Recession, Hyperinflation, and Stagflation: Crash Course Econ #13

Crash Course: Economics
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[Jacob] I'm Jacob Clifford.

[Adriene] And I'm Adriene Hill.

[Jacob] And today, finally, Crash Course, is gonna live up to its name. We're gonna talk about crashes - economic crashes.

[Adriene] Crash Course - we've been waiting for this!

[Crash Course theme music playing]

[Adriene] In Germany in 1923, people were doing strange things like using money to wallpaper their houses and burning money for heat. What was going on? Had they all gone crazy?

Nope! In the early 1920's, Germany was in the grip of something called hyperinflation. In order to pay massive reparations to the Allies after World War I, Germany printed a lot of their currency - the Mark.

One result of all this additional money was higher and higher prices. By November 1923, it took a trillion marks to buy one U.S. dollar.

There were one thousand billion mark notes in circulation. The mark was effectively meaningless.

A similar situation developed in Zimbabwe a few years ago. Starting in 2007, inflation grew rapidly, like really really rapidly. By September 2008, the International Monetary Fund estimated the annual inflation rate at 489 billion percent.

In practical terms, the Zimbabwean dollar lost 99.9% of its value between 2007 and 2008. It's hard to even imagine what that looks like. Prices nearly doubled every 24 hours and businesses revised prices several times a day.

In June 2008, *The Economic Times* reported, "A loaf of bread now cost what 12 new cards did a decade ago."

The government issued currency in huge denominations to keep up with rising prices. The million dollar bill, the billion dollar bill, and finally in 2009, the hundred trillion dollar bill - the largest denomination of currency ever issued.

The good news was that everyone was a billionaire. But the bad news was that those dollars were virtually worthless.

[Jacob] One definition of hyperinflation is when a country experiences a monthly inflation rate of over 50% or around 13,000% annual inflation.

But believe it or not, Zimbabwe's recent inflation isn't unique, and it's not the worst inflation in history.

In fact the worst was in Hungary in 1946. Between July 1945 and August 1946, the price level in Hungary rose by a factor of three times ten to the twenty-fifth. And yes, any time you have to express your inflation rate using scientific notation, that's a bad thing.

Besides the obvious confusion over what prices to charge for things, why is hyperinflation so bad?

Well inflation, and especially hyperinflation, erodes wealth. In Zimbabwe, people who had worked their whole lives and saved up for retirement, saw their savings just wiped out.

Extreme inflation also forces people to spend as quickly as possible rather than save or lend, so there is no money available to fund new businesses. And all that uncertainty limits foreign investment and trade.

So, hyperinflation is bad. But how does it happen? Let's go to the Thought Bubble.

[Adriene] So, we're simplifying this stuff a lot. But the root of the problem in both Weimar Germany and Zimbabwe was that the government was paying their bills by printing new money.

An increase in the money supply can have two effects. It can increase output or increase prices or some combination of the two. Inflation starts when output is pushed to capacity and can't rise much further, but policy makers continue to increase the money supply.

In theory, once output is maximized, the more money you print, the more inflation you'll get. Simple, right?

Well, that doesn't fully explain why Germany's or Zimbabwe's inflation rose exponentially. Was the government really printing that much money? Not exactly.

After a couple years of doubling prices, people started to expect high inflation, and that changed their behavior. Say you're planning to buy a new refrigerator, and you expect prices to rise quickly. You buy it as soon as possible before the price has had a chance to change. But with everyone following that logic, dollars start to circulate faster and faster and faster.

Economists called the number of times a dollar is spent per year the velocity of money. When people spend their money as quickly as they get it, that increases velocity, which pushes inflation up even faster.

You get a vicious cycle of higher prices, which lead to expectations of higher prices, which lead to higher prices.

The hyperinflation in Germany ended when the government replaced the worthless mark with a new currency. Zimbabwe ended its hyperinflation by abandoning its currency altogether. Now, its citizens use U.S. dollars or currencies from neighboring countries.

The good news is that prices have since stabilized and real GDP has begun to increase.

[Jacob] Thanks Thought Bubble.

So, if you ever control a national economy, try to avoid hyperinflation. You might also want to stay away from depressions.

A depression is kind of a hard thing to define, but basically it's when real GP falls and keeps falling for a long period of time. This has all sorts of terrible effects like high unemployment and falling prices.

Before the 1930's, economists use the term depression to describe sustained falls in GDP. But after The Great Depression, economists started using the word recession for downturns to avoid association with the 1930's.

I guess calling it a depression was just too depressing.

When the stock market crashed in 1929, it didn't just cause problems for stock brokers. Everyone freaked out and stopped spending, and the economy ground to a halt.

Of course, that's not the only reason for The Great Depression. Actually, there's still a lot of debate about the causes.

Anyway, when economies fall into deep recessions, there are more workers than there are jobs and more output than consumers want to buy. So both income and prices fall.

Central banks can try to use Expansionary Monetary Policy to speed up the economy. So for example, in the U.S. The Federal Reserve can lower interest rates. This encourages consumers and businesses to take out loans, and hopefully, get the economy going again.

But if people start changing their expectations and anticipate further price declines, they'll change their behavior in ways that work against the central bank.

Like, if you're planning to buy a refrigerator and you expect prices to fall, you're gonna wait to get a lower price. But, if everyone follows that same logic, then spending declines and so does the velocity of money.

That leads to further price declines and a vicious cycle of falling prices, which leads to expectations of lower prices, which actually leads to lower prices. It also leads to layoffs at the refrigerator factory and so on and so on and so on.

This is called a liquidity trap and some economists believe it's a worsening factor in economic downturns including The Great Depression.

[Adriene] Speaking of The Great Depression, after the initial crash of 1929, The Federal Reserve dropped interest rates to zero, output and prices fell, and regular people started to expect further price declines. Unemployment rose to 25%, and the average family income dropped by around 40%.

This is...not great. Once interest rates hit zero, and prices were still falling, the central bank was in a bind. Continuing deflation meant that borrowing money was a bad deal, even with no interest.

The money you pay back in the future would have more buying power than the money you originally borrowed. This discouraged people from buying homes or cars and discouraged businesses from borrowing to expand capacity.

In fact, getting out of The Depression took nearly a decade. And it wasn't really monetary policy that put an end to it. It was the massive government spending of World War II.

Okay, you don't want hyperinflation. You don't want depressions. You also don't want stagflation. That's when output slows down or stops or stagnates at the same time that prices rise. So, stagnant economy plus inflation equals stagflation.

Get it? It's a portmanteau.

[Jacob] The U.S. experienced stagflation starting in the 1970's, after a series of supply shocks including a rise in oil prices and, believe it or not, a die-off of Peruvian anchovies, which were important for animal feed and fertilizers. This combination of events meant the economy couldn't produce as much.

The Fed tried to address this by boosting the money supply and cutting interest rates, but output couldn't rise much because of low productivity and the oil shortage. So, all that extra money just triggered inflation.

It got even worse when people began to adjust their inflation expectations. Businesses started to expect costs to rise even further, so they laid off workers, and that put the economy back into a recession.

When The Fed boosted the money supply again, that raised inflation expectations even more. This ended in the early 80's when a new Federal Reserve Chairman took over. His name was Paul Volcker. He actually cut the money supply and raised interest rates dramatically.

Output plummeted, and unemployment reached ten percent, but prices stopped rising and so did inflation expectations.

The economy gradually recovered, and Paul Volcker got the credit for ending stagflation.

So hyperinflation, deflation, depression, stagflation - they're all extreme economic circumstances, but these extremes show us why it's so important to measure and understand the overall economy.

In some cases, government action or inaction made things worse. And in other cases, the government helped the economy get back on its feet.

It's important to keep in mind that the economy is made up of collective decisions of individuals. It's people like us, our expectations matter. If enough people fear a recession, they're gonna decrease their spending, and that's gonna cause a recession.

[Adriene] Next week, we're gonna look at different economic schools of thought. But regardless of philosophy, policies designed to steer the economy need to address expectations and focus on creating confidence.

[Jacob] Thanks for watching. We'll see you next week.

[Crash Course theme music playing]

[Jacob] Thanks for watching Crash Course Economics. It's made with the help of all these awesome people.

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We'd also like to thank our High Chancellor of Learning, Dr. Brett Henderson and our Headmaster of Learning, Linea Boyev. Also, our Crash Course Vice Principals, Cathy and Tim Phillip.

Thanks for watching! DFTBA