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The Great Depression and the Great Recession

In the discussion of our contemporary economic disease, the Great Depression analogy refuses to go away. Almost every policymaker 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».

As in the era of the Great Depression, prominent economists (Robert Gordon, Tyler Cowen) are now worrying about an end to the high productivity age, and contemplating a world in which the fundamental technical impetus to growth is rapidly eroding so that the only gains lie in catch-up processes.¹ That effect may explain why we find it hard to see precisely where the epicentre of the current malaise lies.

Like the Great Depression, which in 1929 appeared as a problem primarily of the United States, but which by 1931 was intensified by Latin American and Central European debt and banking crises, the Great Recession has been changing its geographic focus. In 2008, in the aftermath of the Lehman collapse, it was viewed mostly as an American crisis, stemming from peculiarities of housing finance; after 2010, the central element appeared to be the linking of sovereign debt and banking problems in the Eurozone.

1. Monetary Policy

A great deal of the anti-crisis policy's focus has been on monetary policy and on the action of central banks. That focus is driven by a strong sense of the lessons of history, which often include the paralysis of political institutions. Thus, the New York Federal Reserve Bank acted in the decisive moment in September 2008 by lending AIG 85 billion dollars in return for 80 per cent of its stock, as well as

1 R. Gordon, «Is US Economic Growth Over? Faltering Innovation Confronts the Six Headwinds», in: CEPR *Policy Insight* 63 (2012); T. Cowen, *The*

Great Stagnation. How America Ate All the Low-Hanging Fruit of Modern History, Got Sick, and Will (Eventually) Feel Better, New York 2011.

supplying 20.9 billion dollars in the commercial credit programme and a 38-billion-dollar facility that provided liquidity for the company's securities. At this time, the Treasury was paralysed, and the Congress still needed to be convinced to act. There is a parallel in Europe, where the European Central Bank has been from liquidity provision in 2008 through to President Mario Draghi's memorable promise in July 2012 to «do what it takes» the only effective European anti-crisis institution. Ben Bernanke is explicit about the historical lesson: «History teaches us that government engagement in times of severe financial crisis often arrives late, usually at a point at which most financial institutions are insolvent or nearly so».² Central banks by contrast can respond more promptly.

The theoretical point is that monetary policy can shift expectations about future and hence current asset values. That affects the question of the solvency or insolvency of agents. In a world of multiple *equilibria*, central banks can in the short term bring agents back into a good equilibrium, and they appear as very powerful mechanisms to restore growth prospects in the short run. In the longer run, they are however completely unable to affect the overall growth rates. Central banks thus become the rock stars of the current crisis.

That analysis depends also on a historical analysis. 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 US 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 linked to sovereign finance problems, was decisive in turning a bad recession into the Great Depression. The collapse and government rescue of the Creditanstalt bank in Vienna in May 1931 and a major banking crisis that also required public funding for bank recapitalisation in Germany in July spread financial contagion from Central Europe to Great Britain and back to the United States, as well as to the whole of Europe.

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 affected 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. Some observers

2 R. Hetzel, *The Great Recession. Market Failure or Policy Failure*, Cambridge-New York 2012, 282.

see analogous monetary policy errors in 2008: in the face of declining consumption and resource utilisation in the spring of that year, the Fed limited downward movement in the funds rate and the ECB tightened.

The stock-market crash in October exacerbated the down-turn 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 down-turn that followed. The Fed adhered to the flawed Burgess–Riefler doctrine which viewed low levels of its borrowed reserves (that is 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.³

2. The Financial Sector

Today – especially in Europe – is more like 1931 than 1929 in that banking collapses played a crucial role in the deepening of the global crisis in 1931. Unlike the United States, where banking was highly localised, continental European economies were characterised 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 per cent of Austrian firms through ownership stakes. The failure or potential failure of very large financial institutions thus posed a major policy problem.

The collapses resulted from the shocks of the international depression being imposed upon bank weakness in countries that had been wrecked by the aftermath of bad policies which 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 post-war reparations issue were enough to topple a house of cards. In the case of the largest European bank collapse, creditors worried that competing claims of official creditors (the reparations creditors, notably France and Belgium, with France depending on reparations to repay inter-allied war debt to the United States and the United Kingdom) as well as short-term creditors (largely banks) and long-term creditors (largely bondholders) from the private sector could not all be met simultaneously.⁴

3 See M. Friedman / A. J. Schwartz, *A Monetary History of the United States, 1867–1960*, Princeton 1963; and A. H. Meltzer, *A History of the Federal Reserve*, vol. 1: 1913–1951, Chicago 2003.

4 A. Ritschl, *Deutschlands Krise und Konjunktur. Binnenkonjunktur, Auslandsverschuldung und Reparationsproblem zwischen Dawes-Plan und Transfersperre 1924–1934* (*The German Business Cycle*,

The Austrian and German problems of 1931 look like an anticipation of the vicious feedback loop that is characteristic of the Eurozone crisis between bank problems and sovereign debt issues. Banks that have difficulties require to be rescued by government recapitalisations, but that worsens the government's fiscal outlook. The down-grading of government debt (held as assets in bank balance-sheets) worsens the position of banks and helps to set off bank runs. The involvement of government in financial rescues transfers private debt into the public sector and may create difficulties for public finance unless there is a dramatic and quick recovery of the prices of financial assets.

Banks in 1931 were vulnerable as a result of poor monetary policy, and they were victims of monetary deflation.⁵ But there were plenty of specific issues which long antedated the collapses of the early 1930s.⁶ These were the result of specific design features of the financial system that could not simply be corrected by macroeconomic policy, whether monetary or fiscal. US banking was highly localised 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 capitalisation 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.⁷

One of the striking features of the Depression analogy is how many of the old 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; recapitalisation 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 epicentre of the central European collapse, in Germany.

Finding a way out of the damage created by the collapse of a systemically important financial institution has always been very tough. Unlike in the case of a 1929-type event, there are no obvious macroeconomic answers to financial distress, particularly when it involves institutions that are deemed to be «too big to fail». The consequence is that the operationalisation of reform proposals,

1924–1934. *Domestic Activity, Foreign Debt, and Reparations from the Dawes Plan to the Debt Default*, Berlin 2002.

5 P. Temin, «The German Crisis of 1931: Evidence and Tradition», in: *Cliometrica. Journal of Historical Economics and Econometric History* 2 (2008) 1, 5–17.

6 H. James, *The German Slump. Politics and Economics 1924–1936*, Oxford 1986.

7 H. James, *The End of Globalization. Lessons from the Great Depression*, Cambridge/Mass. 2001; O. Accominotti, *Contagion and the Sterling Crisis of 1931*, Working Paper 2009.

whether in the Dodd–Frank Act or in the UK Vickers report or the EU Liikanen report on bank structural reform, is highly complex and will require substantial practical modifications. There is an unpleasant trade-off: bigger banks can distribute risk more widely and thus offer in effect an insurance on hard-to-value individual assets; but that makes the too-big-to-fail problem even more acute.

A major collapse of a large part of the financial system requires slow and painful cleaning-up of balance-sheets as well as microeconomic 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 behaviour. 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. Again, there is a hard trade-off: improved capital ratios are a policy goal because that makes the banking system safer; but the easiest way to improve capitalisation is to reduce the balance-sheet, and the regulatory response is thus widely blamed for problems in banking lending. Regulators reduced liquidity requirements in January 2013 in the name of greater «realism».

In addition, bailouts create political economy problems. Bailouts are inherently controversial, because they distribute public money in an arbitrary way, to one recipient rather than another. The politics of bank and industrial bailouts after 2008 have already 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 or with a substantial degree of public investment – Citigroup, Lloyds-HBOS, Royal Bank of Scotland, Commerzbank – have 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.

3. 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 1931–1933 flowed back to the creditor countries, above all to the United States. 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. One of the features of the current crisis is that there has been no complete reversal of credit flows: instead, in the eurozone, public debt was largely substituted for private debt in the period 2010–2012.

At the time of the depression, there was a great deal of discussion about the need for more and better international co-operation in order to prevent a spiral of panic. 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 task) but also in devising crisis support mechanisms for troubled debtors. The highpoint of international co-operation was supposed to be the 1933 London World Economic Conference, but its failure was almost predestined. The plenary meeting was paralysed by the way in which the preparatory commissions had worked. Monetary experts argued that an agreement on currency stabilisation 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 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 as well as unsure, and they could not afford to alienate public support.

4. 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.

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 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 rollback of the too-big-to-fail doctrine. Bank rescues have also had a significant impact on the deterioration of many countries' fiscal position.

Trade is another area where major vulnerabilities will continue. Currency break-downs are often followed by trade fights. Monetary policy is not seen any longer as promoting a stable measure of value; it is not just a short-term stabilisation tool, but has rather become 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 stabilise expectations and to prevent a worse spiralling of crisis. But policymakers and their advisers will create inappropriate expectations when some simple policy proposals are built up as the basis for the hope that they can alone guarantee recovery. As both Europe and the United States are likely to have rather anaemic 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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