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Musings & Amusings: Politics

When asked what he'd do if he woke up to find he'd been elected mayor of New York, William F. Buckley replied, "Demand a recount!"

Comedian Jackie Mason's solution for reforming Congress, "Put them on commission."

According to Harry S Truman, "A statesman is a politician who's been dead ten or fifteen years."

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The crunch that stole Christmas. The financial crisis has finally helped turn the economic slowdown into a major recession resembling those of the mid-1970s and early 1980s. Car sales and consumer confidence have plunged to the lowest levels in decades. Jobs and Gross Domestic Product (GDP) are both declining. However, a replay of the 1930s economic collapse is not likely. And a number of forces will turn things around by the middle of next year. These include the many dramatic policy actions already taken as well as the all but certain fiscal stimulus package that will be enacted during the next few months.

Until September, the Federal Reserve, the Treasury and Congress had been able to patch the cracks developing in the nation's financial system. By mid-September, however, the dam finally broke, inundating a number of major financial institutions. The Dow Jones industrials, which had already fallen almost 20 percent from the record close of October 2007, plunged another 20 percent in a couple of weeks. Legislation was rapidly passed in October to rescue the financial system by pumping in billions of dollars. While this seems to have slowed the spread of financial distress, it has not been able to stop a deep recession from unfolding.

Consumers, who generate more than two-thirds of the nation's GDP, have really cut back. Consumer purchases fell 3 percent during the third quarter – the first major decline in nearly 20 years – and dropped further in October. It is now likely that this year's Christmas retail sales could be below last year's, which is both unusual and troubling. The good news is that there will be more Christmas bargains. The bad news is that there will be fewer retailers around after the holidays.

Households have lost a stunning \$10 trillion dollars of wealth from the falling stock market and declining home prices. When wealth was rising, they used some of it to support their buying habits. Incomes are also shrinking with fewer employees on the job. During the first ten months of this year, 1.2 million jobs have been lost, more than half of these during August-October. Amidst such a huge rise in uncertainty, the Conference

Board's measure of consumer confidence fell to a record low.

But it's not just consumers who are having problems making ends meet. Most cities and states are attempting to hold the line on spending as the weakening economy causes tax revenues to fall. Furthermore, the credit crunch has raised municipal borrowing costs. Falling endowment values due to the stock market debacle are forcing colleges to tighten their belts and defer major construction projects.

The malaise has quickly spread overseas, enveloping tiny Iceland as well as enormous China. The Euro currency zone is in recession, and so is Japan. This means that U.S. exports will weaken as demand from these countries fades. The stronger dollar of recent months, which stems from the inflow of foreign capital seeking the safety of U.S. Treasury securities, further weakens our exports.

How bad will it get? Practically every news media account calls this the worst situation since the Great Depression of the 1930s. I think this can be both true and very misleading. While the financial system is experiencing more problems than at any time since then, the decline in the real economy (jobs, incomes, unemployment) is highly unlikely to get anywhere near as bad.

The Great Depression spanned more than a decade. The economy peaked in mid-1929 and did not fully recover until well into World War II. The first contraction started in August 1929 and continued until March 1933. Unemployment rose from 3 percent to 25 percent while real GDP and the Consumer Price Index both fell about 25 percent. Another contraction hit in 1937-38 so that the unemployment rate was 17 percent in 1939.

At the worst of the Depression, there were no unemployment compensation and no bank deposit insurance. These were enacted much too late to prevent the decline. Plus, there were huge policy blunders, especially by the Federal Reserve. President Roosevelt might just as well have said "The only thing we have to fear is the Fed itself."

Congress passed the Smoot-Hawley Tariff Act of 1930, which led to a global trade war that simply made a bad situation worse. Hundreds of economists petitioned Congress not to pass this legislation. This unanimity is remarkable in and of itself because economists usually can't even agree on what time to have lunch.

Precious time was wasted during the first years of the Depression as large parts of the banking system were allowed to collapse. The resulting contraction of money and credit not only made unemployment worse, but it helped usher in the period of deflation. Falling prices for goods, services and assets further weakened the financial system and the economy. The Depression differed from the recessions that followed not only in degree (length and depth) but in kind (deflation).

Interestingly, fiscal (budget) policy was nowhere near as expansionary in the 1930s as is commonly believed. For one thing, state and local government were much larger then relative to the federal government. In order to balance their budgets, they were raising taxes and cutting spending. While municipalities are contracting today, their actions are more than offset by the billions being pumped into the economy by Washington.

The 1930s are most relevant for helping us understand what NOT to do. They do not provide the basis for a plausible economic forecast.

The two most recent recessions in 1991 and 2001 also provide little guidance since they were the mildest on record. In fact, had it not been for Saddam Hussein's invasion of Kuwait and the terrorist attacks of September 11, these slowdowns might not have even qualified as recessions.

The current recession is much more likely to resemble the downturns of 1974-75 and 1981-82. These were among the worst of the post-World War II period, but nowhere near as bad as the 1930s. Both lasted five quarters, and the unemployment rate rose an average of four points.

Both were caused by what might be described as "category 5" economic hurricanes. The 1974-75 downturn was precipitated by OPEC's quadrupling of oil prices in November 1973. The 1982 recession followed Paul Volcker's monetary policy "shock therapy," which was designed to kill inflation after the CPI had soared to 13 percent. The Federal Reserve slammed on the monetary brakes so hard that the prime rate climbed to a record 21½ percent, and 30-year fixed-rate mortgages topped 18 percent.

When the National Bureau of Economic Research finally gets around to it, this panel of academics will probably date the start of the recession sometime during the first half of this year. One recent "unofficial" survey of economists says the economy peaked in April. Anyway, GDP, which declined a little in the third quarter, is falling at a 3-4 percent pace in the final quarter as consumers pull back further. After falling further during the first half of 2009, I expect GDP will start rising during the third quarter.

However, not all economic indicators will stop deteriorating at the same time. Employment is apt to continue declining somewhat longer than GDP as businesses get the initial increases in output through increased overtime. Thus, the "jobless recoveries" that followed the last two recessions are likely to happen again. Bankruptcies and foreclosures probably won't improve until 2010.

This is a bit more pessimistic than the current consensus of economists, which sees GDP rising again in the second quarter of next year and the unemployment rate peaking at 7½ percent. All things considered, these are rather small differences.

Finally, it is important to understand the way economists talk. Recession is when the economy is declining and recovery is when it starts to grow again. However, it will take quite some time for the economy to fully recover. For example, house prices won't regain their previous peaks for years even through they'll start rising by the end of 2009. When your doctor says you're recovering, he means you're getting better. When he says you've recovered, he means that you are completely healed.

Seasonally Adjusted Holiday Greetings!



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