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### Analysis

## Economic History and the Financial Crisis

Gary Hawke\*

Age leads us to revalue wisdom and experience relative to energy and enterprise, and to think we have been there before. An economic historian looking at our current situation in the light of the 1930s should ask two questions: What should we remember? What have we learned?

There is plenty to remember. Most economic historians attribute the severity of the Great Depression of the 1930s more to mistaken policy responses than to the initiating behaviour of market participants.

An even stronger consensus among economic historians is that absence of international co-operation increased the severity of the Great Depression.

There is equally no dispute that the hardship of the 1930s was intensified by the 'dead hand of orthodoxy'. What are now regarded as undoubtedly policy mistakes were the outcome of well-intentioned and consistently-applied orthodox but outdated beliefs. The most important policy mistakes were made by the Federal Reserve, and owed most to confidence that banks behaved according to the precepts of respectability and responsible banking rather than profit maximization, and to rules of thumb about bank balances in the Fed Reserve system, and 'real bills doctrines'.

What we see depends on from where we are looking as well as on what we are looking at. What are now accepted as observable facts took time to understand. There are other lessons which we have learned since the 1930s, which throw light on experience then and even more

on how we should relate that experience to our current circumstance.

We have experienced the Keynesian Revolution. Like 'Renaissance' or 'Reformation', 'Keynesian Revolution' has become so unspecific that inferences drawn from it are not only different but also inconsistent. Of immediate relevance to us is the lesson that governments can use fiscal policy to promote economic growth.

Governments could not use new learning until it was well understood, and fiscal expansion played little role until late in the experience of the 1930s. Governments are complex, and what the central government does is not necessarily the same as what the government sector does – the actions of local governments can offset central fiscal policy.

Government actions can also be countered by private responses. That is the clearest lesson of experience between the 1930s and now. For many countries, after the 1930s rather than in the course of the Great Depression itself, and in response to World War II as much as to adverse economic experiences, governments as a whole were increasingly seen as able to pursue a collective interest. Fiscal policy was immediately available and private support was readily mobilized for social objectives.

It did not last. The attractions of an agreed response to external challenges became less prominent. Societies became larger and more diverse so that it was more difficult to encompass private interests in a single construct. Eventually, the coincidence of unemployment and inflation in the 'stagflation' of the 1970s destroyed the conception of governments implementing a simple social choice of a trade-off. Governments were no longer accepted as benevolent instruments which expressed the popular will. Their actions were assessed and could be countered rather than as acquiesced in. Signalling and incentives came to the fore.

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Reactions are not always negative. In many circumstances, some long familiar from the theory of duopoly and many developed as part of game theory, private decisions are interdependent. The best course for one player depends on what other players do. Investment in one activity depends on market assessments in another. Consequently, fiscal policy gradually came to be conceived not as a direct expression of the general will, but as shaping the context in which decentralized decisions are made.

National experiences included many variations on this common story, but there are general implications. We should distinguish fiscal stimulus from additional public spending. If spending were the road to prosperity, we would not wait for a crisis before embarking on it with enthusiasm. Additional spending sends signals to which we should expect reactions - it does not translate directly into additional aggregate demand. Fiscal stimulus should be about overcoming co-ordination problems

The second important lesson from the years since the 1930s is that managing tension between growth and security should be distinguished from deciding the balance of private versus public activity. Growth requires change whereas security is linked to maintenance of the status quo.

Managing risks is often best approached through pooling them, and benevolent governments were obvious pooling instruments. Risk management is more complex when governments are less trusted to be benevolent to everyone. Technical change added impetus to a search for policy adaptation. Large parts of such social overhead capital as electricity supply could be managed competitively with only the national grid managed as a monopolistic regulated public utility. Cellular telephones meant that even local telephone systems did not need to be monopolistic. While much of the driving force was technological, there were still deeper forces at work. In the early 1970s, economists, especially Black, Scholes, and Merton worked out how to price derivatives. The management of risk was vastly changed although it took some time for new opportunities to be recognised and exploited. Market transactions could be used to manage risk in a way that had not previously been possible. The lesson learned in the 1930s was that a combined portfolio could be more diversified than a number of private portfolios. There

was usually a cost, but diminution of risk justifies an insurance premium. There was more cost in that a single mechanism did not suit everyone. What the innovations of the 1970s made available - mostly in the 1980s - was an alternative mechanism for managing risk, a market-based one.

The issue of growth versus security was no longer the issue of private versus public that had been recognised and utilised from the 1930s onwards. We have encountered problems in the new ways of managing risks, but the appropriate response is not to abandon everything that was gained and think we can return to a distant past.

The first requirement is accurate diagnosis. A New Zealand economist, A.G.B. Fisher, wrote in 1932 about the Great Depression:

*The chances of recovery are to a considerable extent dependent on the degree to which people believe, either that the depression is, so to speak, an act of God, a disaster like an earthquake or a flood, which could not have been avoided, and whose consequences must be faced bravely without complaint, or that depressions are the consequence of the limitations of human intelligence and foresight, limitations which are not absolute, but which it is the business of science to push further and further back.*

We still need positive thinking and not merely condemnation of greed and reassertion of moral authority by regulation. We should not retreat to what was orthodox and conventional some time ago – and is now outdated.

Perhaps the biggest change of all since the 1930s is the rise of Asia. As we look for mechanisms to avoid a repetition of a lack of international co-operation it is to Asian thinking about common objectives and peer review to which we should look. And as we explore relations between governments and private sectors, we should look to the future rather than the past, and start with accurate diagnosis of Asian ideas of co-operation rather than traditional notions of monitoring and accountability.

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