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Bad News in the Great Depression, the Great Recession, and Other U.S. Recessions: A Comparative Study^{☆,☆☆}

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Abstract

In economic recessions consumption usually drops in tandem with other aggregate quantities as output or employment. Following the permanent income hypothesis, these drops can be rationalized by the idea that consumers have pessimistic views about their long-run income. Using a standard signal-extraction model, we show that this pessimism can be due either to a persistent fall of aggregate productivity before and during the recession (signaling a future decline of income), or to other negative information *unrelated* to contemporaneous fundamentals, which we label “bad news”. We classify U.S. recessions (from 1919 to 2015) according to a (bad) news index reflecting this negative information. We find that *both* the Great Depression and the Great Recession score highest in this index. The index is such that we can rule out that this is due merely to the length or the depth of these recessions. Instead, these two recessions are similar in that both were aggravated by a wave of pessimism about future income which cannot be related to contemporaneous fundamentals.

Keywords: pessimism, beliefs, permanent income hypothesis, news and noise

JEL Classification Codes: E20, E32

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