Title

Stock Markets, Policy Failure, and Economic Collapse: A Comparison of 1929 and 2008

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Certificate

This is to certify that the research paper titled 'Stock Markets, Policy Failure, and Economic Collapse: A Comparison of 1929 and 2008' has been completed by Naisha Bansal, Class 11 under the guidance of Ms Manvi Gupta as part of the as part of the Young Scholar Research Mentorship Programme of the Indian School of Business and Finance (ISBF). The work is original to the best of our knowledge and prepared for educational purposes.

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Declaration

"I, Naisha Bansal, hereby declare that this paper is my original work and has not been copied from any source. All references used have been acknowledged."

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(1) Introduction

The stock market is a marketplace where companies raise capital by issuing shares of ownership, and investors trade those shares among themselves. In essence, it enables businesses to obtain funding from the public and gives investors an opportunity to own a stake in those companies' profits and growth [(1)]. Share prices are determined by supply and demand in an open market – when more people want to buy a stock than sell it, its price rises, and vice versa. This process of price discovery reflects investors' collective expectations about a company's future and the broader economy. Because of this, the stock market serves as a barometer of economic health and sentiment ([1]). A roaring, bullish market often signals optimism and expansion, whereas a sharp decline can foreshadow economic trouble. The late 1920s stock boom and the 2000s housing-driven market surge both exemplified how exuberant investors can drive asset prices to unsustainable heights, setting the stage for a crash when reality catches up.

A well-functioning stock market relies on confidence in the financial system. Here is where government policies become vital. Monetary policy and fiscal policy are two key tools that authorities use to influence the economy and, by extension, financial markets. Monetary policy refers to central banks' management of interest rates and the money supply ([2]). For example, a central bank like the U.S. Federal Reserve can cut interest rates and inject money into the economy to spur growth in bad times, or raise rates and tighten money in boom times to curb inflation. Fiscal policy, on the other hand, refers to governments' decisions on taxing and spending ([3]). By increasing public spending or cutting taxes, a government can directly boost demand in the economy (creating jobs and income), while doing the opposite can cool down an overheating economy. Both policies have a powerful impact on business conditions and investor behavior ([4]). When used wisely, they can moderate the ups and downs of economic cycles. When used poorly – or not at all – the consequences can be disastrous, as history shows. With these basics in mind, we can now explore how the interplay of the stock market and policy failures contributed to the Great Depression, and how lessons from that era influenced the handling of the 2008 financial crisis.

(2) The Great Depression (1929–1939)

The Great Depression was the harshest economic collapse in modern history, and it began with a stock market implosion. In the 1920s, the stock market had been soaring to unprecedented heights amid the “Roaring Twenties” prosperity. Easy credit and speculative frenzy drove share prices well beyond sustainable values. This euphoria abruptly ended in October 1929 with the Wall Street Crash. Over a few panicked days, billions of dollars of wealth evaporated as prices plunged. By the time the market hit bottom in mid-1932, U.S. stocks had lost about 85% of their value from the 1929 peak ([5]). Investors who had bought stocks on margin (using borrowed money) were wiped out. Businesses could no longer raise capital, and consumer confidence was shattered. The stock market crash acted as the spark for a wider economic conflagration.

What made the ensuing downturn so uniquely severe were cascading bank failures and policy mistakes that allowed an ordinary recession to spiral into a years-long depression. After the crash, thousands of banks faced runs by panicked depositors, and many banks collapsed, wiping out savings. The money supply contracted drastically – by nearly 30% from 1930 to 1933 – as loans dried up and banks hoarded the remaining cash ([6]). As credit froze, businesses couldn’t get financing and had to cut back or close, leading to mass layoffs. Crucially, the Federal Reserve (Fed), which had been created just years earlier, did not act aggressively to counter these forces. In fact, the young Fed tightened monetary policy in the early 1930s, raising interest rates in an effort to defend the gold standard and curb speculative excesses ([7])([8]). This move, done in the midst of a collapsing economy, turned out to be a grave error. By reducing the availability of money and credit when the economy desperately needed them, the Fed’s action (and inaction in providing emergency liquidity) intensified the deflationary spiral. Decades later, economist Milton Friedman famously demonstrated that this “misguided tightening of monetary policy” in a time of crisis was exactly the wrong cure and greatly worsened the depression. In other words, the central bank’s failure to stabilize the banking system and expand the money supply was a key factor that “led to a banking panic far more severe than was ever experienced before the Federal Reserve System was established” ([9])([10]).

The economic pain of the Great Depression was staggering. Between 1929 and 1933, U.S. real GDP fell by about 36%, and the unemployment rate soared to roughly 25%, meaning one in four workers was jobless ([11]). Wages and incomes collapsed alongside output. Breadlines and soup kitchens appeared across America as families struggled to survive. With so little money in circulation, prices fell about 27% (a deep deflation), which only increased the burden on debtors and further discouraged investment ([11]). Globally, the depression spread like contagion, exacerbated by trade protectionism (e.g. the Smoot–Hawley Tariff of 1930) that choked off international commerce. It is hard to overstate how severe and protracted the Depression was: nearly a decade of high unemployment and stagnation, with recovery only haltingly beginning by the late 1930s. Even in 1937, a full eight years after the crash, U.S. unemployment was still around 15% and output remained well below its 1929 peak ([12]).

How was such a catastrophe eventually resolved? The turnaround came through a combination of new policies and historical circumstances. In 1933, amid the depths of the crisis, Franklin D. Roosevelt assumed the U.S. presidency and launched the New Deal – an aggressive program of fiscal and financial reforms. The government, for the first time, took a direct role in trying to stimulate demand and cushion the populace from hardship. Federal spending was ramped up for public works projects (building roads, dams, bridges and other infrastructure to create jobs). Landmark programs like Social Security were established to provide income to the elderly, and the Federal Deposit Insurance Corporation (FDIC) was created to insure bank deposits and restore trust in banks ([13]). Under New Deal legislation, rules were introduced to regulate the stock market and banking (for example, the Glass–Steagall Act separated commercial and investment banking) in hopes of preventing the same financial recklessness that led to the crash. Equally important, the United States abandoned the gold standard in 1933, which freed the Federal Reserve to expand the money supply. This monetary easing helped halt the free-fall of prices and encouraged lending again. As economist Christina Romer later showed, the growth of the money supply after 1933, aided by gold inflows, was crucial to the recovery of the U.S. economy ([14]). By the mid-1930s, these measures began to stabilize the economy – banks reopened, confidence slowly improved, and the worst of the deflation was over. However, the New Deal's fiscal stimulus, while significant, was not enough by itself to end the Depression. The U.S. economy really regained full strength only with the massive government spending of World War II, which finally brought output and employment back to full capacity ([15]).

Notably, Milton Friedman's analysis of the Great Depression came decades later (his seminal work *A Monetary History of the United States* was published in 1963), but it fundamentally changed how we understand that crisis. Friedman (with co-author Anna Schwartz) argued that monetary policy failures turned an ordinary recession into the Great Depression – essentially, the Fed "failed to provide banks with necessary cash to avoid bank failures from bank runs" ([10]). This view challenged the earlier Keynesian explanation that only a lack of government spending (aggregate demand) was to blame. Over time, Friedman's insights gained wide acceptance and became hugely influential. In fact, they would directly shape how future policymakers responded when another severe financial crisis hit in 2008. Federal Reserve officials came to recognize that aggressively easing monetary policy in a crisis – not tightening – is vital to stave off economic collapse ([7])([8]). As we will see, the contrast between 1930 and 2008 in central bank behavior was literally a matter of life and death for the economy. Friedman's legacy thus lives on in the lessons learned from the Great Depression, ensuring that such a calamity "won't happen again" if those lessons are remembered.

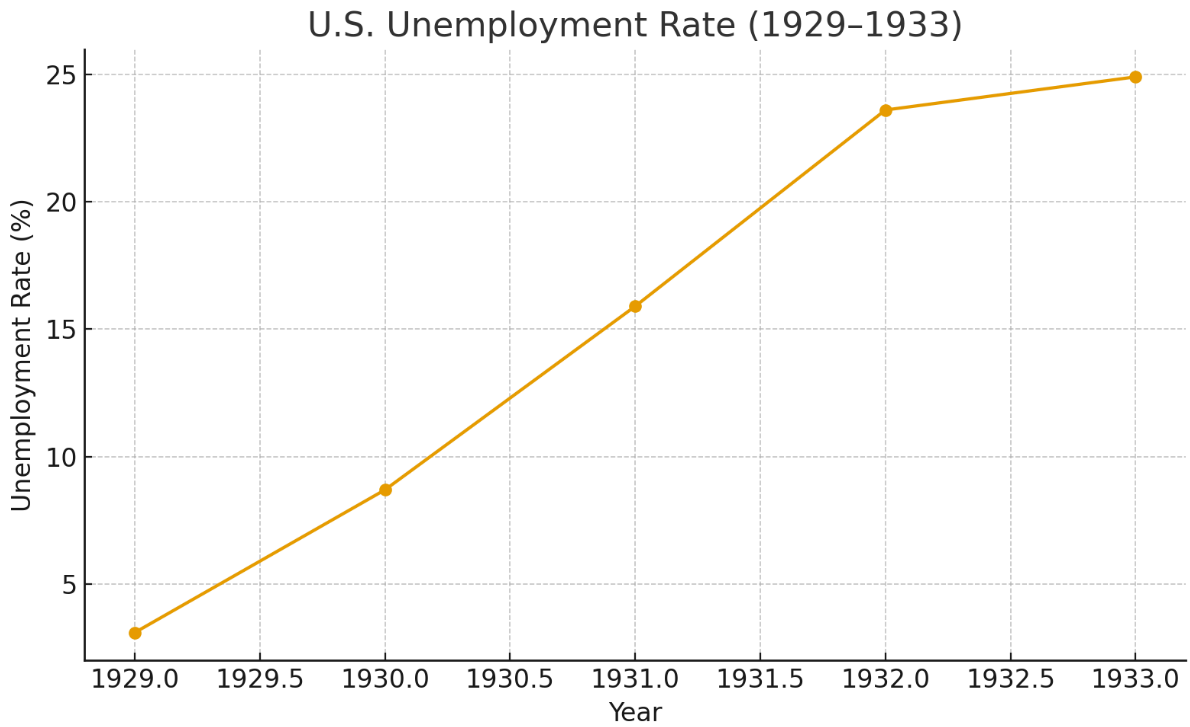

Figure 1: U.S. unemployment during the Great Depression versus the Great Recession. In 1933, unemployment peaked near 25% as the Depression deepened, far above the 10% peak reached in the 2008–09 recession. The Great Depression's severity was vastly greater, in both duration and magnitude, than the downturn of 2007–2009.

(3) The 2008 Financial Crisis (Great Recession)

Fast-forward about 80 years from the Great Depression, and the world faced another major economic calamity: the 2008 financial crisis, often called the Great Recession. This crisis differed in origin – it was rooted in a housing market bubble rather than the stock market – but it led to a similarly perilous meltdown of the financial system. In the early-to-mid 2000s, U.S. home prices skyrocketed amid a frenzy of subprime mortgage lending and speculative investment in mortgage-backed securities. Banks and investors believed these complex securities were safe, in part because credit rating agencies gave "AAA" ratings to billions of dollars of mortgage bonds that didn't deserve such high marks ([16]). When the housing bubble burst around 2007, many homeowners defaulted on their loans, and those once-highly rated mortgage assets plunged in value. By 2008, major financial institutions worldwide were suffering huge losses, since they had loaded up on these toxic assets during the boom. The pressure came to a head in September 2008 with the collapse of Lehman Brothers, a 158-year-old investment bank. Lehman had massive exposure to bad mortgages and, when no one stepped in to save it, the firm was forced into bankruptcy – a shocking event that sent fear through markets. The failure of Lehman Brothers set off global panic; credit markets froze as banks refused to lend to each other, and stock markets crashed around the world ([17]). At the height of the fear, "markets basically stopped functioning properly," and the economy stood on the brink of what many feared could become a new Great Depression ([18]).

Yet, in 2008–2009, unlike in 1929–1930, authorities reacted with extraordinary force to arrest the collapse. Crucially, the Federal Reserve, led by Chairman Ben Bernanke, took the opposite approach of its predecessors in the 1930s. Bernanke – who was a scholar of the Great Depression and had long studied its causes – was determined not to repeat the Fed's past mistakes([19]). As soon as the crisis intensified, the Fed slashed interest rates aggressively, eventually dropping its benchmark rate effectively to 0% by December 2008 ([20]). By cutting the federal funds rate to near-zero, the Fed aimed to flood the banking system with liquidity and make borrowing as cheap as possible to prop up economic activity. This move was "the exact opposite of what the young Federal Reserve did in the wake of the 1929 crash" ([20]). In other words, rather than tightening credit, the Fed opened the monetary spigots. It also undertook unconventional measures – creating new lending programs to unfreeze credit markets and later buying large quantities of bonds in a policy known as quantitative easing – all to prevent a wholesale financial collapse. Bernanke's swift actions embodied the hard-won lesson from Friedman and Schwartz: that expanding the money supply and acting as lender of last resort in a crisis can prevent a banking panic and deflationary spiral ([7]).

At the same time, the fiscal policy response in 2008–09 was dramatically more aggressive than during the Great Depression. In the early 1930s, President Herbert Hoover had been hesitant to run budget deficits, and even Roosevelt's New Deal, while groundbreaking, was constrained by political opposition and a limited appetite for deficit spending. By contrast, in 2008 the U.S. government moved rapidly to deploy hundreds of billions of dollars to rescue the financial system. U.S. Treasury Secretary Hank Paulson and Fed Chair Bernanke went to Congress urgently in late 2008, warning that a gigantic intervention was needed to prevent an outright collapse of the economy ([21]). The result was the Troubled Asset Relief Program (TARP) – a roughly $700 billion emergency package to recapitalize banks and stabilize the financial sector ([22]). In a matter of weeks, lawmakers and President George W. Bush approved this unprecedented bailout fund, reflecting a near-consensus that aggressive steps were essential ([21])([22]). In addition to TARP, early 2009 saw a massive fiscal stimulus bill (~$800 billion) passed to jump-start the economy by boosting government spending and cutting taxes. The scale and speed of these fiscal measures were in stark contrast to the 1930s, when fiscal expansion was smaller and slower. Indeed, one analysis noted that the differences between the 1930s response and the 2008 response "could not have been starker" ([21]) – policymakers in the modern crisis were far more willing to pump money into the economy to avert disaster.

Thanks to these rapid interventions, the worst-case economic outcomes were avoided. The Great Recession was severe – the U.S. economy went into a deep downturn from late 2007 to mid-2009 – but it never reached anything close to the depths of the Great Depression. For example, U.S. real GDP fell by about 5% during 2007–2009, as opposed to the catastrophic 30%+ contraction of the early 1930s ([23]). Unemployment, while painfully high, peaked around 10% in late 2009 and then gradually receded ([24]). There was no prolonged mass unemployment of 25% as seen in 1933. And importantly, there was no deflation – consumer prices in 2008–09 stayed roughly flat or rising slightly, whereas prices collapsed in the 1930s ([24]). By about 2013, a few years after the crisis, U.S. output and stock prices had fully recovered to pre-crisis levels ([25])([26]), whereas in the Great Depression such recovery took well over a decade (and really only occurred with WWII). In short, the 2008 crisis, while immensely painful, turned out to be a "Great Recession" and not a second Great Depression.

This outcome was not simply luck – it reflected, in large measure, the different choices made by policymakers who had learned from the past. As one Federal Reserve economist noted, as bad as 2008–09 was, “severe as it was, it doesn’t compare on scale with the Great Depression” ([27]).

A major reason we did not suffer another Great Depression in 2008 was that leaders explicitly applied the lessons of the 1930s. Ben Bernanke’s mindset in 2008 was shaped by his knowledge of what Friedman, Schwartz, and other scholars had taught about the Depression’s causes. In 2002, at a celebration of Milton Friedman’s 90th birthday, Bernanke (then a Fed governor) addressed Friedman and said: “Regarding the Great Depression: You’re right, we did it. We’re very sorry. But thanks to you, we won’t do it again.” ([28]) This remarkable admission – acknowledging the Fed’s culpability in the 1930s collapse – foreshadowed how Bernanke would later act when he had the chance. True to his word, in 2008 he did not allow the money supply to collapse or the banking system to implode the way it did in 1930–1933. Instead, the Fed under Bernanke flooded the system with money and kept the banks afloat, exactly as Friedman’s analysis suggested was necessary ([29]). Likewise, government institutions created after the Depression helped buffer the 2008 shock. For instance, FDIC deposit insurance meant that even when some banks were shaky, ordinary depositors didn’t run to pull out cash en masse – a stark difference from the uncontrolled bank runs of the early 1930s. Social safety nets like unemployment insurance and Social Security (legacies of the New Deal) also helped families avoid destitution, preventing a collapse in consumer demand as extreme as that of the 1930s.

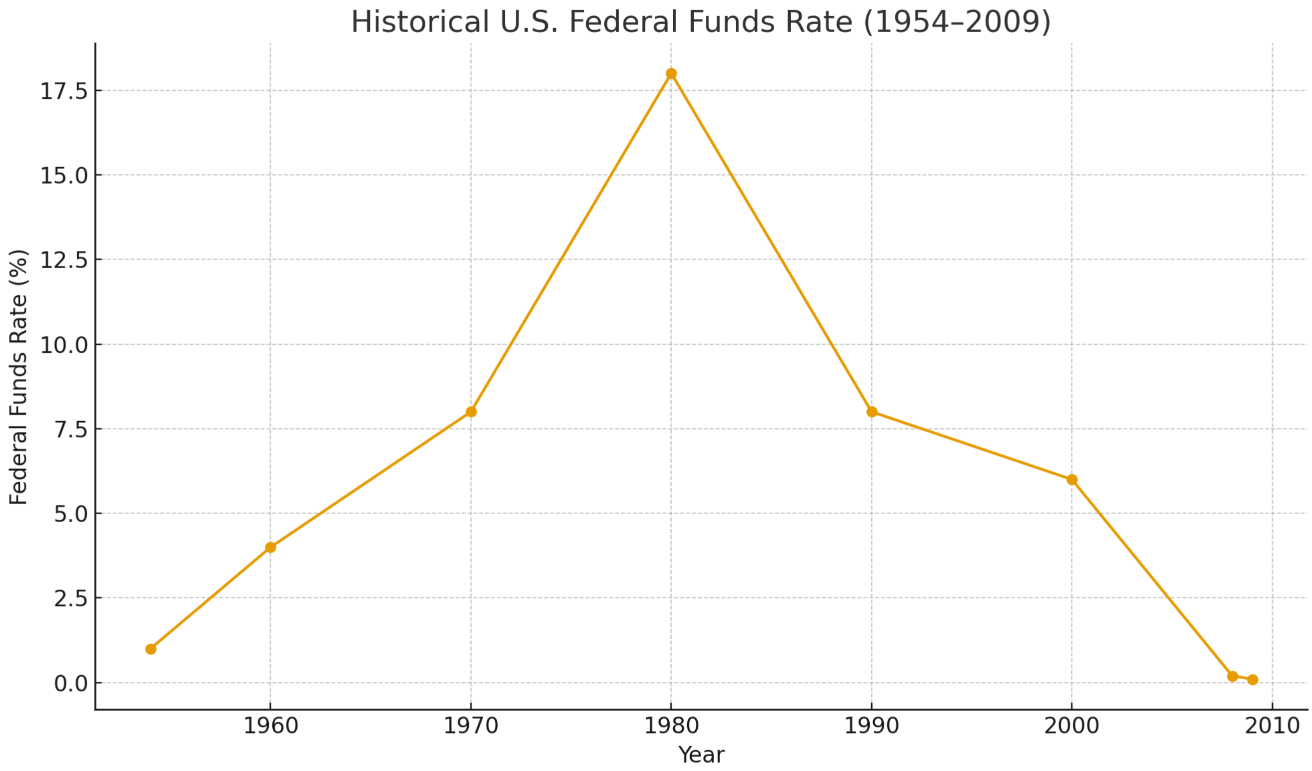

Figure 2: Historical Federal Reserve interest rates (1954–2009). This chart shows the U.S. federal funds rate over time, including the sharp drop to near-zero in 2008 (far right). During the Great Depression (not shown here, as Fed rates before 1954 are not on this chart), the Fed raised rates in 1929–1930 – a policy error that worsened the downturn ([7]). In 2008, by contrast, the Fed slashed rates to 0%, reflecting a deliberate use of expansionary monetary policy to combat the crisis ([20]).

In retrospect, the 2008 financial crisis can be seen as a real-world test of whether we absorbed the lessons of the Great Depression. The verdict, by and large, is that we did – at least in terms of crisis response. The parallels between the two events are instructive: in both cases a speculative bubble (stocks in the 1920s, housing in the 2000s) led to a financial panic and economic downturn. But in the Great Depression, policy responses were slow, hesitant, and often counterproductive, whereas in 2008 the response was swift, bold, and informed by history. While the Great Recession still inflicted heavy economic damage, it was contained before it could evolve into something on the scale of the 1930s. The fact that 2008 did not repeat the Great Depression is itself a testament to the progress in economic understanding. Ultimately, the experience showed that when policymakers act decisively to stabilize banks, pump liquidity, and support demand – essentially doing the opposite of what was done in 1929–1932 – a financial crisis, however severe, need not become a decade-long depression.

The hope is that future generations will likewise remember these hard-learned lessons, so that history's worst economic tragedies need not repeat themselves.

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