NBER WORKING PAPER SERIES

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Working Paper 15584
http://www.nber.org/papers/w15584

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
December 2009

Paper prepared for the conference, " Past and Present: From the Great Depression of 1929 to the Great Recession of 2009" BBVA Foundation, Madrid October 29, 2009 The views expressed herein are those of the author(s) and do not necessarily reflect the views of the National Bureau of Economic Research.

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NBER Working Paper No. 15584
December 2009, Revised January 2011
JEL No. E58,N0,N12

ABSTRACT

This paper examines three areas in which analogies have been made between the interwar depression and the financial crisis of 2007 which reached a dramatic climax in September 2008 with the collapse of Lehman Brothers and the rescue of AIG: they can be labeled macro-economic, micro-economic, and geo-political. First, the paper considers the story of monetary policy failures; second, there follows an examination of the micro-economic issues concerned with bank regulation and the reorganization of banking following the failure of one or more major financial institutions and the threat of systemic collapse; third, the paper turns to the issue of global imbalances and asks whether there are parallels that might be found in this domain too between the 1930s and the events of today.

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The Great Depression Analogy

Michael Bordo and Harold James

In the discussion of our contemporary economic disease, the Great Depression analogy refuses to go away. Almost every policy-maker referred to conditions that had "not been seen since the Great Depression," even before the failure of Lehman. Some even went further – the Deputy Governor of the Bank of England notably called the crisis the worst "financial crisis in human history". In its April 2009 *World Economic Outlook*, the IMF looked explicitly at the analogy not only in the collapse of financial confidence, but also in the rapid decline of trade and industrial activity across the world. In general, history rather than economic theory seems to offer a guide in interpreting wildly surprising and inherently unpredictable events. Some observers, notably Paul Krugman, concluded that a Dark Age of macroeconomics has set in (Krugman 2009). There are however substantial uncertainties about what precisely the lessons of history might be. Charles Plosser, president of the Federal Reserve Bank of Philadelphia, recently said tellingly that: "We are still rewriting the narrative, and gaining an understanding, of what happened in the Great Depression and why. No doubt it will be at least 50 years before we understand very well what happened in 2008 and 2009 and whether the Federal Reserve undertook the right policies or the wrong policies." (New York Times, 2010)

This paper examines three areas in which analogies have been made between the interwar depression and the financial crisis of 2007 which reached a dramatic climax in September 2008 with the collapse of Lehman Brothers and the rescue of AIG: they can be labeled macro-economic, micro-economic, and global. First, the paper considers the story of monetary policy failures; second, there follows an examination of the micro-economic issues concerned with bank regulation and the reorganization of banking following the failure of one or more major financial institutions and the threat of systemic collapse; third, the paper turns to the issue of global imbalances and asks whether there are parallels that might be found in this domain too between the 1930s and the events of today.

Monetary Policy

Almost every contemporary use of the depression analogy takes the year 1929 as a reference point. But there are really two completely different pathologies during the Great Depression, which involve different diagnoses and different cures.

The first, and the most famous, pathology is the U.S. stock market crash of October 1929. No other country had a stock market panic of the magnitude of the American one, in large part because no other country had experienced the euphoric run-up of stock prices that sucked large numbers of Americans, from very different backgrounds, into financial speculation. The second sickness, contagious banking panics, was decisive in turning a bad recession into the Great Depression. A series of bank panics beginning in October 1930 in the United States converted a not unusual recession from 1929-1930 into a serious slump. Through the fixed exchange rate gold standard the U.S. depression also affected the rest of the world. Events took a turn for the worst after the collapse and rescue of the Creditanstalt bank in Vienna in May 1931 and a major banking crisis in Germany in June. This spread financial contagion to Great Britain, to France and back to the US .

The 1929 panic has dominated a great deal of the analysis of the depression for two rather peculiar reasons. First, no one has ever satisfactorily been able to explain the collapse of the market in October 1929 in terms of a rational explanation, in which market participants reacted to a specific news event. So the crash presents an intriguing intellectual puzzle, and economists can build reputations on trying to find innovative accounts. Some people just conclude that markets are simply irrational. Indeed, there is considerable evidence that the most disturbing shocks to market expectations do not arise from identifiable "news" (Bouchaud 2010). Others (notably White) have argued that investors might have been able to foresee the Depression, or that they were pondering the likelihood of protectionist reactions in other countries to the American (Smoot Hawley) tariff act which had not yet even been cast in its final form.

The second reason that 1929 has been popular with academic and political commentators is that the aftermath of the collapse provides a clear motive for taking particular policy measures. Stock exchange collapses or the end of asset bubbles do not necessarily lead to prolonged recessions of deep depression. In October 1987 and again in March 2000 sharp stock market collapses triggered both an extension of liquidity by the central bank and fiscal easing. Keynesians thought that government fiscal demand can stabilize the expectations of the market, and thus provide an overall framework of stability. Monetarists saw monetary stability as the key to avoiding dramatic output contractions. Much of this debate has focused on the United States: in other countries, especially debtor countries, the gold standard constrained monetary policy so that it is hard to speak of policy options. The only country where there was an equivalent room for maneuver to the United States is France.

The Great Contraction of 1929-1933 in the United States during which prices, real output and money supply declined by about a third,and which spread to the rest of the world, was precipitated by policy failures at the Federal Reserve. A tight monetary policy to kill stock market speculation in 1928 led to a recession beginning in August 1929. This policy was based on the real bills view that stock market speculation would lead to inflation, a bust and then deflation. The stock market crash in October exacerbated the downturn but did not cause the depression. The failure of the Fed to follow its mandate from the Federal Reserve Act of 1913 to act as lender of last resort and to allay a series of four banking panics beginning in October 1930 led to the serious downturn that followed. The Fed adhered to the flawed Burgess Riefler doctrine (Meltzer 2003) which viewed low levels of its borrowed reserves(i.e discount window borrowing) and short-term interest rate indicators as signs of monetary ease and hence did not act. In addition some

Fed officials believed in the liquidationist doctrine and saw bank failures as beneficial. A major hike in the discount rate in the fall of 1931 to protect the dollar after sterling exited from the gold standard added fuel to the fire.

Recovery began in March 1933 with Roosevelt's banking holiday, ending the fourth banking panic. The nation's banks were closed for a week during which an army of bank examiners separated the insolvent from the rest. Insolvent banks were closed ending the uncertainty driving the panic. This action was quickly followed by FDR taking the U.S. off the gold standard in April, Treasury gold (and silver) purchases designed to raise gold prices and prices in general, and formal devaluation of the dollar by close to 60% in January 1934. These policies produced a big reflationary impulse from gold inflows which were unsterilized passing directly into the money supply. They also helped convert deflationary expectations into inflationary ones (Eggertsson 2008).Also of key importance in preventing future banking panics was the institution of federal deposit insurance(FDIC) in the Banking Act of 1933 which went into effect January 1 1934.

The recovery of 1933 to 1941 in the United States was largely driven by gold inflows (initially reflecting Treasury policy and the devaluation, later reflecting capital flight from Europe as war loomed). Expansionary fiscal policy, despite the conventional wisdom, played only a minor role in the recovery of the 1930s (Romer 1992). Recovery was impeded somewhat by New Deal cartelization policies like the NIRA which in an attempt to raise wages and prices artificially reduced labor supply and aggregate supply (Cole and Ohanian 2004). Over the period 1933-1937 output increased by 33%.

The Federal Reserve was largely passive in the 1930s. Along with the bankers, it had been blamed by the Roosevelt administration for the failures of the 1920s and early 1930s. Major reforms in the Banking Acts of 1933 and 1935 greatly increased the powers of the Federal Reserve Board in Washington at the expense of the Reserve banks and especially the New York Fed. Despite its increase in power, the reconstituted Board of Governors under Chairman Mariner Eccles was passive and largely subservient to the dictates of Treasury Secretary Morgenthau. The Fed in the 1930s continued to follow the same precepts as it did in the 1920s and early 1930s. Its policy indicator continued to be the level of free reserves(excess reserves less borrowings from the Fed). In the 1930s borrowed reserves were negligible so excess reserves became the indicator. As the decade wore on member banks largely absorbed the gold inflows into excess reserves, held as a precaution against a repeat of the type of turbulence experienced in the early thirties. By 1935 excess reserves amounted to 50% of total reserves. Fed officials increasingly viewed the build up of excess reserves as a threat to future speculation and inflation. They also saw the presence of sizable excess reserves as preventing them from future tightening. Similar concerns have been voiced about the build up in bank excess reserves in 2008-2009. According to the Burgess Riefler doctrine which prevailed at the Fed, the way the Fed could control interest rates was by forcing banks to borrow from the Fed. Once borrowed reserves were less than the open market portfolio, then open market sales could force the banks to borrow. Banks would then want to reduce their indebtedness by contracting their lending (Meltzer 2003 pp 520-521).

The Recession of 1937-1938: The recovery was interrupted by a serious recession (the third worst of the twentieth century) from May 1937 to June 1938. Friedman and Schwartz (1963) and Meltzer (2003) and others attribute the recession to a serious policy mistake by the Federal Reserve. Mounting concern by the Fed over the build up in excess reserves in member banks led the Board to double reserve requirements in three steps between August 1936 and May 1937. The rationale for this action was to restore the Fed's control over monetary policy and remove the inflationary threat posed by the excess reserves. The Fed used the blunt instrument of raising reserve requirements rather than conducting an open market sale of securities because excess reserves exceeded the Fed's portfolio of securities and sales would reduce the income earned from it. According to Friedman and Schwartz the banks were holding excess reserves as a precaution against a repeat of the banking panics of the 1930s. When the Fed locked up these reserves the banks cut back on lending and sold earning assets to restore the precautionary cushion they had held. The Fed's contractionary policy action was complemented by the Treasury's decision in late 1936 to sterilize gold inflows in order to reduce excess reserves. These policy actions led to a spike in short-term interest rates and a severe decline in money supply precipitating a 5 % decline in real GDP.

Other explanations given for the recession of 1937-38 include: a tightening of fiscal policy when the Administration ended a generous veteran's bonus, increased income tax rates and imposed a tax on undistributed profits; gold hoarding brought about by fears of another dollar devaluation coupled with a boost to money wages by the Wagner Act (Sumner 2009) and a switch back from inflationary to deflationary expectations (Eggertsson and Pugsley 2006).

The recession ended after FDR in April 1938 pressured the Fed to roll back reserve requirements, the Treasury stopped sterilizing gold inflows and desterilized all the remaining gold sterilized since December 1936, and the Administration began pursuing expansionary fiscal policy. The recovery from 1938 to 1942 was spectacular, output grew by 49% fueled by gold inflows from Europe and a major defense build up.

The Liquidity Trap: The 1930s were characterized by very low interest rates. Short-term rates were close to zero through much of the decade. Long-term rates were close to 2%. The traditional Keynesian view has been that monetary policy was impotent because the U.S. economy was in a liquidity trap. Like the 1930s a Federal Funds rate in 2008 close to zero(the zero lower bound) has again raised the issue of policy impotence.

Subsequent research by Brunner and Meltzer (1968) found no evidence for the liquidity trap. There was a spectrum of rates well above zero throughout the 1930s and the Fed could just as easily have bought securities other than short-term Treasury bills (Basile and Rockoff 2009). The real problem was not that Fed policy didn't work but rather that the Fed was unwilling to use the tools that it had to conduct expansionary monetary policy because it feared a resurgence of asset market speculation and inflation (Orphanides 2004).

Lessons for Today: The history of the 1930s experience has several lessons for the present discussion over the policies that the Fed could follow to ensure a rapid recovery without engendering inflation.

The first lesson is that the Fed like its predecessor seventy years ago has the tools to reflate the economy and to prevent a resurgence of inflation. In the 1930’s the Fed was only a minor player in the recovery because it was reluctant to use expansionary open market purchases for fear of rekindling speculation and inflation. It was not in reality stuck in a liquidity trap or hampered by the zero lower bound. Instead the Treasury through its policies towards gold and the consequence of devaluing the dollar did more of the heavy lifting to promote recovery.

In the recent crisis the Fed’s policy of sterilizing the effects on the monetary base of its diverse liquidity operations through much of 2008 (until September) made monetary policy tighter than it had to be and likely exacerbated the recession which began in December 2007(Hetzel 2009) .However since October 2008 the base greatly expanded and the policy adopted in January 2009 of quantitative easing (and continued in November 2010) by purchasing long-term Treasuries and mortgage backed securities can be viewed as a replay of the expansionary Treasury gold policy of the 1930s.

Second, the Fed will eventually have to tighten as the economy recovers and excess capacity is reduced. Some have raised the fear that this could produce a repeat of the recession of 1937-1938 were the Fed to attempt to reduce the excess reserves and the banks (still gun-shy from the recent crisis) to scramble to replace them. This should not be a problem for a number of reasons. First the excess reserves were built up in the two eras under very different Fed operating procedures. In the 1930s the Fed could not target the interest rate as it had done in the 1920s because the banks were reluctant to borrow reflecting a stigma from doing so. Moreover the build up of excess reserves was a consequence of the gold inflows and, given the Fed's preferred operating procedures, created a problem for it.

Today the Fed follows an interest rate target and it can pay interest on reserves (IOR). The build up of reserves reflected sterilization of the Fed's liquidity operations using interest on reserves,(when the federal funds rate was close to zero), as the mechanism to get banks to hold them. Were the Fed to wish to tighten it can separate its monetary policy operations from its liquidity policy by changing the spread between the funds rate and the IOR. (Goodfriend 2009). Unlike the Fed of the 1930s, today's Fed can use reverse repos or open market sales of its long-term securities to do the tightening. Were it to wish to reduce excess reserves to encourage banks to lend it could pay negative interest on reserves as was done recently by the Riksbank in Sweden.

The main concern for today is not that the Fed can not exit from its present strategy because it can, but that when it exits and begins tightening that if unemployment were still to be high and were to begin to rise again in the face of the tightening, that the Fed would come under political pressure to abandon its efforts and cave in under the pressure. In that case inflationary pressures would build up as the bond markets and the public began to doubt the Fed's resolve. This is what happened in 1966 and 1969 under William McChesney Martin and in 1973 under Arthur Burns, leading to the Great Inflation.

The Financial Sector

Banking collapses played a crucial role in the deepening of the global crisis in 1931. Unlike the United States, where banking was highly localized, continental European economies were dominated by financial systems in which a small number of very large banks dominated the economy. In Austria, where the crisis began in May 1931, the Creditanstalt controlled some 60 percent of Austrian firms through ownership stakes (Nötel 1984). The failure or potential failure of very large financial institutions thus posed a major policy problem.

The collapses were the result of the shocks of the international depression imposed upon bank weakness in countries that had been wrecked by the aftermath of bad policies that produced inflation, hyper-inflation, and a destruction of banks' balance sheets. An intrinsic vulnerability made for a heightened exposure to political shocks, and disputes about a central European customs union and about the postwar reparations issue was enough to topple a house of cards.

Banks in 1931 were vulnerable as a result of poor monetary policy, and they were victims of monetary deflation (Temin 2007). But there were plenty of specific issues which long-antedated the collapses of the early 1930s (James 1986). They are the result of specific design features of the financial system that could not simply be corrected by macro-economic policy, whether monetary or fiscal. U.S. banking was highly localized, and thus vulnerable to geographically limited shocks (such as the agricultural depression); while larger nationwide banking in Canada was much more resilient. Banks in many debtor countries in South America and Central Europe accumulated mismatches between assets (in local currency) and liabilities (in dollars or other key currencies), that made for a vulnerability to currency turmoil. Universal banks suffered large losses on their shareholdings, and as their capitalization fell, cut back on their lending. Some British banks (the so-called merchant banks) had heavy overseas exposures that made them vulnerable to foreign crises (James 2001, Accominotti 2009).

One of the striking features of the Depression analogy is how many of the answers regarding the banking sector are popular again today: in particular, the provision of state guarantees to attempt to revive the interbank market and bank lending; recapitalization of banks with public money; and the establishment of “bad banks” to take problematic assets off banks’ balance sheets. All of these policy responses were tried in the 1930s, most notably in the epicenter of the central European collapse, in Germany.

Some of the initiatives that the German government took had a quite modern ring to them. Indeed this was an area in which the German government appeared to act swiftly in order to implement a crisis management strategy. First, the government reorganized the banks, merging the two weakest ones, Danat and Dresdener Bank, that had been at the origin of the banking collapse, and injecting government money into all of them. Initially, the government had tried hard to get private money as well, and there were intense negotiations with the leading figures of the powerful Rhine-Ruhr steel lobby. In the end the business leaders only agreed if the government would put in more money, and if the government advanced them the sums that they were supposed to invest in the recapitalization of Danat Bank. By 1932, 91 percent of the Dresdner Bank's capital, 70 percent of Commerzbank's and 35 percent of Deutsche Bank's was in public ownership.

Second, the German central bank (the Reichsbank) pushed for a new institution which would allow it to discount bills from banks which could not be traded because the interbank market had stopped operating. This institution, named the Akzept- und Garantiebank, was established with breath-taking speed. It was given a public guarantee in order to provide the additional signature that made bills eligible for Reichsbank lending (rediscounting).

Third, the Reichsbank eventually (in December 1932) created what would now be called a "bad bank" to take over troubled assets whose prices no longer corresponded to the value at which they were set in the banks' balance sheet. Two new institutions would take assets off firms' and banks' balance sheets: the first, the Deutsche Finanzierungsinstitut AG took over up to three quarters of the bad assets of a bank, but required an annual amortization at 3 percent. The second, the Tilgungskasse für gewerbliche Kredite, required a much lower rate of servicing, only 1 percent, for an initial three year period, followed by higher rates as economic recovery set in.

Lessons for today

The consequence of the long academic and popular discussion of the 1929 crisis and the appropriate policy response is that people have come to the expectation that there must be easy answers. But the collapse of Lehman Brothers in September 2008 was a 1931-like event, the failure of a large financial institution. The answers required are less obvious than in the domain of monetary or fiscal policy, where lessons of the Great Depression are much clearer.

Finding a way out of the damage created by the collapse of a systemically important financial institution was and is very tough. Unlike in the case of a 1929-type event, there are no obvious macro-economic answers to financial distress, particularly when it involves institutions that are deemed to be “too big to fail”. Some famous macro-economists, including Larry Summers, the chief economic thinker of the Obama administration until late 2010, in consequence tried to play down the role of financial sector instability in causing depressions. Robert Lucas’s claim in 2003 that the “central problem of depression-prevention has been solved” is one of the central pieces of evidence for Krugman’s onslaught on conventional macro-economics.

1. A key problem at the heart of both the 1931 crisis in Central Europe (but not in the United States) and of 2008 in the U.S. and Europe was the doctrine of “too big to fail”. For the U.S., this doctrine was born only in the aftermath of the Latin American debt crisis of 1982, which threatened the solvency of almost all financial institutions in the industrial countries. In 1984 the doctrine was applied to justify the decision to bail out Continental Illinois, the fourth biggest U.S. bank which was insolvent. As banks grew in the 1990s and 2000s, and their interconnectedness increased, the doctrine evolved and was augmented by an argument about banks being “too interconnected to fail”. In 2008 the doctrine contributed to the worsening of

financial crisis, as the belief that large commercial banks would not be allowed to fail was extended to investment banks with the rescue of Bear Stearns in March 2008. Then in September when Lehman Brothers was allowed to fail and AIG was rescued the resulting confusion led to panic. Too big to fail has also hampered the recovery by preventing the use of the good bank/bad bank solution (that had been used so successfully in the past by Sweden and other countries) towards Citigroup, Bank of America in the US and some big banks in Europe: RBOS, Lloyds-HBOS, UBS. In consequence, governments took on too large shares in financial institutions in order to recapitalize them, a move analogous to what happened in 1931 in Germany. And as in Germany in 1931 several governments have already been repaid by some of the banks which were rescued at a profit. A major collapse of a large part of the financial system requires a slow and painful cleaning up of balance sheets; and in micro-economic restructuring, which cannot be solely imposed from above by an all-wise planner but also requires many businesses and individuals to change their outlook and behavior. The improvement of regulation and supervision, while a good idea, is better suited to avoiding future crises than dealing with the consequences of a catastrophe that has already occurred.

3. The involvement of government in financial rescues transfers private debt into the public sector, and creates difficulties for public finance unless there is a dramatic and quick recovery of the prices of financial assets. The Austrian government's answer to the 1931 Creditanstalt crisis involved taking over the bank, and eventually merging it with other weakened Austrian banks, the Wiener Bankverein and the Niederösterreichische Escompte Gesellschaft. The government

subsidy was expensive, amounting to 9 to 10 percent of GNP, substantially less than the cost of bailouts for Mexico or Japan in the 1990s, but much less than the cost of the Irish government's ill-conceived guarantee of Irish bank deposits in 2008, which was responsible for sending the government deficit to over 30 percent of GDP in 2010. In the 1930s, the aftermath of the bailout paralyzed Austrian policy throughout the 1930s and made the country vulnerable to internal extremism and external attack. It is likely that Irish politics will be profoundly transformed in the wake of 2011 elections.

4. Bailouts create political economy problems. Bailouts are inherently controversial, because they distribute public money in an arbitrary way, to one recipient rather than another. In the United States, Herbert Hoover's innovative Reconstruction Finance Corporation of 1932 quickly ran into problems because of this issue: it turned out that the credits were going to banks, farms and businesses that were well connected with Republican politics. Germany offers an even more dramatic example of this kind of problem. As part of the bank bailout in the aftermath of the 1931 crisis, 2.5 m. Reichsmarks was put into a small Berlin institution, Hardy & Co., that was a subsidiary of the Dresdner Bank. This money was primarily intended to flow into the electoral campaign coffers of Paul von Hindenburg, the veteran First World War commander who had been elected President of Germany and was standing for reelection in 1932 (Bähr and Ziegler).

In the fragile situation of Weimar Germany, the bailout that was at the center of the government's response to the banking crisis ran into every kind of objection. The claim that the government had been engaged in the "socialization of losses" became an important part of the turbulent electoral campaigns of 1932. In order to get support from the Akzeptbank, banks had to demonstrate that “important economic interests” were at stake, and in practice the majority of Akzeptbank credit went to the savings banks (*Sparkassen*). It was also used to support enterprises in strategically vital areas, notably Silesia. The special issues involved in the support of Silesian industry, and the fear of an opportunistic takeover by foreign issues, led to the Chancellor Heinrich Brüning’s most problematical and indeed scandalous rescue operation, the so-called Gelsenberg purchase concluded on the last day that Brüning and his Finance Minister Hermann Dietrich, the driving force of this bailout, were in office. In this transaction, the government, which as a result of the banking crisis had become Flick’s largest creditor, bought out Flick’s interest in the steel giant Vereinigte Stahlwerke. Dietrich’s former State Secretary Hans Schäffer referred to the operation as “extreme stupidity”.

The rescue of the Creditanstalt was also accompanied by massive corruption, the revelation of which became the stock-in-trade of the opposition Nazi movement in Austria. Then, as now, there was massive public hostility to the idea of a bailout, in that it appeared to be a form of support for the institutions and people who really bore the responsibility for the crisis.

The cost of bailouts, even when they seemed to have been administered promptly and with high efficiency as in the German case, thus exceeded the simple fiscal arithmetic. They brought the state into a series of contentious micro-level decisions on the health of particular enterprises and on the fate of individual bank directors. Given the poisonous ideological backdrop of anti-Semitism in the context of Central Europe in the 1930s, it is unsurprising that this radical doctrine was fanned by the character of the government’s response to banking crises, and that both in Germany and more explicitly in Austria a process of expropriating Jewish property (“aryanization”) that was at first called Germanization or Austrianization set in even before the Nazis took power in those countries. The episodes of managing bank failures in retrospect look like the beginning of a process of state-domination, corruption, and even racial persecution that would roll on like an ever more menacing snowball.

The politics of bank and industrial bailouts after 2008 raised fears of a new financial and economic nationalism, as governments become more directly involved in the micro-management of the economy. Banks in state ownership of with a substantial degree of public investment – Citigroup, Lloyds-HBOS, RBS, Commerzbank –cut back on foreign activities and sold foreign assets, at least in part because of government pressure that taxpayer money should not be used for the benefit of foreign borrowers. Economic nationalism was even more evident in the debate about government rescues of the automobile industry in 2009, where domestic jobs are protected at the cost of foreign jobs in an industry dealing with global overcapacity.

Global Imbalances

Global imbalances played a major role in the origins of the Great Depression and many argue that they are also a significant cause of the Great Recession. In the Great Depression, the imbalances were unwound and reversed: capital after 1931-33 flowed back to the creditor countries, above all to the U.S. The unwinding of imbalances involved an asymmetric adjustment. Creditor countries did little, while the deficit countries reduced their level of economic activity in order to make transfers.

Of course not all imbalances are bad or unsustainable. In the nineteenth century, some countries ran persistent deficits because they were growing more quickly (Australia or the U.S.) and others had substantial surpluses because of high savings accumulation in a mature economy (UK and France). Some countries (such as the Ottoman empire or Russia, or Greece) had public debt induced deficits that were unsustainable, and which led to isolated debt crises but no general reversal of capital flows. In the 1920s, the imbalances that built up in central Europe were heavily driven by unsustainable expansions of public spending and private consumption; and the simultaneous collapse led to a general reversal of capital flows.

There was in the Great Depression a great deal of discussion about the need for more and better international cooperation. In 1930, the Bank for International Settlements began work in Basel. Its creators, above all the influential Governor of the Bank of England, Montagu Norman, envisaged its role as not only arranging for the safe and painless transfer of German reparations (its primary role) but also in devising crisis support mechanisms for troubled debtors.

The highpoint of international cooperation was supposed to be the 1933 London World Economic Conference. But its failure was almost predestined. The plenary meeting was paralyzed by the way in which the preparatory commissions had worked. Monetary experts argued that an agreement on currency stabilization would be highly desirable, but that it required a prior agreement on the dismantling of trade barriers – all the high tariffs and quotas that had been introduced in the course of the depression.

Trade experts met in parallel and made the mirror image of this argument. They agreed that protectionism was obviously a vice, but thought that it was a necessary one that could not be addressed without monetary stability. Only leadership by a determined great power, prepared to sacrifice its particular national interests in order to break the resulting impasse, might conceivably have saved the meeting. But such leadership was as unlikely then as it is now.

A further lesson of the London Conference of 1933 consists in governments' unwillingness in times of great economic difficulty to make sacrifices that might entail a short-term cost. Even if the result would have been longer-term stability, the immediate political consequences were too unpleasant. In adverse economic circumstances, governments felt vulnerable and unsure, and they could not afford to alienate public support.

Finally, faced by a realization of inevitable failure, participants look for a scapegoat. The 1933 Conference looked like a classic detective novel in which every party had a reason to be a suspect. Britain and France had turned away from internationalism, adopting trade systems known as "Imperial Preference," which favored their vast overseas empires. Germany's president had just appointed Adolf Hitler's radical and aggressive government. The German delegation was led by Alfred Hugenberg, who was not a Nazi but wanted to show that he was an even more implacable nationalist than Hitler himself. The Japanese government had just sent troops into Manchuria. Of all the major powers in London, the United States looked the most reasonable and internationalist by far. It had a new, charismatic president, who was known as an Anglophile and a cosmopolitan spirit. Franklin Roosevelt was already taking vigorous action against the depression, and was trying to reorder the failed US banking system. Roosevelt did not know what line to take at the conference, and his stream of advisers offered inconsistent counsel. At last, he lost patience and announced that for the moment the US had no intention of stabilizing the dollar. This message, delivered on July 3, 1933, was known as “the bombshell.” Roosevelt talked about the need to restore “the sound internal economic system of a nation” and condemned the “old fetishes of so-called international bankers.”

Everyone pretended to be shocked at the failure of internationalism. But, at the same time, they were delighted to have found someone who could be blamed for the failure of the conference.

Lessons from the Failure of International Cooperation:

The most obvious lesson from the history of the Great Depression concerned the desirability of an institutional mechanism to prevent a collapse of trade as a result of protective and retaliatory measures – tariffs and quotas. The international trade regime has been institutionalized, first through the GATT and then through the WTO. Although a large number of countries introduced some protective measures in the wake of the financial crisis, only about 1 percent of world imports were affected by the new trade measures instituted between October 2008 and October 2009, in other words in the most severe phase of the crisis (OECD 2010). G-20 meetings in November 2008 and April and September 2009 produced agreements on anti-protectionist measures, and some countries (notably Australia, Mexico and Canada) instituted a systematic reduction of tariffs (though Mexico, like Russia, took measures to restrict the import of foreign automobiles).

There was a rapid collapse of trade in the six months after the collapse of Lehman in September 2008, whose major cause was the unavailability of trade finance rather than trade protection measures. OECD exports fell by 12.9 percent in the last quarter of 2008 and by 30.0 percent in the first quarter of 2009. After April 2009, trade recovered rapidly. Nevertheless, world trade in 2009 was around 12.5 percent lower than in 2008 although it has almost recovered in 2010. (OECD 2010)

In the debates before the World Economic Conference, a critical issue was how trade and foreign exchange policy interacted. Multilateral institutions in the Great Recession by contrast have dealt largely with a different coordination exercise: they have been concerned both with the coordination of fiscal stimulus and with exchange rate coordination. In addition, central banks extended swaps, less as an act of monetary policy coordination but rather largely in order to deal with the currency requirements resulting from large currency mismatches in the balance sheets of major cross-national banking groups.

Both the fiscal and the exchange rate sides of the coordination exercise are potentially problematic. The emphasis on fiscal stimulus in the early phase of the crisis made some countries vulnerable to doubts about fiscal sustainability in the second part of the crisis. In the European Union, Greece and Spain at first presented their stimulus packages as contributions to European recovery rather than as sources of fragility.

More importantly, the modern discussion of foreign exchange policy is much more controversial and difficult to resolve than trade issues, and the international institutional setting – the International Monetary Fund - which originally managed this issue in the Bretton Woods era has largely lost competence in this field. There has been a great deal of discussion of strengthening multilateral surveillance in the wake of the crisis, but such surveillance has not had a major policy impact. Instead, there are repeated accusations that exchange rates are being manipulated in order to achieve trade advantages, accusations which recall the bitter polemics of the 1930s. The United States believes that China is undervaluing the renminbi in order to drive exports; Europeans complain that quantitative easing is a trade policy designed to drive down the dollar; Americans assert that the Euro troubles are a mechanism for lowering the European exchange rate; and even more troublingly, in the European context, southern Europeans are beginning to interpret the story of the locked exchange rate of the single currency as a device to obtain export advantages by Germany (and other northern European states).

The result of these controversies has been an erosion of international economic cooperation. In the half year following the 2008 collapse of Lehman, during the most intense phase of the current financial crisis, the world’s political leaders reassured themselves that this time international cooperation was working splendidly – by contrast with the grim precedent of the nationalistic and autarkic 1930s. The global elite constantly rehearsed and replayed a soothing mantra. Heroic figures, led by Gordon Brown, were rescuing the world through far-sighted and beneficent public action. But since then, in an uncanny echo of the earlier collapse of international efforts at understanding, the prospects for sustained cooperation and for agreement on who should adjust have faded. Growth is returning for both the major surplus and the deficit countries, and it might in consequence be argued that the coordination failure does not matter. But the global imbalances are still there, and to the extent to which they are driven by the expansion of public debt liabilities may be “bad” imbalances capable of leading to a 1930s style reversal.

The 2010 equivalent of Roosevelt’s bombshell has come from the Republican “shellacking” of President Obama in the mid-term elections. The outcome is a restoration for the logical and beautifully designed system of checks and balances that the eighteenth century constitutional fathers drew up. That system can work as intended and produce an accurate reflection of the concerns of ordinary Americans. It is likely to prevent further big bailouts, further economic stimulus measures, but also to block efforts at government budget balancing. The final confirmation of the new U.S. stance came one day later, with the Fed’s announcement of the new $600 bn. quantitative easing program (QE2). The Fed was quite right to claim that the program was not unusual, and that it represented merely monetary policy as usual. It may be that it is exactly what the U.S. economy needs at the moment – in precisely the same way as in 1933 the U.S. needed a flexible exchange rate and benefited from escaping from golden fetters. Some commentators however argue that the pace of recovery as a result of the private sector's own energy and continuous monetary stimulus since late 2008 may have made QE2 redundant. The decision however was justified by Fed officials by reference to the dual mandate of the Fed, to maintain price stability (where for the moment there is no threat of either significant inflation or of any deflation) and also a level of economic activity that might generate an improvement in the labor market.

It is only when it comes to the international arena that the Fed's actions are inconsistent with price stability in other countries – or "clueless" as German Finance Minister Wolfgang Schäuble undiplomatically put it. A howl of outrage about U.S. monetary policy followed from the finance ministries of every emerging market economy. The Brazilian Finance Minister, Guido Mantega spoke of a new "currency war" involving competitive devaluation (*Financial Times*, 2010). The American complaint that China was deliberately under-valuing its exchange rate looked out of place as expansionary Fed policy may have fuelled currency wars by weakening the dollar and providing cheap funds that would surge in a wave of lending to fuel potential emerging market bond bubbles. U.S. monetary policy is having an impact on emerging markets. Low U.S. rates are fueling a new version of the carry trade, and setting off inflationary booms in east Asia which are difficult to control by conventional means. The new U.S. policy mix is likely to be interpreted by some as a return to the 1930s experience, when the U.S. turned on in itself, abandoning attempts to steer a global economy.

The failure of currency coordination which would go against perceived sovereign interest is not surprising from a political economy viewpoint, and the logic for it in a regime of floating exchange rates compared to the interwar gold exchange standard is not compelling in terms of economic theory. There were similar failures in the early 1970s, after the Smithsonian meeting to determine a set of new exchange rates, or in the mid-1980s, when attempts at coordination in the Plaza and Louvre Finance Ministers' meetings increased rather than decreased financial instability. The only major reason to worry about such failures today is that frustration about the currency regime can translate potentially into powerful demands in parliaments and other representative assemblies for trade retaliation as a response to a currency war. So far, this trade counterblast remains a topic for discussion rather than a reality.

Moreover, the consequence of failure of international cooperation has not been nearly as negative as in the 1930s, because there has as yet been no sudden reversal of capital flows. So far, in the aftermath of 2008, some smaller debtor countries have been obliged to undertake a sharp adjustment (Latvia moved from a current account deficit of 13.1 percent in 2008 to a 8.6 percent surplus in 2009, and Hungary from – 7.1 percent to + 0.2 percent)). But there has been no reversal of the position of the largest debtors, the United States or the United Kingdom. Even the Eurozone problem cases, Greece, Ireland and Spain continues to run a substantial current account deficit, with (increasingly nervous) foreign investors still buying government debt (at a substantial premium).

In the Great Depression, the major international policy problem lay in the export of deflation by the surplus countries, France and the U.S. Today's equivalent to France's sterilization of gold inflows in the 1920s would be the argument that China is exporting deflation through the sterilization of foreign exchange purchases. But the other side of the modern story, the continued large deficits of the major deficit economies (US, UK etc.) do not parallel the dramatic adjustment of the 1930s. In the Great Recession, instead the export of inflation recalls the experience of the late 1960s and the early 1970s reflecting the exorbitant privilege (in the events that produced the breakdown the par value or Bretton Woods system). Again, this 1970s analogy would point to the danger that currency uncertainty may lead to new trade policies.

Why Lessons are Painful

There are many lessons from the Great Depression that can and should be learnt in respect to the management of our current crisis; but they are often not as simple or as easy as many commentators believe. The most important and most unproblematic lesson is concerned with the avoidance of the monetary policy error of not intervening in the face of banking crises. The policies of the major central banks – the Federal Reserve, the European Central Bank, the Bank of England – suggest that this is a lesson that has been in the main learnt. However the Fed after expanding liquidity in the fall of 2007 then followed too contractionary a policy in the first three quarters of 2008 which may have exacerbated the recession that began in December 2007. Some major economies, notably the United States and China, have also embarked on large fiscal stimulus programs although the jury is still out on how effective they were . In the Chinese case, there is an acute danger of inflationary overheating; in the U.S. case, there is the fear that the fiscal stimulus will significantly worsen already fundamentally unsustainable debt dynamics.

Learning from the Great Depression in other areas is much harder. A major financial collapse has long-lasting consequences, which cannot easily be removed. Both the lesson from the Great Depression about the slowness and the painfulness of bank reconstruction, and the lesson about dependence on a large external provider of capital, are unpalatable. Limiting the size of banks that are too big or too interconnected to fail is a major political problem, especially as such institutions constitute a powerful lobbying force. The current strategy of guaranteeing banks, but also deposits and a broad range of other liabilities, is likely to encourage a further extension rather than a roll-back of the too-big-to-fail doctrine. Bank rescues have also had a significant impact on the deterioration of the fiscal position of many countries.

Trade is another area where major vulnerabilities will continue. Currency breakdowns are often followed by trade fights. Monetary policy is not perceived any longer as solely promoting a stable measure of value, but also (as in the 1930's) as a tool with which countries can fight each other for trade advantages.

For a long time, it was much easier to repeat the soothing mantra that collectively the world community has learned how to avoid a 1929-type of collapse, and that the world's central banks in 1987 or 2001 clearly showed that they had learned the right lesson. It is undoubtedly meritorious of governments to stabilize expectations, and to prevent a worse spiraling of crisis. But policy-makers and their advisers will create inappropriate expectations when some simple policy proposals are built up as the basis for the hope that they alone can guarantee recovery. As both Europe and the United States are likely to continue to have rather anemic recoveries, it is as important to take a sober and realistic approach to the unpalatable lessons of the Great Depression as it is to celebrate the fundamental point that we do know more about monetary policy.

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