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Comparative Analysis of the Great Depression and the Sub-Prime Crisis

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ABSTRACT: Financial Crisis, a phrase that is an inevitable component of financial health of any economy. Hence understanding of financial economics remain incomplete without in depth knowledge of financial crisis. Talking about financial crisis, two major subject areas emerge *i.e.* the Great Depression and The Sub-Prime Crisis. This paper focuses on understanding the relevance and impact of these two crisis and digging deeper to understand which of the two has deeper effects in light of the fixed or the floating exchange rates. The object of thorough consideration of the two crisis has its roots in their impact on the world. The paper also deals with realising the significance of banking system and the role it plays in stimulating or depressing the influence of crisis situation on the asset market in any economy, especially that of belonging to the third world. Withstanding the important bearing of crisis situation, the paper also attempts to bring out the role of government in containing the economy in these circumstances.

Key Words: Financial Crisis, Sub-prime crisis, Fixed Exchange rate, Floating Exchange Rate, Collateralized Debt Obligations, Precautionary Demand andPonzi borrower

I. INTRODUCTION

Financial crisis is inborn of financial economics which may or may not appear with a warning. There are two broad approaches to understand crisis, viz. the Kindleberger approach and the business cycle approach. Kindleberger (1978) explains crisis as, “that occur impulsively as the result of mob psychology or panic” [1]. He identifies two variants of this psychology, one ‘self-fulfilling prophecy’ where people expect the crisis situation, take actions accordingly realizing their expectations. Two, ‘self-filling prophecy’ where households are myopic and can not ascertain uncertainties in the financial environment and hence take no necessary precautions making the crisis situation worse.

The other explanation of crisis situation in functioning of an economy is nothing more than a usual, periodic state as one of the stages of business cycles. It has a simple functioning mechanism. The return on assests are anticipated to fall in recession, which makes repayment of loans by the borrowers difficult thereby increasing their chances of defaulting the loans and hence turning them into non-performings ones. Consequently, bank depositories resort to withdrawing their deposits from banking system thereby losing people’s confidence on the system and hence creating a situation of bank run. Financial crisis is like pretty girl, difficult to define but recognisable when it seems. Political-theorist-turned-economist John Stewart Mill claims that “the bubbles alone does not cause crisis, credit and debt play an essential role”.

The question of prudence of either of the two crises, the great depression or the sub-prime is raised in light of the fixed or the floating exchange rate. One pool of economists across the globe believe adoption of floating exchange rate minimizes the impact of crisis on real economy.

One of the common feature between the two crisis in question here are their place of origin. Both the great depression and sub-prime crisis originated from the States and spread to the other part of world like an epidemic. Another common feature of the two crisis is that of their roots in financial sector and then sweeping all the major sectors and bringing about an overall impact on the macroeconomic level. The aim is to analyze these two crisis in detail with an outlook to study their various other facets.

II. METHODOLOGY

This research study goes on to evaluate how are the two major financial crisis in the world are different not only in their origin and features but also in their impact on the world with special reference to emerging market economies. The researcher has tried to derive meaningful results from mapping the literature available in reference to the crisis along with contemplated study on the data available on various aspects of financial markets in the world economy. Also, a brief account of the literature review has also been presented to make the foundation of understanding and research work stronger.

III. ANALYSIS

A. The 'Bubble' Game

King Ronald R, Smith Vernon L and Williams (1983) defines an economic or asset bubble as, "trade in an asset at a price or price range that strongly exceeds the asset's interinsic value. It could also be described as a situation in which asset prices appear to be based on implausible or inconsistent views about the future" [6]. Economic behaviour in any economy impacts the magnitude of investment and hence credit in any economy, especially in developing economies. Availability of credit has an important bearing in any economy, it shoots up with sound blaring and slows down with economic recession. The easy availability of credit coupled with sound financial functioning of a state advances more investments that help economies in building their creative capacity and pace up the process of growth. However, this investment process carries with itself a heavy cost that may be understood as "overtrading" which is observed in the periods of boom in certain sectors. Overtrading becomes a problem when huge amount of money is invested in specific areas based on speculations resulting in humungous volumes of trade in them. This results in short-term capital gains followed by "euphoria" and hence giving birth to bubbles.

The banking sector plays a very crucial role here. Banks while getthing carried away with market sentiments an in order to prevent lose of their market share advance loans without proper background check and further aggravate speculative transactions. Banks generally ease their credit mechanism by loosening the minimum marginal requirements that significantly adds on to the burden of non-performing assets of the banks. Such a congenial investment environment create socio-psychological set up in making the bubble stronger since it is hard to remain indifeerent to enter the speculators' circle when already existing pool may be observed minting returns on their existing investments. Charles Kindleberger coined the expression "There is nothing as disturbing to one's well-being and judgment as to see a friend get rich" and it helping in the blowing the bubble. This bubble then attracts investors across the globe and hence making its roots stronger involving masses. The developing world on the other hand get not only exposed to the risks associated with bursting the bubble but also face exchange rate risk in their existing vulnerable state of economy and that of their currency. Once burst, these bubbles leave deep, difficult to recover impact on its investors and hence expanding the blanket of crisis [10].

B. Banking Sector Troubles

Banking sector plays a very decisive role in the times of crisis. There is compelling evidence to show significant impact of failures on account of banking system to exacerbate the crisis situation. Predicament emerging from financial sector makes people loose their confidence on banking sector leading to voluminous withdrawals of households' savings. This further leads to decrease in the money in circulation worsening the situation further.

Friedman and Schwatz (1963) argue that banking crisis increased the public desire currency-to-deposits ratio, as strove to convert deposits into cash, which reduce the money supply and led to decrease in prices and output. According to Friedman and Schwartz (1963), the banks were affected more when the Great Britain took departure from the gold standard, followed by many countries like France, Belgium, Switzerland, Sweden and Netherlands among the others. The foreign investors started withdrawing their investments from global markets due to their lesser returns coupled with high risks. Also, Foreign Central banks drew down their deposits to increase the earmarking of gold because of which the reserve was fall to $275 million from $450 million [2]. With this decline in the reserves, the banking sector got affected suggestively. People started holding their savings in cash that followed outflow of gold reserves to maintain gold standard. All these together made the US economy face problems both in the internal as well as external markets. The banks were left with only two alternatives, viz. borrowing from the Federal Reserve or auctioning their assets. They did both but worked none. Friedman suggests a more decisive role of the Fed to cure the situation. He claimed that the Fed could have more actively performed his responsibility of

being the lender of lawst resort, could have increased currency in circulation through open market operations abiding by the securites from banks and could have easily met people's demand for money.

Bernanke (1990) on the other hand, gave contrary solution to that given by Friedman and Schwartz and endorses panics in the banking system in crises situation directly affecting the supply of money and real economic activities. According to Benarke, the debt crisis was a separate and exogenous shock as opposed to some economists who consider it to be induced. It was the inability of the Fed to control the currency in circulation which led to sudden fall in asset prices followed by overall decline in the price level of the economy. However IS LM framework does not support the contraction in supply of money as decisive factor in causing depression. This may simply be explained by leftward shift in LM curve, IS being the same leading to increase in the rate of interest and fall in the level of output. The decrease in the level of output meant increase in the price level whereas the crisis situation kept the prices low and hence increasing unemployment due to decreased output [5].

Friedman and Schwartz (1963) brings out the inability of the Fed to monitor supply of currency to remedy the catastrophe along with emphasis on the demand side of money which they label as problem of "liquidity preference". The low state of financial sector decreased demand of money by masses. It was only the 'speculative and precautionary' demand for money that saw an increase that affected the economy even further. It is the transactionary demand of money that helps the real economy to function and a sharp decrease of demand for money on this account pushed the economy into depression. With such a strident fall in transaction demand for money decreased aggregate demand from people since their portfolios of income shifted from spending to saving. This together shifted the IS curve to left thereby contributing to declining output followed by steep fall in price level and putting a halt on economic growth by massive increase in jobless people. The government could have contained this situation by increasing its expenditure targeted towards people's demand for commodities and help the economy function on a smoother growth trajectory.

A striking contrast on how the two crisis have dealt with banking sectors emerges with that of portfolio. The great depression saw a more diversified porfolio of the loans advanced by the banking sector not only in terms of varied sectors but also pertaining to different branches via which the loans were advanced. The surprising observation reveals that not only the loans were advanced to different set of people, the deposits also came from various sectors and varied groups that helped the Fed to have a more concentrated effort of revival. While the one in 2008 saw crisis majorly in the housing sector related to mortgages by banks. Since banks generate their profits primarily by advancing loan, strict measures should have been enfored to check the 'information capita' to identify the creditworthiness of borrowers. This could have helped banks to clearly distinguish between the reliable borrowers and unreliable borrowers so as to minimize on the non-performing assets. The weakness of enforcing proper norms to identify the credentials of the borrowers became one of the determining reasons for the great depression. The 2008 financial crisis basically stem from the nature of its underlying asset, the housing sector that has always been believed to appreciate in due course of time. This lead the banking system advance numerous loans to the investors who considered it to be a 'safe investment', invested unchecked amount thereby inflating the risk of banks to loose money. This could be understood as one of the examples of the problem of asymmetric information and 'Moral Hazard' (John Perkins, 2008) [3,8].

C. The Moral Hazard Problem

Moral Hazard for a lay man be understood as,"someone's willingness to take risk, particularly excessive risk that he would normally avoid because the person already knows that someone else is going to bear this risk". For instance, a person who has taken a car insurance becomes careless of parking his car since he is assured that his loss via theft or damage will be redeemed by the insurance company.

Moral hazards may be claimed to have played noteworthy role in financial crisis. The financial crisis 2008 saw various mortgage brokers seeking loans from banks for unreliable households. These mortgages got converted into securities under different names, like Collateralized Mortgage Obligations (CMO), Collateralized Debt Obligations (CDO), and Collateralized Loan Obligation (CLOs). These securites got high credit ratings from various rating agencies like Moody's Fitch, Standard and Poor that also encouraged people to invest their lifetime savings in them. However, these ratings were found to present false claims at the later stage.

While the moral hazard problem had an explained role to play, it could have been simply avoided had it was analysed via the 'principle-agent problem'. The capitalist enterprises, the principal (the shareholder and board of director) hire the people such as managers (the agent) to carry out the business. The agent knows how the business is working and can pursue their self-interest which makes ruinous to the business. For example, the restaurant owner hires a manager to look after his restaurant. The owner will have an anticipated interest that his manager should

behave honestly and not to cheat the business as well as the customer. The owner can't see everything that is going into the restaurant. The owner suffers the problem which called in economics term the problem of "asymmetric information." In which the principal (owner) knows less than the agent (manager).
This is completely appricable on bank's mortgages. When the bank's agent start given a loan to the Ponzi borrowers, it creates a background for crisis. Hyman Minsky identifies three major categories of borrowers viz., the Hedge borrowers, the Speculative borrowers and the Ponzi borrowers. Hedge borrowers are those who make the payment on both the principal amount and interest amount of their debt. Speculative borrowers are those whose income will cover only interest payment, not the principal amount. For the principal amount, they have to roll over their debts, selling new debts to covers old debt. Ponzi borrowers are most dangers to the economy, their income cover neither interest nor the principal amount. These CDOs along with Ponzi borrowers started forming the bubbles. The availability of credit on easy terms ignited the file of bubble in the real estate sector but could not continue for long.The bubble blasted when supply exceeded its demand resulting in the falling prices laying the foundation stone for sub-prime crisis.

D. Government and Its Discontents

The Government, more specifically the states holds the responsibility to take necessary measures to revive the economy from depression. The US government followed the classicals idiology during the great depression and hence followed the 'Laissez faire' policy resulting in no intervention by the state in market economy and confining its boundaries only to administrative jobs. Classicals propogated the market mechanism of demand supply interaction to reveal the most efficient allocation of resources. J.B. Say also proposed the law on which markets should function saying, 'Supply creates its demand'. Hence in event of full employment level of output, the markets should be left to struggle on their own that will eventually attain their equilibrium without any external help. John Maynad Keynes (1930) describes the great depression as the failure of classical economics. He brings out simple explanation and solution to the great depression. Keynes propose active participation of the government to revive the economy especially in the uncertainties prevelant in the interwar years. The government could have easily expanded its expenditure to target the demand of goods and services that was declining because of the constant fear of war among the people along with stooping level of confidence in the financial sector. This would have accelerated aggregate demand which could meet the flood of available commodities in the markets thereby containing prices and protect the labor from losing their jobs and hence maintaining the state of employment and the level of output in the economy [4].
The government could have made use of its most powerful institution, the Federal reserve to get a hold over the shaky state of the economy. The federal reserve, on the other hand has been found to follow two different strategies to deal with the great depression and that of financial crisis in 2008. Friedman and Schwatz (1963) claim that "during the first three years of the Great Depression the Fed tolerated and even reinforced a substantial shrinkage of the money supply". They suggest the increased liquidity in the banking sector to solve the liquidity problem in this state where as Fed initiated withdrawl of money from the banks that feared run to prevent losses further. Friedman argues that many banks could have been barred from defaulting if the central bank kept faith in them and supported them with different means. The Federal Reserves which was expected to loosen up its monetary policy rather enforced strict tools to restrict the currency in circulation.
Financial crisis in 2008 on the other hand observed consistent expansion in the currency in ciculation via banking sector Nouriel Roubini, (2011) [7]. The fed also introduced 'Quantitative Easing' at the same time to bail out the banks form bankruptcy. This lead to increased intervention of the banking systemn via open market operations where they accumulated securities to release money in circulation. The policymakers strongly internalised one of the important lessons of the monumental monetary policy mistake committed during the early thirties at the Fed. The interest rates were also slashed by the Federal reserve to make easy credit available to people. However, this crisis also witnessed failures in the policymaking on account of the government. The notable casualty was the Glass-Steagall Act of 1933. The Glass-Steagall Act had created the firewall between commercial banks (which took deposits and made loans) and investment banks (which bought and sold securities). But this provision didn't last long, by thousand cuts the provision where died. It's beginning in the late 1980s; the federal reserve board permitted commercial banks to buy and sell the securities of 10 percent of their profit. Slowly they increased the permit to 25 percent by 1966. In 1966 the Bankers Trust became the first commercial bank to purchase the securities, soon after that other banks followed suit.
The Glass-Steagall was repealed when the commercial banking instruments, insurances and securities are brought under one roof. In 1999 when the Financial Service Modernization Act propounded by the Congress repealed the

Glass-Steagall. Through this FCMA the investment banks, commercial banks, and insurers could go for mergers. The 2008 crisis could have been easily avoided had these mergers not allowed by FCMA.
One of the common problems with the depression is that of "Liquidity preference" [4] for demand for money. According to Keynes, the transaction demand for money related to "the need of cash for the current transaction of personal and business exchange". It bridged tha gap between business costs and sale proceeds. But during the depression, the number of transactions are not same as normal situation since people prefer to save more.The transaction demand for money depends upon the level of income, the interest rate. the transaction demand for money is a direct proportional and positive function of the level of income.

$Lt = kY$

Where,
Lt is transaction demand for money
k is the proportional of income which is kept for transactions purpose and
Y is the income.

During the depression, the level of income decrease but the fall in the transaction demand for money is more than the decrease in the income. When there is fall transaction demand for money it effects the commodity market. The IS curve will shift to the left. In an economy when there is constant supply but the demand is decreasing it lead to the unemployment.
To increase the transaction demand, the government should intervene aggressively in the economy via expanding its expenditure. If the central bank increases the money supply to increase the demand, the proportionate increase in money supply may not be observed. During the depression, the government must intervene, become a lender of last resort and provide a massive fiscal stimulus in order to increase the demand.

E. Exchange Rate Substance

The world economy has experienced fruits of both, the flexible and the fixed exchange rate. The Greenback episode, 1861-78, was witnessed in the era of flexible exchange rate. The world economists were fully aware of crisis not leaving a positive impact on the economy. If asked to choose between the two modes of determining the value of currency, major economists would propose the floating exchange rate which may also not be considered as free from flaws but the one with relatively lesser issues for having slower negative impact of crisis on real economy. The great depression observed Gold Standard which was not accepted with open arms in its initial stages but was widely accepted post hyperinflationary trends being obeserved in the Euro zone. The whole of Europe accepted Gold standard to have a better control over supply of money except for Spain and other small countries which resorted to the silver standard.
A set of economists argue the gold standard to be the prime reason for the Great Depression to arise. Eichengreen and Sachs (1985) gives relevant evidence that countries which left the gold standard and associated with contractionary monetary policies could recover from the depression more quickly than those who stayed in the gold standard [9]. But if the fixed exchanged was the problem then the 2008 financial crisis should not affected the countries since the major part of the world followed the floation exchange rate then.
The great depression was an outcome of mix of many factors. Putting the complete blame on the gold standard would leave many stones unturned. Also, absence of any strong international institution to safeguard or guide the economies in the event of havoc also created panic that further exacerbated the crisis situation. The role of central bank has also been found to function at two extreme poles during the two crisis. All this together may explain the duration for which both the crisis left an impact on the countries in the world. The earlier one was more severe and prolonged where as the one in 2008 could be dealt with in relatively shorter span of time making use of more efficient ways.

IV. CONCLUSION

On digging deep multi-facets of the two major crisis perceived by the world economy, one may easily conclude that monetary policy alone is handicapped to revive an economy from depression. It has to certainly be couply with an active fiscal policy introducing a more targeted approach. Two approaches were proposed to remedy the situation that arose with the 2008 financial crises, viz., cutting the tax rates that would definitely have a quicker delivery and increasing the government expenditure as proposed by Keynes (1930). The state followed the Keynes approach and could bring out the economy from recessionary state in a very short span of time along with restricting the spread

effects of the crisis in a glorious way. Also, one may not completely ascertain whether the flexible or the fixed exchange rate prevents an economy to go into recession. Both have their own strengths and weaknesses [4].

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