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Business Economics-Marco Project

Topic:- Comparative analysis of 1929 vs 2008 crisis

Contents

Introduction

Before getting into the comparative analysis of the 1929 and 2008 financial crises, I would like to explain both of these scenarios. By mainly asking a few questions. How did these crises happen? Who all were affected during this time? What steps were taken to correct this crisis?

1929 Financial crisis(a.k.a Great Depression)

The Great Depression was a global economic downturn that began in 1929 and lasted until roughly 1939. It was the longest and most severe downturn in the history of the industrial Western world, resulting in fundamental upheavals in economic institutions, political economics policy, and philosophy. Despite its beginnings in the United States, the Great Depression resulted in steep declines in output, massive unemployment, and severe deflation in practically every country on the planet. Its social and cultural ramifications were no less catastrophic, particularly in the United States, where the Great Depression was the country's biggest struggle since World War II.

Economic history

Various countries were affected by the Great Depression at different times and in different ways. In the United States and Europe, the Depression was particularly lengthy and severe; in Japan and much of Latin America, it was gentler. The world economy's worst slump in history was caused by several factors, many of which were reasonably anticipated. Consumer demand declines, financial panics, and misguided government policies all contributed to a drop in US economic output, while the gold standard, which connected nearly all of the world's countries in a network of fixed currency exchange rates, was instrumental in spreading the American downturn to other countries. The end of the gold standard, as well as subsequent monetary reforms, were critical to the recovery. The abandonment of the gold standard, as well as later monetary reforms, were key components of the massive recovery from the Tremendous Depression, which involved both great human misery and substantial legislative changes.

Timing and severity

In the summer of 1929, the Great Depression began in the United States as a regular recession. However, the fall accelerated in late 1929 and lasted until early 1933. Real production and pricing both dropped sharply. Industrial production in the United States fell by 47 percent between the peak and the trough of the depression, while real GDP fell by 30 percent. The wholesale price index plummeted by 33%. (Price decreases of this magnitude are referred to as deflation). Although there is some controversy regarding the veracity of the figures, it is widely agreed that the unemployment rate at its height topped 20%. In the summer of 1929, the Great Depression began in the United States as a regular recession. However, the fall accelerated in late 1929 and lasted until early 1933. Real production and pricing both dropped sharply. Industrial production in the United States fell by 47 percent between the peak and the trough of the depression, while real GDP fell by 30 percent. The wholesale price index plummeted by 33%. (Price decreases of this magnitude are referred to as deflation). Although there is some disagreement over the reliability of the numbers, it is commonly recognized that the unemployment rate at its height reached 20 percent.

Causes of the decline

The fundamental cause of the Great Depression in the United States was a decrease in consumer spending (also known as aggregate demand(AD)), which led to a decrease in production as manufacturers and merchandisers discovered an unanticipated increase in inventory. The causes of the US spending recession varied throughout the Depression, but they all added up to a significant decline in aggregate demand. The gold standard was primarily to blame for the rest of the world's financial collapse. Other factors, however, contributed to the downturn in many countries.

Stock market crash

The value of the US stock market nearly quadrupled in the eighteen months leading up to the crash on "Black Thursday," October 24, 1929, in a frenzy of speculative purchasing. Millions of shares of the stock were exchanged at ever-falling values on that day, as well as on "Black Tuesday," October 29.

The stock market catastrophe of October 1929 was only the beginning. By mid-November, the stock market had lost a third of its value, and by 1932, when the market reached the bottom, equities had lost 90% of their value. In 1932, a share of US Steel that had previously sold for $262 was reduced to $22.

Although the stock market fall signaled the commencement of the Great Depression, it was just one of the numerous causes that contributed to its beginning. A weak banking system, a further drop in already low agricultural prices, and industrial overproduction all contributed to the economic downturn. The devastating Hawley-Smoot Tariff of 1930 (which raised average tariff rates to about 60%) spurred America's international trade partners to raise tariff rates on US-made goods in response. Global commerce has declined as a result, and global economies have continued to suffer.

Because people were worried about the economy's future, the stock market crash led to a huge decline in consumer spending. Lower consumer and company expenditure resulted in a 47 percent drop in industrial production and a 30 percent drop in the real gross domestic product (GDP).

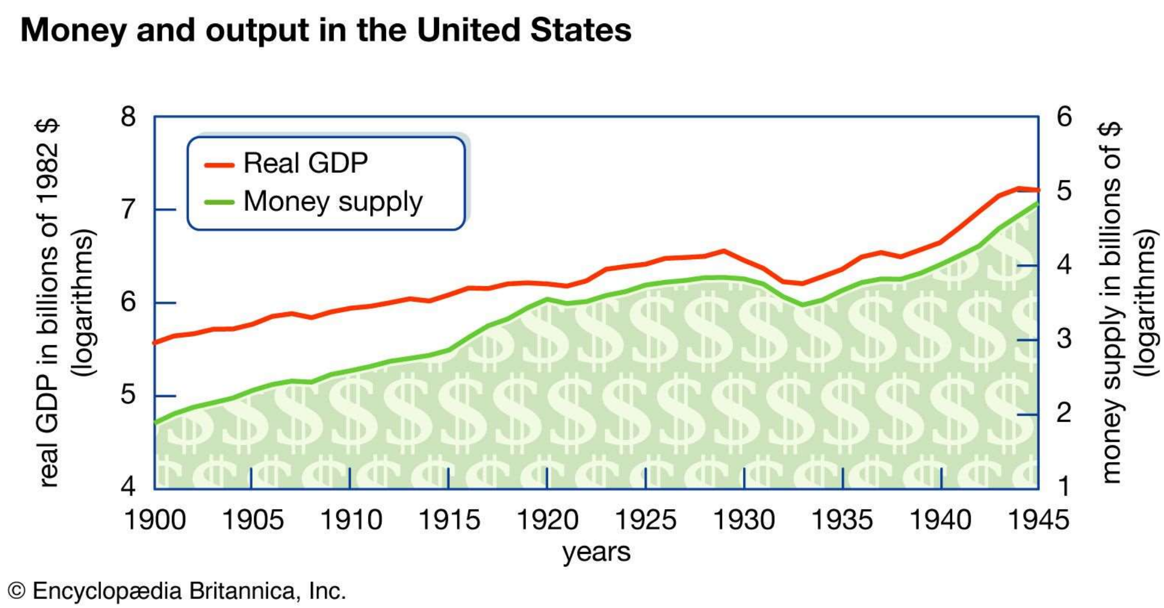
The stock market crisis drastically decreased aggregate demand in the United States. Following the crash, consumer durable goods purchases and business investment both plummeted. One possible explanation is that the financial crisis created significant uncertainty about future earnings, causing individuals and businesses to postpone purchases of durable items. Although the drop in stock prices resulted in a very minor loss of money, the crisis may have lowered spending by making people feel poorer (see consumer confidence). Real output in the United States decreased significantly in late 1929 and throughout 1930 as a result of the severe drop in consumer and business spending, which had been dropping slowly up to this point. While the stock market crash and the Great Depression are two distinct occurrences, stock price losses were one factor contributing to decreases in production and employment in the United States.

The drop in spending ultimately led to a decline in employment. At the height of the depression, unemployment exceeded 20 percent.

Banking panics and monetary contraction

Four waves of banking panics hit the United States, wreaking havoc on the country's financial system. One-fifth of the banks that existed at the start of 1930 had failed by 1933. The Federal Reserve did very little to help stop the downturn, enabling fear to diminish the money supply in the United States. In September 1931, it also constricted the money supply and hiked interest rates.

I believe that the Federal Reserve's decisions to reduce the money supply had a severe contractionary effect on output. A simple image may provide the clearest indication of the crucial role monetary collapse played in the United States Great Depression. The graph depicts the money supply and real output from 1900 to 1945. Both the money supply and output tend to expand slowly in normal times, such as the 1920s. Both, however, plunged in the early 1930s. The shrinking money supply inhibited spending in a variety of ways. Perhaps most importantly, consumers and entrepreneurs came to expect deflation as a result of actual price drops and the rapid decline in the money supply; that is, they expected wages and prices to fall in the future. As a result, even if nominal interest rates were low, people were hesitant to borrow because they were concerned that future earnings and profits would not be sufficient to satisfy loan obligations. As a result of this reluctance, consumer spending and business investment both fell sharply. The panics undoubtedly contributed to the drop in expenditure by instilling pessimism and a lack of confidence. Furthermore, as a result of so many people's failures, lending was disrupted, limiting the capital available to support investment.



The gold standard

The gold standard, which measures the standard unit of a currency against a set quantity of gold, connected other countries' currencies to the US dollar and helped spread the downturn abroad. The gold standard, which ties a set quantity of gold to a standard unit of currency, connected other countries' currencies to the US dollar and helped spread the downturn abroad.

International lending and trade

A decline in foreign trade and lending from the United States also contributed to the global spread of the economic crisis. The reduction in production in the United Kingdom was around one-third that of the United States. The decline in production in Germany was roughly equal to the drop in production in the United States. The Smoot-Hawley Tariff Act of 1930 had an even greater impact on foreign trade.

Excess Debt

Banks issued margin calls when the stock market fell in 1929. Entire portfolios were liquidated as a result of the large number of shares bought on margin by the general public and the lack of cash on the sidelines. As a result, the stock market began to decline. Many investors lost everything, because the Federal Deposit Insurance Corporation (FDIC), which protects depositors' money, didn't exist at the time. Many Americans began withdrawing money from banks, leaving the banks with large losses as a result of making too many risky loans.

Effects of the 1929 Financial crisis

- Around the world, there was an abrupt drop in living conditions.
- Many businesses were forced to close as demand for goods and services plummeted, resulting in increased unemployment. In the early 1930s, industrialized countries had unemployment rates as high as 25%.
- Industrial production in the United States fell by roughly 47%, GDP fell by 30%, and unemployment surpassed 20%.
- The banking panics caused 20 percent of banks to fail by 1933.
- The abandoning of the gold standard substantially aided the recovery from the Great Depression by the late 1930s.
- In the United States and abroad, welfare state expansion, as well as labor unions and organized labor, took place.
- For stronger government regulation of financial markets, the Securities and Exchange Commission (SEC) and other regulatory bodies were created.

Steps were taken by the government during the 1929 crisis

President Hoover initially approached the economic downturn from the standpoint of his long-held voluntarist principles—that is, his belief in minimal government intervention in the economy, as well as his conviction that providing direct public assistance to individuals would weaken individual character, turn people away from the work ethic, and lead them to become reliant on government handouts. By 1931, Hoover had changed his mind and advocated government intervention in the economy, reversing his previous position. The federal government committed $300 million for the nation's first relief and public works projects in July 1932, while the Reconstruction Finance Corporation (RFC) authorized the funding of $2 billion to banks, railways, and other privately held corporations.

In November 1932, Franklin D. Roosevelt was elected president in a landslide, winning 57.4% of the vote to Hoover's 39.7%. The **New Deal** was a set of domestic policies enacted under President Franklin D. Roosevelt that dramatically expanded the federal government's role in the economy in response to the Great Depression.

The New Deal created a broad range of federal government programs that sought to offer economic relief to the suffering, regulate the private industry, and grow the economy. The New Deal is often summed up by the "Three Rs":

- **relief** (for the unemployed)
- **recovery** (of the economy through federal spending and job creation), and
- **reform** (of capitalism, using regulatory legislation and the creation of new social welfare programs).

Roosevelt's New Deal expanded the size and scope of the federal government considerably, and in doing so fundamentally reshaped American political culture around the principle that the government is responsible for the welfare of its citizens. As one historian has put it: "Before the 1930s, the national political debate often revolved around the question of *whether* the federal government should intervene in the economy. After the New Deal, the debate rested on *how* it should intervene.

- **The Agricultural Adjustment Act (AAA)**, boosted agricultural prices by offering government subsidies to farmers to reduce output.
- **The Civilian Conservation Corps (CCC)**, employed young, single men at federally funded jobs on government lands.
- **The Federal Emergency Relief Act (FERA)**, gave federal grants to states that funded salaries for government workers as well as local soup kitchens and other direct-aid to the poor programs.
- **The National Recovery Act (NRA)**, sought to boost businesses' profits and workers' wages by establishing industry-by-industry codes that set prices and wages, as well as guaranteeing workers the right to organize into unions.

- **The Federal Deposit Insurance Corporation (FDIC)**, guaranteed individuals that money they deposited in a bank would be repaid to them by the federal government if their bank went out of business.
- In 1934, Roosevelt supported the passage of the **Securities and Exchange Commission (SEC)**, which brought important federal government oversight and regulation to the stock market.

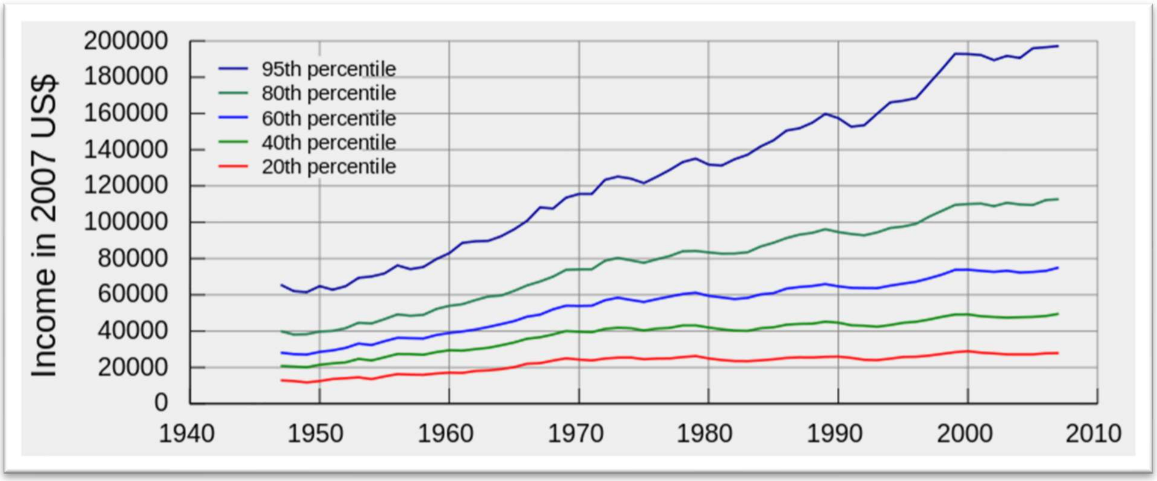
2008 Financial crisis(a.k.a Great Recession)

The Great Recession of 2007-2009 was the worst global economic crisis since the Great Depression in the 1930s. The recession resulted from a combination of tax cuts, spending increases, and the devastating effects of a banking crisis in the subprime mortgage market. The recession contributed to rising income inequality and prompted a debate about the role of the federal government in regulating the private industry.

What caused the great recession?

When US President George W. Bush took office in 2001, he launched a series of economic policies that significantly increased the federal budget deficit while nearly doubling the national debt. While the conflicts in Afghanistan and Iraq devoured vast financial resources, the Bush administration boosted government spending, most notably in the areas of Medicare and defense spending.

Meanwhile, the Bush administration passed some of the country's most significant tax cuts. All marginal tax rates were reduced, and some tax credits, such as the child tax credit, were increased. Critics of the so-called "Bush Tax Cuts" said that they exacerbated income inequality by disproportionately benefiting the wealthy. Others have blamed rising inequality on technical advancements, free trade policies, and labor unions' dwindling strength. While economists debate the causes and implications of income inequality, one thing is certain: the average American household is currently in poorer shape than it was a quarter-century ago. Meanwhile, the Bush administration passed some of the country's most significant tax cuts. All marginal tax rates were reduced, and some tax credits, such as the child tax credit, were increased. Critics of the so-called "Bush Tax Cuts" said that they exacerbated income inequality by disproportionately benefiting the wealthy. Others have blamed rising inequality on technical advancements, free trade policies, and labor unions' dwindling strength. While economists debate the causes and implications of income inequality, one thing is certain: the average American household is currently in poorer shape than it was a quarter-century ago.

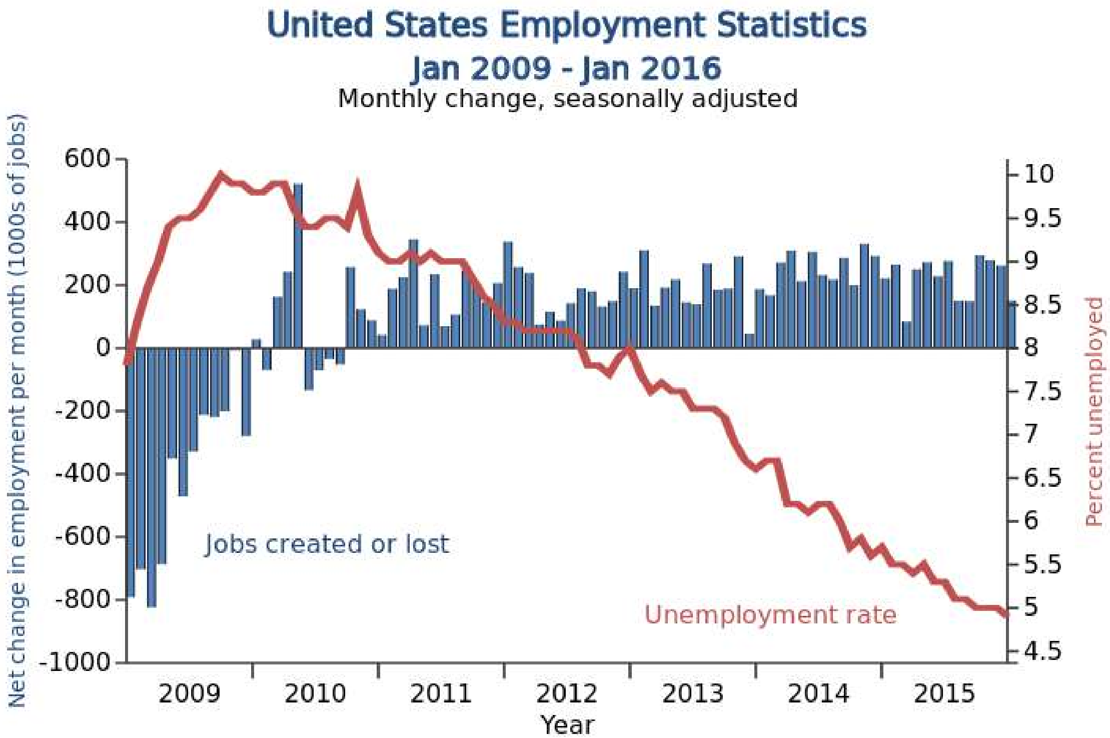


The US economy has already entered a recession by 2007. Consumer spending was falling, unemployment was growing, and financial markets were in turmoil. However, it was the September 2008 collapse of Lehman Brothers, a prominent Wall Street investment firm, that precipitated the country's worst banking crisis since the Great Depression. The boom-and-bust cycle of free-market capitalism, as well as the Federal Reserve's monetary policies, both contributed to the formation of the crisis.

The Federal Reserve (the central banking system of the United States) had implemented monetary policies targeted at increasing homeownership rates. Excessive house development, credit liberalization, and the expansion of high-risk mortgages all contributed to the formation of a housing bubble. When the housing bubble burst, many homeowners were unable to pay their mortgages as the value of their homes dropped, leaving them with debt greater than the worth of their properties.

To avoid what Federal Reserve Chairman Ben Bernanke referred to as a "global financial disaster," the Bush administration approved a large federal intervention to ameliorate the worst consequences of the crisis. President Bush authorized a $168 billion economic stimulus plan in February 2008, primarily consisting of income tax refunds. The Emergency Economic Stabilization Act of 2008 includes $700 billion to support the Struggling Asset Relief Program (TARP), which offered loans to troubled institutions.

Several of the country's top financial institutions have been acquired by other corporations or helped out by the federal government. The bailouts entailed a direct transfer of taxpayer funds to the banks. In February 2009, US President Barack Obama signed a $787 billion economic stimulus plan that included expenditure increases as well as tax cuts. Between 2008 and 2012, the US national debt increased by $6 trillion, although unemployment peaked at 10% in 2009 and subsequently fell.



The Dodd-Frank Wall Street Reform and Consumer Protection Act was approved in July 2010. The law aimed to address some of the fundamental causes of the financial crisis but stopped short of splitting up the largest banks, which had become even larger as a result of the wave of mergers and acquisitions that followed the collapse of the housing market.

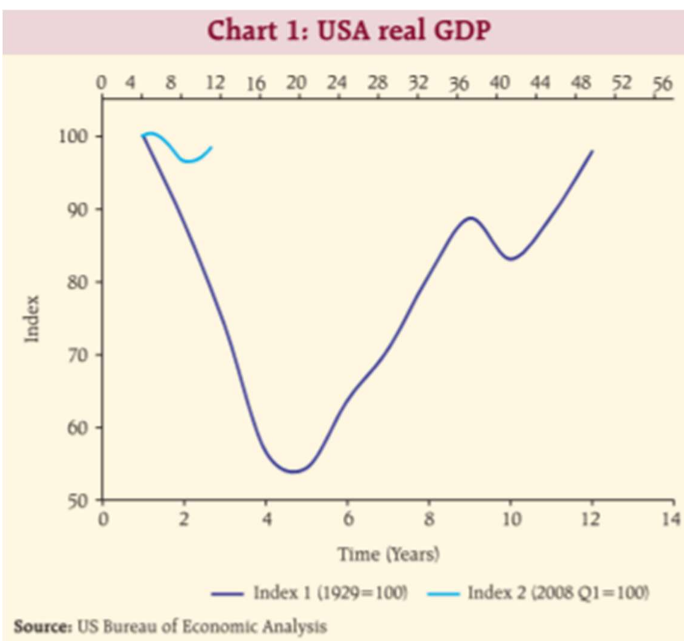
Comparative Analysis between the Great Depression and Great recession(Conclusion)

The similarities

Both were accompanied by severe economic downturns. Furthermore, the diagnoses and recommendations were identical. Both disasters were attributed to market failure. Roosevelt devised the New Deal to address the apparent market failure associated with the Great Depression. In a nutshell, the prescription was a tremendous expansion of the government's reach and participation in the economy. This sort of invasive approach has also occurred in the aftermath of the Great Recession, bringing in a slew of new government regulations, notably those affecting banks and financial organizations. And why shouldn't they? After all, politicians informed us that banks (and bankers) were to blame for the Great Recession (read: market failure).

- Both catastrophes occurred after times of rapid economic expansion.
- They caused massive economic downturns, and are consequently regarded as the two worst economic disasters to hit the United States in the previous century.
- Both incidents were followed by the government's substantial participation in economic relief and the implementation of various legislation and regulations.

The first point to make is that the Great Recession was a pretty small event in terms of the deterioration of the actual economy as measured by real GDP, Industrial Production, or Unemployment. Between 1929 and 1933, real GDP in the United States decreased by about 30%, whereas it declined by slightly more than 5% between 2007 and 2009. (Chart 1).



Unemployment in the US peaked at 25 percent in 1933 versus a little above 10 percent in 2009 (Chart 2).

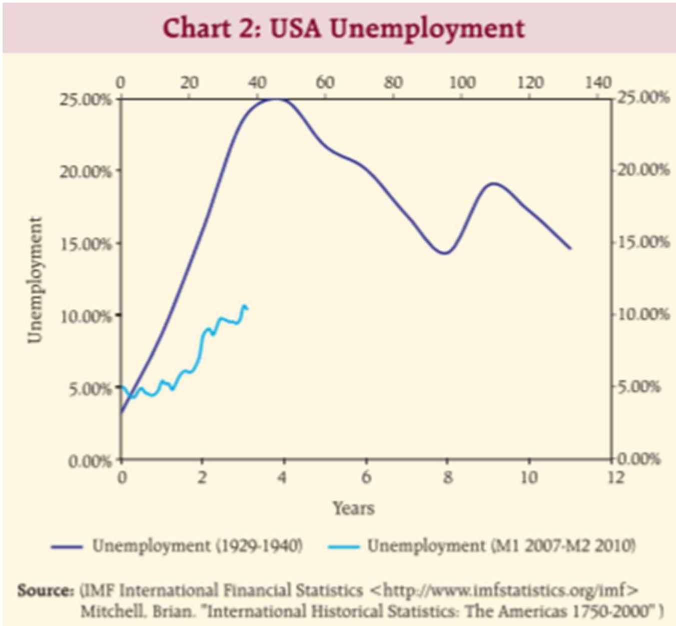


Chart 2: USA Unemployment

Source: (IMF International Financial Statistics <http://www.imfstatistics.org/imf> Mitchell. Brian. "International Historical Statistics: The Americas 1750-2000")

Other advanced countries' experiences were similar. For comparison, between world industrial production in the 1930s and recently see Chart 3.

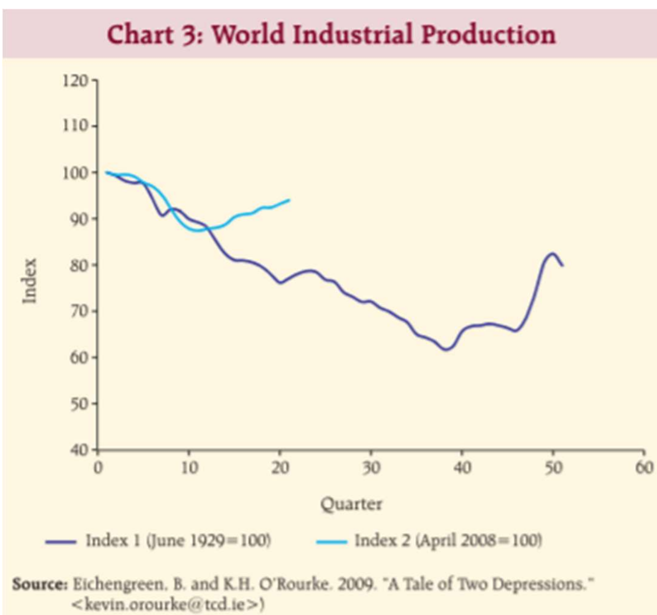


Chart 3: World Industrial Production

Source: Eichengreen. B. and K.H. O'Rourke. 2009. "A Tale of Two Depressions." <kevin.orourke@tcd.ie>)

Second, the recent financial crisis, as well as the Great Depression, were both global financial disasters. Bordo and Landon Lane (2010a) defined the global financial question as "what would have occurred if the Federal Reserve and other central banks had not pursued the aggressive policies that they did?" Neither would it have happened if other aspects of the financial safety net, such as deposit insurance and different automatic stabilizers, had not been in place.

The third element of commonality is the character of the recoveries following the recession's bottom. Both events experienced sluggish recoveries, with the real economy increasing at a slower rate following the business cycle trough than the downturn. The rebound following 1933 was swift but insufficient to overcome the prior decline. One potential explanation for the 1930s' insufficient recovery is that it was hampered by the New Deal National Industrial Recovery Act (NIRA) policies, which aimed to cartelize both goods and product markets (Cole and Ohanian, 2004). The present recovery is likewise gradual and has been dubbed a "jobless recovery," as were the two previous recessions (Charts 5 and 6).

Chart 5: Business Cycle Peak August 1929

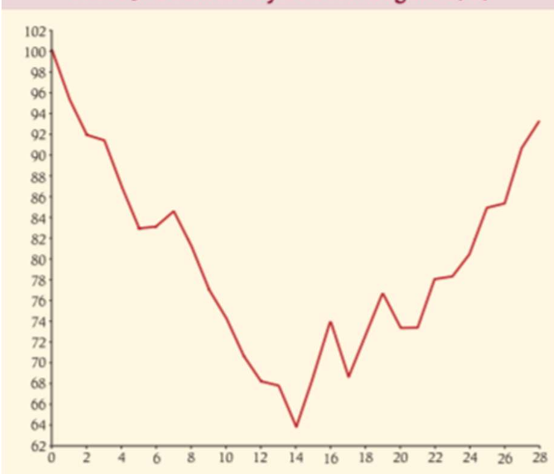
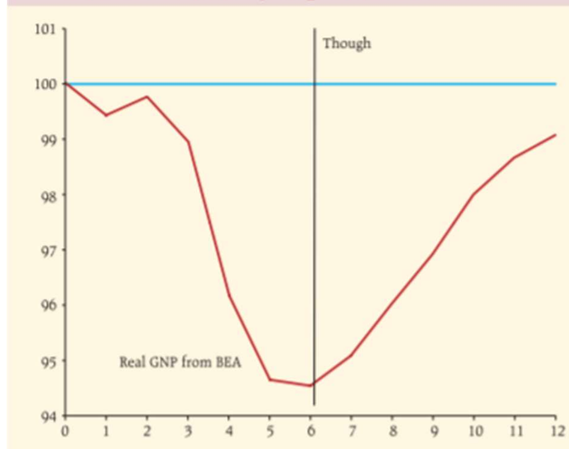


Chart 6: Business cycle peak December 2007



Source: Bureau of Economic Analysis

The fact that both eras were preceded by asset price bubbles and crashes is a fourth commonality between now and then. In the 1920s, there was a housing boom and collapse, as well as a Wall Street boom and crash in 1929. (Charts 7 and 8).

Chart 7: Real house prices 1929-33

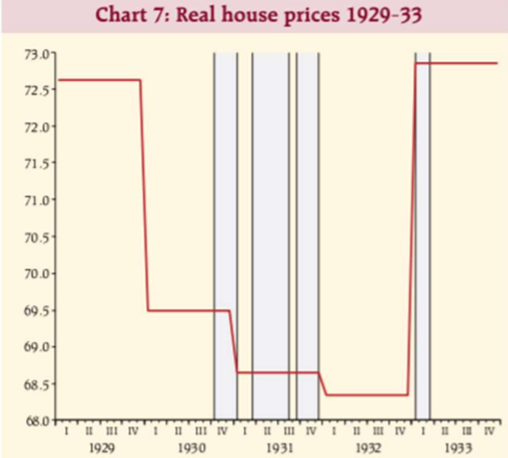


Chart 8: Real house prices 2007-2008

The latest crisis was precipitated by the subprime mortgage-related housing bubble, which exploded in 2006. Unlike the 1920s, the early 2000s IT boom did not lead to a financial disaster (Charts 9 to 11).

Chart 9: Real stock price 1929-33

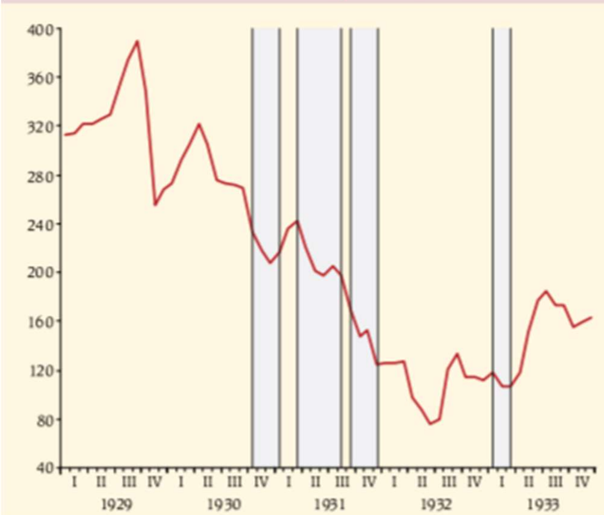
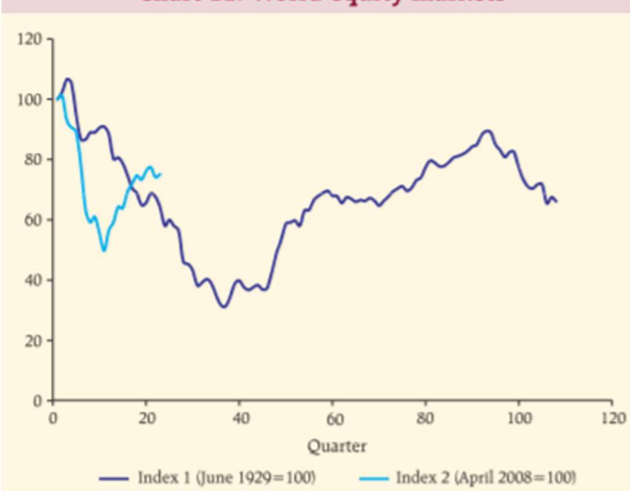


Chart 10: Real stock Price 2007-2009

Chart 11: World equity markets



Source: Eichengreen, B. and K.H. O'Rourke. 2009. "A Tale of Two Depressions." <kevin.orourke@tcd.ie>)

The Differences

Particulars	Great Recession	Great Depression
Period	The Great Recession lasted from December 2007 to June 2009, a span of more than 1.5 years.	The Great Depression lasted from August 1929 to March 1933, a span of more than 3.5 years. However, the aftereffects lingered until the late 1930s.
Origination Event	The global financial crisis was precipitated by the breakdown of the US housing bubble in 2005–06.	It all started with the massive drop in stock values that occurred in September 1929.
Economic impact (Gross Domestic Product (GDP))	During the period, the US GDP shrank by 4%, while global GDP shrank by 5%.	During the era, the US GDP fell by 30%, while the global GDP fell by 27%.
Unemployment Rate	The US GDP fell by 30% throughout the time, while the global GDP fell by 27%.	During the Great Depression, unemployment in the United States peaked at 25% in 1933.
Fed's Response	The Fed lowered interest rates and injected massive amounts of money into the economy.	The Fed raised interest rates to limit speculation in the securities market.

The true issue came as a result of a series of financial crises that began in October 1930 and finished with the March 1933 Banking Holiday. Milton Friedman and Anna Schwartz (1963) proposed that panics lowered the money multiplier and therefore the money supply by lowering deposit currency and deposit reserve ratios (Charts 12 to 16).

The 1930s panic, which exacerbated in 1931 when it became worldwide, represented a fear contagion as the public transformed their savings into money, i.e., they hoarded cash. The general population launched a series of bank runs, resulting in enormous bank suspensions. There was a significant liquidity shock in modern terms. The fall in nominal expenditure was caused by the collapse of the money supply.

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