Another Great Depression?

The Great Depression began in earnest in October of 1929. By 1933, unemployment rates spiked to 25%, incomes plunged, construction stopped, thousands of banks failed and people suffered for years. The seriousness of the current economic situation invites comparisons to 1929. How a government responds to an economic crisis is vitally important. Generally, that response comes in the form of monetary and fiscal policy. Let's hit the highpoints.

The Monetary Front

The Federal Reserve System, which is an independent branch of the federal government, sets the country's monetary policy in an effort to promote economic growth, price stability, and full employment. Since these objectives are generally at odds with one another, the Fed must generally prioritize its objectives. At the moment, it's a safe bet that our Fed's primary focus is economic stability.

As depression-era depositors stormed the U.S. banking system to demand their cash, banks collapsed. The result should not have surprised regulators because banks are simply not designed to refund depositors' money en masse. Yet, due to liquidity constraints imposed by the country's adherence to the Gold Standard (abandoned long ago), the Fed had little ability to support the banking system when it most mattered. Consequently, 9,000 banks eventually failed. By 1933, these failures resulted in the nation's money supply shrinking by about a third. The shrunken money supply dramatically exacerbated the decline in income, employment, asset prices, and wealth.

In contrast, our current Fed has not only injected massive amounts of liquidity into the banking system, it has made emergency funds easier to obtain, arranged mergers of distressed institutions, intervened directly in the money market, and made an effort to coordinate its policies with those of similarly affected countries.

Prominent economists agree that an ineffective depression-era Fed helped convert what might have been a run-of-the-mill recession into the greatest economic funk of modern history. And although some may argue the modern Fed has been behind the policymaking curve to an extent, informed observers generally concur that our current Fed has been creative and responsive, if not proactive.

The Fiscal Front

During the depression, plunging incomes and asset values caused tax revenues to decline dramatically. To avoid falling into a budgetary deficit, the government slashed spending. To replenish waning tax coffers, lawmakers later imposed a significant tax increase. However, the lack of liquidity, reduced governmental spending, and increased taxes conspired to quell demand and strangle the

economy for the better part of a decade.

While there is near universal agreement among economists that persistent budgetary deficits do eventually become problematic, economists now understand that short-term deficits can provide a vital source of stimulus to a sagging economy. Consequently, when it became apparent that the economy might have been slipping into recession earlier this year, Congress undertook $150 billion worth of deficit spending in an effort to prime the economic pump. The $700 billion rescue package that was signed into law earlier this month provided an additional $150 billion worth of stimulation (even if much of it came in the form of pork-barrel fat).

While no one can promise that the current malaise won't morph into another depression, it does appear that policymakers are heeding some important history lessons.

TWO WAYS TO CLEAN A BATHROOM

In drafting the Emergency Economic Stabilization Act of 2008, a major point of contention was whether the Treasury should purchase toxic assets from afflicted institutions, or inject capital directly into them in exchange for an ownership stake (for the benefit of the people).

Treasury Secretary Henry Paulson's apparent preference is to purchase toxic bank assets from struggling banks and to otherwise interfere with them as little as possible. However, many economists would prefer that the Treasury inject capital into ailing institutions and take an ownership interest in them while they endeavor to clean up their messes. Financial institutions tend to prefer Paulson's method — probably because it implies less governmental interference. What's the difference between the methods?

Paulson's approach would be analogous to hiring a janitorial service to clean a filthy bathroom in an office building. In contrast, the preferred "capital injection" approach would be more akin to a management company buying an interest in the entire office building and agreeing to oversee the maintenance of its bathrooms as part of the deal. While the janitorial service may, in fact, clean the bathroom acceptably well, the management company would be more likely to ensure that the plumbing functions properly.

Whether Paulson's investment banking ties influenced his preference or not, the final version of the rescue package apparently does contain a bit of language that affords the Treasury the latitude to tackle the problem both ways. Due to the size and nature of the mess, having a second bathroom crew probably isn't a bad idea.