The History of Financial Crises

By Dr. Monia Mazigh, 2019©
The 1929 Crash
The Historical Context

- Cars and construction thrived in 1920s
- Wages and consumption went high
- Unemployment was around 3.2%
- Ford was making 9000 of its Model T cars per day
- In 1925, $5 billion were spent for new built homes
- 1923 and 1926 were slow, but overall, the economy was strong
- Banks were doing well
The Roaring Twenties

♦ The decade that followed World War I and led to the Crash, was a time of wealth and excess

♦ Building on post-war optimism, rural Americans emigrated to the cities in vast numbers throughout the decade with the hopes of finding a more prosperous life in the ever growing expansion of America's industrial sector.

♦ In 1927, Herbert Hoover, who later became US President, labeled it: “an orgy of mad speculation”
Banks in America

- American banks were doing well
- There were 25,000 lenders. Their combined balance-sheets were at $60 billions
- 60% of the assets were loans and 15% were cash
- Even the investment securities were made of bonds, half of them made up with ultra-safe government bonds
- Because of all the flourishing economy, banks kept capital buffers at minimum
The Federal Reserve

♦ Should the Fed raise the interest rates to slow the market or cut them to help the economy?

♦ In 1928, the central bank raised rates

♦ It was a CATASTROPHIC ERROR!

♦ The rise from 3.5% to 5% was too small to slow the market. Instead the share prices increased with the Dow Jones index hitting a high of 381
Dilemma

- Share prices of firms exploiting new technologies: *radio, aluminum, airplanes* became very popular.
- But these shares didn’t pay any dividends.
- Investors kept buying them in the hope that the prices will keep increasing.
- Established businesses were slowing down.
- Prices in older industries were going down.
From Rural to Cities

- While the American cities prospered, the vast emigration from rural areas continued to neglect the US agriculture industry, and created widespread financial despair among American farmers throughout the decade.

- This would later be blamed as one of the key factors that led to the 1929 stock market crash.
The Crash by Dates

♦ March 29, Federal Reserve warned that there is a lot of speculation.

♦ A mini crash ensued. A lot of investors started selling so fast.

♦ The National City Bank would provide $25 million in credit to stop the market slide

♦ Automobile went down. Steel production went down. Consumers debt went high because of easy credit

♦ Despite these signs, the gain in the stock market continued

♦ The Dow Jones: from June to September, it made 20% gain
More Dates before the Crash

- September 3 1929, the Dow Jones value reached a peak of 381.17
- September 18 1929, the prices on New York Stock Exchange market abruptly fell
- On September 20 1929, the British stock market fell when top investor Clarence Hatry and his accomplices were arrested for fraud
- Periods of high volumes sells followed by brief recovery periods of rising prices
- On October 24 1929, the market lost 11% of its value.
Before the Crash

- By the end of September, the market was down 10% from the peak (the "Babson Break"). Selling intensified in early and mid October, with sharp down days punctuated by a few up days.

- “Sooner or later a crash is coming, and it may be terrific”

- Panic selling on huge volume started the week of October 21. It intensified and then culminated on October 24th, 28th and especially the 29th: Black Tuesday
The Crash

- **On October 29, 1929,** William C. Durant (founder of GM Corporation) joined with members of the Rockefeller family and other financial giants to buy large quantities of stocks to demonstrate to the public their confidence in the market.

- But, their efforts failed to stop the large decline in prices. Due to massive volume of stocks traded that day, the ticker did not stop running until about 7:45 p.m. that evening.

- The market had lost over **$30 billion in the space of two days** which included **$14 billion** on October 29 alone.
Watching the Ticker Tape
More Bad News

♦ Over October 28th and 29th, the Dow lost almost 25% of its value.

♦ By November 13th, it was 198 down 45% in two months
WALL ST. IN PANIC AS STOCKS CRASH

Attempt Made to Kill Italy's Crown Prince

Hollywood Fire Destroys Films Worth Millions

High Duty Group Gave $700,000 to Coolidge Drive
After the Crash...

- For most of the 1930s, the Dow began slowly to regain the ground it lost during the 1929 crash and the three years following it.

- Beginning on March 15, 1933, with the largest percentage increase of 15.34 percent, with the Dow Jones closing at 62.10, with an 8.26 point increase.

- The largest percentage increases of the Dow Jones occurred during the early and mid-1930s. In late 1937, there was a sharp dip in the stock market, but prices held well above the 1932 lows. The market would not return to the peak closing of September 3, 1929 until November 23, 1954.
Bank Failures Waves

♦ In 1930, bank runs in agricultural states such as Arkansas, Illinois, Missouri: 1350 banks failed

♦ In 1931: banks in Chicago, Cleveland and Philadelphia closed

♦ Britain dumped the Gold Standard, its exchange rate dropped. American exporters suffered

♦ Bank panics followed in Austria, Germany

♦ American started running for cash
How to Stop the Hemorrhage

♦ A bond-buying campaign by the Federal Reserve brought some respite

♦ In February 1933, lenders in Nevada, Louisiana and Michigan shut their doors

♦ City bankers turned to the Federal Reserve Bank for cash

♦ On March 4 1933, the Federal Reserve Bank refused

♦ The Federal Reserve Bank failed its mission to act as a source of funds in all emergencies
The Great Depression

- More than 2000 of the banks that closed during that week of 1933 never opened again
- Nearly 11,000 banks failed between 1929 and 1933 and the money supply dropped by over 30%
- Unemployment rose to 25%
- It took more than 25 years for the Dow to reclaim its peak of 1929
Analysis

- The stock-exchange speculation had led hundreds of thousands of Americans to invest heavily in the stock market. A significant number of them were borrowing money to buy more stocks.

- The wheat prices: the link between the drought (grain price fall) and the stock market.

- If people expect there will be a good harvest next season the future prices will go down as the supply will be more than the demand and the investor won’t receive the high prices they were promised and they won’t have enough profit to invest in the stock market.
Chaos in the Banking System

- Perhaps the most important effect was chaos in the banking system as banks tried to collect on loans made to stock market investors whose holdings were now worth little or nothing at all.

- Many banks had themselves invested depositors' money in the stock market. When word spread that banks' assets contained huge uncollectable loans and almost worthless stock certificates, depositors rushed to withdraw their savings.

- Unable to raise fresh funds from the Federal Reserve System, banks began failing by the hundreds in 1932 and 1933.
The Failure of the Banking System

♦ By the inauguration of Franklin D. Roosevelt as president in March 1933, the banking system of the United States had largely ceased to function.

♦ Depositors had seen $140 billion disappear when their banks failed.

♦ Businesses could not get credit for inventory.

♦ Cheques could not be used for payments because no one knew which cheques were worthless and which were sound.
Financial Consequences

- Roosevelt closed all the banks in the United States for three days - a "bank holiday." Some banks were then cautiously re-opened with strict limits on withdrawals. Eventually, confidence returned to the system and banks were able to perform their economic function again.

- To prevent similar disasters, the Federal Government set up the Federal Deposit Insurance Corporation, which eliminated the rationale for bank "runs" - to get one's money before the bank "runs out."
More on the Causes: Buying on the Margin

- Buying on credit was the practice of buying shares on the margin.
- This meant you only had to pay 10 or 20% of the value of the shares; it meant you were borrowing 80-90% of the value of the shares.
- This enabled more money to be put into shares, increasing their value.
- It is said there were many ‘margin millionaire’ investors. They had made huge profits by buying on the margin and watching share prices rise.
- It leaves investors very exposed when prices fell.
- These margin millionaires got wiped out when the stock market fall came. It also affected those banks and investors who had lent money to those buying on the margin.
Irrational Exuberance

- A lot of the Stock Market crash can be blamed on over exuberance and false expectations. In the years leading up to 1929, the stock market offered the potential for making huge gains in wealth. It was the new gold rush. People bought shares with the expectations of making more money.

- As share prices rose, people started to borrow money to invest in the stock market. The market got caught up in a speculative bubble. – Shares kept rising and people felt they would continue to do so.
Irrationality

- The problem was that stock prices became divorced from the real potential earnings of the share prices. Prices were not being driven by economic fundamentals but the optimism/exuberance of investors. The average earning per share rose by 400% between 1923 and 1929. Yet, those who questioned the value of shares were often labeled doom-mongers.

- This was not the first investment bubble, nor was it the last. Most recently we saw a similar phenomena in the dot com bubble.
Mismatch between Production and Consumption

- The 1920s saw great strides in production techniques, especially in industries like automobiles. The production line enabled economies of scale and great increases in production.

- Demand for buying expensive cars and consumer goods were going down.

- Towards the end of the 1920s, many firms were struggling to sell all their production. This caused some of the disappointing profit results which precipitated falls in share prices.
Agricultural Recession

- Even before 1929, the American agricultural sector was struggling to maintain profitability.
- Many small farmers were driven out of business because they could not compete in the new economic climate.
- Better technology was increasing supply, but demand for food was not increasing at the same rate.
- Prices fell and farmers' incomes dropped.
- There was occupational and geographical immobilities in this sector, and it was difficult for unemployed farmers to get jobs elsewhere in the economy.
Weaknesses in the Banking System

- Before the Great Depression, the American banking system was characterized by having many small to medium sized firms. America had over 30,000 banks.

- They were prone to going bankrupt if there was a run on deposits.

- Many banks in rural areas went bankrupt due to the agricultural recession.

- A negative impact on the rest of the financial industry.

- Between 1923 and 1930, 5,000 banks collapsed.
The Remedies

- A massive injection of publicly supplied capital
- $1 billion went to more than 6000 of the remaining banks
- The **Glass-Steagall** rules that separated stock market operations from lending
- They gave the Fed new powers to regulate banks who customers used credit for investment
- The **Federal Deposit Insurance Commission** (FDIC) was established January 1st, 1934 to deal with bank runs
New Rules

- The FDIC protected $2500 of deposits per customer
- Depositors trust the FDIC, they wouldn’t queue up at banks each time there is a crisis
- Banks started advertising that they were FDIC insured
- Banks were able to reduce liquidity and equity buffers
- Central banks and FDIC became at the head of the financial system
Different Views of the Great Depression

Monetarists View

Monetarists highlight the importance of a fall in the money supply. They point out that between 1929 and 1932, the Federal reserve allowed the money supply (Measured by M2) to fall by a third

- **M1** = cash and assets that can quickly be converted to cash
- **M2** = savings deposits, money market mutual funds and other time deposits, which are less liquid and not as suitable as exchange mediums but can be quickly converted into cash or checking deposits.
Monetarists such as Friedman criticize the decisions of the Fed not to save banks going bankrupt.

They say that because the money supply fell so much an ordinary recession turned into a major deflationary depression.

According to Friedman, what plunged the country into a deep depression was the collapse of the banking system during three waves of panics over the 1930–33 period.
Keynes emphasized the importance of a fundamental disequilibrium in real output.

He saw the Great Depression as evidence that the classical models of economics were flawed.

Classical economics assumed Real Output would automatically return to equilibrium (full employment levels);

However, the great depression showed this to be not true.
Keynesian View

♦ Keynes said the problem was lack of aggregate demand. Keynes argued passionately that governments should intervene in the economy to stimulate demand through public works scheme - higher spending and borrowing.

♦ Keynes heavily criticized the UK government's decision to try balance the budget in 1930 through higher taxes and lower benefits. He said this only worsened the situation.

♦ Keynes also pointed to the paradox of thrift.

♦ Paradox thrift: point out that individuals try to save more during an economic recession, which essentially leads to a fall in economic growth.
The Marxist View saw the Great Depression as heralding the imminent collapse of global capitalism.

With unemployment over 25%, Marxists held that this showed the inherent instability and failure of the capitalist model.

They pointed to the Soviet Union as a country which was able to overcome the great depression through state sponsored economic planning.
How Important was Stock Market Crash of 1929?

- The stock market crash of October 1929, was certainly a factor which precipitated events. It did cause a decline in wealth and severely affected confidence.

- However, changes in share prices were a reflection of the underlying boom and bust in the economy.

- The collapse in share prices might not have caused the great depression, if bank failures had been avoided.

- In October 1987, share prices fell by even more (22%) than black Monday. But, it didn't cause an economic recession.
The State to the Rescue of Capitalism

- By 1934, the state made the financial system more stable
- The risk moved from the banks to the taxpayers
- In 2008, Citigroup and Royal Bank of Scotland were enormous with combined assets of nearly $6 trillion. The capital buffers were so small
- These banks were rescued by the government. Their collapse would mean long term economic depression
- IMF estimated that the world’s largest banks benefited from implicit subsidies of a total of $630 billion in 2011-2012
And the story continues...
The Great Depression video

- https://www.youtube.com/watch?v=GCQfMWAikyU