Comment

Parallel lines

- *The two great financial crises of the past 100 years exhibit some notable parallels*
- *True, important lessons in policy-triage were learned from the earlier episode*
- *Moreover, these served to limit the macroeconomic fallout from the recent turmoil*
- *Unfortunately, however, follow-through has been patchy, with other lessons ignored*
- *These oversights have left the global economy unbalanced and vulnerable*

Mixed report card

A second Great Depression has been avoided

Many of the circumstances surrounding the recent Global Financial Crisis are familiar to students of early twentieth century history. And the general consensus is that today's policymakers have done a better job than was done 80-odd years ago. After all, a second Great Depression was avoided. That said, the record is hardly blemish-free: more than seven years on, the trajectory of recovery remains generally shallow and uneven, and the outlook beset by uncertainty.

Today's uninspiring upswing and insecurity suggest that, whatever the achievements of the past several years, some policy choices were off-beam. Unfortunately, in being so, they reflect, perhaps even embody, echoes of past errors.

Depression economics

The causes of the 1930s downturn were many and various …

The propagation and intensification of the Great Depression reflected a number of mutually-reinforcing considerations, extending to deep-seated distortions in the allocation of international resources and policy shortcomings at the conceptual, institutional, and conjunctural levels. [1] These factors can be summarised as follows:

- **A build-up of macroeconomic imbalances and perverse capital flows**. This owed much to the changes in relative economic power and the flawed financial settlement that followed World War I. As a result, the cyclical upswing of the 1920s was regionally uneven, and characterised by numerous underlying vulnerabilities. Globally, prices (especially commodity prices) fell, although Germany, and to a lesser degree France, offered conspicuous exceptions.
- **A fixation with the resurrection of a system of hard currency pegs – the gold standard.** Many of the requisite conditions for the success of the pre-war gold standard, such as flexible wages and prices and a generally rational allocation of international capital, disappeared in 1914. Moreover, the rules that had previously governed the system were in the post-war period often bent or flouted. As a result, the regime first struggled to contain burgeoning financial excess in the US in the 1920s, then it imposed a stifling deflationary bias on to monetary policy in a number of important economies at key junctures, not least at the very depths of the downturn, when exchange rate stability was initially favoured over domestic macroeconomic stability. In the 1930s, the longer an economy was wedded to gold, the longer it remained depressed.
- **Slack regulation and oversight in a number of financial systems, and especially the US**. In combination with the intermittent tailoring of Federal Reserve interest rate policy to prevent excessive gold inflows, the regulatory regime encouraged undue private sector leverage, a build-up of low-return physical investment, and speculative excesses in various risky asset markets, including housing. And the distribution of income became markedly more unequal.
- **Banking system fragilities.** When the downturn came, many banking systems were fragmented, inadequately serviced by the central bank as lender of last resort, and exposed by poor systems of deposit insurance and prudential management. The many bank failures in the US and in Europe resulted in the significant loss of deposits, the blocking of accounts, and an unwillingness to lend. Animal spirits experienced a crushing blow.
- **The lack of a global hegemon.** The huge economic and financial costs wrought by World War I meant that the UK could no longer fulfil this role. The US, relatively unscathed by the conflict, was the most powerful economy in the world: but it had neither the mature institutions, the personalities, nor the desire to take up the mantle. Neither was there any international agency to co-ordinate policy and channel emergency aid and funding.
- **Macroeconomics in its infancy.** There were few macroeconomic data, government share in GDP was small, and automatic fiscal stabilisers were underdeveloped. There was little understanding of the concept of effective demand, or of how fiscal and monetary policy might be employed to sustain it. Theories of stabilisation policy were being developed, but they were incomplete and often treated as heresy by the powers that be. Going into the crisis, the

conventional wisdom was that, provided governments were left well alone, focussing in particular on 'sound finance' and currency stability, economies would soon shrug-off shocks.

- **Protection.** A rising tide of protectionism in the 1920s morphed in the 1930s into tariff wars, the creation of discrete trading blocs, wholesale exchange controls and, in some cases, not just bilateralism, but reversion to barter. The tendency to turn inwards in the search for remedies to the slump poisoned the well of international co-operation and flattened international trade.

History resonates

… and some are all too familiar today

Consideration of this list reveals a number of similarities between the earlier period of financial turmoil and the most recent emergency.[2] In the run-up to 2007, for example, the world was similarly beset by large macroeconomic imbalances and perverse international investment trends. The emerging-market savings glut and tendency of capital to flow 'uphill' to the developed world was particularly aberrant, and exerted destabilising downward pressure on risk premia.

Policymakers, meanwhile, demonstrated an analogous fixation with rule-based policy regimes. Inflation-targeting was near ubiquitous; and Europe opted for the hardest of hard currency pegs, a currency union. Narrow inflation-targeting, while outwardly successful in eradicating previous inflationary excesses, and for a time seemingly consistent with macroeconomic stability, proved ill-equipped to address financial excess and capital misallocation. The creation of the euro in advance of thoroughgoing fiscal and banking union, and when Europe lacked the institutional and supply-side flexibility to cope with large asymmetric shocks, exacerbated the crisis, and has become associated with deepening deflationary pressures.

Encouraged by the ascendency of the free-market credo, and the apparent tendency towards macroeconomic stability, financial regulation of once-tightly-controlled systems was increasingly left to the sector's own devices. Long-dormant hazardous conflicts of interest within financial firms were resurrected, wholesale funding exploded, bank capital ratios were inadequate, compensation and incentive structures became increasingly warped, prudential oversight and risk management systems failed to keep up with increasingly complex and highly-geared investment vehicles, and a huge shadow banking system of hedge funds, private equity firms and other opaque and barely-regulated entities emerged.

Financial market exuberance, private sector balance sheet excess, and large distributional gains for the asset-rich were the inevitable consequence of all this, yet, as in the 1920s, there was little consensus among policymakers about what constituted a bubble, and hence what could, or should, be done about it. When asset values reversed, just as in the 1930s, paper wealth disappeared, confidence and trust in the financial sector evaporated, and leverage, which had hitherto been everyone's friend, became a savage enemy. The much-vaunted macro stability proved to have been an illusion.

Lessons learned and errors repeated

There are, however, also major differences between the era of the Great Depression and the 2008 crisis. Three especially stand out.

Important policy pitfalls were no doubt avoided ….

First, there has, so far, been no slide into outright protectionism and bilateralism. Second, notwithstanding the political tensions within the euro area, neither has there been a complete breakdown in international co-operation. And third, and most importantly, policymakers grasped the central importance of back-stopping financial systems and sustaining aggregate demand. As private sector spending slumped in 2009, fiscal policy was loosened aggressively across the globe. Meanwhile, central banks, albeit on occasion with a lag, acted as generous lenders of last resort, and monetary policy was loosened dramatically.

At the same time, mistakes were made: and some have been redolent of the blunders and miscalculations of the 1920s and 30s. In particular, in our judgement, policy activism has not been allowed to go far enough. Although conceptual frameworks have become more sympathetic to dealing with a major financial crisis, policymakers have again been hampered by incomplete data and, in some cases, by a lack of imagination. As in the Great Depression, they failed to grasp just how bad things were becoming, and hence their response fell short. Furthermore, even when policymakers' diagnoses were accurate, implementing the optimal response proved impossible in the face of entrenched vested interests and political opposition.

History, or at least its interpretation, also on occasion gave policymakers a poor steer. The Great Depression was in many ways a bank-based crisis, and Fed Chair Bernanke was one of the foremost academic experts on how banking sector dysfunction exacerbated the downturn. But, especially in the US, the 2008 crisis was grounded in the opaque world of shadow banking. Policymakers, not least those under Bernanke's tutelage, at first gave insufficient weight to the influence of hedge funds, money market funds, special purpose vehicles, and derivatives, which were immune to deposit insurance, bank capital requirements, and other policy responses.

… but equally mistakes have been made …

The inter-war years showed clearly the dangers of shoehorning a series of heterogeneous economies into a single, tough, exchange rate regime, the tendency for capital flows in such regimes to gravitate from low interest rate economies to high interest rate economies, the traumatic consequences when these flows stopped, and the social and political turmoil that ensues when the only viable response is perceived to be one of austerity. Yet the euro has remained sacrosanct as the keystone of European economic policy.

The success of the immediate policy response in preventing an outright collapse in economic activity weakened the incentive to follow through with a more sustained approach to stimulus and reform. Quantitative easing was initially applied episodically. Financial sector vested interests were able to mobilise to oppose radical change in regulation. And in the euro area, it was impossible to overcome resistance to the pooling of sovereign debts and comprehensive banking union.

The avoidance of catastrophe also encouraged rapid policy normalisation after the emergency had passed. Fear of inflation and public indebtedness quickly returned to the top of the policy agenda, much as in the US in 1937, and with some of the same unfortunate consequences.[3] Although market pressures were focussed on individual sovereign delinquents, fiscal expansions were generally thrown into reverse in 2010, as the oxymoronic notion of 'expansionary fiscal contraction' came into vogue. The idea that underinvestment in infrastructure, research, and education could and should be reversed when interest rates were historically low gained little traction.

… sometimes for very understandable reasons …

Central bankers, meanwhile, were conflicted. While many saw and acted on the logic of offsetting the impact of fiscal U-turns, they were also conscious of political opposition to their expanding role as unelected technocrats. They exercised restraint, not least to protect their independence. Monetary policy has become extraordinarily unconventional, yet its evolution has often proved hesitant and reluctant, and radical options such as nominal GDP or price level targeting, the elevation of inflation targets, and outright debt monetisation have (so far at least) been eschewed.

… although other errors warrant less sympathy

The inflation of the 1970s proved a more palpable and enduring influence than the distant, deflationary, 1930s, while issues of moral hazard, if not morality *per se,* have intervened in the policymaking process. The speed and manner in which unconventional monetary policy has progressed has been influenced by concerns that super-low interest rates and abundant liquidity threaten another bubble and crash. But it is in Europe that moralistic arguments against unorthodoxy have exerted the greatest influence. The notion that for every reckless borrower there was a reckless lender has been lost. The northern creditor nations see themselves as virtuous and prudent, but dismiss the southern European debtor nations as unprincipled and spendthrift. For their part, the southern Europeans have come to view the north as patronising and callous.

Such entrenched attitudes have stymied the introduction of optimal macroeconomic stabilisation policies. In particular, the 1930s lesson that it was very hard for closely-knit economies collectively to export their way out of a slump has been forgotten. Just as importantly, the political effort being put into saving the euro is sapping the energy for institutional reform and sovereign debt restructuring. At the very least, European integration has been set back a long way.

Finally, too little has been done to make the world a safer financial place. Too many entities remain too big to fail. Increases in liquidity and capital requirements have been limited. Controls on banks' proprietary trading are patchy and incomplete. The movement of derivative trading into clearing houses may have concentrated risk rather than reduced it. European banking union is partial.

Enduring vulnerabilities

The world remains today acutely vulnerable to shocks

The failure to take on board all the lessons of history leave the global economy, Europe especially, in a fragile and dangerous condition. The risks of a repeat of 2008 are higher than they should be: the ability of the global economy to escape with limited damage next time is questionable.

Watch for:

- A dramatic reaction in both the markets and the real economy to US monetary tightening.
- Further traumatic iterations of the euro area's existential crisis.
- More resort to financial repression, fiscal unorthodoxy, and protection to create policy space.■

[1] For more details see chapters 4, 14, and 17 of Jones, Russell (2014). *The Itinerant Economist. Memoirs of a Dismal Scientist.* LPP.
[2] These points expand on themes developed in Eichengreen, Barry (2015). *Hall of Mirrors. The Great Depression, the Great Recession, and the Uses — and Misuses — of History.* OUP.
[3] It is a little known fact that the US downturn of 1937, provoked by a simulataneous and premature tightening of fiscal and monetary policy, was actually initially more precipitous than that of 1929. Unemployment, close to 25% of the workforce in 1933, was back at close to 20% of the workforce in 1938. It was only when this tightening of policy was thrown into reverse (not least because the US had begun to re-arm) that recovery resumed.