- Stainbeck’s (1939) Pulitzer Prize winning epic.
- Oklahoma sharecroppers driven out of home by destitution, set out to California.
- Quite a typical story of Great Depression.

"Okies" Driving to California During the Great Depression
A Migrant Family Looking for Work During the Great Depression

A Christmas Dinner During the Great Depression
A School In Alabama During the Great Depression

People at an Employment Agency During the Great Depression
The Great Depression (GD)

- “Roaring Twenties”
- Stock market plunged (October 29, 1929)
  Banking system collapsed
  Factories and businesses closed
  Crops could not be sold
- Economic activities plunged by one third
  25% of Americans were unemployed for nearly a decade
- The Great Depression spread rapidly from the US to Europe and the rest of the world as a result of the close interconnection between the United States and European economies after World War I
GD Gave Rise to Two Important Questions

- Why did it happen?
- What should Economics be about?
  - Early Economists worried about
    - Growth
    - Economic Systems: market vs others
    - Whether the government should intervene
  - Economists do have to think about issues such as
    - Volatility of aggregate output
    - Unemployment and Inflation
    - How should the government intervene?

Influence of Great Depression on Macroeconomic Debates

- Macroeconomic stabilization policies
- Importance of ‘effective’ demand
- Importance of the role of government
  - Fiscal and monetary policies
  - Social safety net
  - Microeconomic policies: govt. programs
Financial Crisis of 2007-08

(1) Homeownership debacle
   + out-of-control financial innovation
(2) Plunge of mortgage-backed securities
(3) Capital shortage of financial institutes
(4) Credit crunch
(5) Paradox of deleveraging

Housing Debacle

[Graph showing the homeownership rate from 1960 to 2004]
What Followed …

(1) Housing bubble bursts
(2) → a surge in defaults and foreclosures, → which in turn has led to a plunge in the prices of mortgage-backed securities (assets whose value ultimately comes from mortgage payments).

What Followed …

(3) These financial losses have left many financial institutions with too little capital (too few assets compared with their debt). This problem is especially severe because everyone took on so much debt during the bubble years.

(4) Too little capital compared to debt. → cannot provide the economy with credit
What Followed …

(5) Financial institutions have been trying to pay down their debt by selling assets, including those mortgage-backed securities
→ but this drives asset prices down and makes their financial position even worse. (This vicious circle is what some call the “paradox of deleveraging.”)
→ Poor Stock market and some panic and herd behavior

Paulson’s Initial Plan

*Buy out the bad assets from the financial institutes.*

**Argument:** Once taxpayer funds had created a market for mortgage-related toxic waste, everyone would realize that the toxic waste is actually worth much more than it currently sells for, solving the capital problem.
Problem with This Plan

The problem needs to be attached at stage (3), not stage (5).

- Families who should not be homeowners became homeowners. These mortgages are fundamentally bad assets.
- These assets are already at a very low price. So, buying the bad assets will be inadequate to flow capital into the financial system.

The Plan That Finally Passed

(1) Has the option of “equity sharing”.
(2) The financial system has too little capital. By being “a partner”, government can provide the capital that the financial institutions need right now.
(3) But when they recover and start making money, taxpayers, as “investors” will be able to share in the recovery and the bailout money can be recovered.
The Plan That Finally Passed

(1) Savings and loan crisis: the feds took over ownership of the bad banks, not just their bad assets. Govt made money.

(2) Government took over Fannie and Freddie. (And that rescue has done what it was supposed to: mortgage interest rates have come down sharply since the federal takeover.)

Just like the crisis, the plan is also fundamentally flawed. Alternative?