# The U.S. Housing Meltdown and the International Financial Crisis of 2007-2008: Lessons from the Great Depression

***An interview with Dr. Ken Matziorinis Economics Professor at John Abbott College***

***conducted by Sarah Haque, Social Science Student on May 7, 2008***

**Q: I wanted to know where you went to School?**

**A:** I went to school at McGill University I did all my three degrees there, Bachelors in economics and political science, Masters in economics and PhD in economics

**Q: What was it about economics that caught your attention?**

**A:** Well, initially I was interested in history, I always loved history, geography and architecture and I still do to this day. In high school I was most inspired by my history teacher Mr. Karl Rhoden, who also taught political science in Grade 11. In my family our main conversations centered around international politics since childhood, so when I took the political science course he turned me on to political science and away from architecture. When I applied to university, my brother told me, "why not apply for economics and political science, they make a good fit and you can earn a living more easily in economics" and I said, "good idea". So I applied to the Joint-Honours program in economics and political science at McGill. In the final year of my bachelor's degree I became more interested in economics, inspired the most by the personality and writings of John Maynard Keynes. At McGill I was exposed to some great professors and the intellectual debates of the time like Monetarist vs. Keynesian schools of thought, Post-Keynesian vs. Rational Expectations among others. So I decided to do my Master's degree at McGill, and then I completed my Ph.D. as well. Although I focused on economics, I never abandoned political science either. I consider my self more of a political economist.

**Q: How long have you been teaching here at John Abbott?**

**A:** I've been teaching at John Abbott since 1981, that's 27 years and at McGill University since 1977 when I was a Master's student.

**Q: I'm curious about the Great Depression and what the main causes and factors were? I know it was an important part of our modern history.**

**A:** Let me preface my answer with the following comment. The Great Depression was the biggest economic catastrophe that the world has ever endured, at least in modern history. It's like a huge tsunami that engulfs the whole planet. But in economic terms, it was the biggest, single economic period of breakdown and instability, it was like a giant economic earthquake that was felt all over the world, in some countries of course more than others. What caused the depression is not an easy thing to answer because there were many factors, both proximate and underlying factors. When you examine all the factors in the world context, the harder and more complex it becomes to explain. Most high school books and the popular literature lead you to believe that the stock market crash of October 1929 on Wall Street is what started the Great Depression. It is true that the stock market crash and subsequent meltdown in stock prices which then spread to the banking system triggered the depression, but that was the proximate, not the underlying cause of the Depression. The stock market crash itself, was the result of a broader set of problems that were bedeviling the world economy at the time. The stock market crash itself did not cause the depression just as the stock market crash of October 1987 did not cause a great depression in the late 1980s and early 1990s. The stock market crash in 1987 was just as bad as the one in 1929 but it didn't result in a depression. Recently, starting in 2007 we've had a housing crash in the United States which has led to a crash in segments of the money market and the banking system and this hasn't yet caused a depression either.

What caused the Great Depression is a more complex than that, yes a big part of it had to do with the stock market crash but there was more to it. What were some of the underlying causes? First of all, World War I proved to be a huge shock to the international monetary system that led to the break down of the gold standard. The gold standard is a global monetary system in which all money issued by banks was backed by gold. All countries that issued money had to have gold to back it up and because they had to have certain amount of gold. Paper money was issued at a fixed rate to the amount of gold that banks held in reserve and paper money was convertible to gold on demand. Because of this there was stability in the world economy and not much inflation. Prices were stable, inflation was low and people trusted their money and the international banking system worked very well. The First World War damaged badly that stability because countries had to print a lot of money without having the gold to back it up. So when you print money without gold it's like issuing cheques that you don't have money in the bank to pay for. When these cheques bounce you have problems and that's how these problems started. The War created inflation and a lots of it from 1914 to 1919 and following that period you had a drop in prices and there was a big deflation that followed. In the meantime the value of money was knocked off because money was no longer backed by gold.

At the same time you had another underlying problem, a geopolitical and economic factor. This is the creation of many countries in the world that had not existed before. Russia suffered the Bolshevik Revolution in 1916 and Russia was no longer a capitalist country and there was civil war there. When the Austro-Hungarian Empire which was allied with Germany lost, the Empire was split into three new countries, Austria, Hungary and Czechoslovakia. New countries were born out of the ashes of the fire. The same thing happened with the Ottoman Empire in the Balkans and the Middle East. There had been a lot of devastation in Belgium, France and Germany, destruction and dislocation in Eastern, Central and South-Eastern Europe as well as in the Middle East which saw the creation of new countries like Turkey, Iran, Iraq, Syria, Trans-Jordan, Saudi Arabia and Egypt. Instability also occurred in Asia, in China, Korea and Indo-China. A lot of deaths, a lot of expenses, a lot of printing of money and a lot of geopolitical instability that led to the creation of new countries that didn't have that much gold to back their currencies with. It was a period of near Biblical change and instability, these are really the main reasons why the depression occurred later on. All the countries that were involved in the Great War accumulated huge debts to pay for the war and in the process, borrowed money heavily from the Americans, Then in the 1920s the United States raised interest rates in order to bring inflation down and then as inflation came down stock prices went up and people started speculating in the stock market and making money by the rising stock prices. Americans rushed to get rich by buying stocks which pushed the price of stocks way up. Don't forget that it was the time that the automobile and electrical appliances including the radio came into being. The Federal Reserve, the newly-created central bank of the United States was afraid that this would end in a bust and would cause a lot of pain for people, so they started raising interest rates to cool down speculation in the stock market, however when they raised interest rates they also raised interest rates for the Europeans who had borrowed money to pay big debts, they couldn't afford to pay. All that set up a chain reaction of events which actually started in Europe, banks were failing in Europe then crossing the Atlantic Ocean to America which led to more bank troubles in America and that's what set the stage for the financial crisis that resulted in the stock market crash of 1929.

But the story doesn't end there. It is one thing to be faced with challenges, it is another story how effectively you deal with them. An other underlying cause of the Great Depression, was our almost complete ignorance of macroeconomics. Now with the benefit of hindsight we know that governments could have dealt with the crisis much differently and more effectively than they actually did. How government policy and law makers reacted to the crisis really decided the course of events that followed and sealed the fate of history. What we know today when we study macroeconomics we did not know back then. Governments pursued all the wrong policies. Instead of letting their budgets go into deficit for a prolonged period they tried to balance their budgets, and in the context of a declining economy were forced to raise  taxes and cut spending, this action exacerbated the recession and turned it into a depression. There were no central banks at the time, responsibility for creating money rested in the hands of the private banks and there was no central bank to assist or bail out failing private banks. When private banks started failing they were allowed to fail and go bankrupt, people lost their deposits, this resulted in a decrease in spending power, collapse of confidence, less aggregate demand, less spending, less production and less jobs. It brought the economy further down. There were no central banks to prevent the private banks from failing. And there was no central bank to print more money, so as banks started collapsing the amount of money they had issued was shrinking, the amount of money in circulation was going down and because there was less money available real interest rates went up. Higher real interest rates and less availability of money made it harder for people to borrow, people could not borrow money to finance their businesses they had to shut down which created lay-offs which made a bad situation worse. And as this was not already enough, governments led by the USA also pursued the wrong international trade policies as well. In 1930 the U.S. congress passed the Smoot-Hawley Act, basically a law to raise tariffs on all imports into the United States, by raising tariffs they made it harder for other countries to sell to the US which pushed them deeper into the recession which further internationalized the crisis. Then these countries were forced to do the same against the Unites States which started a trade war around the world which forced international trade to go way down. These really the real underlying factors that led to the Great Depression. Governments mishandled the stock market crash and contributed to instability by following the wrong fiscal policies, the wrong monetary policies and the wrong trade and exchange rate policies. They made a bad situation worse! Now, had they known what we know today about how to manage economies in trouble, the Depression would not have happened. But it is also true that what we know today about managing the whole economy we learned the hard way by making those mistakes. Out of the ashes of the Great Depression macro economics was born. The truly great economist John Maynard Keynes found the way to put the pieces of the puzzle together and devised a new theory of how the economy works and what to do to prevent recessions and inflations and control the economy at the aggregate level. What we know today we learned the hard way by paying a very high price of making these mistakes back in the 1930's.

**Q: We are currently hearing that there is a recession or a possibility of a recession in the United States, what is a recession?**

**A:** A recession is a drop in the level of business activity, in the amount of production, employment and income taking place in a country from quarter to quarter. When production starts to fall instead of rising, that's what you call a recession.

**Q: Is the US currently undergoing a recession?**

**A:** Well I just read an article saying that the US economy expanded at 0.6% in the first quarter which means that officially we cannot say that the US is in recession which is actually good news. The US economy has slowed down but at least it is not in recession yet. Whether the US is in recession or not we will only find out later, because the GDP figures are subject to a lot of revisions. However, despite what the GDP figures indicate I believe that the U.S. is currently undergoing a recession who's magnitude will only be known after the fact.

**Q: If the US went into recession would Canada follow?**

**A:** As a general rule yes, because our economy depends a lot on the US. 80% of our exports which represent a third of our total production go to the United States.

Q: **Is it possible if we enter a recession that something as bad as the Great Depression can happen again?**

**A:** It's always possible for this to happen again but less likely because we've learned a lot from the experience of the Great Depression. Today we understand how these crises are born and how they spread and metamorphose themselves into broader economic recessions, so our understanding is much greater and we know how to handle them which we didn't know before. Also, we have created counter-acting institutions that were not available in the 1930’s, for example central banks. Central banks serve like fire departments, when there’s a fire you call the fire department which comes immediately and extinguishes the fire before it has had the chance to spreads from one house to the whole neighborhood. Today we have deposit insurance, if a bank fails depositors do not lose all their money as it happened in the 1930’s. Today we have unemployment insurance, if there are mass layoffs people will not be out of money entirely, they will still receive money from the government to keep spending so these are examples of tools at our disposal that are institutional mechanisms that are available today that did not exist in the 1930’s that make a repeat of the Great Depression less likely. Also, governments have learned how to use countercyclical fiscal, monetary and exchange rate policies to deal with depressions and promote recovery and stability.

**Q: Let’s say the United States goes into a recession, or deep into a recession, how will this affect other countries because it is the superpower of the world?**

**A:** Just as it affects Canada because they are our biggest neighbor and trading partner it also affects the whole world economy because the whole world economy is interdependent and relies on a strong US economy. We buy and sell to each other and because the US is the world’s biggest market and the worlds largest economy accounting for over 25% of the global GDP, it will obviously have a big effect on the world economy. But the good news is that today the US economy is not as big as it was at the end of World War II. In 1945 the US accounted for 55% of the world economy. In the 1950’s through the 1980’s, the world was much more dependant on the US than it is today. Today with China rising, Russia recovering, India rising, with Europe strong and rising, the US economy has lost its status as being the only larger consumer, so the weight of the world’s economy is much better distributed. It doesn’t just depend on one pillar, it is spread over many pillars, thus even if the US economy suffers a severe recession chances are that the rest of the world economy this time will manage quite well despite the US.

**Q**: **Is the US doing a good job in handling the current situation?**

**A:** Well it’s too early to say. So far the US government and the US central bank have acted vigorously and quickly to deal with the problem, they’re doing the best they can to manage their crisis. They can do more but that takes time, discussion, consensus and politics, but in terms of the emergency measures that they could have been taken, they’ve taken them all.

**Q: What caused the current situation? Is it the War of Iraq or is it something else?**

**A:** Well what caused it is the collapse in housing prices. This event in turn triggered a banking and financial crisis because banks had borrowed money to lend to the homeowners to buy the overvalued homes. The people who lent the money to the banks are now unwilling to lend more money and the banks are stuck with the bad loans. In fact it is a double crisis, a housing collapse and a financial crisis all in one. Moreover, complicating the situation is that the US is also running a huge trade deficit with the rest of the world which means it has to borrow nearly $2 billion dollars a day just to pay its bills to the rest of the world. It's a very serious crisis, I would say that it's as bad as the one the world faced in the late 1920s that precipitated to the stock market crash and led to the Depression. These problems can occur any time, when people think that prices can only go up and never down they misjudge and overpay and over borrow and then eventually when prices start to fall they pay the price so this is what happened in this episode. It has to do with the fact that the US had gone into recession in 2001 and they had to lower interest rates to help the economy get out of it. But monetary authorities probably lowered interest rates too much and kept them low for too long at the same time it has to do with the fact that the US is spending more than it earns, it's importing more from the rest of the world than it sells, so it has to borrow more from the rest of the world. Because the rest of the world is willing to lend to the US at low interest rates the US has plenty of rope to hang itself with. What I mean by this is that the rest of the world has trusted the US and were willing to lend at low rates to the United States, which kept interest rates low which promoted demand for housing which pushed housing prices way higher than they should have gone, that's what triggered the current recession.

**Q: The US currency has been falling against other currencies, how does this happen and does this help the US or does it hinder it?**

**A:** When an economy is not doing well the rest of the world can see that so they are not willing to invest as much in that country as they would otherwise, which means that this country doesn't attract a lot of buying interest from other countries which means that their currency goes down in value. It's like a company stock, if a company is not doing very well investors are not willing to buy its shares and if there is no buying interest in its shares the price of the shares declines. The value of a country's currency works exactly the same way, so it's like the US economy is a business called USA Inc. Less willingness to invest in the country results in less demand and more supply which drives the currency lower. Now is this benefiting or helping the US economy? Well in the short term, it is a benefit because it makes US exports cheaper so it promotes US exports of goods and services to other countries while it makes imports from other countries more expensive so it makes Americans do more spending at home. For example take tourism, instead of traveling abroad Americans are now doing more traveling inside the country and they spend their US dollars inside the country which is good for the US. That's the short-term positive effect of a lower currency, but there are longer-term disadvantages. All the money that the US has borrowed becomes more expensive with the currency going down, which means they have to work harder to make those payments in the future. They need to work harder, to produce and sell more goods to pay their debts. Even worse, however, is the fact that the US dollar is not just the currency of the United States, it is also the world's currency whether we like it or not. All countries rely on the US dollar for their contracts in commodities like wheat and oil, all central banks keep most of their reserves in US dollars. In international trade when you are buying and selling commodities it is the currency you use for pricing commodities and making payments. The problem is as the value of the US currency declines, it destabilizes the international monetary system which means all the countries in the world that use the US dollar as a substitute for gold in their official foreign exchange reserves lose confidence in the US dollar because it's value goes down, it is becoming a less reliable and more problematic currency to use. The more they lose confidence the more they look for ways to place their money in other currencies like the Euro, as well as commodities like gold and silver and now crude oil and agricultural products. This is why we've experienced recent increases in the price of metals, of gold and now agricultural commodities. When people lose their confidence in the US dollar they will try to put their money in something else that will hold it's value. Carried to its extreme, it's better to have a bushel of wheat then a bag of US dollars that is just paper not being backed by the US government.

**Q**: **I know we have started using many of these agricultural products for fuel and energy. Aside from this what are other factors that are causing the current food crisis?**

**A:** Absolutely, you see, first of all because people are losing faith in the US dollar they would rather buy commodities, by buying commodities to protect themselves from the drop in the US dollar, without wanting to they are pushing the price of agricultural products and commodities higher, which creates inflation which makes it harder for people to buy food. They are contributing to a global agricultural crisis. But at the same time as the US dollar falls, because oil is priced in US dollars, the producers of oil are receiving less money for the oil they sell, so if the value of the US dollars in which they are paid, say Saudi Arabia gets paid in US dollars for the oil it sells, the US dollars are going down in value so they raise the price of oil to compensate. So the lower US dollar is causing the price of oil to go higher which makes it harder for people to pay their bills, drive their cars and heat their homes. At the same time because in agriculture you use tractors, diesel fuel, fertilizers, these fertilizers are produced with oil. So higher oil prices are also causing the cost of materials that go to growing food to go up as well. Not to mention transporting food products from one end of the world to the other. So the lower dollar is pushing the price of oil and energy higher, the price of energy is pushing the cost of producing agricultural products higher and creating a vicious cycle. This is how a crisis in one market metamorphoses itself into a crisis in an other market.

**Q: We're already seeing the negative affects of the lower US dollar. Is there a way to increase the value of the US dollar so these negative affects don't get worse?**

**A:** Is there a way to prevent this vicious cycle from taking its course? Yes, there is. But that also has it's own consequences. The US can support the dollar by keeping interest rates higher, keeping higher interest rates allows investors to invest in US securities to make more money this therefore makes the US dollar more attractive, this stops the slide in the value of the currency. But at the same time higher interest rates keep inflation down which slows the rise in the price of commodity prices. With higher interest rates we'll see oil prices and agricultural prices come down, lower inflation and a stronger dollar.

**Q:** But **the United States is currently lowering interest rates.**

**A:** Exactly, why are they not raising interest rates? Because amidst the housing collapse in the United States which is threatening to put the US into recession the US government has chosen to cut interest rates to prevent a recession from happening instead of keeping interest rates high to support their currency and keep inflation low.

**Q: So basically they're choosing to save themselves as opposed to the rest of the world?**

**A:** That's a wise inference you have just made, that's exactly what's happening. The US is looking after it's own immediate self-interest which is to prevent a recession from taking place, which also makes good politics for the Bush Administration in the midst of an election year. The current US administration wants the republicans to win so they're going to do everything possible to make sure that the US economy doesn't go into recession. But, in the process they are endangering the strength of the US dollar and creating problems for the rest of the world which is destabilizing the world economy. The right policy to follow should be a stronger currency with higher interest rates, even if this means a recession at home. Recession may not be good for the short term, but it will help root out speculation, restore integrity, bring down inflation and reduce the trade deficit which is the corner stone of a lasting turnaround in the US economy. In the process, by showing that the US is taking responsibility for its own problems, it will also help restore international confidence in the US dollar.

**Q: So what does the rest of the world do to make their negative affects lessen?**

**A:** In Europe the European Central Bank has taken a firm stand not to cut interest rates, to them fighting inflation and maintaining stability is the first priority. By choosing not to inflate they promote the integrity of the European currency. In other countries the responses vary. In Canada we've chosen to cut our interest rates, but not as much as in the United States, basically we've taken a course that is in between the one followed in the United States and the one followed in Europe. So we're kind of in the middle because we're very close to the US. In china there's a lot of inflation and in Saudi Arabia and the Gulf countries also there is very high inflation. These countries need to let their currencies go up in value and re-value their currencies, which they have been keeping artificially low. That is going to happen very soon. China will revalue its currency the renminbi and the Gulf countries will end the peg to the US dollar because their currencies are currently fixed to the US dollar. That will push the value of the US dollar lower, precipitating an international monetary crisis and further undermine the US dollar in the world economy. Such a scenario is not good for long-term US interests and is not good for Canada either, because it will push up the value of our currency even more and hurt our manufacturing exports. Other countries are trying to deal with the situation the best they can.

**Q: Like you said, Canada is between the US and Europe, but we cut our interest rates so we are following the US more than Europe to a point, is this positive or negative for us?**

**A:** For right now we have to do some hedging because we are not sure how things are going to work out in the end. We know the US economy is slowing down because of slowing sales of cars and manufacturing to the US as our dollar has increased in value. This is hurting us, so we need to cut interest rates to support and shield our economy. At the same time another part of our economy, our resource producing economy in Alberta and British Columbia and Newfoundland is getting a high price for oil, energy and natural gas and for our agricultural exports so that part of our economy doesn't need lower interest rates. At this point we're not sure how things are going to work out, so at this point instead of being sorry we're playing it safe. So for now we're cutting interest rates, if we see the US economy doesn't slow down too much we can always put them back up again. If we see the US recession triggers a major slowdown in the world, well we've already lowered interest rates, we're half way there we can cut them even further. I think that the Bank of Canada is doing the right thing by choosing this particular path, at least so far at this point.

**Q: Is Canada also undergoing a housing crisis like the United States?**

**A:** The answer is no, Canada is in a far superior position than the United States right now for a number of reasons. First of all we never had a real estate bubble, real estate prices will correct in Canada, housing prices will go down that's my forecast for this, by 10% to 15% which is just a correction, they will not go down by 25% or 30% which is what is happening in the United States. Secondly banks in Canada never gave people loans that didn't have the credit capacity to borrow in the first place, we didn't give all the bad loans that the US did at ridiculous terms, so we don't have that kind of problem. Third, our banks didn't issue to the same degree the type of securities that the Unites States banks issued, so we don't have that kind of financial banking crisis either. The Canadian government has a surplus as opposed to the US government that has a deficit, our trade balance with the rest of the world is positive. Canada has a surplus in its trade with the rest of the world while the US has a very large deficit. Our international debt is falling to the point where either this year or next year Canada will become a net creditor country, meaning the rest of the world will owe us more money than we owe them. By contrast, the US has become the biggest debtor in the world. World demand for energy and natural resources is high and will stay high and we have most of the resources the world needs, while the US has depleted much of its resource base and relies more on manufacturing and services. For the first time in our 150 year history, things are much better on the Canadian side than on the US of our border. Not to mention that comparatively Canada has a lot of resources and a small population while the US has a big population with relatively few resources. We are net exporters to the world while the U.S. are net importers from the world, we are net exporters of natural gas they are net importers of natural gas, we have lots of agricultural land they have lots but shrinking agricultural land, we have lots of water they have decreasing supply of water. Geopolitically Canada has a huge territory with a small population, which still has a lot of resource potential, which the US does not have. In a shrinking world, in a world where the population is growing, the demand for resources is growing, Canada is in a relatively better position than the US, which puts us in the driver seat more than at any other time in our historical relationship with the United States.

**Q: Where does this leave developing countries? How will they be affected by all of this turmoil and where do they stand?**

**A:** Well it depends on which developing countries you are looking at. You can group developing countries into three categories, a) the very poor developing countries that don't have many resources to sell or they don't have an entrepreneurial culture; b) developing economies that have natural resources to sell and a lots of entrepreneurial dynamism which is the other extreme and c) developing countries that have one or the other but not both resources and entrepreneurial cultures, somewhere in the middle of the first two categories. Let me start with the more dynamic economies with natural resources, economies like Saudi Arabia, Russia and Brazil that have a lot of resources to sell, or like China, India and Korea which don't have many resources but have dynamic economies. They will do well because they have learned the trick of economic development, they're industrializing and they have huge internal markets, they can meet the needs of their own people and become self-reliant, they don't have to rely on the United States that much. What happens to the US economy will not impact them as much because they've got the goods that the world needs and they have dynamic growing economies with large internal markets to support themselves. They'll do okay! The poor countries that don't have the resources or the strong economies will get hurt, because they don't have resources to sell. Other countries in the middle will struggle more, but they will make-do the best they can with the situation. For example countries in the middle are countries like Turkey, the Philippines and Mexico, they aren't rich in resources they don't have tremendous dynamic economies but at least they have other means to manage whereas the poorest countries' economies will suffer the most.

**Q: Just to end off, how do you see things unfolding in the next 10 years or so?**

**A:** Well this is a very tall question and is difficult to answer. The US economy, as big and strong as it is, and has been for a long time is losing much of it's importance in the world. As the gene of free market capitalism has left the US bottle and spread to the rest of the world, the rest of the world economy from the European Union to China, India, Brazil, Russia and the Middle East will go on growing while the share of the US economy in the world will surely diminish. We will be moving away from a uni-polar world economy, dominated by the United States to a multi-polar world economy where nobody really will be in charge. Secondly the importance of the US dollar will decline as a reserve currency, as other countries' dependence on the US decreases. Don't be surprised if the Euro overtakes the US dollar and becomes the world's most important reserve currency. Also possible is the formation of an Asian block of currencies comprised of those of Japan, China and India or some variation of the above. Either way, there will be a lot of turbulence, change and instability for the world economy. It will be a period of growth for most countries but combined with a lot of economic, political and social instability and more inflation, because resource pressures and environmental concerns will surely drive up agricultural and commodity prices. The fact that the international monetary system will be unstable will also contribute to inflation and I see that in the horizon for the next 10 years. The big wild card will come from the ecological and environmental issues such as climate change and global warming which we will have to deal with, they are very unpredictable. How we deal with global warming might create further problems for the economy because if we have to reduce consumption of energy, that will hurt the economy at least for the foreseeable future. If we see major instability in the patterns of global climates that will create droughts in some countries and floods in others, that will affect the agricultural supply, it will create food shortages and rising prices, so one way or the other the next 10 years are going to be more unstable than any of the periods since World War II. We’re going back to a period of turbulence, indecision and transformation like the 1930’s. Lot’s of instability and turbulence but hopefully no depressions or major world wars.