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A 2008 Recession does not equal the Great Depression

Some people are worried the current credit crisis is different from previous times – they're concerned the US could be facing a long recession or even slide into a 1929-type depression. Yes, it is very different this time around - but the factors causing the Great Depression were vastly different to the credit crisis we face today. The impending US recession should remain exactly that - a US recession.

What we are witnessing at the moment is a global financial system that is struggling to function adequately as a result of a credit squeeze. A credit squeeze occurs when banks stop lending to each other as well as other business customers. At the heart of this credit squeeze is the high risk 'sub prime' loans and loan derivatives that international banks have on their balance sheets.

The consequence of this credit squeeze affects all sectors of the economy. Unemployment is rising in the United States, production of goods and services is falling and people are beginning to consume less because it's harder to borrow money. It was easy for US consumers to borrow money via home equity access loans when house prices were rising, the opposite is true now. Economists are almost unanimous that the US is already in a recession, and the large economies in the G7 are likely to follow suit. No economy is immune from this global credit crisis, and this includes Australia - you only need look at the Australian share market performance over the last 9 months to see this. At last count, the Australian share market had dropped approximately 40% since its peak in October 2007.

While this 'new reality' is extremely disappointing for investors, it's important to remember recessions don't last forever. Since the 1940's we have endured 10 recessions. On average they have lasted 10 months. We have also suffered 10 post-war bear markets, defined as declines of at least 20%. The average decline was 31.5%.1 Every time however, the bear markets were followed by periods of economic growth and share price recovery. We don't know when the recovery will commence in regard to the 2008 bear market. We do know from history that recoveries, when they do commence, can often be sharp and unexpected.

With so much fear and anxiety in the market place, some people compare today's climate with the Great Depression of 1929 – 1932. This is not a justifiable comparison. Why is it different now to the Great Depression?

First, the US government expenditure now represents approximately 20% of GDP. The US spends money on social security, defence and infrastructure providing significant stabilisation to both the US economy and the world economy. During the Great Depression the US government expenditure accounted for just 3% of GDP.

The second and more significant difference is that in 1929 the US Federal Reserve failed to intervene. This inaction and incompetence on the part of the US Federal Reserve and Treasury were major contributing factors to the depression. Dr Ben Bernanke, the current US Federal Reserve chief, is a scholar of the Great Depression and has committed to ensuring the US Federal Reserve's mistakes of the past will not be replayed. Back in 1929, the US Federal Reserve and Treasury stood back and did not act to stabilise the financial system. They did not inject money into the financial system (as they are doing now with a $700 billion troubled asset relief package). Consequently, 2 out of 5 of US banks failed.2 While Lehman Brothers recently collapsed, only shareholders lost money - not depositors. Depositor runs in 1929 were endemic and 40% of people lost their bank savings. Unemployment rose to 15% and a large proportion of the population couldn't afford basic necessities.3

Today is a very different scenario. What central banks are doing in 2008 is adopting a concerted joint strategy to support international banks with proactive funding measures to allow them to ride out the credit squeeze. There will be some consolidation of banks and other financial institutions. Some big banks are now buying smaller more vulnerable rivals for discount prices. Bank of America bought Merrill Lynch recently and locally CBA purchased Bank West from HBOS. There is possibly going to be some bank failures in the US and Europe. Lehman Brothers was the first notable casualty, but this consolidation will continue with the support of the central banks around the world until banks are once again back to good health.

The key in today's environment is to stay diversified and committed to long term investment plans, however difficult it is to remain patient. There will clearly be a tightening of belts when it comes to expenditure, but most of us will continue to live our lives and consume (albeit somewhat less) in the midst of a recession. We can be sure there will be more negative sentiment, more gloom and doom and generally everyone will be a little worse off. After the recession ceases, employment will again increase and share prices will recover. As in past recessions, as a whole share prices have subsequently risen again and then exceeded their previous highs. Companies have continued to pay dividends throughout previous recessions.

While we don't have a crystal ball to tell us when investment markets will improve, it is comforting to know that eventually they will.

1 Robert J Samelson - Washington Post
2 Australia Financial Review - 6th Oct 2008
3 Australia Financial Review - 6th Oct 2008

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