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Five Reasons Why Today is Different From the Great Depression

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With headlines featuring awful economic news and carnage in the securities markets, more and more commentary is drawing comparisons between current market conditions and those that followed the stock market crash of 1929. Perhaps when so many things are going so wrong on so many fronts, it is natural to gravitate toward this most dire historical analogy. After all, there are some similarities between today and the 1930s, including a preceding period of excessive debt, subsequent massive deflation in asset prices, corresponding trauma in the banking and financial system, and a resulting economic slowdown that spread quickly and dramatically throughout the rest of the world.

However, in times of great distress and universal pessimism, it is relatively easy to confuse the possibility of the worst-case scenario with the probability that it will actually occur. So while no one can predict with complete certainty that the next Great Depression will not happen in the near future, it is important to move beyond historical sound bites in making comparisons between 2008 and the worst economic catastrophe in the past 100 years. The following are key differences between the current environment and the early years of the Great Depression (1929-1932), when the economy was at its worst.

KEY TAKEAWAYS

- **There are some similarities between today's financial and economic climate and the Great Depression, but those similarities do not mandate that the world is predestined to follow a path into a decade-long depression.**
- **Moreover, there are clear differences between the current state of the U.S. and global economies and the early 1930s.**
- **The level of bank failures and unemployment, while worsening in recent months, is nowhere near the dire levels seen during the 1930s.**
- **Most importantly, unlike during the early years of the Great Depression, the Federal Reserve and U.S. government have moved aggressively to counter-act deflationary forces with an array of extraordinary actions and stimulative spending.**
- **The dramatic policy responses by central banks and governments around the world in 2008 underscores that we are living today in very different times than the world experienced 80 years ago, and it may serve investors well to take those differences into account.**

1 *Economic Contraction: Not Yet in the Same Neighborhood*

While there is no formal textbook definition of a depression, it can be colloquially summarized as a really bad recession. A common rule of thumb is that a depression is a contraction where the economy shrinks by 10% or more. Depressions occurred relatively frequently in the 19th century, but the worst downturn the United States has experienced since the 1930s was a 3.4% contraction from 1973-1975. During the Great Depression, the economy contracted by an estimated 25%-30% from 1929-1932, a massive loss of output that burdened the economy for more than a decade thereafter.[i] To put the damage into more human terms, unemployment reached an estimated 25%, meaning one in four Americans was out of work.

EXHIBIT 1: Major differences between 2008 and the Great Depression include less severe economic conditions, and more aggressive and robust government and monetary policy responses.

	Great Depression (1929-1932)	Today
Economic Contraction	25% Unemployment	6% Unemployment
Banks	Hundreds of failures No deposit insurance	~20 failures Increased deposit insurance coverage amount
Monetary Policy	Decreased money supply	Massive liquidity injections; rate cuts
Federal Government Policy	Small steps, raised taxes, tariffs	Massive recapitalization of financial system
Global Response	"Beggar thy neighbor" policies raised tariffs and destroyed world trade	"Rush to rescue" policies to aid banking systems

Source: FMRCo (MARE) as of 10/31/08.

As of October 31, 2008, the U.S. unemployment rate was 6.5%.[ii] It has risen nearly two percentage points during the past year, and all indications are that it could go much higher in the months ahead. However, even more bearish economists tend to estimate unemployment to peak somewhere around 10%, which would leave it nowhere near the neighborhood reached in the 1930s. Even if these estimates prove too sanguine, it would likely take a series of unforeseen catastrophes, well beyond the current pessimistic outlook, to achieve such a deep economic contraction. In other words, as bad as things seem right now, they would have to deteriorate at a completely different degree of magnitude to reach the economic devastation of the 1930s.

2 *Banking System: Not Near Collapse*

During the early 1930s, with no deposit insurance to reassure them, nervousness among depositors caused many to withdraw funds from banks. The runs on banks in many cases became self-fulfilling prophecies, as recognition that other depositors may withdraw their funds first became a threat to all. A series of banking panics followed, with hundreds and eventually thousands of banks failing, causing the U.S. financial system to essentially collapse.

Today, the U.S. credit markets are in crisis. Confidence has plunged, and financial institutions are struggling to dispose of troubled assets. However, only 22 banks have failed so far. The federal government raised the level of deposit insurance in October to further guard against any potential seeds of public panic. Financial firms that depended on non-deposit funding, such as independent investment banks, have gone bankrupt, been merged away, or converted themselves to banks. So while the banking system remains in distress, we are not experiencing an all-out banking panic in the vein of the 1930s.

3 *Monetary Policy: Extraordinary Fed Action*

Whether or not you agree with the assertion in Nobel laureate economist Milton Friedman's landmark book, *A Monetary History of the United States, 1867-1960*, that the Great Depression was caused mostly by monetary policy errors, there is plenty of evidence that the Federal Reserve (Fed) in the 1930s was not particularly helpful. As asset prices spiraled downward after the 1929 stock market crash, the Federal Reserve allowed the money supply to decline. Thus the Fed accommodated the deflationary forces that had taken effect, resulting in prices that fell 10 percent per year during the early 1930s.

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In contrast, the current Federal Reserve has embarked on the most ambitious monetary action in its history. Due to the trauma in the financial system, the Fed has been unable to drive market interest rates lower simply by easing its policy interest rate, so it has established multiple facilities and policies to inject liquidity into the financial system. The Fed has doubled its balanced sheet since September, rapidly expanding the money supply. While its efforts to counter deflationary forces remain ongoing, they stand in sharp contrast to the passive role played by monetary authorities in the 1930s.

4 *U.S. Government Policy: Stimulative Prescription*

Some historians assert that Herbert Hoover has received a bum rap, and it is probably true his administration was not as passive in the face of economic calamity as sometimes portrayed. However, the government response before FDR took over in 1933 was simply too scattered and small in scope, given the financial ruin and economic catastrophe it confronted. Some policies proved counterproductive and probably served to worsen the downturn, such as raising tariffs (through the 1930 Smoot-Hawley Tariff Act) and hiking income taxes.

Today, it is not difficult to argue that the U.S. government has already been more forceful in its economic response during the past several months than during the entire three-and-a-half years before the New Deal began in 1933. In an effort to staunch panic in the financial markets, the government took over mortgage giants Fannie Mae and Freddie Mac, in addition to insurance giant AIG. It approved $700 billion to re-capitalize the banking system. It provided $100 billion of tax rebates to consumers, and has rolled out a number of initiatives to help struggling homeowners. There is likely much more to come, as the incoming Obama Administration has signaled its intent to pursue an additional economic stimulus program in the neighborhood of $500 billion. While government intervention of this magnitude raises many challenges about financing the efforts as well as ensuring they do not stifle private sector activity in the long run, it provides an effort to counter plunging private demand that was absent at the outset of the Great Depression.

5 *Global Response: Rush to Rescue*

In the 1930s, the economic devastation spread from the United States—then the world's largest economy as it still is today—to the rest of the globe. On the heels of the disastrous Smoot-Hawley Tariff Act, which placed tariffs on more than 20,000 imported goods of up to 60% of purchase prices, countries around the world responded by raising their own tariffs and shutting out imports from abroad ("beggar thy neighbor" policies). This effectively led to the collapse of global trade.

More recently, such protectionist measures have been few and far between, and they have been overwhelmed by a rush to rescue ailing banks and stimulate weakening economies. Every large European country has injected capital into its banking system and increased government deposit guarantees. Many countries have announced large economic stimulus programs, including China, Japan and Germany, and almost every major economy in the world has cut interest rates. The International Monetary Fund has disbursed billions in rescue financing to countries in crisis. The scope of the global policy response has been massive and shows few signs of slowing.

Investment Implications

The challenges faced today by the global economy and financial system are staggering. For the United States, all economic indicators point to an economic downturn that will at least rival any in the post-war period. However, all historical analogies are imperfect. The world changes too much over periods of decades, particularly economies powered by constantly changing technologies, to find a precise fit for any historical parallel. While there are admittedly some similarities between today's environment and the 1930s, those similarities do not mandate that the world is predestined to follow a path into a decade-long depression. The dramatic response by central banks and governments around the world faces challenges and potential ill side-effects of its own. But this response underscores that we are living today in very different times than the world experienced 80 years ago, and it may serve investors well to take those differences into account. ■

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Past performance is no guarantee of future results.

[i] – Source: "Money, Gold, and the Great Depression," speech on March 2, 2004 by Ben Bernanke at Washington and Lee University, Lexington, VA.
[ii] – Source: Bureau of Labor Statistics, Haver Analytics, FMRCo (MARE) as of 10/31/2008.

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