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War and Depression: A Comparative Study

Sarthak Roy Chowdhury
Assistant Professor,
Deptt.of Economics,
Gokhale Memorial Girls' College,
Kolkata

Abstract

Out of the thirteen recessions (at least) which took place in the United States (U.S) after "The Great Depression",war has played a key role in at least eight of them leading to a combined GDP decline of 51.6% over the years . Even though the attacks of 9/11 caused a mild recession of 0.3% decline in the GDP, it led to the U.S.-Iraq war. One can say that war is either a pre-condition or a consequence of recessions. This paper aims to highlight that such might not always be the scenario. The major meltdowns that we have chosen to study thus establish such a result.

Keywords: War, Depression, Economy, Crisis, Boom, Mortgage, Unemployment, Europe, Stocks.

Introduction

What exactly perpetuated The Great Depression is a question that has been answered and analysed in many different ways, however the core essence of it remains the same. The pre-conditions of this depression was set by WWI. Because of The United States' participation in WWI which was sufficiently costly; the U.S. economy had turned inward during the 1920s.Top of it all the stock markets crashed worldwide (due to extensive buying on the margin). A banking collapse took place in the United States. Extensive new tariffs and other factors contributed to an extremely deep depression. The United States did remain in a depression until World War II, which helped the U.S. economy to combat the depression to quite an extent. In 1936, unemployment fell to 16.9%, but later returned to 19% in 1938. Again war and depression is strongly connected in the case of the Vietnam war.

Owing to the recession of 1957, U.S. entered the decade of the 60s with unemployment and excess capacities.

In the early 1960s the US economy was in the average prosperity period preceding the boom. In the Industrial cycle of 1965 it entered the boom phase properly.This transition was assisted by economic policies, such as, the Kennedy –Johnson tax cuts along with the escalated participation in the Vietnam war. The official US price index after remaining stagnant throughout 1964 suddenly surged by 3.5% in the year 1965, the same year escalation in the Vietnam war was in it's earnest.Such correlation can thus be seen between war and depression time and again with 2007-08 subprime crises being a strong exception. Whether this exception dilutes the strength of such correlation is what we attempt to analyse in this paper.

Aim of the Study

To clarify the connection between war and depression.

Problem

Is war and depression always strongly connected? This paper aims to discuss that by focusing on the following with respect to the given recession periods,

(i) The factors leading to the depression and the co-relation of war with such slumps and it's subsequent effects on the economy,
(ii) The policies implemented to handle the crises and prepare the economy for recovery.

Analysis and Findings

A Look into the Subprime Crisis of 2007 -09

The global recession of 2007-9 was without a doubt the most severe since the great depression of the 1930s. A large part of the wealth of US households evaporated: Household net worth in the US (including nonprofit organizations) went from $42.1 trillion (4.4×GDP) in 1999 to $51.7 trillion (3.6×GDP) in 2008 while the consumer price index (CPI) increased

by 29%, and the number of households in the US increased to 117 million from 104 million.1 As a result, the net worth per household in real terms (1999 dollars) declined sharply from $402,000 to $343,000, a 15% drop. The unemployment rate captures the difficult times of the average citizen even better: it went up from 4.4% in 1999 to 7.2% in 2008 – and peaked at 10.1% in October 2009, even as discouraged workers increasingly dropped out of the workforce and no longer counted in the unemployment statistics.

The events subsequent to the problem that occurred in the subprime market of the US have been leading the US into a recession. The booming real estate markets and the debt-backed US economic growth during the last couple of decades have rendered this small segment of the US financial market attractive. But over-securitization of products in this category, despite its tiny size relative to the entire US financial market, has made it possible to exhibit wide-spread impacts on their lenders in the domestic market and across borders, particularly in other developed markets. The overt culprit is a combination of the weakened credit worthiness of some US customers and the poorly timed, aggressive securitization practices of mortgage finance intermediaries.

Weakness in Real Economy

The US's liability and trade deficits were still growing as recovery from this situation can only be limited with the dollar being weak. The international competitiveness of US industry and products faced challenges, in association with renovation and prices during the last 20 years, in particular from newly developing countries. Foreign capital flew into safe assets in the US after the Asian Financial Crisis, but this option was not as attractive anymore.

The real estate market continued to decline and this squeezed the nation's propensity to consume, which created recessionary pressure inthe US. This pressure caused instability in the employment market, further contracted the domestic market, and there was danger of the recession being realized.

In December 2007, the US job market showed signs of contraction for the first time in five years. Specifically, the largest range of employment declines came from the service sector. As of July 2008 most international institutes expected the US growth rate to be about 2%, but with the view of the depression getting more consistent, the IMF changed their expected growth rates to 1.3%.

The subprime mortgage crisis is a burst of vulner ability that reigned in the real economy as well as in the financial sector of the US. US growth was in downward correction, with the five-year average growth rate being 3% until 2007, with a drop to a rate of 2.5% in 2007, and a further drop in 2008. The current account deficits continued to increase. Industrial productivity weakened. Where as there was little change to savings rates, concerns arise about inflation.The main reason for loss of growth momentum could be associated with the decline of previously strong consumption, which reached more than 70% of the GDP. At the end of 2007, the average debt-to disposable-income ratio per household was 130%, and most individual debt was used to purchase housing. Housing costs in the US (S&P/ Case-Shiller's housing index) declined since in the market peaked in 2005. Mortgage companies' lending conditions complicated and the investment rate in home building declined rapidly since 2005. This clearly meant that the real asset market was slowing.The possibility of households filing for bankruptcy would increase if the market interest rates did not continue to decline when the real estate market fell. The policy of interest rate cuts was effective to protect individuals from bankruptcy. It was difficult however to expect the real asset market to be revitalized throughout the whole market so it's effect on individual consumption was thought to be small. The evident recession in home building during the 2006 and 2007 provoked the subprime mortgage crisis.

Policies

The Federal Reserve, Treasury, and Securities and Exchange Commission took several steps on September 19 to intervene in the crisis. To stop the potential run on money market mutual funds, the Treasury also announced on September 19 a new $ 50 billion program to insure the investments, similar to the Federal Deposit Insurance Corporation (FDIC) program.

The Securities and Exchange Commission announced termination of short-selling of 799 financial stocks, as well as action against naked short selling, as part of its reaction to the mortgage crisis.

In 2008 the United States Congress passed and then President George W. Bush signed the Economic Stimulus Act of 2008, a $ 152 billion stimulus designed to help stave off a recession. The bill primarily consisted of $ 600 tax rebates to low and middle income Americans.

The G-20 countries met in a summit held on November 2008 in Washington to address the economic crisis. Apart from proposals on international financial regulation, they pledged to take measures to support their economy and to coordinate them, and refused any resort to protectionism.

Another G-20 summit was held in London on April 2009. Finance ministers and central banks leaders of the G-20 met in Horsham, England, on March to prepare the summit, and pledged to restore global growth as soon as possible. They decided to coordinate their actions and to stimulate demand and employment. They also pledged to fight against all forms of protectionism and to maintain trade and foreign investments.

They also committed to maintain the supply of credit by providing more liquidity and recapitalising the banking system, and to implement rapidly the stimulus plans. As for central bankers, they pledged to maintain low-rates policies as long as necessary. Finally, the leaders decided to help emerging and developing countries, through a strengthening of the IMF.

A Comparison With U.S's Past Recessions

We have identified at least 13 recessions in the US since the Great Depression. While the starts of these recessions were often in the financial sector, all of these affected the real economy.

Causes

The Great Depression

The aftermath of WWI had led to severe global economic imbalances. After four years at war, the worlds' economy had been drained. Britain, whose economy had relied on trading, faced serious economic problems. 40% of its merchant fleets had been destroyed by German submarines in the war, making it difficult to export goods. Other countries imposed high tariffs on imports to protect their own industries, but this hurt Britain's economy. Britain's old and out-dated factories, machines, and mines also hurt its industries.

In 1921, Warren Harding became the new president of the United States. Under Harding, America's unemployment rate plummeted from 11.7% to 2.1% between 1921 and 1923. Technology was booming: electrical appliances and packaged food made daily life easier, while radios, movies, air travel, international airmail and auto mobiles all became more common. American farmers, however, were not faring well as crops were being cheaply imported from Europe. There was no longer a high demand for American crops as there had been during the war.

America's economy took a turn for the worse in October 1929 when the stock market crashed. This caused The Great Depression: a time of slow business, high unemployment, low prices, and low wages. As 85,000 businesses failed, unemployment shot up from 3.2% in 1929 to 23.6% in 1932. Banks were forced to close as they had loaned money to European and American businesses and didn't have enough money to honour the deposits.

So we can say the pre-conditions of The Great Depression were: Uneven distribution of wealth under Harding's leadership (1920s), Global depression following WWI, Unsafe business practices- $ 7 billion in credit purchases, buying on the margin, What did buying on the margin mean? Buying on the margin in the 1920s meant that a person could put down a small percentage of his money (10%) to buy a stock and the broker would cover the rest. If the stock prices dropped too low the broker would issue a "margin call" which meant all the money put down by the broker had to be paid back. Using this method people could but 50 stocks for $10 instead of 5 with a loan from the broker. Once the stocks were sold the broker would get his money back along with a portion of the profits.

This system worked till stock prices started to fall. At a point the stock prices got so low that selling of the stocks could not cover the money owed by the speculator.

Recessions of 1957-61 and 1973-75

The 1957-58 recession was preceded by an acceleration of the inflation rate from 0 in early 1956 to nearly 4 per cent in early 1957.

In contrast to most other recessions, no one dominant factor characterizes the relatively mild 1960-61 recession. It is perhaps best viewed as the net result of a combination of several factors, their only common thread a mistaken reading of the strength ofthe real economy and the threat of inflation. Owing to the recession of 1957-61, the US economy entered the decade of the 60s with high levels of unemployment and excess capacity. The millions of unemployed workers and idle plants and machines meant that industrial production could increase rapidly in response to increasing demand. Since supply was rising almost as fast as demand, prices rose very slowly. According to the US producer price index prices had hardly changed between 1960 and 64.As is seen in the phase of average propensity of the industrial cycle, interest rates rose but slowly at 4 percent or slightly higher.Back then the Truman administration still expected to borrow money at less than 2.5 percent per annum. Slowly the long term interest rates were eating into the profits of the enterprise.In the early 1960s the US economy was in the average prosperity period preceding the boom. In the Industrial cycle of 1965 it entered the boom phase properly.This transition was assisted by economic policies, such as, the Kennedy–Johnson tax cuts along with the escalated participation in the Vietnam war. The official US price index after remaining stagnant throughout 1964 suddenly surged by 3.5% in the year 1965, the same year escalation in the Vietnam war was in it's earnest.The Vietnam war was too small a war, from the US perspective to lead to a contracted reproduction of a full scale war economy. It meant that a growing portion of the Industrial capacity and labour of the US economy had to be devoted to meet the needs of the war, which was on top of the "cold war" military expenditure.All this, added to the tax cuts by Kennedy resulted in the US economy having less excess capacity and unemployed labour at any time since the Korean war. US could no longer increase production as fast as demand at existing prices. In a capitalist economy it meant that demand was reduced to supply through a rise in prices; and thus the boom of 1960s was entered, with Vietnam war being the stepping stone.

Also a quadrupling of oil prices by OPEC coupled with high government spending because of the Vietnam War led to stagflation in the United States. The period was also marked by the 1973 oil crisis and the 1973–1974 stock market crash. The period is remarkable for rising unemployment coinciding with rising inflation.

Subprime Crisis 1990s

On August 2, 1990, The Republic of Iraq invaded the State of Kuwait, leading to a 7-month occupation of Kuwait and an eventual U.S.-led military intervention. The 1990 oil price spike occurred in response to the Iraqi invasion of Kuwait.Lasting only 9 months, the price shock was less extreme and of shorter duration than the previous oil crises of 1973 and 1979-1980, yet the rise in prices is widely believed to have been a significant factor in the recession of the early 1990s. Average monthly prices of oil rose from $17 per barrel in July to $36 per barrel in October. As the US led coalition experienced military success against Iraqi forces, concerns about

long-term supply shortages eased and prices began to fall.

In comparison to the above causes the subprime crisis of 2007-08 occurred due to reasons which were completely independent of global military interactions as has been discussed in the previous section.The overt culprit was a combination of the weakened creditworthiness of some US customers and the poorly timed, aggressive securitization practices of mortgage finance intermediaries.

Policy Choices

The Great Depression

Although the American economy started it's recovery in the second quarter of 1933 nevertheless it got stalled and did not commence until 1935 and extended into the late 1937, when a new depression occurred. The economy had not yet recovered from the depression when it got attracted to WWII which provided some relief to the economy in the context of combating the period which was marked by a significantly low level of employment.

The painfully slow recovery of the American economy compelled it's people to put their trust into the federal government.The federal government took over responsibility for the elderly population with the creation of social security and gave the involuntarily unemployed, unemployment compensation. The Wagner Act (of 1935 was enacted to eliminate the employer's interference with the autonomous organisation of the workers into union) dramatically changed labour negotiations between employers and employees by promoting unions and acting as an arbiter to ensure "fair" labour contract negotiations.

Hoover's fiscal policy accelerated the decline. In December 1929, as a means of demonstrating the administration's faith in the economy, Hoover had reduced all 1929 income tax rates by 1 percent because of the continuing budget surpluses. By 1930 the surplus had turned into a deficit that grew rapidly as the economy contracted. By the end of 1931 Hoover had decided to recommend a large tax increase in an attempt to balance the budget; Congress approved the tax increase in 1932. Personal exemptions were reduced sharply to increase the number of taxpayers, and rates were sharply increased. The lowest marginal rate rose from 1.125 percent to 4.0 percent, and the top marginal rate rose from 25 percent on taxable income in excess of $100,000 to 63 percent on taxable income in excess of $1 million as the rates were made much more progressive. We now understand that such a huge tax increase does not promote recovery during a contraction. By reducing households' disposable income, it led to a reduction in household spending and a further contraction in economic activity.

The Fed's expansionary monetary policy ended in the early summer of 1932. After his election in November 1932, President-elect Roosevelt refused to outline his policies or endorse Hoover's, and he refused to deny that he would devalue the dollar against gold after he took office in March 1933. Bank runs and bank failures resumed with a vengeance, and American dollars began to be redeemed for gold as the gold outflow resumed. As financial conditions worsened in January and February 1933, state governments began declaring banking holidays, closing down states' entire financial sectors. Roosevelt's national banking holiday stopped the runs and banking failures and finally ended the contraction.

Recessions of 1957-61 and 1973-75

From the late 1960s to early 1980s– the period known as the Great Inflation– the U.S. economy experienced rising inflation and instability in real activity. During periods of expansion in 1967-68, 1972 and 1976-78 the Federal Reserve delayed too long in raising interest rates.

Federal Reserve's failure to control inflation during the 1970s was due to constraints imposed by the political environment. Members of the Fed understood that a serious attempt to tackle inflation would be unpopular with the public and would generate opposition from Congress and the Executive branch. The result was a commitment to the policy of gradualism, under which the Fed would attempt to reduce inflation with mild policies that would not trigger an outright recession, and premature abandonment of anti-inflation policies at the first sign of recession.

A review of FOMC documents identifies six key turning points during the Great Inflation: In mid- to late 1972, the Fed held off on tightening monetary policy in the face of intensifying inflationary pressures. While the inflation rate was suppressed because of price controls, excessive GDP growth and falling unemployment created inflationary pressures that burst out in 1973. The Fed made the same error in 1977-1978. Though the annual inflation rate rose continuously during this period, the Fed maintained an expansionary policy throughout 1977, tightening only modestly in spring and fall 1978. These efforts were not enough to prevent a burst of inflation in 1979. In early 1970, late 1973, and late 1974, the Fed eased policy prematurely during attempts at disinflation. In each case the decision to ease came at the first sign of economic weakness and before any progress had been made in reducing inflation. Finally, in 1981 the Fed maintained its tight policy despite high unemployment, easing in 1982 only after inflation had fallen considerably. The decision to maintain tight policy during the 1981-82 recession signalled the end of the Great Inflation.

Subprime Crisis 1990

The U.S. Federal Reserve's monetary tightening in 1988 targeted the rapid inflation of the 1980s. By increasing the federal funds rate and lowering growth expectations, the Fed hoped to slow and eventually reduce inflationary pressures, creating greater price stability. The August 6 invasion was seen as a direct threat to the price stability the Fed sought. In fact, the Council of Economic Advisors published a consensus estimate that a one-year, 50 percent increase in the price of oil could temporarily raise the price level of the economy by 1 percent and potentially lower real output by the same amount.

Despite the potential for inflation, the U.S. Fed and central banks around the globe decided it

would not be necessary to raise interest rates to counteract the rise in oil prices. Rather, the U.S. Federal Reserve decided to maintain interest rates as if the oil price spike were not occurring. This decision to refrain from action stemmed from confidence in the future success of Desert Storm to protect major oil-producing facilities in the Middle East and a will to maintain the long-term credibility of economy policy that had been built up during the 1980s.

To avoid being accused of inaction in the face of potential economic turbulence, the U.S. revised the Gramm-Rudman-Hollings Balanced Budget Act. Initially, the act prohibited the U.S. from changing budget deficit targets even in the event of a negative shock to the economy. When oil prices rose, revision of this act allowed the U.S. government to adjust its budget for changes in the economy, further mitigating the risk of rising prices. The result was a peak in prices at $46 per barrel in mid-October, followed by a steady decline in prices until 1994.

To summarize the policy choices taken during the given recession periods we notice that Hoover initially in 1929 reduced income tax only to facilitate large increase in the later part of 1932. This increase led to a cut in household spending and contraction in economic activity.

As for combating the recession of the 70s, inflation rates were suppresses by price controls. It was the tight monetary policy of the Feds that brought an end to The Great Inflation in 1982.

However for the subprime crisis it was the US government's confidence in The Desert Storm that refrained them from taking any action during the oil price spike.The US government thus did not raise the interest rates to counteract the rise. Instead the revised the Graham-Rudman-Hollings Balanced Budget Act which prohibited them from changing the budget deficit target in the act of a negative shock to the economy.

As for the policies chosen to combat recession of 2007 we notice a mix of fiscal and monetary policies with acute intermediate steps.It is hard to pinpoint a specific policy pattern that can be implemented without a shred of ambiguity in any recession period. Not all policies that were implemented in the given periods were completely alike and neither were they very different. It was rather a healthy mix of various monetary and fiscal policies. The nature and type of every recession is different even though they affect the real economy in similar ways. The policy patterns must be conducive to the nature of the recession which can only be determined as and when the economy faces the turmoil.

Conclusion

While each financial crisis no doubt is distinct, they also share striking similarities, in the run-up of asset prices, in debt accumulation, in growth patterns, and in current account deficits. This paper argues that the current subprime financial crisis bears strong implications to real economic situation of the US. We have compared the current situation to past recessions and discussed inherent causes leading to such recessions and the policy mixes that provide a good fix to the implications of the economic crises.

Upon viewing the analysis we will indeed find a connection between war and depression.It is true that phenomenon such as wars set out a wave that spreads across the economy in the form of severe implications but it is actually the changes in the real economy that give rise to recession.

Now commenting on the connection between war and the recession periods that we have chosen to study in this paper we will find that the Great Depression was one of the major consequence, if not only ,of World War I. The drained economy which the nation faced after World War I combined with weak leadership pushed the economy to it's brink and gave rise to one of economic history's toughest periods.Can we see a strong co-relation between war and recession here? Yes, but is this relation consistent throughout? No because the connection seems to weaken as we proceed further. In studying the case of the U.S's involvement in the Vietnam War we will find that the Vietnam War was too small a war from the perspective of the United States to launch into a full scale war economy. The only reason of U.S.'s escalated participation in the Vietnam war was to assist it's transition into the boom phase by creating a situation of less excess capacity and unemployed labour.It was Kuwait's intention to sell oil at a cheap rate to the United States under the table. This manoeuvre of Kuwait led the Republic of Iraq to invade Kuwait leading to a seven month of it's occupation and an eventual U.S led military intervention .The connection of war to this period does not seem to be relevant beyond this point.

The reason that the 2007-9 financial crisis had a monumental effect on the global economy despite the complete lack of connection to war goes to corroborate the fact that war and recession is not always strongly connected, sometimes even absent .Recession is ultimately caused by severe changes in the real economy even though it's implications may origin from non-economic events such as war.

So it is true when we study the history of the past U.S. recessions war can be seen either as a pre-condition or as a consequence of recession and hence we cannot out rightly alienate the fact that war causes recession or vice versa, but at the same time we must keep in mind that it is that changes in the real economy brought on by non-economic circumstances such as war or a rise in the global oil prices and like that is actually responsible for financial meltdowns.

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