Compare/Contrast

The Great Depression and Current Financial Markets

By Nick Paterakos, CIMA®

The financial panics of October 2008 and March 2009 have subsided and world markets have rebounded. Some of the global economy’s fundamentals have continued to deteriorate while some leading indicators are turning up. Though the short-term picture has brightened, the possibility of a worldwide depression lingers. Does our future hold additional and severe, long-lasting, life-changing financial conditions?

To examine that question, I’ve looked to the 1930s and other recognized depressions for clues. In this paper I consider data as well as intangibles that may help in a comparative analysis of the Great Depression and current events.

A depression is a contraction in economic activity of 20–25 percent that lasts several years. The Great Depression was the most severe in our nation’s history. It started after the market crash in late 1929 and lasted until 1938. In depressions of the 1870s and 1890s, gross domestic product (GDP) returned to its original level in five years; recovery from the Great Depression took almost 10 years.

But economic depressions are so rare that data describing their preconditions are scarce. Today’s economy and overall accumulated wealth—individual and national—are dramatically different from the 1930s, possibly muting the validity of comparing the situation we’re living in to the Great Depression.

This comparison, however, still has value, even if it only illuminates the similarities and the differences between now and then. So what follows is a comparison, categorized by the characteristics and impacts of, as well as responses to, depressions.

This current contraction will be labeled definitively only after it has passed. But for now, comparing historical events and data may help us understand what is happening in the interim and provide timely advice and reassurance for our clients.

Debt Collapse and Economic Shock

Many recessions are the result of inventory correction or some other economic dislocation. The Great Depression and the current decline, however, were set off by a sudden collapse in asset prices against a backdrop of high debt levels. Indeed, this is perhaps the strongest similarity between our current situation and the Great Depression. In both the Great Depression and today’s decline, sudden loss of wealth reversed a long period of rapidly increasing prosperity and triggered a cycle of asset destruction.

The shock that began the Great Depression was the stock market crash, which resulted from overborrowing; during the 1920s leverage rates of up to 90 percent debt were not uncommon.1

The recent dramatic leveraging of housing was similar to the leveraging of stocks in the late 1920s. The latest asset boom, especially in real estate, was conspicuous because it didn’t result from greater incomes or demand; it resulted from credit-induced excess liquidity.

We’re now experiencing the deleveraging of the inflation in housing prices that grew over 20 years or more.

Figure 1 shows that today’s debt level as a percentage of income is above that of the 1930s.2 Debt as a percentage of GDP reached almost three times disposable income at the onset of the Great Depression, and surpassed that in the past few years.

How will the reduction of this debt play out? It could take place all at once but more likely it will take place over an extended period of increased savings. In any case, savings will rise to meet debt. The nation has gone from negative savings to a 5-percent savings rate in a matter of months, and this response likely will continue.

The downturn also may make consumers less amenable to taking on future debt. Harry Dent, Jr., in his latest book, The Great Depression Ahead, believes this shakeout or depression largely will revolve around restructuring the debt of the banking system, companies, and the U.S. government.3

Indeed, maybe the U.S. consumer is financially unable to take on additional debt to sustain spending levels. If this is the case, the question of whether banks are willing to lend becomes moot. Regardless, with asset prices down, a lack of collateral and income should mean a period of slower, lower growth.

Impacts on World Trade

Noteworthy declines in world trade as economies shrink are a trademark of depressions, and some of today’s picture seems to mimic the Great Depression. World trade is collapsing, wealth is evaporating, the banking system is broken, deflation is a growing threat as companies close plants and cut pay and prices, and leaders worldwide are struggling to halt the decline.

Furthermore, the International Monetary Fund reports that for the first time since World War II the United States and other industrial nations are suffering simultaneous economic decline.4

The credit crunch has curbed financing for exporters and importers and led to a

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Market declines are another depression characteristic. Like the Great Depression, the current economic decline is global. Domestically and internationally, all markets have crashed from their highs. Since peaking in October 2007, the Dow Jones Industrial Average (DJIA) has fallen more than 50 percent. Over a similar time period—1929 to 1931—the DJIA average fell 55 percent. It dropped to 89 percent below its 1929 high before beginning to recover in mid-1932.

Relatively speaking, overall economic and balance-sheet losses for the recent decline have been significant and in the ball park of the initial Great Depression declines. Combined with collapsing house prices, the free fall in the stock market will destroy $23 trillion worth of U.S. wealth, according to Lawrence Lindsey, a former senior White House official who now heads his own consulting company in Arlington, VA.

Decline in the Gross Domestic Product

Declines in the GDP are one of the defining characteristics of recessions and depressions.

In March 2009, Harvard economist Robert Barro said he believed that the near term holds roughly a 30-percent chance of a 10-percent decline in GDP and consumption—his definition of a depression. In fact, the economy contracted at a 6.2-percent annual rate in the last quarter of 2008—the worst point to date in the recent decline.

GDP forecasts for 2009 fall mostly in the low-single-digit range. Stimulus and low interest rates are leading to forecasts of slow growth for 2010. Jan Hatzius, chief U.S. economist at Goldman Sachs Group Inc. in New York, predicted a GDP decline of 7 percent in the first three months of 2009; the number came in closer to a 6-percent decline.

During the Great Depression, GDP declined 8.6 percent in 1930, 6.4 percent in 1931, and 13 percent in 1932. These numbers bode well for the current decline, given the extent of wealth destruction that has taken place of late. Wealth destruction, however, is a major determinant of decreased spending. But it’s unlikely that the economy will continue to decline at the rate of the 4th quarter 2008 and 1st quarter 2009. Such a period of stability reduces the chance that we will be reprising the GDP declines of the Great Depression.

Curtailed Lending

The pullback in lending as banks hoarded capital was crippling in the Great Depression, and it has been disabling in the latest downturn. Indeed, the contraction in bank lending is making it hard for Federal Reserve Chairman Ben Bernanke and his fellow policy makers to get much traction with their efforts to stop the economic decline. This type of breakdown happens only two or three times a century, and weaknesses in the economy and the financial industry feed on each other and can lead to a “downward vortex,” said Treasury Secretary Lawrence Summers. Summers also has voiced concern about a return of deflation, which wreaked havoc during the Great Depression. As wages fell back then, workers had a harder time paying debts, thus aggravating banking woes.

Levels of U.S. public debt now are at levels seen in the United States in the 1930s and in Japan in the 1990s. The collapsed lending market is forecasting rising defaults through 2009. The global default rate on speculative-grade debt will peak at 16.4 percent in November, worse than in the Great Depression, according to Moody’s Investors Service.
Unemployment

During the Great Depression, unemployment peaked at an estimated 25 percent and wages (for those who still had jobs) fell 42 percent. Today people are losing jobs at an alarming rate of almost half a million per month.

But determinants of potential layoffs are GDP and corporate earnings, and both are flattening at this time. Though we are at 25-year highs for unemployment, it seems as if the free fall on corporate balance sheets and in business has leveled, making huge future layoffs unlikely.

Impacts on Leading Industries

While we discuss the prospects for an economic depression, some industries could already be there. Housing has led the way, and with little sign of an upturn. While the credit crisis has moderated with better access to capital, housing prices are not necessarily increasing. Residential investment is down 37 percent in the past four years. But that compares favorably with the 80-percent drop in spending on home building that occurred from 1929 to 1932.

The auto industry is in similar straits. U.S. motor vehicle output slumped 75 percent from 1929 to 1932.13 The rate of auto sales dropped by almost half after the October 2008 collapse in equity markets. General Motors and Chrysler needed government loans to temporarily stay afloat, and they ended up in bankruptcy anyway.

The financial services industry also has suffered in the recent decline. Since mid-2007, institutions worldwide have racked up $1.2 trillion in credit losses and write-downs. Announced financial-industry job cuts have topped 280,000 in the United States alone.

Government Response

Government initiatives abound in these situations until the economic decline reaches a bottom, and Washington’s response to the current economic decline reveals its severity. Decisive action has been taken and extraordinary efforts have been made to stabilize the financial industry. But the initial ineffectiveness of these efforts may signal that this most recent decline is different from normal cycles and represents something more severe.

The Great Depression actually was aggravated by the federal government’s poor monetary policy. Instead of pumping money into the economy and increasing the money supply, the Fed allowed the money supply to fall by 30 percent between the end of 1929 and 1933. Government officials now, especially in the United States, are moving more rapidly to deal with the crisis and avoid a similar mistake.

Here’s what happened back then: After the 1929 crash, the Federal Reserve became accommodative. The Fed made funds available to banks so they could continue securities lending. Interest rates moved down quickly, and the discount rate (the rate at which the Fed lends to commercial banks) fell from 6 percent in October 1929 to 2.5 percent in June 1930. In fact, federal policy, protectionist blunders, and bank bankruptcies or panics weren’t of concern as markets continued to tumble in the fall of 1930. The money supply declined only slightly in the next year.

The first large bank failure took place in New York in December 1930. More and larger bank failures ensued. By 1933, 11,000 of the 25,000 banks in the United States had failed. The consequence was sharp decreases in the nation’s money supply and a huge psychological impact on consumers that kept them from spending. And it wasn’t until four years into the Great Depression—1934—that bank deposits finally became guaranteed.

By the time programs were legislated to lift the nation out of the Great Depression, they were generally ineffective. Individual behavior had been changed because of deflation and high savings. The current economic decline started a couple years ago but was not immediately recognized as severe, so the government did not mobilize quickly. However, since the October 2008 market downdraft, the government has responded in dramatic fashion with programs that aid nearly every area of finance and banking with substantial quantities of capital.

In our current decline, large banks went under sooner in the cycle and the Federal Reserve responded quickly by increasing deposit insurance as soon as banks began to fail. Bernanke also cut the benchmark short-term bank lending rates to almost zero. According to the Federal Reserve, money-supply growth accelerated.14 In addition, massive stimulus packages have effectively reduced tension in the credit markets from October 2008 levels. Though stressed, the movement in the credit markets is in the right direction.

Deflation

A long decline in asset prices has been a major characteristic of each U.S. depression, and the 1930s’ deflation, asset destruction, and effect on lifestyle was the worst decline in U.S. history. The current contraction has resulted in asset prices well below their peaks and has significantly reduced purchasing power. The government clearly aims to stimulate growth, however, and the result more likely may be inflation rather than deflation. The thought process is that we believe drastic measures to inflate asset prices will arrest the deflationary cycle. Warren Buffett, chief executive officer of Berkshire Hathaway, said he believes that stimulus efforts may lead to higher inflation than the inflation of the 1970s.15

Taxes and Saving

As the Great Depression progressed, tax increases literally drained spending. In 1929 the top tax rate was 24 percent. By 1932, it was 63 percent, and it reached 79 percent in 1936.

Today it is unlikely that Washington would enact a tax change that would
hinder economic growth. One would expect that tax brackets would not increase. However, we must be aware that increased taxes from states and other sources, all together, might have the same impact. Additional tobacco, gas, and usage taxes will add up. State budget shortfalls may mean higher taxes. However, it is unlikely the overall rate will approach tax levels of the 1930s.

The economy’s continuing current deterioration, however, likely will have enduring impacts. U.S. households already are rebuilding savings in response to the crisis. The savings rate rose to 5 percent in January, the highest in almost 14 years.

**Trajectory**

Current economic statistics versus 1929–30 are remarkably similar. It is clear we have passed the definition of the average recession. Are we heading toward depression? How does the rate of descent compare to other depressions?

The stimulus and the resulting increase in the money supply may change the trajectory of this market cycle. Growth in the money supply and deficit spending may reduce the possibility of deflation. The massive liquidity will have consequences. We know from economic theory that inflation results from an increase in the money supply as production declines or remains unchanged. Is a deflationary depression worse than an inflationary depression? Or does the stimulus create a new set of inflationary problems?

**Conclusion**

The economy will recover, but it may not have the legs of a normal recovery because of the need to raise taxes. The other difficult-to-measure effect is the
cost of money in the future. Currently trillions of dollars are scared to invest in anything but Treasuries. This flight to safety surely is helping the government fund bailout packages. The demand for money will be great for some time to come, but the desire to cheaply lend to the government may end. The velocity of money could increase, inflation may rise, or confidence that the government can repay may change.

Our economy could experience a prolonged period of adjustment, which is more common during periods with high levels of debt, satiated needs, and impaired balance-sheet losses from traumatized markets. The deficits and the adjustment period may signal that the recent U.S. spending path was unsustainable. To regain balance we may need to become more competitive to grow our export economy. If consumers throttle back, balance sheets will improve. Will the global economy grow to allow us to pay down debt? The duration of this downturn will be answered by how quickly we can attain a sustainable balance.

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Endnotes
2 Figure 1 is from Michael Hodges, “American Total Debt,” a chapter of The Grandfather Economic Report, available at http://mwhodges.home.att.net.
9 Miller, ibid.
10 TradeRoots.org, ibid.
11 Miller, ibid.
15 Miller, ibid.