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Revisiting the Macroeconomic Causes and Effects of the Great Depression and the Great Recession

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Abstract:

The Great Recession which initiated in 2008 was a recent economic crisis that had widespread implications across the globe. The Subprime Crisis in the United States triggered the recession, which later turned into a global contagion. On comparing the magnitude of devastation that occurred in the Great Depression about a century ago, the impact of the Great Recession seems dwarfed. This article gives an overview of the causes and effects of the Great Depression of the 1930s and the Great Recession which took offin late 2007.An attempt has been made to juxtapose both these scenarios which caused the economic disarray and the aftermath. The impact of the Great Recession on the Indian economy has also been briefly touched upon.

Keywords: *Business cycle, recession, depression, economic crisis*

1. Introduction:

The global economy has witnessed diverse economic scenarios in the last hundred years, most of which were associated with the United States (US) economy. About ninety years ago, the worst ever economic crisis was observed, which is ominously remembered as the Great Depression. After the Great Depression of the Thirties, the industrialized economies which participated in the World War II witnessed rapid economic expansion in the post-war period, often referred to as the 'golden age of economic growth'(Vonyó, 2008). This growth is often credited to the extensive reconstructionwhich took place after the devastation caused by the War. Post this golden era, an unprecedented challenge of 'stagflation' came by in the seventies, where the US economy witnessed a slowdown coupled with rising unemployment and inflation.Later, we witnessedthe globalization boom caused by the massive information technology revolution. The dynamics of information technology have been transmitted

to ourmacroeconomic environment.Unlike old days, every dimension of our lives is evolving at a precipitous rate. The rules of the game have changed.

However, despite the availability of complex economic models, cutting edge technology and information overload, uncertainty and unpredictability prevail. A probable root cause of it may be our innate tendency to be complacent coupled with overconfidence bias. Today we are at the brink of an economic meltdown that no one ever dreamt of.A possibility of an economic crisis because of a pandemic was a practical impossibility even till the end of 2019. Similarly, about thirteen years ago, we failed to foresee the advent of the impending Great Recession. The latter part of the first decade of the Twenty-First century was marred by economic turbulence across the globe. Over a decade has passed, but the experiences of the Great Recession arestill crisp. The miseries were unprecedented for the commoners of the contemporary generation.The term ‘Recession’,nowadays is a generously used term we keep hearing in news channels and the conversations of laymen and has become a part of the common man’s lexicon. Most of the economies worldwide are witnessing one as a result of the COVID-19 pandemic. However, the economic implications of the COVID-19 pandemic are yet to pan out completely; hence the ongoing economic slowdown is not part of this study.

Technicallythe concept of recession is not as straightforward as it sounds.Also,‘Depression’ is a phenomenon which we haven’t experiencedin our lifetimes yet.Before understanding the technicalitiesof recession and depression, it is indispensable to touch uponthe concept of Business Cycles.

1.1 Business Cycles:

Burns and Mitchell, in their seminal work on business cycles, gave the following definition of business cycles:

“Business cycles are a type of fluctuation found in the aggregate economic activityof nations that organize their work mainly in business enterprises: a cycle consistsof expansions occurring at about the same time in many economic activities, followedby similarly general recessions, contractions, and revivals which merge intothe expansion phase of the next cycle; this sequence of changes is recurrent but notperiodic; in duration business cycles vary from more than one year to ten or twelveyears; they are not divisible into shorter cycles of similar character with amplitudesapproximating their own.”(Burns and Mitchell, 1946).

This working definition of business cycles given by Burns and Mitchell in their *magnum opus*is arguably the most widely accepted. They characterized business cycles as fluctuations in aggregate economic activity which are recurrent in nature, the duration of which ranging from one year to ten or twelve years. This explanation of the phenomenon of business cycle introduced subjectivity in the business cycle analysis since no quantitative criteria arementioned by them to measure the cyclical fluctuations.However, Geoffrey Moore, an intellectual descendent of Mitchell at

the National Bureau of Economic Research ('NBER'),elaborated on the methodology adopted by the NBER: "*In deciding what movements in the economy qualify as a business cycle the NBER looks broadly at three dimensions of recessions: how long they last; how deep they get; and. how wide are their effects among industries or other sectors of the economy.*"(Moore, 1983). This approach was subsequently adopted by the Economic Cycle Research Institute ('ECRI'), a commercial research entity co-founded by Moore. At ECRI, they replicated NBER's approach by encapsulating it as 'Three Ps' for identifying business cycle turning points i.e., pronounced, pervasive, and persistent.

Since identification and measurement of business cycles involve a certain amount of subjectivity, there arises a need for a central authority to carry out this activity to be widely acceptable. TheBusiness Cycle Dating Committee ('BCDC') of the NBERis a pioneer organization in recording the business cycles of the US economy. The Centre for Economic Policy Research ('CEPR') adopted the business cycle dating methods of the NBER to track the European business cycles. Though, no entity keeps track of business cycles in India. However, in the Indian context, taking into accountthe challenges of limited data availability and recurring revisions in published macroeconomic data, extensiveempirical research has been carried out to identify and date the business cycle peaks and troughs. Mall pioneered the work of dating Indian business cycles using the growth cycle approach for the pre liberalization period (Mall, 1999). This research was succeeded by the works of Patnaik and Sharma (2002), Mohanty et al. (2003), Chitre (2004),Dua and Banerji (2012) and Pandey et al. (2019).

1.2 Recession:

A significant decline in economic activity is generally referred to as a recession. A recession begins after the peak in economic activity is attained and continues till the trough.According toa popular notion,a recession occurs when the real Gross Domestic Product ('GDP') declines for at least two consecutive quarters. However, detecting recession is a considerably complex activity that cannot be condensed into a simple rule of thumb.

According to the NBER, "*A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. A recession begins just after the economy reaches a peak of activity and ends as the economy reaches its trough.*"(NBER, 2010).

As evident from the definition, similar to the definition of business cycles,the criterion for declaring a recession has not been quantitatively defined.This gives NBER the discretionary power to subjectively analyze the macroeconomic variables and declare recessionwhenever the criteria set by them are fulfilled.The weakening of one particular sector does not constitute a recession;nor does a dip in the economy for a short duration of time. The effect has to bepronounced, pervasive, and persistent. To confirm these facts, NBER's BCDC plays a vital role.

The nature of business cycles is fairly dynamic resulting in structural shifts. The Twentieth century witnessed wide fluctuation in economic activity. Hence, a recession in those times was referred to as a situation when there was an absolute decline in economic activities. So, during a recession, there was a decline in the national output. This approach of measuring business cycles is referred to as the classical approach. However, the variability in economic activity has significantly declined in recent times. We rarely experience a decline in economic activity in absolute terms. What we experience is the decline in the growth rate of the economy. Hence, we have switched to measuring growth cycles and growth rate cycles instead of the classical business cycles.

1.3 Depression:

In the normal course of business cycles, a decline in economic activity is known as a recession. But when a recession persists for a longer duration with more severe macroeconomic implications, it is referred to asa depression.Depression occurs when an economy suffers from extremely high levels of unemployment, inflation, loan delinquencies, and a significantdrop in aggregate demand, trade and commerce for a long period.However, unlike recession, NBER has not defined the term 'Depression' officially. Historically, depression has occurred only twice since the Nineteenth century; the first one in the 1870s and the next one occurred in the 1930s, better known as the Great Depression.

2. The Great Depression of the 1930s:

The Great Depression of the 1930s was the worst economic crisis of the modern industrialized era, which lasted for almost ten years.The seeds of this crisis were sown in the early twenties, notably brandedas the 'Roaring Twenties'. During this period, the industrialization and modernization of the United States were at theirzenith. Since the beginning of the Twentieth century, the income and spending of people took off due to rapid industrialization. The stock market witnessed a huge bull run. The United States' wealth more than doubled in the Twenties decade alone.

However, behind this hysteria, the symptoms of the recession were shadowed. Inflation started to accelerate steadily. This escalated the interest rates levels. Due to over-investment, the capacities of industries were left underutilized. With rising interest rates and declining demand, repayment of loans by the industries became more painful. This caused widespread delinquencies across the economy.

When these symptoms became more prominent, the stock market collapsed inlate October 1929. This marked the beginning of the infamous Great Depression.The stock markets dropped by about 90 percent. Investors lost millions in this collapse. Since they were financed by financial institutions, people lost confidence in the credibilityof these financial institutions. This led to several bank runs, wiping out about one-third of the Banks of the United States by the mid-1930s.

Unemployment peaked at 25percent in 1933. The real GDP fell by about 30percent during this period. The level of global output plummeted by about 9.35percent.The United States, primarily being a consumption-driven economy, transmitted the effects of the Great Depression to its trade partners, making it a global contagion. Europe was most affected by the Great Depression because of its intimate trade relations with the US.

The Great Depression gave birth to macroeconomics as a discipline when J.M. Keynes published his most influential work 'The General Theory of Employment, Interest and Money' in 1936. Keynes suggested expansionary fiscal policy to deal with depression. The effects of the Great Depression started diminishing after the newly elected President Franklin D. Roosevelt implemented the New Deal policy and spent heavily on creating infrastructure, which created jobs and slowly enhanced the aggregate demand in the economy. With the success of Keynesian economics, it became the norm amongst the Central Bankers. The US economy further picked up after yet another spike in industrialization caused by the Second World War and the economy was driven out of the Great Depression.

3. The Great Recession of 2008:

The Great Recession was the longest ever recession in the recorded history. This time as well, like the Great Depression, the recession originated from the United States.The housing market was the felonthis time. With the new millennium, came the demand for houses in the US economy. The housing boom, which began in the early 2000s, saw a rapid and unrealistic surge in the real estate market. This asset bubble was further fueled by cheap credit infused by the banks. The investment banks and other financial institutions took advantage of it and introduced Mortgaged Backed Securities ('MBS')to the investors with very attractive interest rates and credit ratings by securitizing housing loans.The financial institutions marketed and sold MBS and other complex derivative products like Credit Default Swaps ('CDS') at unprecedented levels, overleveraging and compromising the entire banking system's solvency. The financial institutions thrived on the real estate bubble till late 2006.

In 2007, the bubble popped. Real estate prices tanked, creating panic in the housing sector. The homeowners were incapable of paying huge instalments for their worthless houses and were unable to sell their houses at a decent price due to the real estate collapse. This caused an epidemic of delinquencies and foreclosure of housing loans. Since these loans were securitized and sold by financial institutions to the investors, the MBS market collapsed which initiated panic in the rest of the financial markets.

Since many international financial institutions had exposure to the US financial markets, the contagion became pervasive across the globe in no time. The NBER announced that the economy peaked in December 2007 and we experienced a recession which continued till June 2009. During

this period, the real GDP across the world plummeted and unemployment skyrocketed. The US stock markets plunged by ~50percent during this recessionary period.

Asia, Africa, Australia and most of the South American countries had no severe implications of recession as that was being faced by North American and European countries. The countries in these regions were impacted only on the exports front; since they had exposure to American and European countries. The real GDP growth rate declined but it never turned negative in most of these countries. The brunt of the Global Financial Crisis had a limited influence on them.

3.1 Impact on India:

Talking of India, it would be surprising to know that technically India did not suffer from recession as per the classical approach of measuring business cycles. We only experienced a decline in the growth rate of GDP during the period of the Great Recession. Before the recession struck the World, India's GDP was impressively growing at 9.3percent, which dipped to 6.8percent as the global recession began. However, the Indian economy showed resilience and our growth recovered to 8percent in 2009-10.The Index of Industrial Production (IIP), which is a composite index to measure growth rates of major industries, declined to 3.2 percent in 2008-09 from 8.7 percent a year before that. Despite the global slowdown in economic activity, the IIP did not turn negative. The index strongly recovered to 10.5 percent within a year(Dixit, 2016).

It was the exports sector which was most wounded by the recession. The exports growth was at its peak in 2007-08 when it was growing at 29 percent. But due to a slump in the Western economies, exports growth fell to 13.3 percent in 2008-09 and subsequently turned negative in 2009-10 to -3.5 percent. Since almost three-fourths of our exports were exposed to the USA and European countries at that time, we witnessed such a steep decline in our exports. Though, rupee depreciation absorbed this decline to some extent. Generally, depreciation of the home currency is a positive factor for exporters, since their revenue increases with depreciation in home currency. The Rupee, which was trading at ~ Rs.40 in March 2008, dwindled to ~ Rs.50 by December that year. So the decline in exports was partly compensated by the depreciation of the rupee.The net investment by the Foreign Institutional Investors (FIIs) turned negative in 2008-09, which happened for the first time in that decade(Dixit, 2016). The effect of this phenomenon was visible in the Indian stock markets, which sunk by about 50 percent in 2008 itself.

One of the prominent reasons for the Indian economy's resilient performance during the Great Recession was that the Indian economy is primarily driven by domestic consumption. India's exports accounted for just about 15 percent of its GDP. Thus, the impact of the global financial crisis was very limited on India.These were the major macroeconomic factors that were afflicted by the Great Recession; still, we managed to dodge it.Our real GDP growth stayed in the positive territory throughout the recessionary phase.

4. The Comparison:

The Great Depression and the Great Recession occurred in totally different backdrops. During the Twenties, the Western economies were industrializing and globalization was practically non-existent at that time in contrast to the contemporary times. The US Federal Reserve was established in 1913, so it wasn't as active as it is today. The currencies existed based onthe Gold Standard system in the Twenties; however, we have fiat currencies now. The financial markets weren't regulated by the Securities and Exchange Commission back in those days. Availability and dissemination of information was a problem in the Twenties.With an in-depth analysis of both the crises, we can apprehend that they were caused by identicalreasons.The interest rates were artificially kept too low for too long. However, the effects of this werequite different in both eras. Cheaper credit availability led to rapid industrialization and over-investment in the early Twentieth century. While lowinterest rates at the beginning of the Twenty-First century caused skyrocketing prices of real estate, making it a bubble.

Talking of the similarities, both the crises began in the USA, which later proliferated across the World. That is why, it is often said that when the US sneezes, the rest of the world catches a cold. Apart from the US, Europe was jolted the most because of its close trade relationship with the US economy. Other parts of the World were mildly impacted by financial meltdowns during both periods.

The role played by the US Federal Reserve (US Fed) during both periods should also be highlighted. Since the US Fed was quite young during the time of the Great Depression, it is often accused of inaction and passive policies which led to further aggravationof the crisis. One in every three banks that existed in the US got wiped out. The US Fed failed to play the role of the lender of last resort, which led to the closure of banks. While, during the Great Recession, the US Fed was alleged to be hyperactive and took too many policy decisions which further complicated the situation. The hyperactivity of the US Fed is often cited as one of the prominent reasons for elongating the recession.

However, the effects of both the financial turmoil are incomparable. The instability we witnessed during the Great Recession was a fraction when compared to that of the Great Depression. As cited above, the stock markets collapsed by ~90 percent during Depression as compared to a ~50 percentdecline at the time of the Recession. The peak unemployment level at the time of the Great Depression was ~25 percent while it peaked at~10 percent in the last decade's recession. The real global GDP plunged by over ~30 percent in the last century's crisis in contrast to just a ~5 percent decline during the recent crisis. The global output tanked by 9.35 percent because of the Great Depression, on the other hand, we just lost 2.95 percent of the global output in the Great Recession.

To conclude, there are some minor similarities between the causes of both the crises, but the

background and scenarios during which they happened and the after-effects of the same are incomparable. The Great Recession seems to be just a mild inconvenience when juxtaposed to the sufferance of the Great Depression.Despite our repeated attempts not to repeat the mistakes of the past, history does keep on rhyming with itself, even if not repeating itself.

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