Roots of Our Depression

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The parallels between 1930 and 2009 grow more frightening by the day. The collapse of asset valuations on Wall Street since October 2007 is almost exactly tracking its fall starting in October 1929. The fall in global industrial production since April 2008 precisely matches its fall from the August 1929 peak. In the case of global exports, the fall since April 2008 is actually faster than that after August 1929, the earlier efforts of Senator Smoot and Representative Hawley notwithstanding.

The big difference in the two episodes is of course the policy response: tepid and half-hearted after 1929, but aggressive starting in 2008, or so it would seem. The $64 trillion question is whether these policies will work. Are they well designed? And will governments and central banks follow through on their commitments?

Understanding whether these policies will get us out of this Depression— for it is quickly getting to the point where we can call it that —requires understanding how we got in. The disturbing parallels between the current situation and the post-1929 slump extend to this aspect as well.

The modern scholarly consensus is that the Great Depression resulted from sharp changes in the global financial landscape on which were superimposed a rigid and unrealistic policy ideology. The late 19th and early 20th centuries had seen the integration of significant new powers into the world economy. There was the industrialization of Germany, but above all there was the emergence of the United States as the largest economy in the world. This changing of the guard was then greatly accelerated by World War I. The United States became the leading global creditor, and Britain's international creditor status was greatly weakened. Germany was on the hook for $33 billion of reparations, and most of its payments ultimately flowed to the U.S. in repayment of war debts. The result was large 뱊lobal imbalances,?with the U.S. on the receiving end. All this liquidity pouring into U.S. markets had to go somewhere. It went first into a real estate bubble in Florida and then into a high-tech bubble on Wall Street.

Superimposed on this financial landscape was a rigid gold-standard ideology that prescribed maintaining prewar exchange rates and financial relationships. Where the growing strength of the U.S. economy and its balance of payments should have been offset by a stronger dollar exchange rate, this ideology instead dictated restoring the prewar constellation of rates.

This left the international monetary and financial system poised for a fall. All that was needed was a small shock – a small rise in policy rates by the Federal Reserve designed to slow the Wall Street boom – to bring the whole house of cards tumbling down.

At this point the rigid and unrealistic gold standard ideology came into play. It made things worse, since it counseled inaction. Only starting at the end of 1931, after the world economy had already gone to hell in a hand basket, was this destructive ideology finally abandoned. Exchange rates were allowed to adjust. Monetary policy was freed up. Central banks could intervene to stabilize their banking systems. But not before millions of innocent victims had suffered immense economic pain and suffering. And not soon enough to avert still graver consequences starting in 1939.

Now again this same combination of sharp changes in the global financial landscape and a rigid and unrealistic ideology have resulted in a crisis as grave as the Great Depression. This time the change in the global financial landscape is the rise of China and the emerging-market savings glut that flooded U.S. markets with cheap funds. The rigid and unrealistic ideology is of course the ideology of deregulation that allowed institutional investors to allocate those funds however they pleased.

The debate is generally framed as a contest between these two factors – which one really mattered? Ben Bernanke blames the crisis mainly on the global savings glut. Others put the onus mainly on lax regulation informed by the mistaken belief that financial markets were inherently stable and self regulating. The reality is that both factors played a role, now as in the 1920s. And it was their interaction that set us up for such a painful fall.

The big difference between the 1930s and the current situation – or so one hopes – is the policy response. Back then it took considerable time, measured in years, for central banks to free themselves of their anachronistic ideology and expand their balance sheets. Even then monetary expansion was tentative. The U.S. for example, rather than expanding money and credit proactively, relied entirely on currency depreciation to attract gold inflows as a way of re-liquifying its economy. Fiscal stimulus, such as it was, was tentative and undersized. Only when governments ramped up spending on rearmament with the approach of World War II did fiscal policy have a measurable impact.

Now, in contrast, the Fed has been quick to cut its policy rate to zero. Its balance sheet has expanded at warp speed, with other central banks not far behind. The U.S. and China have put in place fiscal stimulus packages approaching 2 per cent of GDP in 2009. We are about to get a real-time test of whether a more aggressive policy response would brought the Great Depression to an early end.

Or are we? In fact there is a danger that monetary easing may work less well than in the 1930s because we have failed to fix our broken banking system. Monetary stimulus may be felt by the economy through a variety of channels, but the most important conduit is still bank lending. And until we fix our broken banking systems, the best efforts of central banks to re-liquify their economies will come to naught.

Here it is particularly disturbing that the United States continues to hesitate to properly recapitalize its banking system. One suspects that Treasury Secretary Geithner understands the issues but is hamstrung by political opposition. Recapitalization will require large amounts of public money. And the Congress, which is a sounding board for popular anger, is likely to refuse to appropriate one more dime of taxpayer money to fix the banks, for better or for worse.

Similarly, as the U.S. economy continues to deteriorate, it looks increasingly likely that another dose of fiscal stimulus will be needed. But rather than engaging in sober debate over how and when, the political class has declared civil war. It has resumed ancient ideological fights about the evils of big government. We even have the specter of President Obama's opponents hoping that his attempt at stabilizing and reviving the U.S. economy will fail so that their own relative political position will be enhanced. This attitude is unlikely to produce the fiscal policy that America needs.

In Europe, similarly, economic prejudices and misunderstandings are gaining ground as conditions worsen. The ECB resists cutting interest rates further, fearing that it will create a liquidity trap, where the reality is that zero interest rates are a symptom of – and an appropriate response to – a liquidity trap, not in and of themselves a cause. Individual EU member states are reluctant to apply the fiscal stimulus that the European economy desperately requires because the integration of their economies means that much of the positive impact will leak out and benefit their neighbors. Increasingly, one fears that Europe will have neither the monetary nor the fiscal policy that it needs to avert economic catastrophe.

So there is a choice. If we put in place appropriate policies, we can have a proper test of whether similar policies could have quickly ended the Great Depression. In other words, if such policies quickly end this Depression, we can be confident that they would have quickly ended the earlier Depression well. Or we can replay the disaster that was the 1930s. In which case we will inherit two historical episodes, about which both it can be asked: Would better policies have made a difference? And, if so, why didn't politicians see the light?

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