

Causes and Similarities of the 1929 and 2008 Financial Crises

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Abstract

After the famous "Coolidge Boom", the United States experienced an unprecedented economic crisis in 1929, first with the collapse of the stock market, the collapse of banks, then the shutdown of industry, the displacement of tens of millions of people, and finally through the capital market to almost all capitalist countries; A century later, another world financial crisis kicked off on Wall Street, starting with the collapse of the stock prices of the two mortgage giants in August 2008 United States leading to the bankruptcy of more than United States subprime mortgage institutions, all five major investment banks, including Lehman Brothers, and a 50 million increase in the number of poor people in the world. Through the comparative analysis of the two crises, this paper expounds the causes of the two crises respectively, and analyzes the similarity between the two crises.

Keywords

Economic Crisis; Stock Market; Policy.

1. Introduction

After the famous "Coolidge Boom", the United States experienced an unprecedented economic crisis in 1929, first with the collapse of the stock market, the collapse of banks, then the shutdown of industry, the displacement of tens of millions of people, and finally through the capital market to almost all capitalist countries; A century later, another world financial crisis kicked off on Wall Street, starting with the collapse of the stock prices of the two mortgage giants in August 2008 United States leading to the bankruptcy of more than United States subprime mortgage institutions, all five major investment banks, including Lehman Brothers, and a 50 million increase in the number of poor people in the world. Through the comparative analysis of the two crises, this paper expounds the causes of the two crises respectively, and analyzes the similarity between the two crises.

2. Causes of the Economic Crisis of 1929

2.1. "Laissez-faire" Policy

Because the United States accumulated a large amount of wealth through arms trafficking in World War I, the economy showed a thriving development trend, in order to further implement the market regulation theory of classical economics, the United States government implemented "laissez-faire" on the market, that is, reducing control, reducing bank deposit interest rates and deposit reserve ratios, and making full use of the market's self-regulation function, but due to the inherent drawbacks of "spontaneity" and "blindness" in the market, small and micro enterprises were squeezed out by large enterprises and a monopoly situation was formed[1]. After successfully capturing the market, monopolies began to produce products in large quantities, resulting in oversupply and overcapacity.

2.2. Subprime Lending Prevailed, and the Stock Market Boomed

In order to absorb excess capacity, banks are the main body involved, issuing large loans to people to stimulate domestic demand and stimulate consumption. And this loan has two significant features: first, it has launched a new model of "installment payment", which is the "mortgage repayment" model that we can see everywhere today; Second, the loan includes a huge subprime loan, that is, the bank lends a large amount of money to low-income groups without repayment guarantees, and the combination of these two characteristics lays a huge hidden danger for subsequent repayment^[2]. However, in the short term, such loans have actually stimulated economic development, and with the support of high production capacity and high consumption, the famous "Coolidge Boom" has United States, and the stock market has soared, making many investors even borrow from banks to buy stocks, hoping to repay the principal and interest through the bid-ask spread. Speaking of this, in fact, it is not difficult for us to see the main contradiction - that is, there is an essential problem in the means of the government and banks to solve overcapacity, as the saying goes: "It is better to teach people to fish than to teach them to fish", stimulating consumption should start from opposing monopoly and solving employment, and the economic prosperity supported by a large number of loans like this cannot last long, and at that time, stocks were the repayment guarantee of most borrowers, and the growth rate of stock prices far exceeded that of the real economy, there were a large number of bubbles, once the stock price fell, Low-income groups simply cannot repay their debts in full.

2.3. The Stock Market Crashed, Triggering a Chain Reaction

In October 1929, people who discovered the problem began to sell stocks en masse, a market signal that sent the NYSE stock index down 13 percent. The Dow Jones plunged 22 percent, and then set off a chain reaction - people borrowed money to speculate in stocks, starting with the banking sector, and a large number of bad debts caused a series of bank failures in United States, 6,987 in 1930, 2,294 in 1931, and 1,456 in 1932. In 1932, the number of enterprises that closed down in United States was as high as 130,000, and the industrial production index fell by 46%, and the bankruptcy of enterprises led to the loss of employees, according to incomplete statistics, the total number of unemployed people in United States at that time peaked at 13.7 million. People have no money to buy food, there has been a nationwide famine, and conservative estimates of the death toll are around 7 million, compared to about 700,000 coronavirus deaths in the United States as of October 2021, which shows the severity of the crisis^[3]. Of course, the crisis also made governments think about the importance of macroeconomic control, and the famous Keynesianism also appeared on the stage of history at this time.

All in all, this economic crisis has three characteristics: it is widespread, long-lasting, and destructive. In contrast, the destructiveness of the 2008 financial crisis does not seem to be so serious and lasted for so long, but due to economic globalization, the financial crisis has spread more widely, and China has also been implicated to a certain extent.

3. Causes of the 2008 Financial Crisis

3.1. "Neoliberal Capitalism" Policy and the United States Dream Down Payment Act

First of all, from the policy point of view, in order to promote economic growth, the United States federal government has pursued "neoliberal capitalism" since the beginning of the 21st century, the central bank has implemented a loose monetary policy on the one hand, and the bank deposit interest rate is extremely low, so that investors turn bank deposits into the derivative financial instrument market, financial products are in short supply, correspondingly,

their prices have risen rapidly, providing profit drive for subsequent financial institutions to issue financial products indiscriminately^[4]; On the other hand, the George W. Bush administration enacted the United States Dream Down Payment Act, which encouraged mortgage lenders (mainly the two oligopolys, Freddie Mac and Fannie Mae) to issue large housing loans to meet the housing needs of United States.

3.2. Subprime Loans Prevail and House Prices Rise

As we all know, the United States credit system roughly divides borrowers into superior, sub-optimal and subordinate, and most subprime lenders have obvious problems with their repayment ability, relying only on their daily income can not fully repay the loan principal and interest, and need to repay the interest through the disposal of assets or external financing or even the implementation of mortgage guarantees^[5]. If the mortgage institution has 2% of the loan cannot be recovered, it will generate a higher financial risk, and United States the total amount of subprime loans in 2005 has been as high as 1.4 trillion US dollars. And the subprime loans have a common feature – borrowers can enjoy very low interest rates and down payments in the first few years, but interest rates will increase significantly in the last few years, resulting in a situation where everyone is happy at the beginning and ends up being stretched.

Since they have to face such huge risks, why do the two giants of United States mortgages, Freddie Mac and Fannie Mae, dare to enter this field? On the one hand, since most middle-class families had already taken out prime mortgages and subprime mortgages at the time, Freddie Mac and Fannie Mae hoped to profit from the new market of "subprime loans". On the other hand, these loans were secured by housing, and because the United States housing market was in short supply at the time, housing prices continued to rise, and the average price reached \$270,000 in January 2007, equivalent to 150% of 2001. In the event of a bad debt loss, the mortgage lender can also auction off the mortgaged property and even make a difference in the price. By 2006, subprime loans accounted for 20% of U.S. mortgages.

3.3. Indiscriminate Issuance of Derivative Financial Products

Of course, mortgage lenders are also aware of the fatal flaw of this approach – once housing prices start to fall, mortgage lenders are at risk of breaking the capital chain. In order to prevent risks, Freddie Mac and Fannie Mae carried out risk passing, packaging a large number of subordinated loan claims into secured debt debt certificates (CDOs) and credit default swap CDSs to sell in the market: on the one hand, they passed on the risks to investors and charged fees, and on the other hand, they raised a steady stream of funds to enable them to issue subprime loans to home buyers again. By 2007, the total CDS in the United States had reached \$58.24 trillion, almost four times the GDP of United States that year (\$14 trillion), and the CDO also peaked in 2007^[6].

In this way, the risk was successfully passed on to the majority of investors, because without the emergence of derivative financial instruments, the worst outcome would be limited to the collapse of the two major mortgage institutions, but driven by profits, the indiscriminate issuance of CDS and CDOs made the crisis spread to the United States and the world through the financial market.

3.4. The Real Estate Industry is Thundering

In fact, the preferential interest rate period for many low-income home buyers has ended at the end of 2007, and there is a situation where the loan cannot be repaid, a large number of properties that are used as collateral began to flow to the market, the supply has increased significantly, and the house price has plummeted, under a series of chain reactions, the losses faced by investors in the derivative financial instrument trading link have reached astronomical under the effect of leverage, resulting in the bankruptcy of a large number of investment institutions, and in early 2008, Bear Stearns, the fifth largest investment bank on Wall Street,

entered bankruptcy liquidation procedures; In September 2008, Lehman Brothers, the fourth largest investment bank, also declared bankruptcy. By the end of the year, the main culprits of the crisis, Freddie Mac and Fannie Mae, were also unable to recover and were bought by the Federal Reserve at a low price.

Of course, the recession of the financial industry is only the beginning, and the impact on the real economy is what the people are worried about. The massive shutdown of financial institutions has brought the global economy to a standstill, unemployment has risen rapidly, reaching 10% in Europe and the United States at the end of 2008, and thousands of people have been displaced as large numbers of mortgaged properties have been repossessed by banks. Although the damage was severe, the current crisis could not be compared with the 1929 crisis, whether in terms of destruction or protractedness, so the impact on people's lives was far less severe than the previous economic crisis.

4. Similarity Analysis

4.1. Policy Freedom, Overcapacity

First of all, from the United States government level, the two crises were carried out free market policies, the United States government called them "laissez-faire" and "neoliberal capitalism" respectively, in the lack of control environment, the disadvantages of the "spontaneity, blindness" of market players are undoubtedly revealed, enterprises began to blindly expand production, resulting in overcapacity, mainly industrial goods overproduction in 1929, and real estate overproduction in 2008.

4.2. The Gap between the Rich and the Poor is Obvious, and Subprime Mortgages are Prevalent

Then, from the perspective of financial institutions, both crises were aimed at absorbing excess capacity, and financial institutions began to lend to groups in need of funds. Since the gap between the rich and the poor has always been relatively evident in the United States, which also includes a large number of subprime loans held by low-income groups, and the repayment is guaranteed by specific assets, the first is stocks, the second is real estate, this inherently highly uncertain asset brings great risk to repayment.

4.3. Industry-specific Acts as a Fuse

Then, from the perspective of the fuse of the crisis, the direct cause of the two crises was the thunderstorm of a specific industry. As mentioned above, the holders of subprime loans use stocks and real estate as guarantee of repayment, and the prices of these assets will fluctuate with the market, and once the relevant industry crashes and the price falls, it will cause a series of chain reactions. There is no doubt that the thunderstorm of 1929 began in the stock market, and in 2008 it began in the real estate market.

4.4. The Financial Sector is Bearing the Brunt, Followed by the Real Economy

When stock prices and housing prices plummeted, financial institutions had a large number of bad debts, went bankrupt and collapsed, becoming the first victims of the crisis. When financial institutions fall, ordinary people are affected, and falling incomes and rising unemployment are inevitable consequences of the economic shutdown.

5. Summary

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