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

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Thomas Hobbes famously described the state of nature as “a war of everyman against everyman” (Leviathan). Throughout history, it appears the closest society has ever come to this state of nature is during economic collapse. We need look at only a few examples, momentous events, made possible for mostly economic reasons, like the Second World War, or the French Revolution, to know that this is true. Thus, it is not only of interest, but it is indeed an imperative for economists to understand financial crises and the way in which they bring the economy and society to the brink of collapse. Looking to the Great Depression and the horror that the political and economic situation in Europe produced subsequently, it is of great interest to understand the 1929 crash that lead to the Great Depression, and how the 2008 financial crisis compares, and whether that crisis could have produced another depression. Upon examination, it will become clear that the two crises were similar in magnitude, and that despite their different causes, both signaled the beginnings of serious recessions that involved falls in world production, world trade, and increases in unemployment. However, the recession following the 2008 crisis was by no means on the scale of the Great Depression, and this is due to the lessons learned from the 1929 crisis and Great Depression: avoiding monetary contraction in the face of recession, and insuring public confidence in the banking system.

The Magnitude of Financial Crisis

The 1929 stock market crash was the beginning of the worst economic contraction in recent history, and the 2008 crisis was similar in magnitude. *The Economist* tells us, "The shock that hit the world economy in 2008 was on a par with that which launched the Depression. In the 12 months following the economic peak in 2008, industrial production fell by as much as it did in the first year of the Depression. Equity prices and global trade fell more." (The Economist) Commenting on the most recent recession, Eichengreen and O'Rourke say, "To sum up, globally we are tracking or doing even worse than the Great Depression, whether the metric is industrial production, exports or equity valuations… This is a Depression-sized event."(Eichengreen and Rourke 2009 pg. 4) The paper charts and illustrates how world industrial output, world stock markets, and world trade all fell on a trajectory at least as bad, if not worse, than during the onset of the Great Depression. According to Bartram and Bodnar global equity markets stood at an all time high in October 2007, and then over the next 17 months collapsed 56%, from $51 trillion to $22 trillion, a loss in value equivalent to about 50% of global GDP. (Bartnam and Bodnar 2009 pg. 1247)The paper goes on, showing that the US S&P 500 index from peak to trough declined by 54.1% from September 2007, surpassed only by the 1929 crash which saw a decline of 83.4% from August 1929. (pg. 1251) *A Tale of Two Depressions* concludes, "…the world is currently undergoing an economic shock every bit as big as the Great Depression shock of 1929-30."

(Eichengreen and Rourke 2009 pg. 7) Clearly, both crashes were serious events that wiped out unimaginable amounts of equity, and they were similar in magnitude. Furthermore, they both signaled the beginning of recessions that lead to falls in world output and trade, and increases in unemployment. However, the current crisis, which we have concluded is every bit as momentous as the 1929 crisis, has not lead to Great Depression levels of unemployment or as large a fall in output, as figure 5.1 and 5.2 show in Bordo (2010). To explain this we must explore the different causes of the two crises and the subsequent policy responses taken in reaction to the crises.

The Mechanisms of Financial Crisis

The Economics of Money, Banking and Financial Markets outlines three stages of a financial crisis: stage one is the initiation of the crisis, stage two is the onset of a banking crisis, and stage three is debt deflation. (Mishkin pg. 203) The initiation of a crisis, which can be caused for a variety of reasons, such as interest rate rises or increases in uncertainty, primarily damage the financial markets through the worsening of adverse selection and moral hazard information asymmetries. These two concepts, moral hazard, and adverse selection, can be defined as information conflicts that discourage lending. A fall in lending then causes a fall in investment spending, the end result being a slowdown in economic activity. This fall in economic activity can then spark a banking panic, stage two of a financial crisis, because of, "…worsening business conditions and uncertainty about… banks health…" (pg.205) Bank runs can then ensue, leading to bank failures. This once again worsens information asymmetries, creating a vicious cycle where economic activity declines even more. If a bank panic is left unchecked, this can lead to deflation because of a falling money supply, which brings us to stage three of a financial panic, debt deflation. Debt deflation leads to an increase in the burden of debt. This once again causes a worsening of information asymmetries, and further declines in economic activity. (pg. 202-206) *Mishkin* states, "The most significant financial crisis that included debt deflation was the Great Depression, the worst economic contraction in US history." (pg. 206) The reason why the world economy has been able to avoid a Great Depression sized downturn so far is because the 2007-2008 financial crisis was able to avoid the full blown banking panic and debt deflation that ensued following the 1929 crisis. Indeed, keeping this framework in mind, we can now explore the different causes of the crises, and lastly provide an explanation for why two crises of similar magnitude lead to vastly different outcomes.

One of the initial signals of the onset of a financial crisis is an increase in interest rates, and this occurred prior to both crises. *Mishkin,* in explaining the stock market boom in 1928 and 1929 and the Federal Reserve's reaction to it, states, "Federal Reserve officials viewed the stock market boom as excessive speculation. To curb it, they pursued a tight monetary policy to raise interest rates; the Fed got more than it bargained for when the stock market crashed in October 1929…" (pg. 206) According to *The World in Depression,* the United States, Italy, Britain, the Netherlands, Germany, Austria, Hungary, Belgium, Sweden, Denmark and Norway had all raised their discount rates throughout 1929, prior to the crash. The crash finally began on the 3rd of October 1929. (The World in Depression 1973 pg. 112-115) Prior to the start of the subprime mortgage crises, the Federal Reserve had also been raising interest rates, as Bordo (2008) outlines, "The crisis started in the U.S. with the collapse of the subprime mortgage market in early 2007 and the end of a major housing boom. It occurred following two years of rising policy interest rates." (Bordo 2008 pg. 2) Clearly, rising interest rates signaled the beginning of both crises. But Fishback tells us, "The similarities basically stop there. The housing boom of the 1920's was more a quantity boom than a price boom… the direction of causation in the 1920's was from economic troubles to the mortgage meltdown – the opposite of the current situation." (Price Fishback 2009) Mortgage troubles were an aftershock of the 1929 crisis, whereas with the 2008 crisis they were the cause. Indeed, Bordo (2008) lists the causes of the 2007-2008 crisis as, "… major changes in regulation, lax oversight, relaxation of normal standards of prudent lending and a prolonged period of abnormally low interest rates." (Bordo 2008 pg. 2) All of these causes contributed towards the boom of the mortgage market in the US, and coupled with the securitization process which saw financial markets across the world exposed to the US mortgage market, caused turmoil in the financial markets when the US housing market began to collapse. Tightening monetary policy, on the other hand, brought on the immediate 1929 stock market crash, and while interest rates did indeed rise prior to the 2007-2008 crisis, this was not the primary cause of the crisis. There are similarities and differences in how both crises communicated into the economy as well. The 1929 crisis,"…caused large losses to individual investors. These cut their spending. Firms… joined in the race for liquidity, and cut their spending. Production fell sharply." (The World in Depression pg. 124) According to *The World in Depression*, there were also declines in commodity prices and imports, which lead to deflation. (pg. 124-125) The 2007-2008 crisis on the other hand, communicated itself across world markets differently, as outlined by Bordo, "Defaults on mortgages spread to investment banks and commercial banks in the US and across the world via an elaborate network of derivatives. It has recently spilled over into the real economy through a virulent credit crunch and collapsing equities market..." (Bordo 2008 pg. 2) The crisis and production contraction largely spread across the world following the 1929 crisis through falls in world trade, while the 2008 crisis spread across the world through securitized mortgage instruments that exposed foreign banks to the turmoil in the US mortgage market. Thus, there is a clear difference between the causes of the two crises and way they communicated into the economy. Having established this, we can now examine the key difference between the two, the policy reaction.

The Great Policy Divergence

The banking panics that followed the 1929 crisis and the 2008 crisis were grave, and though we cannot understate the severity of both, the 1929 crisis saw a decline in the money supply precipitated by banking failures that has never again been seen, including during the 2008 crisis and subsequent recession. Discussing *A Monetary History of the United States,* Bordo (1986) states, "Friedman and Schwartz attribute the massive decline in prices and real output in the U.S. 1929-33 to an unprecedented decline in the quantity of money. This fall was largely caused by bank failures in 1930-31 and 1933, although they argued it could have been prevented by active monetary policy."(Bordo 1986 pg. 16) Indeed, bank runs following the 1929 crisis lead to a large number of bank failures, while following the 2008 crisis there were almost no bank runs. This is mostly due to Federal Deposit Insurance Corporation (FDIC) insurance introduced in 1934, as Bordo (2010) tells us, " Moreover the deposit ratio did not collapse in the recent crisis, it rose. There were no runs on commercial banks because depositors knew that their deposits were protected…" (Bordo 2010 pg. 31.) The result is that bank failures were,"…miniscule relative to the 1930s (Figure 5.8) as were deposits in failed banks relative to total deposits (Figure 5.9)" (pg. 34) Whereas a huge number of banks large and small failed following the 1930's, the 2008 crisis was defined by large bailouts of big banks to avoid too-big-to-fail problems, where the collapse of a systemic institution would threaten the safety of the entire financial system. According to Bordo (2008) the 2008 crisis saw the rescues of Bear Stearns by JP Morgan and funds from the Federal Reserve, the nationalizations of the Fannie Mae and Freddie Mac, which had enormous functioning's in the mortgage market, and the nationalization of AIG. (Bordo 2008 pg. 3-4) This was followed by a bailout bill called Troubled Asset Relief Plan of $700 billion dollars,"…devoted to the purchase of heavily discounted mortgage backed and other securities to remove them from the banks' balance sheets and restore bank lending."(pg. 4) Following the Lehman Brothers bankruptcy, the only major bank allowed to fail during the 2008 crisis, Bordo (2008) describes how,"…interbank lending effectively seized up on the fear that no banks were safe." This leads into a statement by Bordo (2010), "Unlike the

1930s the deepest problem of the recent crisis was not illiquidity but insolvency and especially the fear of insolvency of counterparties." (Bordo 2010 pg. 2) This gives rise to an idea then that worries about the solvency of major banks fueled the 2008 crisis, whereas following the 1929 crisis, large swaths of bank failures lead to a collapse in liquidity and a collapse of public confidence in the banking system, which was avoided following 2008 by the monetary policy response and regulations like deposit insurance. This problem of illiquidity following the 1929 crisis was brought on by the banking panic and banking failures, which caused a fall in the money supply. Monetary policy in response to the 1929 crisis was largely contractionary, even though *The World in Depression* describes how, "The action of the Federal Reserve in buying securities in the open market and lowering rediscount rate in New York brought credit markets quickly into good order." (*The World in Depression* pg. 127) Policy remained contractionary, because these actions by the Federal Reserve were essentially, too little, too late, "By this time, however, the deflation had been communicated to fragile commodity markets and durable-goods industries." (pg. 137) This works through the Fisher effect, where even though the Federal Reserve was cutting interest rates, the real interest rate was increasing because of deflation, and so the money supply was contracting. This contractionary monetary policy allowed deflation to occur in the economy, which aggravates debt problems. Debtors find themselves owing the same amount in nominal terms, put pay this debt with a more valuable currency due to deflation. The effect is that debt increases in real terms. According to the *Federal Reserve Bank of Minneapolis*, after 1929 deflation in the US accelerated, and bottomed at -10.3% in 1932, and inflation did not occur again after 1929 until 1934. On the other hand, inflation was 3.8% in 2008 in the US, and bottomed at -0.4% in 2009, and rebounded to 1.6% in 2010. (Federal Reserve Bank of Minneapolis) From macroeconomics, we know that systematic inflation can only be caused by money supply growth. If we look at money supply data, we should see a contraction before deflation, and an expansion before inflation, and Figure 5.3 of M2 of Bordo (2010) confirms this. Monetary policy by the Federal Reserve, and the contraction it allowed following 1929, caused deflation and exasperated the financial crisis by causing debt deflation to occur. Expansionary monetary policy, followed by the Federal Reserve following 2008, avoided debt deflation, and contained the crisis from worsening into depression. Thus, avoiding an illiquidity crisis, the monetary and fiscal authorities across the world only had to confront a crisis of confidence in the solvency of too-big-to-fail banks. Hagen (2009) puts this well when he says," The main factor driving the dynamics of the crisis in 2008 was thus different from than in 1929. Then, it was largely the collapse in the public's confidence in the banking system. This time, it was largely the collapse in the banks' confidence in the soundness of other banks…" (Hagen 2009 pg. 7) By cutting interest rates to historic lows and conducting unorthodox policies like quantitative easing, central banks like the Federal Reserve, Bank of England, and European Central Bank were able to avoid the collapse in liquidity that turned a financial crisis in 1929 into the Great Depression. Indeed, *The World in Depression* puts this best when quoting Milton Friedman as saying, "Whatever happens in a stock market, it cannot lead to a great depression unless it produces or is accompanied by a monetary collapse." (*The World in Depression* pg. 121) This is and will remain the factor that kept the world out of another Great Depression following the 2007-2008 financial crisis, and the defining difference between the 1929 crisis and 2008 crisis.

Throughout this examination, it has been demonstrated how the 2007-2008 financial crisis was just as severe as the 1929 crisis, and despite the differences in causes of the crises, the 2008 crisis had just as much potential of producing a depression had the monetary authorities not learned the lessons of the Great Depression. There could have been a banking panic similar in scale to 1929 had too-big-to-fail banks been allowed to collapse, and a subsequent deflation that would have brought economic depression. Indeed, the world could very well have found itself in Great Depression levels of production contraction and unemployment. Setting aside the economic damage, the societal damage caused by the Great Depression is immeasurable, and this collapse sowed the seeds for political crisis in Europe and the horrors of the Second World War. Indeed, we must always keep in mind the lessons of history as economists if we are to avoid the Hobbesian state of nature that society is always one economic crisis away from.

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