

# The DEPRESSION of 2008-09 (The Great Recession)

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## Depression vs. Recession

- A recession is a decline in the nation's total economic output (measured by Gross Domestic Product) for two or more quarters in a row.
- "It's a recession when your neighbor loses his job," Harry Truman said, "it's a depression when you lose yours."
- Minsky defined a depression as a recession caused by a severe financial crisis. Depressions tend to be deeper, longer, and different than other recessions.

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## Recessions/Depressions in the U.S.

- NBER: 21 different recessions in the U.S. from 1854-1939. Average recession lasted almost two years, recovery the same.
- Nine or more qualified as depressions, including the Great Depression. GDP usually declined for about a year longer than other recessions, and the recovery afterwards was typically slow.
- After 1945, our recessions became less common, and – except for the severe recession of the early 1980s – they also became shorter and shallower.

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## Recessions/Depressions Abroad

- IMF: postwar recessions caused by banking crises in other countries tend to follow a similar pattern.
- After a typical crisis, GDP falls for three straight years, and never fully recovers even after growth returns.
- Seven years later, GDP usually remains about 10 percent below its pre-crisis trend.

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# In the Great Depression

- A recession led to a stock market crash but more importantly a banking crisis, which turned it into a depression.
- This was made much worse by tight monetary policy, which caused severe price deflation.
- It was compounded by states reducing spending in response to falling taxes.
- By 1932, the Hoover Administration was raising taxes and cutting spending to balance its budget.

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# Attitudes in 1929

## Andrew W. Mellon, Hoover's Treasury Secretary:

- "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate."
- "It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people."

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## Comparisons to the Great Depression

- DJIA lost 46% of its value from 10/10/1929 to 10/9/1930.
- In 1929, 1.4% of homeowners lost home to foreclosure.
- In first ten months of decline alone, 744 banks failed. Then it got worse through Spring 1933. Depositors lost \$140 billion, more than all of 1929 GDP.
- GDP declined by 1/3, unemployment rose to 25%.
- Depression spread from here to the rest of the world.

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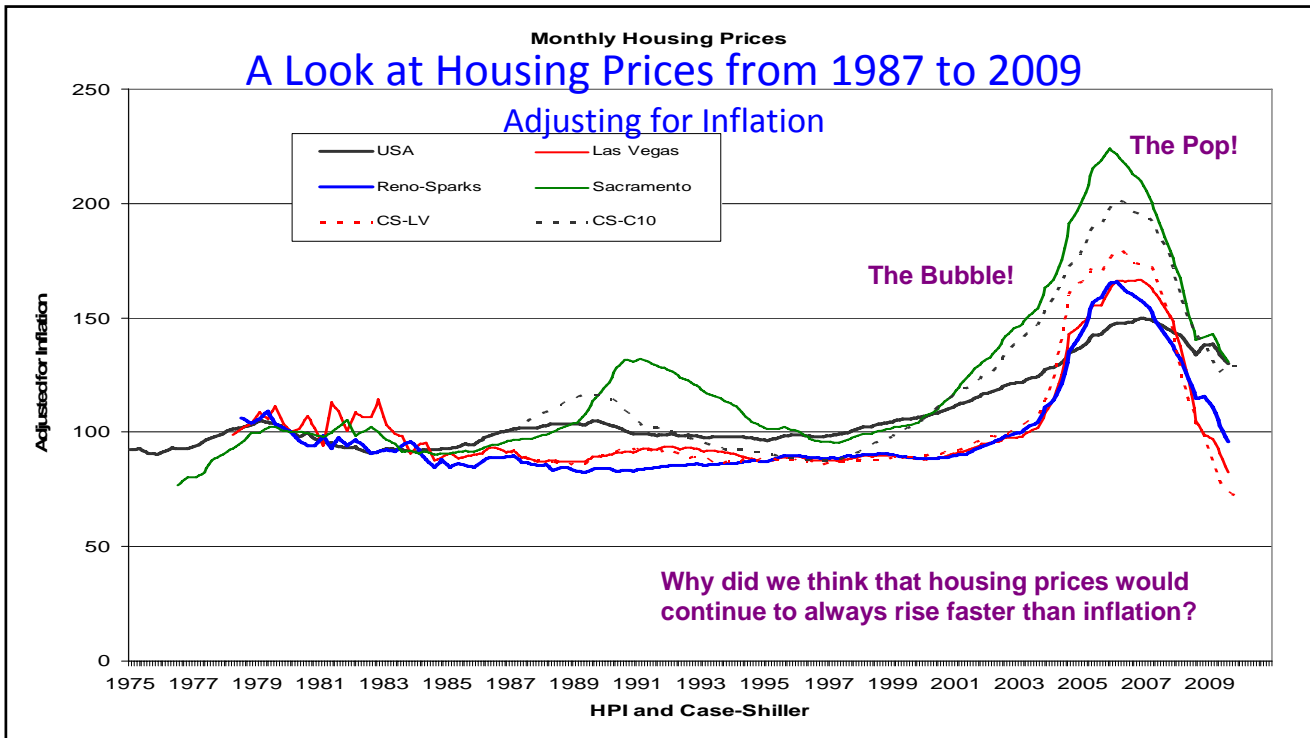
## What led us here?

- The U.S. economy reached what Paul Krugman calls a “Wile E. Coyote” moment.
- The current focus is on unemployment and budget deficits, but we also saw a credit crisis, a dramatic fall in the dollar, rising trade deficits, and a big jump in oil prices, commodity prices, and food prices.



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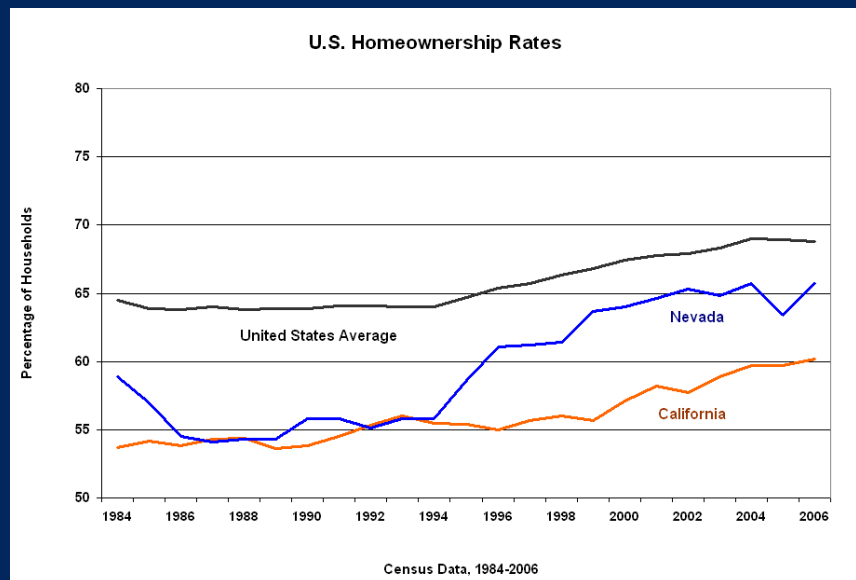




## The "Ownership Society"

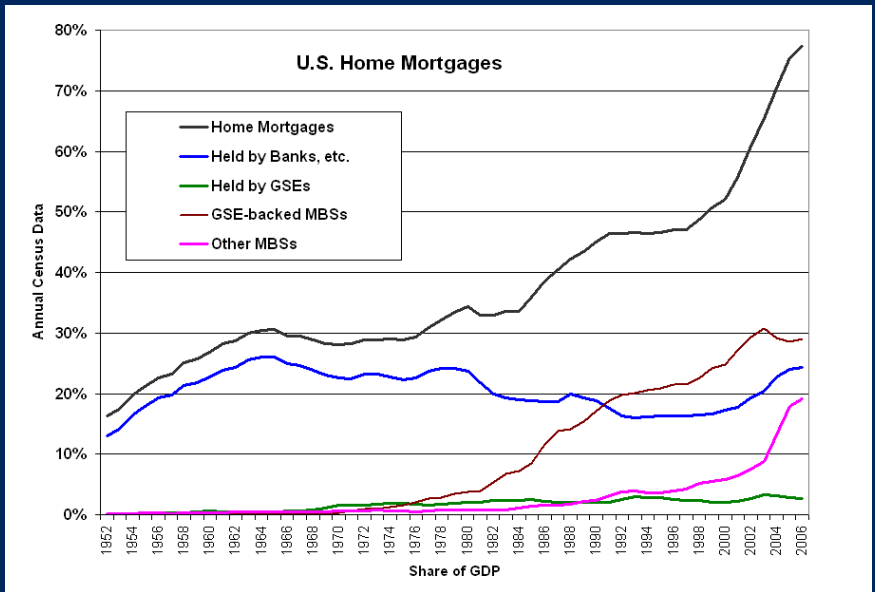
Between 1994-2004:

- Est. 15 million new homes owned,
- 9 million at trend, plus
- 6 million more (5% rise).
- California and Nevada started catching up to rest of the country.



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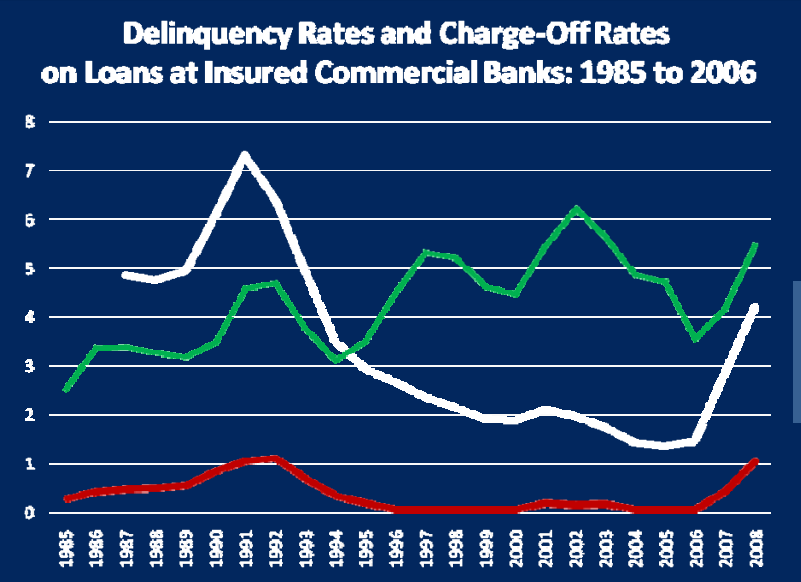




Mortgage debt grew MUCH faster than either income or home ownership

- First Wave (1950s)
  - commercial banks
- Second Wave (1980s)
  - GSE-guaranteed securities
- Third Wave (>2002)
  - other mortgage-backed securities

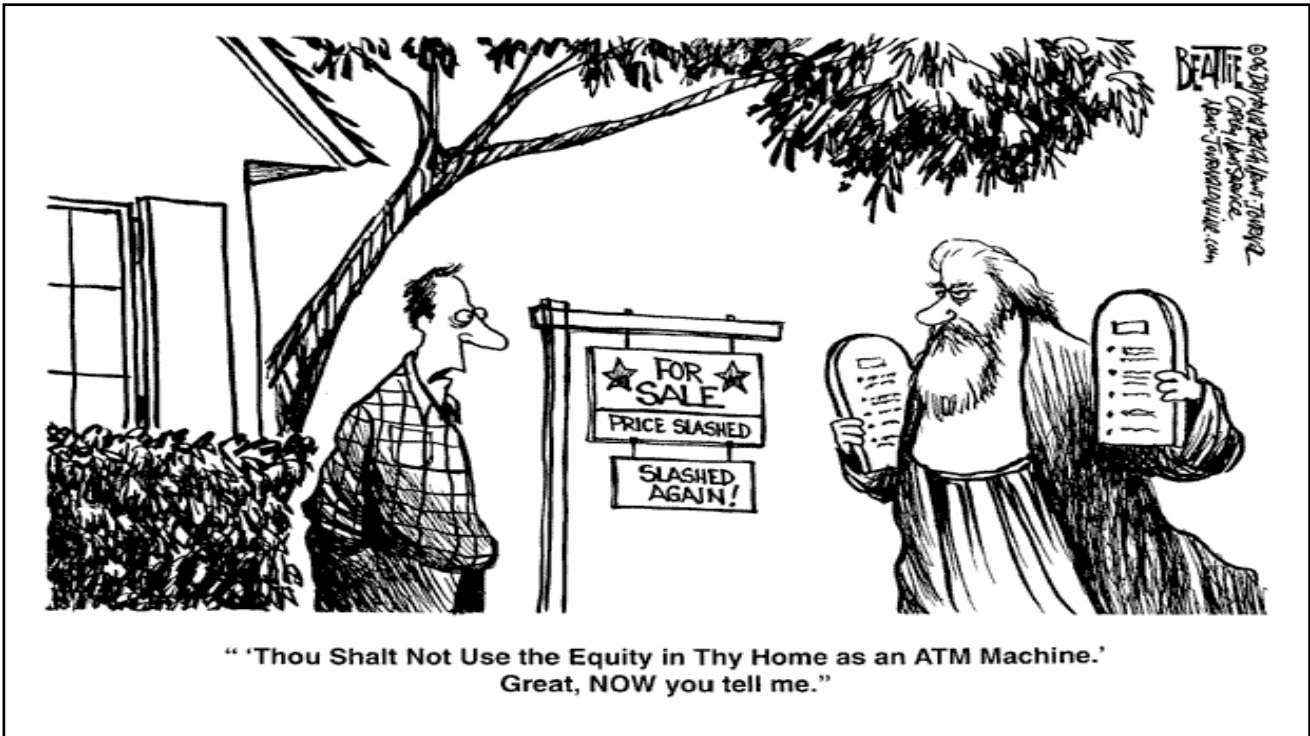
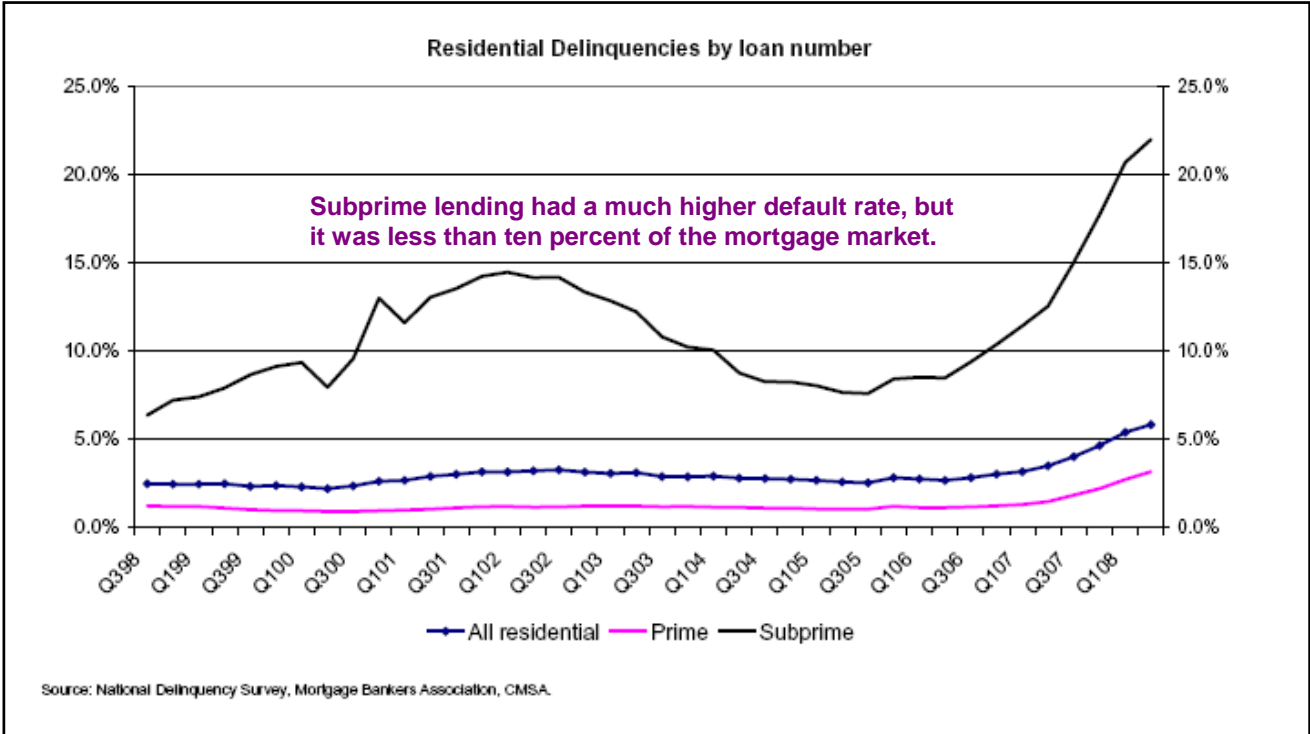
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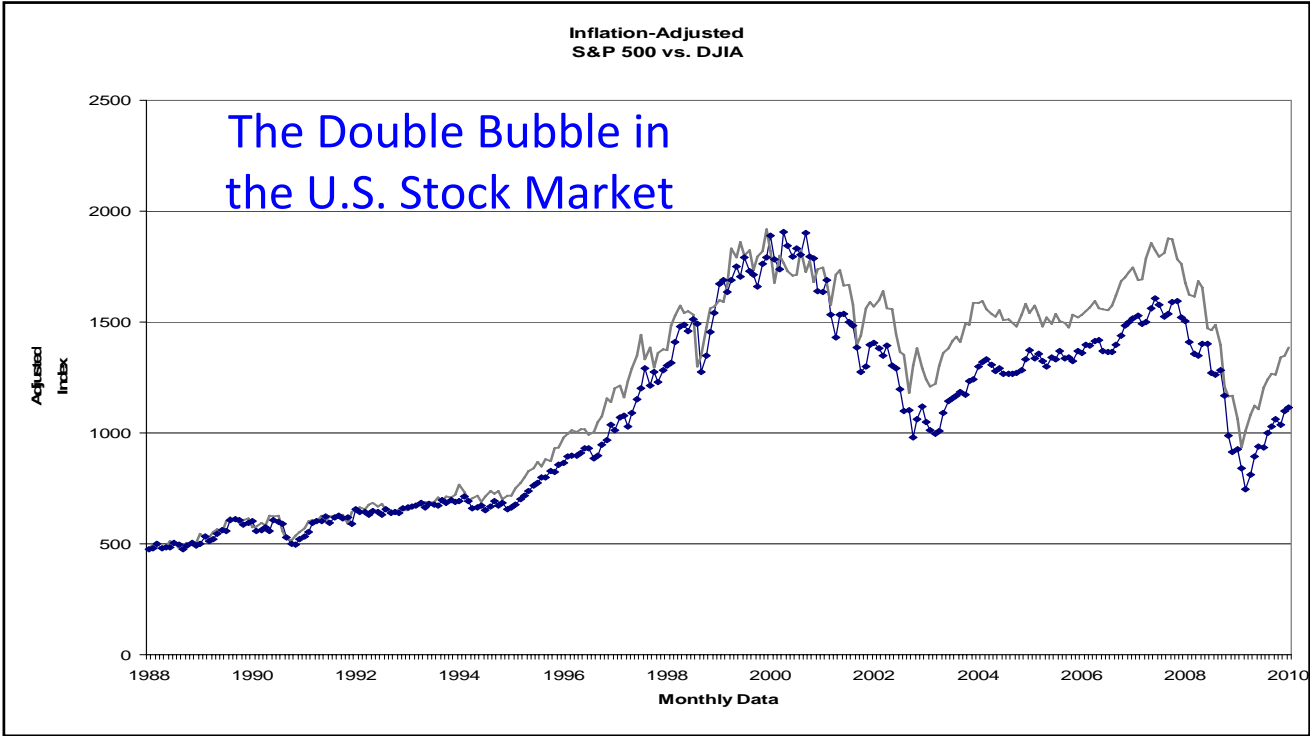


Real estate mortgages seemed like such good investments

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It is hard to believe the market was acting rationally.



## A Longer Look at the DJIA – Adjusting for Inflation (1949-2009 Monthly Close)



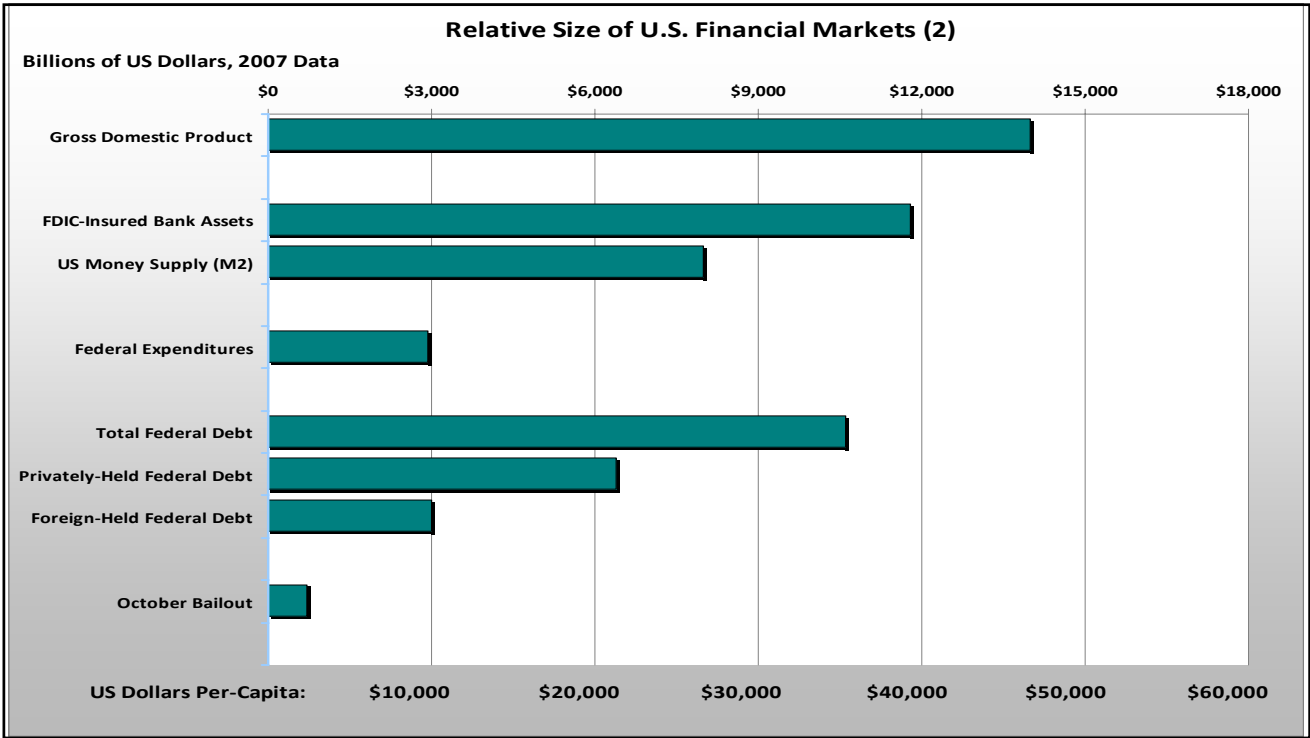
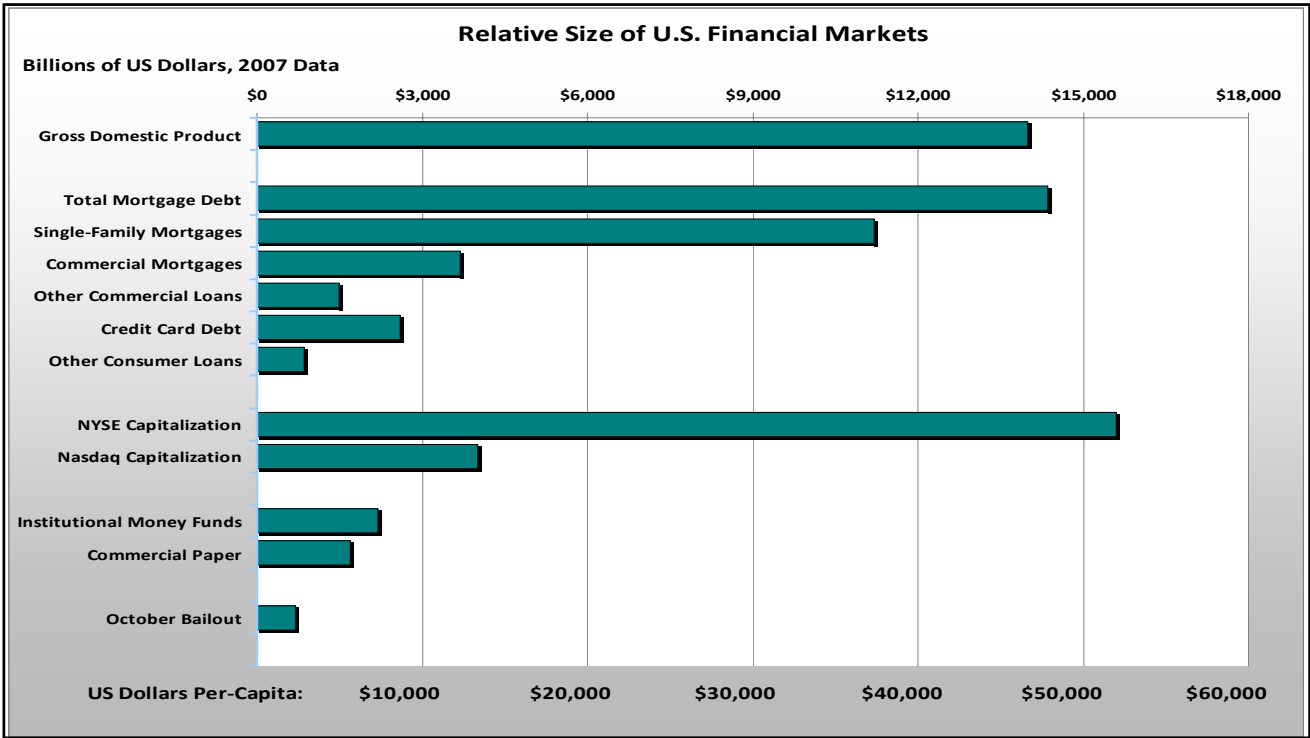
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the Bubble in  
NASDAQ?

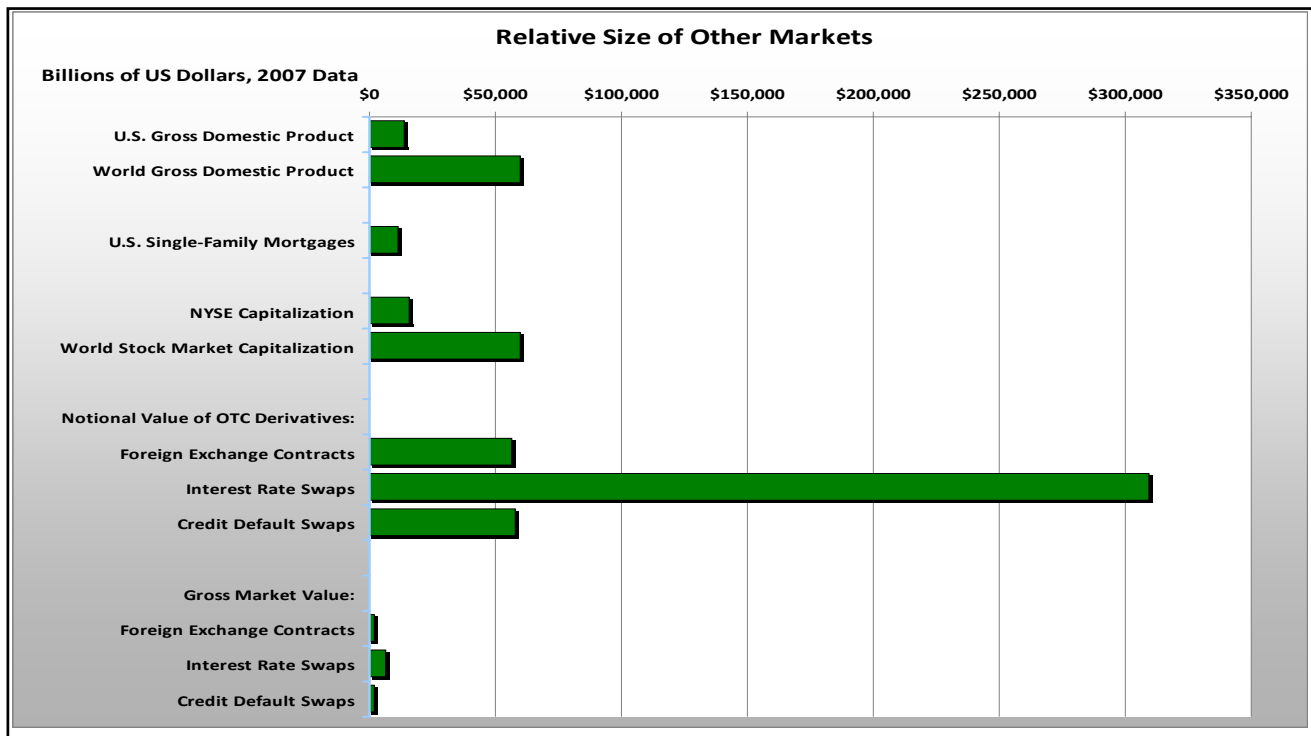
Remember the  
Enron scandal?

How did we  
become so  
forgetful?

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## What Caused all this Lending?

- New homebuyers, existing homeowners, and speculators.
- Mortgage brokers and predatory lenders.
- Financial market consolidation.
- Firms competing for highest returns.
- Short-term incentives for financial managers.
- Investment banks, rating agencies, and hedge funds.

## Let's not forget Hubris.



- Some risks are not diversifiable.

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## What are Derivatives?

A derivative is a financial asset whose value is derived from *other* financial assets (e.g., futures, options, swaps).

- A derivative is financial insurance against price changes: a risk-averse person pays another party to take their risk from them.
- The most common type of derivative is an interest rate swap, but there are more types of derivatives than bets in a casino.

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# Why are Derivatives a Problem?

- Insurance markets are regulated to make sure the insurer has adequate capital. Derivative markets are not.
- Derivative markets can be complex, and traders on both sides may not realize what they are doing.
- Derivatives are not transparent, often off-book, and huge.
- You don't have to own the asset to buy insurance on it. This can lead to pyramiding of side bets. There are also often multiple generations far removed from the asset.
- All insurance markets have problems of moral hazard.

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# What Else Caused It?

- Fannie Mae (FNMA) and Freddie Mac (FHLMC)
  - Privately-owned, government-sponsored enterprises responsible for the mortgage-backed securities market for conforming loans. These were latecomers to the subprime debacle, but they also may have led many mortgage brokers to believe they would guarantee bad loans.
- Federal Reserve Bank
  - Monetary policy made cheap credit available, creating incentive for combining short-run borrowing and long-term lending. Twelve FRBs are controlled by member banks, and failed to regulate bank involvement in the derivatives markets.

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# The Federal Reserve chose not to regulate derivatives or act to prevent bubbles

Alan Greenspan recently testified,

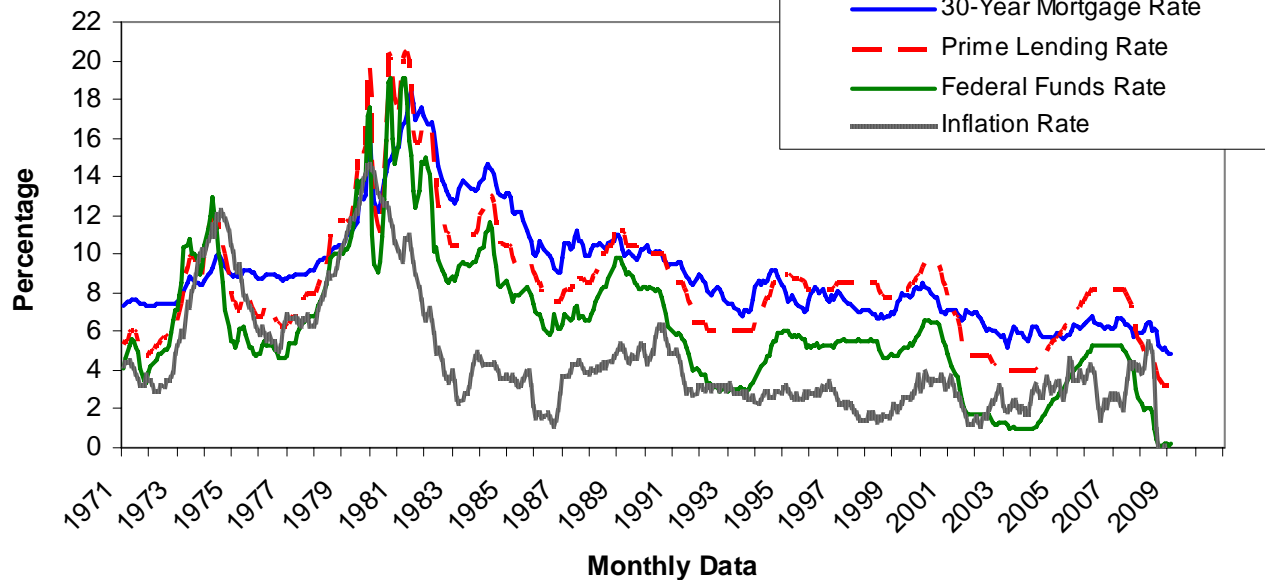
- “I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms.”

- Congressional testimony, October 22, 2008

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## Mortgage Rates have been much more Stable than either Prime or the FFR



## Let's Not Forget the Federal Government

- Encouraged more people to buy homes, and pushed lenders to devote some portion of their lending for those who would normally not get loans.
- Removed regulations on lending practices and on derivative markets, and negligent in enforcing existing regulations. Pressure to turn a blind eye to emerging problems.
- Allowed financial mergers that made these firms too big to fail. The role of campaign contributions from financial sector...

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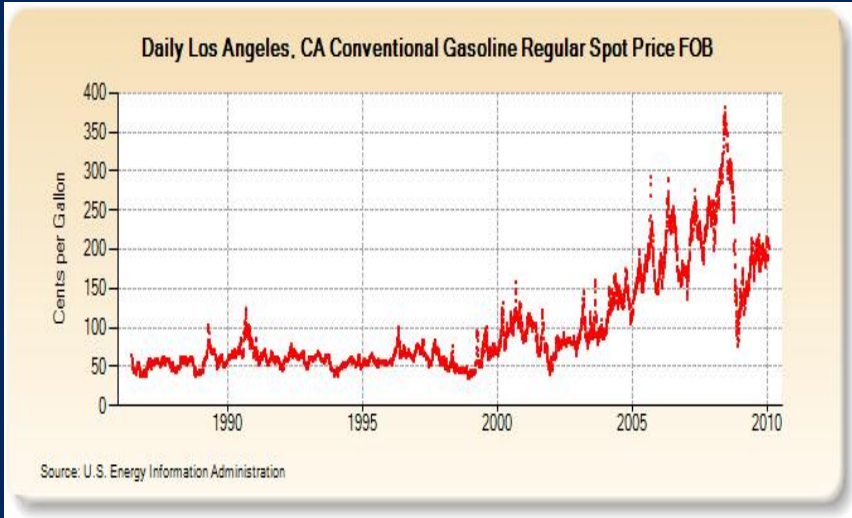


## Financial Markets are Prone to Market Failure

- Market economies are most efficient when (1) there is competition, (2) everybody knows what they are buying and selling, and (3) external spillover effects are minimal.
- Finance fails on at least two: information and contagion.
- Basic problem: banks are lending somebody else's money.
- Government insurance (FDIC) and private insurance (CDOs) both lead to moral hazard, excessive risk-taking for short-run profit. Bailouts are just an extreme form of insurance.

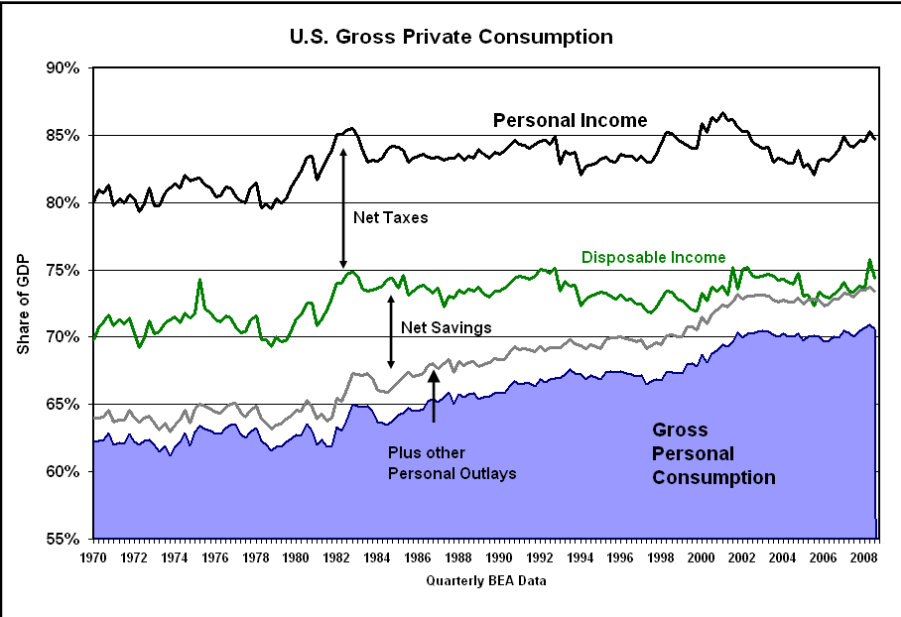
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Rising Oil & Gas Prices helped to pop the bubble.

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A Major Cause/Effect is Household Spending

Over the last decade:

- a sharp rise in consumption
- A fall in personal domestic savings

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# The Great Recession

- This recession is estimated to be the biggest worldwide since the Great Depression.
- In 2008-2009, OECD says GDP fell by:
  - 2.5% in the United States, 2.1% in Canada
  - 13.7% in Turkey
  - 8.5% in Japan, 8.6% in Mexico, 8.4% in Ireland
  - 3.3% in Iceland, 4.9% in United Kingdom
  - 4.8% in Euro area, including 6.9% in Germany

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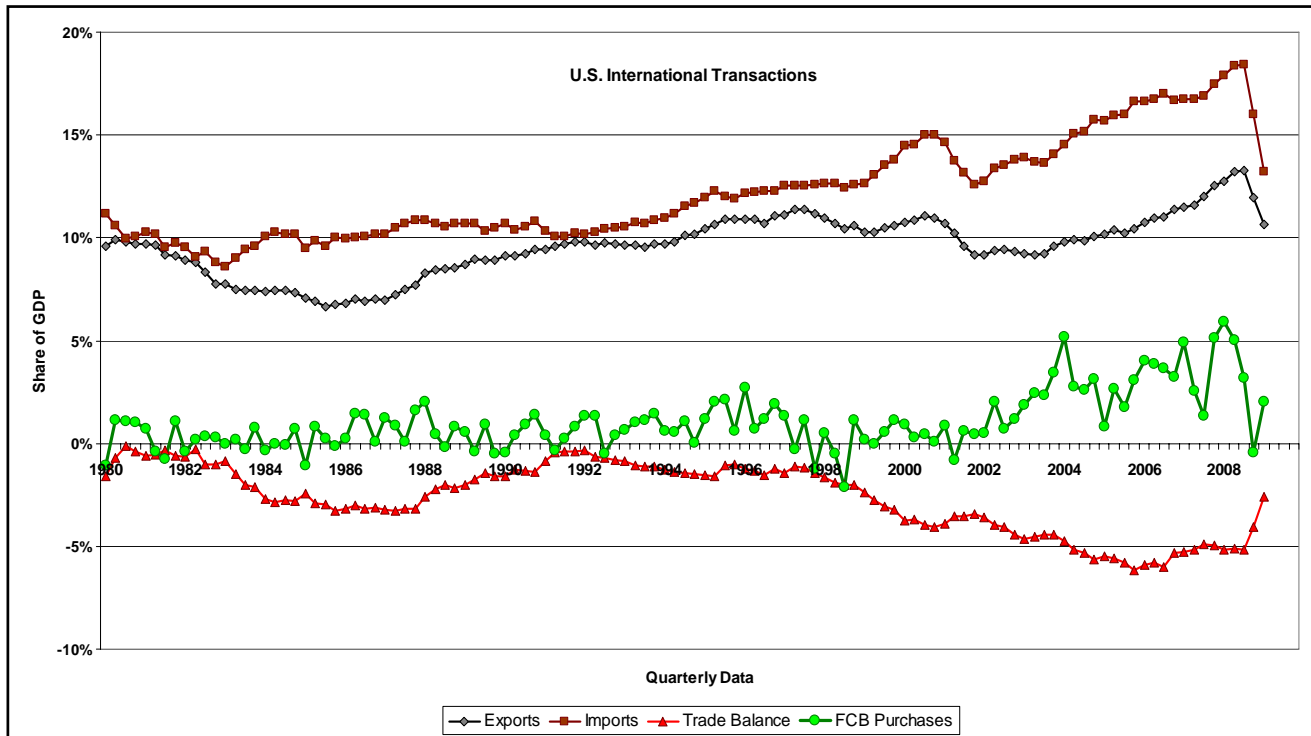


# What are the Global Implications?

- Much of the savings being lent to Americans came from foreign sources.
- Housing bubbles occurred in dozens of countries.
- Many foreign banks engaged in the same practices as U.S. firms.
- Markets for derivatives are often offshore.
- Foreign markets rely on exports to American consumers.

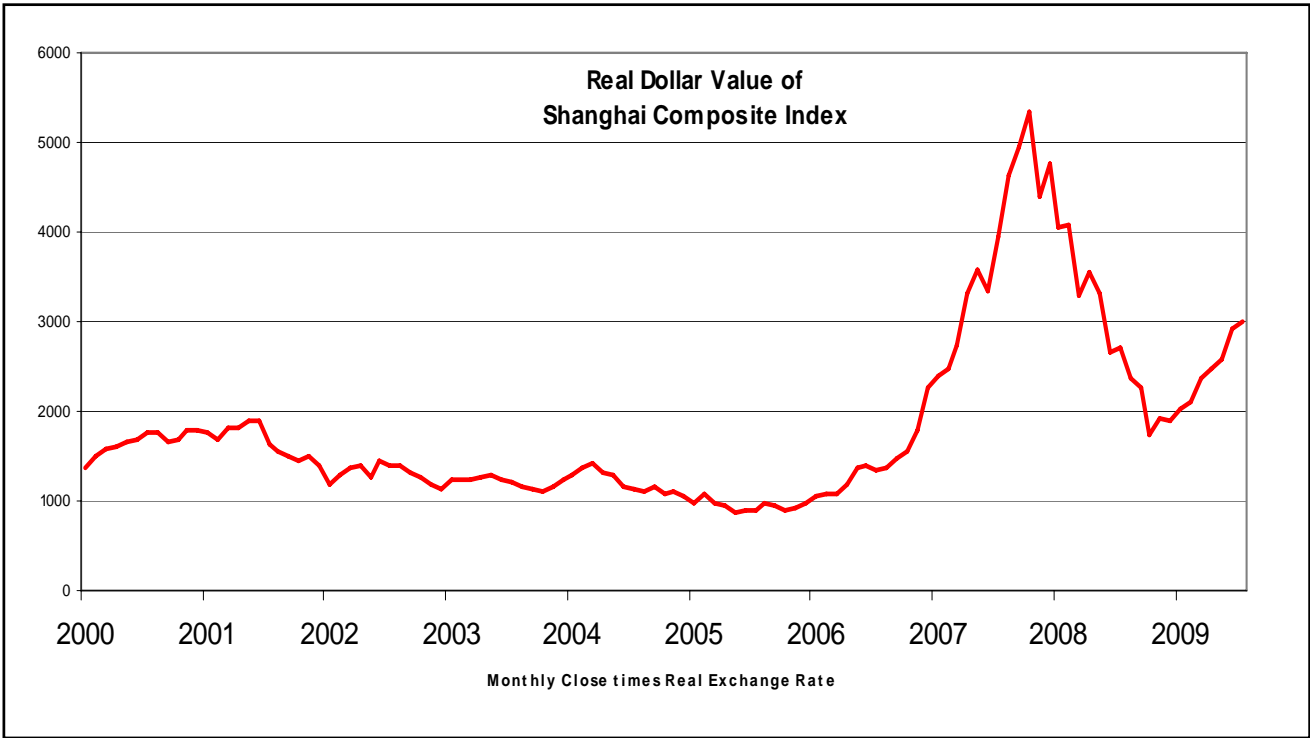
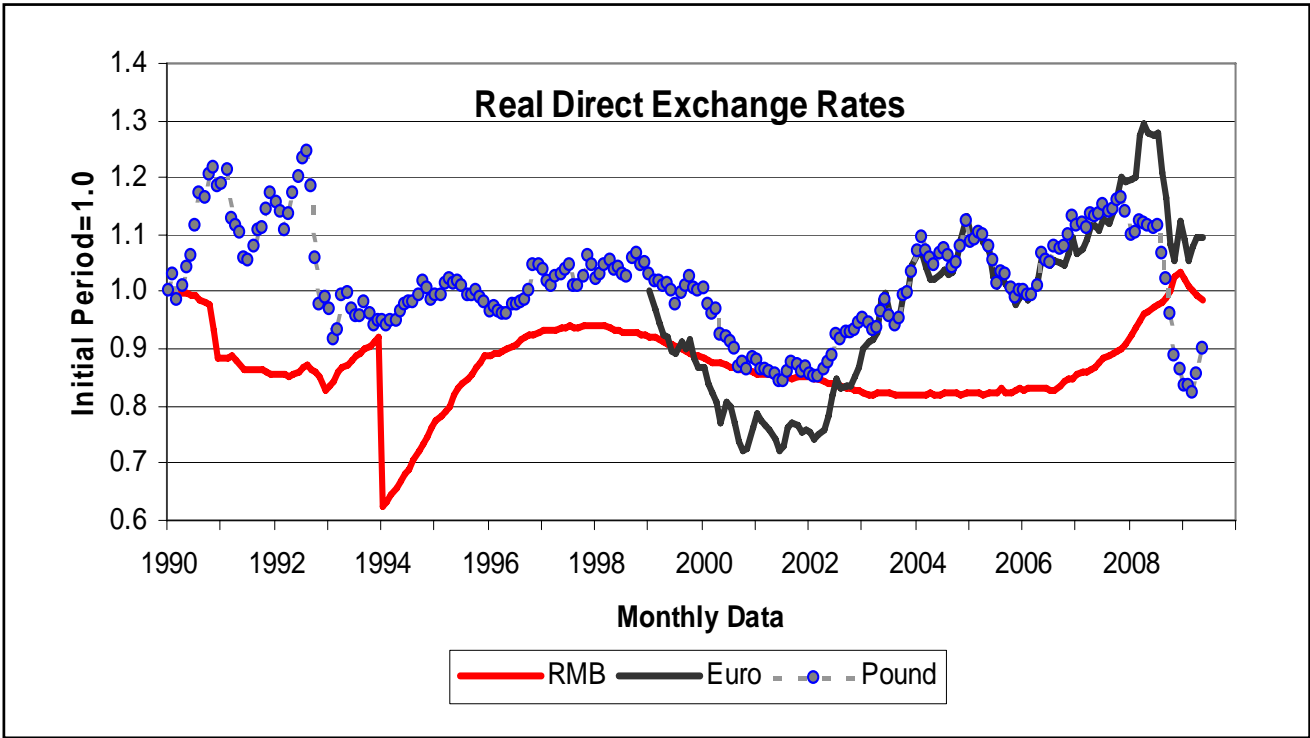
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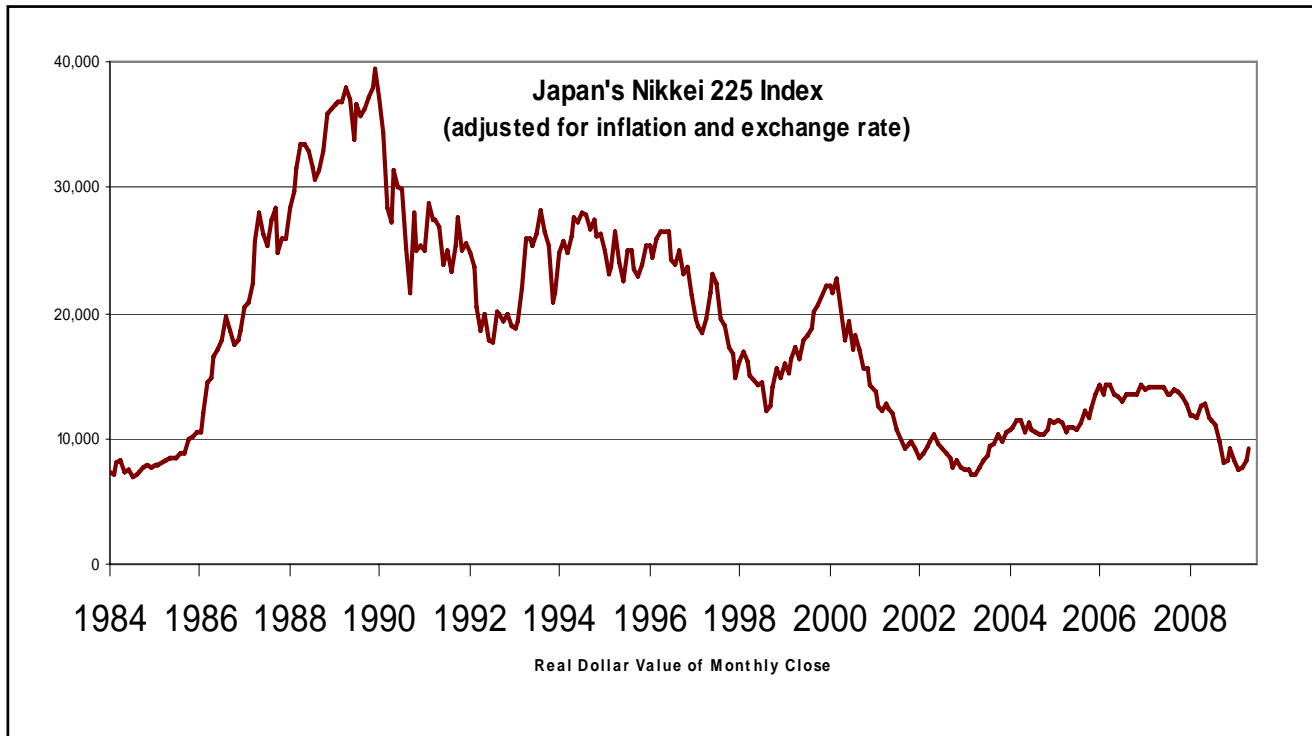




## Foreign Exchange Rates

- From 2006-2008, foreign currencies were becoming more expensive in Dollar terms, and this was starting to rein in the trade deficit.
- Falling demand for imports and troubles in other countries led this to reverse in the last three quarters.
- This is likely to be a temporary depreciation of foreign currency, with effects on the trade deficit.





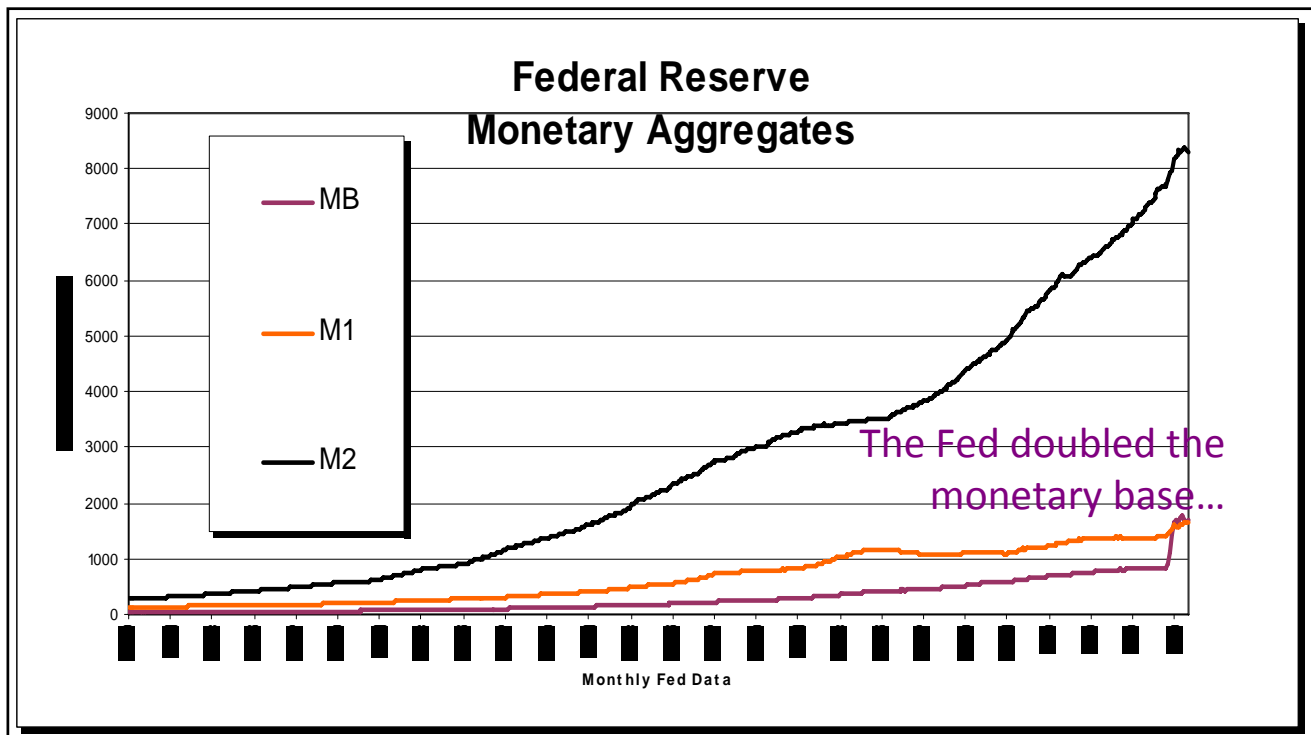
## Bank Bailouts

- Emergency Economic Stabilization Act:
  - \$700 billion authorized in October 2008.
  - TARP funds began with plan for purchase of troubled MBS, but changed to a preferred stock model, with restrictions over executive pay.
  - Many large financial institutions have begun to pay these amounts back.

# Monetary Intervention

- Federal Reserve authorized:
  - Purchase of government bonds, helped drive yield to zero.
  - Purchase of private mortgage-backed securities for the first time.
  - Central bank currency swaps.
  - Target federal funds rate near zero.

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## Worries about Inflation

- Rise in Monetary Base would normally have been inflationary – but deposit expansion multiplier collapsed!
- Primary worry was deflation, as during the Great Depression.
- M2 has not grown much, no sign of inflation yet.
- A Good Sign – worries have switched.
- Bernanke needs an exit strategy, to reduce reserves when banks start lending again.

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## Fiscal Intervention

- Economic Stimulus Act of Feb. 2008:
  - Tax rebates for 2008, estimated \$150 billion cost (about 1% of GDP) in 2008.
- American Recovery and Reinvestment Act of 2009:
  - Estimated \$800 billion cost over several years, with less than \$200 billion spent in FY 2009, and \$400 billion in FY 2010 (about 3% of GDP).
  - About 40% in tax credits, 30% in state fiscal support, and 30% in infrastructure investment (education, energy, health care), and some extended benefit support.

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## Fiscal Skepticism?

- Economists are very skeptical about fiscal policy working when we are close to full-employment.
  - Higher real interest rates crowd out investment.
  - Higher dollar crowds out exports.
  - Higher debt leads to future deficits.
- But we are NOT near full employment, and monetary policy isn't enough when banks are scared and interest rates are zero.
- What are our choices?

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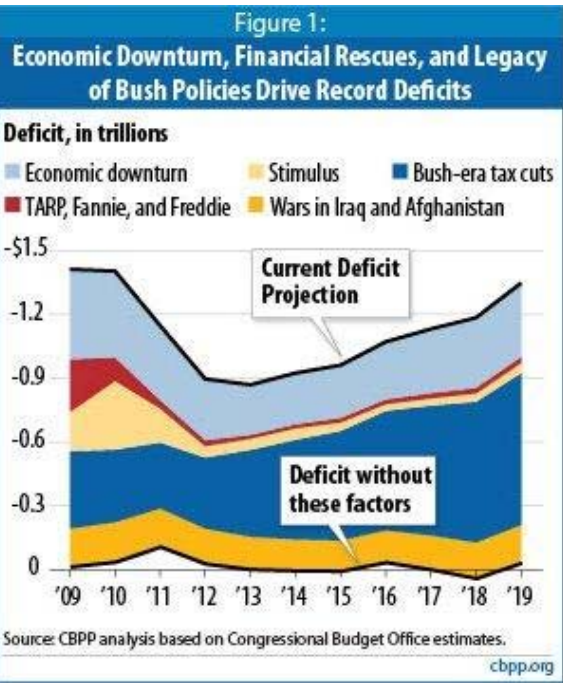


## Worries about the Debt

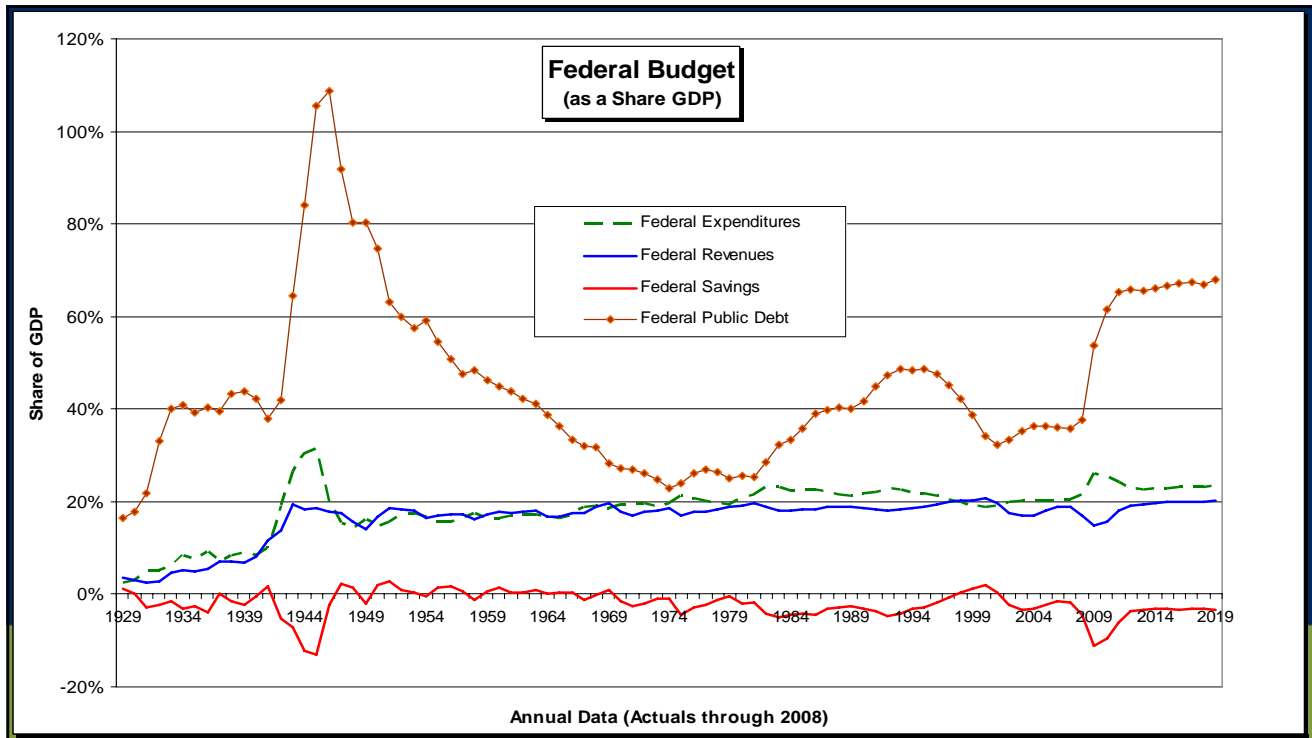
- Recent estimates have raised 2009-2019 cumulative federal deficit projections from around \$7 trillion to \$9 trillion.
  - Falling revenues due to slower growth, assumption that tax cuts will be extended in 2012.
  - Servicing growing federal debt.
  - Additional tax cuts and expenditures from ARRA.

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The Stimulus  
made big  
budget deficit  
projections  
even bigger.



## Is it Worth it?

- The total economic loss from the Great Depression was perhaps 120% to 140% of 1929 GDP (about \$20 trillion now).
- The total loss from the 1980-1983 recessions was 15% to 17% of 1979 GDP (\$2.4 trillion).
- The IMF estimates a typical depression costs more than 50% of GDP cumulatively over 7 years (\$7 trillion).

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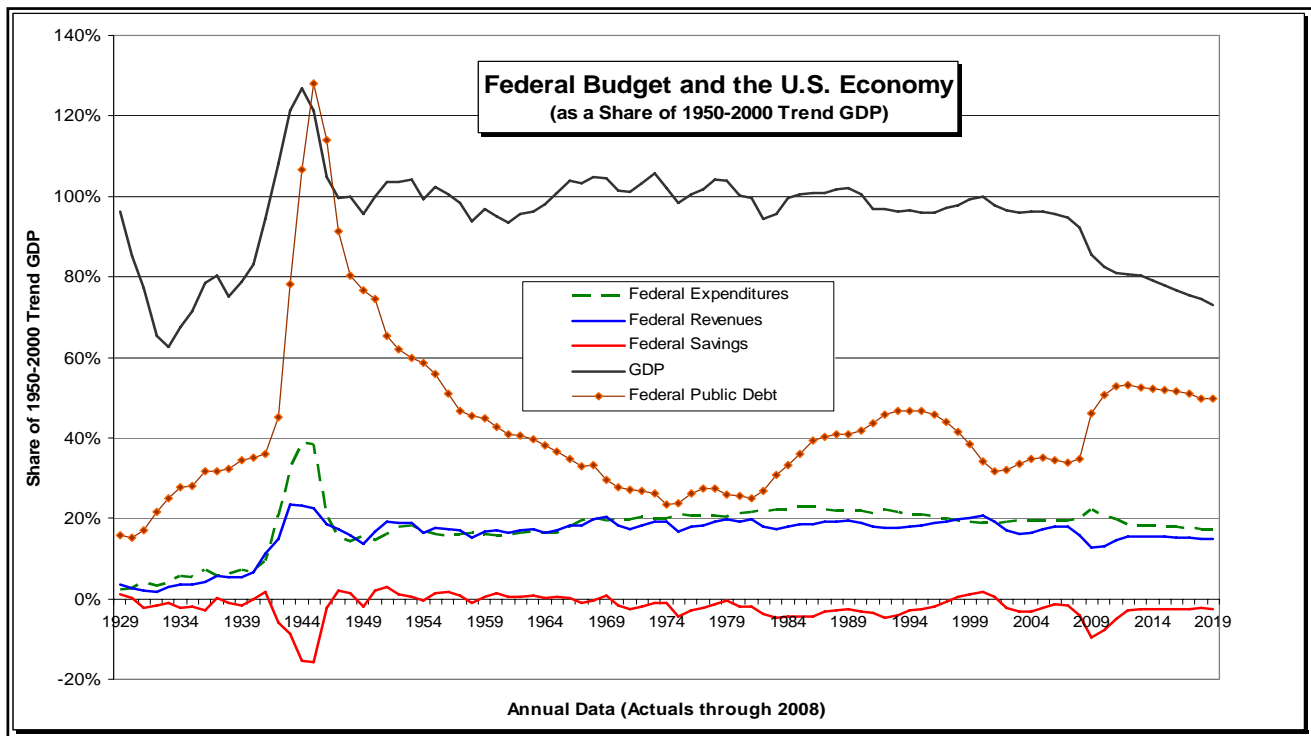


## The Stimulus added \$1 Trillion to the Federal Debt

- If this spending could prevent only a fifth of the effect of a typical depression...
- If GDP would have declined 8% instead of 4%...
- If the recovery would have begun in 2010:1 instead of 2009:3...  
... then it would be a very good investment.
- But we don't KNOW what would have happened without it.
- And it probably wasn't done optimally.

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## In the Current Depression...

- A severe banking crisis led to a stock market crash, and a fall in GDP for four straight quarters, for a total drop of almost 4%.
- In the last two quarters, GDP has begun to grow again, though unemployment still remains high.
- Though states continued to follow their depression-era habits, the federal government helped to fill in part of the hole they were digging themselves into, to help prevent the typical downward spiral in spending.

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# Financial Regulation?

- How do we prevent this from happening again?
- The federal government seems afraid to shut the barn door while the horses are gone.

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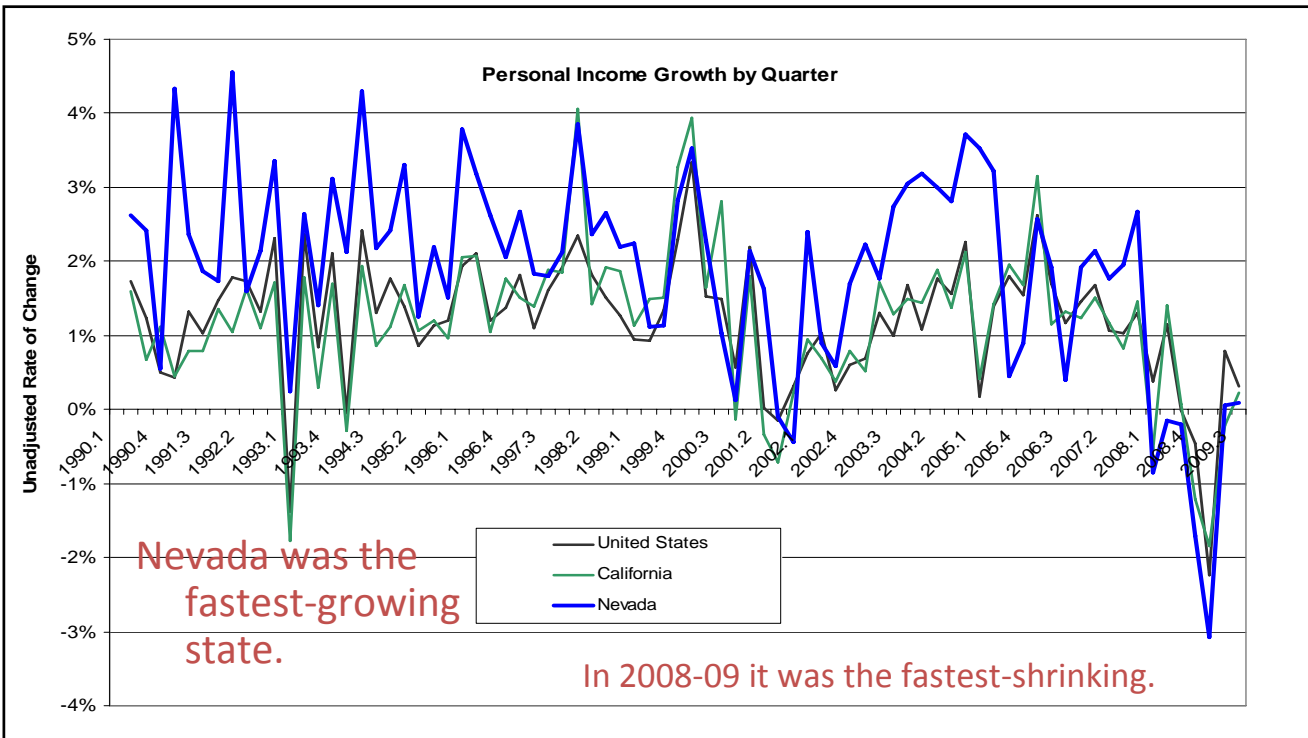
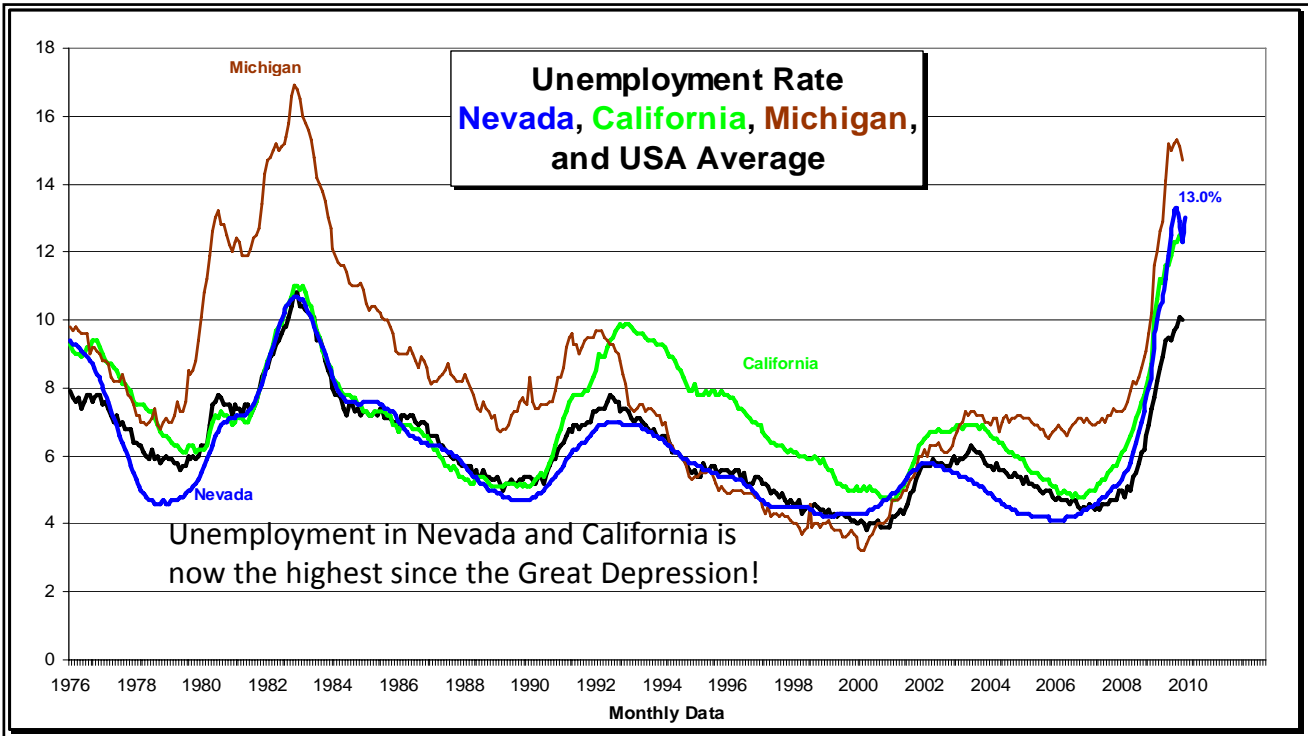


# Will Things Return to Normal?

- On one hand – remember 9/11?
- Overconsumption is not sustainable
  - Households too, not just government.
  - Foreign countries did our saving for us.
- Nevada was particularly dependent on gaming, construction.
  - Much of this was driven by Californians letting their housing investments do their savings for them.

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## We are at a turning point...

- Our government debt is large, and growing, but not yet unsustainable. Will the current deficit be temporary or permanent?
- Our economic trajectory is not sustainable. We can't keep our spending growing faster than our income, and depending on other countries to keep financing that spending.
- Similarly, many countries with high savings rates have seen us as an export market driving their growth AND a place to invest their savings.

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## How do we escape?

- Time – there is still significant deleveraging that still needs to occur. Housing prices must also stabilize.
- Confidence – consumers and investors no longer are as worried that we are in freefall.
- Restructuring – high consumption with trade deficits/foreign borrowing is not sustainable.
- Policy – difference between short-term intervention and long-term growth strategies.

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# What is the Prognosis Now?

- Housing prices are stabilizing nationwide – but Nevada is still being wagged by California.
- There is still a significant inventory of foreclosures and forced sales which are waiting to go on the market.
- Recession is likely over now, but recovery may take a year or more to get started.
- Unemployment lags growth, and acts as a brake.

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