As the US and global governments begin their latest round of talks on how to get the credit markets functioning again, **Denise Bedell** looks at how current efforts – and the current crisis – compare with the experience of the **Great Depression**

Learning from the past

Many commentators have remarked on the similarity between the current financial crisis and the situation that led to the Great Depression of the 1930s: both involved a collapse of confidence and both necessitated extensive government efforts to calm market fears. Yet we should not be quick to claim that the situation today will inevitably see economies spiral into a depression of 1930s' proportions – for a start, today's regulatory environment is entirely different. But we can still learn lessons from past crises that can help guide the success of current efforts and curb the length and severity of the present turmoil.

The 1930s turned out to be the proving ground for many of the economic policies now taken to heart by legislators in the US and globally. To put the situation in context, the 1920s were a period of strong economic growth in the US. The country was riding high on the post-war boom and the stock markets were flourishing. Consequently, in 1928, the Federal Reserve began driving up interest rates and rate-sensitive industries began to slow. As industries such as construction stagnated, consumer spending slowed


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and greater volatility was seen in stock prices.

The culmination of this was the stock market crash of 1929, which sent confidence plummeting. Herbert Hoover was president at the time, and his administration took a hands-off approach to guiding the markets. Peter Bethlenfalvy, group managing director, global corporate finance, at ratings and market analysis firm DBRS, says that many lessons came out of the Hoover period. “First, within six months of the stock market crashing, he put in place the Hawley-Smoot Tariff Act to raise tariffs – making imported goods more expensive,” says Bethlenfalvy. “His goal was to have US consumers buy more domestic product, but it actually had the opposite effect and trade dropped off as other countries raised tariffs in response.”

In addition, in December 1929, the Fed let the New York Bank of the United States go to the wall. Bethlenfalvy continues: “It had 450,000 depositors and they let it fail. Three hundred banks had failed by 1930 and the Fed did nothing. They didn’t provide any emergency lending, they provided no liquidity to these banks, which had assets devaluing – and these were not junk bonds that were devaluing; they were Treasuries or railroad bonds and the like.” By this point, the Fed could not lower interest rates because it had used most of its credit supporting the Gold Standard in the 1920s.

By 1933, when Franklin Delano Roosevelt became president, more than 9,000 banks had closed their doors, leaving depositors and shareholders with about $2.5bn in losses – equivalent to about $340bn today. Bank closures led many more to withdraw their savings and normal lending and money supply collapsed. That – along with the need to support the Gold Standard – led to deflation. As with today, credit became scarce and consequently businesses suffered, adding to the vicious cycle.

Bethlenfalvy says: “Then in 1933 with FDR and the New Deal, in the first 100 days we had the Emergency Banking Act put through – which shut all banks on March 4, 1933. They reopened on March 9 with treasury supervision; however, only three-quarters of the banks reopened. The goal was to

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provide government support for all these banks – so there is clearly a parallel there with what is happening today. Also, they created the FDIC, which insured deposits up to $5,000 – so again a parallel. And FDR suspended the Gold Standard, so they could provide interest rate relief.” Abandoning the Gold Standard and allowing the dollar to devalue was perhaps the single most important step taken, as it allowed money supply to grow and curtailed deflation.

Risk management and the mortgage markets

There are a number of similarities between the crash of the 1930s and today. Nigel Myer, financial institutions credit analyst at Dresdner Kleinwort, says: “The key similarities between this and previous negative cycles are excess asset prices and a crisis of confidence. That was clearly evident this time around. It is perhaps even more evident in a service-based economy than an industrial economy, as in previous negative cycles.”

However, the main drivers of the crisis today are somewhat different than those in the 1930s. First, the developments in the US subprime mortgage market and across the US housing market are unquestionably the mechanical triggers for the market and banking crashes. House price declines destroyed

Paul Belanger, partner, business and securities groups, Blake, Cassels & Graydon

business models underlying mortgage lending in the US over the last six years.

Those business models propping up the subprime development were based on the notion that people who originated the loans would either sell them on – and thus not have to worry about defaults – or that house prices would keep going up and those defaults would never happen. When house prices did stop growing at a phenomenal rate, originators stopped being able to sell them on and had to face the consequences of their underwriting decisions.

Other contributing factors were the risk management practices, increased leverage and asset-liability mismatch at global financial institutions. Paul Belanger, partner, business and securities groups at Blake, Cassels & Graydon, says: “The question is, how did we get to a place where those business models were actually

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Belanger says that this demonstrated the huge system-wide failure of proper risk management. "When Enron and WorldCom happened, the government response was to implement Sarbanes-Oxley. It was not really aimed at Enron and WorldCom – which were essentially about high-level executive fraud – rather it was aimed at risk management and internal controls. But it clearly wasn't really up to the challenge, was it – given the failure of internal risk management and control that we are seeing now? All the money spent on implementing Sarbanes-Oxley was clearly completely wasted."

Belanger points to the institutional use of risk management: "Were people truly using models to manage risk exposure, or were people essentially using the models to support the conclusions that they wanted to reach – which was that they would make greater compensation if the banks did these deals."

In addition to internal risk management, the risk models used by rating agencies have been brought into serious question with losses seen on even highly-rated securities.

Regardless of the drivers, the big difference between the 1930s and today has been the government response and the speed of action to curb the crisis. One Toronto-based capital markets lawyer says: "In the 1930s it wasn't Congress's role to provide stimulus – now that is clearly seen as their role."

Nigel Myer, financial institutions credit analyst, Dresdner Kleinwort

With the launch of the housing package earlier this year, and the Emergency Economic Stabilization Act of 2008/The Troubled Asset Relief Program (TARP) granting up to $700bn in funds to help stabilise the US banking sector and credit markets, it is clear that nowadays stimulus is indeed a mandate of Congress.

Global impact

The big question is whether regulators, and market participants, have learned from the past and whether these lessons are being applied to the present. Bethlenfalvy notes that in the 1930s the central banks didn't play much of a role in supporting banks, providing liquidity and so on. He says: "So these are good lessons learned in the 1930s that are being applied today. The biggest difference is that today they have been monetising liquidity and illiquid assets."

The global responses to the current crisis are quite different from those in the 1930s. In the 1930s, even though world governments faced a global depression and a global meltdown, there was no co-ordinated effort to solve it. Global synchronisation has now become a cornerstone of the current response by governments and central banks. For example, interest rate cuts were co-ordinated with the Bank of Canada, Bank of Japan, ECB and the Federal Reserve in early October. In addition, global entities are providing swap lines and supporting US dollars to each other.

Belanger points out that we are also seeing a global co-ordination of liquefying assets. Although the most talked about bailout package is TARP and the $250bn pledged from that to buy illiquid bank assets, governments around the world are providing economic stimulus and supporting financial institutions by providing liquidity or buying their toxic assets.

The EC in October announced €1,300bn to bolster banks and world leaders have met on several occasions to direct corresponding efforts. Belanger says: "I think the global co-ordination has been impressive. I don't think it is easy to co-ordinate such efforts globally. The fact that they have succeeded is a sign of how important this crisis is being taken by global governments. There is a lot of fault to find that we are in this mess, but not a lot of fault to find with the efforts to get out of the mess."

One big focus seen today, that was absent in the 1930s, is the recognition that global bodies must work together on banking and market supervision and on efforts to increase transparency and risk management. In Europe, José Manuel Barroso, the European Commission president, noted that EU-level banking supervision was imperative. "It is essential to go beyond the short-term measures and to put into place a structured, truly European response," he said.

Although the direct impact of the crisis has only been felt minimally in Asia, at the Asia-Europe Meeting in late October, more than 40 global leaders agreed to "undertake effective and comprehensive reform of the international monetary and financial systems".

At the meeting, UN Secretary General Ban Ki-moon noted in an address that developing nations may be hit next by the crisis. He said that, although at present developed nations are taking the brunt of the financial meltdown, "we fear the next shoe to drop will be emerging economies".

The Bank of China's vice-president, Zhu Min, at an Asia-Europe Business Forum in October, also noted that the global financial crisis will be felt in Asia over the coming six months. "We shouldn't think this is going to be over soon. The key issue for Asian countries is to prevent the banking crisis from turning into a currency crisis," he said.

According to Belanger, all central banks need to be focused on getting the credit markets functioning more normally than they are right now. He says: "The risk premiums that banks must pay to borrow are extremely high – an unprecedented high. They are aiming at getting that lever of monetary policy functioning again. Global co-ordination is important because it is a global problem. And countries realise they have to convince the world at large that systemically-important banks are not going to fail. They are trying to tell the world that if you have lent money to systemically-important banks then you are going to be paid. It is too early to tell if it is successful, but by year-end we should know."

Adds Myer of Dresdner Kleinwort: "I think the current bailout packages we are seeing are proving absolutely necessary in order to stop the complete crisis of confidence. With the packages, they have the crash trolleys out and have applied the defibrillator so the patient is at least alive. So now the global economy needs to be nursed back to health. But that will be a slow process."

One London-based senior equity capital markets banker says: "I think they have decided that they will succeed. They will do whatever it takes to succeed, they will repair the credit markets, and if the current packages aren't enough then they will throw another log on the fire. I don't think they will have to nationalise banking systems in order to achieve that. I suspect what they have done will work, but if it doesn't then there is still more they can do in guarantees of bank obligations. That would be the next step."

When the markets have settled down, the landscape will be dramatically changed. What companies take away from the crisis and how business models change as a result will have much to say about who successfully navigates the rough waters ahead. ■

Other crises

Aside from the Great Depression, the US has faced numerous other banking and market meltdowns and has taken lessons from those in dealing with the current crisis. In 1907, the stock market fell almost 50 per cent after a retraction of market liquidity from a number of banks and the failure of the Knickerbocker Trust Company.

Loss of confidence by depositors and the lack of a lender of last resort led many regional banks to withdraw reserves. Order was restored when New York businessman John Pierpont Morgan pledged his own funds – and convinced other financiers to do the same – to prop up failing banks. As a result of the Panic of 1907, the Federal Reserve was created in 1913.

However, this was not the first major crisis faced by the US financial system. Indeed, for the first 150 years after the creation of the US financial markets there was a crisis of some sort about every 20 years.

The panic of 1819 was probably the first boom-to-bust cycle seen in the US. The panic of 1837 led to a five-year depression. The panics of 1857, 1873 and 1893 each saw bank failures, and the panic of 1901 saw the stock market tumble to unheard-of lows.

In the 1980s and early 1990s, the US faced another significant predicament with the savings and loan crisis. This was precipitated by the housing market boom of the late 1970s, followed by sinking property values in the mid-1980s and asset-liability mismatch as interest rates skyrocketed.

This, in combination with relaxed regulatory oversight and new speculative opportunities – in the form of deposit brokerages – led to the failure of many S&Ls, the injection of about $160bn from the government to prop up financial institutions and markets, and the closing of about 1,600 non-S&L banks.