Unit Two: Assignment 4: One Cause,Two Economic Crises

Introduction: When Everything Goes Wrong

Imagine if half the people in your town suddenly lost their jobs. Imagine if banks started closing and people couldn't get their money out. This happened twice in the last 100 years—during the **Great Depression** (1929-1939) and the **Great Recession** (2007-2009). Both times, people argued about the same basic question: should the government step in to fix the economy, or should it stay out and let businesses figure it out for themselves?

Surprisingly, both economic disasters started the same way—with **speculation** (people making risky bets with money, hoping to get rich quick). But governments in the 1930s and the 2000s handled these crises differently, giving us a chance to see which approach works better.

The Great Depression (1929-1939)

Background: The "Hands-Off" Approach
Before 1929, most governments followed ***laissez-faire*** economics. This French term means "let it be" or "hands off." The idea was simple: the received wisdom at the time was that businesses know best how to run the economy, so governments should stay out of their way. Politicians believed that if something went wrong, the **free market** would fix itself automatically. A free market is one in which buyers and sellers buy and sell products without government interference or controls. Prices are determined by **supply and demand**. Supply is the available amount of a product and demand is the amount of public interest in purchasing that product. If supply remains constant and demand increases, the value of a product goes up. If supply increases and demand remains constant, the value of the product goes down.

What Caused the Great Depression?
Prior to the 1920s only the wealthiest people could participate in the stock market, i.e. the lower classes couldn't afford to lose money like the wealthy; however, common sense barriers to investing for the middle and lower classes were removed by the banks themselves. Investment banks allowed the lower classes to **buy on margin**, i.e. instead of having to have all the money to buy a stock outright, a buyer could have as little as 10% of the required money (and they'd borrow the remaining 90% at interest). So, you could buy $1,000.00 worth of stock with just $100.00 cash down and borrow the remaining $900.00. If the stock increased in value, the investor would make money, e.g. if the stock rose to 1,200.00, you'd make a $200.00 profit. But if it dropped to $800.00, you'd lose your $100.00 while still owing $900.00 for your loan (plus interest).

There was a lot of excitement among these new investors (who dreamt of becoming millionaires themselves). Unfortunately, companies made so many products (increased supply) that there weren't enough people to buy these products (demand was too low). Workers just didn't make enough money to be able to purchase all these extra products; they bought only necessities. Some investors saw the problem as early as 1928 and started selling their stocks before they lost their value. Eventually, in 1929, everyone started selling off their stocks at the same time, i.e. everyone became sellers and no one was buying. This made virtually all stock worthless and everyone lost the money they invested. This was called the stock market crash or "Black Tuesday" (October 29, 1929).

The Domino Effect:

- People lost their money in the stock market
- They couldn't pay back loans to banks
- Banks thus no longer had money and they failed and closed
- Even people who didn't risk their money on the stock market lost their savings when banks went bankrupt
- Due to the lack of regulations (laws), banks literally loaned their customers' savings to investors (and when the investors lost out on the stock market people who saved their money at banks also lost out)
- Businesses closed because no one had money to buy anything
- More people lost jobs
- Even fewer people had money to spend
- And even more people lost jobs, etc.

First Response: Wait It Out

Both the Americans and Canadians believed the economy would fix itself. They thought government help would actually make things worse. This *laissez-faire* approach failed—by 1933, about 25% of Americans, and 30% of Canadians, were unemployed.

The New Approach: John Maynard Keynes

A British economist named **John Maynard Keynes** had a different idea. He said governments should spend money during bad times to "jump-start" the economy. Here's how his theory worked:

1. Government creates jobs (building roads, parks, etc.)
2. People earn wages from these jobs
3. People spend their wages on food, clothes, etc.
4. This stimulates demand because people have money
5. Businesses begin to increase the supply by hiring workers
6. Economy recovers

This is called **pump priming**—like priming an old water pump to get it started. The Canadian and American governments eventually placed Keynes' ideas into action:

- Created government jobs programs
- Started **social safety net** programs (unemployment insurance, social security)
- Regulated banks to prevent them from making unnecessarily risky investments

Critics in Canada and the United States said government controls and intervention was wrong. They:

- Called it "frightful waste and extravagance"
- Argued it scared businesses from investing
- Said it would make the depression last longer

What Actually Ended the Depression?
Here's the surprising part: most historians agree that **World War II**, not the New Deal programs, finally ended the Great Depression. When governments started spending massive amounts of money on weapons, ships, planes, and soldiers, etc. it created demand; and this in turn created millions of jobs to create supply (and this got the economy moving again). This was government spending on a huge scale—much bigger than the New Deal. For example, the Canadian government spent 20 million dollars from 1933 to 1939; however, during the war years (1939 to 1945) the Canadians spent ten billion. Canada emerged from the war with one of the world's ten largest economies.

The Great Recession (2008-2009)

Background: The Same Problem Returns
By 2007, many people had forgotten the lessons of the Great Depression. Banking rules were relaxed, and once again, speculation caused a major crash. Specifically, a law called the ***Glass-Steagall Act*** (1933) was passed. This law prevented banks from risking their customers' money. Also, this act forced banks to be either an *investment* bank (that sold stocks) or a *regular* bank that took deposits and made loans. You could no longer be both. In 1999, President Bill Clinton overturned *Glass Steagall* and once again banks could both sell stocks and give out loans. This action on the part of the Americans placed the global economy at risk because, unlike in 1929, the economy of every country now depended heavily upon one another.

What Caused the Great Recession?
In the 1920s, banks sold stocks to investors who really couldn't afford to lose money. In the 2000s, banks gave mortgages (house loans) to people who really couldn't afford them. For example, when *Glass Steagall* was the law banks couldn't give loans to people who couldn't afford them. Specifically, a person making as little as $30,000.00 a year might be given a mortage for a home in the $100,000.00 range; however, after Clinton repealed *Glass Steagall* banks were free to give people making $30,000.00 (or lower) mortgages in the $400,000.00 to $1,000,000.00 range. Banks reasoned that houses always appreciated (increased) in value; and that even if a person defaulted (failed to pay and thus lost their home) the bank could always sell the home and make their money back. The banks were wrong.

Banks made the problem even bigger by bundling these risky loans together to create a new financial product called a CDO (collateralized default obligation). Simply put, people who take out loans pay interest every month to the bank. This is one of the reasons banks loan money, i.e. they charge interest and so not only get back what they loaned but make additional money; however, by bundling (packing together) a 100 mortgages together, banks created a product they could sell to investors who now received that interest instead of the banks. Investment bankers thought they were clever, in that, they bundled risky loans (ones unlikely to be paid off) with low risk loans (ones taken out by the middle class and the wealthy); they believed bundling risky with safe mortgages would make CDOs a safe and stable investment; and, in a sense, banks who gave the initial loan made money in the form of interest and then made additional money by selling that loan to investors (who also took a share of the interest paid on the mortgage). As early as 2003, economists were warning the public about the dangers of CDOs and a coming economic collapse.

Banks counted on housing prices always increasing. The problem with this assumption is even housing values go up and down according to the forces of supply and demand. Thus, the economic collapse came when housing prices started falling in 2007-2008. Housing prices fell because demand declined because people started defaulting on their mortgages in the tens of thousands. The whole economic system, not just housing, collapsed:

- People couldn't pay their mortgages
- Banks lost billions on CDOs
- Major banks like Lehman Brothers went bankrupt

- Credit markets froze—banks stopped lending money because of the risk
- Businesses couldn't get loans and started laying off workers
- Mass unemployment resulted

Unlike in the 1930s, governments in 2008 acted fast. They remembered what happened when governments waited too long during the Great Depression: nothing.

What Governments Did:

- **United States**: Spent $787 billion on stimulus programs
- **Canada**: Spent $12 billion on economic stimulus
- Central banks in both countries printed and injected new money into the economy

The Great Recession lasted about 18 months instead of ten years like the Great Depression. Most economists agree that quick government action prevented a much worse disaster.

Questions to Think About
For all the following questions, you must use the introduce, illustrate and conclude approach. Each question has a specific word count range. Work within that range if you want to earn full marks for the assignment.

1. How were the government responses to the Great Depression and Great Recession different? Why do you think governments in 2007 responded so differently compared to those of the 1930s? (50-200 words)

2. The Great Depression lasted ten years while the Great Recession lasted about 18 months. Based on what you've read, why was the Great Recession so comparatively short? (50-200 words)

Final Task

After the Great Depression, when Glass Steagall was the law, there was a saying floated around in the banking world, i.e. banking should be boring. Use Google to find an explanation for what bankers meant by this saying. Do not use AI. Please include the URL(s) where you found your information. Your response should follow the introduce, illustrate and conclude format and be in the 100-300 word range.