Crisis and Reform:
Lessons for Asia from the Two U.S. Financial Crises

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Since the founding of the Federal Reserve System in 1913, there have been just two financial crises in the United States: the 1930s Great Depression Crisis and the 2008- Financial Crisis. Four comparisons are made. First, the 1930s Crisis was longer, 2 to 3 times larger in its GDP declines and unemployment increases, and had double-digit deflation for 2 years. Second, while the 1930s Crisis contributed to a sharp reversal of 80 years of economic globalization, i.e., increasing integration of national and regional labor, financial, and product markets, significant reverses had already occurred prior to the crisis. Since the 2008- Crisis occurred after a second 50-60-year wave of globalization, we also consider whether the 2008- Crisis will end economic globalization. Taken together the two crises provide new information for policymakers in China—the new creditor country—to ponder. Its four largest banks are surely too big to fail; its Central Bank has never managed a fiscal crisis originating in China; and the effectiveness of its fiscal policy is unknown.

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I. Introduction

The ongoing global financial crisis ("the 2008- Crisis") has heightened interest in the 1929-1933 Great Depression financial crisis ("the 1930s Crisis") that spread from the United States to other countries, particularly those countries adhering to the gold standard. The 1930s Crisis is of particular interest today, as it marked the definitive end of a long wave of globalization that started in the 1850s and produced unprecedented integration of regional and national commodity markets, stabilized exchange rates sufficiently to facilitate massive cross-border flows of capital, and allowed hundreds of millions of people to migrate to the land-rich, labor-poor Americas. It would take, however, just four years for the financial crisis and the accompanying deep income and employment declines to eliminate more than two-thirds of nominal international trade and investment flows. While most economies began to recover in the early and mid-1930s, the national recoveries were not accompanied by substantial recoveries in migration, exports, or capital flows. The institutional and physical destruction of World War II left many firms without sufficient capacity to engage in trade. Institutions that supported international trade and investment flows at the height of the first globalization wave in 1910 were no longer functional, and governments substituted extensive capital and exchange controls. Globalization proceeded slowly as new national and international institutions to support trade and finance developed slowly or were not expected to persist. For example, it took over a decade after the end of World War II for such major trading countries as France and Britain to reestablish such basic institutions as exchange rate convertibility.

Over the next 50-60 years, a second era of globalization emerged that encompassed a growing number of countries and was accompanied by a new set of global and regional institutions to support these markets. By 1996, the extent of market integration in product and financial markets had exceeded their pre-World War I heights on most measures of integration. As the 2008- crisis unfolded, international trade and financial flows again declined at faster rates than GDP, mirroring the pattern observed in 1929-1933. A look back at the 1930s Financial Crisis in the mist of the 2008- Crisis prompts an obvious question: Will the 2008- Crisis stop and possibly reverse much of the second wave of globalization? Harold James (2009) in his thoughtful comparison of the 1930s and 2008- crises declares that the second globalization wave is finished and speculates that recovery of the necessary trust to reestablish frayed and broken international relationships will only happen when there has been a restoration of frayed values within countries. In other words, national recoveries could, once again, occur without market integration being restored.

There are several other issues and questions pertaining to the 2008- Crisis that are might be viewed differently if we consider how similar issues were addressed by policymakers in the 1930s crisis. One issue regards differences in their depth, duration, and deflation. While these differences are in part due to the timing and scale of U.S. government policies, the extent of unemployment in 1933—

24.9 of the labor force—greatly exceeded unemployment at the height of the 2008-Crisis—10.1 percent and correctly changed priorities for government action. A second issue regards how our understanding of the 1930s Financial Crisis has changed over time and how misdiagnoses led to implementation of a mix of useful reforms and counterproductive policies. Poor diagnosis of the causes of the 2008-Crisis could lead to similar problems. A third issue concerns the recovery policies adopted by two new presidents (Roosevelt and Obama) who both were inaugurated near the depth of the crisis. Many of President Roosevelt's legislative initiatives clearly inhibited rather than facilitated recovery; worries about Roosevelt's policies subsided somewhat amongst the general population when a strong recovery ensued over the course of his first term, March 1933 to March 1937. Are these concerns transferable to President Obama's legislative initiatives? In particular, is fiscal policy driven by increased government purchases of goods and services and relief to state government and highly impacted groups likely to be effective in restoring the economy to full employment? Fifth, the Roosevelt policies towards the banks and the stock market (banks: they were segmented along geographic and functional lines (Glass-Steagel), deposit insurance was required at all national banks, the dollar was devalued, and bad banks closed after mandatory federal inspections; stock markets: new information requirements regarding a corporation selling its securities and additional restrictions on underwriting activities, with regulations enforced by a new national regulatory agency, the Securities and Exchange Commission (SEC). While the combination has been judged deficient by many scholars, it was effective enough in the short run to restore public confidence in the banking system, end the 1930-1932 deflation, and provide a mild monetary stimulus. Does it help us evaluate today's plans for financial regulatory reform. Finally, as China transforms into one of the world's leading economies, are there lessons to be learned from the two U.S. financial crises that it should consider when it finally encounters and needs to manage a financial crisis originating from within China. If China's share of world trade increases as its GDP grows, even a financial crisis that is limited in its financial effects to China's borders will still produce changes in trade flows that could produce crises in other countries.

II. Differences in Magnitude and Duration

There are big differences in the magnitude and duration of the 1930s and the 2008-Crises.[1] GDP fell in nominal and real terms for 3.5 years during the 1930s Crisis. From the business cycle peak in August 1929 to its trough in March 1933, nominal US GDP fell by 46 percent while the GDP deflator fell by 19 percent. The decline in overall real GDP (~29.3 percent)—and it was even larger for durable consumer goods (80 percent) and manufactures (40 percent)—and in prices (26 percent) outstripped those for any other 3.5 year period since the federal government was formed. By contrast, the decline in real GDP (chained 2005

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[1] Fishback (2008) in a three-part *Freakonomics* blog in the *New York Times* made these points about the duration of the business cycle, the magnitude of the decline in real GDP, and the extent of deflation.

dollars) from the start of the U.S. downturn in December 2007 to the resumption of real GDP growth in the third quarter of 2009 was only 3.7 percent. While this is the largest decline in output in a U.S. recession since the 1930s, it just does not compare in magnitude.

How comparable are the two crises in duration? Since GDP has grown for two consecutive quarters, the NBER is likely to declare that the recession ended in July or August of 2009. If so, this recession would be the longest downturn (20/21 months) since the 1930s, but would also be less than half of the 43 months registered from the September 1929 peak to the March 1933 trough of the Great Depression.

Unemployment rates in the two crises are also very different in magnitude. In the 1930s Crisis, the unemployment rate rose from 3.2 percent in 1929 to 24.9 percent in 1933. At the end of the March 1933-May 1937 recovery, the unemployment rate (adjusted for federal employment of unemployed workers) had only fallen to ~9 percent. With the sharp decline in GDP from May 1937 to June 1938, the adjusted unemployment rate rose to ~12 percent in 1938. The increase in the U.S. unemployment rate during the 2008- Crisis is not nearly as large, increasing from 5.0 percent in December 2007 to 10.1 percent in October 2009.[2] Whether the United States will also experience historically high unemployment rates during the recovery from the 2008- Crisis is widely debated, particularly in light of the slow recovery in U.S. employment after the 2000-2001 recession and the large increase in U.S. government debt stemming from the TARP and other bailout measures.

While the changes in unemployment rates and GDP differ greatly across the two crises, changes in the consumer price index are radically different both qualitatively and quantitatively across the two crises. During the 2008- Crisis, there is only period, July 2008 to December 2008, in which the All-Urban CPI is declining. From January 2009 to January 2010, the CPI has increased in all but one month (March 2009 = -.1 percent), with actual inflation during 2009 amounting to 3.8 percent. While the U.S. economy had a short brush with deflation (primarily the result of falling prices of petroleum products) during the second half of 2008, the 2009 monthly series represents a break from that period. By contrast, deflation is high and persistent during the 1930s Crisis, amounting to 31.1 percent between 1929 and 1933.

One implication of the longer and deeper recession of the 1930s and its record unemployment was that the incoming Roosevelt administration had to place a much higher priority on providing relief to the unemployed than the incoming Obama administration. This was due not only to the large percentage of unemployed workers but

[2] The rates are strictly not comparable across these periods as the methodologies for collecting the data have changed substantially. Unemployment was, however, often more damaging during the 1930s because there were fewer workers employed per household and less generous benefits for an unemployed worker.

also to the long duration of many workers' unemployment. Robert Margo observed that "according to a Massachusetts state census taken in 1934, fully 63 percent of unemployed persons had been unemployed for a year or more. Similar long-term unemployment was observed in Philadelphia in 1936 and 1937" (Margo, 1993, p. 42).

III. Changes in How We Understand the 1929-1933 Crisis

Ben Bernanke has said that understanding the Great Depression is the Holy Grail of macroeconomists. Our understanding of the Great Depression has, however, been constantly changing over the last 30 years as new generations of economists apply new theories and analyze more dimensions of this complex episode. Since a summary of this research is beyond the scope of this project, this section focuses instead on aspects of the new understanding that resonate in the 2008- Crisis and be useful in preventing a financial crisis in another large country.

First, it is difficult to point to a structural problem in 1929 that could have been responsible for such a long crisis. A 1920s housing boom was coming to an end, but the run-up in housing prices--~40 percent—was relatively small compared to the run-up in housing prices in the United States from 1997 to 2006—83 percent. The Federal Reserve had raised interest rates in 1928 and 1929 partly to rein in the speculative stock market boom, but the increases were relatively small. Since the CPI was already falling in 1928 and 1929,

Second, Randall Parker's (2007) interviews with 12 leading macroeconomists who have published major studies of the Great Depression show that virtually all have accepted Eichengreen's (1992) finding that the Gold Standard played a major role in transmitting the crises in Britain and the United States to other gold standard countries. Bordo, Erceg, and Evans (2000) have combined

IV. Will the 2000s Crisis End Economic Globalization?

The answers for each of the three sets of markets are quite different. Immigration to the United States reached historical peaks (new arrivals/population) between 1870 and 1910. Throughout the period of record immigration, a backlash against large-scale immigration was building in the United States (Williamson, 1998). Congress enacted a ban on all immigrants from China in 1882 and President Roosevelt's 1906/1907 Gentlemen's Agreement with Japan banned working-age male immigrants from Japan. Congress passed legislation to limit immigration by instituting a literacy requirement in 1891 and 1913 that failed to become law due to vetoes by President Cleveland and President Wilson, respectively. In 1917, President Wilson reversed course and signed a new immigration bill with a literacy test and bans on immigration from a wide mix of countries in Asia and the Middle East. The end to large-scale immigration came with the passage of even stricter legislation in 1921 and 1924 that imposed small binding quotas on new immigration immigrants. For all intents and purposes, a backlash against labor market integration had been building in the United States prior to World War I, but it was

the debacle of the World War and its aftermath—not the Great Depression--that killed globalization in labor markets..

The 40-year period before the 2008- Crisis was also marked by a large increase in legal and illegal immigration flows. Passage of the Immigration and Nationality Act in 1965 removed country quotas and placed no limits on issuance of family reunification visas. A political backlash against large immigration flows began developing as the composition of immigrants changed in the 1980s and 1990s to incorporate more low-skill people. Unlike the pre-WWI backlash, it had little success in passing restrictions on immigration, as the number of foreign-born in the United States population increased by an average of one million per year from 2000 to 2006. However, in the two years prior to the financial crisis, there is a major break in this series. Between 2006 and 2007, the increase in the number of foreign-born declined to just 500,000 people, and between 2007 and 2008, the number of foreign born did not change. Some migration flows reversed direction, with millions of Mexican workers in the US Southwest returning to Mexico in 2008 and 2009. Did the 2008- Crisis kill labor market integration? Because the fall in immigration flows occurred just prior to the 2008- Crisis, they could have been influenced by the increase in uncertainty about the US economy that was present prior to the onset of the crisis. In short, it's too early to tell.

Did the Great Depression kill global integration of product markets? While many trade economists and macroeconomists focus on the 1930 Smoot-Hawley Tariff Act as the event unleashed that prompted other countries to raise their tariffs, the backlash against higher trade flows began in the late nineteenth century, as Germany and France raised tariffs on wheat to counter growing imports of wheat from the United States. Blattman, Clemens, and Williamson (2002) found that an average of (unweighted) global tariffs increased between 1860 and 1910. Because countries often specified their tariff as a nominal fixed fee, the inflation of World War I reduced effective tariff rates from 15 to 10 percent. However, during the 1920s most countries, including the United States, enacted major increases in their tariff schedules that pushed global average tariff rates to an average 15 percent. The 1930s Crisis has, however, a major impact on average tariff rates, via the huge deflation experienced by gold standard countries. The real protection provided by a fixed nominal tariff rate increases as deflation reduces the product price to which it is applied. Deflation and government legislation, such as Smoot-Hawley, to increase tariffs combined to raise the average effective tariff rate to 25 percent by the mid-1930s. Did the 1930s crisis kill globalization in product markets? While barriers to trade had been sporadically increasing since the 1860s, the deflation and tariff increases triggered by the 1930s crisis played critical roles in shrinking trade in the 1930s. It is, however, also worth noting that the Smoot-Hawley Tariff Act only lasted four years, replaced in 1934 by the much more flexible framework of reciprocal tariff reductions.

Is the 2008- Crisis likely to kill globalization in product markets? Again, one can argue that globalization is beginning to wane as countries rely more on regional

and bilateral trading agreements to liberalize trade. And while WTO negotiations to reach a agreement on a new round of trade liberalization have stumbled several times in the last decade, the WTO agreement binds current tariffs and provides a mechanism for countries to protest increases. Despite the large falls in exports that many countries have experienced due to falls in income and consumption in high-income economies, there would have to be a major abandonment of institutional commitments for trade to follow the same patterns as it did during the 1933-1937 recovery in the United States.

V. Lessons for China from the Two U.S. Crises?

Are there lessons for China from the two U.S. crises? Surely the primary lesson is that large economies are still vulnerable to major financial crises. Allocating additional resources towards crisis prevention and developing plans for managing a crisis, whether imported or home grown, would seem to have higher payoffs as awareness of potential vulnerability increases.

In addition, the two U.S. crises came without much warning. In the spring of 1930, many U.S. policymakers, cheered by the stock market's recovery, thought that the recession would likely be a short, not too painful garden-variety one. And in the fall of 2006, there were few U.S. economists and policymakers who thought that the combination of problematic subprime mortgages and a housing price bubble would combine to generate a global financial crisis. Chinese policymakers could also encounter a similar situation if a financial crisis ever breaks out in China.

The 2008- Crisis saw the U.S. government forced to make hard choices about which investment and commercial banks to rescue. Many were just too big to let fail, as their failure might have jeopardized confidence in the financial system. In fact, the large commercial banks that failed had all made highly questionable investments in subprime mortgages despite regulatory oversight. China's four large banks all seem, like the big U.S. commercial banks, too big to fail Like AIG, are there other major corporate players whose failure could jeopardize China's financial system and economy.

Many of the problems in the U.S. mortgage markets were due to huge imprudent investments by quasi-public corporations—Freddie Mac and Fannie Mae, each with its own regulator. The extent of the public role in these corporations was not well known until the U.S. government provided huge bailouts to them from August 2008. Quasi-public, quasi-private corporations are ubiquitous in China's economy, facilitating government control and leadership in selected economic sectors.

Finally, the 1930s Crisis and Japan's lost decade of the 1990s both provide warnings about the extensive harm that deflation can inflict on an economy. The swift reaction of the Federal Reserve Board to even the hint of inflation in the Fall of 2008 coupled with the relatively short length of the 2008- Crisis (hopefully!) clearly

show that over-reaction to looming deflation may be a far better choice than paying too much attention to the Central Bank's balance sheet.

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