The narrative structure of global weakening
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Recent indications of a weakening global economy have led many people to wonder how pervasive poor economic performance will be in the coming years. Are we facing a long global slump, or possibly even a depression?

A fundamental problem in forecasting nowadays is that the ultimate causes of the slowdown are really psychological and sociological, and relate to fluctuating confidence and changing "animal spirits," about which George Akerlof and I have written. We argue that such shifts reflect changing stories, epidemics of new narratives, and associated views of the world, which are difficult to quantify.

In fact, most professional economists do not seem overly glum about the global economy's prospects. For example, on September 6, the OECD issued an interim assessment on the near-term global outlook, written by Pier Carlo Padoan, that blandly reports "significant risks" on the horizon – the language of uncertainty itself.

The problem is that the statistical models that comprise economists' toolkit are best applied in normal times, so economists naturally like to describe the situation as normal. If the current slowdown is typical of other slowdowns in recent decades, then we can predict the same kind of recovery.

For example, in a paper presented last spring at the Brookings Institution in Washington, DC, James Stock of Harvard University and Mark Watson of Princeton University unveiled a new "dynamic factor model," estimated using data from 1959 to 2011. Having thus excluded the Great Depression, they claimed that the recent slowdown in the United States is basically no different from other recent slowdowns, except larger.

Their model reduces the sources of all recessions to just six shocks – "oil, monetary policy, productivity, uncertainty, liquidity/financial risk, and fiscal policy" – and explains most of the post-2007 downturn in terms of just two of these factors: "uncertainty" and "liquidity/financial risk." But, even if we accept that conclusion, we are left to wonder what caused large shocks to "uncertainty" and to "liquidity/financial risk" in recent years, and how reliably such shocks can be predicted.

When one considers the evidence about external economic shocks over the past year or two, what emerges are stories whose precise significance is unknowable. We only know that most of us have heard them many times.

Foremost among those stories is the European financial crisis, which is talked about everywhere around the globe. The OECD's interim assessment called it "the most important risk for the global economy." That may seem unlikely: Why should the European crisis be so important elsewhere?

Part of the reason, of course, is the rise of global trade and financial markets. But connections between countries do not occur solely through the direct impact of market prices. Interacting public psychology is likely to play a role as well.
This brings us to the importance of stories – and very far from the kind of statistical analysis exemplified by Stock and Watson. Psychologists have stressed that there is a narrative basis to human thinking: people remember – and are motivated by – stories, particularly human-interest stories about real people. Popular stories tend to take on moral dimensions, leading people to imagine that bad outcomes reflect some kind of loss of moral resolve.

The European crisis began with a Greek meltdown story, and it appears that the entire global economy is threatened by events in a country of only 11 million people. But the economic importance of stories bears no close relation to their monetary value (which can be measured only after the fact, if at all). It depends, instead, on their story value.

The Greek crisis story began in 2008 with reports of widespread protests and strikes when the government proposed raising the retirement age to address a pension funding shortfall. Reports began to appear in global news media portraying an excessive sense of entitlement, with Greeks taking to the streets in protest, even though the increase was modest (for example, women with children or in hazardous jobs would be able to retire with full benefits at just 55, up from 50).

That story might have invited some gossip outside of Greece, but it gained little purchase on international attention until the end of 2009, when the market for Greek debt started to become increasingly unsettled, with rising interest rates causing further problems for the government. This augmented news reports about Greek profligacy, and thus closed a negative feedback loop by attracting intensifying public interest, which eventually fueled crises in other European countries. Like a YouTube video, the Greek story went viral.

One might object that most people outside of Europe surely were not following the European crisis closely, and the least informed have not even heard of it. But opinion leaders, and friends and relatives of the least informed in each country, were following it, and their influence can create an atmosphere that makes everyone less willing to spend.

The Greek story seems connected in many people's minds with the stories of the real-estate and stock-market bubbles that preceded the current crisis in 2007. These asset bubbles were inflated by lax lending standards and an excessive willingness to borrow, which seemed similar to the Greek government's willingness to take on debt to pay lavish pensions. Thus, people saw the Greek crisis not just as a metaphor, but also as a morality tale. The natural consequence was to support government austerity programs, which can only make the situation worse.

The European story is with us now, all over the world, so vivid that, even if the euro crisis appears to be resolved satisfactorily, it will not be forgotten until some new story diverts public attention. Then as now, we will not be able to understand the world economic outlook fully without considering the story on people's minds.

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