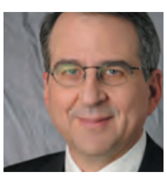
GENERATION RECESSION?

How the Recession May Change America



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Many people commonly use the term "Great Recession" to describe the 18-month downturn that ended two years ago, as if it is somehow equivalent to the Great Depression era. In fact, the Great Depression consisted of two separate recessions, punctuated by an expansion from 1934 to 1936. The cumulative loss of output during the decade between 1929 and 1939 was on the order of 20 percent, a far cry from anything we have experienced since.

The recession officially dated from December 2007 to June 2009 was neither as long nor as steep as the recession of 1929–33, let alone the entire Great Depression. Nevertheless, the analogy between the Great Depression and current experience continues to resonate. Perhaps it is because the severity of unemployment already surpasses any episode our country has experienced since the Great Depression. Or perhaps it is because the collapse of housing prices and the magnitude of home foreclosures exceed all records since the Great Depression. Or perhaps it is because nothing else has shaken the public's confidence in the economy since the Great Depression.

There are many differences between today's economy and that of the 1930s, some of which are the direct legacy of that tragedy. We have a much stronger social safety net in place now than when the Great Depression started. And today's economic policymakers responded quickly and forcefully to counteract the recent downturn.

Yet, the evolution of the Great Depression should serve as a grim reminder that much remains unknown about the ultimate footprint that the Great Recession will have on the nation. At this point, we simply don't know what choices people will make in response. Among the many aspects of economic life that could be affected are labor force participation, housing choices, personal saving, the financial system, the scale of government, and monetary policy. What we do know is that these choices are important to monitor. How they develop could determine just how "great" this most recent recession really turns out to be.

The Variables

Labor force participation has declined considerably since the onset of the financial crisis, led by 25- to 54-year-olds. Clearly, many have become discouraged about their ability to find an acceptable job. Many of those who remain in the labor force but are unemployed have had to contend with extremely long spells of joblessness or underemployment.

During the Great Depression, many breadwinners suffered several years of unemployment, and families endured considerable hardships. In response, many states and the federal government expanded their social safety nets: Unemployment insurance, social security, and aid to families with children received increased public support and funding. The federal government directly created jobs through several large-scale programs such as the Works Progress Administration. Labor union membership grew steadily for decades.

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From a personal perspective, how will the Great Recession shape our perspective of what constitutes "a good job"? What strategies will individuals adopt to better prepare themselves for the unpredictability of working life? From society's perspective, what happens to the skills of those who endure the hardship of long-term unemployment or underemployment—are there cost-effective ways to reduce the deterioration in knowledge and skills that could result? What strategies could be adopted to smooth the transition back into productive work and to reduce dependence on the social safety net?

It goes without saying that the housing market was the epicenter of the financial crisis, and its malfunctioning remains one of the key obstacles to a sustainable recovery. During the Great Depression, depressed housing values and "underwater" homeowners were also barriers. One significant difference between then and now is that our modern financial system turned ordinary home mortgages into highly complex and securitized financial instruments, making it much more difficult to coordinate a solution with all of the affected parties. Add to that the poor underwriting standards underlying some of these mortgages, and it is easy to see why it has been a challenge to "put Humpty Dumpty together again."

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The housing market suffers from a lack of confidence on the parts of sellers, buyers, and lenders as to the "true value" of properties. Lenders have retreated from their very expansive view of what constitutes a "creditworthy borrower" and are rethinking how to price for the risk of a loan. Many foreclosed homeowners have been forced into becoming renters, and many potential homeowners are becoming renters either by choice or by necessity.

From a personal perspective, how will the Great Recession affect the way in which people view a home as the "best investment they can make?" What other vehicles might rise to take the place of housing as an important household asset? From society's perspective, should we continue to provide an allowance for home mortgage interest expenses in the tax code? Should we continue to support the owner-occupied mortgage market through government-sponsored enterprises? How might a permanent rise in demand for rental housing affect the development of neighborhoods and communities? What are the implications for the construction, real estate, and home-furnishing industries?

Saving and financial literacy in a post-recession world also deserve consideration. Although there is plenty of blame to go around, one of the contributing factors to the housing boom was the willingness of people to live beyond their means. Too many households saved too little, and they often borrowed against their homes to finance current consumption. Many American consumers did not understand the financial products they were dealing with, either as mortgage borrowers or as investors.

What does it mean to be financially literate? From a personal perspective, will the financial crisis convince people to save more? How many people will develop the habit of "paying themselves first" before spending the rest of their paychecks? Will people become more careful in their use of financial products, and more demanding of the financial institutions with which they do business? From society's perspective, how much *caveat emptor* will we expect, and how much *caveat venditor* will we demand? The mortgage foreclosure crisis provides a powerful example of how society at large can benefit from better individual financial decision-making.

For example, research at our Bank and by others shows that foreclosed homes depress the prices of neighboring homes that are not in foreclosure. We can gain a lot by finding more effective ways to educate people in their use of financial products, to incent saving, and to engage in even rudimentary financial planning.

Government policy also bears scrutiny. Let's start with fiscal policy. Deciding to put the federal budget on a sustainable path is not the same thing as deciding on the scale and scope of government. Arithmetically, there are many ways to make spending and taxes add up to the same number. Should we approach budget balance through more tax revenue, or through less spending? Which taxes and which spending? And don't forget regulatory policies, which can also significantly affect resource allocation decisions made in the private sector.

The size and scope of the federal government expanded considerably during and after the Great Depression. Although many economic historians have come to view this expansion as broadly supportive of both longer-term economic growth and stability, most economists recognize that there are limits to that process. The question is, have we reached or crossed that limit, or do we need to rely on the federal government once again for stability and growth? The debate rages on in our current political discourse.

Another debate is under way about the role and conduct of monetary policy. The Federal Reserve (along with the central banks of several other countries) has taken many unusual steps to supply liquidity to financial markets, facilitate credit availability, and spur economic growth. These unusual steps have greatly increased the amount, nature, and maturity structure of the Federal Reserve's assets, and they have also led to innovations in direct lending programs to financial institutions. Both the Federal Reserve's ability to respond to the financial crisis in unusual ways, and its choice to do so, have been profoundly affected by the Great Depression. Consequently, there is an irony — one that parallels the questioning of expansionary fiscal policy — to the discord that has arisen over the use of the unusual policy tools.

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Uncertain Future

During the Great Depression, people did not know it was the Great Depression. The Great Depression evolved and was characterized by episodes of expansion and subsequent relapse. How today's economy progresses from this point is unclear. Confidence is low, and it's susceptible to bouts of self-perpetuation. At the same time, we have the benefit of knowing that as a nation we not only *recovered* from a somewhat similar painful period, we prospered.

What seems increasingly clear is that we are living through a historically fascinating period. The generation of people who are coping with economic problems today may well change the ways in which they think, and those changes may well change our economy. That could be something to worry about. But then again, it could also be something to look forward to. ■

More on financial literacy

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