Compare and contrast the current financial crisis with that which started the Great Depression.

-EC248 Term Paper-

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Introduction

The impact that the 2008 financial crisis has had on the world economy has led many to draw comparisons to the Great Depression. But how similar are the two events? What were the causes of both and how do the events compare to one another?

In view of these questions, section one will seek to analyse the role that consumption, investment and uncertainty played in both crises. Reference will be made to the effects on small businesses and the uneven burden that has fallen on them as a result of the contraction of credit. The effects of which being directly related to both investment and the confidence levels within the economy.

Section two will analyse the monetarist idea that the Depression was caused by contractionary monetary policy and then compare the policy response of the 2008 financial crisis. In addition, analysis will be made of the collapse of financial institutions and the interconnected role the banks had with housing, which in both crises played a significant role. Finally, a discussion of the problematic interest rate "zero bound" and how this played a part in both crises.

It is to be noted that analysis will be primarily in reference to the United States. Whilst both crises are undoubtedly global, I have chosen to focus my analysis due to the particular severity and role the country played in the crisis.

Section One: Crises, Consumption, Investment & Uncertainty.

Reinhart and Rogoff (2009) suggest that financial crises share many core characteristics. The first being the collapse of asset markets; Market dips in *financial* crises are far more pronounced in terms of their depth and severity. This is echoed by Shachmurove (2011) who points out that "Real housing prices decline an average of 35% over six years, while equity prices collapse an average of 55% over downturns of about three and a half years" during the course of the crises.

Furthermore, extended and prolonged declines often seem to be related to a fundamental break down in the financial mechanism of the economy. Financial crises and in particular the Great Depression and Great Recession are characterised by "debt explosions", the cause of which suggested by Irving Fisher (1933) are periods of "over-indebtedness", periods in which credit is often easy to come by. As Fisher goes onto say "over-investment and over-speculation are often important; but they would have far less serious results were they not conducted with borrowed money." A phrase that rings true in relation to the collapse of banks in both, the Great Depression and the crisis of 2008.

Periods of widely available credit often are a result of over-confidence in the economy or poor policy making. Each being applicable to the recent crisis. There were signs at points in both periods that growth had become speculative on the back of an extended period of economic prosperity. Before the beginning of the downturn in 1929, the US stock market had been on a "Dizzying Ride... Stock prices and the daily volume of shares traded continuing to set records in the late twenties" (Smiley, 2002, P.10) whilst the period wasn't *purely* speculative, nearing its end it exhibited largely speculative growth through over-confidence in the market. In the case of the Great Recession, the role of Freddie Mac and Fannie Mae in engineering credit for what were considered sub-prime individuals caused a similar effect.

However, untangling the web of financial maladies is not as simple as that. As Christopher Dow (1998) and many other economists have pointed out, "it is difficult to use econometric tests of the contribution of various factors... to identify the causation of the Great Depression, because all important variables turned down together". This being said, the relationship that consumer expenditure and investment share with output and share prices leads many to believe strongly that there is causality between these variables.

This relationship led Peter Temin in 1976, to pose the question "Is there anything in the macroeconomic data to suggest that 1930 was different from 1921 or 1938?" The answer he suggested was an autonomous decline in consumption. However, the cause of which was left unexplained. "The fall of consumption must be regarded as truly autonomous, which in this case means also unexplained..." (Temin 1976, P.83).

Others since have made additions and developed this idea, Christopher Dow (1998, P162) suggesting that the bubble, which, at its height had become largely speculative, subsequently burst and caused "A large downward shock to expectations of a sort that is likely to follow an excessive boom" The results of which led to "a big fall in consumption, a very big fall in fixed investment, and a big fall in stocks". (Dow, 1998, P162)

Broadly speaking, the 2008 financial crisis showed similar signs of a drop in consumer confidence and subsequently consumers became less willing to invest and purchase in goods. A large shift in expectations is a theory often espoused for a drop in Consumption. With the relative booms that preceded both crises it seems possible that on the back of such an extended period of growth and stability that a downturn and shock to the system on the scale that both exhibited would cause consumers to turn inward.

Certainly it has been shown that, non-durables and services sagged immediately after both periods, indicating consumers increasing uncertainty. Furthermore, businesses whether by choice or not found themselves either unwilling or unable to invest. Robert Hall (2010) suggesting in terms of the domestic downturn that "Households are building their financial assets rather than using their discretionary income to buy cars, houses and furniture".

In relation to business, the Federal Reserve Bank of New York, reports in a qualitative survey that small businesses cite "Poor Sales" as their "single largest problem associated with weak economic conditions". (Sahin et al, 2011) Understandably lack of demand and the inability to find liquidity due to the credit crunch drives many businesses out of operation, causing the mass unemployment seen in both crises.

Bernanke (2000, P46) notes the spread of the financial distress and how "the subset of corporations holding more than $50 million in assets maintained positive profits throughout this period, leaving the brunt to be borne by smaller companies". This squeeze on small businesses is endemic in both periods. Large and more fortunate businesses instead benefiting due to their trusted nature, but also their ability to manipulate their cash ratios in regards to their receipts.

Worsened by commercial bank failures Dow (1998, P173) notes "Banks will have been seeking to restrict lending for reasons of normal commercial prudence; borrowers too will have felt it unwise to continue borrowing on the earlier scale; and the authorities will not have had it in their power, merely by making reserves more freely available, to prevent a decline in the money stock."

Bank closures as a result, have played and are playing a large part in the decrease of the money stock. Small businesses often considered the life-blood of an economy suffer greatly when more "selective" lending takes place and is one of the key contributors to the depth and severity of the contractions in both cases. Helen Manning Hunter suggests that during the Great Depression small firms "probably suffered a severe liquidity crunch during the episodes of restrictive monetary policy that were associated with the downswings of 1931-32 and 1937-38" (1982, P884)

It comes as no great surprise then, when the financial mechanisms that underpin the operation and flow of the economy break down, consumption and investment are hit the hardest. Consumers, many of whom rely on the availability of funds for mortgages or durable goods such as cars find themselves not only unable, but often less certain of the future and thus unwilling to invest and spend their income. Furthermore, businesses in the face of poor sales and poor future outlook also become more cautious in terms of investment. Expansion and growth becomes a secondary goal, the process of day to day survival in periods of poor liquidity being difficult enough.

The format of the banking sector has also proved to be particularly troublesome. During the Great Depression the network of small, localised banks that were relatively undiversified caused difficulties including the drying up of credit flows. These "non-member" banks often feared borrowing from the Federal Reserve or were simply unable to access funds at the discount window. Regulation for that matter or as Dow (2008) describes it "scanty banking supervision" is a common theme in both periods also. The crisis in 2008 suffered from a severe case of the principle agent problem, bankers nonchalantly investing with no real penance for failure.

Section Two: Monetary policy & the problematic Zero-Bound.

Monetary policy in both crises has played a contentious role. Advocates of the monetarist reasoning to the Great Depression like Friedman & Schwarz are highly critical of the role that the authorities played in causing deflation and the contraction of the money supply that they argue contributed to the severity of the crisis. However, monetary authorities of the time came to a crossroads, on one hand it did not wish to interfere and restrain economic expansion, but on the other they were aware of the need to restrain wild speculation.

The reaction to this problem, and the mistakes learnt from the period are what many argue separate the two. Early, or *earlier,* intervention and a combination of fiscal and monetary policy in the form of the "Troubled Asset Relief Program" (From here in referred to as TARP) and the reduction of interest rates being what many believe to have at least played a role in mitigating the damage of the collapse.

Despite fiscal and monetary stimulus through the implementation of TARP and Quantitative easing, the US is still struggling with a slow, fragile recovery. Furthermore, it's battling, just as Franklin Roosevelt did, the concept of the Zero-Bound for interest rates. The difficulty, when faced with the fact interest rates can't go lower is that monetary authorities then find themselves unable to pursue further stimulus through these roots, shutting off one of the major channels available to policy makers.

Friedman & Schwartz's Monetary Hypothesis (1963) argued that a reduction in the Monetary Stock was indicative of a drop in demand. Monetarists in general, argue that, as a result of this there is often a drop in output and additional repercussions on employment as a result. Thus, Friedman & Schwartz's assertion is that "a vigorous and restrictive policy in early 1928 might have broken the stock market boom without it having to be kept in effect long enough to constitute a serious drag on business in general."

However, critics of the monetarist approach (including Dow, 1998) rebut the idea that the contraction was purely monetary. Arguing that monetary growth did not occur because their simply was not enough demand for borrowing and that Friedman and Schwartz are making the assumption that the banks were adequate and able to lend for all but the explicit reason there were not enough reserves.

Despite similarities, in that both crises observed "substantial stock market booms and continual growth in money and nominal income prior to the decline" (Dwyer & Lothian, 2012) the difference has been, that the marked decline of the money supply that took place during the Depression has not occurred in the US in the current crisis.

Whether this has been avoided through better guidance or simply lessons learnt from previous experience remains to be seen. Friedman and Schwartz (1963) argue that with the death of Benjamin Strong in 1928. The Federal Reserve lost not only valuable leadership but also valuable knowledge and guidance in such tumultuous times. Contrary to this economists such as Calomiris and Wheelock have observed that "Monetary policy between 1929 and 1931 appears largely consistent with what Strong outlined in the 1920's. (Wheelock, 1991).

Regardless, it is fairly clear to conclude that monetary policy from 1929-1933 was an unbridled disaster. The "Money Supply and the Price Level both having fallen by one third, ex-post interest rates rose well into double digits, and banks failed by the thousand" (Calomiris and Wheelock, 1998)

Section Three: Housing and the International Dimension of the Crisis.

Post-First World War there was a sizeable imbalance in housing, the growth of dwellings simply not matching the growing demand from households. Thus in the years that followed, overzealous lending combined with the speculative bubble that was forming, resulting in rampant overbuilding. When subsequent crises hit large scale foreclosures and a collapse in the mortgage market were inevitable. As Mishkin (1978) identifies, "Demographic shifts and overbuilding in the residential housing market often have been singled out as important determinant of the economic contraction of 1929 to 1933".

Similar events have taken place as of late, the freedom of credit and pervasiveness of sub-prime mortgages peaking in the years before the crisis. In addition the development and complexity of the financial products that made these developments in housing possible fuelled the growth and speculative nature of the bubble that was forming.

When housing causes the collapse of market systems there is a far larger effect than the average downturn. The balance sheet approach to the Great Depression suggests that "the severity of the business downturns in 1930 and 1938 were in part a result of the sharp decline in the stock market through its effect on the valuation of household financial assets and net wealth" (Mishkin, 1978).

It is therefore clear that these two events seem to have struck the hardest because they directly affected households; the inability for families and individuals to maintain homes not only triggering a decrease in consumption and investment but also playing a role in turning the tide of the confidence in the economy. From strong speculation and optimism on the back of a period of sustained prosperity, the tide quickly reversed, pulling down stock prices and increasing uncertainty.

Conclusion

Many features of the recent recession are directly comparable to the Great Depression. The repeated crises in the stock markets and the comparable banking and housing failures that underpin both periods. However, with the current financial crisis still ongoing and the European sovereign debt crisis looming the Great Recession still is yet to fully play out.

During both periods, domestic households and small businesses were hit particularly hard. Consumption and investment as outlined in section one dropped considerably. If we are to subscribe to the expectations theorem, consumers suffered a marked drop in confidence and subsequently reduced consumption. This was outlined in the fact that consumers reduced spending on durables. With the future being unsure credit flows that were usually utilised to facilitate this kind of expenditure ran dry. This left businesses in a sticky situation, suffering poor sales and an uncertain future. Banks, now with tighter lending policies squeezed business liquidity, running many out of work.

Furthermore, policy choices before and after the events played a significant role in shaping the format of the crises. Monetarists argue that poor monetary policy in the form of "tight" money led to the depth and severity of the Great Depression. Shachmurove (2011) suggesting that lessons learnt from these crises helped form better responses, however, despite this; issues like financial regulation still are highly relevant and contentious today.

To summarise, the crisis we've observed recently shared many fatal traits with that of the Great Depression. Whilst the Great Recession is still playing out it is certainly possible to draw comparisons between both. Whilst the Great Depression seemingly experienced far higher unemployment and a far larger contraction, we are yet to see the end of the current dip and thus wait with bated breath as to its conclusion.

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