

## AN OVERVIEW OF FINANCIAL CRISES IN U.S.

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### Abstract

In this article, most severe U.S. recessions from the Great depression to Dot-com bubble were revealed and analyzed. The most grounded explanation for these economic downturns comes from Austrian business cycle theory. Firstly, U.S. Federal Reserve Board intervenes to the financial market and cuts interest rates to stimulate borrowing from the banking system. This expansion of credit causes an expansion of the supply of money through the money creation process in a fractional reserve banking system. This artificial process leads to an unsustainable monetary boom and it results in widespread malinvestments. Later, when inflation accelerates and it causes a burst of financial and real estate bubbles, Federal Reserve Board increases interest rates. A credit crunch or recession occurs when credit creation cannot be sustained. A history and main causes of financial crises show that financial booms and severe busts can be avoided if the lessons from the history would be learned and, most-likely, U.S. and other industrialized countries would return to the gold standard and let free market do its job.

*Keywords:* financial crises, recessions, Austrian business cycles theory, malinvestments, gold standard.

### Introduction

Financial crisis is widely known term which is used when financial institutions or investment assets suddenly lose a large part of their value. In the 19th and 20th centuries most of the financial crises and recessions were associated with panic in the banking sector. Other situations that are usually called financial crises are bursting of financial and real estate bubbles, crashes in stock markets, currency crises and other crises (Kindleberger, 2005).

Many economists have analyzed financial crises and tried to find the reasons why world economy constantly suffers from booms and busts. A lot of theories exist explaining how we could avoid financial crises but still we face with them periodically. So the main aim of this article is to review greatest recessions in U.S. and announce not just a reasons but also propose how to avoid them in the future. The reasons of the financial crises will be analyzed according to Austrian business cycles theory which we believe is the most grounded of all.

Generally, recession describes the reduction of a country's gross domestic product (GDP) for two or more successive quarters of a year (Huerta de Soto, 2006). U.S. National Bureau of Economic Research reports about the beginning and the end dates of recessions and according this institution U.S. has had 16 recessions since 1920, their average duration of one recession was 16 months. Most of these downturns affected whole world economy because of globalization processes. The focus of the article is on U.S. economy.

### **Austrian business cycle theory: a brief explanation**

The Austrian business (or trade) cycle theory seems to be the most grounded of all theories trying to explain real causes of financial crises and recessions that occurs quite periodically in industrialised countries.

An Austrian theory explanation begins with the role of the central bank and its monetary intervention into the economy. Firstly, consumers' time preferences tell us how much capital will become available through consumers' savings. When the central bank (in our case Federal Reserve Board or FED) artificially cuts interest rates, entrepreneurs and investors get wrong signal believing that consumers are willing to delay consumption and save more than they really are saving. The natural interest rate (the one that would exist on the market without any intervention from FED side) measures consumers' time preference because it demonstrates what borrowers must pay to lenders to induce the lenders to delay their own consumption. This policy of the central bank (artificial lowering of interest rates) promotes excess in the credit by keeping interest rate too low for too long. Prices and wages are then bid up in capital goods industries, but as this new money trickles down to consumers, their time preferences have not actually changed, thus there is no increase in demand for the now abundant capital goods. The central bank knows that such a financial boom cannot be sustained indefinitely without leading to ever-increasing rates of inflation and then interest rates

are simply increased. Financial market begins to feel credit crunch and this increased supply of unwanted capital goods, or malinvestment, must then be liquidated. This liquidation is then followed by a recession or depression, which is the economy's healing period, helping to reallocate the factors of production to more productive and efficient ways of satisfying customer needs (Hayek, 2008; Mises, 2006; French, 1992).

During economic downturns many economists and people blame capitalism, but we have to understand that artificial lowering of interest rates, printing money (un-backed banknotes) out of thin air, bailout plans and nationalization of financial institutions – all of them are the features of centrally planned economy, not capitalism or market economy. And nevertheless, these government interventions repeat over and over again through the modern history and no lessons are learned. Sir Winston Churchill once observed: “Those who fail to learn from history are doomed to repeat it”. So its time to learn to all of us the lessons in order to rethink the very way of economy regulation for the sake of a long-term and sustainable growth of economics with all positive consequences to all of us.

## Great Depression

The Great Depression was an economic downturn in most industrialized areas of the world that started in 1929 and ended somewhere about 1939 (the end year in U.S. was 1933). It was the longest and most severe depression ever experienced by the industrialized Western world. In U.S. this depression started with stock market collapse on October 29, 1929, known as Black Tuesday.

The Great Depression, directly or indirectly, affected every country, rich or poor – market prices and profits, international trade, personal income plunged by half to two-thirds. The biggest influence of the crisis felt hard industrialized cities. Construction sector was almost halted by 80%. Rural economy suffered from very low crop prices, which fell by about 60%. During Great depression 25% of Americans were unemployed (Rothbard, 2000).

U.S. government and business spent much more in the first half of 1930 than in the corresponding period of the previous year. But different situation was on consumer's side because most of them suffered severe losses in the stock market the previous year so most consumers reduced their expenditures by 10%.

In the beginning of 1930, FED tried to stimulate economy and credit was available to most American citizens with low interest rates, but people didn't want to increase their debts by borrowing so credit market was in stagnation. People income was stable in early 1930 but still by May 1930 car prices fell to below the levels of 1928. Income drastically began to drop in 1931. U.S. economic downturn started pulled down most other countries in the world, especially it effected Europe and Canada. With Smoot-Hawley Tariff Act of 1930 U.S. government intervened to the market and tried to shore up economy by rising tariffs on over 20,000 imported goods to record levels, but it gave negative effect, because many countries retaliated with their own increased tariffs on U.S. goods and American exports and imports slumped by more than half. Generally, world trade declined by 66% between 1929 and 1934 and this government intervention just created more tension and prolonged depression period. Many economists agreed that the end date of depression was March 4 of 1933 when Franklin Roosevelt was inaugurated and spearheaded of the Emergency Banking Relief Act (or simply “Bank holiday”). The act allowed a scheme that would close down insolvent banks, reorganize them and reopen those banks strong enough to survive. About two-thirds of U.S. banks quickly reopened under this act, and confidence in banking institutions was somewhat restored. On April 5 of the same year President Roosevelt signed Executive Order 6102. This order allowed a plan that required holders of significant quantities of gold to sell their gold to the government at the prevailing price of \$20.67 per ounce. Directly after this sale, the price of gold from the treasury for international transactions was increased to \$35 per ounce. The U.S. government thus made nearly 15 dollars profit per ounce, and devalued the dollar by 69.3% (Rothbard, 2000; Hall *et. al.*, 1998). And then U.S. started to use gold standard.

What were opinions of different economists regarding causes of the Great depression? Austrian economist, 1974 Nobel Prize laureate, Friedrich August von Hayek with American economist Murray Rothbard explained main reasons of the Great depression. According to them, the main reason was the expansion of the money supply in the 1920s that led to an unsustainable credit-driven boom. These two economists blame Federal Reserve Board (FED) for printing money out of thin air and inflating money that led to an unsustainable boom in both asset prices (stocks and bonds) and capital goods (Hayek, 2008; Rothbard, 1969). In 1928, FED tried to suppress this boom by raising interest rate but it was far too late and, in the Austrian economists' view, a downturn was inevitable.

American economist Milton Friedman and current chairman of FED Mr. Ben Bernanke assert that the Great Depression was caused by monetary contraction and continuous crisis in the banking system. M. Friedman thinks that FED, by not acting, allowed the money supply to shrink by one-third from 1929 to 1933 and it caused the stock market crash on Black Tuesday. Also the economist say that if FED had provided emergency bailout to these key banks, or simply bought government bonds on the open market to provide liquidity and increase the quantity of money after the key banks fell, all the rest of the banks would not have fallen after the large ones did, and the money supply would not have fallen as far and as fast as it did (Friedman, 1971).

Austrian theory supporter M. Rothbard criticizes M. Friedman's statement that FED failed to inflate the supply of money, because from February to July 1932 central bank bought \$1.1 billion of government securities, increasing its total holdings to \$1.8 billion (Rothbard, 1969). Also M. Rothbard adds that American people at downturn period lost faith in the banking system, most of the money was kept at home and this factor was beyond the control of FED.

These Great depression facts demonstrates that FED ignored free market principles and tried to stimulate economy by low interest rates from Post-World War I period, but this intervention caused just malinvestments and price inflation which had to be eliminated during downturn. But, unfortunately, FED intervened to the market again by buying government securities and inflating dollar and this misleading actions just prolonged Great depression.

### **Recession of 1953**

In U.S. this economic downturn began in the second quarter of 1953 and continued till the first quarter of 1954. It is estimated that the total recession cost roughly \$56 billion but of course this recession is not comparable with the Great depression, which was the longest and most severe depression the industrialized Western world ever experienced. The reasons of this recession began from Post-World War II period when immigration level in U.S. started to increase in high rates and it induced a massive living house building boom. Between 1945 and 1951 the housing boom was supported by low interest rate (roughly 1.5%) and number of new housing started to increase from 937,000 in 1946 to 1,692,000 in 1950 (construction of the living houses accounted for 7.1% of real GDP in 1950) (French, 1997). The problem is that FED stimulated economy just by printing money out of thin air, but not from savings or investments. During this period was made too many malinvestments (housing) and it artificially increased house prices. Furthermore, in 1950 U.S. began military actions in Korean War and it required huge amount of money. So inflation rate increased and reached 8%.

If we compare recession of 1953 with the Great depression, few similar facts can be determined – firstly, FED intervention to free market by fixing low interest rate to stimulate the economy which led to high rate of inflation. Then U.S. Central bank started to fight with the inflation – raised interest rates and again it caused downturn of the economy. These actions of FED led to an increase in consumer expectation of an inevitable recession of 1953, but this economic slump wasn't so deep because of the established gold standard. As Austrian economics explained after artificially created boom from Post-World War II period inevitably came a severe economic downturn, which was originated by FED intervention into free market.

### **Oil crisis of 1973**

The oil crisis began on October 15, 1973, when the members of OAPEC (Organization of Arab Petroleum Exporting Countries) declared an oil embargo in response to the U.S. and Western countries decision to support the Israeli military during the Yom Kippur war. The effects of the embargo were immediate and in 1974 oil prices suddenly rose from \$3 to \$12 per barrel. It was the largest energy crisis in the history of world. OAPEC used the embargo in this way as a political tactic, the world's largest consumer of oil perceived the power that they had over the world through oil. U.S. oil imports from the Arabian countries fell from 1.2 million barrels to 19,000 barrels per day (Barsky *et. al.*, 2004). The shortage of oil was shattering to the Western economies leading to the crisis of stagflation.

Furthermore, by the early 1970s, high government spending due to the Vietnam War led to high inflation in the U.S. Besides that, U.S. increased its budget and trade deficits to foreign partners so in August of 1971 President Richard Nixon decided that the United States would no longer exchange dollars for gold – it was the end of the gold standard in U.S. After this decision more and more dollars were printed out of thin air (an increase of 10%) and then this money was sent overseas, to pay for the military expenditures (French,

1997). That's why most of the countries were demanding gold from U.S. to redeem its debt. And shortly most of the countries also refused to use the gold standard. The currencies became "fiat" not linked to or representing a claim on gold or anything else.

Oil crisis, involvement in Vietnam War and the end of the gold standard in U.S. increased distrust among investors and it generated a burst of asset bubble and crash in the stock market (Dow Jones Industrial Average lost 45% of its seven year value). During the oil crisis U.S. GDP fell by nearly 2.1% and inflation rate jumped from 3.4% to 12.3% (Barsky *et. al.*, 2004; French, 1997). The world oil embargo of 1973 and stock market crash began in October 1973 and ended in December 1974.

But oil embargo was caused mainly by price control of U.S. government, because taxes added as much as 60 % to the price of a gallon of petrol also massive government spending due to the Vietnam War and huge inflation - all these facts demonstrate government ignorance of capitalism principles. The end of the gold standard was the biggest mistake ever made by U.S. government which gave even greater control over U.S. monetary system. And according to Austrian theory of business cycles, massive spending and capital creating out of thin air brought U.S. to inevitable bust which ended in December 1974.

### **Early 1980s recession**

This 1980s recession was a severe economic downturn in the United States which began in July of 1981 and ended in November 1982. The primary reason of this recession was a policy established by the FED in 1980. The Depository Institutions Deregulation and Monetary Control Act gave the Federal Reserve greater control over the banks:

- Forced all banks to abide by the FED's rules;
- Allowed credit unions and savings and loans to offer checkable deposits;
- Allowed banks to merge;
- Raised the deposit insurance of US banks and credit unions from \$40,000 to \$100,000;
- Removed the power of the Federal Reserve Board of Governors under the Glass–Steagall Act and Regulation Q to set the interest rates of savings accounts;
- Allowed institutions to charge any interest rates they chose.

This policy gave wide variety of actions and banks rushed into real estate lending, speculative lending, and other ventures without taking into account the risk. At that time many people had one's faith in the banking system and deposited their money into banks, because Federal Deposit Insurance Corporation (FDIC) insured all deposit accounts. The FDIC was created to maintain public confidence and encourage stability in the financial system.

After oil embargo in U.S. interest rate was fluctuating from 4% to 13%, but suddenly in June 1981 FED started to fight inflation by raising interest rates to 20%. No doubt, inflation reached high rates through enormous credit expansion. Shrinking money supply plunged the American economy into a deep recession. In December 1982 the unemployment rate in the U.S. reached 10.8% (highest rate in post-war period), employment conditions deteriorated every month (French, 1997). Job cutbacks were especially severe in construction sector, steel and automobiles industry.

In June 1982, the number of bank went bankrupt steadily and it was a result of wrong monetary policy of FED and blind performance of commercial banks that lent a huge amount of money to very risky projects without proper risk analysis and pledging overvalued assets as a security. In the end of the year, FDIC had spent \$870 million to purchase bad loans, but it was too late to rescue number of banks from bankruptcy. Later this institution was reorganized.

FED interventions into banking sector with greater control policy and drastic change on interest rates were the main reasons of this recession. FED policy of low interest rates, non-existence of gold standard and fractional reserve banking system let to create new money out of nothing and it led to massive malinvestments (speculative stock market bubbles, housing boom) and high inflation. Massive bankruptcies of commercial banks were caused by fractional reserve banking system. And during this economic bust government tried to stimulate economy by printing and injecting new money into banking sector and it didn't allowed the malinvestments to be liquidated and according Austrian theory it just prolonged downturn.

### Early 1990s recession

This 1990s recession began in July 1990 and ended in June 1992. It was the longest recession since World War Two (see Figure 1.), it lasted roughly 22 months. Unemployment rate reached 8% during this recession.

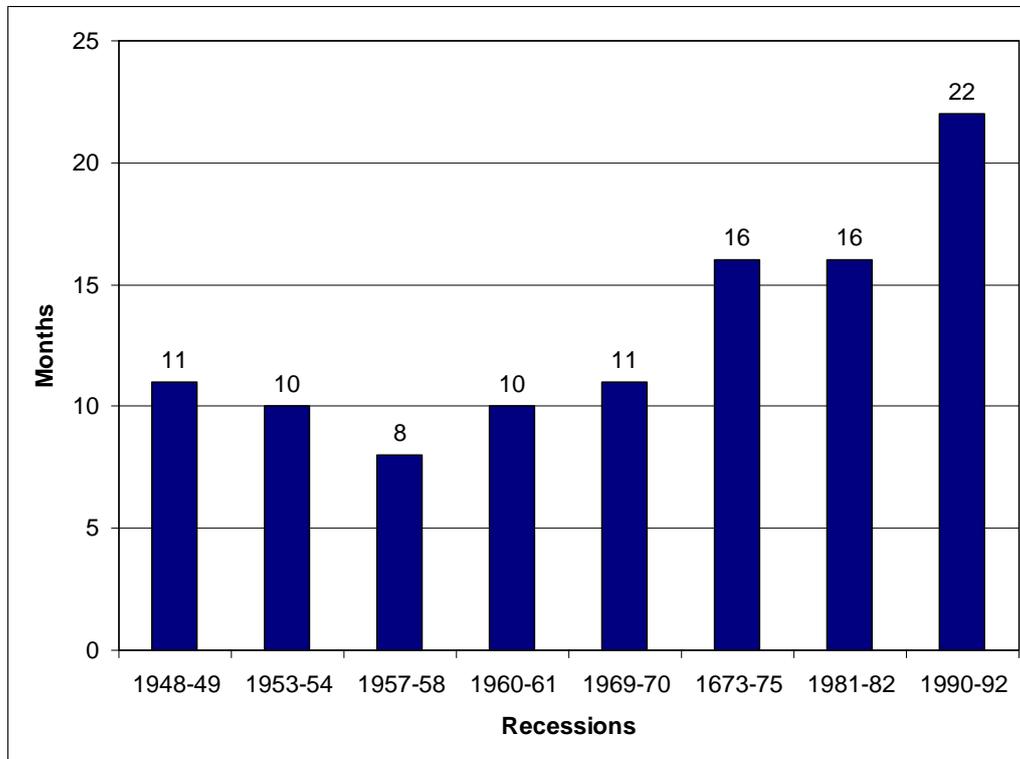


Figure 1. The length of recessions from 1948 to 1992

This recession started on Black Monday of October 1987 when the stock market collapsed (Dow Jones Industrial Average Index fell by 22.6%). During the downturn of the Dow Jones many people sold out their assets, but, suddenly, stock market began to recover quickly. However, the most of the savings and loans were beginning to collapse, placing the savings of millions of Americans in jeopardy. Furthermore, in August 1990, U.S. began military actions in Persian Gulf War and then possible recovery was just an illusion. The oil price jumped from \$21 a barrel to \$46, it increased inflation but to less of a degree as the oil embargo in economic slump of 1973 (Mischel *et. al.*, 1993). Next few years high unemployment rates, massive government budgetary deficits, and slow figures of Gross Domestic Product growth affected the United States until June 1992. It is clear that history repeats itself and reasons of this recession were the same as in previous downturns analyzed – firstly, it started with massive government spending and high inflation. Most of the resources were allocated in Persian Gulf War and economic downturn, according Austrian theory, was a time of malinvestments liquidation. This period of liquidation was inevitable, because most of the capital didn't come from savings or investments, but it was simply created out of thin air.

### Dot-com bubble

“Dot-com” is referred to a company that does most of its business on the Internet, usually through a website that uses the popular top-level domain, “.com”. Dot-com was a speculative bubble covering roughly the period between 1995 and 2001 during which stock markets in Western countries saw their value increase rapidly from growth in the new internet sector and related fields of IT (information technology). Stock prices of Dot-com companies rose at a very fast pace and it was caused by prevailing low interest rates, credit expansion and low unemployment level. The fast increase in stock value made investors decide to buy in expectation of further rises, rather than the thoughts that the shares were undervalued. And due to that, many

Dot-com type companies become very aggressively overvalued (see the Figure 2 where the performance of the technology-heavy NASDAQ index is shown).

Observing the situation, FED decided that interest rates were too low for too long and starting from 1999 to early 2000, they increased interest rates six times. After that the economy was beginning to lose its speed of expansion. The investments without taking care of the business plan (or in short malinvestments) were obviously a huge problem and the result came from the companies themselves resulting on huge losses – most of the Dot-com companies became bankrupt. That leads on heavy fall down on NASDAQ by 80% and all Dot-com companies.



**Figure 2.** The technology-heavy NASDAQ index fluctuations between 1994 and 2005

For example, the Learning Company (American educational software company) bought by Mattel (Toy company) in 1999 for \$3.5 billion, sold for \$27.3 million at the burst of the bubble. Second example is Boo.com, which spent \$188 million in just six months in an attempt to create a global online fashion store but suddenly went bankrupt in May 2000 (Little *et. al.*, 2004).

Here we can see the same situation as in previously analyzed recessions. Firstly, FED cut interest rates and then many people started to invest in Dot-com companies. They believed that new technologies would have a revolutionary impact on productivity and this Internet boom will never end. But again FED increased interest rate to curb inflation and many Americans started to feel severe credit crunch.

During Dot-com bubble many people believed that it was a time of prosperity but it was just a illusion, because FED policy of low interest rates and fractional reserve banking system created billions of dollars out of thin air. It led to massive malinvestments on Internet companies and induced inflation-induced boom-and-bust-cycles, which lead to unsustainable debt levels on U.S. budget. This FED interventionism was total ignorance and abuse on free market principles and people's time preferences, which are crucial points on capitalism.

### Conclusions

In this article, most severe U.S. recessions from the Great depression to Dot-com bubble were revealed in light of Austrian business cycle theory. The following conclusions may be done:

- A closer look at all analyzed cases of economic downturns prove that U.S. in fact has never had free market in its economic system – manipulating the money supply and interest rates rejects all

the principles of the free market. What we have had till now is mixed economy that incorporates a mixture of private and government ownership or control, or a mixture of planned and market economy. Results of analyses of most severe recessions show that this artificial mixture doesn't work properly – monetary system must be reformed in order to avoid artificial booms and severe economic downturns in the future.

- Monetary reform, if implemented properly, would neither cause deflation nor inflation. Firstly, this monetary reform should start from questioning of Federal Reserve System and fractional reserve banking system - these two systems create capital out of thin air.
- It is advisable to analyse the possibility of reintroduction of standard of some real equivalent of value such as gold.
- Large scale monetary reform would not just eliminate artificial boom–bust cycles, but also would brought transparency to all government actions, because it would not be able to waste money created out of thin air.
- Results of analyses of U.S. recessions show that government intervention to the market and bailout plans during recession periods usually prolong economic downturn, because interventionism doesn't allow rapidly liquidate malinvestments.

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