The Global Financial Crisis and the Lesson-Drawing Problematique[1]
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Everyone presenting at this symposium has an inference problem, the problem of inferring which aspect of their work they're supposed to discuss. My inference problem may be more serious than most, since my work is historical, atypically for this setting. That work is also on *international* money and finance, where the stated focus of this symposium is money and banking. Still, I infer from the fact that I was invited to participate in this session that it would not be amiss for me to talk about my work on international business cycles, monetary transmission, and the Great Depression (the last of which my co-presenter has called "the holy grail of macroeconomics").

As always, it is important to set the stage. Early work on the Depression was heavily closed economy. I am thinking, first and foremost, of Friedman and Schwartz's *Monetary History of the United States,* arguably *the* most influential book on money and banking in the 20th century.[2] Methodologically, Friedman and Schwartz showed how statistical and narrative material could be combined into more than the sum of the parts. They described a model in which shocks to the money stock and the banking system were transmitted to the real economy. They applied their framework to the Great Depression, the ultimate testing ground for any theory of macroeconomic fluctuations.

I don't believe I'm doing violence to their analysis when I say that theirs was essentially a closed-economy model in which the money stock was under control of the national authorities, and in which the gold standard, exchange rates and capital flows were not central to the story. This was a logical perspective for economists writing in the 1950s and early 1960s, when open-economy considerations didn't loom as large as before or since, and for scholars whose stated focus was the United States, a relatively closed economy.

But it became less logical once one recognized that the Great Depression was a global phenomenon and that national monetary policies were endogenously determined, to a considerable extent, so long as countries maintained fixed exchange rates, as they did in the 1920s and 1930s. This realization was a couple of decades in coming, post-*Monetary History of the United States*, because the application of monetary economics to historical episodes, like the Great Depression, was initially a practice confined primarily to the United States (where the closed-economy perspective was most defensible, as just explained). The New Economic History, as well as what I like to call Yale-MIT Monetary Economics, also developed first the United States. Consequently the first applications of that monetary framework by New Economic Historians were, for reasons of convenience and predisposition, to the United States.[3]

[1] For the Nobel Symposium on Money and Banking, Stockholm, May 26-28, 2018.
[2] Milton Friedman and Anna Schwartz, *A Monetary History of the United States, 1863-1960* (Princeton University Press, 1963).
[3] On the New Economic History, see Robert Fogel, "The New Economic History, I: Its Findings and Methods," *Economic History Review* new ser. 19 (1966), pp.642-656. On the Yale-MIT Monetary Economics as I learned it, see William Brainard and James Tobin, "Pitfalls in Financial Model Building," *American Economic Association Papers and Proceedings* 58 (1968), pp.99-122, and Olivier Blanchard and Stanley Fischer, *Lectures on Macroeconomics* (MIT Press, 1989). And finally, for application of the Yale-MIT Monetary Economics to

This is not to claim that open-economy analyses of the Depression were without precedent. Especially influential were Ragnar Nurkse's *International Currency Experience*, written before Friedman and Schwartz, and by Charles Kindleberger's *World in Depression*, written subsequently.[4] But in neither case were the statistical and narrative approaches combined as successfully, and in neither case was it straightforward to recover the underlying model.

My work emphasized the global character of the Depression, the gold standard as a constraint, and the endogeneity of monetary conditions. Using formal models and narrative evidence, it attempted to relate the singular allegiance of certain countries to the gold standard, despite evidence of its destabilizing effects, to their historical experience of hyperinflation and social conflict, during and after World War I, when that regime was in abeyance. It tried to show how a system that had been stabilizing before 1914 become destabilizing thereafter, owing to changes in the social and political context in which it operated (due to the advent of universal male suffrage, the spread of trade unionism, the publication for the first time of unemployment statistics, and the development of theories of the "trade cycle" linking fluctuations in unemployment to money and credit conditions, all of which greatly complicated life for central banks). It sought to explain how that system had become more fragile owing to the spread of foreign-exchange reserves (allowing more money and credit to be pyramided on a narrow base of gold), the more limited credibility of the official and social commitment to gold convertibility (for the reasons just mentioned), and declining scope for international cooperation (due to the legacies of World War I). It attempted to show how a relatively modest contractionary monetary shock in the United States in 1928-29 could have such profoundly destabilizing consequences for monetary and credit conditions worldwide (by linking monetary and credit conditions in the United States to monetary and credit conditions in the rest of the world, via the pegged exchange rates of high capital mobility of the international gold standard, and by showing how the effects of that shock were amplified by their interaction with the weak balance of payments position of countries that had been on the receiving end of capital inflows from the United States in the preceding period).

There were then a set of amplification mechanisms, focusing on money and banking, that made the Great Depression great, and a series of corrective mechanisms eventually ending it. The gold standard, as it operated in the early 1930s, prevented central banks from acting as lenders of last resort, a fact that goes a long way toward explaining the incidence of banking crises and panics (a point made by Richard Grossman in the *Journal of Economic History* and by Bernanke and James in a 1991 conference volume).[5] Those banking crises had negative consequences for economic activity operating through both monetary and nonmonetary channels

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Friedman and Schwartz's problem, see James Tobin, "The Monetary Interpretation of History: A Review Article," *American Economic Review* 55 (1965), pp.462-485..

[4] Ragnar Nurkse, *International Currency Experience* (League of Nations, 1944); Charles Kindleberger, *The World in Depression 1929-39* (University of California Press, 1973). I would also mention in this context W. Arthur Lewis, *Economic Survey 1919-1939* (Allen & Unwin, 1949).

[5] Richard Grossman, "The Shoe that Didn't Drop: Explaining Banking Stability during the Great Depression," *Journal of Economic History* 54 (1994), pp.654-682; Ben Bernanke and Harold James, "The Gold Standard, Deflation and Financial Crisis in the Great Depression: An International Comparison," in Glenn Hubbard (ed.), *Financial Markets and Financial Crises* (University of Chicago Press, 1991), pp.33-68.

(as documented in Ben's 1983 *American Economic Review* piece).[6] The collapse of the gold-exchange standard then had a deflationary impact and aggravated financial distress by destroying the foreign-exchange component of global liquidity (as Ben argued in his 1995 *Journal of Money, Credit and Banking* lecture).[7]

All this made abandoning the gold standard the key to recovery. Abandoning it allowed central banks to act as lenders of last resort. It ended deflation and pushed prices back up despite near-zero interest rates and liquidity-trap-like conditions, in countries like Japan, where the authorities were able to definitively alter expectations by radically depreciating the exchange rate, in Sweden, where they were able to specify a price-level target, and in the UK, where they adopted a policy of cheap money (committing to keeping credit conditions accommodating for as long as it took).[8] Doing so relieved the pressure for governments to resort to tariffs and quotas to bottle up a fixed lump of demand, given that, once monetary policy could be actively utilized, that fixed lump of demand was no longer fixed.[9]

Many of these positive outcomes could have been achieved, of course, within the framework of the gold standard had central banks and governments cooperated with one another. The chaotic side-effects of the collapse of the system could have been avoided. But cooperation was impossible because of domestic constraints (both institutional and political), international tensions (reparations and other legacies of World War I), and ideological considerations (specifically, the existence of conceptual frameworks that differed across countries). In these circumstances, unilateralism was the only route to recovery.

Given this, the interesting question is why some countries clung to the gold standard as long as they did. Another way of asking the question is: why did countries and societies draw the specific "lessons of history" they did? This question is important for understanding crises more generally, so I will return to it.

We have been asked by the organizers, in the title they gave this session, to draw comparisons, where the most obvious comparison is, of course, with the Global Financial Crisis. The policy response this time was better, as everyone knows. Central banks were quicker to intervene as lenders of last resort; they were able to do so because few of them had rigid exchange rates target to defend. It helped that they were quicker to recognize that the crisis was global and therefore to extend credit and swap lines to one another, and more broadly to coordinate their response. It helped that they had compatible conceptual frameworks, giving rise to shared diagnoses of the crisis and a shared understanding of the appropriate response. It helped that they had met regularly as members of the Group of 20, the Bank for International Settlements, and the Bellagio Group. The one-off meeting of four leading central bankers at the

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[6] Ben Bernanke, "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression," *American Economic Review* 73 (1983), pp.257-276.

[7] Ben Bernanke, "The Macroeconomics of the Great Depression," *Journal of Money, Credit and Banking* 27 (1995), pp.1-28. I like to think that I made a number of these points as well. See Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939* (Oxford University Press, 1992); Barry Eichengreen, "The Origins and Consequences of the Great Slump," *Economic History Review* 45 (1992), pp.213-239; Barry Eichengreen, "Understanding the Great Depression," *Canadian Journal of Economics* 37 (2004), pp.1-27.

[8] See Gauti Eggertsson, "Great Expectations and the End of the Depression," *American Economic Review* 98 (2008), pp.1476-1516.

[9] Barry Eichengreen and Douglas Irwin, "The Slide to Protectionism in the Great Depression: Who Succumbed and Why?" *Journal of Economic History* 70 (2010), pp.871-897.

Long Island estate of Treasury Undersecretary Ogden Mills in 1927 was a poor substitute by comparison.[10]

I don't want to over-praise the policy analysis and response. We specialists in monetary economics, to paraphrase Queen Elizabeth, could have done a better job at seeing the crisis coming and pressed more effectively for anticipatory action. We (I include myself) were focused on the wrong crisis, on global imbalances rather than the housing and housing-finance crisis. One reason for this misguided focus was that global imbalances and not the housing bubble or problems of housing finance had been more prominent in the run-up to the Great Depression.[11] The risks that global imbalances might unwind in disorderly fashion, as they did starting in 1928, thus became part of distilled wisdom about how crises develop. And once the crisis struck, some central banks, such as the ECB, remained in denial about its global nature long after this should have been self-evident. (Recall how the ECB raised interest rates in 2008, implicitly dismissing the so-called Subprime Crisis as an American problem.) The turn to fiscal consolidation was premature, partly because of flawed economic analysis but more fundamentally because of political ideology. But then it's easy for me to criticize. I wasn't in the room.

Each crisis influences the next one. It does so through the interpretation analysts attach to that most recent crisis – which is itself influenced by the dominant interpretation of past crises – and, through that channel, by shaping changes in financial, regulatory and other policies. In the current case, we will have to see how enduring those regulatory and other changes turn out to be. One of my arguments, based on the comparison with the Great Depression, is that by averting the worst – by preventing another Great Depression – policy makers relieved the pressure for root-and-branch reform of financial markets and allowed forces hostile to more fundamental reform to reassert themselves and begin rolling back earlier reforms more quickly than would have been possible otherwise – as we saw in the U.S. just last week.[12] To be clear, I'm not arguing that it would have been better to allow the financial system collapse on the grounds that we then we would have had more enduring reform. But I am arguing that we should be aware of the consequences.

It is also important to acknowledge the existence of competing narratives. In the case of the global financial crisis, there are those who would blame not lax regulation or excesses in securitization markets but the GSEs: Freddie Mac and Fannie Mae. In the case of the Great Depression, there are those who would blame government interference in the operation of markets (Hoover's high wage policies, FDR's New Deal) or the policy uncertainty caused by

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[10] These gentlemen were Governor of the Federal Reserve Bank of New York, Governor of the Bank of England, head of the German Reichsbank and Deputy Governor of the Bank of France. Air travel, one should acknowledge, also plays a role (Norman, Schacht and Rist had to cross the Atlantic by ocean liner).

[11] Olivier Accominotti and Barry Eichengreen, "The Mother of All Sudden Stops: Capital Flows and Reversals in Europe, 1919-32," *Economic History Review* 69 (2015), pp.469-492. There had been a housing bubble in the United States in the 1920s, but it was even more limited regionally than the housing bubble of the 2000s, peaked already in 1926 (well before the onset of the Depression), and was not accompanied by equally dramatic excesses in banking and securitization markets.

[12] Barry Eichengreen, *Hall of Mirrors: The Great Depression, the Great Recession, and the Uses – and Misuses – of History* (Oxford University Press, 2015).

abandoning the gold standard.[13] I for one am not convinced by these alternatives. But it is important to understand why societies converge on certain dominant interpretations of the past, since those dominant interpretations condition perceptions of current events. They influence how policy makers respond and, no less, what economists model.

But while there is work in political science, in sociology, in legal theory, in cognitive science and in history on the evolution of dominant narratives and interpretations, there is little in economics.[14] We could do better at understanding model selection and how it is influenced by history. I myself am of the view that we should view economic models as analogies, and that the nature of our training inclines economists, in our effort to converge on a dominant narrative or interpretation, to employ historical and logical analogies.[15] We therefore need to understand better the nature of analogical reasoning.[16]

This brings me to a final issue – that of false analogy – relevant to a session with the title *Lessons from the Global Financial Crisis and Crises Past*. An analogical fallacy, according to Madsen Pirie, "consists of supposing that things which are similar in one respect must be similar in others."[17] This kind of fallacious reasoning by analogy is a very real problem when attempting to draw lessons from the Global Financial Crisis and crises past .

An example is the analogy between the gold standard and the Great Depression on the one hand and the euro crisis on the other. For about ten years it was popular to argue that because the gold standard collapsed in the Great Depression, the euro system would collapse in the Great Recession. Or, framed normatively, it was popular to argue that since countries recovered in the 1930s only after they abandoned the gold standard, European countries in order to recover should abandon the euro.[18] My view from the start was that this was flawed

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[13] See Charles Calomiris and Stephen Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (Princeton University Press, 2014); Lee Ohanian, "What – or Who – Started the Great Depression?" *Journal of Economic Theory* 144, pp.2310-2335.

[14] For a sampling of this work from these five disciplines, see Francis Gavin, "Thinking Historically: A Cold War Historian's Reflections on Policy," unpublished manuscript, Johns Hopkins University (2018), Andrew Brown and David Spencer, "Understanding the Global Financial Crisis: Sociology, Political Economy and Heterodox Economics," *Sociology* 48 (2014), pp.938-953, James Kwak, "Cultural Capture and the Financial Crisis," in Carpenter and David Moss (eds), *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (Cambridge University Press, 2014), pp.71-98, Usha Goswami, "Analogical Reasoning in Children," in Dedre Gentner, Keith Holyoak and Boicho Kikniov (eds), *The Analogical Mind: Perspectives from Cognitive Science*, (MIT Press, 2001), pp.437-370, and Aaron O'Connell, "Deja Vue All Over Again? Vietnam, Afghanistan and the Search for Lessons of History," unpublished manuscript, University of Texas at Austin (2018).

[15] Itzhak Gilboa, Andrew Postlewaite, Larry Samuelson and David Schmeidler, "Economic Models as Analogies," *Economic Journal* 124 (2014), pp.513-533.

[16] There are several reasons for thinking that analogical reasoning is especially prevalent in the analysis of financial crises. First, the literature suggests that individuals are likely to rely on analogy when they disagree on the principles needed for deductive reasoning. Here it is directly relevant that saltwater and freshwater economies rely on different bodies of theory when attempting to make sense of financial crises. Second, crises are when the pressure to act is greatest but also when there is least time for theorizing and data gathering, causing policy makers and others to resort to the shortcut of analogical reasoning. These points are elaborated in Barry Eichengreen, "Economic History and Economic Policy," *Journal of Economic History* 72 (2012), pp.289-307.

[17] Madsen Pirie, *How to Win Every Argument: The Use and Abuse of Logic* (Continuum, 2006). For a more rigorous treatment see Paul Bartha, *By Parallel Reasoning: The Construction and Evaluation of Analogical Arguments* (Oxford University Press, 2010).

[18] See inter alia Paul Krugman, "Europe's Impossible Dream," *New York Times* (20 July 2015), https://www.nytimes.com/2015/07/20/opinion/paul-krugman-europes-impossible-dream.html.

analogical reasoning.[19] Some similarities between the gold standard and the euro there were, but over-emphasizing them led commentators to neglect key differences. Reintroducing your national currency when you no longer have one is an order of magnitude harder than devaluing that currency when you still retain it, and the destabilizing financial consequences of even contemplating that option, in the case of the euro, are considerably greater. The euro was an obligation of and governed by a treaty signed by a group of countries, whereas going on or off the gold standard was a unilateral national decision that did not immediately put other treaty obligations and political relationships at risk.[20] These two considerations, one financial and one political, made it obvious (at least to me) that no European country was going to abandon the euro. The comparison between the crisis of the euro and the crisis of the gold standard was valuable because it pointed up differences, not similarities.

Leaving us with the question of why those differences were so widely overlooked. Valid analogical arguments "are based on *relevant* similarities between two systems," in the words of Paul Bartha, who wrote the book on the subject.[21] How do we determine what is relevant or at least increase the likelihood that when engaged in analogical reasoning we will focus on and not overlook matters of relevance? Part of the problem was that of the "searing analogy." For foreign policy scholars, it is always Munich, or it is always 1914, since those are the historical events most deeply seared into the collective consciousness. For scholars of financial crises, it is always the eve of the Great Depression.[22] Related to this is the fact that too many policy makers have at their disposal a single dominant analogy rather than a portfolio of analogies, each of which they can test for fitness to circumstances, before selecting the most relevant alternative. In other words, a little bit of historical knowledge is a dangerous thing.[23]

Specifically, in the case of the gold-standard-euro comparison, it was necessary, in order to determine what was relevant, to understand the political, institutional and historical context of the two systems and not just master analytical models of their economic and financial aspects. But not everyone had invested in understanding that context. I would make the same argument about the importance of that investment more generally for drawing lessons from financial crises, and even more generally for doing good economics.

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[19] Barry Eichengreen, "The Breakup of the Euro Area," in Alberto Alesina and Francesco Giavazzi, *Europe and the Euro* (University of Chicago Press, 2010), pp.11-56.

[20] That is to say, abandoning the euro could have spelled the death knell for the European Union itself.

[21] My emphasis on "relevant." Bartha, *Parallel Reasoning*, p.8.

[22] Cognitive scientists refer to this as the "accessibility" of the searing historical analogy, psychologists like Kahneman and Tversky to the "availability heuristic."

[23] See Ernest May, *'Lessons' of the Past: The Use and Misuse of History in American Foreign Policy* (Oxford University Press, 1973). What I mean to convey, more precisely, is that *having only* a little bit of historical knowledge is a dangerous thing.