Financial crisis and depression: Are there lessons to draw from the Great Depression?[1]

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Abstract:
This paper compares the crises of the 1930s and 2008 on two points: firstly, policymakers' reactions at the height of these two banking and financial crises (reactions that differed substantially, notably thanks to the experience gained from the Great Depression in both the US and Europe); secondly, the financial regulations implemented in the wake of each crisis. We show how the set of regulations adopted during the Great Depression was gradually challenged from the 1950s to the 1990s. Many inconsistent or inefficient provisions were done away with, but these changes led to renewed critical weaknesses that would become apparent in 2008. Due to a lack of consensus among policymakers and economists, the lengthy period of stagnation since 2008 has not (yet) given rise to a regulatory trend of similar magnitude.

Every time a serious economic downturn strikes the US,[2] comparisons with the Great Depression of the 1930s flourish. Just after the 2008 "Great Recession" broke out, such comparisons abounded among economists and policymakers (Eichengreen and O'Rourke, 2009, 2010; Krugman, 2009; Short, 2009; Voynet, 2008). Eichengreen and O'Rourke's successive articles, published on the VoxEU policy portal, clearly showed that the 2008 crisis struck with an intensity that was equivalent, if not greater, than its 1929 predecessor. On a global scale, GDP, world trade and stock market indices suffered very abrupt declines in the months following the peak. These comparisons reached a very large audience (nearly 450,000 views, according to VoxEU), and this popularity was no doubt one of the factors that convinced policymakers that the situation was urgent and warranted radical decisions. Thus, on 24 November 2008, Barrack Obama, then president-elect, appointed Christina Romer, a professor of economics at Berkeley, as the Chair of the Council of Economic Advisers, specifically mentioning her research on the Great Depression. The Obama administration's stimulus package was directly inspired by Romer's experience. In Europe, Mario Draghi stated without hesitation that the European Central Bank's actions had averted a major depression.[3] Additional proof of this lasting preoccupation with the Great Depression, the highly reputable *Oxford Review of Economic Policy* published, in October 2010, a special issue on the 1930s crisis – as did the academic journal *Daedalus* and probably others. Then the flow of publications came to a halt, with the 2010 economic recovery and ensuing stability that most likely prompted certain observers to conclude that the comparison was no longer very pertinent. It then became apparent that the two crises, while bearing some resemblance in terms of financial

1 I would like to thank Eugene White for his suggestions regarding this paper.
2 As economic discourse has focused on the US since 1945, whatever happens elsewhere never has the same impact on this discourse.
3 *New York Times*, 2016.

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imbalances both within certain major economies and internationally, were very different in other respects. In Europe, in particular, the current context of EU integration is strikingly different from the 1930s context of acute tensions left over from the First World War and the subsequent conflictual monetary and fiscal stabilisation measures. This explains why, although the euro area debt crisis was long and difficult to resolve, it did not tear apart the euro area. Moreover, China's emergence, while challenging US domination (just as the US's emergence had upturned British domination), is a more gradual process and, for the time being, more contained on a financial level. In this article, we will set aside these crucial factors (for an overview, see Hautcoeur, 2009) to focus on two comparisons between the Great Depression and the Great Recession: the handling of banking and currency crises, on one hand, and the resulting new financial regulations, on the other hand. The former point illustrates one of the reasons why the 2008 downturn did not degenerate into something worse, whereas the latter shows us the lessons that were drawn from the earlier crisis. These lessons still inform how we think about financial regulation today.

Emergency bailouts

In 1929 as in 2007, policymakers were able to resolve the earliest troubles relatively easily, and this success minimised underlying tensions and suggested that ordinary methods of action could continue. This was the case for the October 1929 stock market crash (even though collective memory often views this crash as having "caused" the Great Depression[4]). This was also the case for the subprime lending crisis in the US, which began in April 2007 with the bankruptcy of New Century Financial, a major subprime lender, followed by the emergency bailout in August 2007 of Bear Stearns, which was sold to JP Morgan Chase with support from the US Treasury.

Historians have confirmed the existence of a speculative bubble in the 1920s on the US housing market and on property-related equities. This was followed by a stock market bubble in 1928-29, probably fuelled by enthusiasm for new technology shares and by excessive lending to stock brokers (Rappoport and White, 1993). The first bubble began to burst in 1926, hitting the property sector hard and possibly contributing to the Wall Street crash, but without a strong impact on banks (White, 2009; Goetzman, 2010). The bursting of the stock market bubble battered speculators who had borrowed money to buy shares, as well as the banks that had lent to them – with repercussions on the economy due to a drop in the value of financial portfolios (Romer, 1990). Nevertheless, the Federal Reserve Bank of New York (which at the time was still fairly independent and had more experience than the Board of Governors of the Federal Reserve System, i.e. the Fed) promptly intervened with the liquidity needed to prevent any dramatic downturns.[5] The impact on the economy was limited to a small fraction of the population and could not have been considerable. This crisis, while acute, was still an ordinary cyclical crisis, perhaps worsened by the under-regulated financial market that had grown too quickly in the 1920s as New York became the dominant financial marketplace in the globe. However, basically, this was no worse than the 1921 crisis and it was resolved by intervention by monetary policymakers. What made the depression

4 See Youssef Cassis's ongoing research on the memory of financial crises.
5 The Fed had analysed the Paris Bourse crash of 1882 and concluded that it should refinance brokers to avoid a chain reaction affecting the banks that financed brokers, and thus prevent a collapse of the Stock Exchange.

unique were the banking crises that occurred in late 1930, in 1931 and in spring 1933 (Friedman and Schwartz, 1963); only the radical measures taken by President Franklin D. Roosevelt in spring 1933 were able to stabilise the financial system and send the economy into recovery. In Europe, spring and summer 1931 also saw a series of major banking crises, on top of currency crises that erupted regularly until the end of 1936. Similarly, it was not until the collapse of Lehman Brothers (one of the leading US investment banks) on 15 September 2008 that liquidity abruptly dried up on the US money market, sparking fears of a widespread banking system collapse.

The difference in reactions is crucial. In early September 2008, the federal government took control of the two mortgage financing companies Fannie Mae and Freddie Mac (which held nearly half of all mortgages in the US). This move illustrated the sizeable potential losses and the need for those losses to be covered by the federal government, which had been responsible for encouraging increased mortgage lending by Fannie Mae and Freddie Mac. The government and the Federal Reserve had decided to set an example with Lehman Brothers, which was apparently insolvent (although its actual insolvency has been disputed since then) and which clearly bore some responsibility for the mortgage market situation. However, the collapse of Lehman Brothers set off a wave of panic. The very next day, the government had to bail out the financial conglomerate AIG; this merely heightened fears. The actual bailout phase fairly clearly involved actions by the government and the Fed that went beyond their ordinary remit. Thereafter, stabilising the situation involved monetary policy that was not only more accommodative (which assumes that there is unmet demand) but was also even active, “flooding” the market with liquidities (the term was used in a frequent firefighting metaphor). The Federal Reserve, which had begun to lower its rates further and further but without expanding its overall balance sheet (the Fed’s key rates stood at 0% at end 2008), unhesitatingly purchased public- and private-sector financial assets on a massive scale during the acute phase of the crisis. As a result, between September and December 2008, its balance sheet expanded threefold before levelling off (Wheelock, 2010).

This aggressive monetary policy was directly inspired by the experience of the 1930s. Federal Reserve Chairman Ben Bernanke had, like Christina Romer, studied the 1930s at length (see his collected articles on the subject in Bernanke, 2000). And like Milton Friedman and Anna Schwartz, Bernanke was convinced that banking crises had been *the* cause of the Great Depression, due to the Federal Reserve’s overly restrictive monetary policy. Inspired by Irving Fisher’s interpretation contemporaneous to the crisis (1933) and supported by theoretical research on information asymmetry in credit (Stiglitz and Weiss, 1981), Bernanke viewed the Great Depression as a vicious circle in which an initial shock was magnified by growing uncertainty, a flight-to-liquidity, with failures of some banks impacting the rest of the banking sector. Meanwhile, companies – asphyxiated as lending dried up – desperately cut their prices and laid off workers, triggering deflation, unemployment and a drop in demand. Faced with this situation, the Federal Reserve’s policy was too restrictive: on one hand, it intervened too little to rescue struggling banks, resulting in thousands of bank failures; on the other hand, it raised its rates and reined in credit as soon as the acute crises were over. This mistaken policy was driven by a conviction that liquidity needs were met with a low nominal rate (although prices were declining, leading to a high *ex post* real interest rate) and by the fact that discount window borrowing was low (this may have resulted from banks’ fear of being stigmatised or by a lack of collateral), as well as concerns about the foreign convertibility of the dollar (despite considerable reserves of gold and silver). In all, the overly timid interventions by monetary authorities (and the correspondingly weak fiscal intervention) did not prevent further bank failures, an additional decline in the money supply and further deflation.[6] In 1932, President Hoover's administration extended the Fed's power to lend during exceptional circumstances (although the Fed made little use of this) and, bowing to public pressure, created the Reconstruction Finance Corporation (RFC) to lend fresh capital to struggling banks. Nevertheless, it did not make widespread use of the RFC, which therefore failed to yield the expected results.[7]

Bank failures continued until confidence was restored by the cumulative psychological impact of a bank holiday (with all banks closed for inspection), massive support from the RFC (which in 1933 acquired stakes in half of all banks in the nation; Mason, 2001) and – probably the key factor – the decision to take the dollar off the gold standard. The upturn in growth of the money supply (which grew by 10% p.a. from 1933 to 1937) undoubtedly contributed to the economic recovery, alongside other New Deal measures.

Thus, historians regard the US banking crises as having played a crucial role in the deepening of the US depression. In Europe, the depression's second epicentre, interconnected banking and currency crises played an essential role – largely independently of the US crisis. With regard to France, recently-published research by D. Lacoue-Labarthe, as well as ongoing research by E. Monnet, A. Riva and S. Ungaro at the Paris School of Economics, suggests that a very large number of mid-sized regional banks disappeared, causing declines in credit intermediation and credit supply that were underestimated in previous research focused on the major Paris-based banks and the Banque de France, which had no liquidity problems (notably thanks to France's international position that enabled it to attract foreign capital). The Banque of France's bailouts of the largest banks did not prevent overall deflation, all the more as the unyielding focus of monetary policy was on maintaining the gold standard and on warding off inflation (an obsession left over from the 1920s).

The banking crisis was more visible and dramatic in central Europe, beginning with the collapse of Austria's Creditanstalt, which had held 70% of all Austrian bank assets following its takeover of Bodencreditanstalt in 1929 (Schubert, 1991). Creditanstalt was rescued by the government and central bank, but the burden for public finances and in terms of money creation was so great that the convertibility of the currency was immediately jeopardised. Then, in Germany, a wave of failures led to the nationalisation of the main banks and implementation of foreign exchange controls in summer 1931. There, too, recent memories of hyperinflation prompted a strong focus on protecting the currency. In the UK, the banking system was resilient but the currency fell victim to the liquidity needs of European banks, which repatriated assets from London. All in all, the countries whose banking sectors were dominated by small-scale, undiversified banks suffered major banking crises and therefore endured harsher downturns in the 1930s – chiefly because monetary authorities in those countries rejected outright monetary stimulus that would have offset the banking crisis effects (Bernanke and James, 1991; Grossman and Meissner, 2010).

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6 More recent research (Calomiris and Mason, 2003) suggests that bank failures are not caused by panics but by the economic difficulties of banks' clients – apart from the major 1933 banking crisis, just before Roosevelt took office from Hoover, which was probably due to the uncertainties of this political change. While these findings challenge the exogenous nature of banking crises as the Depression's primary cause, they do not diminish the role of banking crises in worsening the downturn, nor do they downplay the need for resolving such crises.

7 Initially, few banks turned to the RFC for support because their names would be made public, sparking immediate concerns amongst their creditors.

Aside from banking crises, currency crises triggered a dislocation of the international currency system, which was based on the gold standard that had just been implemented across Europe following the difficult adjustments required after the First World War (Wolf, 2010). The devaluation of the pound (in September 1931), a major international trauma at the time, was followed by several countries in the years thereafter. Still other countries followed in Germany's footsteps in implementing foreign exchange controls and seeking autarky. Within the gold bloc led by France, maintaining the gold standard was only possible through protectionism and deflationary policies that worsened the crisis.

The 2010 European sovereign debt crisis (which began when the main credit rating agencies downgraded Greece's sovereign debt in December 2009) also merits a comparison with the 1930s, with the euro replacing the gold standard as a straitjacket preventing the exchange rate adjustments that would have ended the crisis (Eichengreen, 1992). Under the gold standard, not only were exchange rates fixed, but so was the conversion rate to gold. This prevented any joint currency adjustment. By contrast, the euro (like the dollar) can float against the other global currencies, notably the Chinese yuan. Whereas in the 1930s, devaluations generally occurred under pressure from the markets and with no international coordination, resulting in negative externalities in the countries still on the gold standard, during the 2010 crisis, the EU, the IMF and the ECB undertook a genuine coordination effort. An emergency plan was set up rapidly, with the ECB announcing in May 2010 that it would accept Greek sovereigns as collateral regardless of their credit rating, whilst the EU unveiled a €110bn bailout, as well as a €750bn "financial stability facility" jointly sponsored by the EU and the IMF. As there is no fiscal union at EU level, we are unable to know how the debt burden will be apportioned or which economic policy would be most effective at reducing the EU's internal imbalances. Nevertheless, a lesson was obviously learnt from the uncoordinated – or even hostile – actions taken by neighbouring countries in the 1930s, when the rising number of defaults (Germany defaulting on war reparations, then France and the UK defaulting on war debts) and ensuing retaliation measures caused most countries to retreat inwards and accelerated capital flight to the US in the run-up to the Second World War.

The New Deal and financial regulation

The conventional interpretation of US financial regulation in the 20th century goes as follows: the New Deal replaced a deregulated financial system with regulations that would avert financial and banking crises for several decades. The dismantling of these regulations, under the influence of neoliberal ideas, rekindled successive financial crises that culminated in the 2009 downturn. However, this narrative warrants clarification on several points and is the subject of a very important debate.

As noted by Temin (2010), due to the quirks in the US election calendar, Roosevelt took office nearly four years after the crisis began, at a time when public opinion was eager for new – even radical – solutions, in an international context of statist policies in Germany and the USSR. By contrast, Barack Obama was inaugurated at the height of the crisis. He was able to take action rapidly, but unlike Roosevelt, he did not have to face political pressure that had built up over years of depression. As a result, Obama did not have to – or was unable to – implement radical reforms, notably with regard to the financial sector. The proponents of deregulation welcomed this situation and emphasised the errors that Roosevelt had made (Calomiris, 2010). Others highlighted the political coherence of Roosevelt's reforms or underscored that they were necessary to address the intrinsic instability of the financial sector (Minsky, 1986). To understand this debate more clearly, let's look at the main characteristics of the New Deal's financial regulation in its original context.

Contrary to what is commonly believed, the US financial system *was* regulated – probably more than any other financial system – before 1929. Since the National Banking System's inception in 1863, *national banks* (i.e. in opposition to *state banks* regulated at the state level) were chartered and strictly supervised by the Comptroller of the Currency, under the authority of the Department of the Treasury. Overcoming decades of hostility to a central bank, the Federal Reserve System was created in 1913 to tackle recurring banking crises. Firms that wanted to issue shares also had to comply with information obligations. Debates about new regulations arose during the 1920s, but the Hoover administration did not envisage an actual regulation of the financial system, even in the midst of the crisis. Granted, in 1932, the Senate bowed to public pressure and set up a commission tasked with investigating banks' behaviour during the crisis. This commission's approach was initially very consensual until after Roosevelt's election, when the lawyer Ferdinand Pecora was appointed to lead the enquiry, which adopted a more aggressive tack. The Pecora Report highlighted shady practices and serious conflicts of interest around the issuance of securities. Roosevelt used the report's findings as a basis for a series of major reforms.

In 1933, the Glass–Steagall Act separated banks' commercial and investment activities, adhering to the real bills doctrine and in reaction to the lending abuses of the 1920s and against the McFadden Act of 1927 (which had made it easier for commercial banks to create investment banking subsidiaries). Also, in 1934, the Pecora Report gave rise to measures that strengthened obligations to inform investors and scaled up supervision of stock exchanges and brokers thanks to the creation of the Securities and Exchange Commission.

However, with its focus on large banks and the New York Stock Exchange, the Pecora Report did not enable the structural weakness of the US banking system to be addressed. It did not challenge restrictions on branching (i.e. banks' creation of branches in states other than their home state), which were viewed as one of the major reasons behind the magnitude of the banking crisis. The dispersion of the banking system was a source of weakness as it hampered diversification (in terms of both liabilities and assets), led to unstable pyramids of reserves in financial centres, and hindered coordinated responses to crises (Calomiris, 2010). The US banking system was characterised (and in fact is still characterised today) by a very large number of small banks operating primarily on a local basis. From late 1929 until late 1933, the number of banks fell from 24,633 to 15,015, with bankruptcies of more than one-third of banks accounting for 14% of deposits, in contrast to the highly concentrated Canadian banking system, which went through the depression unscathed and cushioned the impact of the economic downturn (Bordo *et al.,* 2011). However, far from challenging the branching restrictions, the Glass–Steagall Act fulfilled a former demand from small banks by requiring deposit insurance (this would favour those smaller banks that had withstood the financial crisis; White, 1983; Calomiris and White, 1994). Thus, this act went against the 1920s trend whereby many mergers and loosening of legislation in certain states had allowed an initial movement of banking sector concentration. As for deposit insurance, while protecting small depositors, it also created risks by dissuading creditors from monitoring banks' behaviour. The Glass–Steagall Act also restricted the creation of new banks. In addition, Regulation Q limited the interest rates that banks could offer their depositors. The regulation's aim was to prevent Wall Street banks from channelling capital to the stock market, but it also restricted competition.

In keeping with the spirit of the times, these measures – which were hostile to the large banks and the New York Stock Exchange – coincided with more direct forms of intervention. In reaction to the bursting of the speculative property bubble in the 1920s and the troubled mortgage market (more than 20% of mortgages were in default in 1933) that blocked any recovery in construction (one-third of construction workers were unemployed), Roosevelt created the Federal National Mortgage Association (Fannie Mae) to revive mortgage lending (McLean, 2015). Furthermore, the Glass–Steagall Act authorised the Fed to purchase government securities. This made it easier for the federal government to obtain financing and created an inflationary bias that was coherent with dollar devaluation but potentially costly in the long term (Calomiris and Wheelock, 1998).

These regulations ushered in a lasting period of financial stability, with no major crises occurring until the S&L (savings and loan) crisis broke out in 1986. However, they were gradually undermined as a "dirigiste" approach to economic policy was challenged, on one hand, and interest rates rose, on the other hand, after the 1951 Treasury-Federal Reserve Accord put monetary policy back in the Fed's hands. These higher interest rates caused pressure to build up in a segmented system of financial institutions competing for the same resources (e.g. between banks and S&Ls, which were not subject to Regulation Q), and spawned new financial products that circumvented regulations and gradually revived the market's central role. Branching restrictions were increasingly regarded as ineffective and were lifted after the bankruptcies of the 1980s. Other regulations were circumvented: beginning in the 1970s, money market mutual funds became a way around Regulation Q, and CDARS was basically deposit insurance with no deposit ceiling. The ban on banks underwriting securities was gradually circumvented after 1987, until finally the 1999 Gramm-Leach-Bliley Act repealed the Glass–Steagall Act. More paradoxically, the pension funds created by the New Deal to manage retirement savings also fuelled the re-emergence of powerful financial markets and helped destabilise other financial institutions (Kregel, 1997). Transactions for pension funds became too large for traditional stock brokers, and membership in the New York Stock Exchange was opened up to investment banks in 1970.

Little by little, all the financial legislation of the New Deal was taken apart. Competition intensified, sparking innovations as well as greater risk-taking (Allen and Gale, 2000). Does this mean that excessive risk-taking then developed, triggering warning signs (the collapse of Long Term Capital Management in 1998 or Enron in 2001) before causing the current crisis (Temin, 2010)? Or does it mean that the New Deal regulations survived so long only because of an extended period of growth, and were not repealed systematically enough in favour of a truly uniform market (Calomiris, 2010)? Undeniably, a detailed look reveals that New Deal regulations were not always coherent – but deregulation actually worsened the disorder. For example, Fannie Mae was privatised (in 1968), then the government created a competing institution, Freddie Mac, in 1970. Later, government policy and competitive pressure converged to push Fannie Mae to finance itself in a way that compromised its stability, setting the stage for the 2008 crisis.

Yet overall, the financial reforms of the New Deal formed a system with a broader set of policies that overhauled labour and taxation and created Social Security. These reforms were aimed less at economic efficiency and more at a fairer distribution of employment and income, combined with less instability. With regard to the financial sector, the New Deal sought to segment the credit market to ensure stability for each segment and especially to guarantee government oversight to the detriment of major financial institutions and the central bank. This went hand in hand with the federal government taking on greater powers from the states (the federal budget more than doubled as a percentage of GDP, and whether intentionally or not, deficit spending became a federal practice), and also from the Fed, as shown notably by the 1934 creation of the Treasury Department's Exchange Stabilisation Fund, which could counterbalance monetary policy.

Furthermore, the dismantling of New Deal financial legislation did not produce a uniform system, and the deregulation of a financial system that is still partially segmented may have exacerbated its weaknesses: with as many supervisory agencies as former market segments (or even more), lacking coordination, these authorities became powerless when the system was deregulated and unified around the financial market. In this regard, the financial stability of Canada is a useful counterexample. The Canadian financial system is relatively concentrated, the banks are large, and a single regulator oversees the entire system (Bordo *et al.,* 2011).

After the 2009 crisis, the US Congress passed the Dodd–Frank Act in 2010. This act provides for greater transparency and accountability for the major banks, notably by laying out a procedure for each large bank to be liquidated and wound up in an orderly fashion so as to protect the government and the Fed from "blackmail" by institutions that are "too big to fail". In keeping with the era, rather than expanding the government's powers, this act delegates enforcement to a wide array of agencies whose remits are sometimes contradictory. The process promises to take even longer, as the large banks very quickly reasserted their right to participate in the banking sector regulation process. The Washington Consensus, after falling into disfavour for two years, has recovered most of its prerogatives. On 22 May 2018, Congress reduced the number of banks on the list of systemically-important financial institutions, thereby subject to direct Fed supervision, from 38 to 12 (out of the 5,670 banks in the US).

Conclusion

When Roosevelt took office, the US was coping with an economic depression that had been worsening for four years. Even though the root causes for the depression probably lay in the popular reactions to globalisation and in geopolitical tensions following the First World War (James, 2000; Kindleberger, 1986), Roosevelt preferred to blame financial speculation and set up a framework of regulations that marked a turning point for the US financial system. In Europe, owing to the two major shocks of the World Wars, financial regulations were implemented over a longer period of time and took national idiosyncrasies into account. Nevertheless, the overall European trend was comparable to the US. Market segmentation and strengthened executive powers were also key features in Europe, even outside totalitarian regimes and after their collapse. Due to the US economic predominance after 1945, deregulations in the US were eventually extended to Europe, either willingly or by force, although the financial systems there have remained partly distinct up to now. Faced with the 2008 crisis, the US has not shifted this free-market orientation so far, apart from implementing a monetary policy whose consequences cannot be foreseen. The European response was not very different – even though it was a sovereign debt crisis (not a banking crisis) that acted as the catalyst for this monetary policy and for building joint structures for regulating banks and markets. But have we learnt all the lessons from the 20th century's turbulent history of financial crises and regulation? At present, the Washington Consensus appears to have been restored, but the reactions to globalisation are hardening on both sides of the Atlantic. Averting another Great Depression remains a serious challenge.

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