

# **Financial Crisis in the Great Depression**

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# **Minsky/Kindleberger Stages of a Financial Crisis**

- Displacement
- Boom
- Bubble/Mania
- Distress
- Panic/Crash
- Revulsion/Discredit
- Depression

# Displacement

“Events leading up to a crisis start with a ‘displacement,’ some exogeneous, outside shock to the macroeconomic system. The nature of this displacement varies from one speculative boom to another. ... But whatever the source of the displacement, it will alter the economic outlook by changing profit opportunities in at least one important sector of the economy. Displacement brings opportunities for profit in some new or existing lines. ... A boom is underway.” Kindleberger [4, pp. 17-18]

# Monkey See, Monkey Do

“Increased demand presses against the capacity to produce goods or the supply of existing financial assets. Prices increase, giving rise to new profit opportunities and attracting still further firms and investors. ... As firms or households see others making profits from speculative purchases and resales, they tend to follow: ‘Monkey see, monkey do.’ ” Kindleberger [4, p. 19]

# Mania/Bubble

“When the number ... indulging in these practices grows large, bringing in segments of the population normally aloof from such ventures, speculation for profit leads away from normal, rational behavior to ... ‘manias’ or ‘bubbles.’ The word *mania* emphasizes the irrationality; *bubble* foreshadows the bursting.”  
Kindleberger [4, p. 18]

# **Failure of Lehman Brothers**

The underlying cause of a panic is excessive credit and speculation.

The trigger for a panic is some specific incident.

The trigger for the Paulson panic was the failure of Lehman Brothers.

# Leverage

Leverage is borrowing to increase the stake of one's investment.

Leverage magnifies gains and losses.

# **Leverage: The Cause of the Paulson Panic**

Large losses by banks and other financial institutions from leveraged investment in mortgages is the cause of the current financial crisis.

# Double Your Money!

Consider a bank or a hedge fund borrowing short-term at 2% and investing in mortgages at 6%. Leverage is very high leverage—thirty-to-one: borrow thirty dollars short-term for every one dollar of equity, and invest the thirty-one dollars invested in mortgages. Per dollar of equity, the cost of borrowed funds is 30 times 2%, namely 60%. The return on the mortgage investment is 31 times 6%, namely 186%. The net profit is 126%, 186% less 60%. The leveraged speculator more than doubles his money each year!

# **Better than Stock Speculation!**

For a stock investment, the investor must pick what stock will go up, and stock prices are unpredictable.

In contrast, the mortgage speculator makes money as long as the situation is steady.

What was forgotten is that the mortgage loan must be repaid.

# **Displacement, Boom, and Bubble**

To speed recovery from the mild recession of 2001, the Federal Reserve pushed down the short-term interest rate to just 1%, the lowest level for many decades.

The fall in interest rates sets off a boom in housing, as mortgage loans are cheaper. Indeed a boom occurred: house prices rose, and many new houses were built.

A classic bubble followed.



# Roller Coaster

# Fine Tuning

“Yielding to political pressures to ‘do something’ may frequently do more harm than good. There is a saying that the best is often the enemy of the good. ... The goal of an extremely high degree of economic stability is certainly a splendid one. Our ability to attain it, however, is limited; we can surely avoid extreme fluctuations; we do not know enough to avoid minor fluctuations; the attempt to do more than we can will itself be a disturbance that may increase rather than reduce instability.” Friedman [2, p. 48].

# Legal Restrictions on Leverage

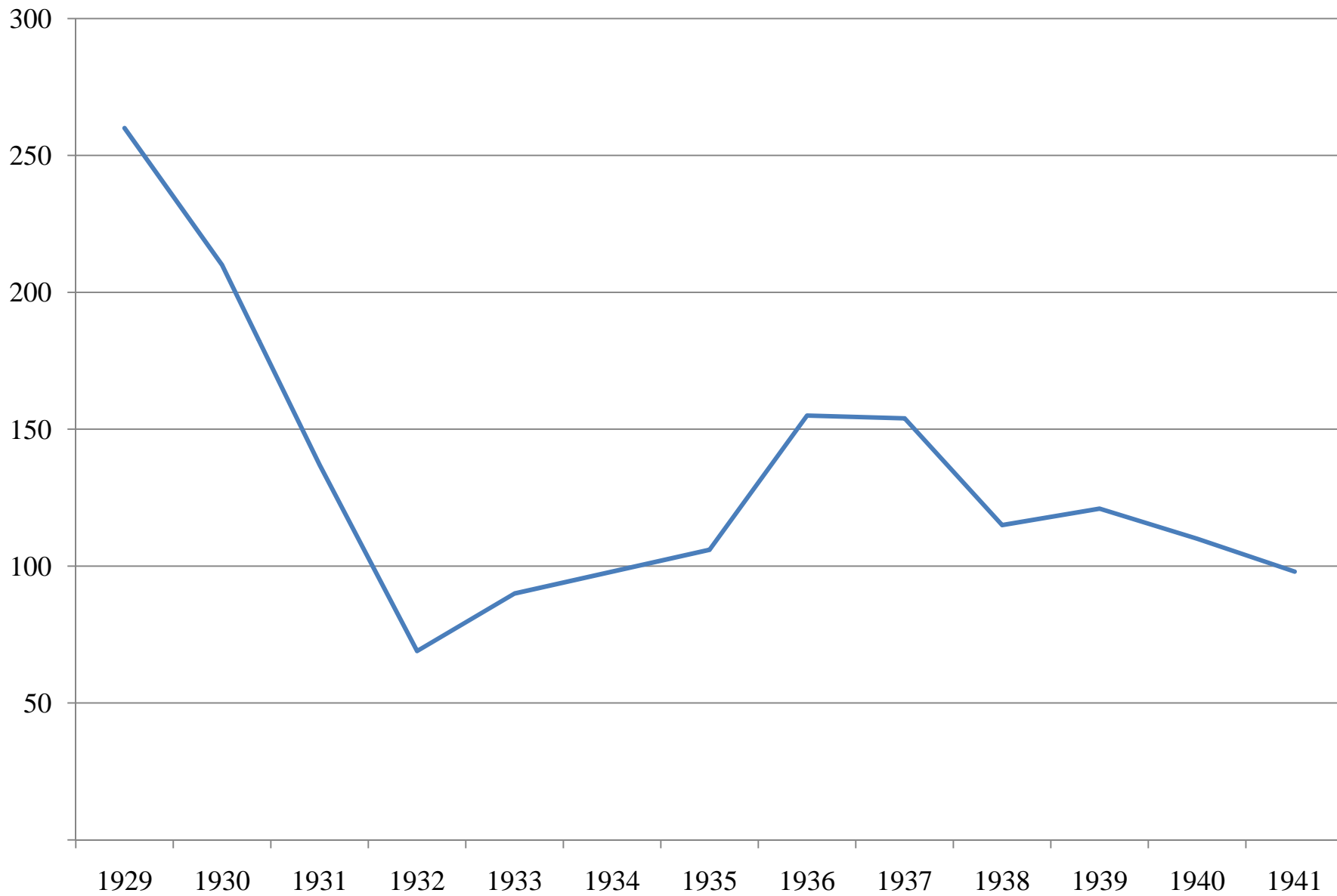
- 50% margin requirement for stocks
- Leverage prohibited for mutual funds
- Hedge funds only for the wealthy

# “Guaranteed” Lending

- Federal deposit insurance
- Mortgage guarantees by Fannie Mae and Freddie Mac
- Credit-default swaps
- AAA credit ratings on risky mortgage pass-throughs

# **The Great Depression**

# Stock Prices



# **William Crapo Durant**

From 1905-1918, William Durant created General Motors, by combining Buick, Oldsmobile, Cadillac, and Chevrolet. Durant was a leader and knew how to make and sell cars. Later Durant was forced out as CEO, but he was wealthy.

During the stock boom of the 1920's, Durant bought heavily on margin. He borrowed large sums simultaneously from different brokerages, while hiding the overall magnitude of his borrowing. When the stock market crashed in 1929, he was ruined financially.

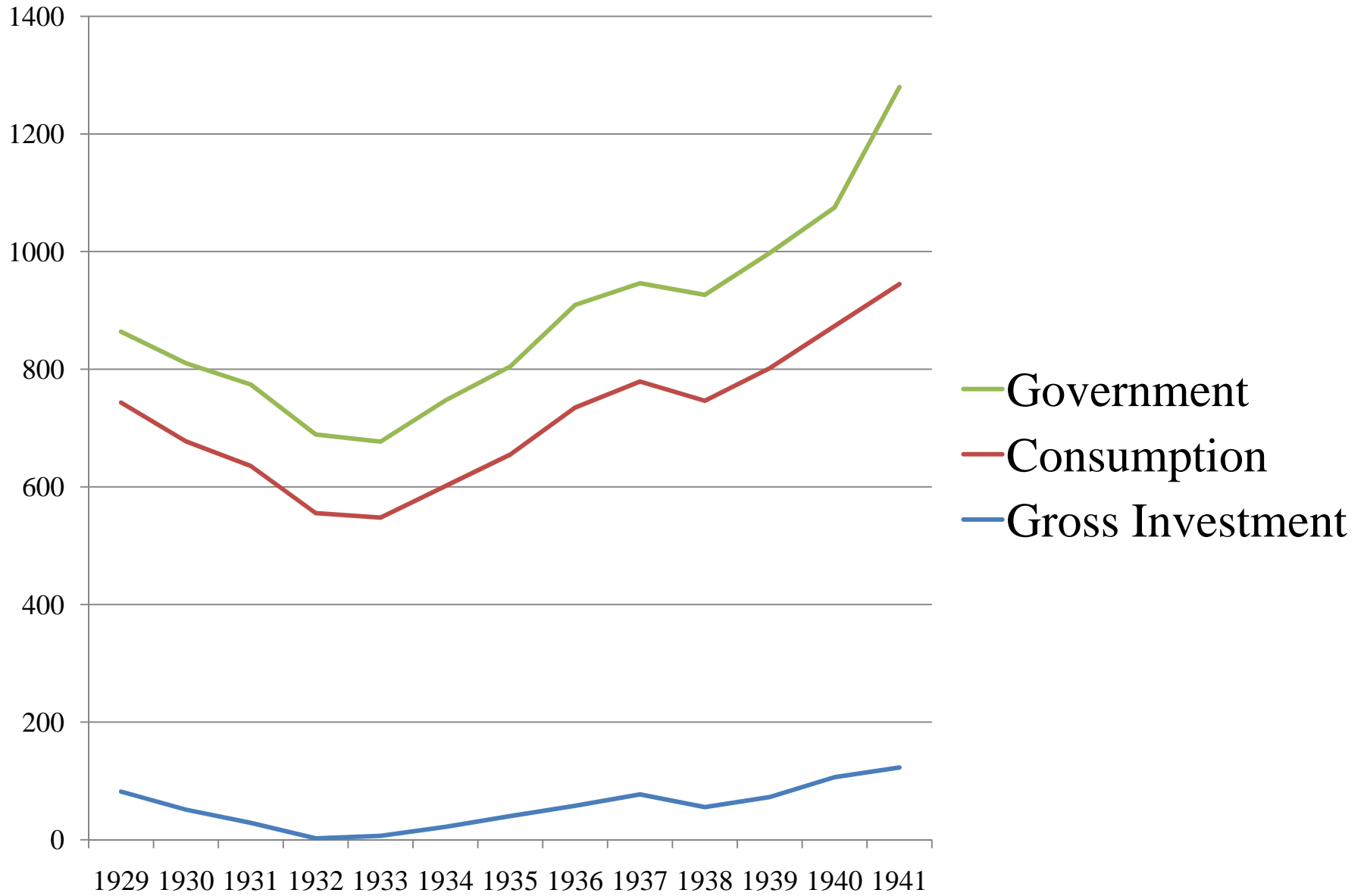
# Investment Trusts

Investment trusts were the counterpart of today's hedge funds.

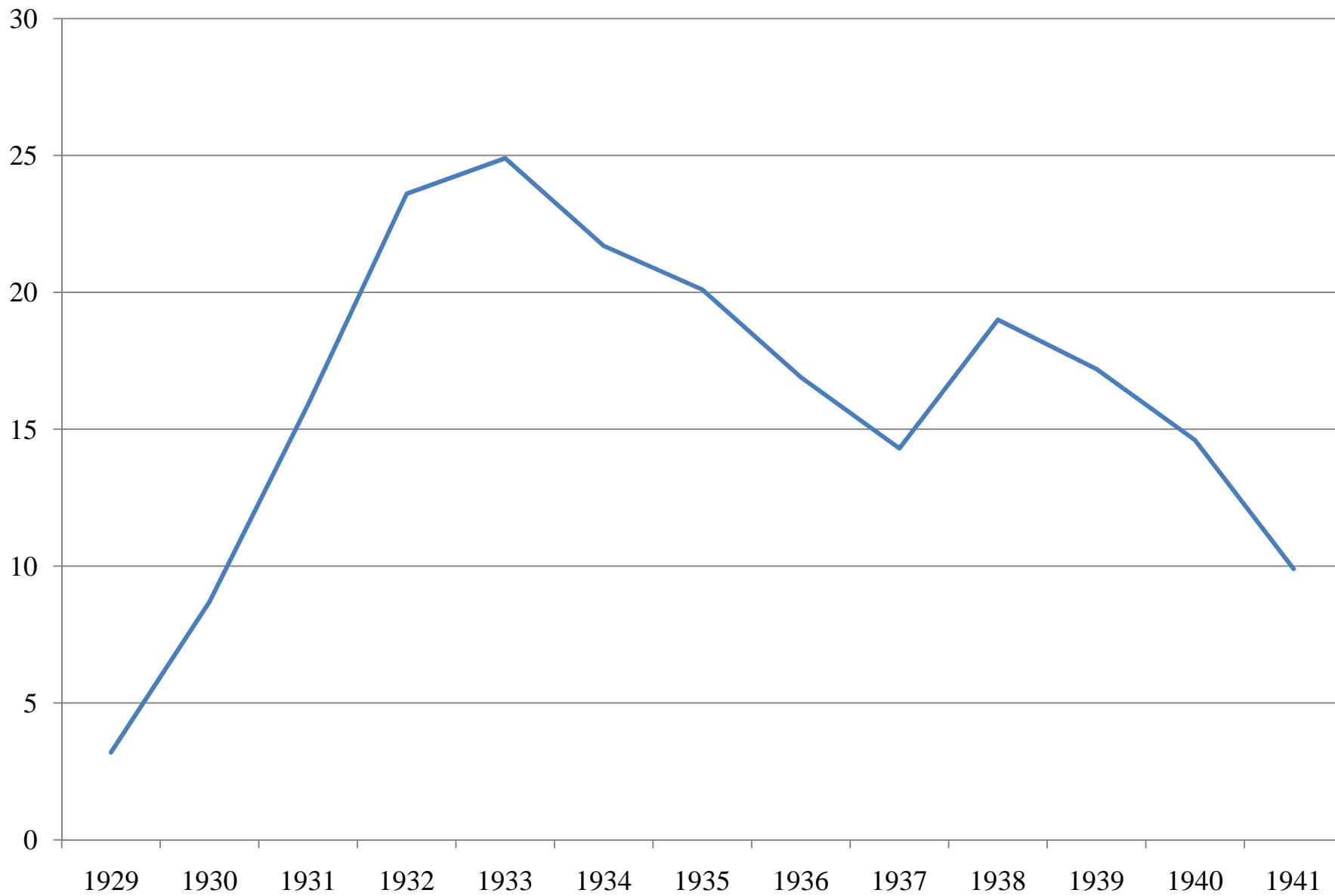
Headed by prominent money managers, an investment trust was essentially a secretive, closed-end mutual fund using leverage.

The stock crash bankrupted the investment trusts.

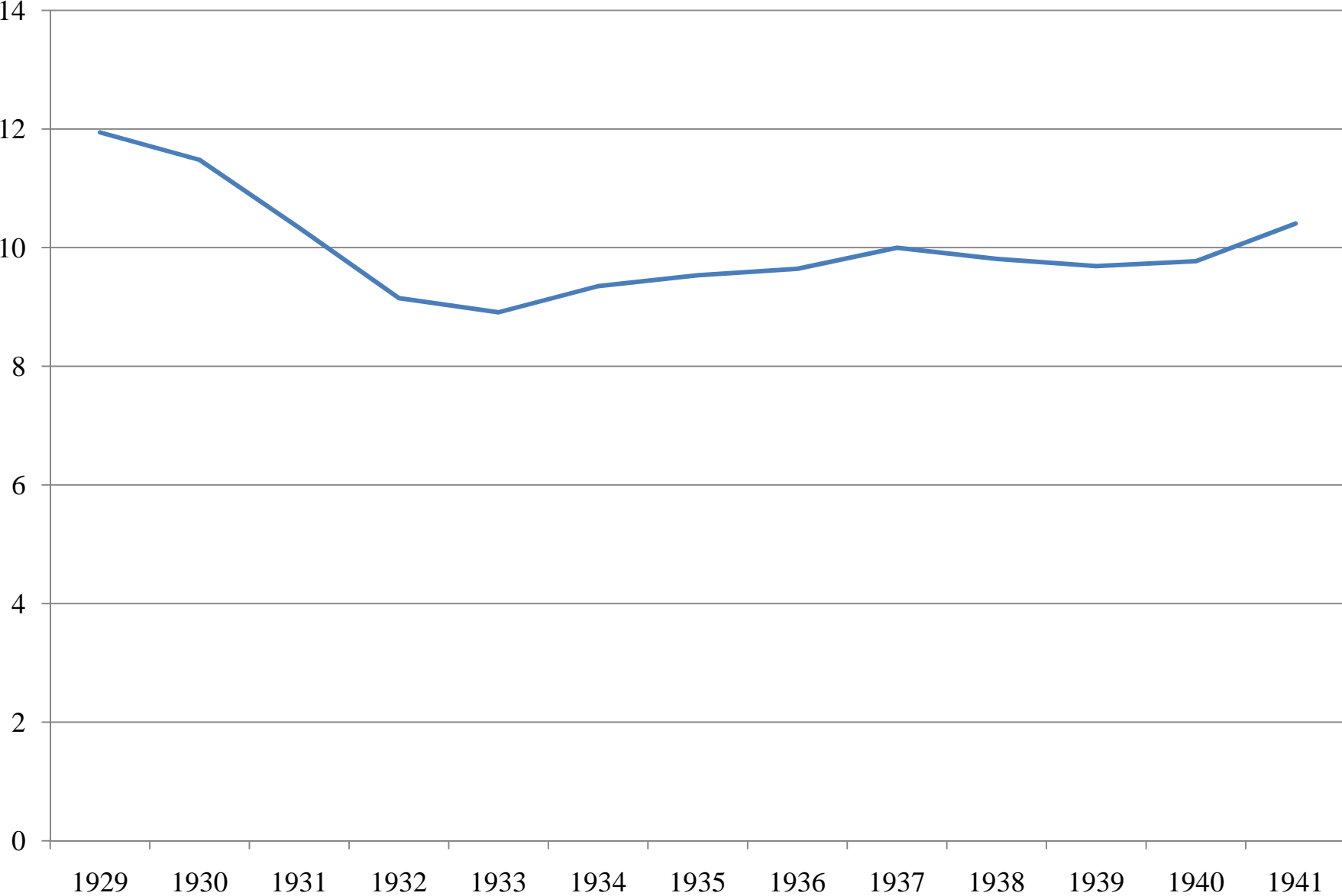
# Real Gross Domestic Product



# Unemployment Rate



# GDP Price Deflator



# Bank Failures

- Bank failures, caused by economic decline
- No government deposit insurance
- Bank runs by depositors
- Excess reserves to guard against runs
- Money supply fell much

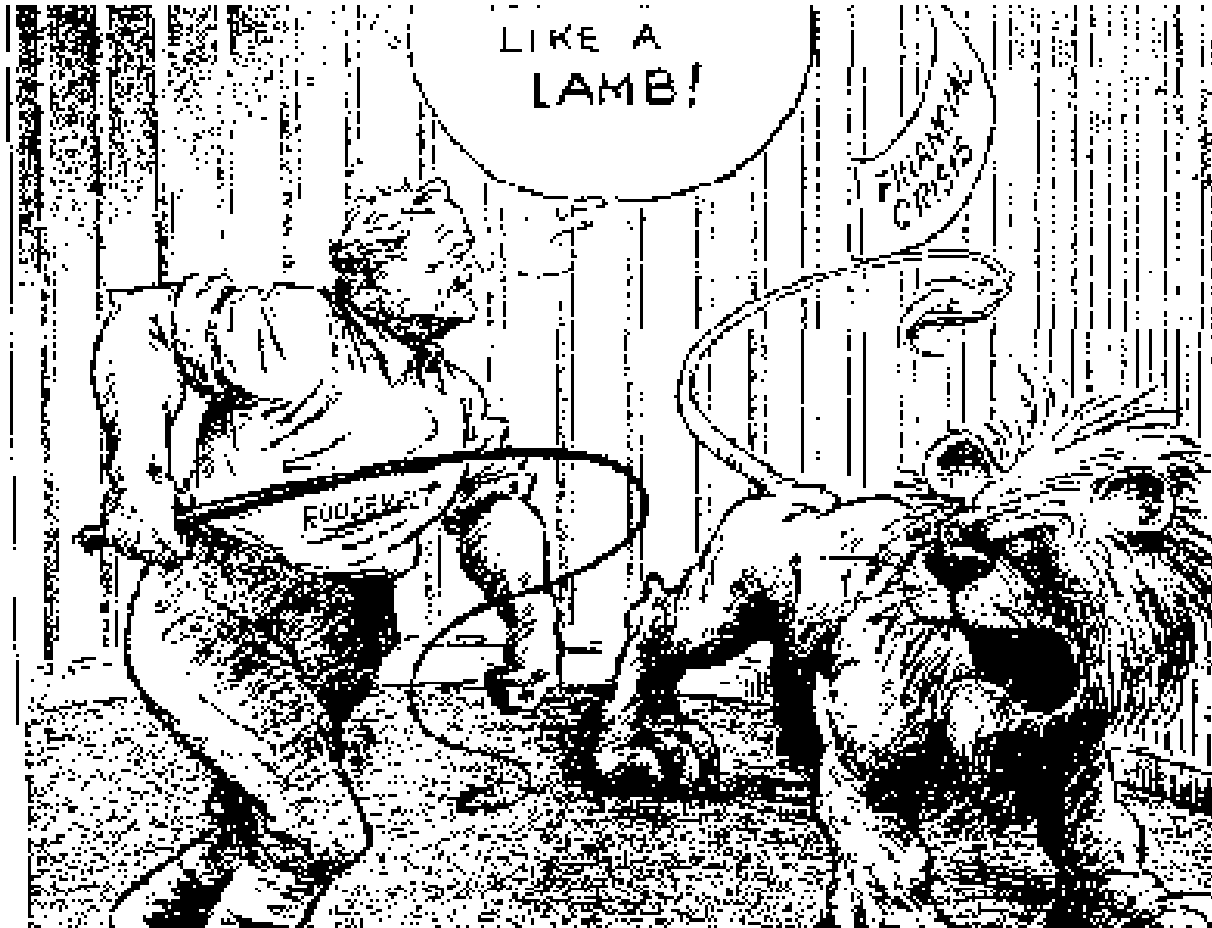
<b>Year</b>	<b>Bank Failures</b>
1929	659
1930	1,352
1931	2,294
1932	1,456
1933	4,004
1934	61
1935	32
1936	72
1937	84
1938	81
1939	72
1940	48
1941	17

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**Frozen Assets**



## The March Lion

# Bank Holiday, March 1933

- Bank panic
- Roosevelt closed all banks for more than one week
- Bank examiners closed unsound banks
- 18,000 commercial banks total
- 5,000 banks did not reopen at the end of the holiday
- 2,000 banks never reopened
- Deposit insurance
- Confidence restored

(Previous holiday in New York by Governor Lehman)

# Emergency Banking Act of 1933

- Conservators for unsound banks  
(rather than bankruptcy and liquidation)
- Preferred stock bought by  
Reconstruction Finance Corporation
- Federal Reserve loans to banks,  
secured by financial assets  
(Federal deposit insurance soon after)

# Bank Crisis Comparison

## Great Depression

- Depression caused losses
- Bank runs by depositors
- Losses mostly in small banks
- Many banks closed,  
confidence restored
- Many conservators
- Federal Reserve:  
Lender of last resort

## Paulson Panic

- Mortgage losses,  
*before* recession
- Bank runs by lenders
- Losses mostly in large banks
- Few banks closed,  
confidence lost
- Conservators for Fannie Mae and  
Freddie Mac only
- Federal Reserve:  
Lender of first resort

# References

1. Lester V. Chandler. *America's Greatest Depression, 1929-1941*. Harper & Row, New York, 1970.
2. Milton Friedman and Walter W. Heller. *Monetary vs. Fiscal Policy*. Norton, New York, 1969.
3. Milton Friedman and Anna J. Schwartz. *A Monetary History of the United States, 1867-1960*. Princeton University Press, Princeton, NJ, 1963.
4. Charles P. Kindleberger. *Manias, Panics, and Crashes: A History of Financial Crises*, rev. ed. Basic Books, New York, 1989.