International Journal of Economics, Commerce and Management
United Kingdom ISSN 2348 0386 Vol. VII, Issue 12, December 2019

http://ijecm.co.uk/

GREAT DEPRESSION AND GREAT RECESSION COMPARED: DOES HISTORY REPEAT ITSELF?

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Abstract

The Great Depression of 1930s occurred from 1929 to 1939 and was the longest and deepest economic downturn in the history of the affected countries. It started following the US stock market crash of October 1929, which caused wealth of shareholders to decline by millions of dollars. By 1933, at the lowest point of the downturn, about 15 million Americans were unemployed and several banks hadfailed. The global financial crises of 2007-2009 was followed by the Great Recession which was the worst since the Great Depression of 1930s. The crises left significant adverse effects on global growth and employment. Policymakers of affected countries responded differently to the outcomes of these crises. The central banks, including US Federal Reserve Bank and Bank of England, provided ample liquidity for the financial institutions and lowered the interest rate to near zero. In this paper, negative effects of Great Depression and Great Recession are compared. Both developments started with the financial crisis. However, in 2008 recession the US economy did not completely collapse as it did in 1933 but, the recovery in the earlier period was much faster than the latter. This implies that the US economy grew at a considerably higher in the late 1930s than it did in the recovery after the 2008.

Keywords: Great Depression, Great Recession, Financial crises, Monetary policy, Fiscal policy, Zero interest rate

INTRODUCTION

The Great Depression of 1930s occurred from 1929 to 1939 and was the longest and deepest economic downturn in the history of the affected countries. It started following the US stock market crash of October 1929, which caused wealth of shareholders to decline by millions of dollars. Subsequently, Over the next few years, consumer spending and investment fell sharply, causing a severe decline in industrial production and employment as failing enterprises reduced employment. By 1933, when the Great Depression reached its lowest downturn, about 15 million Americans were without a job, and several banks had failed.

Throughout the 1920s, the U.S. economy grew rapidly. Encouraged by buoyant economy, many invested their savings in shares. The share prices rose significantly, reaching a peak in August 1929.

Meanwhile, falling production and rising unemployment, made stocks to become overvalued. Furthermore, with low wages, consumer spending declined; the agricultural sector of the US economy was already depressed due to drought and food prices fell. Banks experienced a large portfolio of non-performing loans.

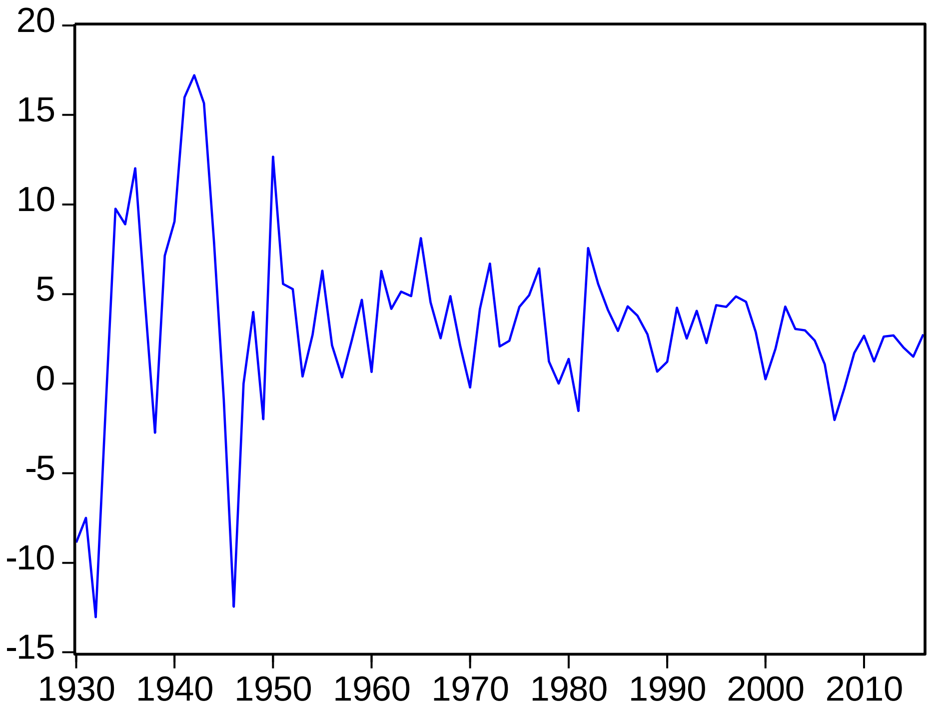
The recession started in the US, in the summer of 1929 as consumer spending fell causing inventories to pile up, leading to lower production and employment. For those who were lucky to remain employed, their wages fell, and their purchasing power declined. However, share prices continued to rise, reaching a level that was inconsistent with companies expected future earnings.

The inflexibility of the gold standard and the fixed exchange rate caused the American downturn to affect other countries in the world, particularly to Europe. The downturn continued to become worse during the next few years, unemployment; reached 4 million in 1930 and rose to 6 million in 1931.

At the same time, industrial production declined by 50 percent. These developments affected Americans' living standard as "Bread lines, soup kitchens" and lots of homeless people became wide spread in American towns. Because of weak demand, farmers failed to harvest their crops, while many people were starving to death in other regions.

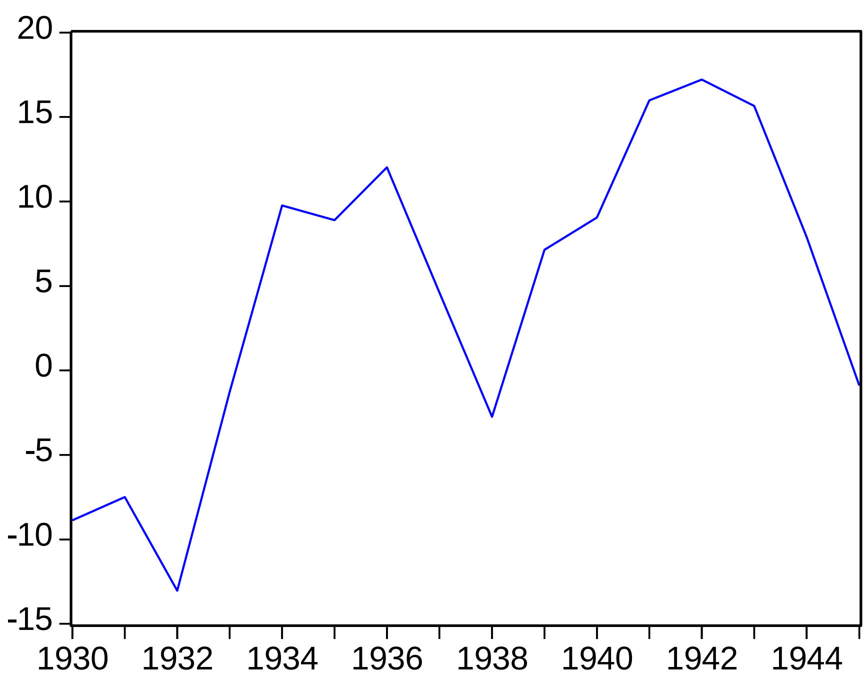
In the 1930, the first banking panics occurred, as depositors lost confidence in the solvency of the banking system and quickly started to withdraw their deposits, causing banks to call in loans to compensate their liquidity. Run on banks occurred in the United States again twice in the 1931 and in 1932. At the beginning of 1933, many banks were forced to close their doors.

Figure 1 Growth of US Real GDP 1930 - 2016



Source: Reproduced from Monadjemi and Lodewijks (2019)

Figure 2 Growth of US Real GDP 1930 -1945



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In Figure 1 the Growth rate of the US economy 1930 to 20016 is presented. Figure 2 illustrates that the depth of the Depression was reached in 1932 when the growth declined to -12 to -13 percent.

The recovery began in early 1933, and the US economy continued to recover during the next three years when on average, the real GDP grew by 9 percent per year. After a severe temporary recession in 1937, the US economy continued to recover in 1938. The second fall in 1937 offsets most of the earlier recovery in production and employment and caused the depressing effects of the Great Depression to continue to the end of the 1930s (see Figure 1).

The negative economic impact of depression in Europe led to the rise of nationalism and the Nazi regime in Germany. The Nazi’s regime conquered several counties in Europe and started the war in Europe. In the United States, President Roosevelt decided to support Britain and France against Germany. In 1941, the entry of the United States into WWII caused significant expansion of industrial production and employment to the level before the depression.

Great Recession 2007 – 2009

The Great Recession (GR) started with the subprime financial crises in the United States and Europe in 2017. The subprime financial crisis was initially in the United States as a result of prolong low interest rate and substantial risky mortgage lending by US and European banks. The sub-prime financial crisis was initially caused by prolonged low interest leading to large quantities of non-performing mortgages approved by financial institutions in Europe and the United States. The crisis became global when high-risk mortgage loans were packaged together, into Collateralized Debt Obligations (CDO), and passed to financial intermediaries throughout the world. The non-performing assets caused a shortage of liquidity in many affected financial institutions. Bank lending was significantly reduced, and the mortgage crises led to the GR, that was the biggest since the GD of 1930s. In the United States the Lehman Brothers declared bankruptcy and the oldest merchant bank Bear Stearns was purchased by Chase Manhattan at 1 dollar per share.

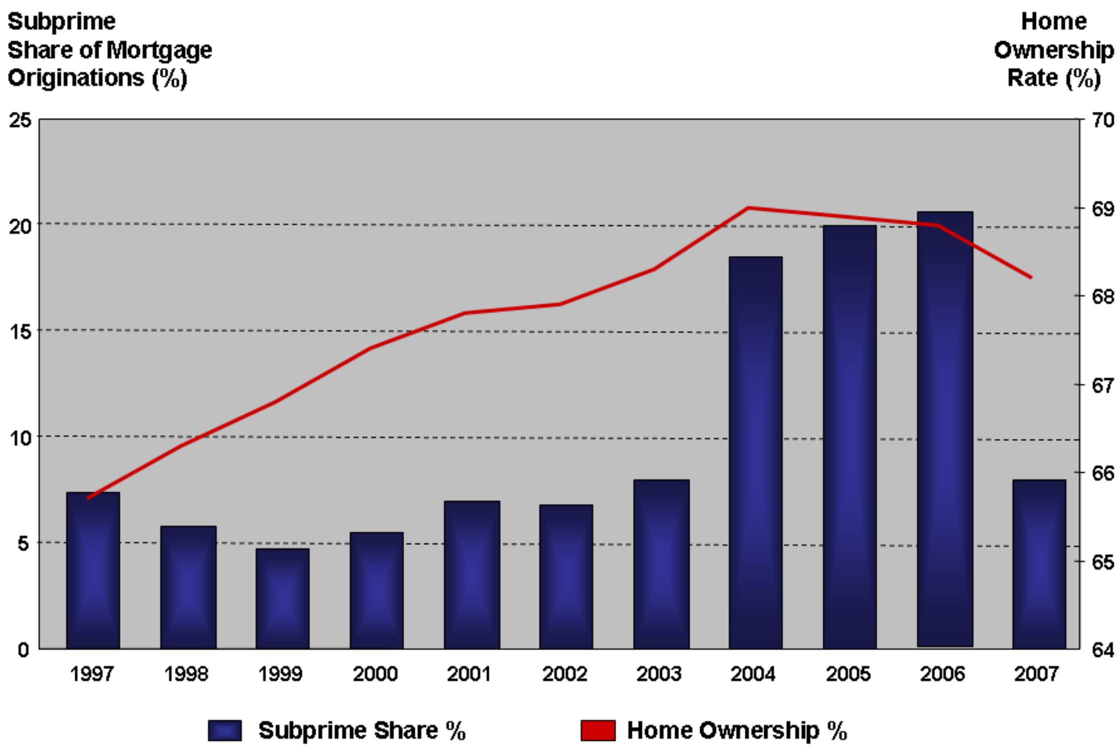
There are different categories of mortgage based upon the credit standing of the borrower[1]. These include sub-prime, Alt-A, and Prime. The share of sub-prime mortgages is presented in Figure 1. The share is the ratio of the dollar value of subprime mortgages to all originations, expressed in a percentage. The level of home ownership is the percentage of

[1] The following discussions are based on: https://en.wikipedia.org/wiki/Subprime_mortgage_crisis

American households that own their homes rather than rent. Sub-prime mortgage was stable below 10% of all mortgage originations until 2004, when rose to nearly 20% and remained there through the 2005-2006 during the peak of the housing boom.

"Sub-prime mortgages rose from only 8 percent of originations in 2003 to 20 percent in 2005 and 2006, while the interest-only and payment-option share shot up from just 2 percent in 2003 to 20 percent in 2005." "Making matters worse, multiple risks were often layered onto individual loans. For example, large shares of sub-prime mortgages also had discounted initial rates that reset after two years, leaving borrowers vulnerable to payment shock. In addition, lenders eased underwriting standards, offering loans requiring little or no down-payment or income documentation, and some engaged in behaviour viewed as predatory. This meant that many loans were underwritten without a clear measure of the borrowers' ability to repay and without equity cushions as protection against defaults. "Housing speculators were also readily able to get loans to buy investment properties, relying on soaring house price appreciation to flip the units and resell at a profit.[2]

Figure 3 Expansion of US subprime lending



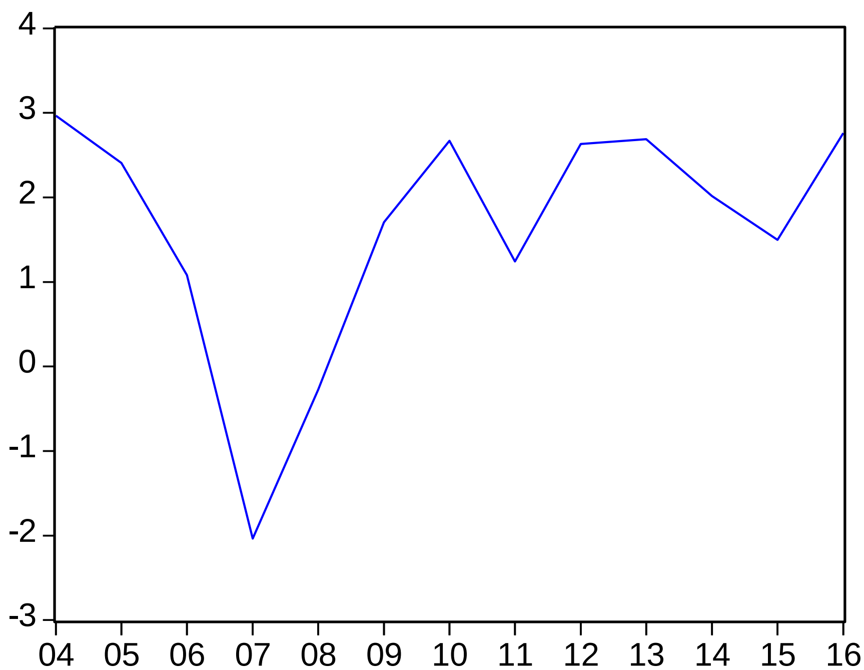
Source: US Census Bureau, Harvard Univ. – State of the Nation's Housing Report 2008

[2] Harvard University, State of the Nation's Housing Report, 2008

Similarities of GD and GR

Blanchard and Summers (2017) argued that in 2008 recession the US economy did not completely collapse as it did in 1933. However, the recovery in the earlier period was much faster than the latter. This means that the US economy grew at a considerably higher in the late 1930s than it did in the recovery after the 2008. In Figure 4, the US economy during 2007 to 2010 grew from as low as -2 percent to as high as almost 3 percent in 2010. In contrast, in Figure 2, the growth of US economy dropped as low as -12 percent in 1932 but quickly rose to +10 percent within next two years. The article points out that the macro stimulation policies, fiscal and monetary, and bail out of financial institutions during the GR, were significantly stronger to keep the unemployment much less than the 25 percent that occurred in 1929.

Figure 4 Growth of US Real GDP 2004 - 2016

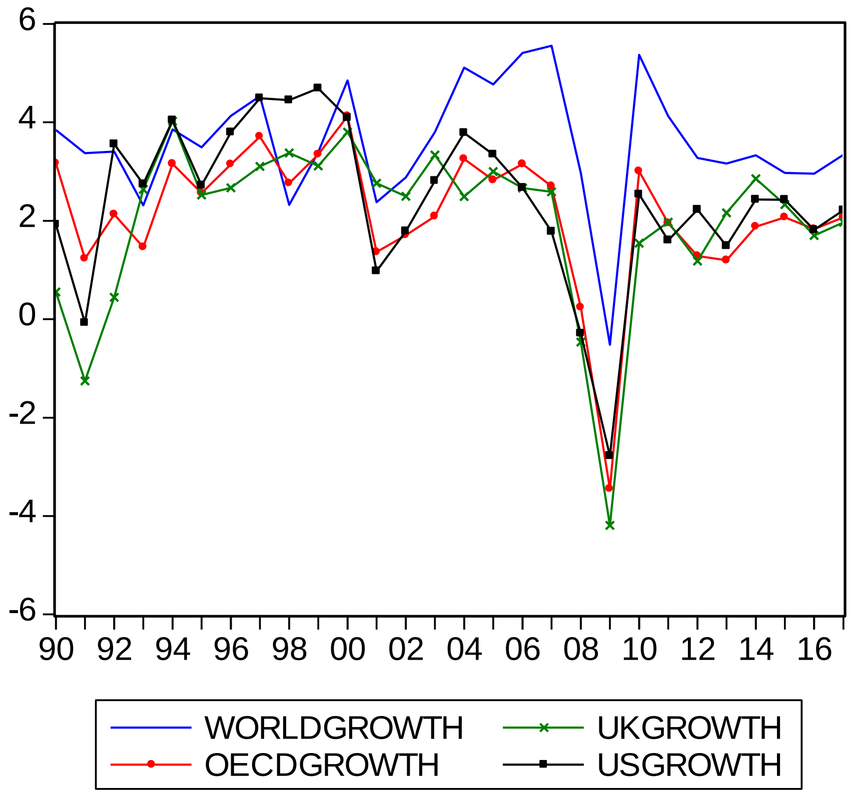


Source: Reproduced from Monadjemi and Lodewijks (2019)

The first victim of banking crisis was Northern Rock in UK where the bank of England was forced to nationalize the bank to create confidence in depositors. In another development, the central bank of Iceland also nationalized all of the banks in an attempt to avoid run-on banks. The financial crisis also affected periphery countries in the European Monetary Union not being able to service their debts as their growth rates were significantly declined as a result of global financial crisis.

Figure 5 shows growth rates of World, OECD, UK and US 1990 – 2017. All four growth rates were negative in 2019 as they were adversely affected by the GR. The world growth rate was less affected relative to the other three growth rates. This observation is as expected as the financial crisis and the GR mainly occurred in the United States and Europe.

Figure 5 Growth Rates 1990 - 2017



Some statistics regarding growth rates are presented in Table 1

Table 1 Some Statistics 1990 – 2017

	World	OECD	US	UK
SD	1.23	1.41	1.62	1.71
Minimum	-0.52	-3.5	-2.77	-4.19
Mean	3.6	2.14	2.4	1.98

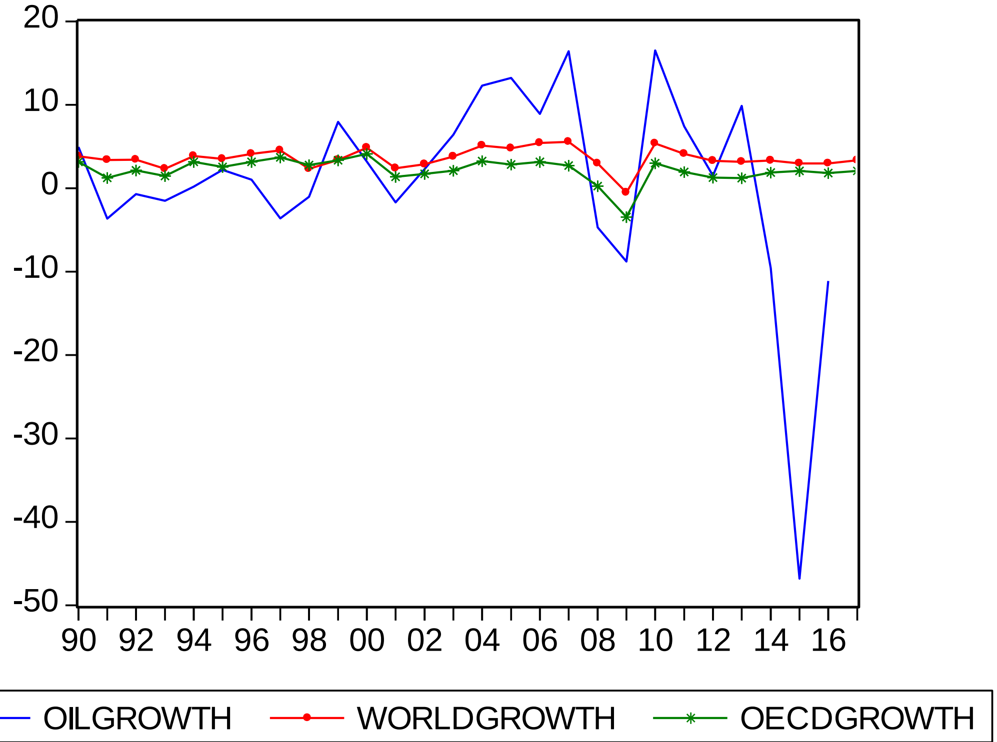
SD stands for Standard Deviation.

UK minimum growth rate occurred in 2009 was lower than the other growth rates. The minimum of World's growth rate was significantly above the others because many counties in the world were not affected by the GR. Also, UK experienced larger fluctuations of growth rate than the other three categories. Furthermore, over almost three decades UK, average growth rate was lower than World, US and OECD.

Further evidence on the depressing effects of the GR is presented in Figure 6 where growth of oil price is superimposed on the world growth and OECD growth. The adverse effects of GR reduced the demand for oil causing drop in international price of oil after a sustained period of stability. Subsequently oil prices dropped significantly as a result of lower demand from China and India.

Monadjemi (2016) argues that Oil Prices have fallen from peak of 145 US dollars per barrel in July 2008 to as low as $28 per barrel in January 2016. This is 81 percent in eight years after nearly five years of stability. In Addition to lower demand, United States has become the world's largest oil producer. US is not a net exporter of oil, but its imports are substantially lower, causing excess supply in the market.

Figure 6 Growth Rates 1990 - 2017



Macroeconomic Policy Responses

In response to the Great Depression, policy makers either stumbled upon or were far-sighted enough to apply expansionary fiscal and monetary policies in line with the teachings of J.M. Keynes. Ultimately it was increased government spending for war purposes that stimulated production and employment. Discretionary macroeconomic policies reduced economic fluctuations in the post-war period of prosperity. However, in the late 1960s these activist policies were questioned and there was a return to pre-Keynesian views of policy rules such as a balanced budget or a constant growth of the money supply. This changed fundamentally when the Global Financial Crisis occurred.

In response to the developing global financial crisis there were fiscal stimulus packages world-wide and very substantial cuts in official interest rates. In 2009 with interest rates close to zero, the Federal Reserve engaged in very unorthodox monetary measures involving quantitative easing, capital injections, and central bank swap lines. A stunning series of unprecedented interventions into the financial system rescued both illiquid and insolvent financial institutions and even involved swapping safe government bonds for toxic assets.

In the U.S 40 percent of conventional deposits were not insured and the government was forced to provide a blanket guarantee – the equivalent of deposit insurance – to all existing money market funds. They guaranteed bank debt irrespective of how prudent or otherwise these institutions had been. The Federal Reserve made loans directly to ailing financial institutions, including non-depository institutions, and bought up long term government debt and mortgage-backed securities, credit card debt and auto loans. The nature of the intervention was so extensive that the distinction between monetary and fiscal policy is now not at all clear as the monetary interventions have clear spending and tax implications.

Keynes's description of financial markets characterized by investor irrationality, bubbles, and destructive speculation appears still to be insightful. Indeed, we have seen the return to favour of stimulatory Keynesian fiscal policy. It was not long ago that there were a number of leading economists - such as Eugene Fama, John Cochrane, Robert Barro and Robert Lucas - who were strongly anti-fiscal stimulus. Cochrane is on record as saying that fiscal stimulus was a 'fairy tale that has been proved false'. No longer is that view sustainable. Similarly, unregulated global financial flows are now viewed more cautiously. The financial sector of the economy needs to be reined-in and its share of GDP and household income reduced. The best way to do that is still unresolved but it appears far better that more resources flow to sectors that create wealth rather than redistribute it. It is technological innovation not financial engineering that provides the dynamism of a modern economy and it is entrepreneurs rather than fund managers that raise our living standards. The concern is that the lessons of the Global Financial Crisis, just like the lessons of the Great Depression, will soon be forgotten and then we can expect to face similar episodes, with all their painful consequences, in the future. It has been said that "Those Who Do Not Learn History Are Doomed to Repeat It" and we must learn from the experiences of these two major episodes of economic disruption.

CONCLUDING REMARKS

Both GD and GR left depressing effects on the global output and employment. However, concerning US economy, the GD caused a complete collapse of the US economy, whereas in 2008 recession the US economy did not completely collapse, the recovery in the earlier period was quicker than the latter. This indicates that the US economy grew at a much faster rate in the late 1930s than it did during the recovery after the 2008.

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