A Comparative Study of the Great Depression and the Great Recession (20694475)

The recent economic downturn of the late-2000s, labeled the "Great Recession" by some, shares several interesting characteristics with the Great Depression of the 1930s. This is especially surprising given the vast body of economic study dedicated to the ascertainment of the Great Depression's causes and ways to ensure that such an economic crisis never occurs again. The existence of such parallels, then, underlines the power of economic forces to produce these business cycles despite mankind's best attempts to stabilize the worldwide economy. This paper aims to investigate commonalities and differences between the Great Depression and the Great Recession and furthermore to motivate the study's relevance to policy reform attempts at combating the most recent contraction. To do so, it examines two aspects of each crisis – its probable causes and the manner of its subsequent worldwide propagation.

The origins of both the Great Depression and the Great Recession can be traced to imbalances in the world economy and the ruling theories that motivate response behaviors. Sustained economic imbalances, manifested by unchecked international capital flows, lead to economic crises as countries with growing current-accounts deficits struggle to convince lender nations of their solvency. At the close of World War I, America found itself lending huge amounts of capital to Germany, which the borrower nation then used to pay war reparations and experience a consumption boom. This continued economic imbalance was sustained by the ruling theory of the gold standard, the belief that currencies of countries backed with gold would remain stable due to the price-specie-flow mechanism as proposed by David Hume in the 18th century. Hume's conjecture was that the international transfer of gold would directly affect prices and, subsequently,

international trade, finally resulting in the restoration of gold and prices to equilibrium levels. While theoretically sound, this hypothesis was not realistic because it assumed that prices were determined in competitive markets and fully flexible. In the early 20th century, prices were sticky, so as German expenditures declined and international trade slowed, prices could not fall rapidly enough to equilibrate the markets, causing widespread unemployment and economic stagnation.

Years later, the end of the Cold War saw the United States become a borrower nation, while China developed into the primary lending country to America. The inflow of Chinese cash produced a consumption boom in the United States that developed into a housing boom. America had since removed itself from the gold standard, which meant that the value of the dollar could change daily, but the new ruling economic theory continued to promote risky business practices that would eventually lead to the Great Recession. More precisely, the United States had adopted an orientation toward free market policies called the Washington Consensus, which was primarily a variation of the gold standard that prescribed stable rather than fixed exchange rates. It also advocated libertarian policies regarding private finance and industry with the belief that competition would ensure continued development and prosperity. Most significantly, beliefs promulgated by the Washington Consensus lent credence to the issuance of mortgage-backed securities, which flourished during the housing boom. These securities bundled a large number of mortgages as an investment that would carry less risk than a single mortgage, under the assumption that homeowners defaulted on mortgages randomly and independently. Unfortunately, as the housing boom ended and house prices fell, homeowners began to

default en masse, greatly and unpredictably increasing the risk of mortgage-backed securities to the point at which buyers could not be found and prices plummeted.

The years leading up to both the Great Depression and the Great Recession were marked by irresponsible investments based on miscalculated risks. The gold standard and the Washington Consensus optimistically modeled adverse shocks to individual countries or homeowners, but they had not anticipated the collective failures that eventually happened, and they suffered from impractical assumptions that could not hold in the real world.

The analysis now moves on to consider the worldwide propagation of economic contraction in both crises. In the early 1930s, government and central bankers sparked the growth of the Great Depression. Influenced by a strict adherence to the gold standard, many countries struggled to maintain deflationary policies, even as doing so drove them further and further into trouble and forced many of their banks to take on increased risk. While failing banks are often cited as a cause of the Great Depression, they fit more closely the description of a compounding symptom, in that they resulted from poor government policies and served to further contribute to the economic decline. Indeed, the bank failures were primarily isolated in those countries on the gold standard.

By contrast, in the late-2000s, banks and other private financial institutions initiated the hysteria that led to the Great Recession. At the end of the housing boom in 2007, homeowners began to default on their mortgages at an increased rate, which drove down the prices on mortgage-backed securities held by investment firms. Bear Stearns was the first major investment house to fall, but the Federal Reserve stepped in to save the firm and manage its sale to J.P. Morgan Chase. Fannie Mae and Freddie Mac, two government-

affiliated mortgage brokers, also required federal assistance. They were followed by Lehman Brothers who, without government intervention, filed for Chapter 11 bankruptcy in 2008. By letting Lehman Brothers fall, the Fed seemed to be pursuing a strategy that reflected the free-market ideology of the Washington Consensus, but within days it extended a substantial bailout to multinational insurance company AIG. This move served to confuse the markets – buyers could no longer make reliable predictions about investments, and as a result the credit markets seized. Soon thereafter economic activity stagnated and international trade halted.

The best course of action for policy-makers to take in dealing with the current and future crises is simply to learn from past mistakes and to understand that economic contractions are not just possible, but probable. This is, however, understandably difficult. For example, though the Washington Consensus sought to eliminate the disadvantages inherent in maintaining a gold standard, it also failed to fully consider the possibility of collective shocks. It is important for the government to avoid providing too many incentives for risky investments. Additionally, the success of New Deal initiatives like the FDIC and the SEC provides evidence that the government can play both a beneficial and restrictive role in the economy. Finally, it is crucial that policy-makers move quickly to recognize and combat potential recessions. In 2008, Chairman of the Federal Reserve Ben Bernanke implored Congress to take action against a potential financial crisis, but policy-makers were unable to put in place legislation to prevent the eventual recession. Granted, advising lawmakers on a course of action to address a hypothetical crisis is both difficult and risky, but perhaps with a growing data set of past crises, it will become easier to predict economic downturns, which will allow policy-makers to take pre-emptive action against future contractions.