BARRY EICHENGREEN

HALL OF MIRRORS

THE GREAT DEPRESSION, THE GREAT RECESSION, AND THE USES—AND MISUSES—OF HISTORY

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Introduction

This is a book about financial crises. It is about the events that bring them about. It is about why governments and markets respond as they do. And it is about the consequences.

It is about the Great Recession of 2008–09 and the Great Depression of 1929–1933, the two great financial crises of our age. That there are parallels between these episodes is well known, not least in policy circles. Many commentators have noted how conventional wisdom about the earlier episode, what is referred to as "the lessons of the Great Depression," shaped the response to the events of 2008–09. Because those events so conspicuously resembled the 1930s, that earlier episode provided an obvious lens through which to view them. The tendency to view the crisis from the perspective of the 1930s was all the greater for the fact that key policy makers, from Ben Bernanke, chairman of the Board of Governors of the Federal Reserve System, to Christina Romer, head of President Barack Obama's Council of Economic Advisors, had studied that history in their earlier academic incarnations.

As a result of the lessons policy makers drew, they prevented the worst. After the failure of Lehman Brothers pushed the global financial system to the brink, they asserted that no additional systemically significant financial institution would be allowed to fail and then delivered on that promise. They resisted the beggar-thy-neighbor tariffs and controls that caused the collapse of international transactions in the 1930s. Governments ramped up public spending and cut taxes. Central banks flooded financial markets with liquidity and extended credit to one another in an unprecedented display of solidarity.

In doing so, their decisions were powerfully informed by received wisdom about the mistakes of their predecessors. Governments in the 1930s succumbed to the protectionist temptation. Guided by outdated economic dogma, they cut public expenditure at the worst possible time and perversely sought to balance budgets when stimulus spending was needed. It made no difference whether the officials in question spoke English, like Herbert Hoover, or German, like Heinrich Brüning. Not only did their measures worsen the slump, but they failed even to restore confidence in the public finances.

Central bankers, for their part, were in thrall to the real bills doctrine, the idea that they should provide only as much credit as was required for the legitimate needs of business. They supplied more credit when business was expanding and less when it slumped, accentuating booms and busts. Neglecting their responsibility for financial stability, they failed to intervene as lenders of last resort. The result was cascading bank failures, starving business of credit. Prices were allowed to collapse, rendering debts unmanageable. In their influential monetary history, Milton Friedman and Anna Schwartz laid the blame for this disaster squarely on the doorstep of central banks. Inept central bank policy more than any other factor, they concluded, was responsible for the economic catastrophe of the 1930s.

In 2008, heeding the lessons of this earlier episode, policy makers vowed to do better. If the failure of their predecessors to cut interest rates and flood financial markets with liquidity had consigned the world to deflation and depression, then they would respond this time with expansionary monetary and financial policies. If the failure of their predecessors to stem banking panics had precipitated a financial collapse, then they would deal decisively with the banks. If efforts to balance budgets had worsened the earlier slump, then they would apply fiscal stimulus. If the collapse of international cooperation had aggravated the world's problems, then they would use personal contacts and multilateral institutions to ensure that policy was adequately coordinated this time.

As a result of this very different response, unemployment in the United States peaked at 10 percent in 2010. Though this was still disturbingly high, it was far below the catastrophic 25 percent scaled in the Great Depression. Failed banks numbered in the hundreds, not the thousands. Financial dislocations were widespread, but the complete and utter collapse of financial markets seen in the 1930s was successfully averted.

And what was true of the United States was true also of other countries. Every unhappy country is unhappy in its own way, and there were varying degrees of economic unhappiness starting in 2008. But, a few ill-starred European countries notwithstanding, that unhappiness did not rise to the level of the 1930s. Because policy was better, the decline in output and employment, the social dislocations, and the pain and suffering were less.

Or so it is said.

Unfortunately, this happy narrative is too easy. It is hard to square with the failure to anticipate the risks. Queen Elizabeth II famously posed the question on a visit to the London School of Economics in 2008: "Why did no one see it coming?" she asked the assembled experts. Six months later a group of eminent economists sent the queen a letter apologizing for their "failure of collective imagination."

It is not as if parallels were lacking. The 1920s saw a real estate boom in Florida and in the commercial property markets of the Northeast and North Central regions of the United States to which early-twenty-first-century property booms in the United States, Ireland, and Spain bore a strong family resemblance. There was the sharp increase in stock valuations, reflecting heady expectations of the future profitability of trendy information-technology companies, Radio Company of America (RCA) in the 1920s, Apple and Google eighty years later. There was the explosive growth of credit fueling property and asset-market booms. There was the development of a growing range of what might politely be called dubious practices in the banking and financial system. There was the role of the gold standard after 1925 and the euro system after 1999 in amplifying and transmitting disturbances.

Above all, there was the naïve belief that policy had tamed the cycle. In the 1920s it was said that the world had entered a "New Era" of economic stability with the establishment of the Federal Reserve System and independent central banks in other countries. The period leading up to the Great Recession was similarly thought to constitute a "Great Moderation" in which business cycle volatility was diminished by advances in central banking. Encouraged by the belief that sharp swings in economic activity were no more, commercial banks used more leverage. Investors took more risk.

One might think that anyone passingly familiar with the Great Depression would have seen the parallels and their implications. Some warnings there indeed were, but they were few and less than fully accurate. Robert Shiller of Yale, who had studied 1920s property markets, pointed now to the development of what looked to all appearances like a full-blown housing bubble. But not even Shiller anticipated the catastrophic consequences of its collapse. Nouriel Roubini, who had taken at least one course on the history of the Great Depression in his graduate student days at Harvard, pointed to the risks posed by a gaping US current account deficit and the accumulation of US dollar debts abroad. But the crisis of which Roubini warned, namely a dollar crash, was not the crisis that followed.

Specialists in the history and economics of the Great Depression, it should be acknowledged, did no better. And the economics profession as a whole issued only muted warnings that disaster lay ahead. It bought into the gospel of the Great Moderation. Policy makers lulled into complacency by self-satisfaction and positive reinforcement by the markets did nothing to prepare for the impending calamity.

It may be asking too much to expect analysts to forecast financial crises. Crises result not just from credit booms, asset bubbles, and the wrongheaded belief that financial-market participants have learned to safely manage risk, but also from contingencies no one can predict, whether the failure of a consortium of German banks to rescue Danatbank, a German financial institution, in 1931; or the refusal of the UK Financial Services Authority to allow Barclays to bid for Lehman Brothers over a fateful weekend in 2008. Financial crises, like World War I, can arise from the unanticipated repercussions of idiosyncratic decisions taken without full awareness of their ramifications. They result not just from systemic factors but from human agency—from the vaulting ambition and questionable scruples of a Rogers Caldwell, who in the 1920s fashioned himself the J. P. Morgan of the South; or an Adam Applegarth, the sporty, hyperconfident young banker who launched Northern Rock, a formerly obscure British building society, onto an unsustainable expansion path. Their actions not only brought down the firms they headed but undercut the very foundations of the financial system. Similarly, had Benjamin Strong, the über-competent governor of the Federal Reserve Bank of New York, not passed away in 1928, or Jean-Claude Trichet not become president of the European Central Bank as the result of a Franco-German bargain in 1999, the conduct of monetary policy might have been different. Specifically, it might have been better.

It is similarly disturbing in light of the progressive narrative that policy was not more successful at limiting financial distress, containing the rise in unemployment, and supporting a vigorous recovery. The subprime mortgage market collapsed in mid-2007, and the US recession commenced in December of that year. Yet few if any observers anticipated how severely the financial system would be disrupted. They did not foresee how badly output and employment would be affected. The Great Depression was first and foremost a banking and financial crisis, but memories of that experience did not sufficiently inform and invigorate policy for officials to prevent another banking and financial crisis.

It may be that the very belief that bank failures were the key event transforming a garden-variety recession into the Great Depression caused policy makers to mistakenly focus on commercial banks at the expense of the so-called shadow banking system of hedge funds, money market funds, and commercial paper issuers. The Basel Accord setting capital standards for internationally active financial institutions focused on commercial banks.[1] Regulation generally focused on commercial banks.

Moreover, deposit insurance was limited to commercial banks. Because the runs by retail depositors that destabilized banks in the 1930s led to creation of federal deposit insurance, there was the belief that depositor flight was no longer a threat. Everyone had seen *It's a Wonderful Life* and assumed that a modern-day banker would never find himself in George Bailey's position. But $100,000 of deposit insurance was cold comfort for businesses whose balances were many times that large. It did nothing to stabilize banks that did not rely on deposits but instead borrowed large sums from other banks.

Nor did deposit insurance create confidence in hedge funds, money market funds, and special purpose investment vehicles. It did nothing to prevent a 1930s-like panic in these new and novel parts of the financial system. Insofar as the history of the Great Depression was the frame through which policy makers viewed events, it caused them to overlook how profoundly the financial system had changed. At the same time that it pointed them to real and present dangers, it allowed them to overlook others.

Specifically, it allowed them to miss the consequences of permitting Lehman Brothers to fail. Lehman was not a commercial bank; it did not take deposits. It was thus possible to imagine that its failure might not precipitate a run on other banks like the runs triggered by the failure of Henry Ford's Guardian Group of banks in 1933.

But this misunderstood the nature of the shadow banking system. Money market mutual funds held Lehman's short-term notes. When Lehman failed, those money funds suffered runs by frightened shareholders. This in turn precipitated runs by large investors on the money funds' investment-bank parents. And this then led to the collapse of already teetering securitization markets.

Officials from US Treasury Secretary Henry Paulson on down would insist that they had lacked the authority to lend to an insolvent institution like Lehman Brothers, as well as a mechanism to smoothly shut it down. Uncontrolled bankruptcy was the only option. But it is not as if Lehman's troubles were a surprise. Regulators had been watching it ever since the rescue of Bear Stearns, another important member of the investment-banking fraternity, six months earlier. The failure to endow Treasury and the Fed with the authority to deal with the insolvency of a nonbank financial institution was the single most important policy failure of the crisis. In 1932 the Reconstruction Finance Corporation, created to resolve the country's banking problems, similarly lacked the authority to inject capital into an insolvent financial institution, a constraint that was relaxed only when the 1933 crisis hit and Congress passed the Emergency Banking Act. Chairman Bernanke and others may have been aware of this history, but any such awareness did not now change the course of events.

In part, this policy failure was informed by the belief, shaped and distorted equally by the lessons of history, that the consequences of a Lehman Brothers failure could be contained. But it also reflected officials' concern with moral hazard—with the idea that more rescues would encourage more risk taking.[2] Owing to their rescue of Bear Stearns, policy makers were already being raked over the coals for creating moral hazard. Allowing Lehman Brothers to fail was a way of acknowledging that criticism. Liquidationism—the idea, in the words of President Hoover's Treasury Secretary Andrew Mellon, that failure was necessary to "purge the rottenness out of the system"—may have fallen out of favor owing to its disastrous consequences in the 1930s, but in this subtler incarnation it was not entirely absent.

Finally, policy makers were aware that any effort to endow Treasury and the Fed with additional powers would be resisted by a Congress weary of bailouts. It would be opposed by a Republican Party hostile to government intervention. Ultimately, a full-blown banking and financial crisis would be needed, as in 1933, for the politicians to act.

It was at this point, after Lehman Brothers, that policy makers realized they were on the verge of another depression. The leaders of the advanced industrial countries issued their joint statement that no systematically significant financial institution would be allowed to fail. A reluctant US Congress passed the Troubled Asset Relief Program to aid the banking and financial system. One after another, governments took steps to provide capital and liquidity to distressed financial institutions. Massive programs of fiscal stimulus were unveiled. Central banks flooded financial markets with liquidity.

Yet the results of these policy initiatives were decidedly less than triumphal. Postcrisis recovery in the United States was lethargic; it disappointed by any measure. Europe did even worse, experiencing a double-dip recession and renewed crisis starting in 2010. This was not the successful stabilization and vigorous recovery promised by those who had learned the lessons of history.

Some argued that recovery from a downturn caused by a financial crisis is necessarily slower than recovery from a garden-variety recession.[3] Growth is slowed by the damage to the financial system. Banks, anxious to repair their balance sheets, hesitate to lend. Households and firms, having accumulated unsustainably heavy debts, restrain their spending as they attempt to reduce that debt to a manageable level.

But working in the other direction is the fact that government can step up. It can lend when banks don't. It can substitute its spending for that of households and firms. It can provide liquidity without risking inflation given the slack in the economy. It can run budget deficits without creating debt problems, given the low interest rates prevailing in subdued economic conditions.

And it can keep doing so until households, banks, and firms are ready to resume business as usual. Between 1933 and 1937, real GDP in the United States grew at an annual rate of 8 percent, even though government did only passably well at these tasks. Between 2010 and 2013, by comparison, GDP growth averaged just 2 percent. This is not to suggest that growth after 2009 could have been four times as fast. How fast you can rise depends also on how far you fall in the preceding period. Still, the US and world economies could have done better.

Why they didn't is no mystery. Starting in 2010 the United States and Europe took a hard right turn toward austerity. Spending under the American Recovery and Reinvestment Act, Obama's stimulus program, peaked in fiscal year 2010 before heading steadily downward. In the summer of 2011 the Obama administration and Congress then agreed to $1.2 trillion of spending cuts.[4] In 2013 came expiry of the Bush tax cuts for top incomes, the end of the reduction in employee contributions to the Social Security Trust Fund, and the Sequester, the across-the-board 8½ percent cut in federal government spending. All this took a big bite out of aggregate demand and economic growth.

In Europe the turn toward austerity was even more dramatic. In Greece, where spending was out of control, a major dose of austerity was clearly required. But the adjustment program on which the country embarked starting in 2010 under the watchful eyes of the European Commission, the European Central Bank, and the International Monetary Fund was unprecedented in scope and severity. It required the Greek government to reduce spending and raise taxes by an extraordinary 11 percent of GDP over three years—in effect, to eliminate more than a tenth of all spending in the Greek economy. The euro area as a whole cut budget deficits modestly in 2011 and then sharply in 2012, despite the fact that it was back in recession and other forms of spending were stagnant. Even the United Kingdom, which had the flexibility afforded by a national currency and a national central bank, embarked on an ambitious program of fiscal consolidation, cutting government spending and raising taxes by a cumulative 5 percent of GDP.

Central banks, having taken a variety of exceptional steps in the crisis, were similarly anxious to resume business as usual. The Fed undertook three rounds of quantitative easing—multimonth purchases of treasury bonds and mortgage-backed securities—but hesitated to ramp up those purchases further despite an inflation rate that repeatedly undershot its 2 percent target and growth that continued to disappoint. Talk of tapering those purchases in the spring and summer of 2013 led to sharply higher interest rates. This was not medicine one would prescribe for an economy struggling to grow by 2 percent.

And if the Fed was reluctant to do more, the ECB was anxious to do less. In 2010 it prematurely concluded that recovery was at hand and started phasing out its nonstandard measures. In the spring and summer of 2011 it raised interest rates twice. Anyone seeking to understand why the European economy failed to recover and instead dipped a second time need look no further.

What lessons, historical or otherwise, informed this extraordinary turn of events? For central banks there was, as always, deeply ingrained fear of inflation. The fear was nowhere deeper than in Germany, given memories of hyperinflation in 1923. German fear now translated into European policy, given the Bundesbank-like structure of the ECB and the desire of its French president, Jean-Claude Trichet, to demonstrate that he was as dedicated an inflation fighter as any German.

The United States did not experience hyperinflation in the 1920s, nor at any other time, but this did not prevent overwrought commentators from warning that Weimar was right around the corner. The lessons of the 1930s—that when the economy is in near-depression conditions with interest rates at zero and ample excess capacity, the central bank can expand its balance sheet without igniting inflation—were lost from view. Sophisticated central bankers, like Chairman Bernanke and at least some of his colleagues on the Federal Open Market Committee, knew better. But there is no doubt they were influenced by the criticism. The more hysterical the commentary, the more loudly Congress accused the Fed of debasing the currency, and the more Fed governors then feared for their independence. This rendered them anxious to start shrinking the Fed's balance sheet toward a normal level before there was anything resembling a normal economy.

This criticism was more intense to the extent that unconventional policies had gotten central bankers into places they didn't belong, such as the market for mortgage-backed securities. The longer the Fed continued to purchase mortgage-backed securities—and it continued into 2014—the more the institution's critics complained that policy was setting the stage for another housing bubble, and ultimately another crash. This fear became a totem for the worry that low interest rates were encouraging excessive risk taking. This, of course, was precisely the same concern over moral hazard that contributed to the disastrous decision not to rescue Lehman Brothers.

In the case of the ECB, the moral-hazard worry centered not on markets but on politicians. For the central bank to do more to support growth would just relieve the pressure on governments, allowing excesses to persist, reforms to lag, and risks to accumulate. The ECB permitted itself to be backed into a corner where it was the enforcer of fiscal consolidation and structural reform. In its role as enforcer, economic growth became the enemy.

In the case of fiscal policy, the argument for continued stimulus was weakened by its failure to deliver everything promised, whether because politicians were prone to overpromising or because the shock to the economy was even worse than was understood at the time. There was the failure to distinguish how bad conditions were from how much worse they would have been without the policy. There was the failure to distinguish the need for medium-term consolidation from the need to support demand in the short run. There was the failure to distinguish the case for fiscal consolidation in countries with gaping deficits and debts, like Greece, from the situation of countries with the space to do more, like Germany and the United States. Thus a range of factors came together. The one thing they had in common was failure.

Much may have been learned about the case for fiscal stimulus from John Maynard Keynes and other scholars whose work was stimulated by the Great Depression, but equally much was forgotten. Where Keynes relied mainly on narrative methods, his followers used mathematics to verify their intuitions. Eventually those mathematics took on a life of their own. Latter-day academics embraced models of representative, rational, forward-looking agents in part for their tractability, in part for their elegance. In models of rational agents efficiently maximizing everything, little can go wrong unless government makes it go wrong. This modeling mind-set pointed to government meddling as the cause of the crisis and slow recovery alike. Interference by the government-sponsored entities Freddie Mac and Fannie Mae had been responsible for the excesses in the mortgage market that precipitated the crisis, just as uncertainty about government policy was the explanation for the slow recovery.

It must similarly be, the intuition followed, that fiscal stimulus, as yet another form of government meddling, could do no good. Economists advancing these ideas invoked models in which households, knowing that additional deficit spending now would have to be paid for by higher taxes later, reduce their spending accordingly.[5] This logic suggested that the effects of temporary fiscal stimulus might be less than promised by their Keynesian proponents. But not even these models implied that temporary stimulus would have no effects.[6] Still, freshwater economists (so called because of their tendency to cluster around the Great Lakes) were quick to leap to this conclusion. George Bernard Shaw's aphorism that you can lay all the economists end to end and they still can't reach a conclusion was nowhere more apposite. This inability to agree on even the most basic tenets of economic policy undermined the intellectual case for an effective response.

In much of Europe, in any case, Keynesian theorizing never took hold. The out-of-control budgets and inflation of Weimar left German economists skeptical of deficit spending and led them to argue instead that government should focus on strengthening contract enforcement and fostering competition.[7] This was a more sophisticated position than the "government bad, private sector good" message that bubbled up from the Great Lakes. But it too sat uneasily with the case for stimulus spending and encouraged an early shift to austerity.

If theory of dubious relevance played a role in this policy shift, then so did empirical analysis of dubious generality. Two American economists presented evidence that growth tends to slow when public debt reaches 90 percent of GDP.[8] No one disputed that heavy debts weigh on economic growth, but the idea that 90 percent was a trip wire where performance deteriorates sharply was quickly challenged. Yet the fact that US and British public debts were approaching this red line and that the Eurozone's debt/GDP ratio exceeded it made it expedient to cite the assertion in support of a quick turn to austerity. What he mischaracterized as the "90 percent rule" was invoked by European Commissioner for Economic and Monetary Affairs Olli Rehn, for example, when justifying the policies of the European Union.

Two Italian economists meanwhile presented evidence that austerity, especially if resulting from public spending cuts rather than tax increases, could have contra-Keynesian expansionary effects.[9] Such results were plausible for an economy like Italy in the 1980s and 1990s, with enormous debts, high interest rates, and heavy taxes. In these circumstances, public spending cuts could bolster confidence, and those confidence effects could boost investment. But however plausible such predictions for Italy, they were not plausible for countries with lower debts. They were not plausible when interest rates were near zero. They were not plausible when the country in question, as a member of the Eurozone, lacked a national currency to devalue and could not readily substitute exports for domestic demand. And they were not plausible when the entire collection of advanced economies was depressed, leaving no one to export to.

This did not, however, prevent the doctrine of expansionary fiscal consolidation from being embraced in all its spurious generality by Congressman Paul Ryan, the self-appointed deficit expert in the US House of Representatives. It did not prevent it from being invoked by EU finance ministers in their post-summit press conferences and communiqués. The idea that fiscal consolidation could be expansionary allowed politicians to argue that austerity could be all gain and no pain. That the reality turned out to be different was a rude shock except for those for whom the pain and gain were not the issue but austerity in and of itself was the objective.

The most powerful factor of all in this turn to austerity was surely that policy makers prevented the worst. They avoided another Great Depression.

They could declare the emergency over. They could therefore heed the call for an early return to normal policies. There is no little irony in how their very success in preventing a 1930s-like economic collapse led to their failure to support a more vigorous recovery.

And what was true of macroeconomic policy was true equally of financial reform. In the United States, the Great Depression led to the Glass-Steagall Act, separating commercial banking from investment banking. It led to the creation of a Securities and Exchange Commission to rein in financial excesses. There were calls now for a new Glass-Steagall, the earlier act having been laid to rest in 1999, but there was nothing remotely resembling such far-reaching regulatory reform. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 contained some modestly useful measures, from limits on speculative trading by financial institutions to creation of a Consumer Financial Protection Bureau. But the big banks were not broken up. Rhetoric to the contrary, little was done about the problem of too-big-to-fail. There was nothing approaching the fundamental redrawing of the financial landscape that resulted from Glass-Steagall's sharp separation of commercial banking, securities underwriting, and insurance services.

The fundamental explanation for the difference is again the success of policy makers in preventing the worst. In the 1930s, the depth of the Depression and the collapse of banks and securities markets wholly discredited the prevailing financial regime. Now, in contrast, depression and financial collapse were avoided, if barely. This fostered the belief that the flaws of the prevailing system were less. It weakened the argument for radical action. It took the wind out of the reformers' sails. And it allowed petty disagreements among politicians to slow the reform effort. Success thus became the mother of failure.

But whatever challenges America faced in getting its political parties to agree on regulatory reform paled in comparison with the challenge in Europe. Where reform in the United States required a modicum of agreement between the two parties, progress in the EU required agreement among twenty-seven governments. To be sure, though all governments were equal, some, like Germany's, were more equal than others. But even in this Orwellian Europe, small countries could cause trouble if they refused to go along, as Finland did when asked to aid Spain through EU's rescue fund, the European Stability Mechanism. Reform might require agreement by countries both inside and outside the Eurozone, as in the case of measures to limit bankers' bonuses, which were stymied when the UK took the EU to the European Court of Justice over pay and bonus regulation.

Nothing more epitomized these difficulties than the fight over banking union. With the creation of the euro, banks throughout Europe became even more tightly connected. But those banks and their national regulators failed to take into account the impact of their actions on neighboring banks and countries. The lesson of the crisis was that a single currency and single financial market but twenty-seven separate national bank regulators was madness. The solution was a single supervisor, a single deposit insurance scheme, and a single resolution mechanism for bad banks. Banking union in its fullness was seen as critical for restoring confidence in EU institutions.

In the summer of 2012, at the height of the crisis, European leaders agreed to establish this banking union. They agreed to create a single supervisor to monitor the banks. But then the process bogged down. Countries with strong banking systems hesitated to delegate supervision to a centralized authority. Others complained that their banks and depositors would be paying into a common insurance fund to bail out countries with poorly run financial institutions. Still others objected that their taxpayers would be on the hook when it came to funding the common resolution authority. The one thing these three groups had in common was, well, Germany, whose chancellor, Angela Merkel, demanded revisions of the EU's treaties to specify how these mechanisms would work, and how they would be financed. But treaty revision was somewhere other governments hesitated to go, since it required the assent of parliaments, and in some cases public referenda, in the course of which the EU's most basic understandings could be cast into doubt.

European leaders therefore agreed to half a loaf. They would proceed with the single supervisor but limit its oversight to Europe's 130 biggest banks, while leaving the single deposit insurance scheme and resolution mechanism to later.[10]

This reflected the difficulty of decision making in a European Union of twenty-seven countries. But it also reflected that the EU did just enough to hold its monetary union together. Through emergency loans and creation of an ECB facility to buy the bonds of troubled governments, it did just enough to prevent the euro system from falling apart. This success in turn limited the urgency of proceeding with banking union. This success too became the mother of failure.

That Europe did just enough to hold its monetary union together and that the euro did not go the way of the gold standard in the 1930s were, for many, among the great surprises of the crisis. In the late 1920s, the gold standard was seen as the guarantor of economic and financial stability, because the decade when it was in abeyance, from 1914 through 1924, had been marked by anything but. It turned out, however, that the gold standard as reconstructed after World War I was neither durable nor stable. Rather than preventing the 1931 financial crisis, it contributed to its development, first by creating a misapprehension of stability that encouraged large amounts of credit to flow toward countries ill equipped to handle it, and then by hamstringing the ability of governments to respond. The results were bank runs and balance-of-payments crises, as investors came to doubt the capacity of the authorities to defend their banks and currencies. Freeing themselves from the gold standard then enabled countries to regain control of their economic destinies. It allowed them to print money where money was scarce. It allowed them to support their banking systems. It allowed them to take other steps to end the Depression.

The architects of the euro were aware of this history. It resonated even more powerfully given that they experienced something similar in 1992–93 with the collapse of the Exchange Rate Mechanism through which European currencies were tied together like a string of mountain climbers. They therefore set out to make their new monetary arrangement stronger. It would be based on a single currency, not on pegged rates between separate national currencies. Devaluation of national currencies would not be possible because countries would no longer have national currencies to devalue. This euro system would be regulated not by national central banks but by a supranational authority, the ECB.

Importantly, the treaty establishing the monetary union would make no provision for exit. It was possible in the 1930s for a country to abandon the gold standard by a unilateral act of its national legislature or parliament. Abandoning the euro, in contrast, would abrogate a treaty obligation and jeopardize a country's good standing with its EU partners.

But while avoiding some of the problems of the gold standard, the euro's architects courted others. By creating the mirage of stability, the euro system set in motion large capital flows toward Southern European countries ill equipped to handle them, like those of the 1920s. When those flows reversed direction, the inability of national central banks to print money and national governments to borrow it consigned economies to deep recession, as in the 1930s. Pressure mounted to do something. Support for governments that failed to do so began to dissolve. Increasingly it was predicted that the euro would go the way of the gold standard; governments in distressed countries would abandon it. And if they hesitated, they would be replaced by other governments and leaders prepared to act. In the worst case, democracy itself might be placed at risk.

This, it turned out, was a misreading of the lessons of history. In the 1930s, when governments abandoned the gold standard, international trade and lending had already collapsed. This time European countries did just enough to avoid that fate. Hence the euro had to be defended in order to preserve the Single Market and intra-European trade and payments. In the 1930s, political solidarity was another early casualty of the Depression. Notwithstanding the strains of the crisis, governments this time continued to consult and collaborate, with help from international institutions stronger and better developed than those of the 1930s. EU countries in a strong economic and financial position provided loans to their weak European partners. Those loans could have been larger, but they were still large by the standards of the 1930s.

Finally, the crisis of democracy forecast by those anticipating the euro's collapse failed to materialize. There were demonstrations, including violent demonstrations. Governments fell. But democracy survived, unlike the 1930s. Here the Cassandras of collapse failed to reckon with the welfare states and social safety nets constructed in response to the Depression. Even where unemployment exceeded 25 percent, as it did in the worst-affected parts of Europe, overt distress was less. This weakened the political backlash. It limited the pressure to abandon the prevailing system.

That the experience of the Great Depression importantly shaped perceptions and reactions to the Great Recession is a commonplace. But understanding just how that history was used—and misused—requires one to look more closely not just at the Depression but also at the developments leading up to it. This in turn means starting at the start, namely, in 1920.