From Great Depression to Great Financial Crisis:

 A Comparative Analysis

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*We have involved ourselves in a colossal muddle, having blundered in the control of our delicate machine, the working of which we do not understand. The result is that our possibilities of wealth may run to waste for a time- perhaps a long time*.

 -John Maynard Keynes

 Excerpt from “***the*** ***Great Slump of 1930”***

Many scholars of history would agree that an underlying objective of studying the events of the past is to gain an understanding of how to apply the lessons they offer to future circumstances. However, there are myriad perspectives and ideologies that can be utilized as a lens for observing and interpreting history. An unwillingness to consider contradictory explanations or a flawed understanding of how favorable and undesirable outcomes manifest themselves can, at times, cause history to repeat itself. Never has this been more apparent than in the recent financial crisis of 2008. Parallels between this twenty-first century crisis and the Great Depression of the interwar period in the 1930s have been examined by a number of economists. The consensus of many is that the financial crisis of 2008 indicates some of the historical economic lessons of the Great Depression were either ignored or forgotten by contemporary experts. However, it is the central contention of this comparative analysis that without the previous experiences of the Great Depression, the impact and duration of the 2008 crisis could have been much more severe.

By evaluating the nature of these two crises, this report specifically seeks to establish that although their similarities imply an inability or unwillingness by U.S. policymakers to learn from the past, the Wall Street Crash of 1929 (the event most commonly associated with the beginning of the Great Depression) did provide future U.S. strategists with a better understanding of how to get the national economy back on solid ground once it had been derailed. In comparing the similarities and differences between these two events, the forthcoming analysis emphasizes the following:

1) Legislation aimed at strengthening private interest groups (be they industrial, technological or financial) can have negative spillover effects regardless whether it coincides with government objectives (isolationism, financial deregulation, etc.).

2) The use of increasingly complex lending instruments (like securities, derivatives, etc.) may signal attempts by the financial sector at mitigating government regulation.

3) Despite differences in the international political environments of the Depression era and 2008, experts in both time periods seem to have underestimated the interconnectedness of the global economy.

4) Globalization played a central role in ensuring the 2008 financial crisis became an international one. The common theme uniting these four points is that, despite the possibility that current policymakers are no more aware of the factors leading to financial crises than their predecessors, the lessons of the Great Depression were useful in dealing with the 2008 crisis once it had occurred.

Financial crises are not simply a contemporary phenomenon; their history potentially pre-dates the study of economics itself. Generally speaking, a review of past international economic crises suggests the origins of many monetary disturbances can be linked to the creation of speculative “bubbles”. These so-called bubbles occur when certain commodities become overvalued in the economic marketplace. This type of speculative investing is often associated with an increased reliance on credit, as eager investors seek to claim themselves a piece of the overvalued “pie”. Also common to the birth of many bubbles is an environment of relaxed or unregulated financial oversight by states.

 The 2008 financial crisis resulted after the speculative bubble created by the domestic U.S. real estate market began to fall in on itself. Some of the problems leading to this recent crisis can be linked to an increased atmosphere of governmental deregulation and downsizing that became more popular in the U.S. during the Carter and Reagan presidencies of the 1980s. This time period also coincides with the dissolution of the U.S.S.R.; an event which may have caused many experts to assert the victory of the U.S. and free market capitalism over Soviet-style economic ideologies.

Another aspect of the global economic environment which helped to fuel the 2008 crisis was the ending of the capital controls that nations had imposed upon themselves as a protective measure to help rebuild their economies after the destruction of World War II. Indeed, by the 1980s, the International Monetary Fund (IMF) was requiring nations to discontinue their policies of capital control as a condition of membership.

These capital controls had been advocated by English economist John Maynard Keynes as a way for states to rebuild their economies after World War II. Their removal by many nations in the 1980s had the effect of exposing states to greater economic uncertainty due to an increased involvement in the global economy. This had the effect of increasing the domestic reliance some nations had on international markets by compounding the connections between states.

Additionally, the correlations between widespread financial liberalization and the concept of globalization are hard to deny. Eliminating barriers to outside investment and limitations on flows of capital leaving their borders increased the interconnectedness of the global economy. Globalization also has important technological implications, allowing for the diffusion of scientific and manufacturing knowledge to areas not traditionally considered worthy of investment. Although a look at the progress of economic development amongst states suggests improvements have occurred at an uneven rate, the fact remains that the globalization process has helped to promote industrialization and investment in many underdeveloped areas.

Regardless, greater interconnectedness and economic cooperation amongst states can be a double-edged sword. Greater globalization of economic markets creates increased risk that policy failures in one nation will spillover and have similarly negative effects (externalities) on others. This was a major factor which contributed to the 2008 U.S. financial crisis becoming an international economic recession.

 What caused U.S. economic policy to deviate so much from the views espoused by Keynes? The theoretical models that seem to be in contradiction with Keynes belong to a tradition of economic reasoning labeled market fundamentalism. This tradition perhaps first came of age in the monetarist perspective of economics championed by Milton Friedman of the University of Chicago back in the 1950s. From the viewpoint of Friedman and his fellow monetarists, “government intervention in economic matters should be reduced to the minimalist functions of instructing central banks to keep currency supplied, dictating the sum of currency in circulation and ensuring deposits are backed by adequate liquidity. This is all the involvement needed to prevent against economic depressions”. The lessons of the recent financial crisis seem to imply major flaws with the monetarist perspective.

Similarly, the efficient markets hypothesis of renowned American economist Eugene Fama is further evidence of a growing movement towards economic deregulation by experts. The efficient markets hypothesis sub-textually advocates decreased governmental involvement in economic affairs by asserting, “market prices always accurately reflect intrinsic values of assets because the prices are determined by the wisdom of experienced actors”. A similar sentiment is contained in the theory of rational expectations, which insists that, “all economic actors are equally imbued with a singular, correct understanding of how markets operate, and thus, can be expected to behave in predictable patterns”. Yet, this seems to fly in the face of logic since it is possible for people possessing equally rational minds to make different decisions given the same set of information. The fact that there is a multitude of different types of economic and political ideologies, instead of only one way of interpreting the world, seems evidence enough of the logical fallacy upon which the theory of rational expectations rests.

The economic crisis of 2008 seems to indicate a lack of empirical evidence to support the market fundamentalist perspective. Economic markets are governed by humans who are neither perfect, nor infallible. Sadly, in spite of rather obvious design flaws, the hypothetical models which market fundamentalism draws upon were utilized to further the case for deregulation. In attempting to explain how this flawed perspective came to dominate the thinking of many U.S. strategists, celebrated economist Paul Krugman wrote that, “the concept of an idealized market was, to be sure, partly a response to shifting political winds, partly a response to financial incentives. The central cause of economists’ failures was a desire for an all-encompassing, intellectually elegant approach that also gave them a chance to show off their mathematical prowess. This romanticized and sanitized version of the economy led most economists to ignore all the things that can go wrong”.

The effect this ideology had on U.S. policy was most pronounced in the 1990s during the Clinton administration, which oversaw a number of initiatives aimed at financial deregulation. In 1999, the Gramm-Leech-Bliley Act repealed part of the Great Depression era Glass-Steagall Act by removing the protective firewalls that had been put in place to separate commercial and private banking. This act essentially allows investment banks to act as a commercial bank, as well as an insurance company by lifting the prohibitions that were in place to keep these institutions from consolidating. The passing of Commodities Futures Modernization Act was another example of the increasing momentum towards deregulation. This act prevented governmental regulation of the emerging derivatives markets which includes the credit-default swaps that played a central role in the crisis of 2008.

These policies led to a dramatic expansion of the U.S. financial sector, which itself played a major role in the 2008 crisis. The practice of sub-prime mortgage lending on home mortgages became commonplace and increased accessibility to home loans fed consumer demand in an atmosphere of lax regulation. Sub-prime loans were mostly utilized by less credit worthy borrowers as means toward receiving financing. These loans were then combined with others to create securities investments that were purchased by financial service companies and banks.

Rising demand for public housing left real estate developers scrambling to construct new homes in order to maintain a healthy supply. The deregulated nature of the market at this time may have had an effect on transparency and communication between developers, brokers and borrowers. As demand for new homes began to level off in 2007, the world economy was itself experiencing a period of depressed spending. In the stagnation, many homeowners chose to leverage their mortgages and pulled value out of their homes which further weakened lenders. In an attempt to compensate, home values began to plummet, causing some investors to lose millions. Interest rates also dropped to low levels, but failed to attract new buyers.

The over-utilization of sub-prime mortgages led to increased numbers of defaults on home loans. This had the effect of compromising the bundled securities that banks and financial institutions were selling one another and holding as reserve capital for lending out. As holders of these debased securities rushed to unload their compromised investments, they drained the liquidity of a number of major banks and financial service providers. Lehman Brothers went bankrupt, other giants like AIG and Bear Sterns were “bailed out” by the government. Many other institutions were similarly impacted and had to be reinforced with tax-payer funds.

Conspicuously culpable in the 2008 crisis were former Chairman of the Federal Reserve Alan Greenspan and current Chairman Ben Bernacke. Both had helped to advocate the strength and infallibility of the U.S. financial sector (as well as the justification for its continued lack of regulation) even as things were beginning to go wrong. Speculating on the possible motivation for their public denials of how bad the situation had become, Krugman observed, “it may be that Greenspan and Bernacke wanted to celebrate the success of the Fed in pulling the economy out of the recession of 2000. Conceding that much of that success rested on the creation of a monstrous bubble would’ve placed a damper on the festivities”.

The wholesale refusals of Bernacke and Greenspan to see the flaws in U.S. financial markets and the potential externalities that could be generated as a result of the increasing interconnectedness of the financial and banking sectors is regrettable. Misplaced trust in largely untested ideologies that had developed in a post-war atmosphere of decreased risk was a major, if not the dominant factor leading to the inevitability of a crisis. Important warning signs, such as the stock market crash of 1987, were overlooked by experts. The Asian financial crisis (that should have been a wake-up call to U.S. economic strategists) was dismissed as a series of regional failures that had their origins in flawed domestic policies of the affected Asian nations, and thus, had no negative implications for the American model. Despite the fact that Asian nations like China, that had resisted economic liberalization policies were among the least effected by the crises, most analysts failed to see the Asian financial crisis for the timely warning that it was.

As confounding as this lack of awareness appears in hindsight, the truth remains that the financial crisis of 2008 could have been much worse without the lessons culled from the Great Depression to use as a roadmap. Economist Jonathan Kirshner concludes that, “the more recent crisis did not spiral out of control because the lessons of the Great Depression had been learned. Initial choices to increase spending and assure adequate liquidity did put the fire out. By well-remembered contrast during the Great Depression, austerity, monetary orthodoxy (gold standard) and collectively disastrous protectionism shoved the world economy into an abyss. In 2008, economic actors had these lessons to use as reminders of what not to do. The two basic levers reached for- flooding the system with liquidity and new programs of public spending- were crucially necessary and pushed in the right direction.” Additionally, the subsequent adoption of corrective legislation such as the Dodd-Frank law and the Volcker rule seem to offer a tacit admission that the crisis had resulted from a lack of regulation and government initiative in economic affairs.

Kirshner’s analysis shows how the lessons gleaned from the Great Depression helped influence the response to the more recent crisis of 2008. Krugman agrees with the path of this corrective action stating that, “when monetary policy is ineffective and the private sector can’t be persuaded to spend more, the public sector must take its place in supporting the economy. Fiscal stimulus is the Keynesian answer to the type of depression we are currently in”.

Worthy of consideration when comparing the Great Depression to the 2008 crisis is the rise of special interest groups and their increasing abilities to influence government policies. In 2008, it was the interests of the financial sector which took prominence over responsible fiscal policies. In the Great Depression, industrial interests were dominating the government agenda of the day.

 World War I had necessitated the creation of trade associations to protect the interests of business and agriculture, and the end of the Great War by no means signaled their decline. In the interwar period, elements of agricultural and manufacturing industries combined their lobbying power into these trade associations, which had influence on the legislative process because of the volume of votes they controlled. During World War I, the chaos enveloping Europe had suspended domestic agriculture and manufacturing enterprises. European demand for the products these industries produced led to growth in domestic U.S. agriculture and manufacturing. When the war ended, European farmers and manufacturers naturally took back their markets, which consequently reduced demand for products coming from U.S. industries. As a means toward mitigating some of the damage from recovering European competitors, U.S. trade associations pressured U.S. legislators to pass laws designed to protect their domestic products from equivalent, if not potentially cheaper, European imports.

The Smoot-Hawley Tariff succeeded in discouraging imports of foodstuffs and manufactured products. However, restricting European access to U.S. markets may have arguably stalled their rebuilding processes, and caused increased competition between states at a time when continental tensions were already running high. This had the effect of weakening European infrastructure so that when the finance bubble of the 1920s finally burst, European banks were in no position to bail out their U.S. counterparts. Here we again see a policy agenda (protectionism) that was not duplicated by U.S. strategists in 2008, and thus, suggests a capacity for policymakers to learn from the mistakes of the past.

Economists disagree about the extent to which the Smoot-Hawley Tariff was a precipitating event for the Great Depression. Yet, most would concur the origins of the crisis were largely a result of international flows of trade and capital, as well as fluctuating commodity prices. The commitment of many nations to the gold standard may have also restricted national leaders from pursuing optimal economic policies.

 In the 2008, a similar commitment to flawed policies and untested perspectives was a major cause of the problem. However, instead of trade associations manipulating Congress (Roosevelt’s New Deal legislation took responsibility for economic regulation away from Congress and gave it to the President) it was a combination of the financial sector, Wall Street and the neoclassical economic agenda of Washington politicians that were now running the show. In much the same way that loyalty to the gold standard proved disastrous for international economic growth in the interwar period, one could similarly conclude that a misplaced commitment to neoclassical economics and the increasing political influence of the financial sector proved disastrous for economic stability in 2008.

The negative effects that the Great Depression and the 2008 crisis had on the stock market were also similar in nature. Some of the commonalities shared by the two events seem eerily comparable to one another. In recounting the events leading to the stock market crash of 1929, Rutgers Professor of Economics Eugene White observed that, “by September of 1929, Federal Reserve indices decreased and increased real interest rates at home and abroad spelled incipient recession. This caused stockholders to revise expectations. The market decreased through October, and as trade volume rapidly increased, brokerage firms were swamped, which made prompt reporting impossible. Investors lost track of their positions.” This account sounds familiar to the more recent crisis in 2008, when investors in compromised securities rushed to unload their tainted investments, and in doing so, drained the capital of a number of financial institutions in their wake.

The interwar period oversaw a U.S. economy growing concurrently with the emergence of new industries and manufacturing technologies. Yet, the banking sector during this time period was arguably more regulated then it was in 2008. In order for actors to maintain their economic influence, they adapted to this environment of regulation and contracting credit availability by utilizing new methods of lending and borrowing. White reminds us that, “regulations imposed on commercial banks in the nineteenth century severely limited their ability to provide large, long term loans and firms turned to financing their investments out of retained earnings and bond and stock issues. The market for industrial securities came of age in the 1920s. Commercial banks did purchase more bonds, but could not legally trade or acquire equities. To circumvent this, they set up wholly owned securities affiliates which allowed them to enter all aspects of investment banking and brokerage. By moving to investment banking, commercial banks continued to work for corporate customers”.

White’s observations here implies that the role of banks in finance was declining in the era of the Great Depression. This differs somewhat with the circumstances surrounding the 2008 crisis. Yet, the rise of the securities market in the 1920s does seem to indicate a meaningful connection with the more recent crisis in some ways. Regarding this seemingly distant time period, White contends that, “In the 1920s, the role of banks as financial intermediaries declined. Securities market growth allowed firms to substitute stocks and bonds for commercial banks loans”.

Although securities also played a role in the 2008 crisis, this decline of the banking sector power in the interwar period seems to run in contrast to the events of 2008. Yet, it may still be possible for one to argue successfully that the decline of banks in the interwar period is similar to the 2008 crisis in the sense that the Gramm-Bliley-Leech Act had reduced the uniqueness of banking functions by allowing for their consolidation with insurance firms and financial service providers. Regardless, what the two events have in common is the fact that, in both cases, the use of securities seems to indicate a move towards undermining regulations through the use of more complex financial devices.

Although the stock market crash of 1929 and the plunge that occurred in 2008 were fundamentally similar in terms of being fueled by an atmosphere of speculation, policy choices aimed at curbing the former were much less successful then those chosen to mitigate the latter. Using the benefit of hindsight, White argues here that, “at the height of the market in August of 1929, many feared excessive speculation as stock prices began to soar relative to dividends. The argument for a fundamentalist explanation of the stock market boom holds that the rise in stock price would have been justified by continued economic growth if policy blunders by the Federal Reserve and Congress had not plunged the economy into a depression. The Fed’s tight monetary policy during these years was a consequence of its fears about the flow of credit to the stock market”.

This was essentially the same problem that occurred with the bundled securities that did so much damage to the economy in 2008. An excess of credit fueled market speculation. Although the actions of individuals were rational, they were collectively much more damaging in combination. However, here we again see the key differences between the approaches of U.S. strategists in 1929 versus the response of officials in 2008. Perhaps it is arguable that although economists like Greenspan and Bernacke were acutely more aware of how to remedy financial crises than their predecessors had been, they both lacked the ability to identify the root causes of crisis in the modern era.

Aside from the similarities between aspects of the Great Depression and the 2008 crisis, there are also some observable differences between the two events. The international political environment marks an interesting point of departure. The Great Depression played out during the interwar period, amidst an atmosphere of international paranoia and a lack of cooperation amongst states. The 2008 crisis happened in a much less contentious environment, but has arguably created greater resentment toward U.S. economic policies at home and abroad.

 The Great Depression happened at a time when states didn’t have a lot of trust or faith in one another. Since policies aimed at ending the international recession proved to be ineffective, nations became even more competitive and suspicious of one another and this helped to spark World War II. By comparison, the international political community was, in many ways, more united and amicable in 2008. Yet, the widespread nature of the damage that the U.S. financial crisis caused helped to reinforce ideological divides regarding the conduct of the global economy, and diminished international faith in the American leadership- perhaps to an even greater extent than the Great Depression had so many years ago. Kirshner somewhat euphemistically refers to this growing international dissatisfaction with American policies as having created a, “new heterogeneity in thinking”.

Also worthy of discussion when comparing these two time periods is the role of industrial globalization in transmitting these crises across national borders. The rise of computer technologies and information systems has obviously facilitated communication in the modern era, but has also increased global interconnectedness, and the dependence some states have upon others. By current standards of development, industrial technologies, manufacturing sciences and communication systems were all very much in their infancy back in the interwar period of the 1930s. Therefore, one of the more troubling aspects of the 2008 crisis is that it occurred in spite of the remarkable advancements in science and understanding that have occurred over the course of the twentieth century. It seems that despite our increased ability to command science and control nature, we are no more able “to see the forest through the trees” than we were a century ago. In other words, the benefits of technology and science have done little to improve the essence of human nature or expand our ability to objectively apply the lessons of history in practical manner.

Regardless, the experience of Great Depression served twenty first century economists as a base of knowledge regarding how not to handle an international monetary crisis. The U.S. was much less of an international leader in the era before World War II than it is currently. Gold was still the basis for international exchange during much of this time period, and the U.S. Dollar was simply a national currency in flux along with the others. Perhaps this explanation bests accounts for the policies of isolation and economic protectionism that only exacerbated the global recession of the 1930s. In the absence of a hegemonic international leader to assume the mantle of responsibility (and unwilling to assume the role itself), the best approach U.S. strategists had available at the time was to effectively bury their heads in the sands of economic protectionism and hope the private sector would be able to heal itself. Such a policy was not an option in the aftermath of the 2008 crisis, with the globe so much more financially integrated than it was a century ago. Comparatively, there was simply too much at stake this time around to sit on the sidelines and wait for the situation to resolve itself. Engaged in a seemingly endless occupation of the Middle East, the U.S. is in no position to allow its allies to languish financially, lest their economic woes weaken their national resolve to participate in the American geo-political agenda.

A portion of the blame for the 2008 crisis lies simply with the actions of individuals who, either because of greed or hubris, earnestly believed like Greenspan and Bernacke that, “this time around is different. The economy has entered a phase where the rules of the past no longer apply”. However, one school of thought argues that financial crises are simply an unavoidable by-product of credit and finance. Although this is certainly not an appropriate excuse as to how the U.S. economy became increasingly less regulated over the years, it does suggest a high level of correlation between systems of capital and monetary disturbances. This phenomenon is discussed at length by Karl Marx who almost prophetically wrote in 1847, “As capitalists are compelled to exploit the existing means of production on a larger scale and set into motion the mainsprings of credit to this end, there is a corresponding increase in industrial earthquakes, in which the trading world can only maintain itself by sacrificing part of its wealth- in a word, crises increase. They become more frequent because as the mass of production consequently causes the need for growth of extended markets, the world becomes more and more contracted and fewer new markets remain available for exploitation”. To paraphrase, the need for continued economic growth begets increasingly risky choices as actors continue to search out new sources of funding to finance their capitalist enterprises. Given the steady march of globalization, it seems as though future crises may be inevitable.

The inability of U.S. strategists to contain the effects of the Great Depression and prevent it from becoming an international monetary crisis ultimately helped to cause World War II. Fortunately, this unfavorable outcome helped to guide the hands of twenty-first century strategists in the aftermath of the 2008 financial crisis. Whether or not the recent financial crisis has been contained or will continue to have spillover effects remains in the balance for now. Scholars of social science and economics should take the lessons to be learned from all past crises seriously to prevent their reoccurrence. From the perspective of history, the greatest tragedies of all are those which were entirely preventable.

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