

# THE GREAT RECESSION AND THE GREAT DEPRESSION: REFLECTIONS AND LESSONS

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My Economics Department colleagues are fond of telling me that, as an economic historian, I have the advantage that I don't have to update my lectures in response to events. My history lectures don't become outdated as quickly as their lectures on, say, the Great Moderation. The fallacy of this view is that while the so-called "facts" don't change, their interpretation does. To take the obvious example, in light of recent events I have had to revise everything I say about the Great Depression. This is the case with regard to the causes of the 1929 crisis, which included the Florida real estate bubble, global imbalances (referred to then as "the transfer problem"), and lax supervision and regulation. And this is the case with regard to the debate over the effectiveness of monetary and fiscal stimulus in the 1930s. It is certainly the case when we ask whether "it" could happen again.

Be this as it may, it remains true that the conventional account of this earlier period powerfully shapes the outlook of current policy makers. Their views are informed by the Federal Reserve's failure to make decisive use of monetary policy and its choosing, instead, to allow the entrenchment of deflationary expectations. They are informed by the Federal Reserve's failure to execute its responsibilities as a lender of last resort, instead allowing the banking system to collapse. They are informed by historical analyses of the actions of the Hoover administration and Congress, which

Revision of a keynote address presented at the Thirteenth Annual Conference of the Central Bank of Chile. This talk has been evolving for some time. Earlier versions of the material, or portions thereof, appeared in *Current History* (January 2009) and were presented at the annual conference of the Central Bank of Argentina (August 2009).

*Monetary Policy under Financial Turbulence*, edited by Luis Felipe Céspedes, Roberto Chang, and Diego Saravia, Santiago, Chile. © 2011 Central Bank of Chile.

raised taxes in the early 1930s in a futile effort to balance the budget, but only reinforced the collapse of private demand. They are informed by memories of how, although the economic downturn was fully underway already in the second half of 1929, no effective steps to halt the fall in prices, stabilize the banking system, and restart investment spending were taken until 1933.

This time, of course, reflecting these “lessons of history,” U.S. policy makers did not hesitate to act. No sooner did the crisis erupt than the Fed flooded financial markets with liquidity. When the economy continued to weaken, it cut interest rates to zero. It intervened in markets for securitized investments of all kinds. In early 2009, it moved to quantitative easing, purchasing treasury bonds.

On the fiscal front, a first dose of stimulus was administered in early 2008, and the Obama administration and Congress followed in 2009 with their \$787 billion stimulus. They clearly took to heart a further lesson from the 1930s: that when interest rates are cut to low levels, fiscal policy becomes even more important for stabilizing the economy.

Through these actions, both in the United States and elsewhere, we prevented the Great Recession from turning into a second Great Depression. But as for how we got into this mess in the first place and why policy was not more successful in containing the crisis, part of the problem may, ironically, be the tendency to take history too literally. While Black Thursday (24 October 1929) and, more generally, the 1929 stock market crash feature prominently in popular accounts of the Depression, scholarly analyses typically treat the crash as a sideshow and emphasize the crisis in the banking system. Such analyses are organized around the First, Second and Third Banking Crises in 1930, 1931 and 1933. Appropriately so, one might argue, since the U.S. economy was heavily bank-based in the 1930s. But with the passage of time, nonbank financial institutions became more important, reflecting the progress of disintermediation and securitization. The current crisis has been a crisis not just for banks but for insurance companies like the American International Group (AIG), for the hedge funds whose distress sales of securities created problems for other investors, and for the securities markets themselves.

Ironically, memories of the financial crisis of the 1930s, which was first and foremost a banking crisis, may have led policy makers to focus on this segment of the financial system to the neglect of others. At first they lent freely to commercial banks but not to other institutions, reflecting the “lesson of the 1930s” that banks are the

weak link in the financial chain. But in the recent crisis, problems were equally pervasive in the “shadow banking system:” that is, among the conduits and special purpose vehicles of investment banks, which did not initially have access to the Federal Reserve’s discount window, and hedge funds and insurance companies such as AIG. Initially, the Federal Reserve hesitated to support this segment of the financial system. I would suggest that this reflected the power of historical narrative—that there existed in the 1930s no shadow banking system for historians to examine. And it reflected the difficulty of realizing that, while history repeats itself, it never repeats itself in the same way.

One can make the same argument about the tendency for authorities to underestimate the importance of credit default swaps (CDSs) and of the CDS-related financial seizure that would follow from the decision to allow Lehman Brothers to fail. The fact that in the 1930s there was no equivalent to CDSs and other complex derivatives may have meant that our policy makers failed to appreciate their importance. Once again, I am suggesting that, while the policy response was positively shaped by historical narrative, that narrative also distorted the response in unfortunate ways.

None of this is to deny that policy makers have done better this time. Of course it would have been hard to do worse.

Our central bankers have also been in constant communication, which of course they were in the 1930s too. But in contrast to the 1930s, the result has been a good deal of actual cooperation. The importance of cooperation is another “lesson of history.” There have been currency swaps between the Federal Reserve System, European Central Bank, and Bank of England. The European Central Bank (ECB) extended euro and dollar swap lines to European countries outside the euro area and the Federal Reserve did likewise with Mexico, Brazil, South Korea and Singapore. These swap facilities did not magically solve the financial problems of receiving countries, but they alleviated the immediate problem of dollar and euro shortages caused by U.S. hedge funds and European banks liquidating investments. This is quite unlike the situation in the 1930s, when France blocked the extension of credits to Austria through the Bank for International Settlements, due to objections to the formation of an Austrian-German customs union and Germany’s decision to build pocket battle ships in violation of the terms of the Versailles Treaty. This proved a fateful decision that allowed the financial crisis to spiral out of control.

Asia is the one place where I detect echoes of the interwar tangle between France and Germany. While Asian countries created a regional system of financial supports, the Chiang Mai Initiative (now referred to, less elegantly, as the Chiang Mai Initiative Multilateralization, or CMIM), they were unwilling to activate it, even in September–November 2008 in response to the most serious global financial crisis in 80 years. The reason is clear: delicate political relations make it hard for Asian countries to demand policy adjustments of their neighbors, and in the absence of such adjustments they are reluctant to put money on the barrelhead.

To finesse this problem, disbursing credits through the CMIM, after the first 20 percent, requires the recipient to negotiate a program with the International Monetary Fund. But with memories of the 1997–98 financial crisis still raw, governments are unwilling to approach the Fund. Beijing prefers to see the creation of a more extensive financial support system within the region, while Tokyo resists this on the grounds that China would eventually become the dominant party in such a system. The Japanese government would prefer recycling Asian reserves through the IMF, where it has twice the voting power of China and designates one of the deputy managing directors, whereas China, whose voting power in the Fund is roughly equivalent to Belgium's, is understandably reluctant to go this route. China is also reluctant to see its currency appreciate against the dollar, a policy that is creating other problems, described below.

It is tempting to draw a parallel with Charles Kindleberger's (1973) interpretation of the interwar depression: that the Depression resulted from the inability of the declining power, Great Britain, to display leadership and the unwillingness of the rising power, the United States, to do so. This time the United States is declining and China is on the rise. I would argue, however, that the parallel is overdrawn. There is no question that a Chinese contribution would be helpful for solving current problems. But China is not yet capable of exercising the kind of leadership that could reasonably be expected of the United States in 1929. In 1929 the rising power, the United States, was already three times the size of the declining power, Britain. Today, in contrast, the United States is still three times the size of China. This is worth bearing in mind when one hears calls for China to boost consumption by enough to offset the decline in U.S. consumption, as U.S. households seek to rebuild their retirement accounts. If there is going to be a decline in U.S. spending, then we will need more than just China to take up the slack.

The other place where we have done a reasonably good job—and here I need to emphasize the qualifier “reasonably”—is in avoiding protectionism. I am aware of the U.S. stimulus bill’s “Buy America” provisions and their unfortunate counterparts in other countries. I am aware of the scorecard kept by the World Bank, showing some 46 new trade restricting measures worldwide in the five months following Lehman Brothers alone. That said, it is still true that we have done better, this time, at resisting protectionism. There has been no wholesale recourse to tariffs and quotas, as there was in the 1930s.<sup>1</sup>

The difference is attributable, once again, to the “lessons of history.” Here, however, we have an instance of bad history ironically producing good policy. The bad history is the belief that the Smoot-Hawley tariff significantly worsened the Depression and provoked widespread retaliation. Smoot-Hawley is entry number 17 on my list of factors contributing to the Depression, organized in descending order of importance. U.S. tariffs were already high as a result of the Fordney-McCumber “skyscraper” tariff of 1922; Smoot-Hawley raised them only a bit further. Monetary, fiscal, financial, and even competition and labor-market policies were all much more important factors in the slump.<sup>2</sup>

Similarly, the fact is that retaliation against Smoot-Hawley was minimal. The measure that set off a wave of retaliation was the British general tariff of 1932, not Smoot-Hawley.<sup>3</sup> But bad history in the service of good policy has its merits. The very phrase “Smoot-Hawley” was enough to restrain our policy makers from their worst protectionist impulses this time.

The other reason we avoided protectionism this time, as I have argued in work with Doug Irwin, is that we deployed appropriate monetary and fiscal measures. In the 1930s, countries resorted to tariffs in a desperate effort to bottle up the available demand, to ensure that whatever spending occurred was on domestic goods. They resorted to tariffs because the case for fiscal stimulus was not understood, and because monetary stimulus was not possible as long as central banks were constrained by the gold standard. Starting in 1931, all things being equal, countries that went off the

1. See Kee, Neagu, and Nicita (2010).

2. One can even make the argument that Smoot-Hawley had a positive impact by putting upward pressure on prices in a deflationary environment. For the conditions under which this result holds, see Eichengreen (1989).

3. See Eichengreen and Irwin (2009).

gold standard and were therefore able to apply first-best monetary stimulus were less inclined to resort to protection. Able to counter unemployment by other means, they did not invoke the fixed-lump-of-spending hypothesis and resort to protectionism. This is where good history has helped to avert a lapse into protectionism. Insofar as our policy makers understood the need to mount a concerted monetary and fiscal response to a Depression-like threat, their protectionism temptation was less.

Let me now switch gears a bit, although the way I am trying to use history in an effort to shed light on recent events will not go away. Given how the Great Recession was a crisis of the international system, one increasingly hears the question of whether globalization might now be rolled back. Here I would distinguish financial globalization from other aspects of globalization. It is possible to argue that the golden age of financial globalization has already passed. In the future, national financial systems will be more tightly regulated (although how much more tightly we will see). Capital requirements will be raised (although how high, once again we will have to wait and see). Given the urgency attached to creating orderly resolution regimes for nondepository financial institutions (something that can be done at this stage only at the national level, given lack of international agreement on how to structure them), pressure will increase to ensure that the domain of such institutions coincides more closely with the domain of regulation. All this will mean that somewhat less capital will flow across national borders. (I emphasize the “somewhat” in that last sentence, to remind you that I am not getting carried away.)

On the recipient side, emerging markets are keenly aware that countries that relied most heavily on capital inflows suffered the greatest dislocations when the crisis hit and deleveraging occurred. Countries such as South Korea, where half of all domestic stock market capitalization was in the hands of foreign institutional investors, saw their markets crash as these foreign investors liquidated holdings in a desperate effort to repair damaged balance sheets. In contrast, the countries that had internationalized their financial markets more slowly suffered less serious disruption. Governments are therefore likely to do more to limit inflows in the future. We have seen the Brazilian authorities impose a 6 percent tax on some forms of portfolio capital inflow. Korea’s Financial Supervisory Agency has announced it intends to impose additional capital charges on banks borrowing offshore. One can question the

effectiveness of these measures: will Brazil's measures be evaded via offshore markets or Korea's via shifting transactions from bank to nonbank financial institutions, for example? To answer these questions, people will almost certainly return, yet again, to another historical episode, namely, Chile's experience in the 1990s.<sup>4</sup>

The other thing needed to deal with capital flows—you will not be surprised to hear this from me—is exchange rate flexibility sufficient to create two-way bets. The absence of this flexibility is fueling the carry trade, which in turn is giving rise to frothy property and asset markets, especially in Asia. Given expectations that the dollar can only decline and that Asian currencies can only rise, there is an irresistible temptation to use dollar funding, at what are effectively negative real interest rates, to invest in Asia, where values can only rise with currency appreciation. Letting currencies adjust now, so that there is no longer the prospect of a one-way bet, would help to relieve this pressure. Latin America is by no means immune to the carry trade, but the fact that the major countries, not least this one, allow their currencies to fluctuate relatively freely means that this tendency has affected local markets less. To put it another way, the point is that U.S. monetary conditions, which remain loose for good reason, are not appropriate for emerging markets, whose problems are, if anything, incipient inflationary pressure and strong economic growth. And capital flows are the vehicle through which pegging to the dollar causes these countries to import U.S. monetary conditions.

I could cite various historical illustrations of the danger. The locus classicus again is the Great Depression. The carry trade contributed to the unstable equilibrium of the 1920s, as investors funded themselves at 3 percent in New York to lend to Germany at 8 percent. Then as now, the migration of capital from low- to high-interest-rate countries was predicated on the mirage of stable exchange rates.

Another example is the 1960s, when Germany was in the position China is in now. Everyone understood that the deutschemark would rise against the dollar. Everyone who could get their hands on dollars poured them into German assets, since exchange rate policy offered a one-way bet. As a result the Bundesbank was forced to wage a continuous battle against imported inflation. One might object: if this

4. The IMF has already done this, in its assessment of capital controls: see Ostry and others (2010).

problem was so serious, why didn't it result in a dangerous bubble followed by a devastating crash? The answer is that the German authorities limited the impact on the economy. They revalued in 1961 and 1969, and they imposed Brazilian-style capital controls in April of 1970 and May of 1971.<sup>5</sup> But it was only when they allowed the deutschemark to float, first in 1971 but especially in 1973, that they finally got a handle on the problem.

Let me turn finally to other aspects of globalization. I want to argue that what is true of finance—that the golden age of globalization is past—is less obviously true of other aspects of globalization. There is little likelihood that we will see this rolled back. U.S. appliance manufacturers continue to do assembly in Mexico, global credit crisis notwithstanding. German auto companies continue to source parts and components in Eastern Europe. East Asia is of course the prime case in point. Trade there, in parts and components, has been growing exponentially. China is effectively serving as a gigantic assembly platform for the region and the world.

Moreover, the logic for these global supply chains and production networks remains intact. The cost of air transport has fallen by two-thirds since 1950. Ocean freight rates have fallen by a quarter as a result of containerization and other advances in logistics. And what is true of transportation is true of communication: the cost of satellite communications is barely 5 percent what it was in the 1970s. Then there is the cost of communicating via the Internet, a medium that didn't exist four decades ago. The outsourcing of back office services, transcription, data entry, and now software engineering and financial analysis to developing economies reflects these same advances in communications technology, which are not going to be rolled back.

To be sure, one can imagine channels through which the backlash against financial globalization could spread. Trade grows more quickly when there is easy access to trade finance. At the height of the crisis the difficulty of securing letters of credit, which are important for financing export transactions and giving exporters confidence that they will be paid, had a profoundly depressing impact on export and import transactions. HSBC, a leading supplier of trade finance, reported in November 2008 that the cost of insuring letters of credit had doubled in little more than a month.<sup>6</sup> In response, however, there were a variety of concerted interventions by multinationals and national import-export banks. The volume of trade has recovered.

5. See Bakker (1996).

6. See Mortished (2008).



And even if financial de-globalization is permanent, it will still be possible for importers and exporters to obtain trade credit from national sources. That is, even if cross-border financial transactions remain more limited than in the past, it will still be possible for U.S. exporters to get trade credit from U.S. banks and for Korean exporters to get trade credit from Korean banks. When only a handful of countries had well developed financial markets and banking systems, this would have been a problem. It would no longer be a problem today.

There may also be a destructive interplay between the politics of domestic economic liberalization and the politics of globalization. Insofar as a legacy of the crisis is an extended period of high unemployment, the voting public may grow disenchanted with liberalization. The end-August 2009 Japanese elections are consistent with this view. The voting public may grow disaffected with globalization since it has failed to deliver the goods.

Here it will be important for our leaders to make the case for free and open trade. They will have to draw a firm distinction between financial and other aspects of globalization. It will be important for them to distinguish between the need for tighter regulation of financial markets, where the justification is clear on the grounds of consumer protection, market integrity and systemic stability, on one hand, and tighter regulation of other markets, on the other, where the need is less evident and the response should be on a case-by-case basis.

These distinctions were not drawn in the 1930s, when there was a backlash against both trade and finance and when governments intervened equally in domestic and international markets. Experience after World War II is more reassuring. In the third quarter of the twentieth century, global trade expanded vigorously, despite the fact that international financial transactions remained heavily controlled. And notwithstanding enduring hostility to the deregulation of financial markets and liberalization of international financial flows, political consensus favoring trade liberalization was successfully maintained through successive General Agreement on Tariffs and Trade rounds over fully half a century. This experience offers at least cautious grounds for hoping that the same will again be possible. I for one am hopeful.

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