# The Depression of 2008-2009

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On January 30, 2009, the U.S. Bureau of Economic Analysis announced its calculation of the GDP for the fourth quarter (last three months) of 2008. Gross Domestic Product measures the total legal output of the economy, not including the underground, non-reported, economy. The announcement declared that real GDP decreased by an annual rate of 3.8 percent in that quarter, “real” meaning after adjusting for inflation. In the third quarter of 2008, real GDP had decreased by half a percent.

Annual US GDP growth has been falling since 2005. The economy grew by 1.3 percent in 2008 due to growth in the second quarter, in part because of the tax rebates given to the middle class in the spring of 2008. That stimulus was too little to stop the downward spiral, and all the money expansion, low interest rates, and financial bail-outs failed to stop the downward momentum, which accelerated in the last half of the year.

The large decline in output, following three years of decelerating growth, has put the U.S. economy in a depression. “Recession” means falling output, while “depression” means an economy substantially below its normal level. All the signs of depression are here - record high unemployment compensation, big bankruptcies, the crash of the financial sector, and the colossal collapse of real estate prices and construction.

Rising exports had boosted U.S. output in 2008 until the third quarter. By the end of 2008, there was a global recession. With higher unemployment and sharply reduced borrowing, Americans bought fewer imports, which hurt the economies of the exporting countries. Also, many countries had their own real estate boom-busts. The downturn in U.S. exports was the first decline since 2003.

Purchases by households of consumer goods continued its decline in the fourth quarter. Economic investment also continued its decline. What drives the business cycle is not households’ consumption, but economic investment, meaning an increase in the production of capital goods. Real estate construction, and related durable goods such as furniture, provides about a third of economic investment, and its decline has been the main driving force in generating the recession. The economy will not recover until investment turns positive.

Severe recessions are usually accompanied by falling prices, or at least a decline in the increase in prices. The prices of household consumer goods fell by 5.5 percent in the last quarter, a huge fall. Combined with lower prices for real estate, low interest rates, and a low price of fuel, the economy is experiencing deflation, falling prices. It is more difficult to cut wages than prices, but we are also seeing wage deflation, mostly in avoiding the usual annual increases, but also in more days off without pay and even some wage reductions.

U.S. government spending grew during 2008. This kept GDP from falling even further, but the spending comes from borrowing, much of it from abroad. State and local governments are cutting back, as their tax revenues decrease, but the federal government just keeps on growing. The BEA reports that real federal government spending increased by 5.8 percent in the fourth quarter. Military spending increased by 2.1 percent, and other federal government spending increased by 14.5 percent. We can expect greater government spending in 2009 as the budget deficit grows to perhaps two trillion dollars.

Economies world-wide are on a downward spiral. Real estate prices are falling, which is really a decline in land values. As land values collapse, loans go into default, banks reduce their lending, both because they have fewer funds to lend, and because of the greater uncertainty about the ability of borrowers to pay back the loans. Unable to borrow, business reduce their operations, and more workers become unemployed. That reduces the demand for goods, and so more enterprises cut back and shut down. It’s a self-reinforcing feedback loop.

The decline in output continues until land values are so low that real estate becomes a great buy. Low interest rates, low rents and real estate prices, and reduced labor costs make production profitable again. The prices of shares of stock are so low that bargain hunters jump in, and the stock market rises, often by big leaps. Long-run investment rises again because investors anticipate a recovery and invest today at low prices to profit from higher prices and greater demand in the future.

During the recession, the usual demand-side policies fail to generate an economic recovery. The central bank buys bonds and increases the reserve funds of banks, but it is futile, as the banks use the extra money to buy out failed banks, pay dividends to prop up the stock prices, and give the chief executives bonuses. Spending for infrastructure - roads, bridges, buildings, pipes - take too long and employs specialized skills, and generally fail to induce a recovery.

There are ways government can stop the downward vicious spiral. The effective demand side way is to give money to the people, thousands of paper dollars to everybody, so they will pay their rentals and mortgages, buy goods, and pay off debts. The effective supply-side policy is a quick and radical tax shift, eliminating all taxes on labor, goods, interest, and dividends, replacing these with a tax that collects the potential rent of land, as if the land were being used in its most productive use. That would quickly push land into productive use. The tax shift would punish land holders for not using their sites productively, instead of punishing people for working and producing and investing.

Government spending is too slow and too specific to have much economic impact unless it is on a huge scale such as occurred in World War II. If government spends huge for civilian goods, it would be a colossal waste of resources. If the people spend it, it would be fruitful, since each individual would spend on what is most useful to them. But this is the year of the ox, so we can expect national governments to slowly plod through the economy, plowing but not reaping.

Using oxen to plow a field is old fashioned. In this year of the ox, government chiefs won’t think outside the box. They look back to the policies of the Great Depression of the 1930s. Like in Great Depression I, they blame wild markets rather than toxic government interventions such as subsidies to real estate. So unfortunately, for the time being, in Great Depression II, we will suffer through the year of the plodding ox rather than what could have been the year of the turnabout roaring bull.

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**FRED E. FOLDVARY, Ph.D.**, (May 11, 1946 — June 5, 2021) was an economist who wrote weekly editorials for Progress.org

Foldvary's commentaries are well respected for their currency, sound logic, wit, and consistent devotion to human freedom. He received his B.A. in economics from the University of California at Berkeley, and his M.A. and Ph.D. in economics from George Mason University. He taught economics at Virginia Tech, John F. Kennedy University, Santa Clara University, and San Jose State University.

Foldvary is the author of *The Soul of Liberty*, *Public Goods and Private Communities*, and *Dictionary of Free Market Economics*. He edited and contributed to *Beyond Neoclassical Economics* and, with Dan Klein, *The Half-Life of Policy Rationales*. Foldvary's areas of research included public finance, governance, ethical philosophy, and land economics.

Foldvary is notably known for going on record in the *American Journal of Economics and Sociology* in 1997 to predict the exact timing of the 2008 economic depression—eleven years before the event occurred. He was able to do so due to his extensive knowledge of the real-estate cycle.