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The tale of two great crises

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ABSTRACT

The Great Depression of 1929 and the Great Financial Crisis of 2008 have been the two big events of the last 75 years. Not only have they produced serious economic consequences but they also changed our view of economics and policymaking. The aim of this work is to compare these two great crises and highlight similarities as well as differences. Monetary policy, the exchange rate system and the role of banks are our fields of investigation. We find interesting parallels between the two big events but also differences in their specific developments.

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1. Introduction

The Great Depression of 1929–1933 (GD) and the Great Financial Crisis of 2008–2009 (GFC) have not only been colossal and worldwide events, but have challenged our “consensus” view of economics. Policymakers as well have had to learn new lessons and adopt, at times improvising, new strategies in response to events. The GD started 86 years ago and has been studied, interpreted and re-interpreted by an army of scholars. It never seems to go out of fashion. The GFC, being almost a decade old, cannot claim the pedigree of the GD nor its monumental literature. Yet, sufficient time has passed since 2008 to justify a comparative exercise, perhaps historically an early one, of the GD and GFC. We intend to identify and analyze those critical factors that are either similar or different between these two crises.

The obvious question is what we consider as critical factors. There is no denying that we have used our own selection process, which has been guided by the historical accounts, the literature, and empirical evidence. We compare the GD and the GFC in several dimensions: we identify common antecedents; measure the impact of both events in terms of GDP loss, inflation and trade dynamics; investigate the influence exercised by banks and monetary aggregates; analyze the role of

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the international monetary system, in particular international cooperation; and discuss policy responses implemented as a result of the two crises.

We start, in [Section 2](#), with the antecedents and focus on monetary policy before the onset of the crises. Before both crises, monetary policy suddenly became extremely restrictive and to this tightness followed a collapse of the equity market in the GD and of the housing market in the GFC, which in turn precipitated the big event. Next, in [Section 3](#), we look at the crises in terms of real sector's performance, specifically the growth of per capita real GDP, the rate of inflation, and the dynamics of international trade. We also explore alternative explanations of the crises. Then, in [Section 4](#), we draw parallels between the functioning of the international monetary system during the interwar gold standard and the sovereign debt crisis in the Eurozone. As to timing, the GFC and the Eurozone crisis (GFC-Eurozone) are two different events. Furthermore, while the fixed exchange rate regime (or more briefly the fix) was prevalent in the GD, the flexible exchange rate regime (or more briefly the flex) was widespread in the GFC, with the notable and important exception of the Eurozone. Despite these differences, we argue, in sympathy with part of the literature, that the sovereign debt crisis in the Eurozone was a direct consequence of the GFC. The nexus between the GFC and the GFC-Eurozone occurs with the sudden arrest and flow capital reversal from the south to the north of the Eurozone in 2008–2009. The flight to quality, triggered by the negative exogenous shock of the subprime crisis, put pressure on the sovereign risk premia of peripheral European countries and led to a quick and sharp macro adjustment in the Eurozone. All of this resonates like the 1928 sudden capital stop to Germany, which in turn did similar macro damage in the GD. In both events, the amplifying role of the fix was exacerbated by a faltering international cooperation, an essential element to prevent a deflationary bias stemming from asymmetric adjustments imposed on deficit countries to restore their external balance. Neither the inter-war gold standard nor the modern Eurozone are pristine examples of such a cooperation. In sum, a comparison between the interwar monetary system and the functioning of the Eurozone is useful in shedding light on the amplification effects of the fix. Finally, in [Section 5](#), we deal with the crucial role played by banks and money both in the GD and the GFC. Banking troubles, whether the cause or the consequence, accentuate their depth of economic crises. When in difficulty, because of either through illiquidity or insolvency or both, banks may impair the money supply process by inducing the public to cash deposits or themselves hoarding monetary base instead of extending loans. Institutions have adjusted after the experience of the GD by guaranteeing deposits into cash at par, but there is no apparent antidote to the depressive effects of banks' raising their degree of risk aversion. Crises, as we have mentioned, provide useful lessons to policymakers. We discuss how central banks have learned from the GD experience. Banking has evolved over the last thirty years. The business of banking is now also done by some non-bank financial institutions, known as shadow banks. The latter are the product of liberalization and regulatory arbitrage. Unlike traditional banks, shadow banks have no direct access to central bank funding, a feature that makes them fragile. They have played a critical role in the GFC.

Despite the many similarities, the two big events present also significant differences. A striking dissimilarity can be found in the reactions of monetary authorities. After the onset of the GFC, first policy interest rates were reduced drastically to approach the zero lower bound, and later unconventional (quantitative) monetary policy interventions were implemented. Nothing of this kind happened after the onset of the GD.

Our comparative exercise will be based on two statistical universes. The first is an aggregate of 14 industrial countries that for short we define the “world.” It will permit us to set the GD and the GFC in a global perspective. The second is a group of five significant countries, the United States, the United Kingdom, Germany, France and Italy, that will be analyzed in detail.

2. Antecedents

Monetary policy is an important aspect in explaining the starting point of many financial crises. This is true, in different degrees, also for the GD and the GFC. In this section, we provide a sketch of critical monetary policy actions that preceded the outbreak of these two great crises. [Fig. 1](#) shows the relationship between the policy interest rate and an index of house prices, the reference “bubble” asset; for details on sources and notes, see [Data appendix](#). The years 1998–2014 cover a sufficiently long pre-crisis period, two crisis years, and a four-year post-crisis phase of two large monetary unions, the United States and the Eurozone.

After the East Asia financial crisis of 1997 and the bursting of the dot-com bubble of 2000, US monetary policy became very accommodating. The Fed funds rate plunged from 6% in 2001 to below 2% at the beginning of 2002, starting a phase of exceptionally low interest rates that is now popularly known as the “Greenspan put”.¹ The housing market was the main but not the exclusive beneficiary of this accommodating policy ([Justiniano et al., 2014](#); [Punzi and Kauko, 2015](#)): borrowing to buy homes became very cheap and consequently pushed up house prices.

Matters changed drastically at the start of 2006. US monetary authorities had two critical concerns, the fear of a “Japanese scenario” and the consequences of a world “saving glut” ([Bernanke, 2005](#)). The first concern referred to the effort of the Japanese authorities to kick start economic growth, through an aggressive cut of their short-term interest rates, in the midst of their “lost decade” of the 1990s ([Hoshi et al., 2004](#)).² This failed because economic growth in Japan was puny

¹ According to [Taylor \(2007, 2009\)](#), the Fed funds rate was well below the value predicted using his standard monetary policy rule during the period 2002–2004.

² The “lost decade” is the expression used by [Hayashi and Prescott \(2002\)](#) to characterized Japan of the 1990s.

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