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Why There Was No Depression

By Robert J. Samuelson
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How close did we come to the Great Depression 2.0?

That question will spawn a cottage industry of books, studies and conferences. But Christina Romer, the head of President Obama's Council of Economic Advisers, already has an answer: pretty darn close. Her conclusion deserves attention because Romer, in her previous academic career, was a scholar of the Great Depression.

"Depression" is a term of art. It's more than a serious economic downturn. **What distinguishes a depression**

from a harsh recession is paralyzing fear of the

unknown -- so great that it causes consumers, businesses and investors to retreat and panic. They hoard cash and desperately curtail spending. They sell stocks and other assets. A devastating loss of confidence inspires behavior that overwhelms the normal self-correcting mechanisms (lower interest rates, inventory resupply, cheap prices) that usually prevent a recession from becoming deep and prolonged: a depression.

Comparing 1929 with 2007-09, Romer finds the initial blow to confidence far greater now than then. True, stock prices fell a third from September to December of 1929; but fewer Americans then owned stocks, and prices had risen early in the year. Moreover, home prices barely dropped. **From December 1928 to December 1929, total household wealth declined only 3 percent. By contrast, the loss in household wealth between December 2007 and December 2008 was 17 percent -- more than five times as large. Both stocks and homes, more widely held, suffered larger losses.**

Thus traumatized, the economy might have gone into a free fall ending in depression. Indeed, it did go into a free fall. The anniversary of Lehman Brothers' bankruptcy in mid-September inspired much commentary that saving the investment bank *wouldn't* have averted the crisis. Too many other lenders held bad loans. True. **But allowing Lehman to fail almost certainly made the crisis worse. By creating more unknowns -- which companies would be rescued, how much were "toxic" securities worth? -- Lehman's bankruptcy converted normal anxieties into extreme fears that triggered panic.**

As credit markets froze, stock prices collapsed. By year-end, the Dow Jones industrial average was down 23 percent from its pre-Lehman level and 34 percent from a year earlier. Financial panic poisoned popular psychology. In September 2008, the Conference [Board's](#) index of consumer confidence was 61.4. By February, it was 25.3. Shoppers recoiled from buying cars, appliances and other big-ticket items. Spending on such "durables" dropped at a 12 percent annual rate in 2008's third quarter and at a 20 percent rate in the fourth. With a slight lag, businesses canned investment projects; that spending fell at a 20 percent rate in the fourth quarter and a 39 percent rate in 2009's first quarter.

That these huge declines didn't lead to depression mainly reflects, as Romer argues, countervailing government actions. Private markets for goods, services, labor and securities do mostly self-correct; but panic, driven by the acute fear of the unknown, feeds on itself and disarms these stabilizing tendencies. In this situation, only government can protect the economy as a whole, because most individuals and companies are

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involved in the self-defeating behavior of self-protection.

Government's failure to perform this role in the early 1930s transformed recession into depression. That changed when newly inaugurated Franklin Roosevelt closed all banks on March 5, 1933. Many were already shut, having suffered massive withdrawals by terrified depositors who feared their funds would be lost. Yet when banks reopened in mid-month, Americans redeposited most of that money. The reason was not just Roosevelt's first calming fireside chat ("It is safer to keep your money in a reopened bank than under the mattress"), argues a study by economist William Silber of New York University. FDR's pledge was credible because the Federal Reserve was authorized to supply currency to any reopened bank equal to 100 percent of its deposits.

Something analogous happened over the past year. Scholars will debate which interventions -- the Federal Reserve propping up a failing credit system, the Troubled Assets Relief Program, Obama's "stimulus" plan and bank "stress test" -- counted most. Regardless, they all aimed to reassure people that the free fall would stop and thereby curb the fear perpetuating the free fall. Confidence had to be restored so the economy's normal recovery mechanisms could operate. This seems to have happened. By last month, the consumer confidence index had rebounded to 53.1. Housing prices had stopped falling. By the Case-Shiller index, they've increased for three months.

But this improved confidence is not optimism. It is the absence of terror. The consumer sentiment index is still weak. Unemployment (9.8 percent) is abysmal, the recovery's strength unclear. Here, too, there is an echo from the 1930s. Despite bottoming in 1933, the Depression didn't really end until World War II. Government didn't ensure recovery. Some policies helped, some hurt. The good news today is simply that the bad news is not worse.

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