Diagnosing depression

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What is the difference between a recession and a depression?

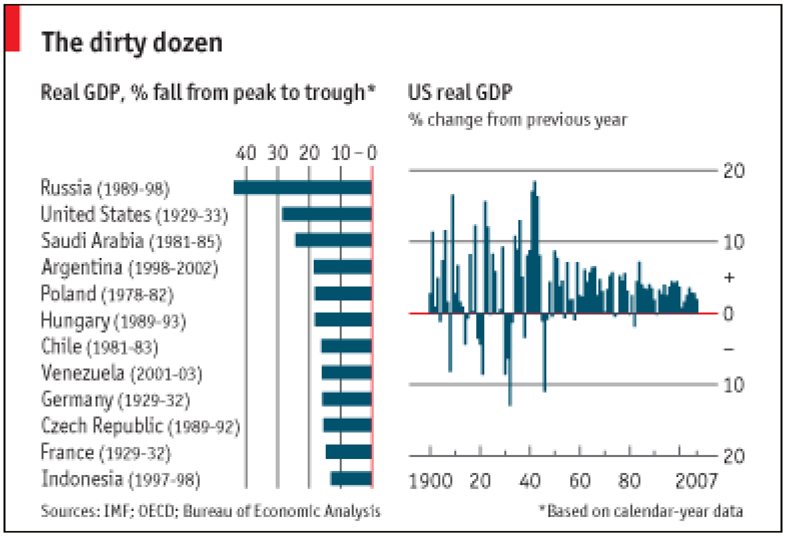
THE word "depression" is popping up more often than at any time in the past 60 years, but what exactly does it mean? The popular rule of thumb for a recession is two consecutive quarters of falling GDP. America's National Bureau of Economic Research has officially declared a recession based on a more rigorous analysis of a range of economic indicators. But there is no widely accepted definition of depression. So how severe does this current slump have to get before it warrants the "D" word?

A search on the internet suggests two principal criteria for distinguishing a depression from a recession: a decline in real GDP that exceeds 10%, or one that lasts more than three years. America's Great Depression qualifies on both counts, with GDP falling by around 30% between 1929 and 1933. Output also fell by 13% during 1937 and 1938. The Great Depression was America's deepest economic slump (excluding those related to wars), but at 43 months it was not the longest: that dubious honour goes to the one in 1873-79, which lasted 65 months.

Japan's "lost decade" in the 1990s was not a depression, according to these criteria, because the largest peak-to-trough decline in real GDP was only 3.4%, over the two years to March 1999. Since the second world war, only one developed economy has suffered a drop in GDP of more than 10%: Finland's contracted by 11% during the three years to 1993, mainly thanks to the collapse of the Soviet Union, then its biggest trading partner.

Emerging economies, however, have been much more depression-prone. Among the 25 emerging economies covered each week in the back pages of *The Economist*, there have been no fewer than 13 instances in the past 30 years of a decline in real GDP of more than 10%. Argentina and Poland were afflicted twice. Indonesia, Malaysia and Thailand all suffered double-digit drops in output during the Asian crisis of 1997-98, and Russia's GDP shrank by a shocking 45% between 1990 and 1998.

The left-hand chart shows *The Economist*'s ranking of slumps in developed and emerging economies over the past century. It excludes those during wartime (both Germany and Japan, for example, saw output plunge by 50% or more after 1944). The depressions in Germany and France in the 1930s make it into the top 12, but not that in Britain, where GDP fell by a relatively modest 6%.



Before the 1930s all economic downturns were commonly called depressions. The term "recession" was coined later to avoid stirring up nasty memories. Even before the Great Depression, downturns were typically much deeper and longer than they are today (see right-hand chart). One reason why recessions have become milder is higher government spending. In recessions governments, unlike firms, do not slash spending and jobs, so they help to stabilise the economy; and income taxes automatically fall and unemployment benefits rise, helping to support incomes. Another reason is that in the late 19th and early 20th centuries, when countries were on the gold standard, the money supply usually shrank during recessions, exacerbating the downturn. Waves of bank failures also often made things worse.

But a recent analysis by Saul Eslake, chief economist at ANZ bank, concludes that the difference between a recession and a depression is more than simply one of size or duration. The cause of the downturn also matters. A standard recession usually follows a period of tight monetary policy, but a depression is the result of a bursting asset and credit bubble, a contraction in credit, and a decline in the general price level. In the Great Depression average prices in America fell by one-quarter, and nominal GDP ended up shrinking by almost half. America's worst recessions before the second world war were all associated with financial panics and falling prices: in both 1893-94 and 1907-08 real GDP declined by almost 10%; in 1919-21, it fell by 13%.

The economic slumps that followed the collapse of the Soviet Union and those during the Asian crisis were not really depressions, argues Mr Eslake, because inflation increased sharply. On the other hand, Japan's experience in the late 1990s, when nominal GDP shrank for several years, may qualify. A depression, suggests Mr Eslake, does not have to be "Great" in the 1930s sense. On his definition, depressions, like recessions, can be mild or severe.

Another important implication of this distinction between a recession and a depression is that they call for different policy responses. A recession triggered by tight monetary policy can be cured by lower interest rates, but fiscal policy tends to be less effective because of the lags involved. By contrast, in a depression caused by falling asset prices, a credit crunch and deflation, conventional monetary policy is much less potent than fiscal policy.

Yes, we have no bananas

Where does that leave us today? America's GDP may have fallen by an annualised 6% in the fourth quarter of 2008, but most economists dismiss the likelihood of a 1930s-style depression or a repeat of Japan in the 1990s, because policymakers are unlikely to repeat the mistakes of the past. In the Great Depression, the Fed let hundreds of banks fail and the money supply shrink by one-third, while the government tried to balance its budget by cutting spending and raising taxes. America's monetary and fiscal easing this time has been more aggressive than Japan's in the 1990s.

However, these reassurances come from many of the same economists who said that a nationwide fall in American house prices was impossible and that financial innovation had made the financial system more resilient. Hopefully, they will be right this time. But this crisis was caused by the largest asset-price and credit bubble in history—even bigger than that in Japan in the late 1980s or America in the late 1920s. Policymakers will not make the same mistakes as in the 1930s, but they may make new ones.

In 1978 Alfred Kahn, one of Jimmy Carter's economic advisers, was chided by the president for scaring people by warning of a looming depression. Mr Kahn, in his next speech, simply replaced the offending word, saying "We're in danger of having the worst banana in 45 years." America's economy once again has a distinct whiff of bananas.

<u>Questions:</u>

1. What is the "rule of thumb" when defining a recession?

2. Is there a definition of a depression?

3. How can we distinguish a recession from a depression?

4. When was the most severe depression after the World War II, and which country experienced it?

5. Why have recessions become milder after 1940s?

6. According to Saul Eslake, what makes a difference between a recession and a depression?

7. According to Saul Eslake, what are the necessary differences in policy responses to recessions and depressions?

8. According to the article, is a 1930s-style Depression likely today? Why (why not)?