Belfer Center
for Science and International Affairs
John F. Kennedy School of Government • Harvard University
July 2009

Policy Memo Series: Economics and Global Affairs

How do we know this is not another Great Depression? Lessons for policymakers from the 1930s

BOTTOM LINES

- The $800 billion stimulus bill of February was too small, by or more half, to knock out the recession or restore full employment; but it would be difficult to double it without risking the loss of global investors' confidence in U.S. debt. Thus it was about the right size, subject to the constraints.
- It would help if major economies could agree to coordinate fiscal expansion.
- For the longer term, we need financial reform in several areas. A partial list includes: executive compensation (discourage golden parachutes and options, unless truly tied to performance), securities (including creating a central clearing house for credit default swaps), mortgages (including consumer protection, standards for mortgage brokers and fixing the originate-to-distribute model, so that lenders stay on the hook), and banks (regulators shouldn't let banks use their own risk models).

By Jeffrey Frankel, James W. Harpel Professor of Capital Formation and Growth, Harvard Kennedy School

The current economic crisis is fundamentally different from those we have experienced in recent past. The proximate causes of previous recessions (1980-2 and 1990-91) were increases in interest rates in response to inflation. This time around, however, low interest rates and loose monetary policy during the period 2003-2005 had contributed to a bubble in asset prices, rather than to inflation. This – coupled with an underestimation of risk in our financial system, failures of corporate governance, and excessive debt by both households and government – caused the crisis of 2007-09.

DISCUSSION

- The downturn is the most prolonged, severe, and synchronized since the 1930s. International trade plummeted in 2008. The World Bank forecasts negative global growth in 2009, for the first time in 60 years.

- But the recession is still nowhere near the 1930s in terms of severity.

- How do we know this will not be another Great Depression? The usual answer: We learned important lessons from the 1930s, and we won't repeat the mistakes that Hoover, Roosevelt, the Congress and the Fed made then.

  (1) The money supply. One key mistake in the 1930s was that the Fed let the money supply fall. Today, monetary easing is unprecedented. But with interest rates at approx. zero percent, it has largely run its course.

  (2) Fiscal policy. In the 1930s, Roosevelt was not constrained by a substantial existing national debt.

Today, the debt inherited from his predecessor limits Obama's ability to sustain record levels of borrowing. Also, notwithstanding their role in having incurred that debt, Congressional Republicans oppose even the fiscal stimulus that was already passed in February, let alone more.

(3) Financial regulation. Thanks to the 1930s, we already have financial regulations designed to prevent deposit runs on banks. But they are clearly not enough to address other kinds of financial panics.

(4) Trade. The lesson that economists have long thought had been most clearly demonstrated by the 1930s is the lesson to which today's Congress has paid the least heed. President Hoover (R) signed the infamous Smoot-Hawley bill in 1930. The consequences are well-known. Other countries instantly retaliated, and emulated this aggressive act of protectionism. Over the subsequent years world trade collapsed (down 60% by 1932), helping to put the "Great" into Great Depression and facilitating the rise of rabid nationalism in Germany and Japan. Today, the Buy America provisions in the original House version of the stimulus bill risked a repetition of the mistake of Smoot-Hawley.

TAKEAWAYS AND RECOMMENDATIONS FOR POLICYMAKERS

- The economy was in freefall at the beginning of the year: GDP fell at an annual rate of around 6 per cent in both the last quarter of 2008 and the first quarter of 2009. Since then, it has begun to level out.

- The $800 billion stimulus has contributed importantly to the moderation – both the portion that has already been spend plus and the knowledge that the majority of the money will arrive over the coming year.

- The stimulus was too small in itself to knock out the recession, or to restore full employment. But it would be difficult to double the stimulus without endangering global investors' confidence in U.S. debt and risking a hard landing for the dollar. Given such constraints, it was about the right size.

- It would help if major economies had coordinated their fiscal stimulus. If any one country leads the fiscal expansion, then it fears resulting trade deficits. This problem would be averted if many countries created a bargain all to undertake fiscal expansion at the same time. President Obama, however, was not able to get agreement on such a deal from other leaders during the London meeting of the G-20 in April, which invited comparisons to a famous failed international economic conference in London in 1933.

DESIRABLE LONGER-TERM FINANCIAL REFORMS

Executive compensation

- The compensation committee should be independent of the CEO. Perhaps it is necessary that the Chairman of Board and the CEO never be the same person.
- Public policy should discourage golden parachutes & options, unless truly tied to performance.

Securities

- Regulatory agencies: Merge the Securities and Exchange Commission with the Commodities Future Trading Commission?
- Create a central clearing house for credit default swaps.
- Credit ratings:
  - Reduce reliance on ratings: AAA does not mean no risk.
  - Reduce ratings agencies' conflicts of interest.

Lending

- Mortgages
  - Consumer protection, including standards for mortgage brokers
  - Fix the "originate to distribute" model, so lenders stay on the hook, retaining ownership of, say, 20% of the mortgages that they originate.

Banks:

- Regulators shouldn't let banks use their own risk models
- Regulators should make capital requirements less pro-cyclical. Current banking rules discourage banks from putting aside large amounts of excess reserves in times of relative prosperity; those should be amended.
- Extend bank-like regulation to investment banks and "near banks," not just rescuing them when crisis hits, but regulating them commensurately in the boom times.

- Until now, global investors have happily financed U.S. deficits. In fact, one of the surprises of 2008 is that the dollar appreciated, as investors flocked to the safe haven of U.S. Treasuries. But it is unclear that the U.S. can rely on foreign support indefinitely; in the long run, we will probably see substantial depreciation of the dollar.

- The crisis has further undermined U.S. hegemony. The long, slow descent of the dollar as the world's reserve currency may accelerate. China has already publicly expressed worry that US Treasury securities would lose value – this may be a turning point.

- The decline of the dollar as the world's reserve currency would have geopolitical implications. It happened the British pound during the first half of the 20th century. Example: Amid the Suez Crisis of 1956, there was a run on the pound. The U.S. decision not to help the beleaguered currency was a key factor that forced Britain to give up its imperial designs.

CONCLUSION

- A good guess is that the monetary and fiscal response we have seen so far have been sufficient to halt the economic free-fall, so that the steep rate of decline will level off in the 2nd half of this year.

- It won't be enough to return us rapidly to full employment and potential output.

- Given the path of debt that was inherited in January 2009, it is unlikely that much more could be done.

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