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Kaposvár University, Faculty of Economic Science, Kaposvár

FINANCIAL CRISIS NOW AND THEN

Margit KEREKES
Szent István University, School of Doctoral Studies, Management and Business Studies
H-2100 Gödöllő, Páter Károly utca 1.

ABSTRACT

Keynes, the British economist, says the state should intervene in the economy: infrastructure needs to be developed, public works have to be organized and social politics are to be improved. If all of the above are achieved, there is a chance of keeping the economy in balance in a time of crisis. In the Great Depression of 1929-1933 Roosevelt's New Deal programme helped the United States to recover from the crisis, conduced to preserve civil democracy and laid the foundations of the welfare state. The so-called sub-prime crisis that began at the end of 2006 represents the culmination of a super boom that started more than 25-years ago. The variable intensity financial crisis originating from the real estate and banking sectors resulted in the decline of the U.S. economy; its slowing economic growth has an impact on the whole world's economy. Therefore, the question is whether there is any way out of the current global economic crisis, like 80 years ago.
Keywords: crisis, economy, global financial and economic crisis

INTRODUCTION

The global economic crisis began with the stock market crash in 1929. In the fear of default, depositors rushed to their banks to withdraw their money. Since banks were not able to pay everyone, they became insolvent and went bankrupt. The banking crisis first caused a crisis in machine industry, then in those industries' that produced consumer goods. Due to the collapse of the USA economy the international trade and financial world also collapsed. In 2006 the financial crisis started again in the USA, in the banking sector, and had an impact on many companies who have since gone bankrupt or were forced to merge with their competitors. This resulted in a downturn in the U.S. economy (limited supply of quality real estate, declining yields) which evolved into a world economic crisis. The American banks, economic and financial institutions suffered losses of billions of dollars that made clear to the American analysts that the country was being hit by a financial crisis and this crisis would soon extend to the entire world.

George Soros, Hungarian-born American investment banker said that "the situation is much more serious than any other time of financial crisis since World War II".

This study analyses the global economic crisis of 1929-1933 and the recent global economic crisis, and tries to draw parallels between the events in these different economic periods. The first part of the study presents the global economic crisis in the two different periods, respectively. The second section provides some examples of the crisis outside the USA, while the third part analyses the implications of the crisis in Hungary. The first part of the fourth section draws the conclusions and the parallels between the two crises, while the second part includes the forecasts. The study is mainly based on Internet articles and reviews.

The Great Depression (1929-1933)

24 October, 1929 "Black Thursday" - selling fever broke out in the New York Stock Exchange, and the abrupt fall of the high share prices - generated by speculators - reached nearly USD 15 billion loss, thus a global economic crisis began affecting almost all sectors and led to a worldwide social reorganization and to the impoverishment of millions.

October 29, 1929 "Black Tuesday" - the stock market crash reached its low point. Over the preceding six days - due to the loss of almost 50 billion USD - depositors, in the fear of default, rushed the banks, which hence became insolvent and went bankrupt (www.pecsinapilap.hu, 2009).

Thus, the global economic crisis of 1929-1933 began, starting in North America and spreading to South America, Australia and also to Europe in 1931. During the crisis *three waves of bankruptcies* swept the United States of America:

1. October - December, 1930: also leading to banking panics, several banks went bankrupt in the absence of a lender of last resort.
2. June - December, 1931: a wave of bankruptcies caused by the restrictive fiscal policy.
3. December, 1932 - March, 1933: low point of the crisis, the unemployment rate rose from 2% to 25%.

Due to the above-mentioned waves of bankruptcies, banks were closed in a number of states. President Herbert Hoover's program of drastic tax increase led to the decrease of bank deposits, which in turn resulted in a monetary contraction. In the situation thus created neither the general measures (such as savings in general) nor the extreme measures (such as coffee heated locomotives) could help.

Most notably, political distrust and foreign policy using economic instruments for political purposes played major roles in the crisis. In the summer of 1931 the Austrian, the German, and the whole Central European banking system collapsed. During the crisis the world's total production fell by 60%, the number of registered unemployed reached about 30 million at the lowest point of the crisis. Governments intervened to facilitate economic recovery by creating job opportunities through nationalizations, central orders and credit and wage controls.

On 4 March, 1933 Franklin Delano Roosevelt, freshly inaugurated U.S. president, formulated new economic and social policies, which, although heavy handed, helped the U.S. economy to recover from the crisis. Roosevelt's comprehensive crisis management programme, the so-called New Deal (for example, a four-day bank holiday, a new banking law, the ban of gold export) gave hope for a recovery even for those most seriously affected by the crisis.

Roosevelt's measures:

- In the inflationary economic policy, the dollar was depreciated.
- The reopening of banks was subject to authorization; this helped to restore confidence in banks.

- The Civilian Conservation Corps was designed to relieve unemployment. In this programme workers planted forests, built roads, bridges and regulated rivers. As for payment they were housed in camps with free accommodation, meals, uniforms, and one dollar per day pocket money was provided to them.
- To stimulate agriculture, cultivated areas and livestock were reduced, farmers were given a moratorium to repay their debts.
- Maximum working hours and minimum wages were determined, thus the circumstances of fair competition in the industry were created.
- The establishment of the social security system started.
- Unemployment aid was granted.

Besides these measures Roosevelt placed great emphasis on keeping the American public informed. For example, all of America followed his radio address called the "fireside chats." Additionally, the so-called "Blue Eagle campaign" proved to be a great idea, which provided that those who complied with the laws of the New Deal could mark their goods with a blue eagle.

In 1935 the supporters of the conservative economic policy engaged a successful counterattack against Roosevelt as some of the New Deal's acts were found to be unconstitutional by the Supreme Court. Therefore, the President executed the necessary amendments and continued his reform policies; he increased the number of board members from 9 to 15, hence there was no obstacle to the adoption of laws considered unconstitutional.

In general Roosevelt's measures were successful. While the main purpose of the "first" (1933-34) New Deal was economic recovery, the "second" (1935-36) focused on social measures, providing employment for two million people, which helped to stimulate the American economy and, as a consequence, America could recover from the crisis by the end of the decade.

Can the United States recover from the crisis that started in 2007?

Global Economic Crisis 2007-2009

Similar to the global economic crisis of 1929-1933, that of 2007-2009 also began in the United States. In recent years, the lending policy of the United States was characterized by granting mortgage loans to individuals without severe credit scoring, while the central bank kept its base rate at a low level. The value of real estate increased steadily due to balanced economic growth, hence the banks were not afraid of the debtors' insolvency. A sort of lending competition started among the banks as more and more people applied for loans. This led to the offering of more risky loans to more "unreliable" debtors financing ever riskier projects.

In addition, financial products have been launched that allowed credit risk derivatives, which resulted in opaque structures. These complex transactions affected the pillars of the system, i.e. it resulted in the drop of real estate prices, which in turn caused the global financial system to become highly instable.

Due to the deterioration of external conditions, the supply of homes for sale increased in the market as of 2006. In the slowing U.S. economy real estate agencies started to go bankrupt, followed by the banks engaged in mortgage loans. All of the above had an impact on the interbank markets since banks were only willing to lend to each other with a high credit default swap because of the fear of bank failures. The banks' confidence was shaken since they were reluctant to lend to other banks or individuals.

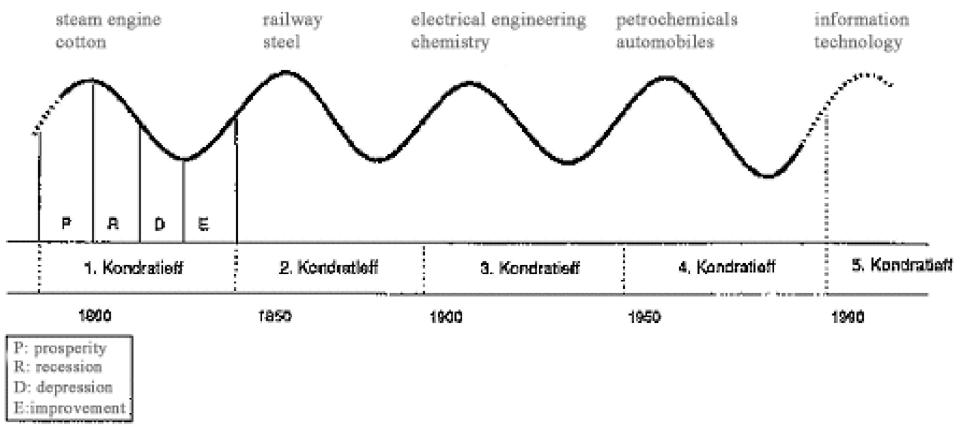
In recent times, not only real estate but also consumer durables were financed by loans in the USA. However, it was even harder to get loans due to bank failures and the negative news coverage, which led to a decline in consumption. Since economic growth is induced by production and consumption growth, it is understandable that the decrease in consumption led to a decline in production, which in turn increased unemployment and a downturn in economic growth. *These were, in fact, the direct causes of the crisis.*

However, the crisis has indirect causes, too.

1. We arrived to the recession phase of the fifth Kondratieff cycle (*Figure 1*).
   - 1st cycle: The steam engine, 1770's – 1830's
   - 2nd cycle: The era of railways, 1830's – 1870's
   - 3rd cycle: The era of electrical engineering and heavy industry, 1870's – 1900's
   - 4th cycle: The era of oil and the automobiles, 1900's – 1970's
   - 5th cycle: The era of Information Technology, 1970's – 2010

Figure 1

Kondratieff cycles



Source: *www.kwaves.com*, 2010

The Kondratieff cycle - also known as K-waves - is an economic theory that posits economic cycles lasting between 40-80 years, besides the "normal" business cycles of 10-15 years. The founder of this theory was Nickolai Kondratieff, a Soviet Russian economist who also helped to develop the first Soviet Five-Year Plan. He published his findings in a report entitled "Long Waves in Economic Life".

The existence of Kondratieff cycles is difficult to prove, since the cycles are long in duration and capitalist economies are relatively young, moreover only 4-6 cycles could have happened so far (*www.kwaves.com*, 2010). However, the global economic

crisis of 2008 fits perfectly to this cycle.
2. The huge storms of the hurricane season in 2008 caused damages for large cities, too. Hurricanes destroyed residential areas and a significant proportion of certain cities. Due to the risk of natural disaster it became more difficult to insure houses in the Southern states.
3. In 2008, America re-elected its president. The presidential campaign absorbed significant amounts of resources, which also had an impact on the poor economic situation of the American economy.
4. The military budget of the USA is huge, many times greater than those of any other nation state.

In addition, the main cause of the crisis was that banks started to lend money to the so-called "subprime" borrowers (subprime borrowers - those who would not apply for a loan in the old credit policy) due to saturation of the credit market. Since banks needed revenue, they used various marketing practices to encourage subprime debtors to borrow and as collateral banks accepted houses, boats, cars or other consumer goods of a high value. In the case of those who became insolvent, the lender bank foreclosed on the debtors' collateral (which the mortgage was based on) i.e. property: boats, cars, consumer goods and any other value to the extent of the liabilities. Among the increasingly fierce lending competition, the number of "unsold" homes and "bad" credits significantly increased, and that finally resulted in the collapse of the housing market, despite its numerous cross-guarantees. The chain reaction of the crisis expanded from the housing market to the banks, insurance companies, and real estate developers, as well as to financial and real estate funds who were involved in the financial and business processes.

Impacts of the crisis over beyond America, now and then (an international outlook, with some examples)

1929-1933

The global economic crisis first broke out in *Austria* in 1931. The banks in Vienna did not realize that following the dissolve of the monarchy there was no longer a need for the large-sized banks, thus, by keeping their branch network they were only able to operate effectively with higher operating costs. Since only the bad clients demanded their services, banks went bankrupt one after the other. Though the state helped those in trouble through bank mergers, only large banks could survive once the crisis had started. In May 1931, Creditanstalt announced its insolvency, which shocked the whole world and led to bank panics. Therefore, the state intervened, the budget undertook the banks' consolidation, however, this almost resulted in state default. In 1934, Creditanstalt merged with Wiener Bankverein and operated as a state-owned single large bank, known as CA-Bankverein. The Austrian bank failures, however, spread to neighbouring Germany too.

In *Germany,* the source of the economic problem lay in the high wages, causing a steady loss of the country's gold reserves, according to certain historians. In July 1931, after the announcement of Austrian Creditanstalt's insolvency, the

Darmstädter- und National Bank went bankrupt, which even the Central Bank was unable to help. With the condition of the re-negotiation of the Treaty of Versailles, France would have given credit to Germany, who did not accept the offer. Due to their "offended policy," Germany was hit the second most after the U.S by the economic crisis of 1929-1933. The dissatisfaction and anger deriving from the crisis helped the Nazis and Adolf Hitler come to power. Hitler pursued a policy under which the government should spend instead of saving. Because of his conqueror plans significant amounts were spent on armaments and on motorway constructions. These public works and employment opportunities not only served to restore the health of the economy, but helped to reduce unemployment as well.

2007-2009

The financial crisis that began the United States caused serious problems worldwide. All member states of the European Union faced major challenges; they introduced a number of measures to ensure financial stability. Many countries had to rescue banks and insurers. More and more countries drew upon the assistance of international financial organizations. The crisis increasingly affected the real economy; factories closed down, reduced production or layed off work force.

In *Germany* three independent payment schemes were established for non-bank deposits, private loans and banking system rescues. The government provided funds up to EUR 70 billion of capital injection for capital investments or for the purchase of the so-called risky positions.

In *Britain*, a capital injection of GBP 50 billion was provided for banking institutions. The institutions had to provide support for those wishing to pay their mortgage, but could not give bonuses to board members. The state helped many institutions with capital injection, including Northern Rock bank, Royal Bank of Scotland, Barclays and Nationwide Building Society.

THE EFFECTS OF THE CRISIS IN HUNGARY, THEN AND NOW

1929-1933

Hungary's economic position seemed to be stabilizing following World War I and the Treaty of Trianon. Favourable sales opportunities arose for our products and our needs could easily be satisfied. Our economic upswing was also highly facilitated by foreign loans.

As of 1929, however, in the worsening financial markets only short-term loans could be taken, which were used to settle our budget deficit. The government drafted a variety of crisis management proposals to increase revenue and reduce expenses. It had to choose between a stable exchange rate or the depreciation of the Pengő currency. Depreciation of Pengő was justified by the fear of inflation. A stable exchange rate resulted in an overvalued currency, which had a very negative impact on our exports.

The crisis had a great impact on *agriculture*, our most important economic sector. Due to the largely opened price scissor, it was difficult to sell Hungarian grain and flour. As in every crisis of overproduction, the global economic crisis of 1929-1933 also led to price reductions in agriculture. As a result, the average price of wheat plunged to its lowest level. The lower prices resulted in lower revenues, which entailed a reduction in mechanization and fertilizer use, and finally this led to the deterioration in yield.

Because of the above-mentioned reasons farmers also got into extreme debt. In 1931 debtor protection entered into force, which defended the indebted farms from mass bankruptcy. This state assistance contributed to the recovery of farms in the mid 30's.

Similar to agriculture, the crisis of overproduction also had an impact on *industry*. During the crisis the volume of industrial production fell by nearly 20%. The largest production decrease was suffered by the iron and steel production industries, mining and metallurgical industries, mechanical engineering, and the timber industry. The production of common, essential products decreased less. By contrast, the textile industry, leather industry, chemical industry, electrical industry and the canning industry actually increased their production.

The major external imbalances also reached the Hungarian economy, which could only be compensated by additional foreign loans. After the bankruptcy of the Austrian bank Creditanstalt, the bank panic also spread to Hungary The Hungarian General Credit Bank fell into the crisis, hence the necessity of a bank consolidation programme arose for its rescue. The government tried to solve the bank panic with a three-day banking holiday. The bank consolidation was not implemented since the state-owned companies were also unable to repay.

However, crude oil and electricity services started to boom after the crisis. The automotive industry had become a leading industry, highways, bridges, tunnels, filling stations and repair shops were built throughout the country. Electrical appliances appeared in households and the radio spread in popularity.

2007-2009

As in other countries, the economic crisis deriving from a financial crisis spread to Hungary, too.

The forint's exchange rate not only depends on domestic internal processes, but is largely affected by foreign investment companies as well. As for investments, safety is one of the most important factors, thus foreign investors prefer safer forms of investments; they invest in securities of developed countries instead of forint denominated deposits or Hungarian government securities.

As the international financial crisis deepened the forint's exchange rate plunged (similar to regional currencies) and the confidence in Hungarian capital markets was significantly damaged. To protect the financial system the government and the central bank of Hungary agreed upon a loan package of about EUR 20 billion with the European Union, the International Monetary Fund and the World Bank, who believed that Hungary, with its allies, is able to ensure effective protection and safety for the Hungarian people, the Hungarian economy and Hungarian businesses. This is obviously not a typical Hungarian phenomenon, since we are facing a global economic crisis and the countries in our region are also having serious problems and they are all trying to mitigate the negative effects of the financial crisis.

The EUR 20 billion loan package represents a guarantee that, if necessary, Hungary will be able to obtain sources with more favourable conditions than market opportunities to stabilize public management and to protect the country and its citizens. This agreement contributed to the stabilization of the forint exchange rate, short- and long-term yields moderated, the government bond market started to operate as normal and the operating conditions of banks and the financial sphere improved.

With the positive effects of the loan package we have tasks to be fulfilled and it also represents a large commitment for our country. For example, the budget deficit per GDP had to be reduced, also several proposed tax laws had to be withdrawn, which significantly affected the last two years' planned budget.

The European Union, the IMF and the World Bank had two requests from Hungary. Firstly, in this recessionary period not to assume more financial obligation than we have for this purpose; secondly, in no way should we forgo revenues. Additionally, we may only intervene in our tax system to the extent that we are able to ensure the same amount of revenue for our budget (www.kormanyszovivo.hu, 2010).

THE EFFECTS OF THE CRISIS

- Our export sales outlook significantly deteriorated as our export partners' economies also weakened. The shrinking export demand negatively affected the corporate sector's profitability primarily, which forced companies to adapt. Their adaptation was mainly manifested in staff reduction, in wage moderation and in investment decisions. The export and import volume declined in 2009 due to unfavourable external conditions. Although businesses can apply for more state support for exports, the outlook is still quite uncertain as it is subject to the changes in the international environment.
- Domestic banks' loan supply is strongly limited. Banks set tighter conditions and apply higher interest rates in lending that are already more difficult and more costly, which sets back retail and corporate sector borrowings.
- Our industrial production has been in constant decline since the second half of 2008. In Hungary, one of the leading sectors of our industry, i.e. the vehicle industry, became vulnerable by the falling demand caused by the crisis - the number of vehicle sales fell by 34% in 2008 compared to 2007.
- The shrinking sales opportunities and the decline of our industrial production consequence the increase of unemployment as the decline in orders and in production enables much fewer people to be employed by companies.
- Rising unemployment negatively affects households' income positions.

CONCLUSIONS

- The global economic crises of the two different periods can be compared to each other mostly by circumstances and the anticipated effects. However, the causes, the real economic effects and the consequences of the global economic crisis of 1929-1933 and of the current one mentioned in this study vary significantly.

- As with any crisis, the state's regulating role becomes more pronounced as in the Great Depression of 1929-1933 and as it is today.
- In general, it can be said that in the post-crisis period it is important to restore foreign trade and develop the internal market as soon as possible, as well as to improve employment.
- The normalization of the banks as financial institutions played an important role in both periods: bank panic then and now, the idea of bank consolidation then and now.
- Bank nationalizations. During 1929-1933, only the state was able to solve the banking crisis in many countries (e.g. in Germany, France, Austria and Italy). Today more and more bank nationalizations are common.
- Overall, today's financial crisis evolved to a global crisis and it is anticipated to be the most serious in a long time. It is already apparent that the crisis causes economic downturn, however, the depth of the recession, its spatial distribution and its expected length cannot be predicted. But as the main message of the global economic crisis of 1929-1933 shows, consumption should be primarily increased in a recession. A crisis can only be avoided by cooperation, but if it has already broken out, then it can certainly only be recovered by cooperation.

FORECASTS

In the forecast of IMF published in April 2009 disappointing growth projections, deeper recession and a longer and more painful recovery are predicted. It is projected that the losses of financial institutions in the global financial market and rising unemployment limit lending more than it is expected for at least another year and a half (www.ecoline.hu, 2009).

Other forecasts say as of 2010 foreign demand brings an upswing as the global economic environment improves and as financial markets calm down, conditions of access to funding sources will become more favourable. However, in terms of export markets a slow external growth can begin only in 2011.

The short term recovery can begin from the recession, leading to a boost demand and to the increase in labour demand, thus a slightly higher employment growth will be expected, accompanied by a gradual decrease in unemployment.

As of 2011 investment activity is expected to increase and national economic investments of the national economy may grow strongly.

Far-reaching consequences, however, would be too early to draw about the current crisis. Some analysts say the crisis will last long due to structural reasons, and it is likely to be extremely serious, multilateral and will have global economic and social consequences, however, its extent is not expected to reach the 1929-1933's crisis level. The state of the world is in many ways different from the conditions of the 1930s.

Other analysts claim, however, it is not the time of the so-called "Great Depression", it is only a "sector downturn" that does not give rise to the national economy that the current crisis is mentioned as a world economic crisis. (*Csaba*, 2009)

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Corresponding author:

Margit KEREKES
Szent István University
Doctoral School of Management and Business Studies
H-2103 Gödöllő, Páter K. u. 1.
Tel: 36-1-231-0444, Fax: 36-1-231-0445
e-mail: mkerekes@upcmail.hu