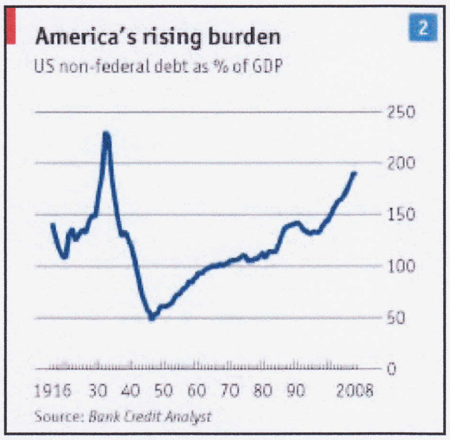
A Time of Reckoning

or what does the current financial crisis and the Great Depression have in common?

by IMCZ Treasurer John Henry Smith

Using more stringent criteria than two consecutive quarters of falling GDP, America's National Bureau of Economic Research (NBER) declared that the USA was in recession from December 2007. However, recessions are predicated on a period of tight monetary policy. In terms of severity, the Fed's tightening process could not in itself be the core cause of the current economic decline. From its low of 0.98% in December 2003, the Fed Funds rate rose to its peak of 5.25% between June 2006 and August 2007 before falling back to its current level of 0.00 to 0.25%. This contrasts starkly with a Fed Funds rate of over 18% in the 1981/2 recession that lasted 16 months and produced an unemployment level of 10.8%!



If this slump does not fit the standard definition of a recession, then what kind of economic turndown is it? Dare I mention the 'D' word? Unlike the 'R' word, there is no widely accepted definition of the term 'Depression' and begs the question: just how severe does an economic crisis have to go before the 'D' label can be attached to it? Recently, the chief economist of ANZ bank, Saul Eslake, claimed that the difference between a recession and a depression is not just simply one of size and duration, but must take account of causes, hypothesizing that an economic depression is the result of the bursting of an asset and credit bubble, the contraction of credit, and a decline in the general price level. Does this ring any bells?

Although we are not yet able to assess with certainty the depth and breadth of today's economic freefall, since the bottom has not been reached yet, direct comparisons to the Great Depression have become more vocal, given the collapse of the housing, credit and stock markets, as well as a sharp contraction of consumer spending as evidenced by the near bankruptcy of the U.S. auto industry. Nearly 2.6 million jobs were lost in 2008, with 1.9 million destroyed in just the past four months. At the current unemployment rate of 7.8%, it is the biggest job loss since 1945, when 2.75 million jobs disintegrated as the wartime economy demobilized.

In a stunning echo from 1933, the U.S. economist, Irving Fisher described debt-deflation as a sequence of distress-selling, falling asset prices, falling monetary velocity, declining net worth, rising bankruptcies, bank runs, curtailment of credit, dumping of assets by banks, growing distrust and hoarding. Does this ring any bells?

Today, debt in America, excluding financial institutions and the federal government, is about 190% of GDP, the highest since the 1930s as this chart[1] shows. Shortly after his inauguration, Barack Obama gave a warning that the USA was at risk of falling into a deflationary spiral that could increase the country's massive debt even further[2]. Comparisons are compelling. For example, debt was lower at the start of the Depression at 164% of GDP, and mortgage debt was modest relative to home values with prices not being notably bloated, falling 24% between 1929 and 1933, whereas since their 2006 peak[3] inflation-adjusted home prices have fallen 27% so far with no sign of bottoming out. In the Depression years, debt burdens shot up because of deflation and shrinking output as nominal GDP fell by 46% between 1929 and 1933. One definition of a depression is a decline in GDP that exceeds 10%. Of course America's GDP has not slid to this disastrous level (yet), experiencing negative growth in the last two quarters of 2008 of -0.3% and -3.8% respectively. Most economists however dismiss the likelihood of a depression. However these reassurances come from many of the same economists who said that a nationwide fall in American house prices was impossible and that financial innovation had made the financial system more resilient. Hopefully, they will be right this time. However, Irving Fisher proclaimed in October 1929 that stocks had reached a permanently high plateau just before the stock market crashed, whereby he lost his $10 million fortune!

Comments of Hildsenrath in video.

Comparing the figures between the Great Depression, it is obvious that the current crisis is not of the same magnitude, but the drivers are very similar.

The US Great Depression 1929 -1933

High leverage: buying on margin, using personal savings and real estate as collateral
Falling assets prices: stock market, autos, real-estate
Fall of GDP: nearly 33%
High unemployment: 25% or 13 million people
Bank failures: In the first 10 months of 1930 744 banks failed - 10 times as many
The U.S. was on the gold standard
Foreclosures:

The Economic Crisis of 2008 - 2009

The economic downfall has not yet bottomed out
High leverage: Personal credit, real-estate, securitization; stock market
Falling asset prices: stock market, real-estate, oil, autos
Banking crisis: credit market illiquidity, especially in the inter-bank market
High unemployment: Now at 7.8%. Could go to 10% to 11%?
Energy prices: Drop from $147 per barrel, but crude oil target of $70 a barrel by OPEC
Food crises:
GDP: Where does that leave us today? America's GDP may have fallen by an annualized 6% in the fourth quarter of 2008
Bank failures:
Failure of the Rating Agencies

Final words

"The worst is not, so long as we can say, 'This is the worst!'"

The euphoria of the housing market bubble can be compared to the euphoria of the stock market in the 1929 crash that led to the Great Depression.

Each economic crisis is different, but the central cause is leverage that brings growth, but generates destructive greed, which in Oliver Stone's film "Wall Street", Gordon Gecko proclaims, "Greed is good!". Recessions end when the drive for profit/survival is greater than the fear of loss!

A depression, suggests Mr Eslake, does not have to be "Great" in the 1930s sense. On his definition, depressions, like recessions, can be mild or severe.

As the underlying collateral declines in value and incomes shrink, the real burden of debt rises. Debts go bad, weakening banks, forcing asset sales and driving prices down further. Fisher showed how such a spiral could turn mere busts into depressions.

1 Issued by the Bank Credit Analyst, a financial research journal
2 *Out of the Keynes's shadow* published in The Economist February 14 - 20 2009
3 SAP/Case-Schiller U.S. National Home Price Index, Bureau of Labor Statistics