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**A Comparative Study Between:**  
**The Great Depression (1929-1939) and the Financial Crisis (2007-2010)**  
**In The United States of America**

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A Master Degree in Literature and Civilization

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# *Dedication*

I dedicate this work to:

My parents ...

My wife, and to my daughters ...

My brothers and sisters...

My wife family...

My friends and my colleagues in work, and in university...

*Atta Titila*

## Abstract

The **Financial Crisis** started as the so called the **Subprime Mortgages Crisis** in the United States at the end of 2007. It gradually spread to all the **Financial Markets** and ended up reaching the real economy. By the end of 2008, the financial crisis had generated a complete economic crisis, announcing that **Capitalist System** of the greatest country in the world had entered in financial **Great Recession** and spread to the other economies around the world. Recent events have reminded us for the **Great Depression** of 1929. Experts and economists resembled and compared the current situation with the Great Depression of the 1930s, And the policy makers have to understand the roots and the dimension of the crisis in order to prevent the negative effects, and change regulation of the financial sector, the debate is of course a reasonable one to have, they have to make sure that the roots of the Crises are similar. So this research addresses the question: **Is the current financial crisis similar to the Great Depression?** For that purpose we have compared these crises from the historical perspective and contextual in their setting in order to highlight the differences and similarities between their causes and consequences and we see whether the policy reactions in Financial Crisis are the same as in the Great Depression, or different.

**Key words:** financial crisis, Great Depression, recession, subprime mortgage, capitalist system, financial market.

## ملخص

بدأت الأزمة المالية في أوت 2007 بما يسمى أزمة الرهون العقارية و انتقلت إلى إفلاس بنوك و انهيار مستمر في أسعار أسواق المال ( البورصات و الأسهم ) في سبتمبر 2008 إلى غاية سنة 2010 و إن كانت آثارها لا تزال إلى الآن . لتعلن بذلك دخول النظام الرأسمالي لأكبر دولة في العالم في أزمة مالية و اقتصادية كبيرة, بل امتدت لأكثر من ذلك لتشمل جميع أنحاء العالم. ومع توالي الأحداث الاقتصادية و انتقالها من القطاع المالي إلى القطاع الاقتصادي حتى أعادت إلى الأذهان أزمة الكساد الكبير لسنة 1929 , فظهرت مقولات و دراسات تنص على أن أوجه التشابه كبيرة بين ما يحدث اليوم و ما حدث في الماضي , و منهم من نظر إلى الأزمة بنظرة أكثر تشاؤم و ذهب إلى أن الأزمة المالية أكثر سوءا من أزمة 1929. من هنا جاء موضوع الدراسة ليحاول تسليط الضوء على أوجه التشابه و الاختلاف بين أزمة 1929 و أزمة 2007 الحالية من حيث الأسباب و النتائج و طرق المعالجة ضمن السياق و الظروف المحيطة بتاريخ حدوثهما.

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## Abbreviations

AAA	Agricultural Adjustment Administration
AIG	American international group
ARM	Adjustable rate mortgages
CCC	civilian conservation corps
CPI	Consumer Price Index
ERA	Emergency Relief and Construction Act
Fannie Mae	the Federal National Mortgage Association
FC	the Financial Crisis
FDIC	The federal deposit Insurance Corporation
FERA	Federal Emergency Relief Administration
FHLB	the Federal Home Loan Bank
Freddie Mac	the Federal Home Loan Mortgage Corporation
FRM'S	Fixed Rate Mortgages
FRS	Federal Reserve System
GD	Great Depression
GNP	Gross National Product
GSEs	Government-sponsored enterprises
IMF	International Monetary Fund
NBER	National Bureau of Economic Research
NRA	The national recovery administration
NRSOs	Nationally Recognized Statistical -Ratings Organizations
RFC	Reconstruction Finance Corporation
SEC	Securities and Exchange Commissions
TVA	Tennessee valley authority
WPA	the works progress administration,

A decorative scroll-like frame with a black outline and a light gray shadow. The frame is horizontal and has rounded ends. The word "Introduction" is centered within the frame in a bold, black, serif font.

# **Introduction**

## Introduction

This issue deals with a comparative study between the Great Depression (GD) (1929-1939) and the Financial Crisis (FC) (2007-2009) which both Originated from the united states of America, these crises are going to be described and explained; we encounter the term crisis on a daily basis nowadays; which is often used to describe difficult situations that are decisive for future, it stands for crucial moment in the time or a important change as well as a difficult in economy.

The Great Depression was the greatest collapse of the economy in the history of the United States of America that began in 1929 and lasted until 1939 (Jones 453)

On the other hand, the financial crisis (FC) which started in 2007 by so called “ Subprime mortgage crisis” and worsened in September 2008 and continued through 2009 (Marc 7)

The Great Depression and Financial Crisis were preceded by a housing boom, a long period of cheap credit and falling stock market, unemployment was high and the value of the dollar was low, the production of goods dropped, small business close and people who lived on credit must pay cash without cash or credit people’s spending stops, and the demand for goods drop.

The Great Depression was transmitted over the world through trade flow and the “Gold Exchange Standard “ which means in economics, monetary system where in all forms of legal tender may be converted ,on demand, into fixed quantities of fine gold , and the Financial Crisis is global, indeed, starting in the spring of the 2008

These parallels between the Great Depression and Financial Crisis are going to be described and explained in this research work as follows:

**In chapter one**, the study looks into the research methodology and the review of literatures that means definition of research problem in section 1.1, the hypotheses of study in section 1.2, while section 1.3 discusses the justification for the study. Sections 1.4, 1.5, and 1.6 deal with the significance of the study, limitation of the study, and definition of the terms and the concepts respectively.

In sections 1.7 and 1.8 the methodological approach and a brief outline of review of literatures and the theoretical framework of the study. This chapter ends with research objectives in section 1.9.

**In chapter two**, we point out to the causes and the consequences of the Great Depression and also the policy response and we provide an overview over the spread of this crisis.

**In chapter three**, we undertake the financial crisis, its causes and its consequences; we also explain how this crisis spread over the U.S.A and the policy response to prevent the negative effects.

Finally, in **chapter four**, we compare the two crises to point out the differences and the similarities and compare between the policies responses during the crises to show what policy makers learned out of the Great Depression to prevent the negative effects of Financial Crisis or reduce its consequences to a reasonable casualty.

## Chapter one

# Research Methodology and Literature Review

✚1-1. Definition of the Problem

✚1-2. Hypotheses

✚1-3. Reason of Choosing the Topic

✚1-4. The Significance of the Study

✚1-5. Limitation of the Study

✚1-6. Definition of the Terms and the Concepts

✚1-7. Methodology of the Study

✚1-8. Review of Literature

✚1-9. The Objective of the Stud

## Chapter One: Research Methodology and Literature Review

This chapter first of all appraises the research methodology and the theoretical framework of our study. It starts with the definition of the problem then it moves to method of the research, reasons of choosing the topic, the important of the research, and its objectives. It then reviews the financial crises theories with particular reference to the schools of thought. It also identifies and it reviews some models of studies relevant to Great Depression and the Financial Crisis.

### 1-1. Definition of the Problem

The issue is interesting in understanding the phenomenon of the economic crises in the United States of America, the interest is in crises from perspective of the economists themselves; indeed, efforts are made to study the economic (financial) crises.

Claes, auditor general of the Swedish national audit office, states that “the financial crises are not a new phenomenon. The world economy has from time to time been bit by crises and the current crisis is most probably not the last one”. (6). In addition, he mentioned that there is no generally accepted theory in the field economics that fully explains, even less can predict such crises (46).

Marc, specialist in macroeconomics policy.<sup>(1)</sup>, wrote a report entitled” *U.S.A economy in recession: Similarities to and differences from the past* “in which he portrayed that there is no exact rule to determine when the crises begin or end, the crises officially announced by the National Bureau of Economic Research (NBER).

The crises are defined by NBER as” significance decline in economic activity spread across the economy, lasting more than few months” based on a number of economic indicators with an emphasis on employment and income.

---

(1) Macroeconomics, deals with modern explanations of national income and employment. It dates from the book, *The General Theory of Employment, Interest, and Money* (1936), by the British economist John Maynard Keynes. His explanation of prosperity and depression centers on the total or aggregate demand for goods and services by consumers, business investors, and governments. Because, according to Keynes, inadequate aggregate demand increases unemployment, the indicated cure is either more investment by businesses or more spending and consequently larger budget deficits by government

Marc added that the NBER does not declare the beginning or the end of the crises until after fact. Thus the length of the crisis will not be known until after the fact.

Stojanov, full professor at university of Regika, faculty of economics, Russia, interpreted the phenomenon of the crises through the reading of Keynes's "*General Theory of Employment, Interest and Money*".<sup>(2)</sup>

Stojanov studied the main causes of the economic crises in general and particularly the present economic crisis, in his study compared Keynes's approach to the crises with the work of modern different economists, he concluded that drop of "marginal efficiency of capital" is the main cause of the economic crises and depressions and that such a drop is an unavoidable consequence of functioning of the market capitalist economy.

He also claimed that "crises cannot be prevented by expansive financial policy. Therefore it should come as a surprise". (293).

Goldstein in his conference entitled "*capitalism in crisis*" on October 6, 2010 states that the capitalist system was showing all the signs and symptoms of being in a profound crisis; he also said that there is a difference between a particular capitalist crisis and an historic crisis of capitalism as system he added that "the Great Depression began as cyclical crisis, the collapse of stock market bubble with an underlying crises of over production, but it soon revealed itself to be a crisis of system".

The present crisis (Financial Crisis) is showing similar signs; what began in December had the basic elements of capitalist crisis, in the sense that it was caused by capitalist overproduction, even though it was precipitated by a financial crisis with the bursting of the housing bubbles.

Overproduction and bursting are characteristic of every capitalist crisis, but this crisis is obviously for more than a cyclical crisis. (1)

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(2) In 1936 the British economist John Maynard Keynes published *The General Theory of Employment, Interest, and Money*. Distressed by the failure of national governments to cope with the Great Depression, Keynes rejected many assumptions of classical economics and argued that state intervention, and in particular regulation of interest rates, could control inflation and minimize unemployment. (Source: Skidelsky, Robert. "Keynes." In *Three Great Economists: Smith, Malthus, Keynes*. Past Masters series 1996. Oxford University).

Rothbard has related the economic crisis with business cycles and the business fluctuations (see glossary) in his book entitled " *America's Great Depression*" he states that "we live in a society of continual and unending change, changes that can never be precisely charted in advance, people try to forecast and anticipate changes as best they can, but such forecasting can never be reduced to exact science and/or can never be perfect."(4-5).

Changes, then, take place continually in all spheres of the economy, consumer tastes shift; time preferences and consequent proportions of investment and consumption changes; natural resources are discovered and others are used up; technological changes other production possibilities...etc. All these changes are typical features of any economic system (Rothbard 6).

Therefore we may expect specific business fluctuation all the time. Rothbard also states that there is no need for any special cycle theory to account for them. There are supplies results of changes in economic data and are fully explained by economic theory (Rothbard 6).

However, what are the explanations and definitions that used to understand and describe the financial crises and from the perspective of that it is often easier to understand phenomena when they are compared with similar phenomena from another time or place. so therefore, this study comes to understand the phenomenon of the financial crisis by comparing between the most severe crises in the United States of America economy, the Financial Crisis(2007-2009) and Great Depression(1929-1939).In consideration of the these financial crises that united states of America has lived in hard times as tool to demonstrate whether the financial crisis has the same causes and consequences as Great Depression of thirty's therefore, it is possible to define a problem question which is: **is the Financial Crisis the same as the Great Depression or different?** This seems to be the principle question that has to be answered.

For that purpose we compare the Financial Crisis with the Great Depression from the historical perspective and economic data. First by examining the causes and consequences that commonly explain the Great Depression and the Financial Crisis, then we see whether the policy reactions in Financial Crisis are the same as in the Great Depression, or different.

## 1-2.Hypotheses

The basic hypotheses of this study are as follows:

- a- There are significant similarities in the causes and consequences between the Great Depression and the Financial Crisis in the United States of America and this is what we are going to show.
- b- The problem of the both crises were direct results of the welfare and prosperity preceding these periods and also they were linked to financial system based on capitalism and the Adam smith doctrine let him do. (Laissez-faire).

## 1-3. Reasons of Choosing the Topic

First, it is simple that we have studied accounting in our first diploma and now we are working in the financial sector when this topic has many debates in our environment, And because it is a common issue between our work and our study, so we choose it to develop our knowledge in the economic field and its terms and ideas by the English language.

Second reason is that the idea of choosing a topic does not come by chance; it is raised when we were studying the American civilization in the first year ,where we were in the midst of the financial crisis, in this module there was the topic of the Great Depression of the 1929;we have observed that there are many features of issue have resurrected nowadays (at 2008),likely, the history is repeated itself, from that time we decided to do analogical study between these crises in order to know why the American economy fall in these crises even it is the most integrated economy in the world.

## 1-4. the Significance of the Study

There is extensive amount of literature on the Great Depression and Financial Crisis which is written from the economic studies perspectives by authors' specialists in the field of the economy. While their theories and studies may have been relevant and contextual for their field and for their establishments, and some other studies relevant to civilization from historic perspective and as important events in the American history; however, we know that economy is a part from the civilization and every civilization depends on economic circumstances as Braudel has mentioned to it in his book entitled *a history of*

*civilizations* that “economy conditions always help to determine the destiny of civilization”(18).

We hope that this study to be contribution to the much necessary studies in civilization in general and to the economic issues in particular; it is therefore a contribution to existing knowledge that makes economic crisis(financial) relevant and contextual to civilization studies.

### **1-5. Limitation of the Study**

The subject of this research work is demanding and requires detailed understanding of economic laws and theories, we hope that we succeed in this issue in describing, identifying and presenting these crises and their causes and consequences; it is worth noting that this issue could not take into account all the explanations on offer, and the economic theories.

The causes and consequences of these crises are dealt with separate chapters for the sake of the better presenting, with the awareness that the complexity of subject.

It is therefore necessary to analyze the interaction of the causes and consequences of the both crises in their place and their time.

### **1-6. Definition of the Terms and the Concepts**

This research work requires several economic terms that must be defined, for this purpose we explain the terms which consist the core of this study, and determine their concepts. And the others economic terms explain in the appendix glossary and through the development of the study.

#### **Crisis**

The majority of the dictionaries define this term as a situation or period in which things are very uncertain, difficult, or painful, especially a time when action must be taken to avoid complete disaster or breakdown.

## **Economic Crisis**

The business dictionary defines an economic crisis as "A situation in which the economy of a country experiences a sudden downturn brought on by a financial crisis, an economy facing an economic crisis will almost likely experience a falling Gross Domestic Product (GDP). A drying up of the liquidity and rising /falling price". ("Economic crisis"). An economic crisis can take form of **recessions** or **depressions**, also called "Real Economic Crisis". From this definition the great depression and financial crises are both considered as economic crises by the most of economists and scholars.

## **Economic Cycle**

According to Mostefaoui the economic (business) cycle is a wave (swing) in economic activities and is characterized by four distinct phases of boom-recession-depression-recovery. He also added that History has also documented various types of business cycles. The major ones include the short term cycle of 10-15 years; average term cycles of 25-30 years, and the long term cycle of between 60 and 70 years. In this concept, the great depression and financial crisis are both business cycles but of greater degree i.e. one in which the economic aggregates behave as in any other business cycle but with greater variation in their alternation (12).

## **Financial Crisis**

"it is a situation in which the supply of money is speeded by the demanded for money, this means that liquidity is evaporated because available money is gone down from banks (called a run), forcing banks either to sell other investment to make up for short fall to collapse" (business dictionary). According to Farid the financial crisis has the following Types:

### **a. Banking Crisis**

When a bank undergoes a sudden hurry of withdrawals by depositors, this is called a *bank run*. Since banks lend out most of the cash they receive in deposits, it is difficult for them to pay back all deposits if these are suddenly demanded, so a run may leave the bank

in bankruptcy, causing many depositors to lose their savings unless they are covered by deposit insurance. A situation in which bank runs are widespread is called a *systemic banking crisis* or just a *banking panic*. A situation without widespread bank runs, but in which banks are reluctant to lend, because they worry that they have insufficient funds available, is called *credit crunch*. In this way, the banks become an accelerator of a financial crisis. (Farid 3)

### **b. Speculative Bubbles and Crashes**

A financial asset (stock) displays a *bubble* (fizz) when its price exceeds the present value of the future income that would be received by owning it to maturity. If most market participants get the asset in hopes of selling it later at a higher price, instead of buying it for the income it will generate, this could be evidence that a bubble is present. If there is a bubble, there is also a risk of a *crash* in asset prices: market participants will go on buying only as long as they expect others to buy, and when many decide to sell the price will fall. (Farid 4)

### **c. International Financial Crises**

When a country that keeps a fixed exchange rate is forced to devalue its currency because of a speculative attack, this is called a *currency crisis* or *balance of payments crisis* (a country fails to give back its sovereign debt is called a *sovereign default*). (Farid 6)

### **d. Wider Economic Crises**

The growth Negative of the Gross Domestic Products (GDP) lasting half or more year is called a *recession*. A prolonged recession may be called a *depression*, while a long period of slow but not negative growth is sometimes called economic stagnation. (Farid 4)

## **Recession**

the National Bureau Of Economic Research(NBER)Defines a recession as “significant decline in the economic activity spread across the economy, lasting more than a few

months” in addition to that, the business dictionary states that a recession does not last longer than one year and recessions are considered a normal part of a capitalist economy.

## **Depression**

This term is defined by the business dictionary as” the lowest point in an economic cycle”, characterized by:

- |   |  |
|---|--|
| 1- Reduced purchasing power                   | 2- Mass unemployment                           |
| 3- Excess of supply over demand.              | 4- Falling price, or prices rising than usual. |
| 5- Falling wages, or wages rising than usual. | 6- General lack of confidences in future.      |

Also called slump, depression causes a drop in all economic activity, major depressions may continue for several year” the great depression is considered as a good example for this by all economist and scholars over the time until now day’s crisis that we don’t know what will be called in the future.

## **1-7. Methodology of the Study**

In this research work, we develop hypotheses that there are significant similarities between the Great Depression and the Financial Crisis in the united states of America and the causes of these crises are linked with financial system from examination and description of existing literature reviews, the hypothesis then is tested using a historical comparative study of two cases study that means the case study of the Great Depression and the case of the Financial Crisis.

Case study which is “detailed examinations of aspects of historical episode to develop or test historical explanations that may be generalized to other events”. (Turney, And Robb 63-4). Thus suited to our study.

According to Williman “a comparative research is often used together with historical research. Researchers compare people’s experiences of different societies, either between time in the past or in parallel situation in the present” (90).so, it is often easier to understand phenomena when they are compared with similar phenomena from

another time or place for example as we know the culture and society rely on what has gone before and often use references from the past to justify the present.

The comparative historical methodology has a rich history in the social research and has been used by theorists. (Mahoney, Rueschemeyer 3)

Also historical comparative analysis is usually conducted at scale of state and it has been used to explain phenomena such as revolutions, political regimes and welfare states (Mahoney 4).

In this research work, the method of compilation is also used which is meant reviewing the results of foreign scientific research work, and conclusions. The method of compilation is carried out with and of wide selection of historical literature.

These seem to be the most important methods which suited to our research work.

## **1-8. Review of Literature**

This study explains and compares two financial crises which have been widely studied and interpreted over time.

There are several definitions and explanations which have been formulated by economists and scholars and even critics; each one defines these financial crises from different perspectives, these studies are relevant to subject matter of this research which we refer in order to develop new ideas that serve our study.

What we certainly aim to offer in this section is an overview of a number of selected perspectives and studies which correspond to the study of Financial Crisis and the Great Depression, and constitute the theoretical frame work of this research.

### **1-8-1. Studies Relevant To the Great Depression**

One of the objectives of this study is the identification of the causes and consequences of GD; there are many articles and studies which can be said to have certain relevance to study of GD. A review of literature (Rothbard, America's Great Depression, 1963, and Cecchetti, understanding the Great Depression: lessons for

current policy 1997) shows that the Great Depression is the most severe collapse in the United States of America economy history.

### 1. Rothbard study (5ed, 2000)

Murray N. Rothbard (the author of 25 books, and thousands of articles, was the dean of the Austrian school of economics and professor at university of Nevada las Vegas) in his study entitled *America's Great Depression* states that the GD is miserable story that no any historian has satisfactory explained it. For half a century, the conventional, explanation provided by John Maynard Keynes<sup>(3)</sup>, and his followers, was that capitalism was incapable of saving itself, and that government did too little to rescue an intellectually bankrupt market system from the consequences of its own folly (madness). This analysis seemed less and less convincing as the years went by; especially as Keynesianism itself became discredited.

So, Rothbard had produced his own explanation to depression in 1963, which he argued that the causes and changes of depression were not due to capitalist system but to government insistence on keeping a boom going artificially by pumping (increasing) inflationary credit. The glide (move smoothly) in stocks continued and real economy went into freefall, not because government interfered too little, but because it interfered too much. (16). Rothbard explained the definition of business cycle and business fluctuation (see glossary), which they are meant change in the economic data, these changes are considered as normal in the capitalist economy (15) he concluded in the last part in his study that "Hoover-Roosevelt continuum of policy that was to make that slump more severe and to prolong it [...] was a failure not of capitalism but the hyperactive state" (16).

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(3) John Maynard Keynes (1883-1946), British economist, one of the most influential economists of the 20th century. His ideas influenced the economic policies of most governments after World War II (1939-1945). His theory is known as Keynesianism or Keynesian economy.

## 2. Cecchetti study (March, 1997)

Cecchetti, Stephen. G<sup>(4)</sup> (1997) has come in his study that the federal reserve played a key role in every policy failure during the great depression he depicted his study on the assumption that "the collapse of the financial system could have stopped if the central bank had properly understood its function as lender of last resort"(1).

Cecchetti was divided his study into four sections and each one started with what he was called the major fallacies that contained in the literature on GD. According to him the four fallacies are:

- 1- The Great Depression was caused by the stock mark crash of 1929.
- 2- The banking system of the 1920's was fundamentally unsound.
- 3- The fact that nominal interest rates were approaching zero meant that Federal Reserve policy was loose and ineffective.
- 4- Tariffs war was primarily responsible for the spread and depth of the depression (3). By analyzing these four fallacies, cecchetti shows us that all these fallacies are results of the policy failure of the Federal Reserve.

## 1-8-2. Studies Relevant To Financial Crisis

### 1. Chari-V, Laurence Christiano and Patrick .Y. Kehoe Study (2008)<sup>(5)</sup>

In their study entitled" *facts and myths about the financial crisis of 2008*".the above authors' analysis has raised questions about the claims made for the mechanism whereby the financial crisis is affecting the overall economy (01)

They started their study from the main point that is policy makers have not done the durable work of persuasive the public-or even academic economists-of the precise nature of the market failure (2-6).

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(4) Department of Economics, OHIO state university and research associate, National Bureau of Economic Research

(5) Chan.v.v. Professor at the university of Minnesota and member of the federal reserve bank of Minneapolis. U.S.A, Christiano: university of north western and member of federal of reserve of Minneapolis, and Kehoe: member of Federal Reserve Bank and NBER at university of Minnesota.

Policy makers see themselves are presenting hard evidence to solve the problem of the crisis, not speculation that differentiates their view of the data from other view, and the logic by which the particular intervention they are advocating will fixes this market failure. They conclude their study by that the responsible of policymakers to analysis the data underlies the need for bold policy with the public (1).

## **2. David. M.Kotz Study (2008)**

Another study from another perspective, which is considered the most recently and relevance to my study of the financial crisis, this study entitled. *“The Financial and Economic Crisis of 2008: A Systemic crisis of neoliberal capitalism”* by David M.Kotz from the University of Massachusetts Amherst U.S.A in the year of 2008.

Kotz argues that the current financial and Real Sector Crisis should be seen a part of larger development that is the current crisis should be seen as systemic crisis of a particular form of capitalism, namely “Neoliberal capitalism”

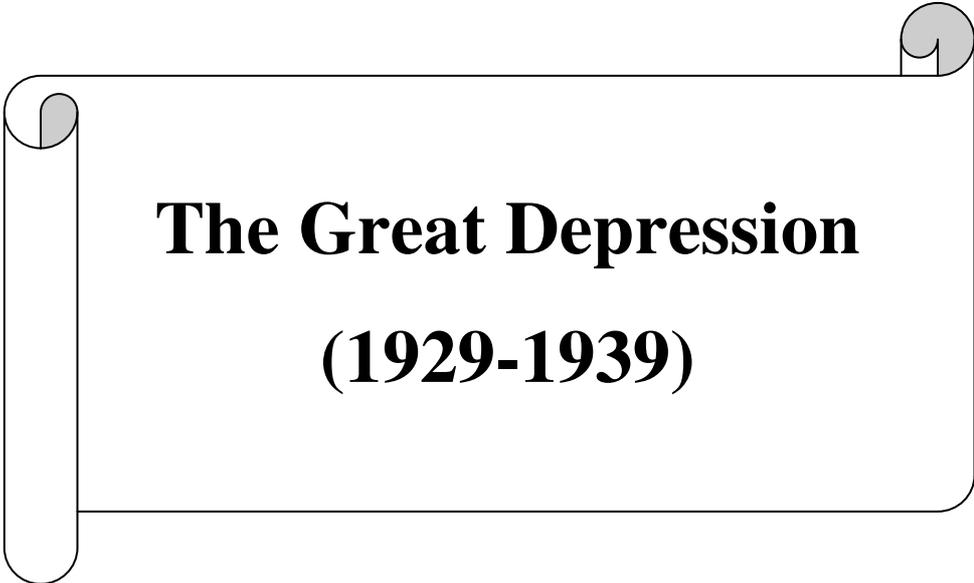
systemic crisis means that the crisis can be resolved only through a major restructuring of the system; if the current situations were not systemic crisis, then it should be possible resolved the financial crisis with appropriate state bailouts of financial institutions and the imposition of some new regulations on the financial system, while mitigating (justifying) the developing recession with large economic stimulus program.

### **1-9. the Objective of the Study**

The main objectives of this study are

- To determine and compare the causes and consequences that led to the Great Depression and the Financial Crisis in the United States of America.
- To identify the causes and consequences of the GD and the FC.
- To show the policy response daring these crisis and how they were transmitted (spread over) the united state of America.

## Chapter two



# The Great Depression (1929-1939)

 **2-1. Historical background**

 **2-2. the Causes of the Great Depression**

 **2-3. Consequences of the Great Depression**

 **2-4. Policy Responses to the Great Depression**

 **2-5. the Spread of the Great Depression**

 **2-6. Conclusion**

## Chapter Two: The Great Depression (1929-1939)

The 1920s, or so-called Roaring Twenties, marked an age of changing values. The historical period, which ran from the end of the WWI recession to the beginning of the Wall Street Crash of 1929 not only saw stock markets reach unprecedented high peaks, but also saw a radically distorted society environment alongside radical technological developments. The 1929 Stock Market Crash revealed economic hard times, forcing the U.S into the most severe economic recession of the 20th century. This chapter introduces and describes the background of this Depression. In order to understand the causes and the effects of this depression and how did it transmit over the USA economy and around the world.

### 2-1. Historical Background

According to Jones the great depression was a worldwide economic downturn that began in 1929 and lasted until 1939 (454).

Shedlia states that less than year after Herbert Hoover <sup>(6)</sup> took office the nation was in the most profound economic depression what became known as the “great depression” was first triggered (activated) by the wall street crash of October 29<sup>th</sup>, 1929, itself the result of the irresponsible speculation in stocks, Speculation in corporate shares was well-known economic fashion of the 1920’s that also marked the president Calvin Coolidge (1924-1927) years (233). These years were characterized by a boom of economic expansion which became known as “the roaring twenties” (Tims 127).

the United States was very rich in these years because the first world war, other countries still to pay it a lot of money, it had masses of materials and factories and it produced more goods every year, it became the first nation in the history to make its way of life on selling huge quantities of goods that gave ordinary people easier and more agreeable lives.

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(6) Herbert Hoover was the republican American president from the 1923 to 1929, before he was a secretary of commerce under the president Coolidge his electives as president was not closely contested, but he inherited an unsound economic situation and did not move to improve it, unable to fight the depression, banned for all nation’s problems, he lost to F.D Roosevelt in 1932(Tims 129)

The businessmen became popular heroes in 1920's and they were admired as the creators of the nations prosperity "the man who builds factory builds temple" said Calvin Coolidge and he added that "the man who works there, worships there". (O'Callaghan 92)

These expressions helped to explain the policies of the American governments in the 1920's; these governments were controlled by the Republican Party which believed in the doctrine of "laissez-faire" freedom of capitalism, a doctrine opposing government interference in the economy with the exception of to maintain law and order.

In these years most Americans think that the rise of their nation as leading producer of manufactured goods, food and services could not have occurred under any economic except capitalism, which many prefer to call free-enterprise-is what made the United States a major economic power.

The entrepreneurs also took full benefit of the lack of government supervision, under the doctrine "laissez-faire" to develop themselves by forming monopolies, eliminating competition, setting high prices for goods and producing unfortunate quality goods. (O'Callaghan 96-9) This situation led the people to get money by any means, at that time, the trade of shares was flourished, and who owns shares in companies, owning the right to its profits, (Shedlia 234-5)

By the end of the year of 1929, the value of all shares had dropped, thousands of people, especially those who borrowed to buy on the margin (difference between the value of loan and the value of payments), found themselves facing the debt and damage. The collapse of American shares prices was known as the "Wall Street crash", it marked the end of the prosperity of the 1920's. (Shedlia 234-5)

The depression that followed this crash was much more serious, it soon became world disaster as Shedlia said, lasted in the U.S.A no less than thirteen years, its causes went far beyond either speculation or the policy of easy credit. The collapse of the nation's financial structure revealed how weak the economic prosperity of the 1920's was. (Shedlia 234-5)

Since this collapse people asked "what has gone wrong? Some blamed the blindness of the politicians for the crash, others the greed of investors, so the biggest changes came

during the democrats administration under the president Franklin. D. Roosevelt, change came to ease the hardship caused by the depression, President Roosevelt and congress passed many new laws regulating sales of stocks and recognizing the right of workers to form unions, these laws and regulations and many other social initiative approved since 1930 have changed American capitalism.

So, the political change occurred in this period, the democrat's president Roosevelt was elected as result of the republicans' failure to solve the problem of depression, he presented and depicted change in the economy of the U.S government consumption spending emerged .this policy was known as the ‘ ‘ New Deal ‘ ‘ (Tims 132)

The second cycle of the great depression began in 1937 the policy reactions toward it began on 1938. The most important pointed out by many economists was the monetary factor (Romer 6)

Monetary contraction (reduction) was the result of poor policy making in the US and led to declining output and prices. The spread of the Great Depression is connected to the Gold standard, which led the Federal Reserve System (FRS) to continue a contractionary policy to keep the fixed exchange rate of the Dollar. Aggregated demand in the US declined considerably. The financial crisis shaped a doubtful setting and led to ambiguity about future income, which reduced investment and consumer demand.

The government responded to the economic ruined with a series of policy actions that only increased it, sinking the economy into the greatest economic catastrophe (Romer 6)

After the economy reached the bottom in 1933, the government continued to treat the illness with a new deal in order to get natural recovery; in 1939, if not earlier, the U.S. government turned its attention away from domestic economic and toward mobilization of the economy for future contribution in the war. (Higgs 2)

## **2-2. the causes of the Great Depression**

Most of the scholars and economists who have studied the GD do not agree on its causes, there are controversies over the main cause of the GD between mainstreams of economic schools of thought have tried to present theoretical support to the GD.

According to the Keynesians – a major school of thought that emerged in response to the GD– market economy was naturally unstable and on its own could have led to periods

of depression and recovery. They, therefore, recommended government intervention to stabilize the economy in order to realize and maintain the desired economic performance.

The other school of thought is the monetarists, a variant of the classical. According to this school, the cause of the GD could be found in the inability of the Federal reserve to prevent bank failure and the decline of money supply between 1930 and 1933 (Friedman and Schwartz).

Still now, the converse about the causes of the GD continues, however, in our study, we take the common causes of majority of their views of the causes of the Great Depression in general.

### **2-2-1.Capitalist Mythology**

Liberal economic was based on the work of economist Adam Smith and his book “*The Wealth of Nations*”. Smith had written that free markets and free trade would create the greatest wealth for society. Liberal economists believed that economic systems were governed by natural rules and that the government should not be actively concerned in the economy. In this view, an economic depression was normal part of the economic cycle and that in time the economy would improve on its own.

This philosophical viewpoint stand in contrast to the expressively severe reality of the Depression where factories and farms stood empty, and in the same time people, who were willing to work, they were unemployed and famished. When the Depression began, economists believed that governments did not have to intervene to help the economy, and that the economy would recover on its own. (Great Depression 8-10)

However, as the Depression continued for years, political pressure on governments to intervene in the economy increased. Because liberal economists could neither propose a solution nor provide a strong explanation as to why the Depression happened, many people began to turn to more radical philosophies, including communism and fascism, to find a solution to the economic crisis. The only countries that seemed protected to the effects of the Great Depression were the Soviet Union and Fascist Italy, where governments directly controlled national economies. (Great Depression 10)

Finally, The Great Depression caused people to lose faith in liberal philosophies

### **2-2-2. The Prosperity Of 1920's**

During these years, the leading nations Germany, France and Britain lost their position in the world 's economy ; the U.S became the new economic power ,which experienced an export boom because the European countries demand for armament, ammunitions, food and clothing due to the first world war ,so at this time the U.S was more or less world 's remaining economic power , as result exports increased from 2.8 billion dollars in 1913 to 7.3 billion dollars , which is the level that was never reached again. (Black 96-9)

The production of the heavy industry boomed as the European allies asked big amounts of steel and the other raw materials for war productions, in addition to the domestic demand, so U.S producers faced further increasing demand, also the agricultural sector encounter advantageous condition as well, the exports of wheat and flour rose from 142 million dollars to 505 million dollars and meat exports from 68 million dollars to 668 million dollars. (Black 96-9)

The production of consumer goods accelerated sharply, the GNP, which stood at 70.3 billion dollars at the end of 1921, jumped to 104, 4 billion dollars in 1929. (Lagayette 135)

In this period, most sectors were boomed, especially automobiles, household equipment, electrical goods and financial and commercial services. Consequence, some people believed that the U.S was found the secret for economic success; it turned from a debtor to creditor country during the World War I, the U.S pre-war debt to foreigners of 3.7 billion dollars had turned into net credit of 12.5 billion dollars (Lagayette 136)

Due to the ease of use of credits for stock-market transactions, the low level of margin supplies and the strong of stock prices investors were able to increase their number of shares without expending any further amounts of their own funds; this very dangerous development, monetary authorities tried to restrict this hot money, but with no success.

Finally, prices swelled to over 60 per cent between December 1927 and September 1929, and the rate of interest of short-term funds or call money doubled during the boom and achieved 12 per cent by the end of 1928. The greatest share of this kind of money had foreign bank agencies, corporations with large cash balances, and brokers and individuals. Those kinds of investors brought a large degree of instability to the Wall Street and they were able to pull out their money at any time if a downturn became apparent. (Brown 412)

Consumer markets were becoming saturated and the economic growth started to decline gradually but the stock market kept rising and rising. The catastrophic result was the collapse of stock exchange prices in October 1929. With this the US economy changed from a slight decline to great economic depression, the Great Depression

### **2-2-3. Stock Market Crash**

The early decline in output in the United States in the 1929 is supposed to have roots from stretched U.S. monetary policy aimed at limiting stock market speculation. The 1920s had been a prosperous decade, but not an excellent boom period; Wholesale goods prices had remained nearly stable throughout the decade and there had been calm recessions in both 1924 and 1927.

Stock prices had risen more than fourfold from the low in 1921 to the peak reached in 1929. In 1928 and 1929, the Federal Reserve (**see appendix 1**) had raised interest rates in hopes of slowing the rapid rise in stock prices. (O'Callaghan 96)

These higher interest rates low spending in areas such as construction and automobile purchases, which in turn reduced production.

By the fall of 1929, U.S. stock prices had reached levels that could not be justified by reasonable anticipations of future earnings. As a consequence, when a variety of events led to gradual price declines in October 1929, investors lost confidence and the stock market bubble burst. Panic selling began on "Black Thursday," October 24, 1929. Many stocks had been purchased on margin, which means, using loans secured by only a small division of the stocks' value. As a cause, the price declines forced some investors to liquidate their holdings. (Romer 3)

Between their peak in September and their low in November, U.S. stock prices declined 33 percent. Because the decline was so impressive, this event is often referred to as the Great Crash of 1929. The stock market crash reduced American cumulative demand significantly. Consumer purchases of durable goods and business investment fell sharply after the crash. A likely explanation is that the financial crisis generated substantial uncertainty about future income, which in turn led consumers and firms to put off purchases of durable goods.

The crash may also have depressed spending by making people feel poorer. As a result of the severe decline in consumer and firm spending, real production in the United States, which had been declining slowly up to this point, fell fast in late 1929 and throughout 1930. Therefore, the decline in stock prices was one factor causing the decline in production and employment in the United States (Romer 3)

#### **2-2-4. Financial and Banking Panics and Monetary Contraction**

In addition to the most serious underlying weakness of economy and the bad distributed of income, Jones states that the American banking system was naturally unsound (454).

After the crash of the market, the first wave of banking panics occurred in the United States. A banking panic arises when many depositors lose confidence in the financial and banking system; at the same time demand their deposits be paid to them in cash.

Banks, which naturally hold only a part of deposits as cash reserves, must liquidate loans in order to elevate the required cash. This process of fast liquidation can cause even a previously solvent bank to fail. (Romer 3)

The United States experienced successive banking panics in the fall during the period of 1930 to 1933. The final wave of panics continued through the year of 1933 and terminated with the national “bank holiday” declared by President Franklin Roosevelt on March, 1933. The panics took a severe duty on the American banking system. By 1933, one-fifth of the banks in existence at the start of 1930 had failed. (Tims 133)

By their nature, banking panics are unreasonable, inexplicable events, but some of the factors contributing to the problem can be explained. Economic historians believe that important increases in farm debt in the 1920s, together with U.S. policies that encouraged small banks to create an environment where such panics could ignite and spread.

The heavy debt rooted in part from the response to the high prices of agricultural goods during World War I. American farmers borrowed heavily to purchase and improve land in order to increase production. The decline in farm goods prices following the war made it difficult for farmers to keep up with their loan payments. The Federal Reserve did little to try to stop the banking panics (Cecchetti 10).

In their study, *A Monetary History of the United States*, Milton Friedman and Anna J. Schwartz state that the governor of the Federal Reserve Bank of New York Benjamin Strong had been a powerful leader who understood the capacity of the central bank to limit panics, but his death left void at the Federal Reserve and allowed leaders with less rational views to put effective intervention. The panics caused a remarkable rise in the amount of currency people wished to hold relative to their bank deposits. This rise in the currency-to-deposit ratio was a key reason why the money supply in the United States declined 31 percent between 1929 and 1933. In addition to allowing the panics to reduce the U.S. money supply, the Federal Reserve also deliberately contracted the money supply and raised interest rates in September 1931 (Romer 4)

The decline in the money supply caused by Federal Reserve decisions had a severe contractionary effect on output; this decline in the money supply depressed spending in a number of ways. Perhaps, because of real price declines and the fast decline in the money supply, consumers and business people came to expect deflation which means that they expected incomes and prices to be lower in the future. As a consequence, even though nominal interest rates were very low, people did not want to borrow because they feared that future wages and profits would be inadequate to cover the loan payments.

This uncertainty, in turn, led to severe reductions in both consumer spending and business investment spending. The panics surely increased the decline in spending by generating pessimism (doubt) and a loss of confidence.

#### **2-2-4-1. Financial Collapse**

According to Bernanke the major components of the financial crisis between 1930 and 1933 were the loss of confidence in the financial institutions, particularly commercial banks and the widespread insolvency of debtors (43). The financial institutions found themselves in trouble and fought for continued existence, of most importance, the problems of the financial institutions were the problems of the commercial banks.

The U.S banking system was consisted of smaller and independent banks; “the dominance of small banks in us was due to in large part to a regulatory environment which reflected the popular fears of large banks and trusts “(Bernanke 44)

The second component of the financial crisis was the widespread insolvency of debtors; Bernanke states that the rate of debt service to national income went from 9 percent in 1929 to 19.8 percent in 1932-33. (46), these higher rates caused problems for both borrowers and lenders, for example, at the beginning of 1933, owners of 45 percent of all U.S farms, holding 52 percent of the value of farm mortgage debt, and it also touched homeowners. (46)

#### **2-2-4-2. monetary contraction**

The economists believe that actions of the monetary authorities could have prevented the decline in the money supply; they saw that the Federal Reserve made a significant error by raising interest rates in 1928 and again in 1931, the later effort to stop the gold reserves and defend the value of dollar. Romer states that “The federal reserve did little to try to stem (stop) the banking panics” (4).

So, the majority of the banks’ failure was caused not by fundamental problems in the banks themselves, but by “runs on the bank “by panicked investors who their savings would be lost.

There is general agreement that these events (banking panics) contributed to 30 percent contraction in the money supply and to the general price deflation.

The banking crisis of 1933 led to the banking act of 1935 which greatly extended the power of the Federal Reserve System (FRS) and established the Federal Deposit Insurance Company (FDIC) as permanent agency of the government (European Commission 14-22).

#### **2-2-5.The Gold Standard**

The central banks in all of the major countries of the world stood ready to exchange their currency for gold at a fixed rate. The only means at that time the gold standard which was a fixed-exchange rate system, the purpose of the system was to stabilize economies through specie flows (Bernanke 70).

If one country's economy began to reduce in size, its collective price level would begin to fall. At the fixed gold-currency exchange, it would then be advantageous to import gold

into the affected country. This would increase the stock of money, and provide a stabilizing force.

Result would be that all fluctuations in the relative price of gold, for whatever reason, would have to be absorbed by the general price level. For example, if an increase in political instability somewhere in the world were to drive up the demand for gold, instead of the currency price of gold rising, the total price level would have to fall.

The gold standard of the interwar period is more correctly referred to as a gold exchange standard, and, as mentioned above, its primary purpose was to establish and maintain a system of fixed exchange rates. While central banks were required to hold reserves to back their monetary base, those reserves could be part monetary gold and part foreign exchange. The U.S. was the major surplus country during this period, and so it was beneficiary of gold (Bernanke 93).

The most persuasive case for the causal role of the gold standard was that the depth of the Depression depended seriously on when a country left the gold standard; those countries that left earliest, such as Great Britain (1931) had lower contractions.

Fixed exchange rates allow transmission of certain types of shocks that are buffered (shielded) by the movements in flexible exchange rates.

In particular, in a fixed exchange rate system, central bank policy is unable to buffer conflict to the real economy in effect; one loses control of the size of one's money stock (Bernanke 93).

## **2-3. Consequences of the Great Depression**

### **2-3-1. Economic Consequences**

The most clear economic consequences of the Great Depression was human suffering; in a little period of time U.S output and standards of living dropped sharply

More than one fourth of the labor force was unable to find work in the early 1930s, which witnessed accumulation unemployment at an unprecedented level; the unemployment rate approached 38% in 1933. (Albers, Lars 7)

In fact, the economic consequences of the 1930s were severe. The severity could be seen in the economic indicators. In effect, unemployment rate was high, industrial production fell considerably. Consequently, taxes were raised, too expensive import tariffs policies were adopted, money supply under the control of Federal Reserve Bank dropped precipitating bank failures and attempts by government to operate balance budget. The decline in economic activities reached its lowest point in 1933. (Romer 7)

Existing statistics reinforced the dark picture of the period. As shown by Albers, and Lars, by 1933 when the cycle reached a trough, unemployment rate was 24.9 per cent, consumer price index, (CPI), was at its lowest value of 75.4, government expenditure was at US \$42.8 billion, Gross National Product, (GNP), stood at the lowest value of US \$222.1 billion, index of narrow money supply was 73.5 per cent, commercial interest rate was 1.7 per cent and the part of gross investment to GNP was at all time low of 3.8 per cent with net investment being negative. Although there was a small recovery between 1937 and 1938, the major expansion came only after World War II. (3-5).

The Depression also played an important role in the development of macroeconomic policies. The central role of reduced spending and monetary contraction in the Depression led British economist John Maynard Keynes to develop the ideas in his *General Theory of Employment, Interest, and Money* (1936). Keynes's theory recommended that increases in government spending, tax cuts, and monetary expansion could be used to counteract depressions. This close, combined with a growing consensus that government should try to stabilize employment, has led to much more activist policy since the 1930s. Legislatures and central banks throughout the world now usually attempt to prevent or moderate recessions. (Black 100-1)

### **2-3-2. Political Consequences**

The crisis has many political consequences, among which was the rejection of classic economic liberal approaches, black states that "the slump and the subsequent depression destroyed the liberal economic order, and led to a collapse of confidence in capitalist structures" (99) this means that the depression led to break main rule of free economic to state intervention in the economic matters.

Roosevelt replaced the economic based on the doctrine laissez-faire in the U.S. with Keynesian policies. These policies increased the role of the federal government in the national economy. Between 1933 and 1939, federal expenditure tripled, and Roosevelt's critics charged that he was turning America into a socialist state. (Black 101)

Moreover, The Great Depression was a main factor in the implementation of social democracy and planned economies in U.S, and on the hand the great depression led to the return of the democrats on the American political scene as result of the republicans' failure to solve the problems of the depression

## **2-4. Policy Responses to the Great Depression**

In this part, we concentrate on The Monetary policy, fiscal policy and reforms under Herbert Hoover and Franklin Delano Roosevelt

### **2-4-1. Herbert Hoover's Policy**

Herbert Hoover, who presided over the first three years of the Great Depression, started several programs, all of which unsuccessful to repeal the slump, In 1930 Congress accepted the *Smoot-Hawley Tariff Act* which raised tariffs on thousands of imported goods, In order to encourage the purchase of American-made products by increasing the cost of imported goods, while raising revenue for the federal government and defending farmers; As reaction, the other nations increased tariffs on American-made goods in revenge, dropping international trade. (Tims 130)

In 1931 Hoover ordered the major banks in the country to shape a group known as the *National Credit Corporation* (NCC), In order to shield its balance sheet from further losses. This policy accelerated the downfall of others banks and contributed to further declines in the falling supplies of money and of credit.

By 1932, unemployment was in higher rates, the agricultural heartland was in drought, businesses and families defaulted on record numbers of loans, and more than 5,000 banks had failed. Hundreds of thousands of Americans found themselves homeless and they began together in the numerous "Hooverilles" that had begun to appear across

the country, in response, President Hoover established the *Federal Home Loan Bank Act*, to encourage new home construction. (Tims 131)

The final attempt of the Hoover Administration to arouse the economy was the passage of the *Emergency Relief and Construction Act* (ERA) which included funds for public works programs such as the creation of the *Reconstruction Finance Corporation* (RFC) in 1932. The RFC's first goal was to provide government-secured loans to financial institutions, railroads and farmers. (Jones 456)

Under Hoover fiscal policy was Passive at best. The federal budget had a small surplus during 1930, a small deficit in 1931 and a deficit of 4 percent of GDP in 1932. During the first three years of the Great Depression, the Federal Reserve tolerated and even reinforced a substantial decrease of the money supply. The disappearance of many banks during the GD led to the destruction of “informational capital” produced by banks during the intermediation process. One of the main intermediate outputs of the banking system is the creation of information about the credit-worthiness of different borrowers. The disappearance of many banks during the Great Depression led to the destruction of borrowers’ credit ratings, causing serious and protracted declines in the supply of credit by banks. (Jones 455-6)

#### **2-4-2. Franklin Delano Roosevelt’s Policy**

Franklin Delano Roosevelt, who became president of the United States in 1932, he argued that reorganization of the economy would be needed to prevent another depression or avoid prolonging the current one; so that he instituted an economic program called the *New Deal* to save the American economy. The *New Deal* programs required to stimulate demand and provide work and assistance for the ruined through increased government spending and the institution of financial reforms.

He started the economic reforms by many of the new laws set up government organizations called “agencies” to help the nation to recover from the depression. The securities act of 1933 which widely regulated the securities industry. This was followed by the securities exchange act of 1934 which created the *Securities and Exchange Commissions*. Among these agencies, the *civilian conservation corps* (CCC) found work for many thousands of young men. The *Federal Emergency Relief Administration* (FERA)

provides individual states government money to help their unemployed and homeless. The *Agricultural Adjustment Administration* (AAA) set out to raise crop prices by paying farmers to produce less. The *Tennessee valley authority* (TVA) built a network of dams and to make electricity and stop floods in poor southeastern region of the United States. The *national recovery administration* (NRA) worked to make sure that business paid fair wages and charged prices; these reforms, together with several other relief and recovery measures, are called the First New Deal (O'callaghan 100-1).

Economic motivation was attempted through a new *alphabet soup* set up in 1933 and 1934 and subsequently extant agencies such as the *reconstruction finance corporation* (RFC). By 1935, the "second new deal" added social security (which did not start making large payouts until much later), a jobs program for the unemployed (*the works progress administration*, WPA) and, through the national labor relations board, a strong stimulus to the growth of labor unions.(Jones, 464) In 1929, federal expenditures constituted only 3% of the GDP. The national debt as a proportion of GNP rose under Hoover from 20% to 40%. Roosevelt kept it at 40% until the war began, when it soared to 128%. By 1936, the chief economic indicators had regained the levels of the late 1920s, except for unemployment, which remained high at 11%, although this was significantly lower than the 25% unemployment rate seen in 1933. In 1937, the Roosevelt administration cut spending and increased taxation in an attempt to balance the federal budget. The American economy then took a sharp decline, lasting for 13 months through most of 1938. Producers reduced their expenditures on durable goods, and inventories declined. As unemployment rose, consumers' expenditures declined, leading to more cutbacks in production. By 1938 retail sales began to increase, employment improved, and industrial production turned up. (Tims 136-7)

## **2-5. the Spread of the Great Depression**

In this part, we show how did the crisis spread from country to country? "The primary transmission channel of the Great Depression was the Gold Standard" (Temin 87).

As Temin mentioned, the fixed exchange rates during the gold standard system made economies weak for negative demand shocks and therefore the system on itself was the main spreader of the shock.

The gold standard was characterized by fixed values of national currencies in gold. This implies a fixed exchange rate between each currency. In addition, there was no international coordinating organization like the *International Monetary Fund* (IMF) nowadays. As a consequence, countries who had a balance of payments deficit had to export gold to keep the exchange rate fixed, whereas countries with a positive balance of payments could import it. A constant deficit therefore was equivalent to running out of gold (or foreign currencies) and indicates that the fixed exchange rate should be depreciated. But instead of depreciation of their currencies, deficit countries chose the way Lowering domestic prices which led to fewer imports and more exports, which improves the balance of payments.

The effects of the Gold Standard were different for different countries. In all major economies, a downward trend could be registered, but the negative growth rates differ from country to country. Interestingly, the Great Britain recovered most quickly from the Great Depression, because it was the first country to abolish the gold standard. The recessions in the US were much more pronounced (Romer 4).

## **2-6. Conclusion**

The Great Depression, GD, in the USA, is described as a “severe depression” which started on the “black” Tuesday 29<sup>th</sup> October, 1929 when a record of 16.4 million shares were sold, compared to 4.8 million shares a day earlier. That decade, the 1920s was termed “roaring twenties” because the USA economy prospered greatly.

Many Americans were able to live above their economic status because of increased consumer credit, which allowed people to borrow money to buy radios, cars, household, and stocks in companies. During the 1920's, increasing numbers of Americans invested in the stock market, which was rising in value. While the rising stock market did make many Americans appear to become richer, it was a risky wealth based on the price of stocks. Most of this wealth was lost in October 1929, when the New York Stock Market crashed.

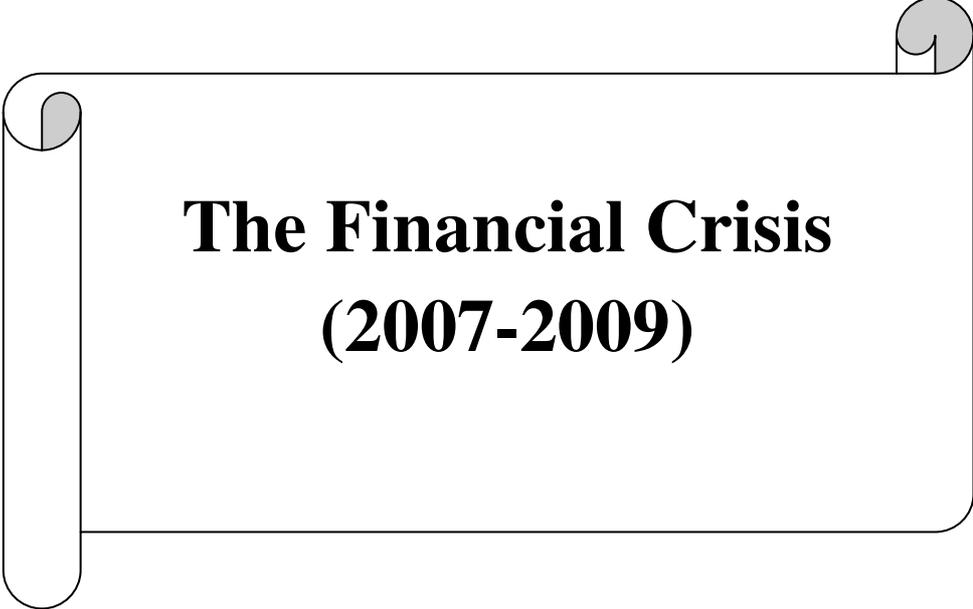
The stock market crash financially ruined investors. Badly, since many investors had borrowed money to buy stocks, money they were now unable to repay, the banks that had lent the money to the investors were forced into bankruptcy. Many banks were forced to call in loans to good businesses to cover their losses, which forced these businesses into bankruptcy.

So, the great depression was the worst economic slump ever in USA history and one which spread to all industrialized world, In effect; the GD describes the economic crisis of the 1930s in the USA that predates Keynesianism. It was a situation when in the face of poor economic performance authorities continued with the laissez-faire policies of the era.

Several authors have proffered different explanations to help explain the causes of the GD. According to some of them, the GD is caused by intervention of monetary authorities in the money market.

The government responded to the economic ruined with a series of policy actions that only increased it, in 1939, if not earlier, the U.S. government turned its attention away from domestic economic toward mobilization of the economy for future participation in the world war two.

## Chapter three



# The Financial Crisis (2007-2009)

 **3-1. Definition and background**

 **3-2. Stages of the Crisis**

 **3-3. the Causes of the Financial Crisis**

 **3-4. the Consequences of the Financial Crisis**

 **3-5. Policy Responses**

 **3-6. the Spread of the Financial Crisis**

 **3-7. Conclusion**

## **Chapter Three: The Financial Crisis (2007-2009)**

The worldwide financial system is now in a severe recession combined with a financial crisis and an enormous loss of confidence. Many experts did not believe that such a deep crisis, like the Great Depression will happen again. But present financial crisis shows that the great depression is possibility to occur again. In this chapter we try to examine and identify this crisis and its causes and its consequences and how does it spread through the USA economy and over the world.

### **3-1. Definition and Background**

A perfect storm, this is one metaphor used by Albers and Lars to describe the present financial crisis. (2), this means in reality the present crisis has not yet got a commonly accepted name. The Great Recession has been proposed. It remains to be seen if this term will be adequate; however the name that will probably call to it in the future, it is no other economic decline after the great depression has been as severe as today's recession.

Although Since that time the United States has experienced 11 recessions; According to the National Bureau of Economic Research the current and eleventh recession began in late 2007 (Burtless 2).

It was preceded by long period of fast credit growth, and rich accessibility of liquidity, elevated asset prices and the development of bubbles in the real estate sector.

It was also perceived that the real economy of US was flourishing on strong fundamentals such as rapid export growth and sound financial positions of households and business economy, These perceptions radically changed in September 2008, Following the successive collapses of the financial institutions in the U.S such as Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, and American International Group (AIG), as a run on those institutions that the market identified as having large mortgage exposures and sharp liquidity risks exploded into a generalized market panic (Moseley 13).

Panic broke in stock markets, market valuations of financial institutions evaporated, investors hurried for the few safe havens that were seen to be left, and complete meltdown

of the financial system became a true threat. The crisis thus began to feed onto itself, with banks forced to restrain credit, banks cutting down credit further, and so on.

The downturn in asset markets spread rapidly across the world. As trade credit became rare and expensive, world trade fell and industrial firms saw their sales drop.

Confidence of both consumers and businesses fell to unprecedented lows and hesitation among banks about the creditworthiness of their counterparts evaporated as they had invested in often very complex and overpriced financial products. As a result, the interbank market almost closed, and risk on interbank loans soared (Moseley 14-5).

At that point, policymakers perceived the crisis mostly as a liquidity problem. Concerning the solvency of individual financial institutions, but systemic collapse was deemed improbable.

The position would without doubt have been much more serious, central banks, governments and national authorities not responded forcefully.

As Bolton states in his study entitled the *U.S financial crisis: a failure to govern* that even in mid-2009, twelve months after the financial crisis entirely exploded in the United States, it is still early to determine all of the exact causes and consequences of the crisis. And he added that many different factors share the responsibility for creating or enabling the crisis: mortgage lenders, borrowers, regulators, investors, rating agencies, and probably many others. (1)

The outcomes of this collapse, more than 6 million Americans have lost their jobs, large and important financial institutions have failed, and trillions of dollars in savings have been lost. It is generally accepted that problems in the United States housing market are the causes of the current United States financial crisis (Bolton 1).

The financial sector could not maintain normal activity which affected the real economy in several ways. Housing prices reached a record low level; the private sector reduced their debt and trade financing problems contributed to a 25 per cent fall in exports.

At this position the whole economy was on a downward path; the automobile sector suffered as car sales declined; Industrial production fell by 15 per cent and the unemployment rate reached its highest level. The crisis was become systemic; and it spread cross various countries; although the policy reply was exceptional; The Federal Reserve lowered the rate to close to zero, introduced massive liquidity procedures and purchased bonds. The government decreased fiscal taxes of nearly 1 trillion dollars. Over time the procedures taken by Federal Reserve and the government to restore some confidence and

to make the financial market functions again (Bolton 1). However, in this chapter we try to understand the causes and the impact of this crisis in its setting.

### 3-2. Stages of the Crisis

In his report The Financial Crisis Inquiry Commission <sup>(7)</sup> portrayed that; In December 2010, the United States was still in an *economic recession* caused by a *financial crisis* that first manifested itself in August 2007 and ended in early 2009. The main features of that financial crisis were a *financial shock* in September 2008 and a simultaneous *financial panic*. The financial shock and panic triggered a severe contraction in lending and hiring beginning in the fourth quarter of 2008. (413)

Some economists describe recent economic history as a recession that began in December 2007 and continued until June 2009, and from which we are only now beginning to recover. Unless this definition of the recession that obscures a more important chronology that connects financial market developments with the broader economy. We agree with national commission which describe recent U.S. economic crisis in five Stages:

- 1- A series of shocks beginning in August 2007, followed by an economic Slowdown and then a calm recession through August 2008, as liquidity problems emerged and three large U.S. financial institutions failed.
- 2- A severe financial shock in September 2008 in which ten large financial Institutions failed, nearly failed, or changed their institutional structure.
- 3- A financial panic and the beginning of a large contraction in the real economy in the last few months of 2008; followed by The end of the financial shock, panic, and rescue at the beginning of 2009; followed by
- 4- A continued and deepening contraction in the real economy and the beginning of the financial recovery and rebuilding period.
- 5- As of December 2010, the United States is still in the last stage. The financial System is still recovering and being restructured, and the U.S. economy struggles to return to constant strong growth. (413).

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(7) The Financial Crisis Inquiry Commission was created to “examine the causes of the current financial and economic crisis in the United States.” The Commission was established as part of the Fraud Enforcement and Recovery Act (Public Law 111-21) passed by Congress and signed by the President in May 2009. This independent, 10-member panel was composed of private citizens with experience in areas such as housing, economics, finance, market regulation, banking,

and consumer protection. Six members of the Commission were appointed by the Democratic leadership of Congress and four members by the Republican leadership. It called for the examination of the collapse of major financial institutions that failed or would have failed if not for exceptional assistance from the government presents to the President, the Congress, and the American people the results of its examination and its conclusions as to the causes of the crisis

### **3-3. the Causes of the Financial Crisis**

The present financial crisis started in the U.S. sub-prime mortgage market in 2007 and then spread to the entire financial and real sectors of the U. S. economy in 2008, and from there to the rest of the world. The initial causes of the financial crisis are clear: huge and increasing amounts of home mortgages; the Specialists attitude on this topic is somewhat similar, the crisis started with a real estate bubble (the burst of a bubble).

Schiller states that “The housing bubble was a major cause, if not the cause, of the subprime crisis and of the broader economic crises we now face” (33).

The national commission states that ten causes of financial crisis all of them related to the housing bubble and financial institutions (413).

#### **3-3-1. the Housing Bubble**

The housing bubbles (Real estate bubbles) which means that are followed by a price decrease (also known as a **housing price crash**) this situation led to the result which we find that the mortgage debt higher than the current value of the property; as consequences the real estate fall in crisis of prices which created enormous losses for homeowners and investors (Thomas et al 1)

The housing bubble has two components: the real homes and the mortgages that financed them.

##### **3-3-1-1. the housing prices**

There was a *housing* bubble in the United States—the price of U.S. housing increased by more than could be explained by market developments since 1990’s

This included still after the U.S. housing bubble burst, there is no agreement on what caused it. Experts still don’t know the relative importance of the possible causes of the housing bubble. (Thomas et al 1)

We agree with national commission at least to identify some of the most important hypotheses:

- **Population growth.** All the areas experienced population growth that far exceeded the national average. More people fueled more demand for houses.
- **Land use restrictions.** In some areas, local zoning rules and other land use restrictions,

as well as natural barriers to building, made it hard to build new houses to meet increased demand resulting from population growth. When supply is constrained and demand increases, prices go up.

- **Over-optimism.** Even absent market fundamentals driving up prices, shared expectations of future price increases can generate booms.
- **Easy financing.** Mortgages made it easier for potential homebuyers to borrow enough to buy more expensive homes. This doesn't mean they could pay for those homes or future mortgage payments in the long run, but only that someone was willing to provide the initial loan. Mortgage originators often had not enough reason to encourage borrowers to get sustainable mortgages.

Consumers also were eager to take part in this process and play this game. Real estate prices began to fall people began to lose their houses and panic spread.

Some scholars argue that the beginning of housing bubble must be sought in 2000. That means the housing bubble was largely created with response of the Federal Reserve to the stock market implosion in 2000; In early 2000, the Federal Reserve reduces interest rates, then it rose interest rates from 2004-2007.

According to Shiller, rising interest rates increased the cost of mortgage in the consequence caused further depressed home prices (33).

### **3-3-1-2.Mortgage origination and securitization**

The second component of housing bubble is the *mortgage* bubble was the main and most significant appearance of a more generalized credit bubble in the United States. Mortgage rates were low relative to the risk of losses, and risky borrowers, who in the past would have been turned down, found it possible to obtain a mortgage. (Fabozzi et Al 423)

Some scholars consider that one of the major factors to blame for the financial crisis was the originate to distribute model of securitization, understanding this problem requires some knowledge of financial markets and process,

We try simplifying some basic terms and definitions need to be explained down.

The mortgage market is a collection of markets, which includes a primary (origination) markets and a secondary market where mortgages trade (fabozzi et Al 422)

Fabozzi defined the mortgage as “a pledge (guarantee) of property to secure payment of debt” the property refers to real-estate, which is often in the form of home, the debt is loan given to buyer of the house by the lender, and “the original lender is called the mortgage originator “(423).

The securitization can be used in two ways in broader and narrower sense, in the narrower sense asset securitization; the term is used to describe the process of pooling loans and using securities backed by these loans.

### **3-3-1-3. the mortgage origination process**

Anyone who wants to borrow money to purchase a home will apply for a loan a mortgage originator the potential homeowner complete an application from which provides financial information about the applicant and pays an application fee; the mortgage originator then performs a credit evaluation of the applicant. (See appendix2)

The two primary factories in determining whether or not the money will be lent are the payment to income ratio and the loan to value ratio, if the lender decides to lend the money, it sends a Letter of commitment to the applicant. At the time the application is submitted, the mortgage originator will give the application a choice of various types of mortgages (fabozzi et al 424-425).

### **3-3-1-4. Mortgage types**

There three main types of mortgage:

a- **Fixed Rate Mortgages:**” (FRM’S) the borrower pays interest and repays principal in equal installments over an agreed period of time, “called the maturity or term of mortgage”. (Fabozzi et al 427).

b- **Adjustable rate mortgages (ARM):** calls for the resting of the interest rate periodically, in accordance with some appropriately chosen index reflecting. Short term market rates (Fabozzi 430).

**C-Hebrides:** contain both fixed and adjustable rate features mortgage loans fall into two categories prime and non-prime mortgage.

### **3-3-2. Federal Reserve and financial institutions**

#### **3-3-2-1. Federal Reserve**

The majority of the economist's criticized the Federal Reserve (**see appendix1**) for having created the conditions for massive expansion of credit that caused the crisis. Some of them attribute the credit bubble and the following financial crisis to the Federal Reserve's excessively easy monetary policy in the past under Greenspan.

Financial institutions offer services related to one of the following operations:

1. Transforming financial assets acquired through the market for the most important of the financial institutes.
2. Exchanging financial assets on behalf of consumers.
3. Exchanging financial assets for their own accounts.
4. Providing investment advice to other market participants.

Financial intermediaries include savings banks, commercial banks, saving and loan associations, credit unions, investment companies, insurance companies and pension funds (Fabozzi 15).

#### **3-3-2-2- Government-Sponsored Enterprises**

Government-sponsored enterprises (GSEs) purchase and securitize mortgages. Securitized mortgages are then sold to outside investors by GSES or kept as an investment.

There are three GSEs:

- The *Federal National Mortgage Association* (Fannie Mae)
- The *Federal Home Loan Mortgage Corporation* (Freddie Mac)
- The *Federal Home Loan Bank* (FHLB) system consisting of 12 regional banks

The GSEs have two negative influences on the financial system, the first it was their investments into the subprime mortgage.

The second, it was to introduce systemic risk into the system, and therefore add to financial crisis. (Thomas et al 3).

The financial crisis has been a crisis not only of the traditional banks but also of “the shadow banking system”. (Acharya and Richardson et al 117).The shadow banking system includes investment banks and insurance companies and managed funds. Which they borrowed liquid and short term leveraged a lot and lent and invested in longer term and illiquid ways, it is for this reason that in the period 2007-2010,many banks and bank like institutions( shadow banking system)failed in consequence, the majority of this system disappeared (see **table 1**).

Year	Number failed banks	Total assets of failed banks (on dollar)
2007	03	2.602.500.000
2008	25	373.588.780.000
2009	140	170.867.000.000
2010	41	22.852.700.000
Total	209	569.910.980.000

Source: data from the federal deposit insurance corporation

#### **Table1: Banks failures**

These failures banks system led to great uncertainty panic and large government bailouts of companies and banks (for example AIG has been nationalized) with the failure of the bank real sector (Federal Reserve short term interest rate is between 0 and 0.25 percent). (Fabozzi et al 636).

#### **3-3-2-3. Rating Agencies**

“Credits rating agencies are firms that offer judgments about the credit worthiness of bonds. They have been issued by various kinds of entities, such as corporations, governments and securitize of mortgage other debt obligations (national commission, 422)

The credit rating judgments come in the form of ratings scale: AAA-AA-A-BBB, BB. And so forth (also with pluses or minuses).

The credit ratings business is dominated by three agencies which are:

- Standard and poor's
- Moody's investor's service
- Fitch ratings

They have the official permission to carry out activities and are appointed as Nationally Recognized Statistical -Ratings Organizations (NRSOs). (National commission)

The credit rating agencies made a major contribution to the financial crisis when they made wrong evaluation for potential borrower and investor and difficulties began in the credit rating market converted from the business « investor pays » into the business “issuer pays” which of complexes securities stored to buy, or buying for ratings began, which in terms credit transparency led to competition to the bottom

### **3-3-3. the Credit Bubble**

The financial and economic crisis began with a credit bubble in the United States. Credit spreads considerably, meaning that the cost of borrowing to finance risky investments declined relative to safe assets such as U.S. Treasury securities. The most notable of these risky investments were high risk mortgages. (Claes 12)

The U.S. housing bubble was the most visible effect of the credit bubble but not the only one. Commercial real estate and leveraged loans were all increased by the surplus of reasonably priced credit. We can explain the credit bubble through: global capital flows, and monetary policy (National commission NP).

#### **3-3-3-1.Global Capital Flows**

The largest oil-producing nations built up large capital surpluses and looked to invest in the United States. Massive amounts of inexpensive capital flowed into the United States, making borrowing inexpensive. Americans used the cheap credit to make riskier investments than in the past.

Global imbalances are an essential cause of the crisis and large increases in capital flows into the U.S. economy encouraged significant increases in domestic lending, especially in high-risk mortgages. (Claes 19)

### 3-3-3-2.Monetary Policy

The Federal Reserve significantly affects the accessibility and price of capital.

This leads some to argue that the Fed contributed to the increased demand for risky investments by keeping interest rates too low for too long, this policy may have contributed to the credit bubble.

### 3-3-4. the Explosion of Debt and Lending Practices

Individuals and institutions have consumed large quantities of credit in the past decade, the credit grew constantly (see **table2**) that shows the rapid expansion of debt in U.S. economy.

years	cross domestic products on billion dollar	Total Credit Market On billion dollar	Nonfinancial Sector On billion dollar	Financial Sector On billion dollar
2000	<b>9951.5</b>	<b>26884.00</b>	<b>6512.60</b>	<b>8104.80</b>
2001	<b>10.286.2</b>	<b>28812.90</b>	<b>6908.10</b>	<b>8982.30</b>
2002	<b>10642.3</b>	<b>31026.10</b>	<b>7089.6</b>	<b>9805.60</b>
2003	<b>11142.1</b>	<b>34647.10</b>	<b>7338.00</b>	<b>10949.30</b>
2004	<b>11867.8</b>	<b>37817.70</b>	<b>7796.3</b>	<b>11935.60</b>
2005	<b>12638.4</b>	<b>41280.30</b>	<b>8471.1</b>	<b>12996.00</b>
2006	<b>13.398.9</b>	<b>45359.40</b>	<b>9363.2</b>	<b>14290.70</b>
2007	<b>14077.6</b>	<b>50051.2</b>	<b>10593.7</b>	<b>16207.50</b>
2008	<b>14441.4</b>	<b>52589.00</b>	<b>11164.8</b>	<b>17108.80</b>

Source: data from the Federal Reserve, flow and funds accounts of the united

**Table2:** the expansion of debt in the U.S

The table (2) shows that the expansion of debt in the U.S was much greater than the expansion of economic activity (as measured by increased GDP).

### **3-3-5. Speculation**

“The first aim of investor is, of course, to achieve as large a profit as possible on invested funds” (Thomas et al 27). In pursuing the above aim, investors are obliged to accept a certain risk. “risk is therefore the possibility that actual profit will be other expected (Thomas et al 27).

In the economy, higher profit is connected with greater risk; risk can be reducing by speeding of investments. Speculation is, therefore, also connected with investment decision or financial instruments, Dodd define speculation a financial actions that does not promise safety of the initial investment along with the return on the principal sum” (NP)

### **3-4. the Consequences of the Crisis**

The consequence of the financial crisis is noticeably evident to all. Stock markets crashed all over the world, with declines ranging from 35-40% over the past 12 to 18 months in most emerging markets. The crisis also has brought important restrictions to investment banking in the United States during the past decade, and a severe recession in most advanced countries and much slower growth in emerging markets. It was the worst economic recession since the 1930s (Salvatore 1).

#### **3-4-1. the Financial and Economic Consequences**

##### **3-4-1-1. the Economic Consequences**

The U.S economy went into a downward movement. The people made the wrong decisions for about a decade, based on the hypothesis that benefit prices would keep on going up. In the U.S., the collective saving rate fell to zero.

We can pose this question what was the point of saving? If you owned a house, its price was going to keep on going up. If you owned stocks, their value was going to keep on going up. So people stopped saving and many borrowed to finance consumption. The leverage ratios of households, of firms, and of institutions, all went up.

When there was the big fall in asset values, people found they were overleveraged and they had saved too little. That means that they stopped doing what they were doing before and started saving to pay down debt and make up their assets (Salvatore 2).

The problem is that because things had been out of hit for about a decade or more, it became very uncertain what things were worth. For example, stock prices have been incredibly unstable in both directions.

There was a dramatic drop in the prices by the beginning of crisis. Then the price went up about 30 percent in the next few months. It is very difficult for people to estimate how much their stock is worth in the long run. It wouldn't be surprising if the stock market went up 50 percent in the next few months. It also wouldn't be surprising if it went down 50 percent after these moves. (European commission 25)

Another example of price instability is commodities. It was only summer of 2008 that oil was trading at \$147 dollars a barrel, and then the price went down to around \$40 in a short space of time. For firms making investments it's also a significant problem to know what to do. In addition to the uncertainty about commodity prices, exchange rates have also been unstable. If you look back to the summer of 2008, the pound sterling was over \$2. Then it went down to \$1.40. The Euro was at \$1.60 then. It went down to about \$1.25 before rising back to about \$1.40. It is very difficult for anybody trying to make decisions because they don't know where prices are going to be in the future. In our outlook, this is what is frightening the global economy. Another One of the most negative effects of the 2008 financial crisis which is the high food prices all over the world, Even if the recent crisis originated in the US, the negative effects spread all over the world, mostly in developing and poor countries economies due to other unavoidable shocks. Those shocks are: High food prices and high expenses on substantive food. Finally the world trade has collapsed. And Gross domestic products decreased at a yearly rate of just about 6% in the fourth quarter of 2008 and first quarter of 2009, and unemployment rate increased to 10.1% by October 2009. (Allen, Carletti 10)

### **3-4-1-2. the Financial Impacts:**

Price is not the only problem. There are also problems in the financial system consist a major cause of the economic difficulties. The crisis began in the summer of 2007 with the compress in subprime mortgages. This caused a problem because these mortgages were seized by institutions that don't deal very well with asset price falls. When people hold stocks in a mutual fund for their retirement, it is not such a large problem if there is a significant descends because on normal the money is not needed for many years.

Many of them were in investment banks and to a large extent they were financed by rolling over short-term debt. In this case, as soon as there is a fall in prices there is a

significant problem, because lenders don't know whether they are going to be paid back. The problems started in securitized subprime mortgages but then they spread to many other parts of the financial system because of the interaction with the real economy.

These credit risk problems have led to a running away to quality with many people wanting to buy government securities. What the central banks have been doing is to try and deal with this desire for high grade securities. (Allen, Carletti 10-12)

The central banks have facilitated this with all these programs that they have where they allow financial institutions to swap a wide range of securities for Treasuries.

As a result the Federal Reserve's balance sheet has expanded from about \$800-\$900 billion before the start of the crisis to about \$2,000-\$2,500 billion afterwards (Allen, Carletti 10-12).

We conclude that there are two basic problems affect on the economic and the financial institutions of United States of America. The first is that people don't know the prices that should be guiding economic decisions. The second problem is the financial system has enormous problems and the two interact

### **3-4-2. the Political Effects:**

In the area of politics, the crisis contributed to a major electoral shift in the US, with the electorate in practically every region of the country shifting its vote clearly toward the Democratic presidential candidate, the Democratic candidate won a large majority of big city and "the election became a referendum on change that the candidate of change easily made a central part of his message" (Laura 1).

Many prominent economists and policy analysts have suddenly supported what amounts to the partial nationalization of major banks and a huge government motivation program. The dominant liberal ideology of the past thirty years appears to have lost its authority, and even some conservative intellectuals have neglected it. This shows that how the policymakers shifting their opinion due to the crisis and this way can be rectified and allow to the people who made the mistakes to take their losses. It is called taking personal responsibility for one's actions (Laura 1).

### 3-5. Policy Responses

The financial crisis led to emergency interventions in many national financial systems. In United States the Federal Reserve, Treasury, and Securities and Exchange Commission took several steps to intervene in the crisis. To stop the potential run on money market mutual funds, the Treasury also announced a new \$50 billion program to cover the investments; the federal deposit insurance corporation (FDIC) made the same program.

Sasi states that” Government and Federal Reserve have increased their level of intervention as the situation deteriorated. They have rescued financial institutions in order to avoid a total meltdown of financial markets; they have eased monetary policy, reducing interest rates in order to counter the effects of the credit crunch; and they have adopted fiscal measures designed to increase demand and employment, including government spending programs and tax cuts. In addition, they have launched a more or less coordinated reform of the international financial system. (7)

As the crisis developed into recession in US economy, economic plans were announced, and Bailouts of failing businesses were carried out.

The President of the United States, George W. Bush and his Secretary of Treasury, Henry Paulson proposed legislation for the government to purchase up to 700 billion dollar of “*troubled mortgages*” from financial firms in hopes of improving confidence in the mortgage-backed securities markets and the financial firms participating in it. This procedure was passed by the congress on October 3, 2008 and signed into law. So, the Federal Reserve announced plans to increase its swap facilities with foreign central banks from 290 billion dollar to 620 billion dollar. As of December 24, 2008, the Federal Reserve had used its autonomous authority to spend 1.2 trillion dollar on purchasing various financial assets and making emergency loans to address the financial crisis, above and beyond the 700 billion dollar authorized by Congress from the federal budget. This includes emergency loans to banks, credit card companies, and general businesses, temporary swaps of treasury bills for mortgage-backed securities, the sale of Bear Stearns, and the bailouts of American international group (AIG), Fannie Mae and Freddie Mac, And Citigroup. (Herszenhorn 12)

In beginning of 2009, the Obama administration declared a motivation plan to restore the economy with the intention to create or save more than 3.6 million jobs in two years. The charge of this preliminary recovery plan was estimated at 825 billion dollars (5.8% of GDP). The plan contained 365.5 billion dollars to be used up on major policy and reform

of the health system, 275 billion to be redistributed to households and firms, 94 billion to be offered to social assistance for the unemployed and families, 87 billion of direct assistance to states to help them finance health expenditures, and finally 13 billion spent to get better admission to digital technologies. The administration also attributed of 13.4 billion dollars aid to automobile manufacturers General Motors and Chrysler. These plans are meant to decrease further economic contraction. (Lothian 7-8)

Finally, we find most of literatures that we are reviewing on the policy responses, and as we mentioned above, initially the general reaction was that the crisis was due to a problem in the financial system, and in particular it was a result of the mortgage market in the U.S. As the crisis developed, there were other significant problems in the financial system. With the view that the problems are in the financial system, the solution is to solve those problems. As long as enough money is put into doing that, the financial system will start working again. Firms will start borrowing, consumers will start borrowing, everything will restore back quickly and the problem will be solved. The real economy will quickly go back to normal.

### **3-6. the spread of the financial crisis**

It is now well known that the recent crisis originated from the United States, spread to Europe and has now become a global issue. And then it transmitted from financial sector to the real economy in the last quarter of 2008. It spread around the world through various channels. Some of these include pressures on financial institutions around the world to raise capital and remove money to maintain liquidity.

It has made it difficult if not impossible for many countries to refinance themselves in international financial markets. The current crisis spread from developed countries to developing and transition economies through decline in global trade and a related collapse in primary commodity exports, on which many countries are dependent (Obayelu 1).

It also spread through a sharp change of the commodity prices which resulted into lower demand for raw materials; lower capital inflows; declining migrants' remittances flows and worsening of external debt indicators (Naudé 6).

We conclude that the present crisis has transmitted to and affect most the countries of the world through three main channels are: banking failures and reductions in domestic lending, reductions in export earnings, and reductions in financial flows between Countries

### **3-7. Conclusion**

We conclude that the financial crisis which started in the U.S. subprime mortgage market and then spread to the entire financial and real sectors of the U. S. economy , and from there to the rest of the world. The primary causes of the financial crisis are clear: huge and increasing totals of home mortgages were given to individuals and families that clearly could not have enough money to repay them.

These mortgages were made at changeable rates when rates were the lowest in those years.

When the interest rates were raised, they caused many homeowners to be unable to make their mortgage payments and default.

These subprime home mortgages were then repackaged into mortgage backed securities and sold to credit market investors.

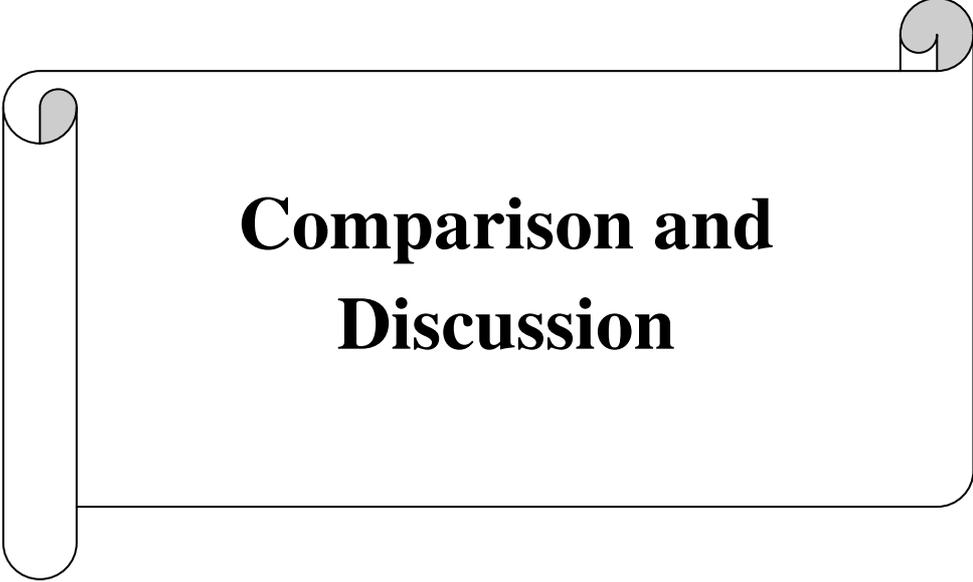
Rating agencies, such as Moody's and Standard & Poor's, gave some of these financial instruments various credit ratings, sometimes triple a ratings, depending on the tranche.

Although the problem of subprime mortgages greatly expanded during the presidency of George W. Bush, the practice started in 1999 during the Clinton Administration when Fannie Mae and Freddie Mac were pushed to grant home mortgages to people who clearly could not afford these mortgages in order to promote the American dream of owning a home.

However, the outcome of the current financial crisis is evidently, Stock markets crashed all over the world, it also has brought important restrictions to investment banking, and a severe recession in most advanced countries and much slower growth in emerging markets it was described by most of scholars and economists as the worst economic recession since the 1930s.

The United States did almost everything possible to avoid the recession, but their efforts may have only succeeded in preventing a deeper recession or depression; the government has taken a number of steps aimed at dealing with this crisis. Emergency legislation passed by the U.S. Congress in 2008 and early 2009 attempted to prevent the failure of major U.S. financial institutions, and to minimize the impact of financial institutions' weakness on ordinary business and consumer borrowing.

## Chapter four



# Comparison and Discussion

 **4-1 .the Duration and Depth of the Crises**

 **4-2. the Economic Indicators**

 **4-3. Similarities**

 **4-4. Differences**

 **4-5. Transmission of the Crises**

## Chapter Four: Comparison and Discussion

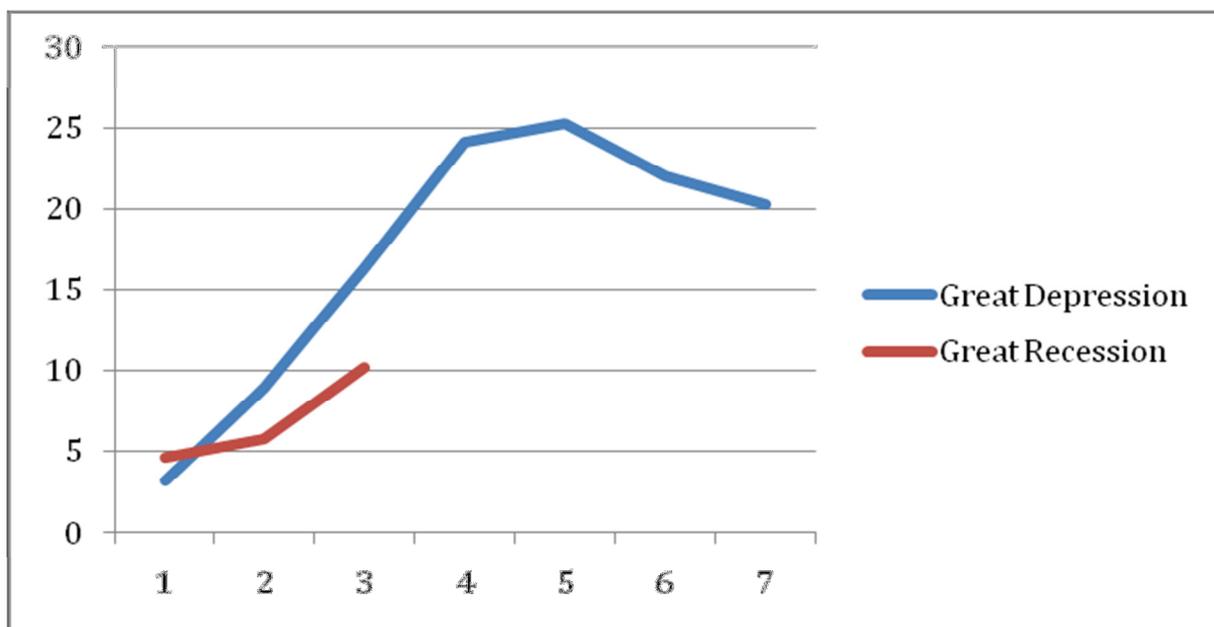
This chapter represents the core of our study in which we compare and discuss the similarities and differences between the 1930s depression and the present crisis concerning the geographical origins, causes, duration and impact, the economic indicators, as both depressions were global, the transmission mechanism and the channels propagating (circulated) the crisis across countries are analyzed. Then the similarities and differences in the policy responses then and now are charted.

### 4-1 .the Duration and Depth of the Crises

As we see in the chapter one, the financial crisis takes the form of recession or depression. Negative gross domestic products (GDP) growth lasting half of year or more is called a recession. And a prolonged recession was called a depression, with the observation that the long period of slow but not necessarily negative growth is called economic stagnation. Since these definitions the financial crisis and the great depression are both depressions; the length of the FC is extended from December 2007 until the end of 2010 (End of FC has not yet been announced officially), and the GD is extended from 1929 to 1939 this means that the GD is the longest one, as we review many literature and economic studies which demonstrated that the FC is longest one since the GD in the history of us economy. Marc states that “the median length of post-war recessions is 9.5 months” (1), nevertheless, the length of depression is related to what were its causes and other factors may be more important in prolonging it. **(See appendix3)**

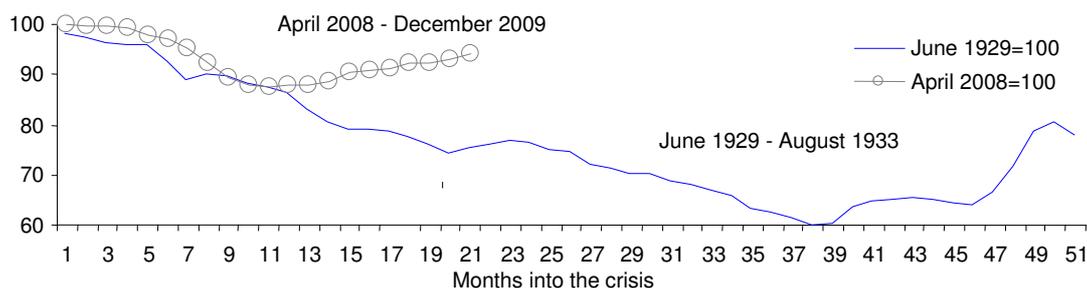
On the level of depth, most of the economists such as Milton Friedman and Anna Schwartz argue that the FC is divided into two different phases. During the first phase, which lasted for the first half of 2008, the recession was not deep as measured by the gross domestic product (GDP) or unemployment. It deepened in the third quarter of 2008, however, and remained deep through the first quarter of 2009. After a small further decline in the second quarter, the economy began to grow again in the third quarter of 2009. While The Great Depression included two recessions, with the first lasting three and half years and the second, beginning four years later, lasting another year. **(See Figure 1 and 2)**

which they show the length and depth of unemployment and GDP during the FC comparing to the GD



$t_0=1929(GD)/2007(FC)$  Source: U.S. Bureau of Labor Statistics

**Figure 1: U.S. unemployment, FC vs. GD**



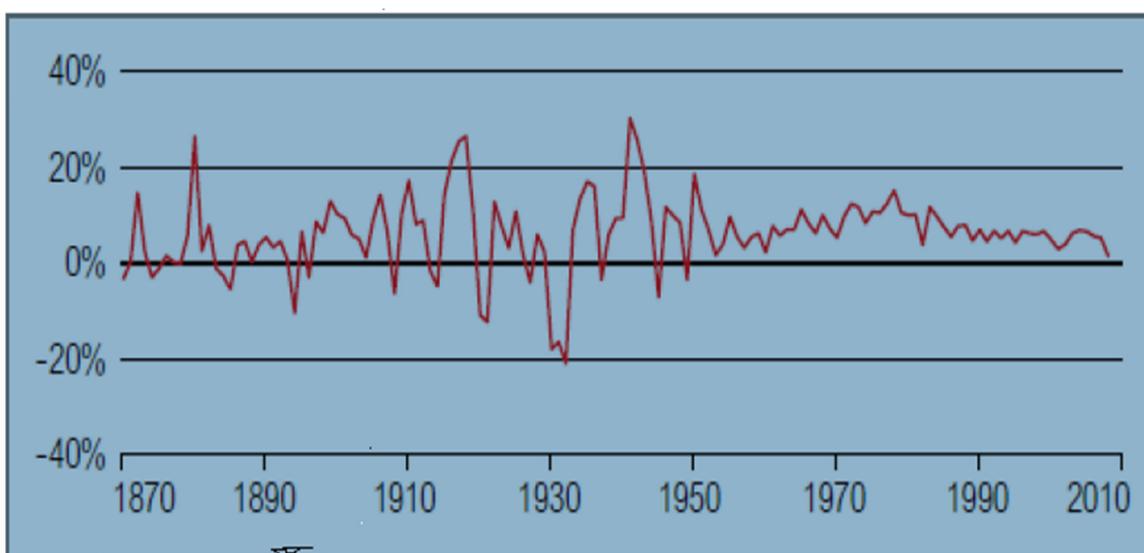
**Figure 2: The GDP during the Great Depression and the current crisis**

As you see in the figure1 and 2 The current recession started too recently to compare it to the entire period, but a comparison of data now and during the first year of the recession indicate that the current recession so far has much less in common with the Great Depression.

## 4-2. the Economic Indicators

In this part we try to compare the economic indicators during the two crises, this means that the crises are measured and analyzed by statistical and quantity economic data

When we compare the growth of gross national product (GNP), according to the forecast data of the IMF the two crises are not as similar as one may expect. As **figure 3** shows, the growth rate of US GNP was fallen by about 20 % year on year during the period 1930 to 1933, the recession in the period 2008 to 2010 is less marked given the drop of US GNP of 2,8% in 2009 and +0,5% growth in 2010 (Schiller, 33).



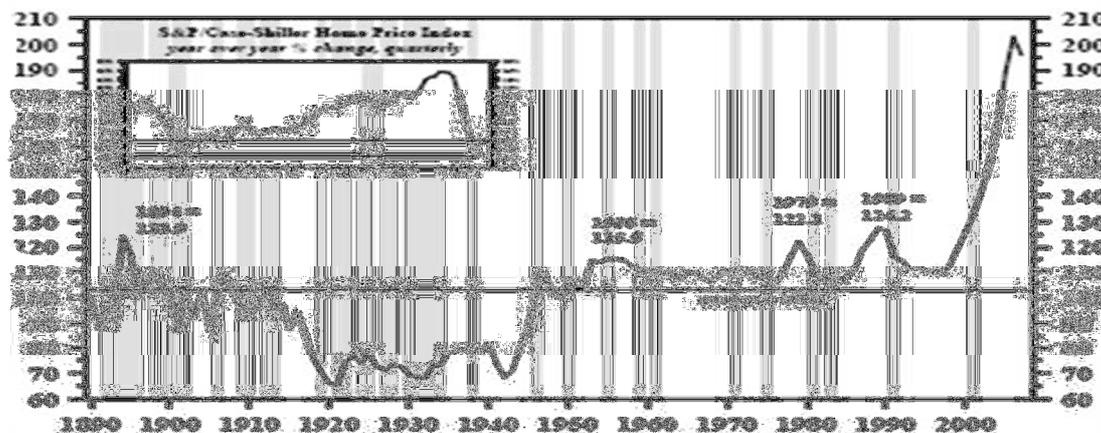
*Source:* (Robert J. Schiller 33).

**Figure 3: Gross national product of the US Changes to the previous year**

If we take growth of the prices, the 1930s were the period of a remarkable deflation (reduction), while this phenomenon has been successfully avoided nowadays. Nevertheless,, the inflation rate comes close to 0 in the US, but this is more a process of deflation due to falling energy and raw material prices than a complete deflationary process.

There is overvalued estate; the real estate market has been driven by number of innovation in real estate finance. Overvaluation in real estate prices implies Overvaluation

in real estate financial instruments: an implosion of real estate prices implies an implosion in those instruments. The **Figure4** makes it clear that the financial crisis overvaluation of real estate prices exceed the one during the GD.



Source: Robert J. Schiller

**Figure4:U.S real housing prices index.**

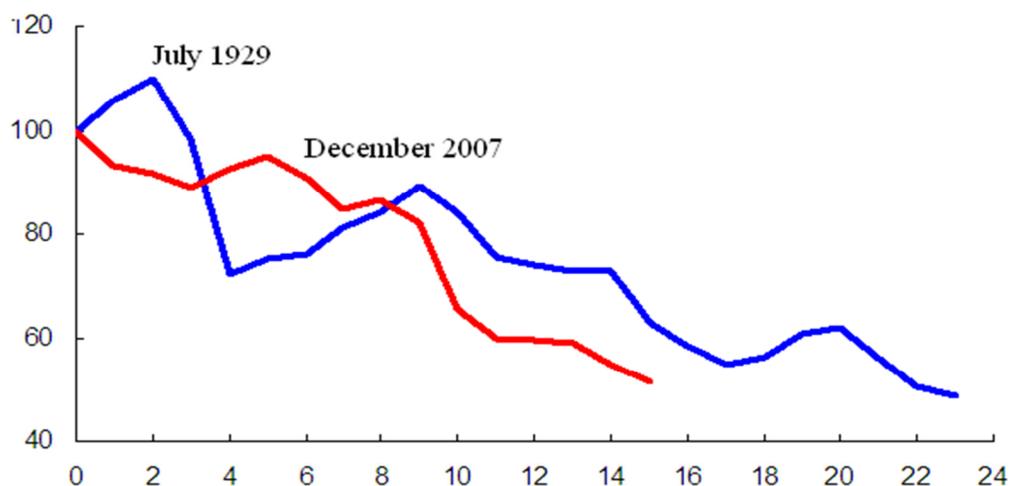
The economic surrounding in the 1930s was weaker than it was in 2000s. Germany was already in a recession before the Great Depression started and the prices in the biggest world economies (Great Britain, Germany and France) already stagnated. So there was a downward pressure on prices, which led to deflation during the 1930s.

On the other hand, in 2007 and 2008, most economies in the world experienced inflation in a range of 2 to 4 %. Banks failed, There were only a few banking runs during the financial Crisis because most governments gave full deposit insurance. But there were also a lot of banks and financial intermediaries, which had funding troubles, because they held or issued US mortgage securities and derivatives. The net merit of intermediaries (like Lehman Brothers) decreased after the default of a large number of mortgages. This led to huge losses for their Creditors and became an international problem, since there was a large cross-border links in short-term money markets. (Moseley 14-15)

So there a difference in the funding system during two crises noticeable but the result for the banking system was the same. The funding problems led to contraction. The method out was to sell assets which puts pressure on the prices of these assets. The holding of liquid assets increased while the holding of risky assets decreased. The falling

asset prices lowered the net worth of the borrowers and they lost their creditworthiness. (Federal Reserve NP)

If we compare financial variables in the US economy **figure 5**, both events are quite similar. The bond spread increased, while loan-to-deposit or loan-to-asset ratios declined as well as the asset prices in the same time.



Source :( federal reserve board)

**Figure 5: stock prices index**

### 4-3. Similarities

There are obvious similarities between the 1929-39 and 2007-2010 crises in terms of preliminary conditions and geographical origin. They both occurred after a continued boom, characterized by money and credit expansion, rising asset prices and high-running investor confidence. They were triggered in first instance by events in the United States, although the fundamental causes and imbalances were more complex and more global, and both spread internationally to profoundly affect the world economy.

In the two episodes, suffering in the financial sectors with worldwide repercussions (effects) was a key transmission channel to the real economy, alongside sharp contractions in world trade. And in each of the cases examined, the financial distress at the root of the crisis was followed by a deep recession in the real economy.

we have seen in the chapter two and three, The 1930s financial panic bears some resemblance to the recent crisis, this concerns the increase of credit and the rise in asset prices in the create to the crisis. This pattern is similar to the expansion of the 'shadow' banking system in recent years, and the important role of liquidity insufficiency at the peak of the panic.

Crisis	Crisis of 2007-2010	The Great Depression 1929-1939
Boom characteristics	Credit expansion, high leverage, asset price increases (especially real estate), flexible exchange rates	Credit growth, asset price increases, inflation, fixed exchange rate
Trigger event	Falling house prices and the failure of Lehman Brothers	Wall Street crash 1929
Policy response	Expansionary monetary and fiscal policy, bail-outs	Initial tightening of monetary policy, exchange rate depreciation

Collected by me from many sources cited.

**Table3: General characteristics of the crises.**

As we see in the table 3, a common feature is that the economic development follows a boom-bust pattern where financial and macroeconomic imbalances are built up during the boom. The economic development is on an unsustainable path and after a triggering event the boom turns into a bust and the economy rapidly deteriorates. The economic decline prompts policy makers to try to mitigate the effects of the crisis.

Due to the complex issues that led up to the Great Depression, and the simple fact that many historians and economists don't have the same opinion on its exact cause, we just look at simple comparison of the financial crisis. We try to collect most the common and similarities of the crises in the bellow elements:

#### **4-3-1.Speculation and the Growth of Credit**

1920's - Consumers were living large and over-spending on credit, and people were generally optimistic about the future. Business was booming as many workers enjoyed

better wages than they had in the past, and was able to purchase life's little luxuries such as cars, household appliances, and radios. (Marc 5-6)

Investing in stocks was seen a sure way to become rich, and even beginner investors borrowed, including mortgaging their homes, to fund their stock purchases. Buying stocks on margins of around 10% became an easy way to buy stock without the capital to do so.

2000's - Demand for homes rose along with property values, as millions of home buyers sought out financing that allowed them to purchase a home with very little, if any, cash saved. (Allen, Carletti 6). Adjustable-rate mortgages, interest-only mortgages, and sub-prime loans allowed people to buy without the cash, current income, or income documentation previously required by traditional lending standards. It was easy for anyone to own a home if they would just agree to the type of financing available to them (Allen, Carletti 6).

Many who were not ready for the long-term financial responsibility of home-ownership suddenly had the keys to the American dream in their hands. Owner-occupants and investors alike thought that buying a home under any terms would give a quick profit as real estate prices soared.

#### **4-3-2. Explosion of the Asset Bubbles.**

1925-1929 - businesses were over-booming, by putting profits into increased production beyond what was sustainable in the marketplace. Consumer demand for durable goods was high, but there was no way that consumers could use all that was being manufactured, causing an extra of product inventory. (Romer 3)

After the initial crash, widespread investor panic caused a massive sell-off, sending the stock market lower. The market experienced a short partial-recovery, and then continued in a downward trend over the next couple of years.

2005-2007 - Speculation drove the real estate market until the mortgage chaos came to

light, as droves of over-extended borrowers could no longer pay their rising adjustable-rate mortgage payments. In 2007, nearly 1.3 million homes were subject to foreclosure activity, up 79% from 2006. Troubled borrowers, who were facing foreclosure, saturated the market with homes for sale. As the supply exceeded the demand, property values declined.

#### **4-3-3. Borrowers Couldn't Pay Back the Debts**

1929-1933 - The Roaring Twenties yelled to stop when the stock market crashed. Banks had loaned heavily on stocks, and were unable to collect on those loans as over-extended investors' holdings lost significant value.

And as the recession deepened, farmers who had already been struggling for the past decade had even more difficulty in paying their mortgages, adding to banks' losses. (9,000 banks faced a lack of capital and a credit crisis) (Tims 133).

Bank runs (massive deposit withdrawals due to customers' widespread fear that the bank would fail) wiped out much of banks' remaining cash (Tims 133).

2006-2008 - Sub-prime mortgage lenders faced heavy losses and started closing their doors. Big banks, who had their hands in the sub-prime market, often by funding the sub-prime lenders, also suffered huge losses and faced bankruptcy or a sell-off. These mortgages with poor underwriting standards had been repackaged into complicated securities and sold to investors, and were beginning to look much riskier than once presumed.

#### **4-3-4. the Problems of Global Economic**

1933-1941 - Since the public held the belief that the strength of the economy was reflected by the performance of the stock market, its collapse caused an extended downturn as people cut spending, took their deposits from banks, and stopped investing in the stock market. With decreased consumer spending added to the difficulty in gaining credit, businesses closed their doors or cut production, forcing many workers to lose their jobs or take reduced hours. Though the stock market crash didn't cause the Great Depression, it certainly contributed to a massive loss of wealth among households and businesses that took over a decade for the world to recover from (Claes 27-28).

2008-.... - Foreclosures and defaults of home mortgages move stealthily (silently) in the financial industry which are acquired or go bankrupt, the government-sponsored enterprises (GSEs) that buy or back half of the nation's mortgages are seized by the U.S. government, businesses affected by the ensuing credit crunch close their doors, unemployment is at 6.1%, and consumers who have gotten used to the home-equity line of credit no longer have funding for their over-spending. And the stock market's turmoil reflects the fear and panic across the world (Claes 27-28).

#### **4-3-5. Republican Then Democrats**

In the realm of politics both crises were began in the era of the republicans and ended under democrats government this means that the crises have influenced on the American people believes and they are shifting their opinion to change pattern of the government in order to rescue and bail out their economy from capitalism.

#### **4-4. Differences**

As we mentioned above the current crisis started rather gradually with a decline in house prices which over time affected the value of many financial instruments. The means to the financial turmoil and the consequent sharp fall in global economic activity was the fall of Lehman Brothers.

Throughout the current crisis the policy response has been exceptional. Monetary authorities cut interest rates aggressively, to almost zero in many cases. Furthermore, they provided a variety of forms of liquidity support and in some cases purchased government debt to hold long term rates low. Governments introduced a range of measures, including guarantees and capital injections, to secure the financial companies. Moreover, the fiscal policy response was extremely strong on in general global basis, although very different between countries depending on among other things the size of the downturn and the initial fiscal policy position in each country.

The most important features of current crisis have been the importance and the deep impact of the financial sector, the complexity of both new financial instruments and some financial companies, and exceptional speed and depth of the downturn. Although some countries were not seriously affected by the initial stages of the financial crisis, almost all countries were severely affected by the second round effects on the real economy; unless

these features which concern the FC, there are significant differences in the level of financial sector, we have:

### **1. A lack of a gold standard**

The U.S currency (dollar) was devalued relative to gold during the Great Depression, so there were attempts to get around restrictions on the money supply, but eventually the gold standard was not fully abolished until 1971, and so the Federal Reserve was a spot more restricted in how much money it could create. This restriction does not exist today.

### **2. American debt during the Great Depression isn't as today.**

Credit cards are a rather new creation, and the national debt and deficit spending were significantly lower.

### **3. America's debt is owned largely by foreigners.**

This introduces the possibility of economic conflict; foreign debt owners can devalue the dollar by selling Treasury bonds as well as dollar reserves.

### **4. The US dollar is the world's reserve currency.**

This helps the United States in a way, as central banks have been inflating their money supply along with the US dollar to maintain equivalence of sorts. In this way, the US gets to export its inflation.

#### 4-4-1. Parallel Facts during the Crises

The following parallel facts in table4 which we use to demonstrate the differences in the size of economic situation during the crises which are updated and gathered by Housing Predictor researchers.

Description	FC	GD
U.S. Population	304 million	1930 - 122 million
Homes in U.S.	129 million	20.7 million
Home Ownership Rates	66.7% down from 69.1% at the height of the boom	48%
Homes in default at least 90 days	9.2% of all U.S. residential mortgages	43.8% at the height
Homes Foreclosed	4.2 Million already foreclosed A total of 10 million forecast through 2012	At the height of the Great Depression roughly 10% entered the foreclosure process. At the end of 1932 some 2.4 million mortgages were in foreclosure. Millions were foreclosed but the final count could not be found by researchers, who combed old economic journals and newspapers in thorough efforts to tabulate the number.
Real Estate Wealth	\$17.5 trillion estimated December 2008	\$89.7 billion
Home Mortgage Debt	\$12.2 trillion - 2008	\$16.3 billion

Source: (Tyler 1)

#### Table4: Parallel Facts

As the facts in the table4 show the size of the current economic crisis is much larger in scale than the Great Depression in the volume of foreclosures and dollars, increases in population, economic growth and the record high number of homeowners need to be taken into account.(Tyler 1-2)

#### **4-4-2. differences of the institutions during the GD and of the FC**

There are several important differences in the structure of institutions between the two crises.

First, during the first three years of the Great Depression, the US was on the gold standard. During those years, the maintenance of a fixed equality with gold has a collision with the use of monetary policy to achieve internal balance. The US abandoned the gold standard only after Roosevelt was elected president during the first half of 1933. Such restriction was present at the FC. In fact the dollar depreciated substantially between summer 2007 and summer 2008 in line with the expansionary policy of the Fed reaching a peak of \$ 1.6 to the Euro in July of that year. It appreciated again, reaching a trough of \$ 1.24 to the Euro in November 2008 due to the collapse of Lehman Brothers and other investment banks, and continued to fluctuate in a relatively wide range till the writing of this article in July 2009 (Federal Reserve NP).

Second, deposit insurance did not exist on the beginning of GD but was established in order to fix the US banking system on the FC. Indeed, Deposit insurance became a permanent fixture of US monetary institutions following the massive banking failures of the thirties. Deposit insurance and the Federal Deposit Insurance Corporation (FDIC) were created as part of the Banking Act of 1933. During the 1930-1933 periods, many of the banking failures triggered by bank runs. Due to deposit insurance there weren't runs on the banks by depositors during the FC. However, during the FC there were runs by financial institutions on other financial institutions (Federal Reserve NP).

Third, there were no bank capital requirements during the GD. By contrast, under the Basel agreements banks were subject to capital requirements on during the FC.

Fourth, the orders of the Federal Government on the two crises and the associated fiscal institutions were completely different. As we see before On the Great Depression, in 1929, the share of federal taxes in Gross Domestic Product (GDP) was less than 4 percent. Unless the FC, in 2007 and 2008, it was around 18 percent. Those differences in initial conditions facilitated the quick operation of fiscal stimulus and bailout packages during the recent crisis (Federal Reserve NP).

Fifth, In the GD the economic institutions for cooperation were weak and ineffective compared to today. The League of Nations, founded in 1919, and the Bank for International Settlements (BIS), founded in 1930, played no role in dealing with the economic crisis. (Albers, and Lars 8).

The lack of international mutual aid and international institutions stands in severe contrast to present conditions in the 1930s. Institutions such as the World Trade Organization (WTO), the International Monetary Fund (IMF), the Organization for Economic Co-operation and Development (OECD), the G20 and the European Union are involved in the design of policy measures to reduce the impact of the present crisis (Albers and Lars 8).

Today's international institutions facilitate coordination by reporting developments and policies across the world in a comparable way. Now policy-makers meet regularly to discuss and to form consensus views about appropriate measures, at the same time learning to understand economic interdependence and to reach coordination. Moreover, in response to the crisis, the international community is also undertaking a repair of the global economic and financial governance in order to minimize the risk of new crises in the future (Albers and Lars 8).

#### **4-4-3. A comparison of policy responses**

The differences between the responses of fiscal and of monetary policies to the FC and to the GD are enormous in more than one dimension.

Under Hoover, The federal budget had a small surplus during 1930, a small deficit in 1931 and a deficit of 4 percent of GDP in 1932. The volume of the increase in 1932 was due to a decrease in tax collections caused by the sharp contraction in income rather than to autonomous fiscal policy. Although the deficit share in GDP increased under Roosevelt, reaching a peak of 5.9 percent in 1934, it weakens in comparison to the degree of fiscal expansion during the current crisis. (Romer 3) In spite of his image as a practical economist, Roosevelt also displayed concern for fiscal discipline.

As a consequence, during the second part of the thirties the budget deficit, leading to a temporary recession in 1938.

The difference with the fiscal policy response during the FC cannot be emphasized. Following the demise of Lehman Brothers in September 2008, Congress and the Bush administration committed \$ 700 billion to restore confidence in the US financial system by taking stakes in many US banks and by total buying of troubled assets. The Emergency

Economic Stabilization Act of October 3, 2009 (Troubled Assets Relief Program or TARP) empowered the Treasury Department to spend this huge amount in order to clean banks and other financial institutions from so-called toxic assets and to recapitalize them by taking equity positions in the US banking system. (Salvadore 2)

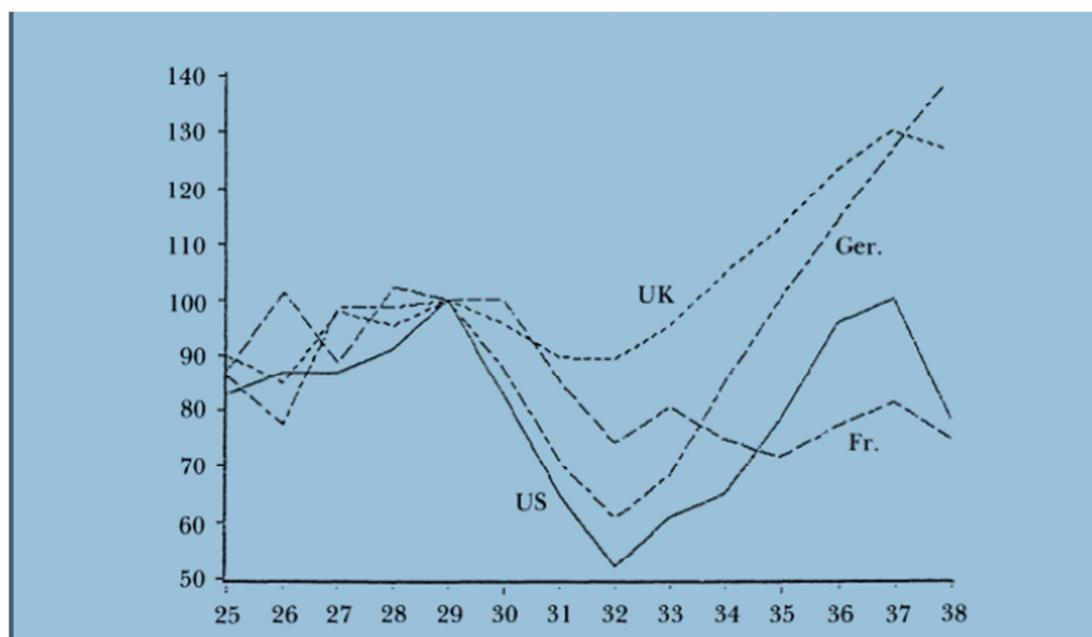
This was soon followed by a \$ 787 billion fiscal stimulus package for the rest of the economy under Barack Obama. This package, known as the American Recovery and Reinvestment Act of 2009 (ARRA), quickly went through Congress, and was signed into law by Obama on February 17, 2009. (Herszenhorn 12)

The international uniform reply to the financial Crisis was and is very important for the recuperation and is a main difference to the situation during the Great Depression where was no international organization like the IMF nowadays. International cooperation is a means for struggle the crisis and a rapid recovery of the world economy. In this respect also the large increase of the fund of the International Monetary Fund for preventing countries to default on their outside debt and to stabilize financial systems in emerging markets are very important. The G-20 evolved as the main forum for international cooperation and crisis management. This time political tensions were avoided and a growing protectionism (like the Smoot-Hawley Tariff Act in 1930) was not taken into consideration as a solution for countries. (Temin 90)

#### **4-5. Transmission of the Crises**

As we see in chapter two the main channel of transmission of the Great Depression was the Gold Standard where the fixed exchange rates made economies subject for negative demand shocks and therefore the economic system was shocked.

As a consequence, nations who had a balance of payments deficit had to export gold to keep the exchange rate fixed, while nations with a positive balance of payments could import it. As the **figure6** shows that all major economies, a downward trend could be registered, but the negative growth rates differ from country to country (Albers, Lars 8).

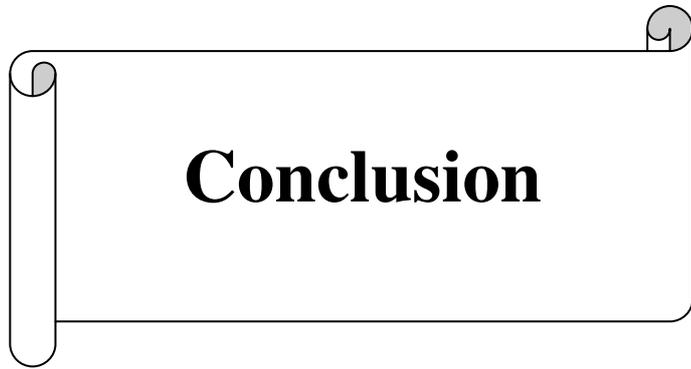


Source: (Temin 90)

### Figure6: the growth rates

The UK recovered most rapidly from the Great Depression, because the UK was the first country to abolish the gold standard. The recessions in the US and Germany were much more pronounced.

The globalization of the financial market and the international trade made a regional crisis to a global crisis within days. So the transmission can be seen as a result of an intensive international connection in the financial market.



## Conclusion

Our issue is a comparative study between the great depression of the (1929-1939) and the financial crisis (2007-2010) is examined with the assumption that there are significant similarities between the two crises.

We review several literatures for this purpose which is based on theoretical and historical method, and sometimes we deal with statistics data analysis because the nature of the topic is required these kinds of economic data such as tables, charts, and diagrams.

We find most of the literature dealing with the economic and the financial crises emphasized on the economic theories, the economists and scholars of the great depression have in the beginning interpreted it with monetary theory which takes the money as factor of stress on the later stage of the great depression and the Keynesians in the contrary concentrate on the probable importance of non monetary factors in the initial downturn such as employs, services, interests. Then the literature has moved towards a comparative approach (for example, Bernanke, Temin, Eichengreen, And Hamilton), the research on the depression is conducted by studying, and comparing two or more countries. Since the financial crisis which revealed to the scholars and the economists the past hard time, and seems resembling and comparable with what happened in thirties.

We pose the question of whether the financial crisis is the same as the great depression or different?

We assume that both the GD and FC caused major financial, economical and social damage. Both crises caused a great deal of suffering; people are experiencing the effects of a recession as deep and painful as the people of 1930s did. Jobs are lost, unemployment reached record level; people are lost their houses and cars. They are again witnessing growing poverty, and companies are again trying to obtain orders and to make payments for employees.

Families are fraught to pay their bills. Economists are terrified that they could return into a second great depression. Governments all over the world are struggling with crisis; they are trying with economic policy to restore the economy and to moderate the consequences of the financial crisis.

The financial crisis is there for the most crises to have befallen (come to pass) the world since the great depression. With the subprime mortgage crisis, the world has experienced a serious decline this means that, for the first time since the great depression; there are (serious) deficit in collective demand, and the consequences of the FC are global (as were the consequences of the GP).

The Financial Crisis as well as the Great Depression is both originated in the U.S. The FC has been marked by a “housing” or housing crisis the last similar major housing crisis in the U.S took place in 1925-1933, with the bursting of the “housing bubble” and it was not until later that it spread to the stock market (Shiller 102-103). Nevertheless, the asset bubble then the stock market in GD and the housing bubble now is therefore the next common point. The stock market in 1930s was described as an eager of speculation just like the housing market now. Just as the GD did back then, the FC has once again pointed out all the weaknesses of the financial institutions and the entire financial system. The loss of the confidence in the financial institutions during the GD and FC was another common point, the government intervention was needed, and the U.S government is again trying to save the financial system. Both crises were thus marked by the government intervention, which is the next.

The economic policy or policy response in the 1930 brought several institutional innovations in both private and public sectors this does not refer only to New Deal (see chapter two, policy response). How has the American government responded to FC (under both bush and the Obama administration)? Response by the government is disappointed by limited to that in the 1930s (Shiller 19).

All this and much more allow the conclusion that there are many similarities between the great depression and the financial crisis in the preliminary conditions and geographical origin as well as there are significant differences in the structure of institutions and in the international surrounding, and in depth and the consequence.

Therefore the phenomenon of the financial crisis is a natural crisis unavoidable in the most integrated economies and the policy response is only means to reduce their consequences and to prevent their transmission. But in our opinion, the significant thing which can be compared is that in 1929 and today, there was an extraordinary boom before the crises, which then led to a complete slump of the economy, so it should become major research efforts in the future in the economy.

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## Glossary

**Adam Smith:** (1723-1790), Scottish philosopher and economist, whose celebrated treatise *An Inquiry into the Nature and Causes of the Wealth of Nations* was the first serious attempt to study the nature of capital and the historical development of industry and commerce among European nations

**Asset prices:** The value of the property that is owned by a person or organization

**Brokers:** Person acting for another in business, as in negotiating contracts, purchases, or sales in return for a fee or commission.

**Burst:** To split or break apart suddenly and violently because of excess internal pressure

**Business Cycles:** Term used by economists to designate a periodic increase and decrease in an economy's production and employment. Economists study business cycles because they have a significant impact on all aspects of an economy

**Business fluctuations:** Variation, vacillation, rise and fall, oscillation, flux, instability, changeability, variability.

**Capital Flows:** in economics, capital, capital goods, or real capital is the manifestation of production, used to produce goods or services, that is not itself significantly consumed (though it may depreciate in the production process), while **a flow** refers to the total value of transactions (sales or purchases, incomes or expenditures) during an accounting period

**Capitalism (Free-enterprise):** The term capitalism was first introduced in the mid-19th century by Karl Marx, the founder of communism. Free enterprise and market system are terms also frequently employed to describe modern non-Communist economies. Sometimes the term mixed economy is used to designate the kind of economic system most often found in Western nations

**Contractionary monetary policy:** It is monetary policy that seeks to reduce the size of the money supply. In most nations, monetary policy is controlled by either a central bank or a finance ministry.

**Credit crunch:** refers to a reduction in the available supply of credit and is a supply-side phenomenon.

**Credit default swap:** is a credit derivative contract between two parties, the buyer and the seller, where the buyer pays some kind of premium to the seller and in return receives a sum of money from the seller if a specified event occurs.

**Default:** failure to finish or fulfill an obligation

**Deposit insurance:** that prevents runs by guaranteeing depositors against losses if their bank or other depository institution should fail

**Derivatives:** are financial contracts or instruments whose values are derived from the value of something else known as underlying.

**Economic boom and bust:** a recurrent cycle of growth, decline, recession, and recovery in the economic activity of a capitalist country.

**Federal Reserve:** Federal Reserve System, central banking system of the United States, popularly called the Fed. A central bank serves as the banker to both the banking community and the government; it also issues the national currency, conducts monetary policy, and plays a major role in the supervision and regulation of banks and bank holding companies

**Financial capital:** It refer to money used by entrepreneurs and businesses to buy what they need to make their products or provide their services or to that sector of the economy based on its operation, i.e. retail, corporate, investment banking, etc

**Financial shock:** In economics a shock is an unexpected or unpredictable event that affects an economy, either positively or negatively.

**Fixed Asset:** Possession or valuable belonging to a business organization that is used over a long period of time. Examples of physical fixed assets include factories, offices, machinery, trucks, company cars, and office equipment.

**Foreclosure:** Legal process in which a person who has made a mortgage (the mortgagor) in order to borrow money loses his or her rights to the mortgaged property. A mortgage represents security, generally real estate, for money loaned. The mortgagor retains possession of the property, and foreclosure is affected only if the mortgagor fails to make payment of the debt at the proper time or fails to meet other obligations specified in the bond or mortgage

**Gold standard:** Gold Standard, in economics, monetary system wherein all forms of legal tender may be converted, on demand, into fixed quantities of fine gold, as defined by law. Until the 19th century, most countries of the world maintained a bimetallic monetary system

**Gross Domestic Product (GDP):** the total value of goods and services produced in a country over a period of time. GDP measures a country's economic activity regardless of who owns the productive assets in that country. For example, the output of United States-owned companies based in Australia is considered part of Australia's GDP rather than part

of the U.S. GDP. Most countries now consider GDP to be the best measure of economic activity.

**Housing bubble:** (Or a **real estate bubble** or **property bubble** for residential markets) is a type of economic bubble that occurs periodically in local or global real estate markets. It is characterized by rapid increases in valuations of real property such as housing until they reach unsustainable levels relative to incomes and other economic elements, followed by a slide in price levels over a number of years.

**Insolvency of debtors:** state of being unable to meet debts and to discharge liabilities

**Liberal economic order:** Beginning in the 18th century many societies around the world were greatly influenced by the rise of liberalism, a school of thought that promoted individual freedom and social progress. Political philosophers such as Adam Smith and John Stuart Mill of Britain argued that society and the economy flourished best when governed least. American economist and Nobel laureate Milton Friedman is one of the 20th century's most prominent advocates of this liberal tradition, although in modern terminology he is often labeled a conservative.

**Macroeconomics:** (From Greek prefix "macro (o)-" meaning "large" + "economics") is a branch of economics dealing with the performance, structure, behavior, and decision-making of the entire economy. This includes a national, regional, or global economy. With microeconomics, macroeconomics is one of the two most general fields in economic services

**Market risk:** refers to a loss in the fair market value of loans, debt securities, and derivative securities because of general economic factors (e.g., a general increase in interest rates will reduce the market value of a bank's fixed-rate debt securities).

**Microeconomics:** (From Greek prefix micro- meaning "small" + "economics") is a branch of economics that studies the behavior of how the individual modern household and firms make decisions to allocate limited resources. Typically, it applies to markets where goods or services are being bought and sold. Microeconomics examines how these decisions and behaviors affect the supply and demand for goods and services, which determines prices, and how prices, in turn, determine the quantity supplied and quantity demanded of goods

**Money supply (money stock):** In economics, it is the total amount of money available in an economy at a particular point in time. There are several ways to define "money," but standard measures usually include currency in circulation and demand deposits

**Monopolies:** economic situation in which only a single seller or producer supplies a commodity or a service. For a monopoly to be effective there must be no practical substitutes for the product or service sold, and no serious threat of the entry of a competitor into the market. This enables the seller to control the price

**Mortgages:** legal instrument that pledges a house or other real estate as security for repayment of a loan. By providing a guarantee that the loan will be paid back, a mortgage enables a person to buy property without having the funds to pay for it outright. If the borrower fails to repay the loan, the lender may foreclose on the property—that is, force the sale of the house to recover the amount of the loan

**New classical macroeconomics:** Sometimes simply called new classical economics, is a school of thought in macroeconomics that builds its analysis entirely on a neoclassical framework. Macroeconomic model is built in analogy to the actions of individual agents, whose behavior is modeled in microeconomics.

**Prosperity:** Period of heightened economic activity in which a society has a feeling of progress and well-being.

**Rate of interest:** Interest is usually paid only on the principal, that is, on the sum of money loaned, and it is called simple interest. In some cases, interest is paid not only on the principal but also on the cumulative total of past interest payments. This procedure is known as compounding the interest, and the amount so paid is called compound interest. The rate of interest is expressed as a percentage of the principal paid for its use for a given time, usually a year. Thus, a loan of \$100 at 10 percent per annum earns interest of \$10 a year.

**Real Estate:** In broad definition, land and everything made permanently a part thereof, and the nature and extent of one's interest therein. In law, the word real, as it relates to property, means land as distinguished from personal property; and estate is defined as the interest one has in property.

**Securitize:** to assure payment of something by giving a pledge or collateral.

**Shares:** finance part of company's stock: any of the equal, usually small, parts into which a company's capital stock is divided 100 shares of General Motors.

**Smoot-Hawley Tariff Act:** it was an act signed into law on June 17, 1930, that raised U.S. tariffs on over 20,000 imported goods to record levels. After it was passed, many countries reacted with their own increased tariffs on U.S. goods, and American exports and imports were reduced by more than half.

**Stock exchange prices:** American Stock Exchange: Along with the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX) is one of the largest exchanges in the United States. Located in New York City, AMEX trades in the stocks, bonds, and other financial instruments of more than 700 U.S. companies, as well as international companies

**Stock:** It refers to the value of an asset at a balance date (or point in time).

**Speculation:** Speculation, buying and selling such items as securities, commodities, or land in the hope of sudden increases in their value, and often with the risk of sudden decline

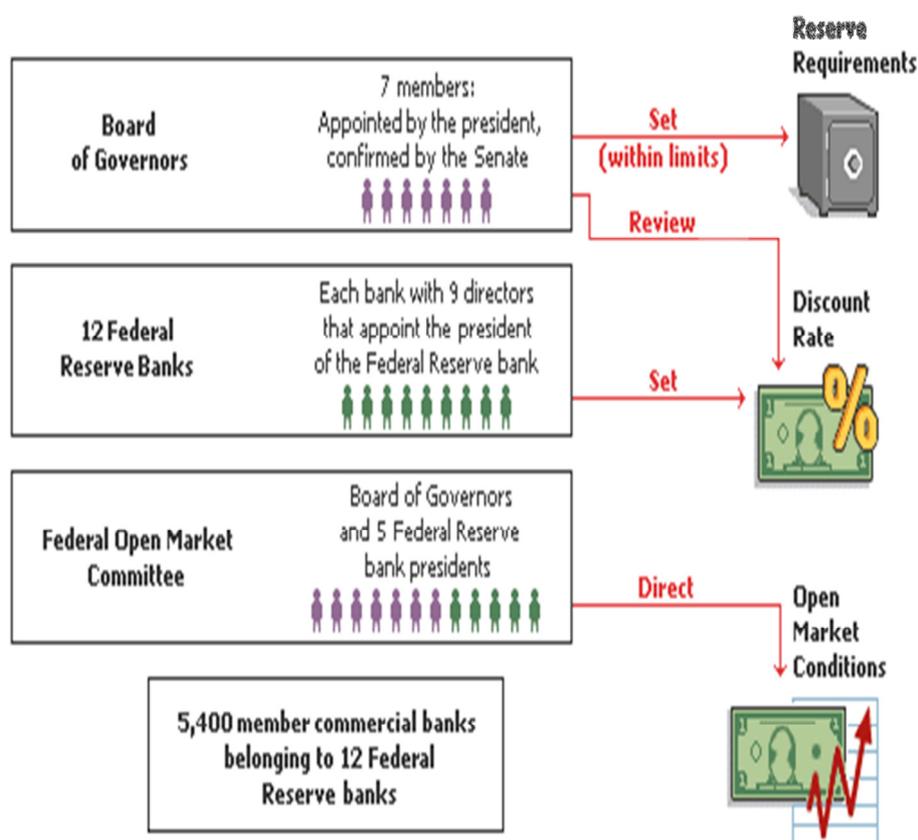
**Subprime loans:** loans given to borrowers who are considered more risky, or less likely to be able to make their loan payments vis-à-vis high quality borrowers.

**Transaction:** An instance of doing business of some kind, e.g., a purchase made in a shop or a withdrawal of funds from a bank account

**Underlying:** can be an asset such as commodities, equities or stocks, residential mortgages, loans, etc.; or an index such as price index, etc.; or other items such as weather conditions on which a derivative is based

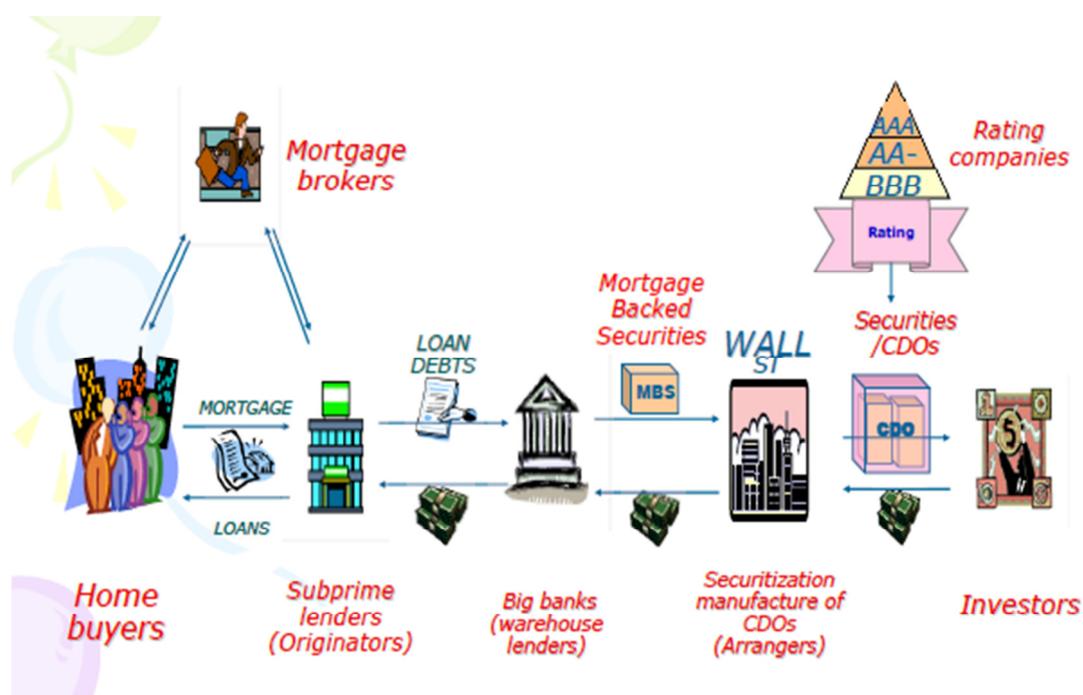
## Appendices

### Appendix1: Federal Reserve System



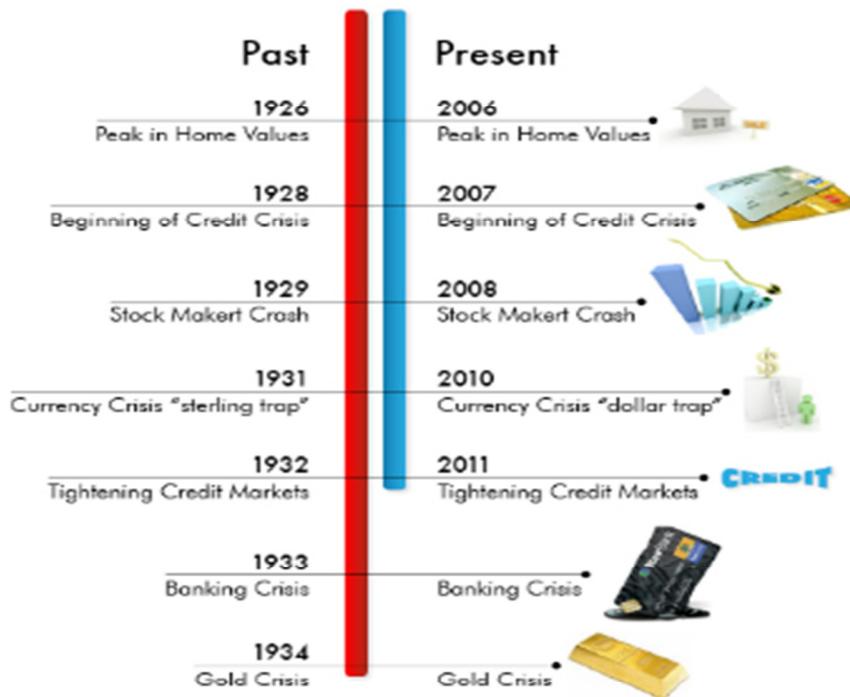
The Federal Reserve Act of 1913 established a 7-member Board of Governors, 12 Federal Reserve banks, and a 12-member Federal Open Market Committee. The Board of Governors sets the reserve requirements for the 5,400 commercial banks that belong to the 12 Federal Reserve banks and also reviews the discount rate by the Federal Reserve banks. The Federal Open Market Committee directs the sale and purchase of government securities.

## Appendix2: the mortgage origination process



Source: “Global Economic Update: Financial Stress and Macro Outlook”, Cheng-Mount Cheng.

### Appendix3: comparison of the duration between the GD vs. FC



Our present day Global Financial Crisis is Phase 4: Deflation of the World Monetary Cycle. The last Phase 4 was the Great Depression. Length of the Great Depression was 60 months ( Month 1 = January, 1929; month 60 = December, 1933).

The beginning of the Financial Crisis was December 2007 and is currently in progress. There were four macroeconomic shocks in the Great Depression. Each shock is color-coded. Shocks occurred in:

1. October 1929, **credit shock**;
2. September 1931, **currency shock**;
3. March 1933, **banking shock**;
4. April 1933, **gold shock**.

The Global Financial Crisis has experienced shock 1, the **credit shock**, and is approaching shock 2, the **currency shock**.