Answer on Question #41000- Economics- Macroeconomics

Recessions and depressions have occurred many times throughout history. To many, they bring fear and uncertainty, but they are actually a natural part of the economic cycle. Unfortunately, there are a lot of myths surrounding market cycles, but in order understand them, we must look beyond these myths. In this article, we'll examine recession and depression, how they work and what they really mean for investors.

What Is a Recession?

First, let's take a look at recessions. There are two definitions of recession: one defines a recession as two consecutive quarters of negative economic growth, and the second (according to the National Bureau of Economic Research (NBER)) defines a recession as a significant decline in national economic activity that lasts more than just a few months.

How It Works

The growth of our economy rests upon the balance between the production and consumption of goods and services. As the economy grows, so do incomes and consumer spending, which continues the cycle of growth. However, because the world is not perfect, at some point, the economy has to slow. This slow down could be caused by something as simple as an oversupply, where producers manufacture too many goods. When this happens, the demand for those goods will drop. This causes earnings to slow, incomes to drop and the equity markets to fall. (To learn more, read Understanding Supply Side Economics.)

Historical Examples

Since the mid-1850s the U.S. had 32 recessions, and according to the NBER, most have varied in length, with the average recession lasting 10 months. The shortest recession on record lasted six months, from January 1980 to July 1980. Two of the longest recessions lasted for 16 months. These were the recessions of November 1973 to March 1975 and July 1981 to November 1982.

What Is a Depression?

A depression is a severe economic catastrophe in which real gross domestic product (GDP) falls by at least 10%. A depression is much more severe than a recession and the effects of a depression can last for years. It is known to cause calamities in banking, trade and manufacturing, as well as falling prices, very tight credit, low investment, rising bankruptcies and high unemployment. As such, getting through a depression can be a challenge for consumers and businesses alike, given the overall economic backdrop. (To learn more, read The Importance Of Inflation and GDP.)

How It Works

Depressions occur when a number of factors come together at one time. These factors start off with overproduction and decreasing demand and are followed by fear that develops as businesses and investors panic. The combination of excess supply and fear causes business spending and investments to drop. As the economy starts to slow, unemployment rises and wages drop. These falling wages cause consumers to cut back spending even more, putting additional pressure on unemployment and wages. This begins a cycle in which the purchasing power of consumers is eroded severely making them unable to make their mortgage payments; this forces banks to tighten their lending standards, which eventually leads to bankruptcies.

Historical Examples

Throughout history, there are several examples of depressions. The most well-known is the Great Depression of the 1930s. However, this one title actually covers two depressions that took place during that time. The first depression occurred from August 1929 to March 1933, during which GDP growth declined by 33%. The second depression ran from May 1937 to June 1938, during which GDP growth declined by 18.2%. In addition, the Great Depression was preceded by another economic depression, which occurred from 1893 to 1898. (To learn more, read What Caused The Great Depression?)

What Can We Learn?

Recessions and depressions provide us with both negatives and positives that we can use to gain a greater understanding of how they work and how to survive them.

Negatives of Recessions and Depressions

There are many negative consequences of recessions and depressions. Let's take a look at a few:

1. Rising unemployment

Generally, rising unemployment is a classic sign of both recessions and depressions. As consumers cut their spending, businesses cut payrolls in order to cope with falling earnings. The difference between the two is that the unemployment rate in a recession is less severe than in a depression. As a basic rule, the unemployment rate for a recession is in the 5-11% range; by contrast, the unemployment during the first period of the Great Depression (1929-1933) went from 3% in 1929 to 25% by 1933.

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2. Economic downturn

Recessions and depressions create a massive unwinding in the economy. During times of growth, businesses keep increasing supplies to meet consumer, demands, but at some point there will be too much supply in the economy. When this happens, the economy slows as demand drops. Recessions and depressions allow us to clear out the excesses of the economy, but the process can be painful and many suffer during this time.

2. Fear

Recessions and depressions create high amounts of fear. As the economy slows and unemployment rises, many consumers become fearful that things will not improve anytime soon. This fear causes them to cut back on spending, causing the economy to slow even more. (For related reading, see When Fear And Greed Take Over.)

3. Sinking values

Asset values sink in recessions and depressions because earnings slow along with the economy. This causes stock prices to fall because of the slowing earnings and negative outlooks from companies. In turn, these falling prices cause new investments for expansion to slow and can affect the asset values for many people.

Positives of Recessions and Depressions

There are many positives that take place as a result of recessions and depressions. They include:

1. Getting rid of excess

Economic decline allows the economy to clean out the excesses. During this process, inventories drop to more normal levels, allowing the economy to experience long-term growth as demand for products picks back up.

2. Balancing economic growth

Recessions and depressions help keep economic growth balanced. If the economy grew unchecked at an expansionist rate for many years, this could lead to uncontrolled inflation. By having recessions and depressions, consumers are forced to cut back in response to falling wages. These falling wages force prices to drop, creating a situation in which the economy can grow at normal levels without having prices run away.

3. Creating buying opportunities

Tough economic times can create massive buying opportunities in huge asset classes. As the economy runs its course, the markets will readjust to an expanding economy. This provides investors with an opportunity to make money as these low asset prices move back to normal.

4. Changing consumer attitudes

Economic hardship can create a change in the mindset of consumers. As consumers stop trying to live above their means, they are forced to live within the income they have. This generally causes the national savings rate to rise and allows investments in the economy to increase once again. (For related reading, see Stop Keeping Up With the Joneses - They're Broke.)

Conclusion

Clearly, both recessions and depressions have many effects on the overall economy. To survive and thrive in these environments requires that you understand what causes them and how those causes create positive and negative effects on the overall economy. Some of the positive effects include taking the excesses out of the economy, balancing economic growth, creating buying opportunities in different asset classes and creating changes in consumer attitudes. The negative effects include rising unemployment, a severe slowing in the economy, the creation of fear and the destruction of asset values. It is by carefully understanding what recessions and depressions are that we can learn how to spot them - and protect investments from them.