

Recession, depression, inflation, deflation ... these words get kicked around quite a bit, but many people have only a hazy idea of what they mean. So I'm taking time here to look briefly at each term, and I think you'll appreciate knowing the what, when, how and why behind these words that journalists tend to toss around a bit cavalierly. Here's a quick look at what these words actually mean.

Recession. A recession is confirmed by negative gross domestic product (GDP) for two or more successive quarters. A bear market can precede or coincide with a recession. Other signs include rising unemployment, declining real estate values, and minimal growth or contraction in business sectors. Sometimes, other factors have played a role – such as U.S. monetary policy, sudden increases in energy costs, and the end or beginning of a war. In the post-World War II era, recessions have averaged about 10 months in duration.¹

Depression. A recession that lasts for years with severe economic depths. The Great Depression was characterized by tremendous unemployment levels (the jobless rate was approximately 25% in 1933) and chilling devaluation of stocks (by 1932, the Dow Jones Industrial Average was down 89% from pre-crash levels). The Depression also saw widespread bank failures – roughly 9,000 U.S. thrifts failed during the 1930s, and all U.S. banks were closed for four days in 1933 by presidential order. When the Depression struck, there was no FDIC, no SEC and no unemployment insurance, making a bad economy worse.^{2,3}

Inflation. Simply defined, this means rising prices. But in addition to retail price inflation measured by the Consumer Price Index, you also have monetary inflation - the growth of the money supply, or the total amount of money in the economy. (Our money supply includes dollars, checking and savings accounts, CDs and money market funds, and short-term transfers of securities in exchange for cash.)

Here is the great balancing act of the Federal Reserve. If it eases the money supply (think lower interest rates), borrowing costs decrease, and investment generally increases. But with easy money, price inflation and currency devaluation follow. The Fed can fight inflation by raising rates to effectively tighten the money supply, but with possible byproducts of reduced consumer spending, lower corporate earnings, and less investment.

Deflation. The opposite of inflation: prices fall. This is a result of reduced money supply and reduced availability of credit. If no one buys anything, business inventories increase as sales of consumer goods decrease, and prices drop in response. This is what happened in Japan in the 1990s; it also happened in America in the 1930s. As prices decline, there is little to encourage investment and hiring. Most economists feel the U.S. has the tools - and the aggressive central bank - to avoid deflation, despite the fact that cheap credit is often a condition for it. (There is also "good" deflation, where cheap productivity increases the quantity of consumer goods and competition drives down prices, effectively increasing consumer wealth.)

Has this been helpful? The Federal Reserve and the Treasury have their heads full of these concerns, and the more individuals understand them, the more they know about how economic trends develop and how economic policy works.

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Citations.

¹ nber.org/cycles.html [8/28/08]

² signonsandiego.com/uniontrib/20081005/news_lzln5dean.html [10/5/08]

³ fdrlibrary.marist.edu/031233.html [11/25/08]