

THE PREMISES OF A NEW ECONOMIC CRISIS – SIMILARITIES WITH THE PREVIOUS MAJOR CRISIS

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***Abstract.** Should we expect a new world crisis? This is actually the big question. The effects of the previous crises were somewhat similar. Although the most recent crisis did not bring as many failures, panic and bank failures as the Great Depression did, the potential danger was real and tangible. The danger of recurring events in 1929-1933 was very close, notably since out of the 13 strongest financial institutions in the US, 12 increased their risk of bankruptcy in just one or two weeks. The major difference between the two episodes refers to the authorities' response to the crisis. While during 1929-1933 the crisis was allowed to manifest freely, during the crisis of 2007-2009 the US Government adopted aggressive measures towards strengthening the financial sector. A number of programs aimed at recapitalizing banks and other financial intermediaries. However, the crisis and the government's inability to understand the significance and importance of the financial sector has turned the Fed into a de facto government agency, as the independence of central banks globally is now strongly undermined. As economists have learned more and more about the importance of monetary and banking leverage in both the contraction and the recovery phases of the crisis, the special importance of sound macroeconomic policies in ensuring economic stability, respectively a strong economy has been recognized.*

***Keywords:** economic crisis, Great Depression, financial crisis, sovereign debt, unemployment, real estate bubble, lender of last resort, stock market crash, aggregate demand, global economy*

***JEL Classification:** G01, G15, G21, G28, H70, H74*

1. Comparative aspects: the great depression of 1929 vs. financial crisis of 2008

We will attempt to present some comparative aspects between the Great Depression of 1929 and the financial crisis of 2008 by highlighting the main driving forces of the crisis and how they relate to each other in

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the context of economic events that have affected the US. In both crises the causal factors were the bad structure of the banking system, the real estate boom, the excessive debts of the natural persons and the financial institutions, as well as the very pronounced economic inequality. However, the measures taken to counteract the crises were different in the two episodes. While the political approach to the Great Depression was characterized by inactivity, the response to the 2008 financial crisis was swift and aggressive in the desire to prevent a recurrence of the Great Depression and to mitigate the immediate negative effects on the economy.

In both crises, 1929-1933 and 2007-2009, the weak and poorly structured banking system played a crucial role in establishing, prolonging and intensifying financial turbulences.

Banks that went bankrupt between 1929 and 1933 in the US were generally small banks, but accounted for about 46.9% of the total banks and owned approx. 20.56% of total active bank deposits. In order to avoid the situations of banking panic, the post-depression legislation introduced the obligatory introduction of bank insurances deposits. In the 2007-2009 crisis, however, the complexity of financial markets also played a key role. In this context, all the rescue measures adopted were justified by the idea that the complex nature of the banking sector imposes an unprecedented degree of government intervention in the private sector.

A banking system based largely on small banks was considered to be the financial equivalent of the egalitarian ideals perceived by most US citizens. However, as seen during the latest crisis, excessive concentration of power in the financial industry can lead to disastrous results. As a result, a poor architecture of the banking sector can be considered as the main culprit that led to both the crisis of 1929 and the one of 2007. The main difference between the banking sector during the Great Depression and the one during the Great Financial Crisis seems to be or the degree of divergence of the market discipline in force during the two episodes. Historically, the economic viability of banks has been reflected by their willingness to take risks and generate profit in order to meet depositors with risk intolerance. On the other hand, the official investigations of the authorized institutions revealed a series of abusive practices and conflicts of interest in the relationship of banks with the capital market.

In a nutshell, in both periods ideology played a key role in shaping the financial architecture and creating a non-optimal banking system. The adoption of sub-optimal banking legislation, respectively of an inadequate

banking structure, generated both major episodes of crisis. Although banking legislation underwent significant changes between the two crises, banks proved to be the main catalyst for the crises both in 1929-1933 and in 2007-2009.

Another parallel between the crisis of 1929-1933 and that of 2007-2009 refers to the accumulation of private debt before both crises, a situation most deeply reflected by the accumulation of mortgage debt. Both historical periods leading to crises were accompanied by the rapid rise in the price of housing and the level of financing, which fueled the real estate boom.

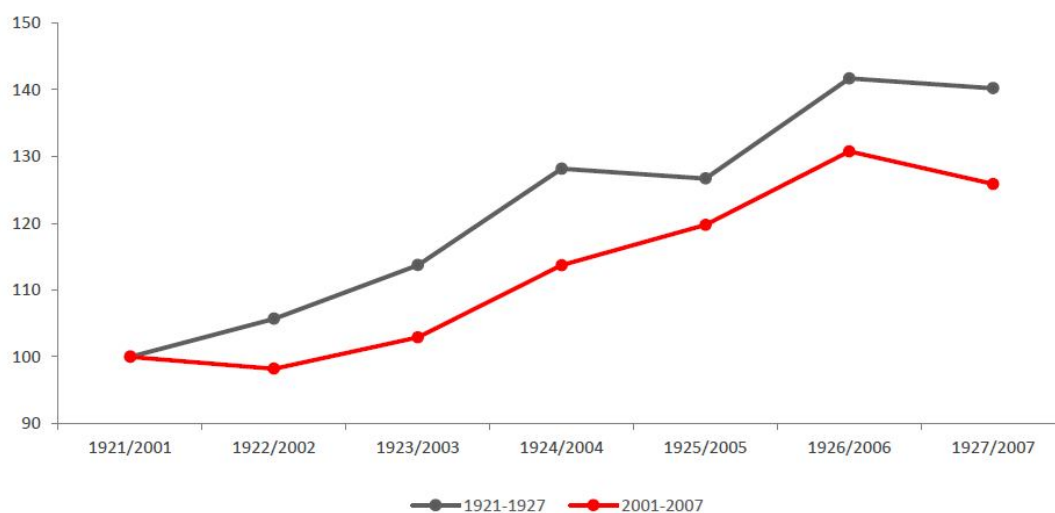


Figure 1. Real value of newly built homes in the USA (1921/2001 = 100).

Source: Carter S. (2006), *Historical Statistics of the United States: Earliest Times to the Present (Part D: Economic Sectors)*. Cambridge: Cambridge University Press

According to the evolution presented in figure 1, the real price of housing increased between 1921 and 1926 by over 40%. A look at mortgage debt indicates that the population was more than willing to buy housing and thus participate in the real estate bubble. Compared to the period before the First World War, mortgage financing in the 1920s increased significantly from 40% to 60%. While the mortgage debt increased by an annual average of approx. 6.73% in the decade preceding the boom, during 1920-1929 it increased to 13.92%.

The fall in home prices a few years before the Great Depression began, may suggest a link between the end of the housing boom and the Great Depression, especially since during the recent pre-crisis episodes the real estate price peaked in early 2006, and the crisis has debuted just two years later. In this context, the housing boom and the Great Depression should not be addressed separately, but should be considered aspects of the mutually supportive crisis.

A model similar to the one that manifested in the 1920s appears in the period before the most recent crisis. For five years before the price of housing reached a maximum, respectively in 2006, housing prices registered increases in real terms of about 31%. Similar to the real estate boom of 1920, mortgage debt increased by approx. 6.57% over a period of ten years, between 1997 and 2007. In the decade before the crisis, the growth rate of mortgage debt almost doubled. A determining factor in the price increase was the relaxation of lending standards for certain categories of borrowers, which also happened in the context of the Great Depression.

The end of the real estate bubble has significantly affected the construction industry, as well as the demand for new housing. For example, the construction of new housing reached a maximum of 937,000 units in 1925 and decreased by 90%, to 93,000 units in 1933. The decrease in the number of new homes was less pronounced in the 2000s, when it registered a 73% decrease from the peak recorded in 2005, from 2068300 units to 554000 in 2009 (Figure 2).

It is obvious that as the price of housing decreases and their number increases, the financial markets are adversely affected, as it happened both in 1929-1933 and in 2007-2009. Interestingly, in both periods the boom real estate was based to a small extent on the financial availability of financial innovations, but rather on the large-scale use of new financial products. However, it is obvious that financial innovation has increased the demand by extending its offer base to potential buyers.

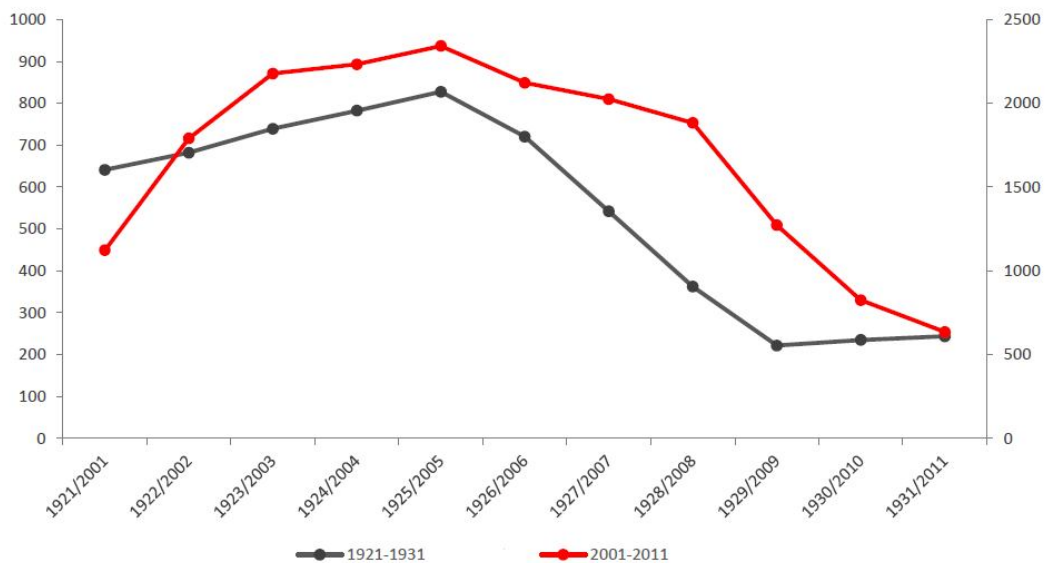


Figure 2. New housing (thousands units).

Source: Carter S. (2006), *Historical Statistics of the United States: Earliest Times to the Present (Part D: Economic Sectors)*. Cambridge: Cambridge University Press

Thus, during both crises, the real estate market experienced a boom in house prices, which were rising strongly and steadily, while mortgage lending levels also rose.

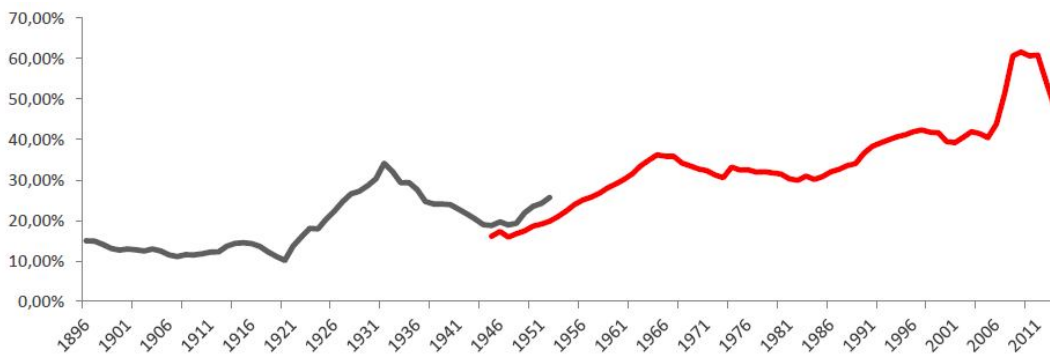


Figure 3. Evolution of mortgage debt.

Source: Umlauf T.S. (2014), *The Great Depression(s) of 1929-1933 and 2007-2009? Parallels, Differences and Policy Lessons*, Conference Paper, <https://www.researchgate.net/publication/279186789>, p. 32

As housing prices fell after 1926 and 2006, debtors faced serious problems with repayment or refinancing of mortgage loans. As a direct

consequence, the foreclosure rate of mortgages increased to unprecedented levels in both 1929-1933 and 2007-2009.

Economic inequality, as a measure of income distribution and welfare in society, has steadily deepened before both crises. Figure 4 shows the inequality measured as a percentage of total income, including capital gains, compared to approximately 10% of the US population between 1917 and 2007.

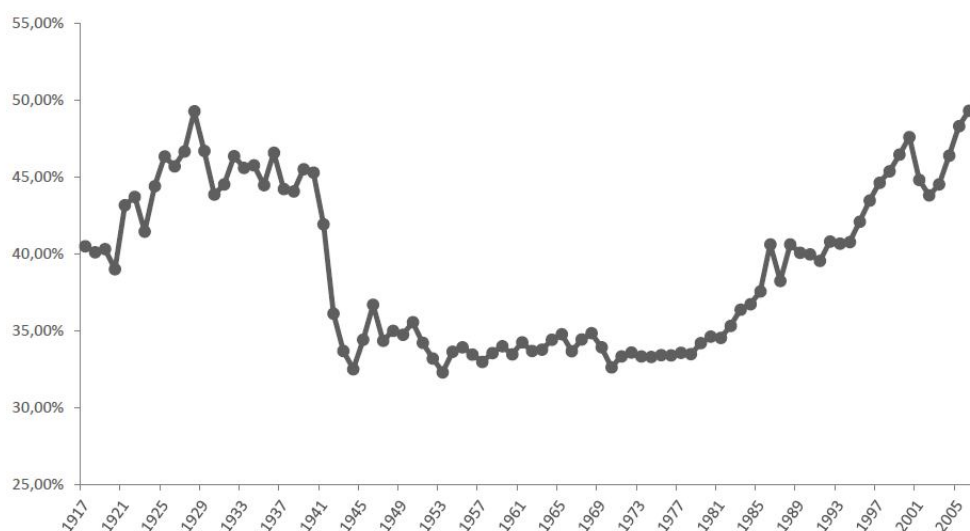


Figure 4. Economic inequality in the context of 10% of the US population.

Source: Umlauf T.S. (2014), The Great Depression(s) of 1929-1933 and 2007-2009? Parallels, Differences and Policy Lessons, Conference Paper, <https://www.researchgate.net/publication/279186789>, p.33

Certainly, the data in the time series clearly indicate the major trends of inequality over the last 100 years, but the available data only concern income, especially for the early 1900s, and as such cannot be considered accurate due to measurement inconsistencies, which makes for such an analysis to be very difficult. However, despite the obvious disparities in data comparability, there is a general consensus, based on reliable data sets, that the polarization of income and wealth was a predominant phenomenon in the early 1980s¹. The phenomenon seems to have been

¹ Morelli S., Smeeding T., Thompson J. (2014), Post-1970 Trends in Within-Country Inequality and Poverty: Rich and Middle Income Countries. Discussion Paper Series 1419-14, Institute for Research on Poverty, <http://www.irp.wisc.edu/publications/dps/pdfs/dp141914.pdf>

particularly pronounced in the USA, where sub-prime mortgage loans originate as well.

As it is known, both crises were preceded by a sharp increase in incomes, welfare and implicitly, economic and social inequalities. At the same time, however, there has been a substantial increase in the ratio between debt and income, especially among the middle and lower class of the population. In this context, the key factor that allowed the proliferation of income and welfare inequality was represented by investors, who used an increasing share of their (higher) incomes to buy financial assets, investments supported by loans granted to workers (lower and middle class). The unprecedented increase in credit intermediation has given workers the opportunity to compensate for the reduction in real incomes, which has resulted in a smaller increase in consumption inequality compared to increased income inequality. As a result, the continuous increase in the ratio between the debts of the workers and their incomes generated financial fragility, which peaked in a financial crisis. Thus we can talk about the theory of economic cycles, according to which stability creates instability, as economic booms lead to non-sustainable expansion of credit.

The essential difference between the two crises analyzed, 1929-1933 and 2007-2009 respectively is represented by the different measures adopted by the governments in response to the crisis.

Between 1933 and 1941, the US government increased its commitment to revive the economy and provide assistance to the population and financial markets. At the beginning of the Great Depression, the official attitude of the US can be summed up as follows: "dismiss the labor force, liquidate the stocks, close the farms, sell the real estate because only this will eliminate the evil in the system"². But in 1930, when the first bank was filled with panic, the government's disposition began to change, and over the next few years a series of programs were implemented to combat the crisis. For example, in 1932, President Hoover signed the Law on the reorganization of corporations which gave authority to a newly created institution, Reconstruction Finance Corporation, to lend to banks, trusts and railway companies, with the possibility that, if necessary, it would expand financial assistance in agriculture, trade and industry.

The authorities' response to the 2007-2009 crisis was different from at least two perspectives. First, the actions taken were immediate, rapid and

² Hoover H. (1952), *The Memoirs of Herbert Hoover: The Great Depression, 1929-1941* (Volume III), New York: The Macmillan Company, p. 30.

totally new. Secondly, the measures focused primarily on supporting the troubled banking sector. During and immediately after the crisis, government actions mainly included monetary and fiscal measures in order to save big banks and major financial institutions. In early 2008, the US Congress authorized the Government to use \$700 billion to purchase toxic assets from the financial system. The funds were subsequently used to make direct capital infusion in troubled organizations. Countless government interventions of this type and not only have prevented the insolvency of banks, first of all the big ones. In addition, the government encouraged the takeover of troubled banks by stronger institutions. Also, the post-crisis policies aimed at adjusting the balance sheets of fragile banks, as well as encouraging them to grant loans with subsidized interest (Figure 5), which would stimulate capital markets and lead to an upward distribution of welfare.

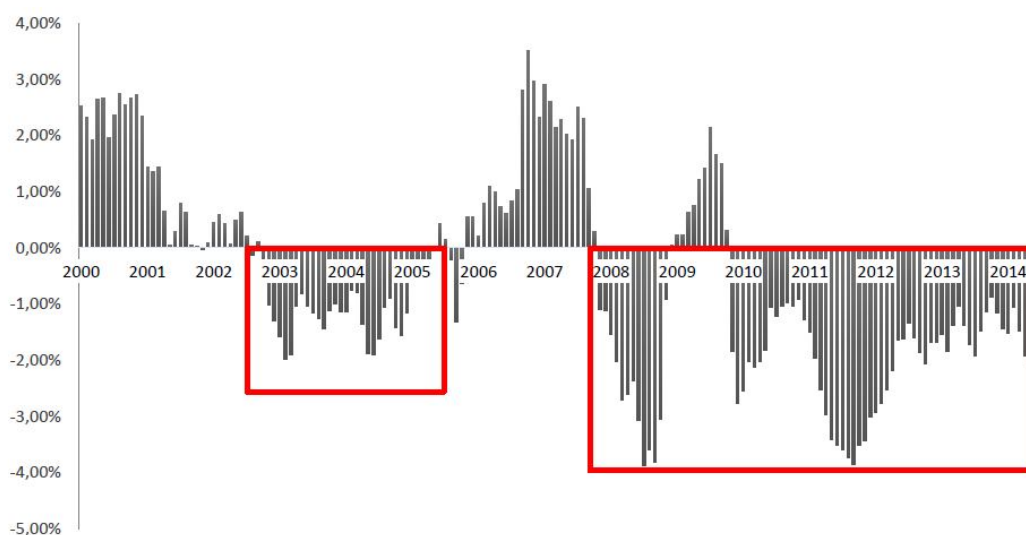


Figure 5. Month real interest rate.

Source: Federal Reserve Economic Data (FRED).

However, the very reasonable monetary policy promoted by the Fed has led to a transfer of welfare on several channels, from low-income entities to high-income ones. For example, if the expansionary monetary policy, promoted by the big central banks after the crisis, generates an increase in profits higher than the increase in wages, households with property claims will disproportionately benefit from a welfare transfer.

2. Can we deal with crises?

A depression of the magnitude of 1929 can no longer occur in the same way. Central banks around the world, including the US Fed, have learned the lesson of history. This is why they have become more sophisticated in managing monetary policies for the stability of the economy. Despite this, monetary policy cannot compensate for fiscal policy. The unprecedented size of US public debt and current account deficits can trigger economic panic, and monetary policy cannot remain impassive.

How can we deal with crises? By implementing anti-cyclical fiscal policies whose main objective is to stabilize the economy through adequate management of aggregate demand and limit capital waste and through monetary policies that protect the payment system and prevent deflation.

The solution of crisis avoidance is represented by microeconomic level adjustments implemented by governments. However, they must be based on the aggregate vision of macroeconomic evolution models.

All the measures to be implemented must start from the known economic truths, from the economic interdependencies and from the knowledge of the real evolution of the overall economic activity.

The key to anti-crisis measures is therefore the monetary and fiscal-budgetary policy, which must be implemented differently in each of the two phases of an economic cycle. In the period of prolonged growth, the monetary policy will be aimed at reducing the aggregate demand and investments by increasing the interest rate and limiting the lending process, while increasing the rigors regarding the circulation of the monetary mass. In the context of the recession, production and investment will be stimulated by reducing interest rates, encouraging the lending process and thus increasing the money supply.

To escape the crisis, the budget will allocate to the public expenditures the necessary funds to boost production and aggregate demand. There will be public procurement and investments in the socio-cultural field, but also in the economic entities owned by the state. It will also reduce the level of taxation.

The anti-cyclical programs will be implemented according to the economic situation through public policies. The aim will be to ensure the stability of the economic processes, the sustainable economic growth and the rebalancing of the balance of payments.

3. Lessons for the future and mistakes to avoid

All forms of crisis that an economy goes through are costly, for some to a greater extent, for others, lesser. However, each manifestation of a crisis may indicate errors and mismanagement, which may provide important lessons for the future.

We consider that the Great Depression was not a failure of capitalism or markets, but rather a result of misguided government policies, especially from behalf of the Fed, which allowed the collapse of the money market and allowed panic to encompass the entire banking system. If the Fed had acted from the root, that is, it would have imposed and made sure that banks hold significant reserves, which would allow them to meet customer reimbursement requests, the money stock would not have dropped significantly, and the economy probably it would not have contracted suddenly. Although the Fed could not borrow directly from banks (the law forbids this), they could have bought securities on the free market and thus make an infusion of capital into the banking system. But since the Great Depression, the Fed has responded quickly to shocks that threatened the financial and banking system.

The crisis episodes stressed the need for the existence and functioning of a lender of last resort, who would have the capacity to provide liquidity to the credit institutions that need them. Providing liquidity through various private offsets has proven to be inefficient.

Imposing limits on the types of products that central banks could invest in is not a solution to reducing the risks associated with portfolios in the financial system. Also, unequal and differentiated treatment of banks mainly leads to the concentration of the most risky assets in only a few institutions, mainly trusts. The negative evolution of the assets held by these trusts, in particular of the loans secured by mortgages, increases the risk of insolvency. If the legislation gives all institutions equal access to investment opportunities and to all assets, portfolio diversification reduces the risk of collapse of a certain type of asset and thus avoids insolvency threats to the entire class of financial institutions.

Whether the access of the trusts to the clearing arrangements could prevent a possible insolvency or not, given the high risk of the portfolios they hold, this cannot be guaranteed.

A legislative reform that makes institutional differences and provides discretionary facilities would impact the entire market economy system. Even if access to a lender of last resort is not restricted, under the conditions of unequal legal treatment, the trusts have no reason to keep

their portfolios with profitable but risky assets. In this context, the possibility of the whole system collapsing is maintained.

The lessons that the Great Depression gives us are just as questionable as the causes that generated it. Currently, central banks function as a lender of last resort in order to provide liquidity to the banking system and to stimulate economic growth. During the Great Depression, central banks did not assume this role. However, it is still unclear whether such a strategy is optimal for ensuring the exit from the crisis. Despite this, the Great Depression teaches us some essential things. First of all, the fact that the inadequate reaction of macroeconomic policies was the main factor that contributed to the deepening and increasing the duration of the Great Depression. Moreover, the lack of adequate monetary and fiscal policy measures of the Fed accelerated the manifestations of the Great Depression. Finally, the protectionism promoted by many countries in the 1930s greatly amplified the recession.

Therefore, the most important lessons we can learn from the 1929 crisis are related to the functions of central banks and the financial system in general. The collapse of the financial system could have been avoided if the US central bank had correctly understood its role as a lender of last resort. Deflation also played a major role, while the gold standard applied at that time as a method of supporting the fixed exchange rate system proved itself disastrous.

Regarding the financial crisis from 2007 to 2009, we can learn five lessons. First of all, the fact that it is very important for the population to maintain their confidence in the banking system and that a collapse generated by the refinancing of loans must necessarily be prevented. Secondly, the level of aggregate demand must be maintained, and deflation should be avoided by implementing monetary and fiscal policy measures. Third, it is important to avoid protectionism in international trade. Fourth, financial markets must remain open and there should be no capital restrictions. Finally, international cooperation should be cultivated, and the phenomenon of excessive nationalism should be avoided.

The crises highlighted the need for immediate corrective measures, which leads to an increase of the restrictions imposed on the economy processes once the first signs of availability decrease are highlighted. Furthermore, the problem of implementing framework regulations meant to ensure the guarantee of deposits and the existence of adequate periodic audits is raised.

4. Conclusions

Both major crises, which had considerable effects on the entire system of the world economy, have led to a decrease in the volume of production due to a decrease in demand, an increase in unemployment and sovereign debt as a result of banking crises.

In both crises the causal factors were the bad structure of the banking system, the real estate boom, the excessive debts of the natural persons and the financial institutions, as well as the very pronounced economic inequality. However, the measures taken to counteract the crises were different in the two episodes. While the political approach to the Great Depression was characterized by inactivity, the response to the 2008 financial crisis was swift and aggressive in the desire to prevent a recurrence of the Great Depression and to mitigate the immediate negative economic effects.

Before 2007, large and complex financial institutions were considered "too big to fail", which allowed the authorities to capitalize on them without precedent. Having implicit and explicit government guarantees, which eliminated market discipline for such institutions, they assumed additional risks, operating at the same time with dangerously low capital rates and relying on highly volatile financing sources.

Despite the different manifestations of then and now, the approach of the structure of the financial sector was fundamentally determined by a dominant ideology. In the 1920s in the US, the legislature tried to keep the banking system unique and unitary, due to a deep distrust of the large financial institutions. In the last decades, confidence in the efficiency of the market has led to a significant increase of the de-regulatory measures, which have given the financial institutions greater advantages and powers, despite the obvious needs of insurance measures.

The effects of the crises were somewhat similar. Although in the most recent crisis there were not as many failures, panic and bank failures as in the Great Depression, the potential danger was real and tangible. The danger of recurring of the 1929-1933 events was very close, notably given the fact that out of the 13 strongest financial institutions in the US, 12 increased their risk of bankruptcy in just one or two weeks.

The only factor that stopped a recurrence of the Great Depression in terms of banking bankruptcy in 2007-2009 was the direct involvement of governments and central banks, who assumed the role of stabilizers, despite their role as a lender of last resort and the principles of the capitalist market economy.

In view of the entire exposition of this paper, we consider that precaution is certainly justified. If the response to the financial crisis of 2007-2009 was effective we will see the long-term effects. The policies adopted seem to have produced satisfactory effects.

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