

# ING Investment Management Market Review

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## Recession or depression?

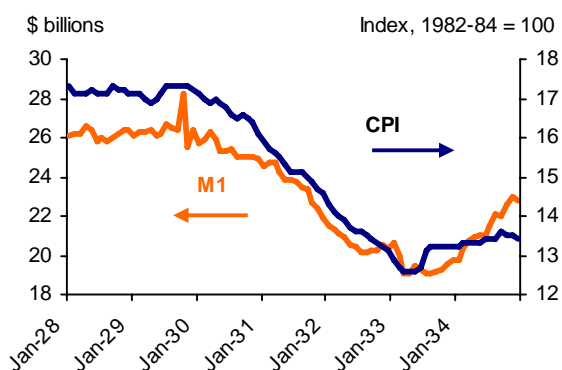
One of the questions we have been getting most often in recent months is “Are we in a recession?” That is now beginning to turn into “Are we heading into a depression?” The reasons for the concern are not hard to fathom. They are an understandable reaction to recent events, which have included the failure or near failure of several prominent financial firms, record-setting wide spreads on corporate bonds, tighter credit standards on the part of banks, rising unemployment, the freezing up of several key financial markets and waves of panic selling in the stock market. These were all features of the Great Depression that gripped the world during 1929-33. Yet in many ways the current economic weakness and financial crisis differ from the Great Depression, making comparisons potentially misleading.

### Recessions vs. depressions

The definition of a recession is straightforward. It is not, as widely believed, two quarters’ contraction in real GDP. That is a rule of thumb (and a pretty good one) developed by Brookings Institution economist Arthur Okun, who noticed that real GDP had declined by at least two quarters in every recession. The actual definition used by the National Bureau of Economic Research, a non-profit organization that makes the recession call, is: “A significant decline in economic activity spread across the country, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production and wholesale-retail sales.”

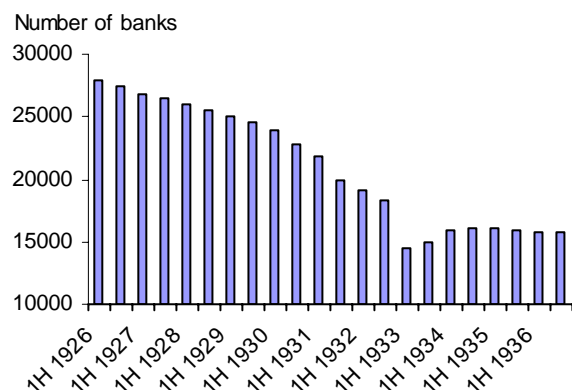
In contrast, no consensus exists among economists about what defines a depression, though certainly part of what differentiates a depression from a recession is scale: Declines in economic activity are so much more severe in depressions that they are arguably different in their very character from recessions. For example, during the Great Depression in the United States, the money supply as measured by M1 declined by 28%. Consumer prices fell 27%, industrial production plummeted 52%, the unemployment rate rose to 25% and about 37% of the nation’s banks failed or were merged out of existence. In contrast, during the last recession in 2001, M1 rose by 5.5%; consumer prices rose 2% year-over-year, industrial production fell only 4%, unemployment peaked at 6.3% (after the recession was over) and no banks failed. To paraphrase Mark Twain, in scale depressions and recessions are as different from one another as lightning and the lightning bug.

**Figure 1. The money supply and prices fell sharply during the Great Depression.**



Source: Federal Reserve

**Figure 2. More than 10,000 U.S. banks closed their doors during 1929-33.**



Source: Federal Reserve

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The consensus among economists responding to the Blue Chip survey is that the United States is in a recession, which some believe will be severe. But few economists are forecasting a downturn as severe as that of 1929-33.

To many economists, however, the distinguishing feature of a depression is an economy and financial markets that are so deeply dysfunctional they prevent the economy from righting itself from a contraction. Here there is greater cause for concern. Several key markets, including the interbank lending market and the commercial paper market, are not functioning well. Their failure to return to normal operation will likely affect the real economy adversely, making any recession that does occur deeper and longer than it would have been otherwise. But rates have come down in both markets – not as quickly as would be desirable – but a sign of improvement nonetheless.

## Policy errors in the Great Depression

Arguably one of the most important differences between the Great Depression and the current situation is that major policy errors were committed during the Great Depression – errors so large that in retrospect they almost beg belief. These errors, which were made in monetary, fiscal and trade policy, are not being repeated.

**Monetary policy:** During the Great Depression the Federal Reserve did conduct open market operations and did reduce the discount rate in an effort to stimulate the economy. These efforts, however, were inadequate to prevent the money supply from contracting severely. As the money supply fell consumer prices fell. With debt contracts denominated in nominal terms, the price deflation raised the burden of servicing the debt, resulting in rising defaults and business failures, contributing to the economy's downward spiral. But that is not all. Incredibly, the Federal Reserve tightened the nonrate terms of discount window lending, in effect closing the window to many banks. Credit terms at the discount window were initially tightened in March 1929. The Fed's intent was to keep banks from using the discount window to finance call loans, which were loans on stock collateral that the Fed thought were fueling a speculative bubble in the stock market. Later, in the 1930s, the Fed maintained the tight credit terms out of concern for earnings at Federal Reserve banks and a desire to avoid lending to what it thought were possibly insolvent banks.

By abdicating the lender of last resort function for which it had been originally created, the Fed failed to prevent many of the bank failures that occurred in the many panics of the 1930s. In a much cited 1983 article, Ben Bernanke argued that the failure of thousands of banks helps explain the long duration and steep decline in economic activity during the Depression. He provided econometric evidence that monetary and price shocks can explain no more than half of the decline in output between mid-1930 and March 1933 (the trough). Introducing measures of bank failures, however, greatly improved the ability of his estimates to explain the decline in economic activity. Bernanke argued that when banks failed, borrowers – chiefly farmers, households and small businesses – were unable to obtain credit at surviving and often distant banks. With less financing available for planting and harvests, spending and housing, and inventories, economic activity plummeted.

**Fiscal policy:** When the Depression began the Federal government balance was in surplus. This is not the ideal fiscal policy stance in the face of declining economic activity, but it was not contributing to the contraction. By 1931, however, declining incomes had resulted in lower tax receipts and had created a deficit. President Hoover called for higher taxes and lower expenditures. Fiscal policy turned sharply restrictive, imposing one of the largest tax increases in percentage terms enacted in peacetime American history. This pro-cyclical fiscal policy did nothing but add to the deflationary pressures already affecting the economy.

**Trade policy:** In mid-1930, seeking to shelter American producers from foreign competition, Congress passed the Smoot-Hawley Tariff Act, which raised import tariffs to the highest rates in American history and to some of the highest levels in the world. Other countries were doing the same in a global “beggar thy neighbor” policy. Global trade collapsed. The government’s index of U.S. exports fell from a level of 100 in 1929 to 34 in 1933.

By way of contrast, today central banks are flooding markets with liquidity and governments are making massive injections of capital into their largest banks. The U.S. government has already launched one large fiscal stimulus package with another coming. Despite talk of “fair trade” initiatives, no one envisages a rise in tariffs comparable to those of 1930. This is a far cry from the utterly inadequate policy responses to the contraction that occurred in your grandfather’s era.

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