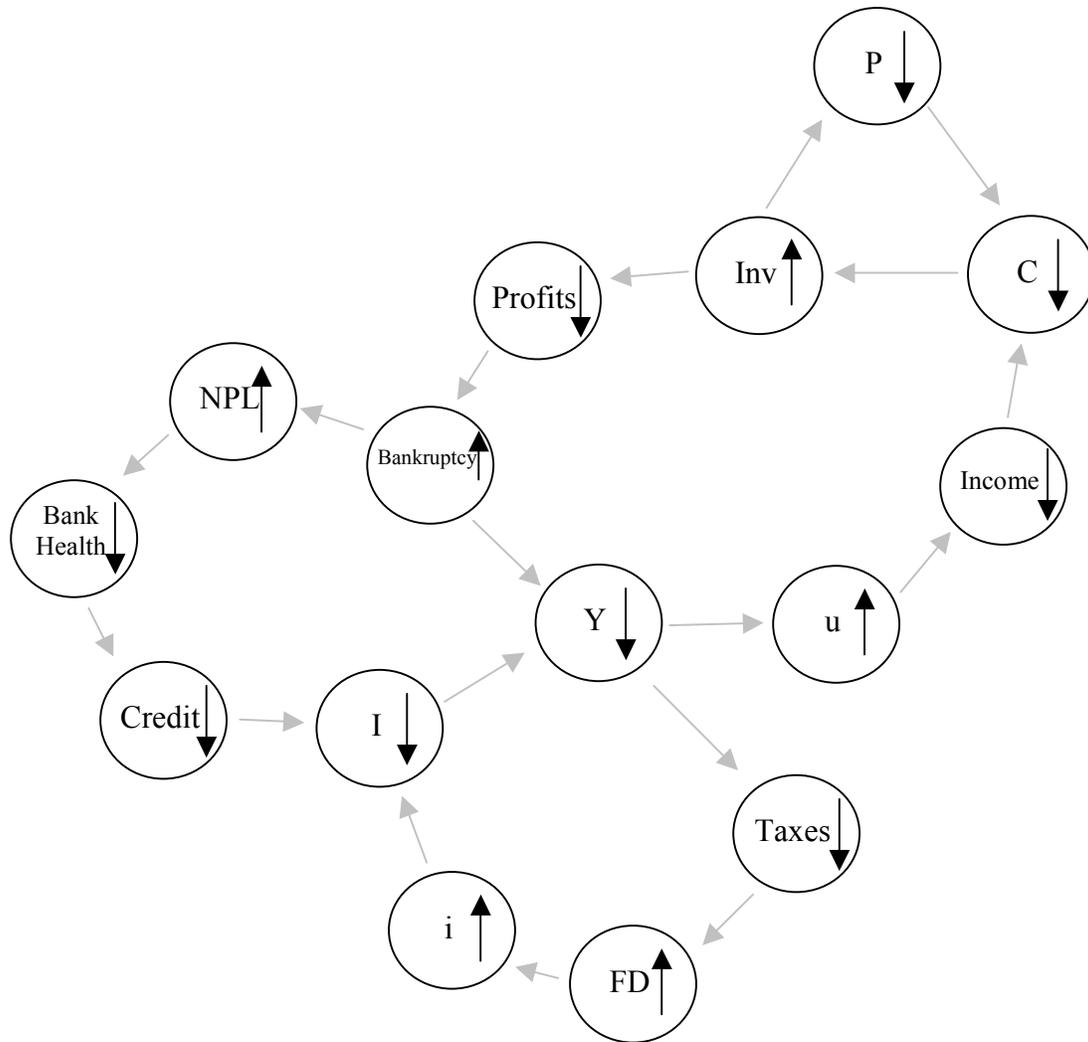


As can be seen, here we also have all the mechanisms in the economy reinforcing them self. The drop in consumption makes output to go down, which reduces income, which further reduces consumption. This is the same mechanism we derived in the babysitter cooperative.

Note that the vicious cycle can start with a drop in prices (deflation), or a change in the mood of consumers (consumer confidence, or political crisis), or a drop in output (a natural disaster), or an increase in bankruptcy (change in accounting standards), or a reduction in income (an unnecessary increase in taxes). It really doesn't matter who starts the cycle, there is very little stopping it.

This mechanism also implies that the fiscal accounts and the health in the banking sector are going to be deteriorated.

The story through the banking sector goes something like this. Bankruptcy goes up which implies that measures of performance in the banking sector deteriorate: specifically, Non-Performing-Loans goes up. The banks have credit risk and therefore the health of their portfolio deteriorates. In the end, credit is reduced and overall investment in the economy falls. This, further, implies that there is a drop in output, which creates more bankruptcy, and the cycle starts all over again. Indeed, the vicious cycle works to exacerbate the crisis.

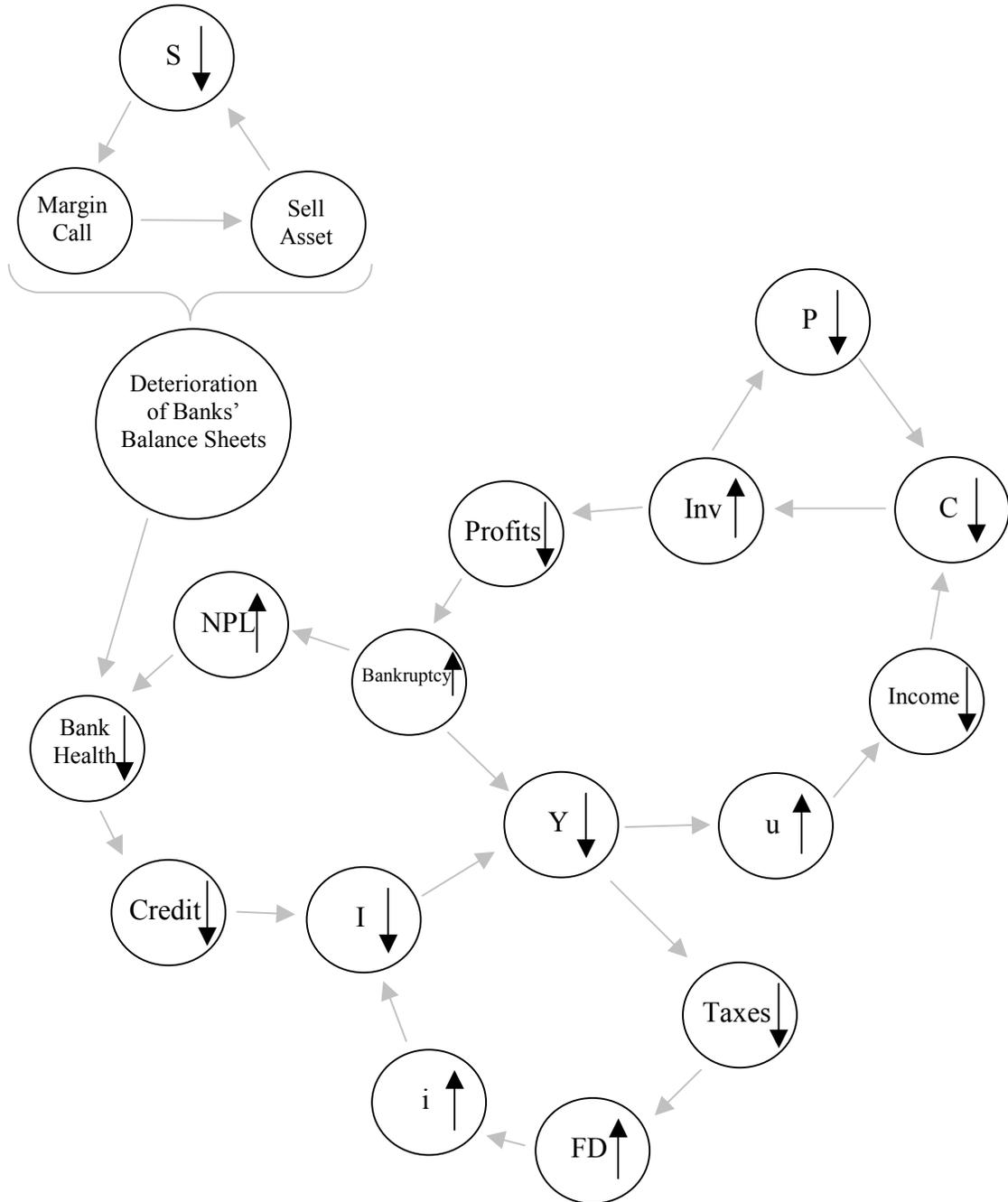


The story through the fiscal accounts is that a drop in output reduces the tax collection (and also increases the expenditures associated with the recession and the unemployment). Both effects deteriorate the fiscal deficit. The increase in government financing increases the interest rate, which further reduces the investment and the output.

Again, note that the crisis can be triggered by any of the variables we are modeling. It can start with a fiscal problem (a Brazilian, sorry I meant an irresponsible government), it can start in the banking sector (reducing credit), or it can start with any of the triggers we discussed before.

Finally, you can have exactly the same vicious cycle starting from an asset price fall. In this case a drop in asset prices creates a loss in wealth in market participants. They are forced, therefore, to sell part of their portfolio, depressing prices in the market even further.

If part of those assets are held by the financial sector. Then, the banks experience losses, credit is lowered, and investment drops. Once output has fallen, all the shocks are spread through out the whole economy.



Imagine that we want to compare several economies by looking at the following indicators: output growth, unemployment, investment, consumption, fiscal deficit, health of the financial sector (NPL), credit expansion, interest rates, consumer prices, and stock market prices.

In this description of the economy, once something goes busted, the rest is a consequence. If the economy has this type of recession, then the day output is not growing, unemployment is high, investment has disappeared, consumption is delayed, fiscal deficits are large, the banking sector is weak, there is no credit to new firms, and the prices of both consumers and stock markets are falling.

This is the typical outlook of a recession in developed markets.

Again, what can trigger it? Anything! It can be consumer confidence reducing consumption first. It can be an asset price bubble going burst. It can be a worse investment environment. It can be bad luck and output loss. It can be bad monetary policy increasing unnecessarily the interest rate. It can be anything. In the end, they all look the same.