VoxEU: a tale of three depressions

The Covid-19 pandemic caused a catastrophic collapse in the world economy. This column analyses the path of this decline and compares it to two other major global crises: the Great Depression in the 1930s and the Great Recession following the banking crisis of 2007-2008, **writes Paul De Grauwe and Yuemei Ji for VoxEU here.**

Different shocks with different policy responses

During the Great Depression, both the monetary and fiscal authorities conducted restrictive policies (Friedman and Schwartz 1963, Eichengreen and O'Rourke 2010).

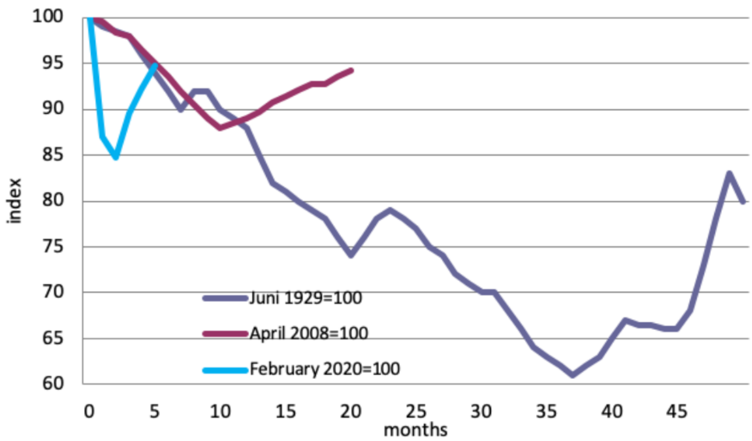
These ill-conceived policies had the effect of intensifying and prolonging the downturn in production and transforming this into a Great Depression. By 2008 policymakers had learned their lessons from history and reacted by monetary and fiscal stimuli. As a result, the economic downturn that initially had all the ingredients of becoming a Great Depression was cut short. How different is the economic shock produced by the Covid-19 pandemic that shook the world at the start of 2020?

It was very different compared to the shock caused by the financial crisis of 2007-2008 and the Great Depression in the 1930s.

A key chart from the article:

The contrast between the aftermath of the Covid-19 shock and those of the two banking crises is strong, in two ways.

Figure 2 Index of world industrial production: Great Depression, Great Recession, and COVID-19



Source: Eichengreen and O'Rourke (2010); Eurostat for EU 2020, Federal Reserve for US 2020, and OECD for China 2020. The February 2020 line relates to the aggregate industrial production of China, the US, and EU. Note that for in the case of China the starting po

First, the intensity of the downward movement after the eruption of the coronavirus pandemic is much greater and faster than that of the Great Depression and of the banking crisis of 2008. The reason is that the pandemic produced both a supply and a demand shock. The supply shock arose from interruptions of supply chains that forced many companies to halt production (Inoue and Todo 2019). This supply shock, in turn, produced major demand shocks: consumers could not get to the shops, workers saw their revenues decline, and animal spirits set in that induced consumers and firms to postpone consumption and investment (Baldwin and Weder di Mauro 2020).

These supply and demand shocks interacted and amplified each other, leading to a swift deflationary spiral that was much faster than the downward spirals after the banking crises of 1929 and 2008. The latter triggered negative demand shocks but did not lead to supply disruptions.

A second difference has to do with the revival observed after the coronavirus shock. We see that once the lockdowns were eased, industrial production rebounded strongly. This revival was made possible by the fact that most governments responded in the right way. They made sure that companies were given financial support and that workers who were at risk of losing their jobs were not dismissed. In Europe, governments simply took over (part of) their wages. This ensured that those employees retained their purchasing power and could therefore continue to buy goods and services and that firms were not driven into bankruptcy. In the US, government spending – including unemployment benefits – expanded massively.

Governments supported their economies so that these were kept alive, making it possible to rebound relatively easily when the lockdowns were lifted.

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