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The Global Economic Crisis through the prism of the Great Depression

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This paper presents the main aspects of the 2008 global economic crisis through the prism of the Great Depression of the 1930s. The aim of this paper is to illustrate the importance of the lessons learned in the Great Depression in overcoming the modern global economy disorders by analyzing the causes of the crisis and the response from the US economic policy. The methods employed in the paper are the following: the method of analysis, the comparative method and the method of deduction. An analytical review of the US anti-crisis economic policy based on relevant statistical data has been presented. The survey results clearly indicate that the crisis has led to a sudden reaffirmation of Keynesian economic policies. The monetary policy was extremely expansionary. The Fed cut its key interest rates to a record low and through open market operations significantly expanded its assets. Confidence in the banking system was preserved and the risk of deflation avoided. The fiscal policy was also counter-cyclical and a few fiscal stimulus packages confirmed a commitment to a strategy of stimulating aggregate demand. By selecting a coordinated and synchronized intervention policy through the G20, the mistakes of economic policy makers of the Great Depression were avoided and pre-conditions created for a structural reform on financial market and economic policy.

Keywords: global economic crisis, the Great Depression, financial system, financial regulation, counter-cyclical economic policy, the USA.

1. Introduction

The Great Depression of the 1930s and the global economic crisis at the end of the last decade were extremely important episodes in modern economic history. Both crises occurred in the periods of unbalanced development of the global economy. Before the Great Depression, the US took a leadership role in the world economy as the most important promoter of the free-market capitalism. The fascinating expansion of industry and the spectacular growth in the 1920s ended up miserably. The ensuing depression was a traumatic experience for all businesses, but, nevertheless, an inspiration for economic theory and policy. Macroeconomics and the Keynesian revolution developed along with innovative institutional mechanisms of Roosevelt's administration in economic policy.

The beginning of the 21st century did not indicate that something similar to the Great Depression could ever happen again. The expansion of the world economy, with a chronic imbalance between the developed economies and the emerging economies of the BRIC countries occurred within a fairly unregulated financial infrastructure. The financial distress that originated in the United States quickly spread to the real sector and the global economy. The economic policy required substantial transformation. However, doubts about the concept of a self-regulating market suggest that the effects of the global economic crisis may bear much deeper and more complex implications than a mere change of the course of economic policy. Therefore, bearing in mind the lessons of the Great Depression, the crucial question is to what extent the dominant neoliberal paradigm will change. Is the creation of a new system of financial regulation a road toward a significant affirmation of interventionist economic policy? Is there an important lesson of the Great Depression to be learned in this area as well? These are the essential dilemmas faced by contemporary economic authors and researchers.

The epicenter of both economic crises is the US economy. Therefore, the intention of this paper is to review the main causes of the global economic crisis, economic policy responses and possible directions of reforms of financial regulation from the perspective of the US economy, with occasional comparisons with the economic conditions from the times of the Great Depression.

2. The causes of the global economic crisis

The global economic crisis occurred in an unbalanced world economy as a result of a strong deregulation of financial markets. The new financial architecture meant a rapid development of financial innovations that had become complex and incomprehensible, and in the time of crisis – threatening and illiquid. The system is based on lenient regulation of commercial banks, even more lenient regulation of investment banks and very little and almost non-existent regulation of the shadow banking system. At the end of the 1990s the strict regulations implemented by adopting the 1933 Glass-Steagall Act were formally abolished. Namely, with the adoption of the 1999 Financial Services Modernization Act, barriers between commercial banking and securities business were removed. The Glass-Steagall Act provisions which prohibit the use of deposits for the purpose of securities trading became inadequate. This made it possible to create a very intricate system of relations between entities in the financial market. In the spring of 2004 the Securities and Exchange Commission (SEC) decided to grant solvency exemption to investment banks and other financial institutions. They were allowed to use their own mathematical models for assessing portfolio risk and thus determine on their own the appropriate level of regulatory capital (Štiblar, 2009).

Deregulation of financial business is closely linked with the credit explosion of the US mortgage market and the process of securitization of subprime mortgage. Conservative banking business became a mere tradition. Lenders no longer had to wait for the mortgage borrower to repay the loan. They converted it in mortgage-backed securities (MBS) and passed them to the final investors. The ability to transfer risk significantly weakened the interest of banks in secure investment and strong credit worthiness of a client. The financial system generated growth in real estate prices as well as overproduction in the construction sector. The availability of mortgage credit to customers who were not able to finance them increased the credit risk and rendered all the criteria of the banking business ineffectual. Issuance of mortgage loans without a certificate of income, job or assets (NINJA Loans) became a common practice in the era of expansion in the US mortgage market. One important trend supports the unsustainability of this model. It is the movement of wages. While housing prices soared, the real income of many Americans was in decline. In 2008, the average household income was 4% lower in comparison with the one in 2000 (Stiglitz, 2008). However, a large number of entities in the financial sector (from mortgage brokers, commercial and investment banks, credit rating agencies to special investment units) were well motivated to create risky and destructive model of moral hazard.

Generally speaking, it is possible to identify some structural weaknesses of the pre-crisis model of financial operations. These include:

- unregulated derivatives in the OTC market;
- risky financial innovations (always a step ahead of the regulators);
- a pronounced asymmetric information in mortgages with variable interest rates;
- lack of understanding of risk that is inherent in complex financial products;
- poor risk management;
- inadequate evaluation of risk by credit rating agencies;
- inappropriate model of regulation through the Basel II;
- risky business model of banks in the securitization process (originate-to-distribute model).

On the other hand, it is necessary to point out some more serious problems in the functioning of the market. These are: the model of corporate management with wrong incentives (bonus payments even in situations where a company makes losses), the moral hazard of top management (personal interests in conflict with the interests of the organization, the principal-agent problem), lack of transparency in the process of securitization (the shadow banking system) and misallocation of capital (cheap capital ended up in the real estate sector instead of manufacturing companies).

Lack of regulation, inadequate control of the financial system and creative financial engineering were not the only causes of the global economic disorder a few years ago. The economic policy deserves some criticism as well. During much of the last decade the US monetary policy was quite expansive. The Fed only cared about inflation trends. However, as in most of the pre-crisis period, the rate of inflation and the output gap were fairly stable, the monetary authorities ignored other important trends, first of all the following: fluctuations in asset prices, excessive growth of investment in the housing sector, consumption growth and a negative trend in the current account deficit. A continuous reduction in interest rates only fueled the mortgage bubble. The increase in key interest rates from mid 2004 to July 2006, which indicated a somewhat restrictive Fed monetary policy, is very reminiscent of the policy before the Great Depression. We should not forget that the Fed's actions during the expansion of the 1920s and on the eve of the Great Depression were deemed irresponsible and inadequate, while monetarists found them to be the fundamental cause of the forthcoming collapse. The Fed allowed the rise of money supply by 61% over 8 years. An increase in interest rates on the eve of 1929 came late and did not reduce speculation but investment in the real economy instead (Friedman & Schwartz, 1971).

3. Lessons Learned from the Great Depression

Modern state intervention, with the lessons of the Great Depression taken into account, was globally coordinated and synchronized. After the collapse of Lehman Brothers in September 2008, the G20 member countries affirmed the application of counter-cyclical economic policy at the first summit in Washington. A coordinated implementation of expansionary fiscal policy measures was agreed upon to stimulate domestic demand and so was expansionary monetary policy in order to stabilize the financial system and ensure the necessary liquidity.

All international financial institutions (the IMF, The World Bank and other multilateral development banks) were recognized as key actors of global interventionism, which required financial support by the G20 countries. The first to react was the Japanese government which responded with a $ 100 billion loan to the IMF. An important conclusion of the first summit was the agreement that no country should use any kind of protectionist measures in the next 12 months. This leads to the conclusion that the leaders of the largest economies in the world understood the lessons of the Great Depression, when the increase in tariffs in the United States (1930) caused a chain reaction and protectionist policies in 60 countries. In modern terms, the decision on the acceptance of free trade has a special dimension if one takes into account that the economy of the G20 countries accounts for almost 90% of the world GDP and 80% of global trade.

The idea of state intervention, which was proclaimed as part of the G20 anti-crisis actions was adopted by almost all the world's economies. Nobody wanted to repeat the mistakes of Hoover's Administration from the period of the Great Depression. Counter-cyclical strategies became a common denominator in the anti-crisis policies of developed economies and developing countries. The US authorities were the first to react to the negative effects of the crisis that emerged in their backyard. When it comes to monetary policy, there was a general consensus to avoid deflation and mass bankruptcy of banks of the Great Depression (Alcide & Gross, 2011). In August 2007 the Federal Open Market Committee (FOMC) launched a reduction of the targeted discount rate, and then the federal funds rate, with a mission to provide liquidity for orderly functioning of financial markets.

After a series of reductions, as shown in the following diagram, the Fed reduced the target federal funds rate to 3% by February 2008. By May of the same year, the rate was 2%, and in December 2008, it reached a record low value of 0-0.25%.This record low value has been maintained up to the present day, while the discount rate, as opposed to the period of crisis, now usually deviates from the federal funds rate. The decision to reduce the usual gap between the discount rate and the federal funds rate (from 100 to 25 basis points), with the extension of time for repayment of the loan from the Fed lending overnight to 90 days, speaks in favour of a more flexible credit policy. As a result of these decisions, the amount of lending to depository institutions by the central bank, through a "Discount Window" reached a record high of 403.5 billion dollars in October 2008.

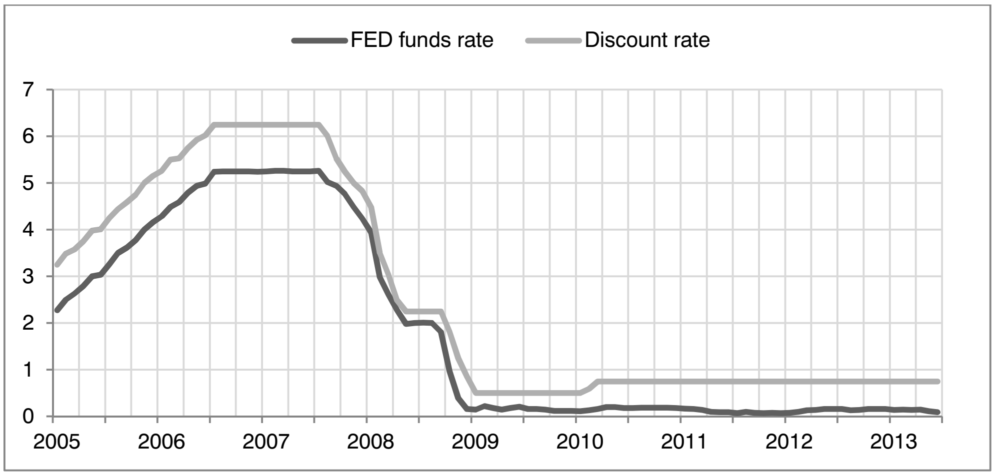

Figure 1: Fed funds rate and the Discount rate
Source: Federal Reserve System, www.federalreserve.gov (Accessed – 01. 08. 2013).

The reduction in interest rates is not a sufficient condition for expansionary monetary and credit policies in crisis. Suffice it to recall the Fed's policy in the Great Depression, when the nominal discount rate during 1932 was 2.5%, but due to the deflation rate of 10%, the ex-post real discount rate rose to 12.5%. The insensitivity of investment to the decrease of interest rates was a confirmation to Keynesians who later concluded in their model that the IS curve was fairly inelastic, and the monetary policy impotent in the fight against economic depression. On the other hand, monetarists believed that the problem of the Fed's strategy was the insufficient use of open market operations as the most essential instrument of monetary policy (Brunner & Meltzer, 1968).

In the modern crisis, the monetary authorities decided to reinforce expansionary measures, which quickly reflected on the balance of the central bank. Thus, the total value of the Fed's assets increased from 894 billion dollars at the end of 2007 to 2,237 billion dollars in December 2009 (Thomas, 2011). The initial growth of the monetary base in 2008 was the result of extreme lending to financial industry by the Fed. At the end of 2007, next to the loans section in the Fed's balance sheet there was the figure of 4.5 billion dollars and a year later, the value of loans granted on various grounds amounted to 1,700 billion dollars (Lawrence, 2009). Furthermore, during 2009, the Fed conducted a mass purchase of mortgage-backed securities which previously had not been part of the assets of the bank's balance. By the end of the year, the value of purchased mortgage-backed securities reached a figure of over $ 900 billion. In addition, the usual buying of long-term government bonds was intensified, as well as bonds of federal agencies, which further increased the money supply. It is interesting that the bonds of federal agencies, for nearly five years, were not part of the US central bank's balance and their value in April 2010 amounted to 169 billion dollars. The total value of purchased government bonds (together with federal agencies' bonds) amounted to 936.5 billion US dollars on December 30th, 2009, which was 60% more than in April of the same year. The pronounced activity of the central bank in purchasing government and mortgage-backed securities until the mid 2013 is clearly shown in the following diagram. This is an illustration of the application of unconventional policy of quantitative and qualitative easing.

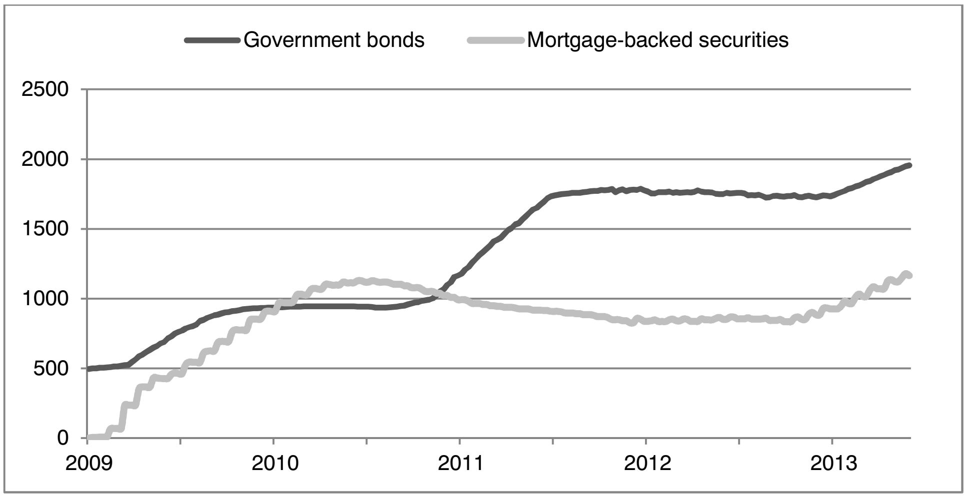

Figure 2: Government bonds and MBS owned by the Fed (in Billion $)
Source: Federal Reserve Economic Data (FRED), http://research.stlouisfed.org/fred2/ (Accessed – 31. 05. 2013).

Complementary to the Fed's measures the confidence of depositors in the banking system was secured by the intervention of the Federal Deposit Insurance Corporation (FDIC), which in autumn 2008 announced their decision that the state would guarantee for all deposits up to $ 250,000 (compared to the previous limit of $ 100,000). Without a deposit insurance mechanism, any effective intervention in a contemporary crisis is unthinkable. Therefore, one should not ignore the fact that the FDIC was established in 1933 as an institutional contribution to the Glass-Steagall Act. At the time it was established, the FDIC received the financial support from the US Treasury and the Fed in the amount of 289 million dollars. After six months of the corporation business operations, only two banks were liquidated. The largest number of suspended banks were recorded in the 1937 crisis. 82 banks were liquidated then, compared to 4,000 banks in 1933. The federal insurance of bank deposits was the most important structural change that has become a prerequisite for monetary stability (Wallace, 1934). It is important to note that the banking system in the early 1930s was doomed to fail due to the lack of the institution for deposit insurance and the lender of last resort (in today's conditions these are central banks).

An analysis of the anti-crisis measures by monetary authorities leads to the conclusion that the central bank used all the instruments at its disposal, thereby acting also unconventionally, in the struggle for the liquidity of financial institutions and the recovery of the economic system. However, the monetary policy measures were not a sufficient condition for overcoming the global economic crisis. The fiscal policy also operated counter-cyclically, which was in line with the recommendations of Keynesian economics. The strategy of balancing the budget from the Great Depression was not an acceptable solution. Hoover's destructive tax policy was avoided, when in the midst of the crisis there was an unusual turnaround in the fiscal policy and a mild expansionary strategy was replaced by a very painful restrictive and pro-cyclic policy. Hoover vetoed public works in 1932 and, with the new Revenue Act, he brought in the largest tax increase in the peacetime US history. The rate of taxation of annual income over a million dollars increased from 23.1% to 57%. The new rate of 6% was applied on an individual annual income of $ 10,000 to $15,000, as opposed to the previous 0.9%. The taxation rate of annual income between 2000 and 3000 dollars rose from 0.1% to 2%. Taxes on corporate profits rose from 12% to 13.75% (Fishback, 2010).

However, at the beginning of 21st century, economic policy makers did not allow themselves such a luxury. The United States implemented three fiscal stimulus packages:

- The Economic Stimulus Act of February 2008. The fiscal package had a value of $ 168 billion, which is slightly more than 1% of the GDP. A refund to low-and middle-income households was provided as well as tax breaks for business; up to July 1st, 2008, more than 70 million US households received a tax refund of $ 950 on average. Studies have shown that the refund had a stimulating effect on the consumption of non-durable goods, with an average increase of 3.5% on weekly basis. Unlike typical households, families with an annual income of less than $ 15,000 increased their consumption of non-durable goods by 6% (Broda & Parker, 2008);

- The Troubled Asset Relief Program - TARP came into force in October 2008. Its value amounted to $ 700 billion. Capital injections to banks were provided. In return, the state received a certain share in the ownership of banks (preferred shares). In this way, $ 205 billion were invested in nearly 700 banks. However, as much as $ 125 billion went to nine largest US banks (Blinder, 2013). In addition to these $ 205 billion, the single largest beneficiary of TARP was the (nationalized) American Investment Group (AIG) with 67.8 billion dollars;
- In the second half of February 2009, the American Recovery and Reinvestment Act – ARRA was adopted which provided a fiscal stimulus of $ 787 billion. According to the US government data from 2013, this amount was later corrected and the final stimulus amounted to 840 billion dollars. Of the total, 290.7 billion went to tax incentives, 255.6 billion were allocated to education, infrastructure and transportation projects and 251.3 billion to health care, unemployment insurance, etc.

The fiscal policy met with much criticism. While some felt that the fiscal measures were ineffective and inefficient, the proof of which was the rise of the unemployment rate from 8.3% in February to 10% in October 2009, others were convinced that the stimulus was too small to solve the problems that were measured in billions of dollars. However, the intervention came at a cost – the growth of public debt and budget deficit. The public debt in the last quarter of 2007 amounted to 64.7% of the GDP, and five years later reached the level of 103.5% of the GDP.

Federal expenditures had, ever since 2002, been above budget revenues. The crisis made this deviation increase significantly. Thus, the 2009 budget deficit reached 1.4 billion dollars (Figure 3).

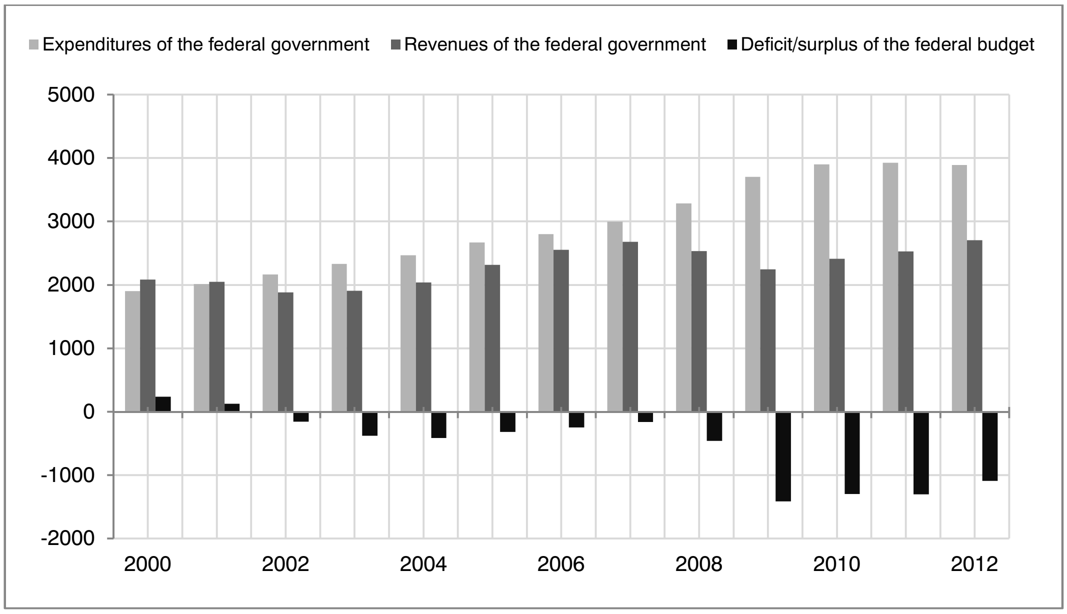

Figure 3: The US federal budget over the 2000−2012 period (in Billion $)
Source: Federal Reserve Economic Data (FRED), http://research.stlouisfed.org/fred2/ (Accessed – 31. 05. 2013).

Without dwelling now on anti-crisis effects of the fiscal policy, the federal expenditures and deficits trends suggest an important commitment to the Keynesian counter-cyclical policy. However, at the fourth G20 summit in Toronto in June 2010, there was a split in the concepts of interventionist policies between the United States and the European Union. While the US administration still supported stimulating spending in order to maintain and ensure the necessary jobs and economic growth, the EU opted for a strategy of balancing the budget. The effects of the choices are clearly visible today. The EU re-entering the recession only reminded of an important event in the second half of the 1930s when the change of course in economic policy (increase in the reserve requirement ratio and tax increase) during the Roosevelt administration led to a severe recession and precipitated the need for a new counter-cyclic intervention.

4. Old lessons – new requirements

The global economic crisis, just as the Great Depression, raised the question of stronger regulation of the financial system. The capitalist economy needs a comprehensive (supra)national institutional framework that will act towards stabilization of economic activity – something similar to major reforms of Roosevelt's New Deal. After all, a valuable depository of mechanisms from this period had an undisputed importance in overcoming the contemporary crisis. Accepting the recommendations of Keynesian economics, with the lessons of the Great Depression learned, leads to the implementation of new measures of financial regulation. In this sense, it is necessary to point out the started reforms and the inevitable demands of the new financial and economic infrastructure of the capitalist model of economy:

- Global implementation of the Third Basel Accord. In addition to the reasonable intentions for tighter regulation, the new agreement is insufficient to solve the structural problems of the banking sector;
- The reform of financial regulation at the national level. With an important global framework, financial regulation must be reviewed in each individual economy according to the specific needs of the national economy;
- Affirmation of financial transaction tax. This is the internalization of negative externalities. Tax is counter-cyclical, it reduces volatility in financial markets and brings revenue to the government which it can use as an anti-crisis fund, when economic trends become negative;
- Change of the current paradigm of corporate governance. Compensation system must be redesigned in such a way that managers focus on long-term objectives of the company, rather than short-term speculative activities. One of the proposals is that compensation is paid through reserved shares that can be "cashed in" only after certain conditions are met (e.g. long-term profit). Compensation policy should be adjusted in such a way that it equally rewards (bonuses) and punishes (penalties) managers depending on the results they achieved for the company;
- The abolition of the practice of rescuing *too big to fail* companies. The new US bill on financial regulation from June 2010 (Dodd-Frank Act) makes it clear that there will be no socialization of private losses of "big players" using taxpayers money;
- Greater transparency of depository institutions. The regulatory reform in the United States included a novelty – The Volcker Rule, which implied abandoning the practice by which banks used deposits of their customers to trade derivatives for their own account. Also, banks were prohibited ownership in hedge funds and private equity funds;
- Prevention of systemic risk. In this regard, the work of the Financial Stability Board, founded in April 2009, is of global importance, as well as the activity of similar institutions at national and regional levels;

The global economic crisis has, as has been stated, actualized the policy of state intervention. When it comes to the future anti-crisis interventions, it is necessary to take into account the following assumptions and instructions:

- A high degree of coordination and synchronization of anti-crisis measures is needed. Therefore, it is necessary to strengthen the institutions of coordination of monetary and fiscal policy (councils, commissions, etc.) so that disagreement between them would not be a limiting factor in their effectiveness;
- Discretion has an advantage over fixed rules in an anti-crisis economic policy. Rules limit the operation and success of monetary and fiscal authorities. Discretion rights provide flexibility, which can significantly affect the efficiency of economic policy instruments;
- The focus of economic policy must be the real sector. We should not forget that the financial crisis of the 2008 quickly turned into a credit collapse, and then the crisis in the real sector. The concept of targeted lending is a link between monetary and fiscal policy (Akerlof and Shiller, 2010). The essence of intervention is the support for small and medium-sized enterprises as generators of economic growth and employment. It is expected that the key role in this process is taken by organizations that are owned by the state or their business is partly financed from the budget (banks, development funds, etc.);
- The priority of economic policy during a crisis must be to stimulate economic growth. The developers of stimulus in particular should promote the public consumption and public investment, whereas tax cuts are a second-rate measure when it comes to importance;

- In times of recession, the focus of fiscal authorities must be the structural rather than the current budget deficit. When it comes to the structural deficit, an important recommendation of fiscalists is that it is necessary to determine what value the budget (i.e. the structural deficit) would have in "normal" circumstances, i.e. at full employment. Then the government would, during the crisis, adjust the policy in line with this reference point, instead of the growing current deficit, which implies that measures have to be restrictive;
- Establishing and/or strengthening of the fiscal stabilization fund. Regardless of whether it is developed or developing economies, policy makers must continuously prepare a better starting basis of a potential anti-crisis fiscal policy. The period of expansion is the best time to secure funding for future anti-crisis policy.

Conclusion

Economic crises are periods in which the leading intellectual and theoretical framework of a government economic policy is reviewed. The dominance of the ideas of new classical economists in the economic policy of the capitalist countries was disrupted by the emergence of the global economic crisis at the end of the previous decade. The crisis confirmed the unsustainability of the concept of unregulated markets. The Anglo-Saxon model of neoliberal capitalism has been shaken and the economic concepts based on the premise of self-regulation of the market mechanism showed systemic weaknesses. There was a sudden reaffirmation of Keynesian economic policies.

Lessons from the Great Depression had an undisputed importance for overcoming the contemporary economic crisis. A synchronized implementation of measures of counter-cyclical economic policy, through the work of the G20, has shown that there exists a clear consensus as to avoid coordination failures and harmful protectionist international trade policies from the 1930s. The monetary policy of the United States was quite expansionary. In addition to cutting key interest rates to a record low, the Fed conducted a policy of quantitative and qualitative easing. By increasing the money supply and the provision of liquidity for institutions, the possibility of deflation and mass bankruptcies of banks, which monetary authorities faced during the Great Depression, was neutralized. The monetary policy measures were accompanied by a complementary strategy of the fiscal authorities. The adoption of several fiscal stimulus packages was aimed at stimulating aggregate demand, output and employment. With certain justified criticism for the socialization of private losses of *too big to fail* companies, it seems that the lessons of the Great Depression, at least when it comes to anti-crisis policy, have been learned. However, in addition to the interventionist economic policy, the question of reform of financial regulation is still open, which should lead to greater business transparency and lower systemic risk. We should abandon the assumption of self-regulation of the market and create a reliable and rigorous system of control and regulation. However, with hindsight, it appears that some changes in macroeconomic policy paradigm are certainly to come, but there is no indication that the neoliberal concept will be completely abandoned.

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