International Journal of Science and Research (IJSR)
ISSN: 2319-7064
ResearchGate Impact Factor (2018): 0.28 | SJIF (2018): 7.426

Causes and Policy Responses of the Great Depression and the Financial Crisis of 2008: A Comparison

Musharrat Azam

Department of Economics, Bangladesh University of Professionals (BUP), Bangladesh

Abstract: ***This paper does a comparative analysis of the causes and policy responses between the Great Depression of 1929 and the Financial Crisis of 2008. The Great Depression in 1929 originated from a stock market bubble burst and a subsequent rise in interest rates due to the Federal Reserve's contractionary monetary policy. The Financial Crisis of 2008 was on the other hand, caused through a real estate bubble burst that escalated with the creation of subprime mortgage backed securities. The Great Depression spread throughout the countries that had been maintaining a strict adherence to gold standard. The Financial Crisis transmitted outside the United States through the process of securitization. A series of monetary and fiscal policies and banking reforms eventually helped overcome the slowdown in economic growth caused by these two financial crises.***

Keywords: Financial crisis 2008, Great Depression

1. Introduction

Both the great depression of 1929 and the recent global financial crisis of 2008 originated from the United States and spread across the countries of the world. The factors that triggered the economic downturns in both incidents are similar but also different in some ways. The great depression generated from a burst of the stock market price bubble which eventually led to a sharp decline in consumer spending on durable goods and business investment. On the other hand, the recent global financial crisis of 2008 did generate from a price bubble burst but this price bubble is from the real estate.

2. Origins of the two crises

The speculative boom in stock prices occurred in the United States in the late 1920's. The stock prices started to increase in 1921 and reached its peak in the fall of 1929. The Federal Reserve adopted a contractionary monetary policyto control the rapid rise in stock prices. On the 24th of October 1929 the stock market bubble burst, declining stock prices by 33 percent. As a result of this stock market crash and higher interest rates implemented by the Federal Reserve private wealth reduced by ten percent and uncertainty about future income among the consumers started to grow[7].

On the other hand, looking into the years preceding the financial crisis of 2008, the Federal Reserve had been keeping the interest rates low in order to avoid recession during the dot com bubble and the downturn in 2001. Japan also kept its interest rates low to tackle possible deflation which pressurized the United States to also keep interest rates low for a long time until the mid-2004. House prices at that time were growing at a rate above the interest rates which gave incentives for households to borrow at the lower interest rates and buy houses thus swelling demand and price of houses. Even in some European countries like Spain and Ireland property prices were escalating but the interest rates set by the ECB were not as low as the Federal Reserve.

Under the new 'originate and distribute model' brokers and investment banks that had the job of securitizing the mortgage loans were paid according to the number of mortgages they approved[1].So this process created incentives for the mortgage brokers to sell as many mortgages as possible, substantially lowering the quality of mortgages than they were under the traditional method. As a result they originated subprime mortgages, lending to households who did not have sufficient income or assets to repay back the loan. Mortgage brokers found it very easy to include subprime mortgages in investment grade securities like collateralized debt obligations (CDO) and pass it on to the hungry investors[10].The federal government supported the subprime mortgage market and institutions like Fannie Mae and Freddie Mac to increase the number of homeowners and to counteract the 2001 recession.

Real estate prices had reached its peak by the end of 2006 in the United States and other European countries. World commodity prices like prices of oil, minerals and food began to shoot up due to rising demands in China from 2004 to 2007[7]. As central banks across the world began to raise interest rates to tackle inflationary problems, it became more difficult for weaker residential mortgage borrowers to meet their debt obligations and they started to default on their loans. Simultaneously as new purchasers stopped entering the real estate market the prices of real estate shot downwards and the bubble burst.

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3. How the crises transmitted to the entire world

There are also differences in how both the crises transmitted from the United States to the rest of the world. The great depression was transmitted because of adherence to the gold standard and a wave of banking panics. The process is elaborated below.

France and United States was the recipient of about 60% of the world's monetary gold during the 1920's. Most European banking structures at that time were forbidden from conducting open market operations to expand the money supply. So even though France was accumulating gold inflows the Bank of France was unable to transform these gold inflows into monetary expansion[4].The Federal Reserve contracted the monetary supply to hold up the stock market speculation and also for the purpose of not losing gold to France. This commitment to the gold standard by the Federal Reserve constrained its ability to increase money supply thereby raising interest rates. These high interest rates in United States and France caused substantial amount of gold outflows from countries like Japan, Germany and the United Kingdom. Central Banks across the world had to increase their interest rates for the fear of losing gold to France and the United States. Thus countries maintaining the gold standard at that time carried the depression and the deflation that was happening in the United States to them.

This contraction in the money supply and heightened interest rates created a wave of banking panics throughout the world. The unit banking structure of the United States consisting of many small and undiversifiable banks together with a huge farm debt of the American farmers resulted in a set of banking panics. The two banks that started banking panics here are the Caldwell and Company and The Bank of the United States. Besides the United States, banks across Europe suffered banking problems throughout the 1920's and 1930's. The most prominent bank failure would be the Creditanstalt bank in Austria in 1931[4].The key reason these banks failed in the depression is due to a severe decline in the deposit currency ratio as depositors started to demand their deposits back because of a lack of confidence in the solvency of the banks. Escalation in the number of outstanding debts being in default, adherence to gold standard, and run by foreign depositors are also the chief explanations why banks failed. These disruptions in quite a number of banks across the world lead to reduction of funds for investments thus impeding growth.

In contrast, the recent financial crisis passed on from the United States to the rest of the world through the structures of securitization as mentioned above. After the Asian Financial Crisis of 1997 Asian economies like China, Singapore, Hong Kong and South Korea started accumulating large amount of reserve surpluses. These economies especially China utilized these reserves to invest in many American mortgage backed debt securities. The supply of this sort of debt security also increased in Europe. Thus the process of rapidly growing defaults that had started in the United States spread throughout the financial system through the composition of securitization. The financial crisis was triggered through the failure of Lehman Brothers in September 2008 who had held strong positions in the subprime and lower rated mortgage markets. This led to a steep rise in risk premium across the global markets.Investors all across the world withdrew from the markets drying up liquidity and the global financial system collapsed.

In both the great depression and the recent financial crisis banks and other financial institutions suffered rising defaults. In both scenarios stock markets plunged but in the recent financial crisis stock market prices plunged even faster than they did during the great depression[2].

4. Policy Responses

During 1932 two major monetary expansionary policy regimes were adopted to tackle the deflationist regime causing the great depression. The first was the opening of the Reconstruction Finance Corporation (RFC) to provide loans to illiquid banks. The second was the Federal Reserve's open market purchases[6]. But both these policies were abandoned soon as it was causing liquidity problems in the banks and hurting their profitability. In 1933 when talks of devaluation of the US dollar in an effort to raise commodity prices began, it led to a major run on the US dollar. From the 6th to 9th March of that year a bank holiday which incorporated closing down the entire national banking system had to be declared followed by the Congress passing an Emergency Bank Act (EBA) declaring to reopen only the sound banks to stabilize the financial system.

Starting from April 1933 the dollar being free from the gold standard began to devalue and declined to about 45% against the pound. The Federal Reserve cut the discount rates and also did not sterilize the gold inflows that fled from Europe to the United States thus allowing monetary expansion. These policies led to gradual rise in stock prices in the second quarter of 1933.

Also in June of 1933 President Roosevelt introduced the Glass Steagall Act of 1933 which prohibited the combination of investment and commercial banking[13].One reason for this separation was due to the belief that banks' involvement in the securities market makes it more vulnerable to the financial meltdowns and another reason is to reduce the power of the investment bankers. In addition to the Glass Steagall Act, the Federal Deposit Insurance Corporation (FDIC) was introduced. This structural change guaranteed depositors their deposits if their banks failed. Also under this act instable banks were forced to merge with good banks or get a new management instead of failing. Although this insurance policy contributed greatly towards the stabilization of the financial system, it created problems of moral hazard. Depositors no longer felt it necessary to examine banks; instead they were only interested if the banks were insured.

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Banks were left with a lack of supervision, making bad investment decisions and the FDIC running out of funds of having to insure all the time.

All these policy reforms allowed the United States and also the countries abandoning the gold standard to gradually recover from the great depression. But it was the fiscal expansion during the World War II that led to full recovery for the United States.

The collapse of Lehman Brothers spread systematic risk throughout the financial system. US Treasury Bills were down to their lowest since 1941. The failure of major investment banks like Merrill Lynch and large insurance companies like American International Group forced the Federal Reserve and the Treasury to arrange for massive bail out packages and merger arrangements. In order to increase liquidity in the banking system the Federal Reserve had launched a Term Auction Facility in December 2007 which is a discounted borrowing rate for banks from the Fed that is auctioned off to the highest bidders[10]. But this this did not manage to solve the asset liquidity problems banks faced in September 2008. In September 2008 the Fed introduced new programs to stabilize the money market outflows like the Asset Backed Commercial Paper ABCP and the Money Market Mutual Fund MMMF. Security regulators around the world temporarily banned short sales of financial stocks.
Also in other parts of the world, countries began to take measures to save major financial institutions from failing. The United Kingdom nationalized the bank Bradford and Bingley, Belgium, Netherlands, and Luxembourg nationalized the commercial finance group Fortis, Germany rescued the real estate financing banks company Hypo Real Estate and Iceland nationalized its third largest bank Glitnir[3].Furthermore through a global coordination,the world's main central banks cut their interest rates by fifty basis points.

5. Conclusion

The cut in interest rates by central banks in the developed nations that followed the recent financial crisis has not yet seen a reversal. The Trump administration has been in support of financial deregulation and has repealed major provisions of the Dodd Frank Act that was enacted back in 2010 to prevent another financial meltdown. All the "too big to fail" banks are now even bigger. All these indicate precedents of the previous financial crisis and is a likely cause for concern right now for policy makers in developed nations.

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