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The Great Depression vs The Great Recession

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Abstract

The Great Depression and the Great Recession are the financial catastrophes that have defined the last century. This paper sets out to explore the main reasons that led to both events and compared them, to then provide an overview of the lessons that can be taken from the past.

A critical review of literature and data from both periods is presented and analysed in the direction of establishing the previously mentioned comparison.

This paper comprises a qualitative analysis based on the main research papers concerning both topics as well as a quantitative analysis of data to better compare them.

Keywords: Crisis, Depression, Recession, Crash

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1. Introduction

The Great Depression, the biggest structural crisis of the past century, has frequently been compared to the Great Recession. A stock market bubble in the 20th century and a housing bubble in the 2000s both resulted in economic downturns. However, the broader economic collapse brought on by the bursting of speculative bubbles was caused by preexisting structural imbalances in the US economy.

This paper intends to compare both economic downturns by exploring the differences and similarities between them, and then complementing the analysis with quantitative metrics. One of the objectives of the study is to show that we can learn from the past by exploring what failed on previous occasions. This study demonstrates that the boom and bubble in the 1920s and the 2000s were driven by comparable mechanisms: rising interest rates, high speculation and low aversion to risk.

First, a literature review is presented in order to better understand the origins and what contributed to both crises, as well as the economic impact and policies used to mitigate the negative effects and protect the economy. Secondly, the analysis starts by taking a closer look at core aspects that contributed to the build-up of the events and then, showing some data about relevant metrics that will help to understand where the Great Depression and the Great Recession differ. To conclude the analysis, some lessons are presented to prevent history from repeating itself.

2. Literature Review

This chapter reviews the literature and research on both events. The first section gives a general overview of the Great Depression, a period of crisis that took part between 1929 and 1933. The second section presents a general overview of the second big crisis being analyzed, the Great Recession of 2008.

2.1. The Great Depression of 1929

2.1.1. Major Causes

<u>Stock market crash</u>

The 1920s, also referred to as the "Roaring Twenties," changed the social, political, and economic spheres. The gross national product (GNP) was well over 105 billion USD and consumer expenditure in the United States was at an all-time high in the early 1920s. People from various socioeconomic backgrounds started to invest in the stock market after noticing the trend of rising corporate sales and the potential to gain a little fortune. The pinnacle of the stock market occurred on September 3, 1929, and it began to fall two days later.

However, U.S. stock values had risen to heights that weren't supported by earning projections and investors started losing faith. On the 24th of October, 1929, a day that would later be known as "Black Thursday", panic selling started. Numerous shares of stock had been purchased on margin or with loans that were only partially secured by the value of the stocks. The result was that several investors were obliged to sell their holdings due to the price declines, which hastened the price drop. U.S. stock values fell 33% between their peak in September and their bottom in November (Romer 2003).

Chaos followed the crash and spread throughout the entire economy. Consumer spending fell sharply, manufacturing facilities reduced output, and businesses laid off employees. People found it challenging to sustain their families as a result of the salary cuts made to those still in employment (Temin 1994).

The collapse of the Financial Sector

At the end of the 1920s, the American financial system was suffering from the stock market crash, corporate failures, bank failures, and world events. Banks called in loans and sold assets which meant that credit froze up. This led to a fall in the money supply meaning less money in circulation, this way reducing prices and leading to deflation. People expected deflation to continue, so they held off on purchases to take advantage of the expected lower prices. Because they would have to pay back the loan in cash, which would be worth more when prices were lower than they were at the moment, they were reluctant to take out a loan at even a minimal interest rate. Alternatively put, the actual interest rate was higher than the nominal interest rate. Deflation caused depression (Temin 1994).

When prices dropped, businesses started cuttings costs, mainly by laying off workers which meant that these workers wouldn't be able to buy anything and businesses wouldn't be able to sell their goods, meaning that inventories started to build up and prices dropped even more. Furthermore, banks weren't laying money to employers to pay their workers.

The Federal Reserve could have done something to prevent deflation, but it failed. The financial crisis came as surprise and decision-makers lacked the authority to heal the economy and the skills to understand what went wrong (Richardson 2013).

The Gold Standard

According to some economists, the Federal Reserve encouraged or spurred the drops in the US money supply to maintain the U.S.'s adherence to the gold standard. Under this standard, each country established its currency's value in terms of gold and used monetary policy to protect the fixed price (Romer 2003). The gold standard had the power to guarantee both economic stability and stabilized interchange. The stability of money values encouraged saving and investing. The assumption that thrift was rewarded was guaranteed by the gold standard, which provided stable prices and limited governments' financial flexibility. This was because there was no threat of financial assets' real value being inflated in the first place (B. Eichengreen and Temin 1997).

According to the gold standard theory, the United States' commitment to stick with a fixed exchange rate regime caused the Great Depression, not avoidable bad policy decisions. However, there was the likelihood that aggressive Federal Reserve actions could lead to a speculative attack on the dollar is a crucial aspect of the gold standard narrative. Since rapid monetary expansion would make market participants question the U.S. commitment to the gold standard, expectations were the major avenue via which Federal Reserve activities could endanger the gold standard. The Federal Reserve did not act because, according to proponents of the gold standard viewpoint, it realized that expansionary measures would likely result in expectations of a devaluation and a swift, catastrophic loss of purchasing power (Hsieh and Romer 2006).

2.1.2. Economic Impact

The greatest economic impact of the Great Depression was people's misery. Over a brief period, the global economy's output and level of living rapidly declined. At the beginning of the 1930s, up to one-fourth of the labour force in industrialized nations was unemployed. Even though conditions had started to get better by the middle of the 1930s, true recovery did not occur until the decade's conclusion.

The global economy was substantially changed by the Depression and the ensuing policy adjustments. The Great Depression hastened, if not actually precipitated, the cessation of the world's gold standard. After World War II, the Bretton Woods system restored fixed currency exchange rates but was never adopted by the world's economies with the same enthusiasm and conviction as they had for the gold standard. Fixed exchange rates had been replaced with floating exchange rates by 1973.

Government control over the economy, and notably over the financial markets, rose dramatically during the Great Depression in many countries. For instance, in order to regulate new stock issues and stock market trading practices, the Securities and Exchange Commission was established in the United States in 1934. The Glass-Steagall Act sometimes referred to as the Banking Act of 1933, prohibited banks from issuing or trading in securities and offered deposit insurance in the US. Deposit insurance developed widely during World War II, eliminating banking panics as a cause of recessions in the United States after 1933 (Romer 2003).

2.1.3. Reforms and Revival

Fiscal policy was only a small component in the process of fostering recovery in the US. In fact, in an effort to balance the federal budget, the Revenue Act of 1932 significantly increased tax rates in the United States, which had the unintended result of further reducing consumption and accelerating the economy's collapse (Romer 2003).

It was not easy to steer the economy in a different direction. The policy needed a big and visible adjustment. The Roosevelt Administration launched a veritable deluge of anti-depression activities, but the United States remained hopeless. The New Deal, as Roosevelt named it, was a thorough strategy that addressed almost every facet of the economy. The New Deal changed American politics and daily life, but it did not lead to a full recovery (Temin 1994).

<u>The First New Deal</u>

The three main projects of the New Deal were the overhaul of the banking system, the expansion of government regulation over the production process, and the creation of a social "safety net." The first of these two was started in 1933 during the renowned "100 days". Many aspects of the economy came under the government's supervision as political control took the place of the market's ostensibly deceptive signals. This worldview was primarily expressed in two significant bills: The National Industrial Recovery Act (NIRA), which created the National

Recovery Administration (NRA), and the Agriculture Adjustment Act (AAA) (Temin 1994). For instance, the AAA provided substantial subsidies to farmers and allowed the government to control the production of agricultural commodities. The Works Progress Administration (WPA) that enlisted the help of unemployed people to work on government building projects was also created. However, actual increases in government expenditure and the budget resulted in a smaller economy. This became particularly evident when state government budget deficits were taken into account, as those deficits shrank at the same time as the federal deficit soared (Romer 2003).

The Second New Deal

The third initiative was Roosevelt's "Second New Deal," which was implemented later. Its goal was to ensure that the entire population benefited from the recovery. Roosevelt increased governmental control over the economy in order to more fairly share its products. For instance, the National Labor Relations Act institutionalized the NRA-based labour organization, and the National Labor Relations Board was established after the NIRA was ruled to be illegal. This board was only one of numerous regulatory bodies established to oversee and govern the economy (Temin 1994).

World War II as a rescue to the U.S. economy

Roosevelt’s New Deal stopped the descent. However, the start of true economic growth only came after World War II. To get people to start spending again, it took a war and an economy that was solely run by the government. The American people were given jobs again because of government investments in labour and capital.

Government consumption expenditures and gross investment rose by 265,6% between 1939 and 1945. By injecting $320 billion into the economy, the Treasury helped the country emerge from the Great Depression and laid the stage for a new period of prosperity and full employment. The Americans went back to work after the war. The unemployment rate was

14.6% in 1940. By 1944, the unemployment rate had decreased to 1,2% from 9,9% in 1941. Without the threat of war, the American government would not have felt the need to exert such extensive control over and financial investment in the economy. Government spending was effective in helping the country emerge from the Great Depression. Americans had more money to spend than at any time during the Depression, even with the costs of the war. The U.S. GDP had doubled since the end of the Great Depression by the time the war was over, reaching its greatest point ever. One of the biggest economic booms in American history resulted from the government having a purpose to reinvest funds into the nation following World War II (Constans 2013).

2.1.4. European Reaction

In the United States and Europe, the Depression was especially harsh and prolonged. Several other countries had financial crises and banking panics in addition to the United States. A series of financial crises that affected a large portion of Europe in May 1931 was brought on by payment problems at the Creditanstalt, the largest bank in Austria, and were a major factor in convincing Britain to abandon the gold standard. Among the countries that were badly impacted by bank failures and unpredictable financial markets were Germany, Austria, and Hungary. These significant financial crises may have resulted from a lack of regulation, local factors, or simple contagion from one country to another. By requiring other nations to experience deflation at the same rate as the U.S., the gold standard also reduced the value of bank collateral and made them more susceptible to bank runs. Similar to those in the United States, panics in the banking industry and other financial turbulence further reduced costs and output in several nations.

Before the 1930s, many European nations had seen considerable growth in the number of union members and had established public pensions. But throughout the Great Depression, both of these movements picked up speed throughout Europe (Romer 2003).

2.2. The Great Recession of 2008

2.2.1. Major Causes

Between 2002 and 2007, the pre-crisis period, growth rates were historically high, particularly for emerging nations. However, this boom was unsustainable and contributed to widespread complacency among policymakers, development experts, and multilateral organizations (Verick 2010).

Mortgage-backed securities

In the 2000s, investors started pouring money into the U.S. housing market. They believed that the interest rates homeowners paid on their mortgages would provide a better return than other investments, such as Treasury Bonds.

Securitization facilitated the increase in household leverage. Rather than giving a house buyer a loan and keeping the money, the original loan was made by the lender, who then added it to a "pool" of numerous other mortgages with similar terms. Then, this pool would be used as security for what was known as mortgage-backed securities (MBS). The borrowers whose mortgages were included in the pool paid the owners of these mortgage-backed securities (Cecchetti et al. 2014). This seemed to be safe due to the rise of home prices to investors and paid a higher rate of return.

Realizing the affluence of these types of investments, lenders started creating more mortgages and, to do so, they had to drop their previously high standards, many using, the so-called “predatory-lending practices”, commonly defined as loans that have terms and conditions that eventually hurt borrowers that impose unfair and abusive lending terms on borrowers, frequently through pushy sales practices.

Predatory lending had a major impact in starting and maintaining the housing bubble, especially through the creation of subprime loans. More loans were made to people with lower incomes, which, in the end, ballooned over their means (Agarwal et al. 2014).

Besides these investments, traders began selling a riskier product called “Collateralized Debt Obligation” (CDO). They created new pools by recombining different mortgage-backed securities, among other things, which would fall into the category of "collateralized debt obligations," or CDOs, in general (Holt 2008).

Low rates

The Federal Reserve drove the federal funds rate down to record levels between 2002 and 2004. Low short-term rates promoted the adoption of adjustable-rate mortgages (ARMs), which fueled the housing boom. Because short-term interest rates were lower than long-term interest rates, ARMs initially allowed the buyer to make lower monthly payments helping more buyers to afford monthly mortgage payments, which led to an increase in home prices (Holt 2008).

As housing costs increased due to new looser lending standards and low interest rates, mortgage-backed securities and CDOs appeared to be an even better option. In principle, the banks would still own a valued home even if the debtors defaulted. Home prices were at levels far higher than what was supported by basic principles (or replacement costs) (Cecchetti et al. 2014).

People started not being able to pay for their houses or maintain their mortgage obligations and the bubble burst, hitting 40% of households. More homes were put back on the market for sale as a result of defaulting borrowers, but since there were no buyers, home prices were falling. As home values dropped, several borrowers stopped making payments because they realized their mortgage payments were more than the worth of their homes. This resulted in an increase in defaults, an increase in the number of homes for sale, and even lower home values. Due to this, major financial institutions stopped investing in sub-prime mortgages, which left sub-prime lenders with a backlog of troubled loans.

Credit Default Swaps

Credit default swaps (CDS) were another financial product used by financial institutions that aggravated all of these issues. CDS enabled investors to purchase protection against the risk of default by a business or a sovereign organization. (Wang and Moore 2012).

After several significant events in 2008, such as the collapse of Bear Sterns and Lehman Brothers, the default risk was passed into the CDS, and their market was drawn significant attention from regulators. CDS spreads could be considered as one of the reasonable approximations to determine how the US subprime crisis has spread to other financial markets around the world (Wang and Moore 2012).

Among the vendors of these credit default swaps were insurance firms, who formerly mostly covered municipal bonds, for example, the well-known case of AIG, did not have the ability to bear the risks and some of the credit default swaps' benefits for hedging were lost. Hence, credit default swaps' built-in leverage enabled greater risk-taking by investors than they otherwise would have taken (M. Stulz 2010). Credit-default swaps were also converted into other securities.

All of this resulted in a complicated web of assets, liabilities, and risk. Investors' perception that defaults would extend beyond mortgages caused systematic risk premiums to start rising across all debt instruments, which led to a general decline in debt prices. Declining debt prices sparked a cycle that eventually resulted in the financial crisis of 2008 by raising perceived systematic risk and raising systematic risk premiums. (Murphy 2008)

Moral Hazard

The entire financial system would be affected once things started to fall apart. Along the process, failures of numerous big financial companies, including Bear Stearns, Lehman Brothers, FHLMC, FNMA, and AIG aggravated the cycle, as a result of these institutions' investments in various types of debt contracts whose value had declined to the point where their liabilities surpassed their assets' market worth (Murphy 2008). Due to mark-to-market pricing, banks were quickly affected by the market liquidity collapse for securitized loans, which had an impact on solvency. Banks weren’t able to securitize the mortgages and other loans they were offering (Barrell and Davis 2008).

The Treasury and Fed allowed Lehman Brothers to collapse in an endeavour to avoid moral hazard and to dissuade the notion that all insolvent institutions would be saved. The government bailed out and nationalized the massive insurance company AIG the next day out of concern for the systemic effects that a failure would have on insurance contracts on securities called collateralized-default swaps (D. Bordo 2008). In order to rescue some important American banks, the Fed greatly increased moral hazard by giving the perception that certain financial organizations were "too big to fail," such as Bear Stearns, AIG, Freddie Mac, and Fannie Mae, among other companies with extraordinarily high risk (Randall D. Harris 2012). However, this move promoted careless, risky conduct. Those large banks typically anticipated that they would be taken care of by the government and began to behave riskily and made dubious investments in subprime mortgages (Busato and Coletta 2017).

2.2.3. Economic Impact

There is a debate between those who believe that politicians should be credited for taking sufficient action to prevent this from developing into a Second Great Depression and those who believe that insufficient action was taken to prevent this from becoming far worse than it needed to be. According to Bernanke, the reason why the downturn was initially so severe was due more to the panic that the housing slump produced than to the crash itself (Bernanke 2018).

The U.S. economy and its citizens suffered greatly as a result of the subprime mortgage lending crisis that began in 2007. Because Americans invest their money mostly in real estate or the stock market, the gloomy market conditions had a detrimental effect on their wealth and assets. Between 2007 and 2010, Americans' average net worth fell from $126,300 to $77,400.

During the previous three years, American families' net worth decreased by an average of roughly 40%. According to estimates, this catastrophe wiped out the savings of most American households for a period of around 16 years. Additionally, the working class's income was impacted by the decline in average wages. According to the Fed report, the wealth of the top 10% of the wealthy elite climbed from $.18 million to $1.20 million between 2007 and 2010. According to U.S. Census Bureau statistics, the decline in share and housing prices had a combined effect of reducing U.S. family wealth by 35%. In 2010, the typical household income fell from $126,000 in 2007 to $77,400. As a result of the population's economic decrease, which plunged them into poverty, more than 46 million people applied for food stamps in 2011, which cost the U.S. Treasury $75.7 billion (Ghafoor Awan 2015).

2.2.4. Reforms and Revival

Some of the harshest fiscal and monetary policies in history were implemented by the U.S. government in reaction to the financial crisis. The response was multifaceted and bipartisan. The Bush and Obama administrations, Congress, and the Federal Reserve all launched an astounding array of programs. In general, the administration sought to achieve two objectives: to heal the ailing financial system and to lessen the looming recession, and finally to resume economic development.

Following the collapse of Lehman Brothers, credit spreads exploded, liquidity vanished, stock prices plummeted, and a number of significant financial institutions collapsed. The disastrous impact on the actual economy, which started to decrease at an alarming rate after Lehman, necessitated further responses. The Fed rapidly reduced interest rates in 2008, eventually implementing a zero-interest-rate policy. In order to lower long-term interest rates, it engaged in extensive quantitative easing in 2009 and at the beginning of 2010. This involved buying Treasury bonds as well as mortgage-backed securities (MBS) from Fannie Mae and Freddie Mac.

The FDIC also made an effort to calm the financial turbulence by raising the limits on deposit insurance and backing bank debt. In October 2008, Congress created the Troubled Asset Relief

Program (TARP), some of which was utilized by the Treasury to provide the country's banks with desperately needed capital. TARP was a huge success, aiding in the stabilization of the financial system and putting a stop to the collapse of the housing and auto markets.

A number of fiscal stimulus initiatives served as the foundation for the strategy to put an end to the recession and kick-start the recovery. Early in 2009, Congress enacted the American Recovery and Reinvestment Act (ARRA), tax rebate checks were sent to lower- and middle-class households in the spring of 2008, and a number of smaller stimulus programs were signed into law in late 2009 and early 2010. The total amount allocated for fiscal stimulus would be close to $1 trillion, or nearly 7% of GDP. The Great Recession had ended, and the stimulus had sparked the recovery as intended (Blinder and Zandi 2010).

2.2.5 European Reaction

Early in October, the global interbank market collapsed, spreading the crisis to Europe and the developing nations. In response, the UK government injected equity into banks, guaranteed all interbank deposits, and provided a ton of liquidity (D. Bordo 2008). Banks began to deleverage and close credit lines as interbank lending dried up, which stopped lending to the economy and had a negative snowball effect. A decrease in household wealth resulted from the tightening of lending conditions (for example, as a result of declines in the value of assets like stocks and real estate). Due to the decline in investment and demand, saving money became the go-to strategy to deal with unfavourable macroeconomic circumstances.

Unwanted stock building forced output reduction for manufacturers. Making matters worse, company investment and demand for durable consumer goods fell dramatically in the final quarter of 2008, which led to a collapse in global trade.

In retrospect, the European Union (EU) should have taken even more drastic action to avoid a crisis even worse than the one of the 1930s. Actions were taken at the EU central bank, and government levels, respectively. The EU unveiled a sizable stimulus program in 2008 under the name European Economic Recovery Plan (EERP) (Szczepanski, n.d.).

3. Main Results and Findings

The biggest economic downturn in modern memory began with the 1929 stock market crash, and the 2008 financial crisis was of a similar size. According to The Economist, “The shock that hit the world in 2008 was on a par with that which launched the Depression. In the 12 months following the economic peak in 2008, industrial production fell by as much as it did in the first year of the Depression.” (The Economist 2011).

Due to the lessons from the Great Depression- maintaining public trust in the banking sector and preventing monetary contraction when dealing with a recession- the recession that followed the 2008 crisis, was by no means of the same size as the crisis of 1929 (Miller n.d.).

Both disasters were undoubtedly severe occurrences that destroyed unfathomable sums of equity and were similar in size. Additionally, both heralded the start of recessions that resulted in declines in global output and trade as well as increases in unemployment. However, the Great Recession did not result in the same unemployment levels as the Great Depression or the same drop in output (Mishkin and Serletis 2011).

3.1 Differences and Similarities

Rising interest rates

An increase in interest rates occurred before both disasters. Officials of the Federal Reserve considered that the stock market boom was due to excessive speculation. When the stock market crashed in October 1929, the Fed received more than it bargained for as a result of its tight monetary strategy to raise interest rates (Mishkin and Serletis 2011). The Federal Reserve also boosted interest rates before the commencement of the subprime mortgage crises. The collapse of the subprime mortgage market in early 2007 and the end of a significant housing boom in the United States marked the beginning of the crisis. After two years of rising interest rates, it happened. (D. Bordo 2008).

Monetary Policy

In the 1930s, the Federal Reserve took a mostly inactive role. It had been cited by the Roosevelt administration as one of the causes of the Great Depression, along with the bankers. Because borrowed reserves were so little in the 1930s, excess reserves were used as a gauge.

As the decade progressed, banks mostly absorbed the gold inflows into excess reserves, which were kept as a safeguard against a recurrence of the type of volatility seen in the early 1930s. Fed policymakers began to see the accumulation of surplus reserves as a danger to future inflation and speculation. They also believed that the existence of substantial excess reserves prevented them from tightening in the future. Similar worries have been raised in relation to the accumulation of bank excess reserves between 2008 and 2009.

Because it was hesitant to undertake expansionary open market purchases, fearing the reignition of speculation and inflation, the Fed played a modest role in the 1930s recovery. It wasn't actually constrained by the zero lower bound or caught in a liquidity trap. Instead, the Treasury undertook more of the grunt work to encourage recovery through its policies toward gold and the fallout from the devaluation of the dollar (Bordo and James 2009).

In the 2008 crisis, the Fed's decision to sterilize the effects of its various liquidity operations on the monetary base for the majority of 2008 (up until September) rendered monetary policy tighter than it needed to be and probably made the recession that started in December 2007 worse (Hetzel 2009). However, the base has significantly grown since October 2008, and the policy of quantitative easing, which was implemented in January 2009 and extended in November 2010, can be seen as a rerun of the expansionary Treasury gold policy of the 1930s. (Bordo and James 2009).

The monetary policies applied by the Federal Reserve in 1929 led to deflation and exacerbated the financial crisis by producing debt deflation. In 2008, the Federal Reserve adopted an expansionary monetary policy that halted debt deflation and stopped the crisis from deteriorating into a depression. The only issue the global monetary and fiscal authorities had to address was a crisis of trust in the viability of “too-big-to-fail” banks as a result of avoiding an illiquidity crisis (Miller n.d.).

In terms of The Great Recession, the most glaring difference between it and the Great Depression may be the scope and speed of the expansionary policy response. Compared to the 1930s, the size of fiscal stimulus and automatic stabilizers has increased significantly. In addition, a number of significant financial institutions have been directly recapitalized or partially nationalized in order to prevent their failure, in addition to the large infusions of money into the financial system. All these actions have prevented a financial crisis.

Due to global policy rate reductions that occurred quickly and the closeness of 2008’s policy rates to zero, monetary policy during the most recent crisis was exceptionally expansionary. In contrast to the 1930s, when central bank policy reacted in a pro-cyclical way, this was a significant change. Fiscal policies in the Great Recession were expansionary to an unprecedented degree in the US, Europe, and other nations, in stark contrast to the 1930s. Government debt ratios and budget deficits as a percentage of GDP have increased to levels not seen in peacetime (Albers and Jonung 2010).

The Financial Sector

The theory of "too large to fail" was a major issue at the core of both the 1931 crisis in Central Europe (but not in the United States) and the 2008 financial crisis in the United States and Europe. The concept, which held that would not allow large commercial banks to collapse, was extended to investment banks with the March 2008 Bear Stearns rescue, which exacerbated the financial crisis. When Lehman Brothers was allowed to collapse and AIG was saved in September, the misunderstanding that followed resulted in panic (Bordo and James 2009).

Both the 1929 and the 2008 crises were followed by severe financial panics, and the 1929 crisis saw a decrease in the money supply brought on by bank failures that never happened again, even during the Great Recession. In contrast to the 2008 crisis, there were essentially no bank runs in the wake of the 1929 crisis, which resulted in a significant number of bank failures (Miller n.d.). This is largely because of the 1934 introduction of insurance by the Federal Deposit Insurance Corporation (FDIC). During the recent crisis, the deposit ratio increased rather than plummeted. Since depositors were aware that their funds were secure, there were no bank runs. As a result, bank failures were extremely low compared to the 1930s (Bordo and Landon-Lane 2007). Massive bailouts of large banks were a defining aspect of the 2008 financial crisis to avoid "too-big-to-fail" issues, where the security of the entire financial system would be in danger if a systemic institution failed, in contrast to the 1930s, when a vast number of banks, both large and small, failed.

Thus, compared to 1929, the primary element influencing the dynamics of the crisis in 2008 was different. The public's loss of faith in the financial system was the main cause at that point. In 2008, it was primarily the loss of banks' faith in the stability of other banks (Hagen 2009).

Economic Impact

Individual investors suffered huge losses during the 1929 crisis. These reduced their expenditures. Companies reduced spending in the struggle for liquidity. Production dropped dramatically. Deflation was brought on by drops in import prices and commodity prices (Kindleberger, DeLong, and Eichengreen 1973). In contrast, the 2007–2008 financial crisis spread differently throughout global markets. Mortgage defaults in the U.S. spread to investment and commercial banks and throughout the world via an intricate web of derivatives. Recently, it has overflowed into the actual economy as a result of a severe credit crunch and a falling stock market.

The 1920s housing boom was more of a quantity than a price boom. In contrast to the 2008 crisis, the direction of causality in the 1920s was from economic difficulties to the mortgage meltdown. Mortgage issues were the origin of the 2008 crisis as opposed to the 1929 crisis, where they were an aftershock (Bordo 2008). The 1929 crisis and subsequent production contraction were mostly brought on by declines in global trade, but the 2008 crisis was brought on by mortgage-backed securities that exposed foreign banks to the unrest in the U.S. mortgage market. As a result, there is a noticeable distinction between the two crises' root causes and how they affected the economy.

3.2 What does the data tell?

Private Debt and Total Debt

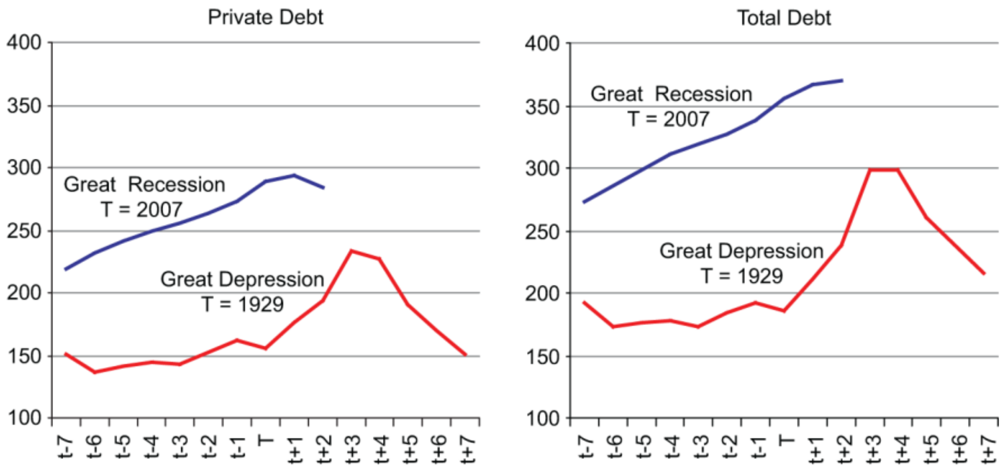

Figure 1. US private and total debt as a percentage of GDP
Source: *Historical Statistics of the United States and Federal Reserve System, Flow of Funds (Z1)*

The leverage of the economy, specifically the debt of the private sector, is the most significant difference between the 1920s and the 2000s. Figure 1 shows that the US debt-to-GDP ratio (private and total) in the 1920s was substantially lower than in the middle of the 1980s and much higher than it was in 2008. After 1929, when the GDP shrank beneath the debt while it stayed basically constant in size, it did begin to increase significantly. The US has never had a debt-to-GDP ratio higher than less than 200 per cent, with the exception of the Great Depression. That threshold was crossed in 1985, and nobody has gone back since. According to data on debt burden by industry, the private sector experienced the largest increase between 2001 and 2007 as compared to GDP, increasing by about 70 percentage points.

Home Prices

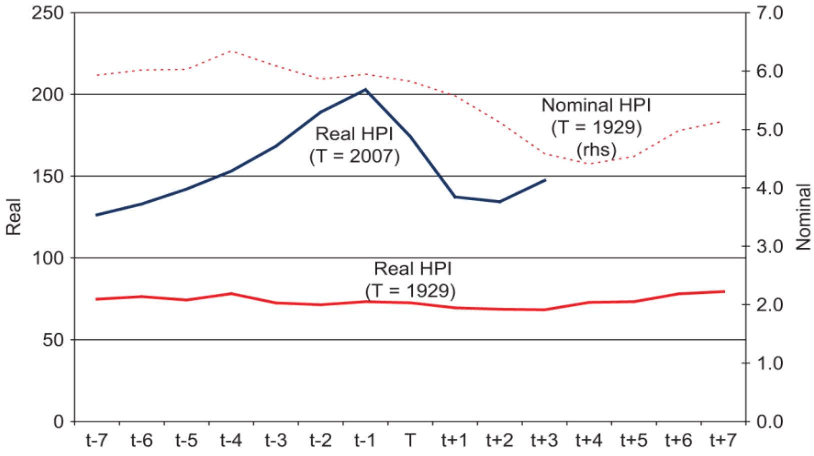

Figure 2. US Home Price Index (HPI)
Source: *Shiller Irrational Exuberance (2005)*

The substantial increase in debt over the 2000s was followed by a significant increase in leverage, which was mostly driven by a housing bubble. This is one of the main causes of the great recession and how the financial crisis significantly affected the actual economy. Because of the high level of private sector borrowing and the 2007 housing market collapse, both banks and homeowners have been severely impacted. In contrast, it appears that the development of the crisis in the 1930s was not significantly influenced by property prices, at least not to the same extent as it was in the Great Recession.

Personal Saving

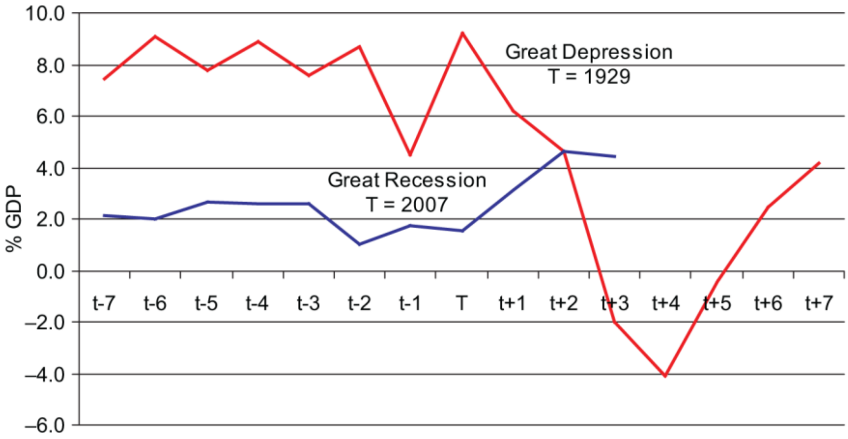

Figure 3. *US net personal savings as a percentage of GDP*
Note: Data for 2010 refer to the average annualized data for Q1 and Q2
Source: Historical Statistics of the United States 1922-49 and Bureau of Economic Analysis (BEA) 1950-2010

Despite significant fluctuations in the late 1920s, the personal (household) saving rate in the

US was less than 2% in 2007 compared to just under 10% at the time of the 1929 crash. Then, savings decreased during the Great Depression, reaching a rate of negative 4% in 1933, before rising with the recovery to reach over 6% in 1937. Since 2008, the rate has begun to rise quickly, peaking in 2009 at 4.5%. Because of this, US households entered the 2007 financial crisis with an extraordinarily low saving rate, which was a mirror image of their high level of debt, whereas the rate was high in the 1920s and decreased in 1930, also as a result of the stock market fall.

Unemployment Rate

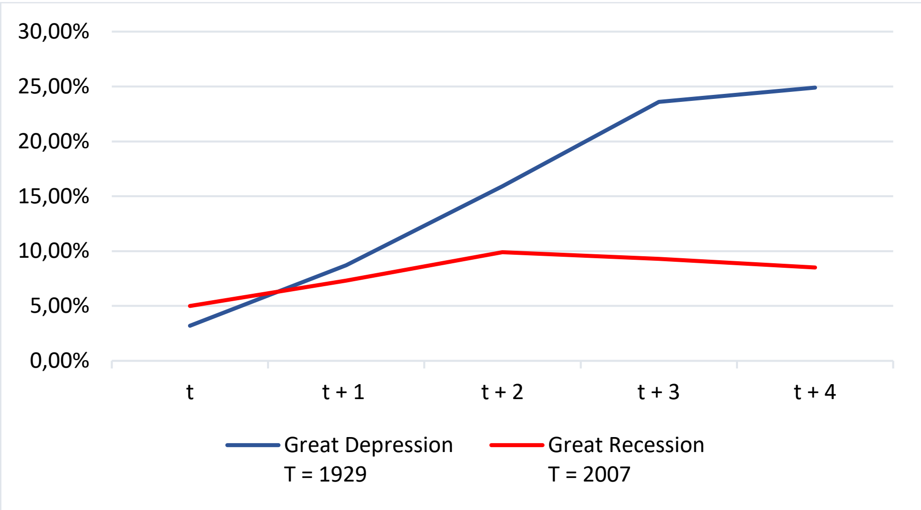

Figure 4. *US Unemployment Rate*
Note: Values from 1929-1939 are an estimate prepared by the Bureau of Labor Statistics (BLS)
Source: US Bureau of Labor Statistics (BLS)

If we take a look at the unemployment rate, it is clear that the more recent crisis wasn't nearly as severe as the one that happened in the 1930s. Actually, as we can observe, through the first years of the Great Depression, unemployment skyrocketed and, the percentage of unemployed people went beyond 25%, which only demonstrates the severity of the event. In contrast to the Great Depression, during the Great Recession, after an initial rise, unemployment actually started decreasing 2 years after the beginning, also because of the policies implemented by policymakers, which learned from previous events.

3.3 What about Europe?

Both crises increased the influence of newly established central banks. During the 1930s crisis, it was the Federal Reserve System, while during the subprime crisis, it was the European

Central Bank (Peicuti 2014).

Countries were obliged to deflate their economies in the 1930s as a result of the failure to abandon gold and devalue currencies. This was the greatness of the Great Depression. To make matters worse, 80 years later, Europe introduced the euro, which is today's version of the gold standard and, in Eichengreen's opinion, another political failure. "Europe was doing far worse than in the Great Depression," was the end outcome (B. J. Eichengreen 2015).

Each crisis prompted a very different response from economic policy, particularly monetary and fiscal policy. Lessons from the Great Depression itself also had a role in this. Fiscal policy was stringent during the 1930s crisis, at least for the first three years. It made an effort to maintain balanced budgets and combat the automatic stabilizers by raising tariffs and taxes and cutting spending. Automatic stabilizers were bigger during the Great Recession. Their impact was increased by the stimulus plans. By using guarantees, recapitalization, or nationalization, bank failures and the collapse of the credit market were thwarted. Additionally, each of these actions was swiftly put into action, occasionally with international coordination.

For monetary policy, the difference in activity is the same. Interest rates were originally raised in 1929 before being gradually lowered. Low nominal rates became high real rates due to significant deflation. Over numerous years, the amount of money in circulation decreased in several countries (at least in nominal terms). This time, monetary policy participated in both conventional and creative growth in the money supply while slashing interest rates all the way to zero. Some institutional elements were beneficial. Due to the European monetary union, and despite Eichengreen's opinion, there was no longer a gold standard to control the money supply and fewer national currencies to defend. The G7, G20, the IMF, and the World Bank all contributed to greater international coordination and greater economic agreement (Aiginger 2010).

3.4 Lessons to be learned

There are several important policy lessons to be learned by comparing the Great Recession to the Great Depression of the 1930s, but it is equally important to keep in mind the lessons learned from past disasters. Government initiatives should help the financial system in the event of a financial crisis in order to avoid the collapse of the credit allocation process and to keep the public's faith in the banking system. However, burden sharing continues to be a problem, and restrictions on liquidity and solvency support are required.

Supporting aggregate demand is essential in order to prevent price and debt deflation through expansionary monetary and fiscal policy. To provide the economy with enough liquidity, monetary policy must cut interest rates and, if necessary, employ unorthodox measures. The goal of fiscal policy should be to encourage overall demand. An early exit is essential since doing so before the underlying recovery takes hold runs the risk of prolonging.

A number of protectionist policies were implemented globally as a result of the Great Depression. More protectionism existed than at any previous time in modern history, which had disastrous effects on trade and output. For the future, it is key to steer clear of protectionism.

Due to issues with the US and European financial systems and a lack of international collaboration, the Great Depression had a role in the breakdown of the flow of capital across borders. Exports of capital decreased. A number of nations implemented controls on international financial flows. These occurrences deepened the depression, a series of circumstances that had been mostly avoided prior to World War I. The free flow of capital should be preserved (Albers and Jonung 2010).

The free-market American economy occasionally falls apart. For about a generation, "big" economic recession could be avoided thanks to the New Deal and a robust postwar expansion, yet under these circumstances, American enthusiasm seems to chafe. As people's memories of previous economic hardships fade, pressure for change on the political and economic fronts intensifies. Uneven global economic growth is tolerated until it becomes necessary to make harsh corrections (Temin 2010).

4. Conclusion

The 1929 and 2007–2009 crises all shared comparable initial circumstances and geographic origins. All of them happened following a protracted boom characterized by an expansion of the money supply and credit, asset prices and investor confidence rising, and excessive risk-taking. Although the underlying causes and imbalances were more complicated and worldwide, events in the United States initially set off all of them. As a result, they expanded internationally and had a big effect on the world economy. Sharp contractions in global trade occurred in tandem with the crisis in the financial sectors in both instances, which had effects on the entire world. And in each of the situations, the economy experienced a severe recession after the financial turmoil that was the cause of the crisis.

During the subprime crisis, institutional considerations, such as the bigger proportion of services and the public sector and the lower fraction of manufacturing, reduced the risk of a more severe crisis. The greater level of receptivity, greater proportions of the financial sector expansion and international investment overall were variables that further increased the risk of cumulative negative spirals. Blunt types of protectionism were impeded by international collaboration.

Despite the fact that the origins of the crises were different, the financial crisis of 2007–2008 was comparable to the catastrophe of 1929 and had the monetary authorities not learnt from the Great Depression, the possibility for depression would also be present during the 2008 financial crisis.

Taking a look at the past is useful to learn from what happened and take the lessons that can help preparing for the future and prevent, or attenuate, the effects of a future crisis.

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