REAL CLEAR POLITICS

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America: Concentrate or Hang

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Anybody who wants to pontificate about the economy, or the budget, or the deficit right now should think about three questions:

1. What changed the Depression from an ordinary recession into a worldwide catastrophe? (And how bad was it, anyway?)

2. Is this crisis the same or different?

3. If there's risk of another depression, how do we stop it?

Most Americans regard the Great Depression as ancient history, about as relevant as the Civil War. From that perspective the current political firestorm over budget deficits, bailouts and bonuses makes perfect sense. But the Great Depression wasn't a fantasy - it really happened, and the conditions which created it have reappeared for the first time since the 1930s. We should take the danger seriously.

Samuel Johnson said that "when a man knows he is to be hanged in a fortnight, it concentrates his mind wonderfully."

We need to concentrate.

How Bad Was The Depression?

We're used to thinking of a recession as something that lasts for maybe 18 months, with GNP declining by 2 or 3 percent. In a bad recession unemployment might hit 8 percent for a year or two. In the deep recession of the early 1980s, unemployment peaked at 10.8 percent and stayed above ten percent for almost a year.

The Great Depression was a different animal.

During the 1930s, GDP fell continuously for four years, from the end of 1929 to the end of 1933, when it hit a low of about 26 percent below its 1929 level. The economy then began to recover, but even by 1938 had barely regained its 1929 level. (If GDP had grown at its normal rate, it would have been about 30 percent higher by then.) Unemployment peaked at just under 25 percent in 1933 and then fluctuated, falling to 14 percent in 1937. It was back at 19 percent in 1938, however. That's ten years after the depression started.

And remember, people who get discouraged and stop looking for work officially don't count as unemployed.

A very back-of-the-envelope calculation suggests that the US economy may have lost between 200 and 250 percent of 1929 GDP during the Great Depression, compared to a decade of normal economic performance and growth.

What would a similar event look like today? We had about 14 trillion dollars of GDP in 2008, but our "normal" growth rate now is a bit slower than it was during the 1920s. Conservatively, a re-enactment of the 1930s today might cost the U.S. somewhat over 200 percent of 2008 GDP, or maybe 30 trillion dollars. Let's say 25 trillion, to be conservative.

But measuring a depression in terms of "lost GDP" doesn't quite capture the pain. We're not talking about people driving slightly smaller cars. We're talking about 20 to 25 percent of the labor force being thrown out of work for up to a decade, and not being able to support their families.

The 1930s depression also collapsed the world economy. Among other effects, the flight of foreign capital destroyed the recovering German economy, with unthinkable consequences. When people despair, "isms" become more attractive.

Do we think the world is a lot more stable now? How much do we want to bet on that?

So Why Did The 1930s Get So Bad?

For a long time economists thought that the stock market collapse of 1929 caused the Great Depression. Milton Friedman took a different view, arguing that a contraction of the money supply turned a minor crisis into a major event. But in 1983, a smart young economist named Ben Bernanke published a paper which modified Friedman's theory.

Bernanke showed that the collapse of the American banking system, including the "suspension" of some 9,000 banks between 1930 and 1933, froze the credit markets, contracted the money supply, and drastically reduced the flow of bank lending, converting the stock market collapse into a depression.

Subsequent events support the Friedman/Bernanke view - for example, the stock market collapses of 1987 and 2001 caused almost no economic contraction, probably because they did not directly attack the financial system. Banks remained solvent and continued to make loans, and the economy did fine.

It turns out that financial credit behaves something like the lubricating oil in an engine - without it the engine seizes up. In 1930 the Federal Reserve Bank refused to use public money to bail out bankers who had made stupid loans. But, with the credit system paralyzed by thousands of bank failures, many otherwise viable businesses also failed. These failing businesses laid off their workers, who stopped spending money, causing other businesses to close, making more loans go bad and causing more banks to fail.

We can all sympathize with the 1930 Fed's desire to make bankers take the consequences of their own lending mistakes. But most of the people laid off during the depression never worked for a bank. And most of the people who died in WWII weren't bankers.

Could This Crisis Become A New Depression?

Financial panics have always been a problem with capitalism, going all the way back to the 1600s. And they seemed to get worse as the economy got more complicated. Finally, in the 1930s, the problem caused so much damage that we "fixed" it by insuring the banks.

Since 1934, federal deposit insurance has prevented major financial panics in the U.S. Because depositors felt safe, the banking system no longer suffered the sudden, catastrophic withdrawals of credit which caused so much havoc in the early 1930s. That changed last year.

The financial system has evolved since 1934, with about two thirds of the credit to businesses and consumers in the U.S. now coming from sources other than insured deposits. The U.S. economy had become vulnerable again, and this crisis has targeted the financial system like nothing else since the 1930s.

Consider the banks and investment banks heading up the list of about 500 companies receiving TARP bailout money from the government. They include four of the six largest US banks -- Citigroup, Bank of America, JP Morgan/Chase, Wells Fargo, and two of the five largest US investment banks -- Morgan Stanley and Goldman Sachs. The other two top banks, Wachovia and Washington Mutual, were both forced into federally funded "rescue mergers." Of the three remaining investment banks, Merrill Lynch and Bear Sterns have been forced into rescue mergers, and Lehman Brothers was allowed to fail outright, with catastrophic effects on financial markets. And TARP is only the tip of the bailout iceberg, as the Fed has extended massive amounts of emergency credit to financial institutions through many other channels. And then, of course, there's AIG.

Would these institutions be insolvent without the bailout money? That depends on how you value the hundreds of billions of dollars of questionable assets on their books. It also depends on how much deeper the recession gets, and on who else fails -- for example, Merrill Lynch and Goldman Sachs both hold billions of dollars of AIG-insured assets. But "solvency" doesn't necessarily save you in a financial panic. Once the financial markets cut off the supply of short term financing to these institutions, they would have been forced into default, absent government intervention.

And the ensuing economic debacle would have justified the fears of investors who pulled out their financing. That's one of the nasty things about financial panics - the investors who run for the door first may get out with their money while those who hang tough end up holding the bag.

Only the Fed's aggressive emergency credit has prevented this scenario from playing out so far. Our economy is on life support.

And, unfortunately, the life support is not working very well.

While the bailouts have prevented a wholesale collapse of the banking system, the Fed has been unable to restart the credit markets. Business credit remains extraordinarily tight, even with the discount rate essentially at zero. In other words, even though banks can borrow money at no cost, many businesses can't get financing at any cost.

The problem is that modern banks no longer hold most of the loans that they originate. In order to hold all of these loans banks would have needed substantially more equity capital even before the crisis. And the crisis has now destroyed what capital the banks did have. Instead of holding loans, banks now package and resell them into a downstream secondary market. Or, more precisely, they did that until a few months ago.

The downstream market for packaged debt no longer exists, because investors have lost confidence not just in the existing debt, but in the whole mechanism for originating and vetting the loans. (Can you blame them?) This breakdown has isolated businesses and consumers from their major sources of private investment capital.

Bernanke and Geithner are struggling to redesign and restart a system which has developed major structural flaws. And they are doing this under time pressure, under political pressure, in the middle of a crisis.

Furthermore, Americans have lived beyond their means for a long time, fueling the world economy in the process. It's only rational that we stop living on credit card debt, but our new found financial conservatism reinforces the downward economic spiral and makes recovery much harder.

Meanwhile the clock is ticking. Once a business has failed, defaulted on its contracts, laid its people off, and has its assets tied up in court, restoring credit flows may not help. It's not so easy to put Humpty together again. If we don't find a solution, and quickly, we will face a very serious problem.

What Worked Last Time?

Roosevelt's spending programs appear to have helped during the 1930s. The Depression started at the end of 1929, when Herbert Hoover still had three years left to serve. Hoover did nothing. When Roosevelt took office in March of 1933 he initiated large spending programs, which were implemented later in the year. Real GDP, which was already down about 25 percent from 1929 levels, declined by another 1.3 percent in 1933, but then turned around and actually went up about ten percent in 1934. Thereafter Roosevelt had some very good years - GDP rose by 9 percent in 1935 and 13 percent in 1936. An abortive attempt to balance the budget in 1938 coincided with a contraction of 3.5 percent in GDP.

Roosevelt also introduced deposit insurance in 1934, so the economic turnaround coincided with both a big increase in government spending and a stabilized financial system.

But we finally got out of the hole with the mother of all "wasteful" government spending programs, starting in 1939 -- building bombs to blow stuff up. We ended up with an extortionate top tax rate of 94%, a ratio of federal debt (held by the public) to GDP exceeding 100 percent (compared to less than 40 percent today). And we then entered a long, sustained period of economic growth and prosperity.

I'm not recommending either that we start WWIII or mimic Roosevelt's programs, only that we should understand history.

So What Should We Do Now?

First, we have to give Bernanke and Geithner time, space and lots of money to find solutions. They're making it up as they go along, which is what you do in uncharted water. It's OJT (on the job training). Personally, I wouldn't want their jobs.

Second, the Federal government should do everything possible to stimulate the economy - cut taxes, spend money, buy bullet trains to Las Vegas, whatever. There is an inherent tension between spending money quickly and spending it wisely, but we shouldn't let that stop us. We should do both. Spending that comes on line several years down the line will still help -- we'll be very lucky if this thing is over by

2011.

I've always been a fiscal conservative. I have a PhD in economics and was on the faculty at the University of Chicago for several years before going into business. I am appalled by the increase in the national debt over the last decade, and by the prospects for the immediate future. But worrying about wasteful spending right now is a bit like arguing about the cost of running the pumps while the ship is sinking.

Let's put this in perspective. If we completely waste a trillion dollars - say by digging holes and filling them in - that's about four percent of the 25 trillion at stake here. If that spending reduces the severity of the crisis by five percent, we've come out ahead.

And when it comes to digging holes and filling them in, we can probably save money on the digging part - there are already enough potholes in the North Central US to absorb lots of budget money. We might repair a few bridges and fix some levies, too. Really, we don't need to waste the money.

Have you noticed lately that people who sound confident about the economy are mostly talking head pundits with no practical experience and no responsibility? And that the people who know what they're talking about, like Bernanke, Volcker, Geithner, Summers and Buffett, take a more cautious line - the situation is serious but things will be fine **if we do what we need to do?**

These folks face a delicate problem. They have to talk enough truth to justify spending trillions of dollars to stop this crisis, without saying things which might scare consumers and businesses into total paralysis.

When our country faces a serious crisis, Americans usually pull together. That's not happening this time - instead we're bickering, finger pointing and maneuvering for political advantage. I don't question anyone's patriotism, I just think that most Americans don't appreciate the danger.

Obama's economic advisors are solid, experienced professionals who understand what happened in the 1930s. They aren't moveon.org radicals. We need to let them work. And we need to keep our minds on the big picture.

Concentrate or hang.

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