AcF 304 Financial Markets

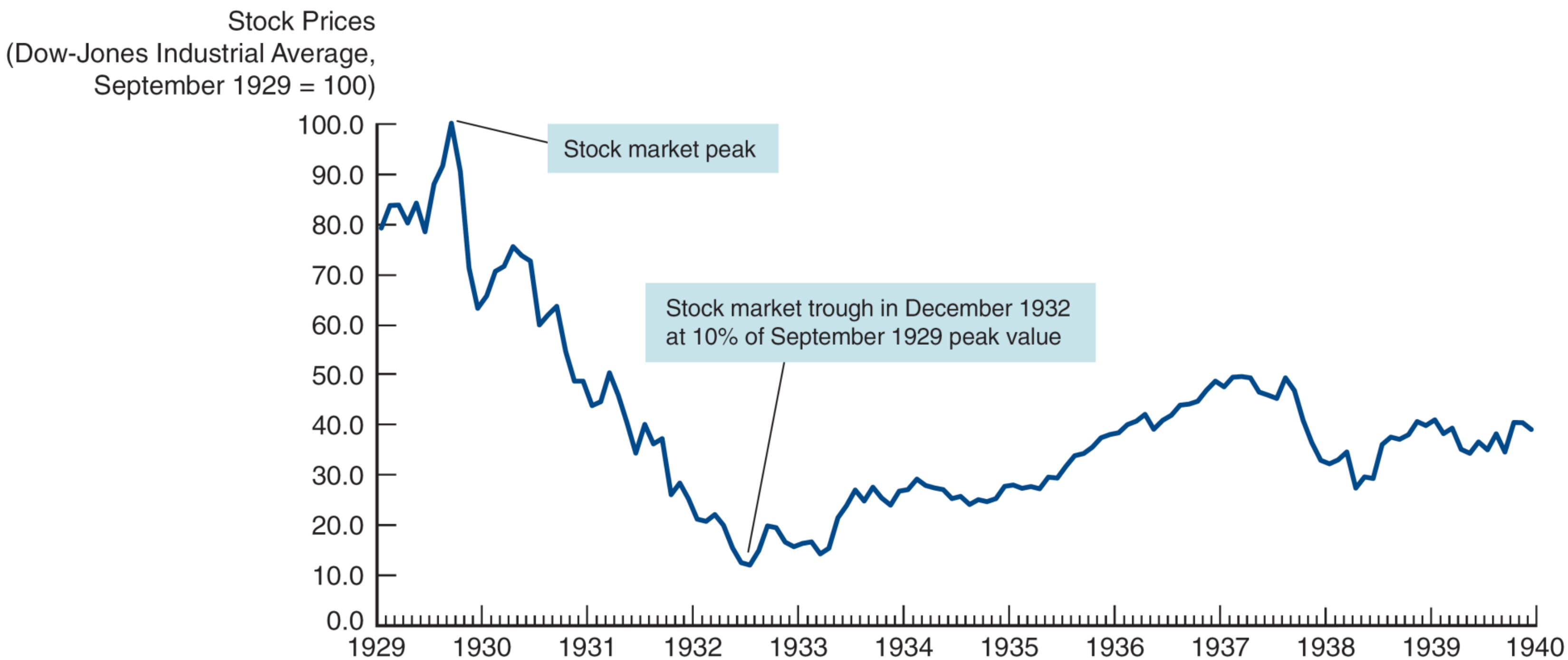
Topic 2: Why Do Financial Financial Crises Occur and Why Are They So Damaging to the Economy?

Part 2 – 1929-1933 Mother of all Financial Crisis: The Great Depression

Case: The Great Depression (1 of 5)

- In 1928 and 1929, stock prices doubled in the U.S. The 'Fed' tried to curb this period of excessive speculation with a tight monetary policy (Reduce 'buying on margin').
- But this led to a stock market collapse of more than 20% in October of 1929, and losing an additional 20% by the end of 1929.
- As the next slide shows, the decline continued for several years.

Figure 8.2 Stock Price Data During the Great Depression Period



Source: Federal Reserve Bank of St. Louis, FRED database: https://fred.stlouisfed.org/series/M1109AUSM293NNBR.


$100 WILL
BUY THIS CAR
MUST HAVE CASH
LOST ALL ON THE
STOCK MARKET

Case: The Great Depression (2 of 5)

- What might have been a normal recession turned into something far worse, when severe droughts in 1930 in the US Midwest led to a sharp decline in agricultural production.
- Between 1930 and 1933, one-third of U.S. banks went out of business as these agricultural shocks led to bank failures.
- For more than two years, the Fed sat idly by through one bank panic after another.

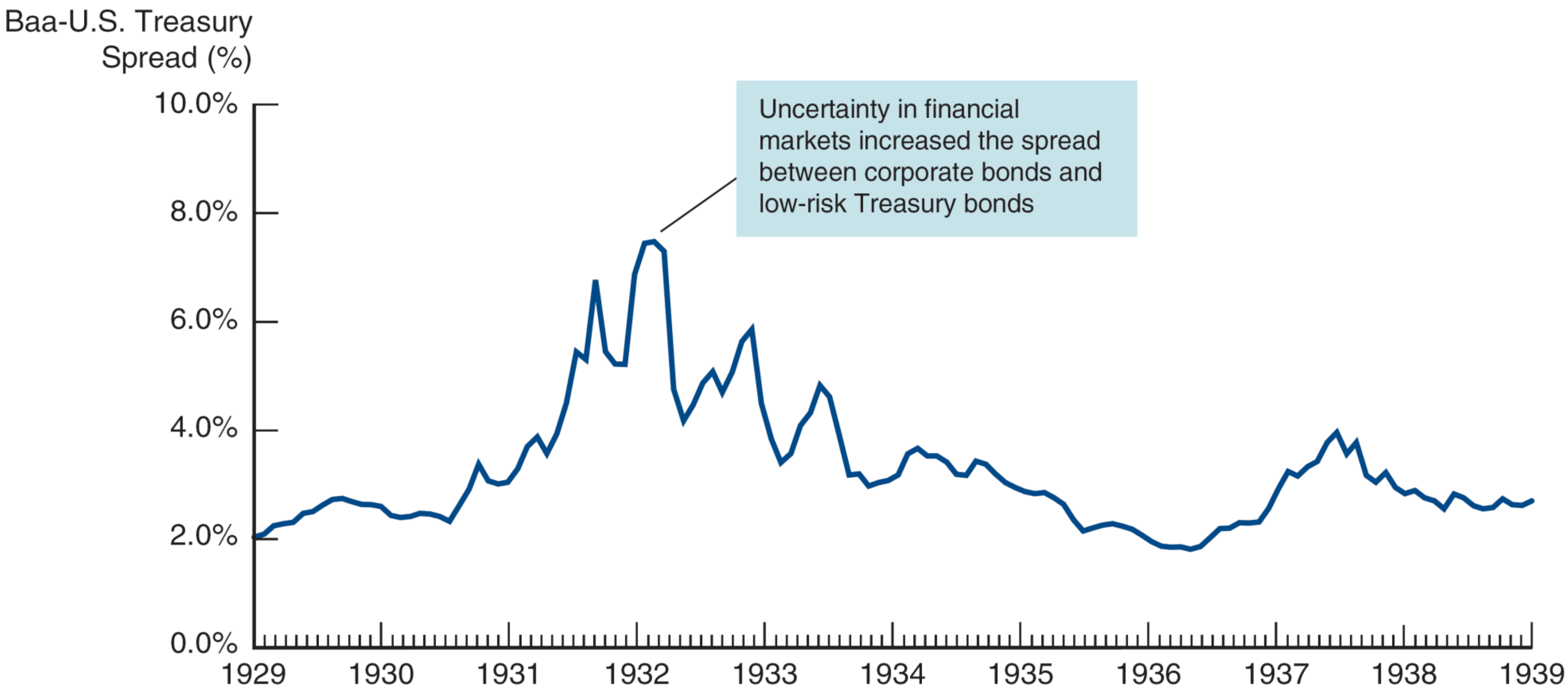
Case: The Great Depression (3 of 5)

Adverse selection and moral hazard in credit markets became severe.

Firms with productive uses of funds were unable to get financing.

Credit spreads increased from 2% to nearly 8% during the height of the Depression in 1932.

Figure 8.3 Credit Spreads During the Great Depression



Source: Federal Reserve Bank of St. Louis, FRED database: https://fred.stlouisfed.org/series/M13036USM193NNBR, https://fred.stlouisfed.org/series/LTGOVTBD.

Case: The Great Depression (4 of 5)

- The deflation during the period lead to a 25% decline in price levels.
- The prolonged economic contraction lead to an unemployment rate around 25%.
- The Depression was the worst financial crisis ever in the U.S. It explains why the economic contraction was also the most severe ever experienced by the nation.

Case: The Great Depression (5 of 5)

- Bank panics in the U.S. spread to the rest of the world, and the contraction of the U.S. economy decreased demand for foreign goods.
- The worldwide depression caused great hardship, and the resulting discontent led to the rise of fascism and WWII.

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Part 3 – Mortgage Backed Securities