

Does History Repeat Itself: Financial Crises

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ABSTRACT

Financial downturns have occurred nearly every 13 years. These downturns are part of a pattern known as the business cycle. There were two major standouts of these financial downturns: the Great Depression and the financial crisis of 2008. These crises were atypical in their scale, magnitude and reach. Although, these two crises share similarities in cause and mechanism, it is important to note that financial crises are not a construct of modern times. Financial crises have occurred for centuries and this study aims to highlight financial crises of the past and apply lessons learned from these to present times.

METHODOLOGY

The following methodologies were used: historical review, analysis, synthesis, induction, deduction, comparison.

INTRODUCTION

The financial crisis of 2008 is heralded as the worst global crisis the world has faced since the Great Depression of the 1930s. The impact of the crisis is astounding and its effects are still being felt. Stock prices are one indicator of how harsh the financial crisis of 2008 was. Before the collapse, the Dow Jones Industrial Average index peaked on October 12, 2007 at 14,093.08 and plummeted to as low as 6,626.94 (Google Finance, 2012) which represents a drop of nearly 53%. During the Great Depression, the Dow Jones Industrial Average faced a similar collapse going from a peak of 381.17 on September 3, 1929 to a low of 41.22 on July 8, 1932 (Rosenberg). To see the impact of the financial crisis of 2008 in terms of dollars we look to its impact on financial institutions across the globe. IMF forecasted that United States and European banks would lose over 2.8 trillion dollars in toxic assets in the period of 2007-2010 (Reuters, 2009). This impact was not just felt in financial institutions but also hit families from all income brackets. Unemployment in the US doubled from 5% on January 2008 to as high as 10% on October 2009 (U.S. Bureau of Labor Statistics, 2012). This impact was also felt in the pockets of the average American family. The net worth of Americans fell by 25% during the crisis (Singh & Bruning, 2011).

The financial crisis of 2008 had an extremely detrimental impact across the globe and it is the goal of economists to better understand what happened and to prevent such a serious collapse from happening again. To prevent such a collapse first we must understand it. There are many theories as to why collapses happen but one leading theory that is commonly accepted is the concept of business cycles.

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Historical data shows that in the last century, the United States economy has experienced ups and downs (Krugman, 2009). This pattern is known as the business cycle and is sometimes referred to as the boom and bust cycle. The latter term better illustrates the nature of the ups and downs the economy experiences. This pattern of boom and bust is evident when looking at the economy in the short term. There are periods of growth and there are periods of decline. In the long term, however, there is a steady upward trend. Thus if we compare the real GDP of the US to the real GDP from 50 years ago there will be a marked increase. If we look closer at this period, we will notice that there are periods of downturn where real GDP decreased such as in the early 70s, early 80s, early 90s and most recently in the last four years.

Periods in which real GDP, output and employment fall for many industries are known as periods of recession. In the past century the United States has faced at least one recession every decade. Each recession varies in length and magnitude of economic contraction. During periods of growth the economy is said to be in an expansion. These periods are characterized by growth in real GDP, industrial output and employment. The turning point between a period of expansion and recession is known as the business cycle peak. The turning point between a period of recession and expansion is known as a business cycle trough or saddle. A recession is typically defined as the reduction of GDP for two consecutive quarters (Dzikevicius & Zamzickas, 2009). The U.S. National Bureau of Economic Research is a research organization that reviews economic data and determines if the country faced a recession and determines the dates that we entered and exited a recession. According to the U.S. National Bureau of Economic Research the United States most recently entered a recession in December 2007 and it lasted eighteen months ending in June 2009 (National Bureau of Economic Research, 2012). Similar to how negative changes in GDP indicate a recession, positive changes in GDP indicate periods of expansion. Table 1 shows all official expansions and contractions as reported by the National Bureau of Economic Research.

There are competing theories explaining why the economy experiences these periods of expansion and recession. One of the leading theories is the Austrian business cycle theory. The Austrian theory begins with the central bank or in the case of the United States, the Federal Reserve and its monetary policy tools. When the Federal Reserve artificially cuts interest rates as it did prior to the financial crisis of 2008, it makes entrepreneurs and investors falsely believe that consumers are willing to delay consumption and save more. The natural interest rate, which is the interest rate if the Federal Reserve did not engage monetary policies, is the rate that lenders must pay to consumers to convince consumers to delay consumption. This monetary policy of lowering interest rates creates excess credit and causes wages and prices to go up. As this increased money from the excess capital comes down to consumers, the consumers' preferences haven't changed (the natural interest rate hasn't changed). Thus, there is no increased demand for this excess supply of goods. The Federal Reserve realizes that such growth cannot be maintained and thus increases interest rates. Markets begin to feel the credit crunch and then the

excess supply of goods and poor investments is liquidated. The liquidation is then followed by a recession, which brings the economy back to its original balance (Dzikevicius & Zamzickas, 2009).

Financial crises lead to devastating effects such as reduced GDP, lower employment, lower wages, decreased investment and decreased production. The primary goal of economists and specifically the Federal Reserve is to not only reduce the effects and length of recessions but also to potentially eliminate them. In order to better realize this goal we will look at past financial crises and compare them to the crisis the United States faced in 2008. By looking at the similarities and differences and comparing them to the Austrian business cycle theory and other related theories we can be better equipped to avoid further financial crises.

DUTCH TULIP CRISIS

The Dutch tulip crisis is one of the earliest recorded and studied crises to plague an economy. It is more commonly known as Tulip Mania. In short, the tulip crisis was a period during the Dutch Golden Age when tulip bulb prices rose so high that they cost as much as a house (Hirschey, 1998). The Dutch Tulip Crisis began in 1593, when Conrad Guestner imported the first tulip to Holland from present day Turkey. The tulip fascinated the Dutch and it quickly became a status symbol to own one. This quickly elevated the price of the tulip. The price rose dramatically again when the tulip contracted a virus typically known as the mosaic virus. The mosaic virus adorned the tulip petal with beautiful strips of color that gave it a flaming look (See Figure 5). At first, people bought the bulb for its beauty, but its quickly rising price attracted investors who bought the bulbs and sold them at a higher price. This further fueled the price increase and tulip prices continued to soar. Tulip mania spread across the Dutch lands and what was once a symbol of status for the rich became an investment tool for the middle class.

Tulip mania continued to spread beyond the middle class and into stock exchanges. Tulip bulbs were being traded in the Amsterdam, Rotterdam, Harlem, Levytown, and Horne stock exchanges (Ubhan, 2007). This opened up the opportunity for speculators to trade options on the tulip bulbs. Options trading allowed people to speculate on the price of tulips by investing only a fraction of the cost of what a tulip bulb actually cost at the time. Just like the housing market saw a steady price increase in the early 2000s, tulip prices were going up steadily and few thought the price would ever go down. The tulip craze was a growing bubble that was ready to pop just as the housing bubble popped and resulted in a financial crisis.

The tulip bubble couldn't grow any larger and it did pop indeed. The Dutch government realized that the bubble was growing and they began to implement regulations. Savvy investors realized that the bubble couldn't grow anymore and they began to liquidate their investments. This increased the supply of tulips on the market, which drove prices down. Prices were further driven down as people began to plant the bulbs to grow more bulbs. Tulip prices began to fall slowly and then the suddenly collapsed. In less than six weeks, the price of tulips fell 90% (Ubhan, 2007). As the tulip market crashed, the Dutch government decided not to intervene. As the tulip market crashed, it affected the entire Dutch economy and Holland faced a severe crisis that lasted for decades.

The Dutch tulip crisis has many connections to the most recent financial crisis and there are many lessons that should have been learned and implemented prior to the crisis. Similar to the financial crisis of 2008, the Dutch tulip crisis was a speculative crisis. As speculators began to invest in tulip bulbs, the price quickly rose and did not reflect the actual value of tulips that buyers would pay. Risky investment tools further exacerbated the problem. Options trading meant that investors could invest in tulips at a fraction of the cost of a tulip bulb. This is similar to how banks convinced the SEC prior to the 2008 crisis to allow them to take on greater debt to make more investments. This increased debt puts more at stake and thus the eventual crisis would be deeper and more protracted. This is what we saw with the financial crisis of 2008, which lasted 18 months, significantly longer than any of the last financial crises after the Great Depression. This is also what happened after the Dutch tulip crisis, which saw the markets affected for decades by the sudden collapse of tulip prices.

THE LONG DEPRESSION, CRISIS OF 1873

The Long Depression was originally known as the Great Depression until the 1930s when the Great Depression took that name. The Long Depression is the longest recorded recession in US history. It lasted 65 months, nearly two years longer than the Great Depression, which lasted 43 months (National Bureau of Economic Research, 2012). The Long Depression is also one of the first modern international crises as it affected economies around the globe.

The Long Depression has a long history that begins in Europe. In the 1860s, European banks began mortgage backed lending programs. This led to a housing bubble where beautiful homes in Vienna, Berlin, and Paris were built and sold. In 1873, defaults on these properties began to restrict lenders and these banks began to call back their loans. European banks called back loans from British banks and they in turn called back loans from American clients. At the time, these American clients consisted largely of railroad companies (Cuzron, 2009).

Before discussing the effects of these loan callbacks, we turn to the situation of railroad companies in the United States. The railroad industry was a booming bubble at the time, just like the recent housing bubble and the Dutch tulip bubble. There was heavy investment and speculation in railroads. In the period of 1868 to 1873, 33,000 miles of railroads were added to the US (Richardson, 2007). This heavy growth in the railroad industry attracted many investors. At the peak of the industry, the railroad companies accounted for nearly half of the employment in the US, eclipsing agriculture. Railroad companies were building a plethora of railroad docks and laying down new track with no immediate monetary award in sight. Speculators fed into this frenzy and further enlarged the railroad bubble.

Elsewhere, another important set of events was occurring. In 1871, the German empire decided to stop minting silver coins. This led to a dramatic drop in the global demand for silver. At the time, the US was a major producer of silver. As a result of this German policy, the US enacted the Coinage Act of 1873, which moved the US to a gold-only standard. This act had the immediate effect of decreasing the

value of silver but it also had a longer-term effect that decreased the money supply in the US (Scott, 1952).

Large speculation in the railroad industry combined with decreased money supply and the European call back of the loans led to the panic of 1873. The panic of 1873 ignited with the failure of Jay Cooke & Company. Jay Cooke & Company was a bank that was heavily invested in the unrealistically booming railroad industry. Cooke's firm was responsible for raising \$100 million in capital for the Northern Pacific Railway. When they were unable to raise this money the bank collapsed and eventually declared bankruptcy. This led to the protracted recession that lasted 65 months. More railroad companies began to fail because they couldn't pay back the loans that the Europeans were demanding and this led to other US banks collapsing. As the railroad industry declined banks collapsed and unemployment increased. Unemployment reached as high as 14% in 1876 (Lee, 2008). The collapses had far reaching effects. Many industries suffered and faced decreased output.

The financial crisis of 1873 has many parallels to the financial crisis of 2008. The most obvious parallels are the growing bubbles. In the Long Depression, there was a European housing bubble and a railroad bubble. These are similar to the housing bubble that the United States faced in the early 2000s. There was over investment in the European housing market and the railroad industry. Over investment led to speculation and risky investment. This sets up the ideal situation for a collapse. The most disturbing fact from this historical example is how closely it resembles what happened in the last few years. The European housing bubble that was growing in the 1860s mimics what was happening in the US in the last decade. Regulators and lawmakers from today should have been more aware of the impending collapse given the parallels to what happened over a century ago.

THE GREAT DEPRESSION

The great depression is the most severe worldwide economic depression in modern times. It is the longest depression that the United States has faced in the twentieth century (National Bureau of Economic Research, 2012). Historians typically mark the beginning of the Great Depression as October 29, 1929 or Black Tuesday. This day was marked by a sudden collapse of US stock market prices. In order to better understand how to avoid recessions we must discuss the events leading up to this day and the aftermath of this day.

Before the collapse on Black Tuesday, the stock market was doing extremely well. In fact, the 1920s are also known as the Roaring Twenties. The 1920s was a time of wealth and excess. This was especially noticeable in the way that people were investing. Just like many believed that the housing market would continue to rise in the early 2000s, people in the 1920s believed that the stock market was going to continually rise and during the twenties this was true. The stock market witnessed a meteoric rise in the 1920s increasing in value five-fold in six years (PBS). The Dow Jones Industrial Average peaked on September 3, 1929 at a high of 381.17. This meteoric rise was fed by over speculation in the stock market.

Because of the great confidence in the stock market, Americans were buying stocks in droves and worse, they were buying stock with credit. This was known as margin buying. People would buy hundreds of dollars of stock with little investment on their part. Politicians were unaware of the economic situation and thus did nothing to control over speculation and margin buying. With all this uncontrolled speculation, the stock prices rose so rapidly that the stock prices no longer truly represented the health of the industries that they were backing. In the month prior to Black Tuesday, there was some volatility in the market just after the market peaked. On October 24, 1929, a record 12 million shares were bought and sold which caused a collapse in stock values. The following Tuesday a new record 16 million shares were put on the market and caused stock values to plummet. Just like speculation in the housing market led to the most recent financial crisis, speculative investing in the stock market led to the Great Depression.

These are the key events leading to the stock market crash of October 29, 1929. The resulting depression escalated because of a number of factors. One factor was the large amount of wealth lost in the stock market. Over the course of the depression, the stock market declined in value by \$40 billion. This directly affected investors but it eventually led to the failure of banks. As banks continued to fail, people not involved in the stock market also lost money as their savings accounts were wiped out.

The government was supposed to do something. After the crash of 1907, the US government set up the Federal Reserve. The Federal Reserve was supposed to mitigate the effects of the crash and bring the economy back. At the time the Federal Reserve decided to cut the money supply. Over the course of the depression they cut the money supply by 1/3 (Kepelian, 2008). This was the exact opposite of what they should have been doing. Banks needed more money at this time but this poor policy decision cut the money supply which led to an exponential growth in bank failures, further wiping out the savings accounts of Americans. Fortunately, the Federal Reserve has learned from this mistake and has implemented better policies after the financial crisis of 2008. After the crisis, the Federal Reserve slowly dropped the federal funds rate to 0% which helped increase the money supply and prevented banks from failing.

Let us review the parallels of the Great Depression to the recent financial crisis of 2008. Both of these crises were led by speculative spending. The Great Depression was led by speculation in the stock markets and the financial crisis of 2008 was led by speculation in the housing market. At both times, the government did little to stop or curb the over speculation. In retrospect, the government should have enacted policies controlling margin buying in the 1920s and more recently the government should have put a stop to sub-prime mortgages. Preventing over speculation is a key lesson learned from these two financial crises.

THE FINANCIAL CRISIS OF 2008

The most recent financial crisis is described as the worst financial crisis to have occurred since the Great Depression. Millions of jobs were lost and trillions of dollars in the market disappeared (Friedman & Friedman, 2009). Looking at this crisis retrospectively, the primary cause of the crisis was the prevalence of sub-prime mortgages followed by the inevitable inability of Americans to pay back these mortgages.

Behind this primary cause there were many factors at play that led to the eventual collapse: the self-interest of executives, the flawed bonus system the lack of regulation, and the inaction of credit agencies.

We will begin by looking at the first two factors at play. It is obvious that executives were eager to make money and combined with a flawed bonus system, executives did anything to make a big bonus. Bonuses were awarded based on annual income and if executives were able to generate a large income on paper they were rewarded heavily. This didn't apply to just executives but all top tier workers. In 2006, Wall Street bonuses totaled a record breaking \$24 billion (Farrell, 2006). This encouraged executives and employees to take big risks to score big bonuses. One risky method was the selling of sub-prime mortgages. Executives encouraged employees to give out as many mortgages as possible. Many of these mortgages were given out with little or no down payment. The prevalence of sub-prime mortgages sky rocketed prior to the financial crisis of 2008 (See **Error! Reference source not found.**).The immediate result was an increase in income on paper and thus an increased bonus for the year. Few were aware of the fallout that was about to result and no one did anything to prevent it.

This leads to the next factor at play - lack of regulation. In 2004, five top investment banks pushed the United States to grant an exemption from the net capital rule which would allow them to take on a greater amount of debt. With this increased debt banks would be able to invest in these risky mortgages and credit default swaps. These regulations were first put in place to prevent such risky investments and these banks worked to reverse these preventative measures. Furthermore neither the Federal Reserve nor the US Government took action to prevent banks from making poor investments into risky mortgages. In fact, the Federal Reserve kept the federal funds rate low during the early 2000s. This action increased the monetary supply and gave the banks more money to make risky investments. Many blame former Federal Reserve Chairman, Alan Greenspan, for the financial crisis of 2008. He was a chief promoter of low interest rates and deregulation in the 2000s which led to over speculation and the eventual crisis that followed (Time Magazine, 2009).

Credit Agencies were also to blame. They were responsible for rating the complex packages of sub-prime mortgages and credit default swaps. They should have lowered the status of these packages because of the high risk involved but they gained heavily from rating these packages favorably. They would collect multimillion dollar fees for rating these complex packages and thus they continued giving high ratings which gave false confidence to the banks that bought and sold these packages. Their high ratings also meant that there was little warning to the impending collapse. If the credit agencies did their job then these packages would have not been valued as high as they were and there would be less speculation in the sub-prime mortgage market.

WHAT DO WE DO NOW

This study has highlighted some of the major financial crises that have plagued our economy and from these crises there are many lessons to be learned. Each of these crises has one important trait in common – over speculation. In the Dutch tulip crisis, there was extreme speculation in tulip bulbs which

drove the price of tulips up. In the Long Depression, there was over speculation in the train industry. In the Great Depression there was over speculation in the stock market. Most recently, in the financial crisis of 2008, there was over speculation in the housing market. Given the recurring trend, it seems like investors, bankers, regulators and the government have not learned an important lesson – stop speculation before it goes rampant. The actual situation is more nuanced. The government and regulators have already put policies into place to prevent over speculation and to prevent the worsening of recessions. After the financial crisis of 1907 the United States created the Federal Reserve. There are also other bank regulations such as capital requirements, reserve requirements, corporate governance, financial reporting, disclosure requirements, credit rating requirements and others. More recently the United States implemented the Dodd-Frank Wall Street Reform and Consumer Protection Act. All these requirements and acts are supposed to prevent deep and retracted recessions from occurring but crises seem to continue to occur regardless. One reason for this is that bankers' and executives' greed finds new and innovative ways to make money that bypass current laws and regulations. This is evident from looking at the past financial crises highlighted in this study. Although all the crises have over speculation in common, in each case there was over speculation in a different area. Investors, bankers and executives find new avenues to make money and this leads to over speculation.

Clearly regulators and the government must act to stop over speculation and they must do so in a way that prevents over speculation in all possible fields. At the same time regulators must not go so far as to restrict the economy. This is a delicate balance with no clear answer available. What is clear, however, is that over speculation must be prevented. Regulation tools must not just target one form of speculation but must they must also be innovative and far reaching so that they catch unsuspected forms of speculation. Furthermore, regulators must be savvier and prepare to catch speculation bubbles before they grow too large and lead to a downfall.

Practical policy tools that should be implemented include strict enforcement of debt ratios, credit reporting and compensation oversight. Implementing these rules will prevent risky investments. With strict enforcement of debt ratios, banks will only be allowed to maintain a certain amount of debt on their statements. This means that they will have to use more of their own money to make investments and thus they will be less likely to make risky investments. Moreover with proper credit reporting, financial packages and industries will be rated according to their actual value and excessive hype in an industry will be slowed before it grows too large. In addition, compensation oversight will prevent executives from pushing risky investments in order to benefit themselves in the short term. Executives should be held liable for future losses and they can be penalized by retraction of bonuses from previous years.

These tools are practical measures that can be set up now to prevent severe financial crises. Beyond these measures, the government and regulatory agencies need to constantly be on the lookout for innovative techniques used by executives and bankers. Regulatory agencies need to be aware that bankers and executives will find ways to bypass the system and thus these agencies must be at the ready.

We must always remember the financial crisis that have plagued the US and international economies in the last few centuries. Keeping these in mind we can prevent future crises from happening again.

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