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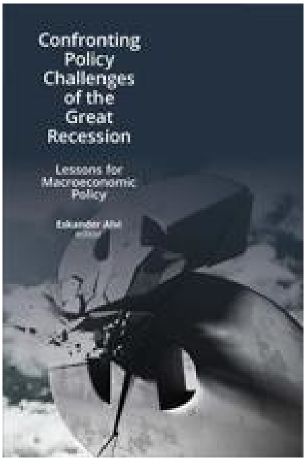

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Lessons for Macroeconomic Policy

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The Great Depression and the Great Recession in a Historical Mirror

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History is a lens through which we—the public and elected and appointed officials—view current problems. The logic of historical analogy is never more compelling than during crises, as there is no time for careful analytical reasoning and no time for building formal models or testing them for fitness to data. In such circumstances, the influence of reasoning by analogy, particularly historical analogy, is considerable. For example, foreign policy specialists point to the powerful influence of the Munich analogy in President Truman's decision to intervene in Korea.[1] Or, think of the power of the analogy between 9/11 and Pearl Harbor, for which a Google search produces nearly 100,000 hits.

So it was with the Great Recession of 2008–2009 and the Great Depression of 1929–1933, the two great macroeconomic crises of the past century. There is no doubt that conventional wisdom about the earlier episode, which is referred to colloquially as "the lessons of the Great Depression," powerfully shaped and informed the response to the crisis of 2008–2009.[2]

The decisions of policymakers were powerfully shaped and informed by received wisdom about the mistakes of their predecessors. In the 1930s when the crisis hit, those predecessors had succumbed to the protectionist temptation. They had cut public spending at the worst possible time and failed to stabilize the money supply. Neglecting their responsibility for financial stability, they had failed to provide emergency liquidity to the banking system. The result was collapsing banks, collapsing prices, collapsing trade, and collapsing activity—in a phrase, the great macroeconomic catastrophe of modern times.

That this economic crisis reflected disastrous but avoidable policy failures became conventional wisdom, courtesy of influential analyses from economists such as Milton Friedman and Anna Schwartz, whose book *Monetary History of the United States* devoted a 110-page chapter to the episode they dubbed "The Great Contraction" (Friedman and Schwartz 1963). In 2008, heeding the lessons of this earlier episode, policymakers vowed to do better. If their predecessors' failure to provide emergency liquidity had produced a cataclysmic banking and financial crisis, then this time they would flood the markets with liquidity and otherwise provide emergency assistance to the banks. If the failure of those predecessors to stabilize the money supply had resulted in a destructive deflation, then this time they would cut interest rates and expand central bank balance sheets. If efforts to balance budgets had worsened the earlier slump, then this time they would apply fiscal stimulus instead.

As a result of this very different response, unemployment in the United States peaked in 2010 at just 10 percent. This was still painfully high, to be sure, but it was far below the catastrophic 24 percent scaled in the Great Depression. This time failed banks numbered in the hundreds, not thousands. While dislocations were widespread, the utter collapse of financial markets, as in the 1930s, was successfully averted.

And what was true of the United States was true also of other countries. Every unhappy country is unhappy in its own way, and there were varying degrees of economic unhappiness starting in 2008. But, a few ill-starred European countries notwithstanding, that unhappiness did not rise to 1930s levels. Because policy was better, the decline in output and employment was less steep, the social dislocations were fewer, and the pain and suffering were less.

Unfortunately, this happy narrative of sage policy informed by "the lessons of history" is a bit too positive. For one thing, it is hard to square with the failure to anticipate the risks. As Queen Elizabeth II famously asked on a visit to the London School of Economics in 2008: "Why did no one see it coming?" (Pierce 2008). Some economists later claimed that they had seen "it" coming (*Telegraph* 2009), but they actually warned of crises that did not occur, like a collapse of the dollar, or issued only vague warnings and without pointing to specific risks.

That even specialists on financial crises did not sound louder warnings—there's my mea culpa—suggests adopting a somewhat less critical posture toward officials in the 1920s for failing to anticipate and head off the risks that resulted in their crisis. Our failure reflects what psychologists refer to as "continuity bias," the subconscious tendency to believe that the future will resemble the relatively recent past (Omer and Alon 1994).[3] It reflects peer pressure to conform and the costs of being ostracized if, for example, you criticized Alan Greenspan's financial stewardship at Jackson Hole in 2005, as one academic was reckless enough to do (Rajan 2005). It reflects the power of a dominant ideology, in this case the ideology of market efficiency and financial liberalization (Patomaki 2009; Suarez and Kolodny 2011). And it reflects the influence of money politics—the influence of big financial institutions, through their political contributions and the revolving door between Wall Street and Washington—in shaping the policy debate (Igan and Mishra 2011; Igan, Mishra, and Tressel 2011; Mian, Sufi, and Trebbi 2010).

Ultimately, however, I would argue that the roots of this failure to see the recent crisis coming lay in the same progressive narrative of the Great Depression. Entirely correctible flaws of collective decision making, that narrative explained, had been responsible for the inability of contemporaries to appreciate the risks to stability in the 1920s and then for their failure to deal effectively with the consequences in the 1930s. Modern-day policymakers had learned from the mistakes of their predecessors. Scientific central banking informed by a rigorous framework of inflation targeting now reduced economic and financial volatility and prevented serious imbalances. Advances in supervision and regulation limited financial excesses. Deposit insurance, put in place in response to the experience of the 1930s, had eliminated the danger of bank runs and financial panics. Conventional wisdom about the Great Depression, that it was caused by avoidable policy failures, was itself conducive to the belief that those failures could be and, indeed, had been corrected. It followed that no comparable crisis was possible now. All of which we now know was dreadfully wrong.

Part of the problem is that we—in this case I mean we economic historians—had always done a better job of explaining the course of the Great Depression than we had in explaining its onset.[4] We had failed to highlight how rapid financial innovation had combined with inadequate regulation and lax monetary policy to create dangerous financial fragilities.[5] We had failed to explain how capital flows to one half of Europe from the other half of Europe and the rest of the world had set up that continent for a fall.[6] We had failed to explain how the naïve belief that advances in scientific central banking had rendered crises a thing of the past, which led contemporaries to discount the risks to financial stability (however, see Barber [1985]). We had failed to explain how a long period of stability—in the 1920s they called it "the New Era" rather than, as recently, the Great Moderation, although the underlying phenomenon was fundamentally the same—encouraged excessive risk taking and empowered those who argued against stricter regulation.[7] Recent experience suggests the need to write this history more carefully. Had we done so earlier, we might have seen more clearly how the same factors were at work in the early twenty-first century.

The fateful decision to let Lehman Brothers fail—the single event that most threatened the stability of global financial markets—also suggests looking at the 1920s differently. Lehman failed because it was insolvent—because its managers had made bad bets. It failed because there were doubts about whether the Fed and Treasury had the legal authority to rescue it.[8] But it also failed because policymakers wanted to make a statement. Having bailed out Bear Stearns six months earlier, they were eager to signal that not everyone would be rescued. And they wanted to shield themselves from criticism from politicians that they were too quick to bail out troubled banks.[9]

Because they lived through this experience, future historians are likely to write the history of the Great Depression differently. They will be reminded that the banking crises of the 1930s reflected not only the fact that central banks and governments failed to appreciate the need to act as lenders of last resort, but, as with Lehman Brothers, their concern with moral hazard and wish to push back against political criticism. The great banking crisis of early 1933 resulted from the failure of the Reconstruction Finance Corporation to rescue Henry Ford's Guardian Group of banks, unleashing a panic that engulfed first the state of Michigan and then the rest of the country.[10] In fact, that decision reflected the criticism to which U.S. politicians, from President Herbert Hoover on down, had been subjected for rescuing Central Republic Trust, the bank of former Vice President (and former Reconstruction Finance Corporation head) Charles Dawes, six months earlier (Vickers 2011). We are reminded that this instinctual desire to "teach them a lesson," to play financial hardball, especially when doing so is a way for officials to rescue their reputations, is deeply ingrained.

There was also the failure to anticipate how disruptive the failure of Lehman Brothers would be. Here too I would blame the "lessons of the Great Depression." The conventional narrative about the Depression focused on the disruptive impact of bank failures and runs by retail depositors.[11] Lehman was not a deposit-taking bank; it did not have retail depositors.[12] Therefore, the conclusion followed, its failure couldn't pose such serious problems.

This view, informed by the lessons of the Great Depression, was why the Basel Accord setting capital standards for internationally active financial institutions focused on commercial banks. Deposit insurance, which was supposed to prevent bank runs, focused on commercial banks. Regulation generally focused on commercial banks. This focus neglected the shadow banking system of investment banks, hedge funds, money market funds, commercial paper issuers, and securitizers. It ignored Lehman's derivatives positions. It ignored the fact that wholesale creditors could effectively run on the bank. The result was the decision to allow the uncontrolled failure of Lehman Brothers, which in my view was the single most serious mistake of the financial crisis.

At this point policymakers realized that they had a situation on their hands—that the U.S. and world economies were on the verge of another Great Depression. The leaders of the advanced industrial countries quickly issued a joint statement that no systematically significant financial institution would be allowed to fail. American International Group (AIG) was bailed out, albeit not on terms that satisfied everyone concerned.[13] A reluctant U.S. Congress passed the Troubled Asset Relief Program on the second try, to aid the banking and financial system. Gordon Brown assembled the Group of Twenty countries in London in February 2009 to produce their so-called "Trillion Dollar Package" of coordinated fiscal-stimulus measures.[14] One after another, governments took steps to provide capital and liquidity to distressed financial institutions. Central banks flooded financial markets with liquidity. Policymakers congratulated themselves that they had avoided another Great Depression.[15]

Yet the results of these policy initiatives were decidedly less than triumphal. Postcrisis recovery in the United States was lethargic. It proceeded at less than half the pace of a normal recovery, a couple of quarters of exceptionally rapid growth in the middle of 2014 notwithstanding to the contrary. Europe did even worse, experiencing a double-dip recession and renewed crisis starting in 2010.

This was not the successful stabilization and vigorous recovery promised by those who had learned the lessons of history.[16] The reasons why are no mystery. Starting in 2010 the United States and Europe took a hard right turn toward austerity. Spending under the American Recovery and Investment Act, President Obama's stimulus program, peaked in fiscal year 2010 and then headed steadily downward. In the summer of 2011, the Obama Administration and the Congress then agreed to $1.2 trillion of spending cuts to be implemented over 10 years. In 2013 came expiry of the Bush tax cuts; the end of the temporary reduction in employee contributions to the Social Security Trust Fund; and the sequester (the across-the-board 8.5 percent cut in federal government spending). All this took a big bite out of spending, aggregate demand, and economic growth.[17]

In Europe the turn was even more dramatic. In Greece, where spending was out of control, a dose of austerity was clearly required. But the adjustment program on which the country embarked starting in 2010 under the watchful eyes of the European Commission, the European Central Bank (ECB), and the International Monetary Fund was unprecedented. It required the Greek government to reduce spending and raise taxes by an extraordinary 16 percent of GDP over four years—in effect, to eliminate more than one-seventh of all spending in the Greek economy. The governments of the euro area as a whole cut budget deficits modestly in 2011 and then sharply in 2012, despite the fact that the currency area was back in recession and other forms of spending were stagnant. Even the United Kingdom, which had the flexibility afforded by a national currency and a national central bank, embarked on an ambitious program of fiscal consolidation, cutting government spending and raising taxes by a cumulative 5 percent of GDP.[18]

Central banks, having taken a variety of exceptional steps in the crisis, were similarly anxious to return to business as usual. The Fed undertook three rounds of quantitative easing (QE)—multimonth purchases of Treasury bonds and mortgage-backed securities—but hesitated to ramp up those purchases even further despite an inflation rate that undershot its 2 percent target and growth that continued to disappoint for three additional years. Not until QE3 did it finally make the kind of open-ended commitment sufficient to vanquish the threat of deflation once and for all.[19]

And if the Fed was reluctant to do more, the ECB was eager to do less. In 2010 it prematurely concluded that recovery was at hand and started phasing out its nonstandard measures. In 2011 it raised interest rates twice. Anyone seeking to understand why the European economy failed to recover and instead dipped a second time need look no further.

What lessons, historical or otherwise, informed this extraordinary turn of events? For central banks there was, as always, deeply ingrained fear of inflation. That fear was nowhere deeper than in Germany, given memories of hyperinflation in 1923. German fear now translated into European policy, given the Bundesbank-like structure of the ECB and the desire of its French president, Jean-Claude Trichet, to demonstrate that he was as Teutonic an inflation fighter as any German.[20]

The United States had not experienced hyperinflation in the 1920s, nor at any other time for that matter, but this did not prevent overwrought commentators from warning that Weimar was right around the corner.[21] The lesson from the 1930s—that when the economy is in near-depression conditions with interest rates at zero and ample excess capacity, the central bank can expand its balance sheet without igniting inflation—was lost from view. Sophisticated central bankers such as Chairman Bernanke clearly knew better, but there is no doubt that they were influenced by the criticism. The more hysterical the commentary, the more loudly the Congress accused the Fed of debasing the currency. The more Fed governors then feared for their independence. This rendered them anxious to start shrinking the Fed's balance sheet toward normal levels before there was anything resembling a normal economy.

This criticism was more intense to the extent that unconventional policies had gotten central bankers into places they didn't belong, like the market for mortgage-backed securities (Cecchetti 2009). The longer the Fed continued purchasing mortgage-backed securities—and it continued into 2014—the more the institution's critics complained that policy was setting the stage for another housing bubble and another crash. This, of course, was the same preoccupation with moral hazard that had contributed to the disastrous decision not to rescue Lehman Brothers. In the case of the ECB, of course, the moral-hazard worry centered not on the markets but on the politicians. For the central bank to do more to support growth would just relieve the pressure on governments, allowing reforms to lag and risks to accumulate. The ECB allowed itself to be backed into a corner where it was the enforcer of fiscal consolidation and structural reform. And in its role as enforcer, economic growth became the enemy.

In the case of fiscal policy, the argument for continued stimulus was weakened by its failure to deliver everything promised, whether because politicians were prone to overpromising or because the shock to the economy was even worse than understood at the time.[22] There was the failure to distinguish how bad conditions were from how much worse they would have been without the policy. There was the failure to distinguish the need for medium-term consolidation from the need for public support for spending in the short term. There was the failure to distinguish the need for fiscal consolidation in countries with gaping deficits and debts, like Greece, from the situation of countries with the space to do more, like Germany. Thus, a range of factors came together. The one thing they had in common was failure.

Inevitably, failures like these have multiple causes. There was the dominance of ideology and politics over economics analysis. There was the failure of economists to effectively make the case for better policies. There was the tendency of economists to forget as many lessons of the 1930s as they remembered. But the most powerful factor in this premature decision to abandon policies that would have done more to support the economy when the economy still needed support was surely that policymakers had prevented the worst. They had avoided another Great Depression. They could declare the emergency over. They could therefore heed the call for an early return to normal policies. The irony is that their very success in preventing a 1930s-like economic collapse led to their failure to support a more vigorous recovery.

And what was true of macroeconomic policy was also true of financial reform. In the United States, the Great Depression led to the Glass-Steagall Act separating commercial from investment banking. It led to the adoption of federal deposit insurance. It led to the creation of the Securities and Exchange Commission to oversee the operation of securities markets, putting paid to the myth of market self-regulation. There were calls now for a new Glass-Steagall, the earlier act having been laid to rest in 1999, but there was nothing remotely resembling such far-reaching regulatory reform.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 contained some modestly useful measures, from the Volcker Rule limiting speculative trading by financial institutions to the creation of a Consumer Financial Products Bureau. But the big banks were not broken up. Rhetoric to the contrary, little was done about the problem of too big to fail (Gormley, Johnson, and Rhee 2015). There was nothing approaching the thorough-going redrawing of the financial landscape that resulted from Glass-Steagall's sharp separation of commercial banking, securities underwriting, and insurance services.[23]

The fundamental explanation for the difference is again the success of policymakers in preventing the worst. In the 1930s, the depth of the Depression and the collapse of banks and financial markets wholly discredited the prevailing regime. This time depression and financial collapse were avoided, if barely. This fostered the belief that the flaws of the prevailing system were less. It weakened the argument for radical action, took the wind out of the reformers' sails, allowed the banks to regroup, and allowed petty disagreements among politicians to slow the reform effort. Success thus became the mother of failure.

To be clear, the argument is *not* that it would have been better to allow the big banks to collapse in late 2008 and early 2009. The consequences for output and employment would have been devastating. Avoiding those devastating consequences and limiting unemployment to 10 percent was a considerable achievement, under the circumstances. But it was an achievement with unintended consequences.

The same is true of Europe's failure to embark on more far-reaching financial reform. This reflected the difficulty of decision making in a European Union of 27 countries. But it also reflected the fact that the EU did just enough to hold its monetary union together. Through emergency loans and the creation of an ECB facility to buy the bonds of troubled governments, it did just enough to prevent the euro system from falling apart. This success in turn limited the urgency of proceeding with more far-reaching reform, from across-the-board debt write-downs to creation of a banking union with a single supervisor for all of Europe's banks and a mechanism for directly recapitalizing troubled financial institutions.

Thus, the very success with which policymakers limited the damage from the worst financial crisis in 80 years means that we are likely to see another such crisis in considerably less than 80 years.

This chapter would be incomplete if it didn't address more about Europe and the euro, given how the euro crisis became the second leg of the global financial crisis. The decision to create the euro in 1999 was one of the greatest economic policy blunders of the twentieth century. (A fitting way, some would say, to bring a century of great economic policy blunders to a close.) In this case, unlike the 2008 crisis, some of us like to think—to echo Queen Elizabeth—that we saw it coming: I'm fond of citing my own 1993 article in which I warned of the dangers of creating a monetary union without a banking union, not that this much affected the course of events (Eichengreen 1993).

This decision to go ahead with the euro is another example of the misuses of history—in this case, of the ability of policymakers to cherry-pick their historical analogies. They argued that financial instability and even World War II, indirectly, had been caused by the competitive devaluations of the 1930s, and not by the rigid gold standard system that preceded them, implying that the risk in the 1990s was competitive devaluations rather than the premature creation of a new gold-standard-like system. John F. Kennedy, when contemplating how to respond to the Cuban Missile crisis, considered a range of historical analogies, from Pearl Harbor to the 1948–1949 Berlin Blockade and the 1956 Suez Crisis, and tested them for fitness to the situation at hand. Exceptionally, he had historians like Arthur Schlesinger in his kitchen cabinet (much as Barack Obama had Christina Romer). Harry Truman, who relied only on the analogy with Munich, did not. He had one analogy and pushed it for all it was worth. So too did the architects of the Maastricht Treaty.

The analogy between the gold standard and the euro system became clearer with the onset of the euro crisis, triggered by revelations about Greece's debt and deficits in late 2009. Just as the gold standard prevented national governments and monetary authorities from responding in the 1930s in stabilizing ways, it now became clear that the euro system posed similar obstacles.[24] That earlier conflict had been resolved by abandoning the gold standard, leading many observers to predict that this one would be similarly resolved by abandoning the euro.[25]

This, it turned out, was another misreading of history. In the 1930s, when governments abandoned the gold standard, international trade and lending had already all but collapsed. This time, in contrast, European countries did just enough to avoid that fate. Hence the euro had to be defended in order to preserve the single-market and intra-European trade and payments. In the 1930s, political solidarity was another early casualty of the Depression (Clavin 2010). Notwithstanding the strains of the crisis, governments this time continued to consult and collaborate. All complaints about the European Union notwithstanding, 60 years of European integration fostered a degree of political solidarity considerably greater than that of the 1930s. EU countries in a strong economic and financial position provided loans to their weak European partners. Those loans could have been larger, but they were large by the standards of the 1930s (Accominotti and Eichengreen, forthcoming).

Here, then, is another case where the history of the 1930s was an imperfect guide to policy outcomes. Where the earlier crisis led to the collapse of the gold standard, the recent one has not led to the collapse of the eurozone. At least not yet.

Notes

This chapter draws on my book *Hall of Mirrors: The Great Depression, the Great Recession, and the Uses—and Misuses—of History* (Eichengreen 2015a). The informal and personal tone of this chapter consciously reflects the lecture format for which it was prepared.

1. There is by now an abundant literature by foreign policy specialists making this point. See, for example, Eichengreen (2012), Kyong (1965), Lawrence (2014), May (1973), Neustadt and May (1986), and Shinko (1994).
2. For anticipations of the fact, see Bernanke (2001) and Romer (1992).
3. On psychological biases in general, there is Kahneman (2011).
4. That Friedman and Schwartz in particular had said relatively little about the onset of the Depression was a subtext of Peter Temin's influential book (1976). One important contribution that did discuss the run-up to the Depression at length was that of Temin's MIT colleague Charles Kindleberger (1973). Another noteworthy if only partially successful attempt to develop this aspect of the story is Bernstein (1989).
5. There were rare exceptions, to be sure; see, for example, White (1984).
6. For an attempt to do so after the fact, see Accominotti and Eichengreen (2016).
7. An early recognition of the point as it applies to the recent crisis is Kohn (2009).
8. See Bernanke (2010) and associated discussion as cited in Pazzanghera (2010). See also the discussion in Geithner (2014).
9. For perspectives on the Lehman Brothers story, see Financial Crisis Inquiry Commission (2011), MacDonald and Robinson (2010), and Sorkin (2010).
10. For details on this crisis, see Kennedy (1973) and Wicker (1996).

11. This was the emphasis of Friedman and Schwartz's influential *Monetary History* (1963).
12. Although it did own an online bank, Lehman Brothers Bank FSB offered community banking services in Delaware, not that this played a key role in the parent institution's failure.
13. Former AIG CEO Maurice ("Hank") Greenberg eventually filed a lawsuit against the federal government disputing the terms of the bailout. At the time of writing, closing arguments were still pending; see Milford and Zajac (2015).
14. As described in the chapter of the same title in Brown (2010).
15. The literature on the impact of these policies is large and characterized by controversy. Among the definitive studies in my view are Feyrer and Sacerdote (2011), Joyce et al. (2011), Krishnamurthy and Vissing-Jorgensen (2011), Mian and Sufi (2012), and Pesaran and Smith (2012).
16. For the current recovery in historical perspective, see Reinhart and Rogoff (2014).
17. Estimates of such impacts differ, of course. A dispassionate analysis, if there is such a thing, is Whalen (2015). The best European equivalent of which I am aware is Barrell, Holland, and Hurst (2012).
18. The literature on fiscal consolidation in Europe is controversial, to put an understated gloss on the point. A meta-analysis of the literature can be found in Gechert, Hughes-Hallett, and Rannenberg (2015).
19. A retrospective analysis with whose conclusions I broadly concur is Rosengren (2015).
20. On Trichet and ECB policy, see Irwin (2015).
21. See the letter from 24 eminent economists published in the *Wall Street Journal* (2010).
22. This is another context in which we are now likely to write the history of the 1920s differently having lived through our own crisis and discovered how difficult it is to track the development of contemporaneous conditions in real time; we are thus likely to better appreciate how contemporaries similarly lacked adequate information on how quickly the economy was in fact contracting in the final months of 1929.
23. A more systematic comparison of financial reform following the two crises is Eichengreen (2015b).
24. A good scholarly analysis is O'Rourke and Taylor (2013).
25. See, for example, O'Brien (2013).

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