

DIMENSIONAL FUND ADVISORS

Then and Now

The World Has Changed since the Great Depression

DECEMBER 2008

The severity of the current financial crisis has prompted many investors and market observers to draw comparisons between today and the string of events that led up to the worst economic downturn in history, the Great Depression. Clearly, parallels exist between then and now, the most obvious being a dramatic drop in stock prices. During the months of September, October, and November of 1929, the S&P 500 Index fell by 33.1%. For September, October, and November of 2008, the S&P 500 was down 29.6%.

Another similarity has been extreme market volatility. In 1929 and the early 1930s, there were periods of persistently high daily volatility in US markets. For example, during the three-month periods ending November 1929 and November 2008, annualized daily volatilities were above 50%.

Standard international definition of "recession": A period in which an economy contracts for at least two consecutive quarters.

Standard international definition of "depression": A deep and prolonged recession.

The failure of major companies may remind some observers of the Great Depression. The world was shocked this fall to see leading global companies such as Lehman Brothers, Merrill Lynch, and AIG experience acute financial distress or even declare bankruptcy. Furthermore, pressure on banks in

September and October was so severe that, for a time, credit was virtually frozen. And, finally, bleak economic indicators over the past few months have suggested that numerous countries may be heading into economic recession.

Most observers would agree that world financial markets and economies are currently in a state of crisis. However, today's market environment and the response of many governments to the current crisis are in some ways dramatically different from the situation the world experienced nearly eighty years ago at the beginning of the Great Depression.

THE EARLY FEDERAL RESERVE

From 1819 to 1907, there were seven banking panics in the US. These were often followed by economic downturns and increased unemployment. In 1913, the Federal Reserve was created, with one of its primary goals being to prevent such panics. In its early years, however, the Fed did not have the tools or knowledge at its disposal to do so. There were four full-scale banking panics after the Federal Reserve Act was passed: one in 1930, two in 1931, and one of unprecedented proportions in 1933. Over 4,000 of approximately 30,000 US banks failed that year. The majority of these bank failures were caused not by fundamental problems in the banks themselves, but by "runs on the bank" by panicked investors who thought that their savings would be lost.¹

Many economists believe the Fed made a significant error by raising interest rates in the spring of 1928 and again in 1931, the latter in an effort to stop the loss of gold reserves and defend the value of the dollar.² There is general agreement that these events

(interest rate hikes and widespread banking panics) contributed to a 30% contraction in the money supply and to general price deflation.

The banking crisis of 1933 led to the Banking Act of 1935. This act greatly extended the power of the Federal Reserve System and established the Federal Deposit Insurance Company (FDIC) as a permanent agency of the government. After the banking acts of the 1930s, insolvent banks were absorbed (under government supervision) by stronger banks rather than be allowed to fail. This change was effective in increasing confidence and preventing widespread runs on banks. Currently, the FDIC provides deposit insurance that guarantees the safety of checking and savings deposits in member banks up to a limit of \$250,000.³

COMPOUNDING FACTORS IN THE 1930S

The problems of this era were compounded by the Smoot-Hawley Tariff Act of 1930. Smoot-Hawley raised tariffs on more than 20,000 imported items. Many countries responded by increasing tariffs on US goods and, as a result, the volume of imports and exports in the United States and around the world fell by upwards of 60%.⁴

To make matters worse, a prolonged drought, which, combined with poor farming practices, devastated the Plains states, extended the length and depth of the economic downturn and had a profoundly negative effect on the American psyche. More than 500,000 Americans were left homeless by the drought and more than 2.5 million people migrated away from the regions that were affected by it.

¹ John R. Walter, "Depression-Era Bank Failures: The Great Congagion or the Great Shakeout?" *Economic Quarterly* (Federal Reserve Bank of Richmond) 91, no. 1 (Winter 2005): 39-54.

² Lawrence J. Christiano, Roberto Motto, and Massimo Rostagno, "The Great Depression and the Friedman-Schwartz Hypothesis" (working paper, Federal Reserve Bank of Cleveland and National Bureau of Economic Research, January 2004).

³ The limit of \$250,000 is currently set to revert to \$100,000 for most types of deposits at the beginning of 2010.

⁴ US Department of State, "Smoot-Hawley Tariff," http://future.state.gov/when/timeline/1921_timeline/smoot_tariff.html.

CONTRASTS

All these factors led to economic statistics in the 1930s that are far grimmer than those being reported today. By 1933, unemployment rates reached 25% in the United States, 14% in the United Kingdom, 19% in Australia, and 19% in Canada.⁵ Today, unemployment rates are 6.5% in the United States, 5.8% in the United Kingdom, 4.3% in Australia, and 6.2% in Canada.

The early 1930s also saw dramatic declines in real GDP around the world. Between 1929 and 1933, it is estimated that real GDP decreased by approximately 30% in the United States and Canada, and by 10%-20% in Australia and the United Kingdom.⁶ For the third quarter of 2008, annualized estimates show declines in GDP of 0.5% in the United States and the United Kingdom.

Banks are also in relatively better shape today than they were in the 1930s. Fifteen US banks failed in 2008 (as of October 31), a far cry from the thousands of failures during the Depression. Because of FDIC guarantees, there have not been widespread runs on banks and customers have not lost their savings as they did during the 1930s. Even more importantly, governments and policy makers around the world have shown significant determination in the current crisis to provide liquidity and increase investor confidence in global markets.

WHERE WE ARE TODAY

In the United States, Federal Reserve Board governor Ben Bernanke, a scholar of the Great Depression, has shown that he is highly aware of the risks of making wrong moves during times of crisis. He recently led efforts to recapitalize the banking system, cut interest rates, and provide liquidity in commercial paper and other areas of the market. The Fed is keenly aware of

the importance of monetary policy in regulating the economy and has a greater ability to do so now than it did in the 1930s.

The governments of Canada, the United Kingdom, Australia, and many European and Asian countries, along with the United States, have taken extraordinary policy measures in recent months that have made some progress in unfreezing credit markets. There has also been an increase in global cooperation among central banks, primarily through coordinated interest rate cuts.

The global financial community now has a level of oversight and cooperation that was unheard of in the past. Bodies such as the G7 and the G20 (the finance ministers from groups of seven and twenty industrialized nations, respectively) and the International Monetary Fund provide forums for international cooperation and coordination during times of economic crisis.

On the whole, governments today appear to have a clearer understanding of the role they can play in economic downturns by providing liquidity to the marketplace and by taking quick, decisive action to increase confidence in the markets. Based on the events of recent months, there appears to be a consensus that global problems require global solutions, and governments have shown a willingness to make coordinated efforts to help ease markets out of crisis.

The world economy undeniably finds itself in a very serious situation today. But when looking at current events in historical context, it is clear that we are still a long way from a Great Depression.

— Gerard O'Reilly

⁵ R.G. Gregory, *Recovery from the Depression: Australia and the World Economy in the 1930s* (Cambridge: Cambridge University Press, 1989).

⁶ Richard Froyen, *Macroeconomics: Theories and Policies* (New Jersey: Prentice Hall Professional Technical Reference, 2004).

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The principal risks of investing in these portfolios may include market risk, risks of concentrating in the real estate industry, real estate investment risk, small company risk, foreign securities and currencies risk, and emerging markets risk. These risks are fully described in the prospectus in the section called "Principal Risks".

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