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Learning from the Past: a comparative analysis of the influences of the Great Depression on the recent financial crisis.

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Abstract

The Great Depression and the recent financial crisis are events that have changed the lives of many American and global citizens. In hopes of preventing similar mistakes in the future, we should study, analyze, and learn from these past events. This investigation attempts to do just that through a rigorous study of the past Great Depression and recent financial crisis. We will explore the two events separately, analyze their similarities and differences and then discuss what we have learned from the Great Depression and see how that knowledge has been used to combat the recent financial crisis. The Great Depression was one of the biggest economic crashes to date and there is still a lot to be learned from that event, but the recent financial crisis also has a lot to offer. We will discuss the financial regulations such as the Glass-Steagall Act, Basel I and Basel II. These new and modified regulations lead to the recent financial crisis. We will identify the biggest changes in regulations and explain exactly why those changes lead to the financial crisis. Additionally, specific economic sectors that played the biggest role in the 2007-2009 crash will be identified and examined. Undoubtedly, the real estate and housing sector played one of the biggest roles but there are also many others that had just as lasting impacts. In aggregate, we will be able to discuss the lessons learned from the Great Depression and what steps were taken in urgent response to the recent financial crisis, and how that influenced the trajectory of the American (and global) economy during, and immediately following, the recent financial crisis. This will help us to formulate responses for future financial crises. We will examine which regulatory policies need to be maintained and which needs to return for the future health of the American economy. This will lead us to discuss what the American government did right and what should be changed and which sectors have too much power in terms of influence. Overall I would like to study, analyze, and learn from these past events in hopes that we will be more prepared for future incidents and hopefully have the means to stop them before they start.

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1. Introduction:

The Great Depression began around 1929 and lasted until the late 1930's to the early 1940's. It was a time when all looked ill, unemployment reached all-time new highs, and the stock market reached all-time new lows. This, to an extent, is very similar to the recent financial crisis. In late 2008 to early 2009 the stock market went through another crash similar to the crash during the Great Depression. However, modern presidents of the United States face more serious issues in association to the fallout of the more recent financial crisis, more serious than the challenges that Franklin D. Roosevelt faced 80 years ago. This is because the United States economy is now more than twice the size it was in 1933 and will soon be thrice the size.[1] Many economists have tried to explain the great depression, and the economists during the 1930's had two dominant explanations. The first involved the two pillars of classical macroeconomic thought, Say's Law and the belief in the self-equilibrating powers of the market, or in layman's terms, "supply creates its own demand." The second theory claims that the great depression was the unavoidable result of the credit boom or overinvestment cycle during the 1920's[2]. These explanations were given during the time of the event, but with the power of hindsight and all the information at hand now, a good theory behind the causes of the great depression points to a time between December 1927 and July 1928 when the Federal Reserve conducted 393 million dollars of open market sales of securities so that only 80 million dollars remained in the Open Market account. This raised the buying rates on bankers' acceptances from 3 percent in January 1928 to 4.5 percent by July. Once this was done, the deflationary pressure on stock

[1] Osenton, 54.
[2] Parker, 9.

prices had been set and in due time the stock market collapsed.[3] Another claim that is often made is that the only reason the crisis in 1931 (great depression) was so long was because of the misguided economic policies in place[4]. These explanations behind the great depression all have strong points, but a single mistake cannot solely take the blame of what led to the great depression; the same goes for the current one.

There are many theories that have been passed around to explain what led to the recent financial crisis and while many people know that the housing and banks were the biggest markets behind the great depression, there were also many other underlying pressures. Through this investigation I aim to separate the economic similarities and differences between the great depression and recent financial crisis. This will then lead me to breakdown the major contributing factors to the recent economic decline (2007-2009 crash). My three dominant points of interest will include:

1. what we've learned from the great depression to help change the course of the 2007-2009 crash,
2. specific financial regulations which were either removed or altered that influenced the 2007-2009 economic downfall, and
3. which economic sectors played leading roles in precipitating the 2007-2009 crash.

[3] Parker, 4-5.
[4] Buchheim, 230.

2. Great Depression:

As stated earlier, there were many influencing factors behind the great depression, one of which includes the deflationary pressure on stock prices. Some other factors include the ensued panic that was fueled when the stock market crashed for a straight month during the 1920's, and many bank failures. October 29, 1929 is now known as Black Tuesday because of the stock market crash that began the great spiral of the great depression. Before Black Tuesday, the United States economy was doing so well that nearly one-half of the world's industrial output in 1925-1929 was produced in the United States. It seemed like a 'new era' but when the stock market crashed everything went the opposite way[5]. As the stock market plummeted so did every other aspect of American life. Along with the stock market, in the first 6 months of 1929, 346 banks failed in the United States. This is a critical example of how bad the economy was. If 346 banks closed today, it would ruin thousands of lives and shut down a large portion of the economy. The region that was hit the hardest was the South-Eastern area of the United States; this includes most of the farmers that moved up north or to the far west, depicted in figure one in orange[6] (figure #1). Alongside that, figure 1 displays the areas that rose even when the economy was in shambles. These areas were mostly the industrial areas which provided a decent amount of jobs but still not have enough employment opportunities for everyone[7].

These causes don't go without effects; a large number of problems arose as a result of the great depression, the main ones include inflation, unemployment, and poverty. The prices

[5] Parker,2.
[6] *About the great depression*
[7] Ibid.

of everyday commodities such as oil,[8] food, and countless other supplies rose extremely high and extremely fast. As for unemployment, it hit 25 percent which was an all-time high[9]. While unemployment hit a new high, poverty also rose; numerous families lived in poverty and were unable to pay for food. The major reason behind the poverty was the unemployment rate, when the workers couldn't find work many of the families that depended on that income would be really damaged. The state that the nation was in during this time is exemplified in John Steinbeck's novel *the Grapes of Wrath,* where a family of sharecroppers is forced to move from Oklahoma because of the economic situation. This quintessential American novel displays the effect the great depression had on a conventional family and clearly describes the resulting poverty, inflation, escalating prices, and unemployment[10].

As best it could, the government tried to intervene, FDR came up with The New Deal, the effects of which weren't as immediate as the country needed. The New Deal was a two-part plan and once it was passed through Congress, this plan enabled FDR to cut 500 million dollars from the budget[11]. FDR planned to cut 25% of the budget by enforcing a pay cut for all federal employees, as well as a reduction in pension benefits for nondisabled veterans[12]. While the New Deal cut pay to government workers, it also gave jobs to many unemployed through public work programs. Though the president was doing this to restart the economy, it had a mixed effect, part of it reduced the money that was being circulated in the economy due to the pay cuts but also gave jobs to stimulate the economy.   These causes, effects, and governmental aid, to an extent, mirror the causes, effects and governmental aid of the recent financial crisis.

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[8] Bordo, 209.
[9] The end of the world has been cancelled for now,2.
[10] Steinbeck.
[11] Osenton, 124.
[12] Osenton, 125.

3. Recent Financial Crisis:

As stated earlier the causes of the recent financial crisis were not solely in one area, but a combination of several of them. Some areas of causation include the housing market and the baby boomers. The housing crisis was when interest rates began rising and the price of house appreciation slowed. Therefore, many borrowers in the subprime market found it impossible to refinance on favorable terms and were unable to maintain their mortgage payments when their loans reset[13]. While the housing crisis was a major influencing factor, the baby boomers were also another major factor behind the recent financial crisis. During the 1980's and 1990's, the boomers helped to create enormous productivity, when they hit 60 years of age (around year 2000) some thought of life beyond their 'conventional career' while others stopped working altogether[14]. When the baby boomers started to hit 60, a large part of the labor force decreased and it became hard to replace their sheer numbers in the workforce, this caused a lot of turmoil in the labor force industries. This eventually led to a halt in industrial process and decreased output.

Much like the effects of the great depression, the effects of the recent financial crisis were inflation and unemployment. Oil prices had peaked due to inflation, but not all items increased in price. Because of the oil prices, the gas prices had also risen exceptionally high to 5.00 dollars a gallon in the summer of 2008[15]. Unemployment in 2010 was at 10 percent, just like during the great depression, this increased poverty rates and had numerous Americans struggling to make ends meet[16]. In 2007 the poverty levels were defined as 10,294 dollars

[13] Ovanhouser, 51.
[14] Osenton, 18.
[15] Osenton,45-46.
[16] Databases, Tables & Calculators by Subject. (2015, June 25)

annual income for a one-person household, 13,167 dollars annual income for a two-person household, and 16,079 dollars for a three-person household. And in 2007, 37 million Americans were living below the poverty level; this is a sizable portion of the American, about 12.3%, were struggling to live on the necessities[17].

Just like the great depression, the government tried to help the people. This time it was in the form of a stimulus package that provided tax rebates of up to 600 dollars per individual, 1200 dollars per couple, and 300 dollars per kid. Though this increased the federal deficit, it also increased the Gross Domestic Product (GDP) in 2008 by 0.7 percent[18]. The stimulus package ultimately tried to restart the economy in hopes that the American citizens would use the money to jump start the economy. The government also loaned huge amounts of money to corporations such as J.P. Morgan which got loaned 29 billion dollars.[19] Several of these major topics show up in both the great depression and recent financial crisis, which I will be addressing next.

4. Similarities:

The similarities of these two depressions include that they both had many of the same causes and effects. Their governmental aid is limited to what each plan did so it is not considered a similarity. The causes that are most obvious include that both had a major stock market crash and both had bank failures. As previously mentioned, the government loaned billions of dollars to many corporations, a vast number of them being banks such as J.P. Morgan which failed during the current depression. Alongside that, a total number of 346 banks died

[17] Osenton, 52.
[18] Ovanhouser, 15-16.
[19] Ovanhouser, 27.

out during the Great Depression. The stock market crashed around late 2008 and early 2009, which was similar to the crash in late 1929. During 1929, the stock market dropped dramatically in one day and continued to drop years later, in 1937 the Dow Jones index fell 7.2 percent in one day and 9% another day[20]. Though the current depression didn't continue to drop years after the stock market crash, it still crashed during the following consecutive months just like the great depression. Both of these occurrences depleted the savings of many Americans, which caused the economy to come to a halt.

Some similar effects caused by the two depressions are unemployment, inflation and a decline of the GDP. Unemployment was at 25 percent during the great depression and 7.2 percent in 2008 and is still increasing. Almost 3 million jobs were lost in 2008, which is the single largest drop since the end of World War II[21]. This big unemployment drop mimics the great depression when a quarter of the workforce was unemployed. While 7.2 percent doesn't seem near 25 percent, the United States has grown in population quite a bit and 7.2 percent is a sizable group of people in the United States. As for inflation, both during the great depression and current depression, oil prices rose to new highs (for their time), gas prices also rose during both depressions caused by the soaring oil prices. The GDP, the market value of all final goods and services produced within a country, only increased by less than 2.5 percent for each year from 2000-2008, and the growth in between years has become smaller and smaller. This 2.5 percent rate is the lowest the GDP has been since the 1930's, which is extremely similar since

[20] Evangelopoulos,81.
[21] Osenton, 47.

the great depression also occurred in the 1930's[22]. This shows that the economic state of the United States is becoming less and less profitable even though the GDP is still positive.

5. Differences:

On the other hand, the differences cover much more areas in each depression's causes, effects, and governmental aid than the similarities. To add to the differences, there will be a global factor within this section. The different causes (more different than similar) are the baby boomers, the housing market, national debt, and lobbyists. The baby boomers are exclusively part of the current depression; they are a prime reason in which the current depression has taken such a hard hit on America. With most of them going into retirement, a lot of vacant jobs are open with no one with the skills, willpower, and frankly, existence to fill them[23]. Even the fundamental aspects of life became difficult to accomplish, such as how one will put their son or daughter through college. As the price of college increased dramatically over the course of 30 years from 3,000 dollars to 35,000, dollars, most families don't save up for such expensive amenities, leaving it to the child to either not go to college or take a huge loan from the bank. This dilemma is a worry for many of the baby boomers, since the boomers spent the money as it came rather than saving. The collapse of the housing market also occurred during the great depression but it is put under differences because of the magnitude at which it has affected the nation in this current depression. It is one of the core reasons as to why the economy is doing so poorly, people took out loans they could not pay back, and a record of 3.16 million homes

[22] Osenton, 45.
[23] Osenton, 55-56.

received foreclosure-related notices in 2008[24]. A major difference between this depression and the great depression was the aid that the government gave, one reduced the budget and one increased it. Both had intentions of starting up the economy again, but the stimulus packages spent millions of dollars to do so which racked up a total of 152 billion dollars and an additional 16 billion dollars in 2009, where The New Deal saved 500 million dollars. While both of these were made to reform the economy, the reason why the stimulus package (2008-2009) worked so quickly was because of the speed at which the economy was dealt with[25]. The lobbyists were also a difference because during this depression corporations spent millions. The pharmaceuticals and health products industry spent 227.7 million dollars, insurance companies spent 138.1 million and many more corporations spent millions on lobbying[26]. This is a drastic change from lobbyists during the great depression. Another area of difference was the lack of global impact throughout the first depression.

Globalization has connected major corporations with all other countries, for example it was often said, "what's good for GM is good for America," this statement no longer holds true.[27] General Motors is now considered a world power because of Globalization and their sole purpose was to gain profit for their shareholders. This meant that if it was cheaper to have a manufacturing facility in other countries they were told to build it there, which meant fewer jobs for Americans[28]. As fewer jobs are available for the common worker, less money is cycled through the American economy making the economy weaker. Economic health is a statistic that measures how well a certain country is doing economically, and as the economy gets weaker

[24] Osenton, 51.
[25] Croft, J. (n.d.). *The great depression – comparisons to today's recession*. Retrieved from http://www.economicstimulusdetails.com/the-great-depression.html
[26] Talbott, 99.
[27] Talbott, 110.
[28] Ibid. mortgage

the nation also becomes weaker[29]. In the 1930's the global impact was still big, but now with modern technology the impact that a little dip in the stock market causes can have rippling effect to nations across the planet. In the United States, the value of all the total publically traded companies in 2006 was 15 trillion dollars, and if we compare that with the rest of the world, trailing behind us is China with only has 3 trillion dollars (USD) and India with 1.7 trillion dollars (USD). As shown, these economies are too small to compete with the United States. Also, these other countries depend on their exports to the United States as their main client, so the trajectory of the American economy also effects them in the same way[30].

6. Learning from the past:

Economically, the recent financial crisis is as they would call it 'déjà vu,' not exactly the same, but eerily similar. The stock market crashed for many years during the great depression while the current one lasted for a much shorter interval, this could be a prime example of how this nation has utilized knowledge of previous mistakes. Economists say understanding the great depression is the Holy Grail of macroeconomics and could help reform a new age of information about economics[31]. This suggests that the great depression holds some of the most valuable information that an economist could study and learn about the United States economy, which undoubtedly holds merit in the health of the global economy as well. The New Deal was a big reason as to why the United States economy came back along with the second New Deal. I can safely say that we learned from that and used parts of it to come up with the

[29] United states, 1.
[30] Talbott, 72.
[31] Parker, X.

economic relief programs that helped hinder the damages that came out of the recent financial crisis.

Many economics believe that we should have let the big corporations fail, namely the ones that were "to big to fail." While I believe they have merit in that statement, I don't think anyone can predict what would have actually happened if the administration had let that happen. If we had let those big companies like GM fail we might have been in an even worse condition. Unemployment would have gotten even higher, GDP would have shrunk tremendously more, and many more people would be unable to pay the debts they already owed which would compound the existing problem. By having the stimulus package and saving the companies I believe the United States government took the safest route out and they learned to do this by looking at what had happened in the past. I hope that we are able to take all the negatives that came out of the recent financial crisis and learn from them again. In the future we should implement more regulations that were changed in the recent years that let commercial banks and investment banks become more liberal with their money. I hope that we are able to become more like Ford when it comes to companies and CEO's. Ford was the only one out of the three big motor companies in the United States that didn't need a bailout[32]. While it wasn't the biggest of the three, their CEO was able to identify the future market, correctly foresee that future, and most importantly, do something about it, something that should be expected of any knowledgeable CEO. As the head of one's company, one has the power to change the present in order to protect oneself from future catastrophes, which the CEOs of GM and Chrysler were unable to do to satisfaction.

[32] Bailout Recipients

7. The Role of Financial Regulation:

There are many financial regulations that changed between the mid-1930s and late 2000s that contributed to the recent financial crisis. Many economics say that the major changes in financial regulations include the Glass-Steagall Act and Basel I and II. While there are more than just those three, I will only discuss those three since I believe those are the biggest changes. First the Glass-Steagall Act, also referred to as the Banking Act of 1933, was a set of provisions placed to separate the investment banks and commercial banks. What this means is that before this act was repealed in 1999 commercial banks that held on to people's money couldn't invest that money in other companies, or houses, but had to rather hold on to that money and act like a commercial bank[33]. While commercial banks would handle that, investment banks were limited to the capital market. This drew a line between them but when the Glass-Steagall Act got repealed (two of the four provisions) the investment banks and commercial banks acted as if they were the same. Commercial banks started investing peoples' money in hopes of generating more profit and investment banks would take others money in order to have more capital to invest in. This also lead to commercial banks and investment banks lending large sums of money to people who couldn't afford the mortgages on their homes which in turn lead to the recent financial crisis[34]. Many economics say that this was the biggest regulatory change in the financial sector that enabled the recent economic crisis to come about. Basel I was a regulation implemented to basically let banks take on more credit risk in "less risky" transactions in hopes to make more profit out of them. This system categorized risk into five categories, cash, public risk, development bank risk, residential

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[33] Glass Steagall Act
[34] Glass Steagall Act

mortgages, ad non-OECD bank debt (Organization for Economic Co-Operation and Development)[35]. Cash, OECD government debt, and government debt took on zero risk. Public sector debt, which went off of ratings (i.e., AAA, AA, AA-), would hold different amounts of risk varying from 0% - 50%. Development bank debt, OECD bank debt, non-OECD public sector debt, and some others would have 20%. Residential mortgages would have 50%. Non-OECD bank debt, plant and equipment, private sector and some others would carry 100% debt[36]. Now multiplying the debt by the respective percentages would give you the total risk-weighted assets (RWA), and banks had to maintain capital that equaled only 8% of their RWA. For example if you had $100 million in RWA you would only have to have $8 million in capital to back it up and the RWA isn't the actual amount of money you are risking , it could be millions more just less riskier[37]. While this regulation tries to encourage less risky deals, it also encourages companies to loan a lot more in terms of "safer" loans. This new regulation allowed many commercial banks to loan more money out and while in theory it was a good idea, only requiring 8% capital to back up the total RWA is extremely low and that is why they started coming up with Basel II. Basel II was basically the same as Basel I but you needed more capital to justify the RWA. Basel II didn't have a set amount of required capital to set aside but they adjusted it while dealing with different situations. Basel II was starting to surface in 2005 and by that time many banks already had loans out to people that simply couldn't afford them[38]. I believe that Basel II regulations gave banks a scare and when seeing the numbers they realized that they had to change things drastically and go into unorthodox methods. Seeing that they

[35] Basel I Definition
[36] Basel I Definition
[37] Basel I Definition
[38] Basel II: Revised international capital framework

had to change their methods and realizing that they currently had too many loans out and were required to change their loan programs was one of the causes of the mortgage bubble popping.

These three regulations all played a big part in the recent financial crisis. The first, Glass-Steagall Act, made it so that commercial banks could play with the money people had given them to keep safe. Much like the Great Depression, when people wanted to take money back the banks didn't have the money to give them and just like the Great Depression many banks closed down as we saw with the current financial crisis. Second, Basel I let banks be more liberal with their investments and rewarded more investment when it came to "safer" loans (example being mortgages). Basel I is, in large part, what lead to the mortgage bubble but Basel II is what popped it. The two regulations were the catalysts for the pop, but the needle itself was Basel II, it was a wakeup call to banks that Basel I was too lenient and the percent of capital needed to counter the amount loaned was just too big of a difference.

8. Impact of Economic Sectors:

The real estate and housing sector is no doubt one of the biggest contributors to the crisis since they are the ones that started the whole crisis. With the mortgage bubble popping and millions of people losing their homes and savings, the housing sector is the sector that is blamed the most often by the media and in turn is what the public views as the main cause. The housing market was also one of the big reasons behind the cause of the Great Depression and due to the fact that Fannie Mae was made as a response to the Great Depression. It was one of two big government-sponsored enterprises (GSE) the other being Freddie Mac[39]. Both of these

[39] Barth, 174

corporations were in the business of mortgages and both were government sponsored. Together they were the biggest companies when it came to mortgages and together they had more than $5.5 trillion in home mortgages. From 1990 to the mid-2000s Freddie Mac and Fannie Mae grew enormously but by the third quarter of 2008 they saw a decline[40]. They were forced to grow so much because of the goals implemented by the United States Department of Housing and Urban Development (HUD) which were lobbied by big investment banks to increase profits. Goals were set and increased each year and subprime mortgages increased as a cause, and to meet goals they would give out more loans in terms of mortgages, thus the bubble began to form[41].

Most people blame the housing sector as the biggest cause of the recent economic crisis but there are also other economic sectors that played a big part in it. Living through the crisis I remember every night the big news stations always covering the mortgage bubble and that being held as the cause of the crisis. The media talked little about the financial sector other than to cover the stock market crash. The financial sector should be held accountable, at least as much as the real estate sector when it comes to the recent financial crisis. The commercial banks and investment banks were able to make risky transactions due to the financial regulation changes. They were able to invest in many different sectors, one including the housing sector, and once the housing bubble popped many of the investments went under and caused a spiraling effect in the other sectors. The financial sector ties into all the economic sectors due to the stock market and personal spending. As investors began to see the housing bubble, they withdrew money from the stock market. This lead to many different sectors being

[40] Barth, 176
[41] Barth, 179

hurt and many people taking huge hits to their savings, as people started to withdraw money from many different sectors, sectors like the automobile sector began to look weak. As people started to not spend money, many sectors felt the pain, one being the automobile sector.

As a resident of Michigan, the automobile sector has always been a big deal. I felt this sector had the third biggest role to play in the recent financial crisis after the real estate sector and financial sector. There was already an energy crisis developing between 2003 and 2008 but in 2008 that's when the automobile crisis occurred. With less people spending on cars the "big three" started to feel the pain and had to resort to layoffs. Unemployment in Michigan was 14.9% and in Detroit it was 28.4% in 2009, over a quarter of Americans in Detroit were unemployed[42]. You can also see that while the housing bubble started around 2007, the effects started to seep into other sectors (automobile sector) in 2008. If the real estate sector was the only one and had no effect on the other sectors we wouldn't have seen nearly as a big effect as we did. The reason the recent financial crisis lasted so long was due to the fact that all the sectors are somewhat connected and while one started to fail the others felt it and it began a rippling effect. The real estate problems had escalated very quickly in effecting every sector in some way and in turn affected the American and global economic world.

9. Conclusion:

No country wants a depression or an economic crisis so we should try to learn from the past. We learned a tremendous amount from the Great Depression but what can we learn from the recent financial crisis? The Glass-Steagall Act was a piece of regulation that should have

[42] Databases, Tables & Calculators by Subject

never been removed. While it might be okay to change a little, I think that it is necessary to keep the commercial banks and investment banks separate. Basel I gave way too many liberties to banks, requiring banks to only have a 8% collateral of capital on their debt is just too little and while they were trying to change it, the damage was already done. The financial sector has too much of an impact of everything else. It is the one sector that connects all the other sectors due to investment related activities. That's not something we can change, but regulations should thus be implemented to prevent spillover from different sectors. The United States can only do so much to prevent this from happening again. Globalization has occurred and now the United States isn't the only big GDP on the planet, while they may still be number one, China and India are becoming bigger and bigger due to the sheer population and work force. If their economies go under the same situation as we faced in 2007 the United States would feel it on a national scale. The stimulus package came from a derivation of the New Deal and it served its purpose, it was meant to boost (stimulate) the economy and it did just that. It got the economy to jump start and if we didn't do that who knows how long it would have taken to get the economy rolling again. The bailout was something that should be studied closely since there were so many moving parts no one knows exactly what would have happened if no bailouts occurred. Hopefully we can analyze the situation in a couple of years and identify exactly what parts of the stimulus package worked and use that information for future crisis. Overall I believe we learned a great deal and in future economic crisis I hope we can look back in the past and be able to adapt to the situation to prevent as much damage as possible. The next time an economic crisis happens it will be on a global scale but we will also have more information to help each other out, that is if we work wisely as a world economy rather than one nation against another.

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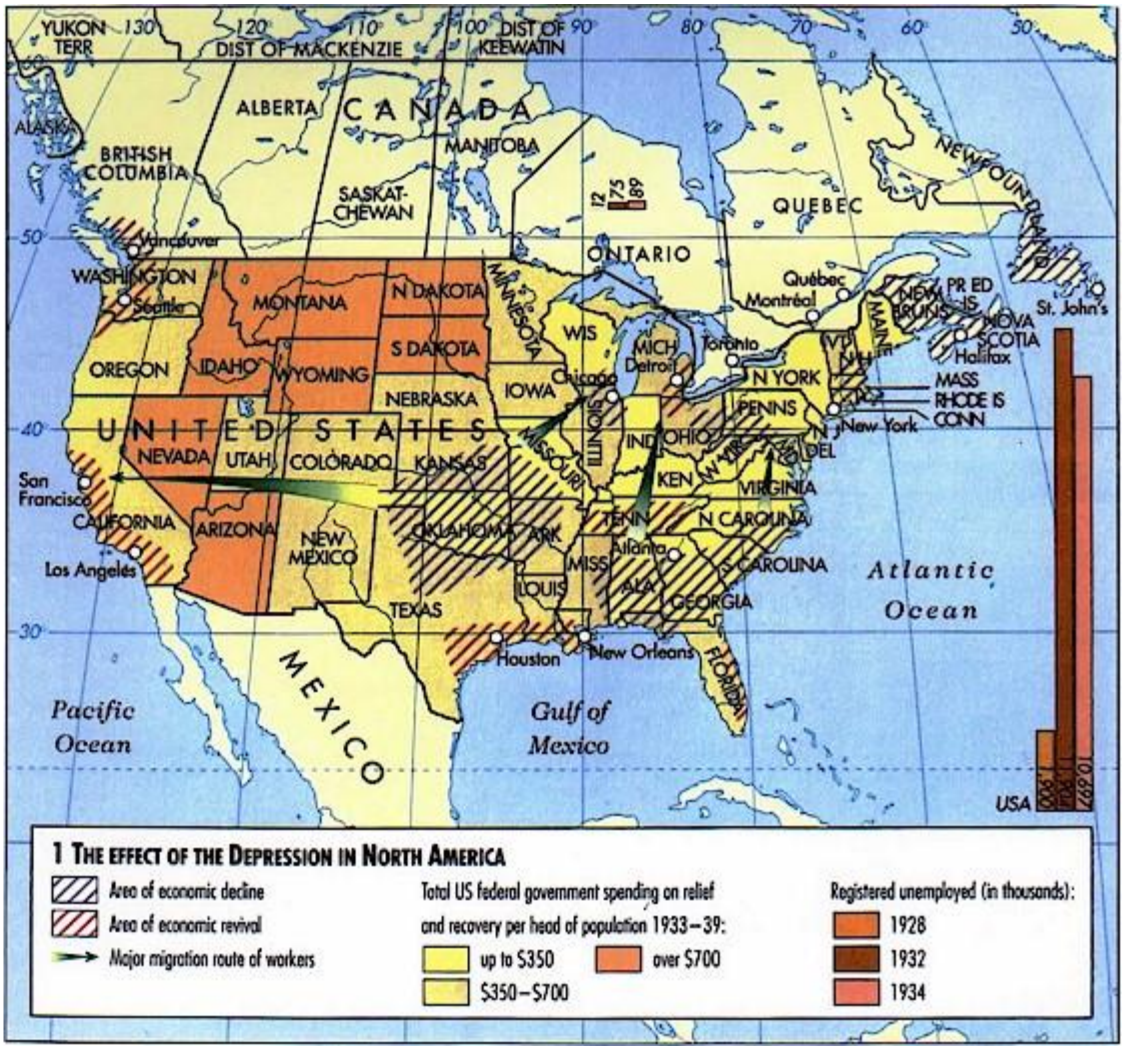
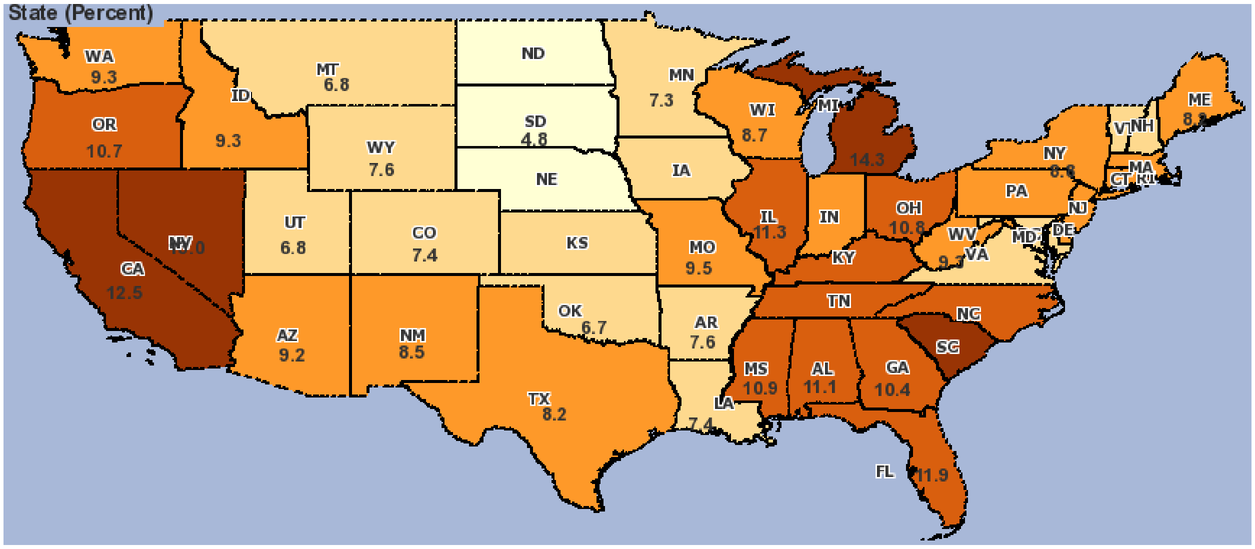
11. Appendix

Figure #1:



About the great depression.

Figure #2:



Oak, R. (2010, March 10)