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Book Review: Hall of Mirrors: The Great Depression, the Great Recession, and the Uses—and Misuses—of History

Eichengreen, Barry (2015). *Hall of Mirrors: The Great Depression, the Great Recession, and the Uses—and Misuses—of History. New York: Oxford University Press. 520 pages. ISBN: 978-0199392001*

Economic analysis of the world crisis of the 1930s, known as the Great Depression in the United States, continues to expand more than 80 years after its onset. Similarly, the Great Recession (2007-2009 in the United States) shows every sign of joining it as a major focus of economic historians. Barry Eichengreen's book, Hall of Mirrors, sets a new standard by combining the two into a set of chronological parallel histories focused on policies and policy makers and the ways they used and misused history. He explores the lead ups to the two crises, the passage of regulations and the omission of regulations that enabled the crises, and most centrally, the reasons why policy makers in 2008 were able to avoid another Great Depression but still allowed a deeper and longer recession than necessary. The histories are told with attention to the details of economic analysis and the contexts of domestic and world politics. Eichengreen's work is qualitative but informed by quantitative analysis and his own extensive research on the Great Depression and financial crises of the late 19th and 20th centuries.

In the acknowledgements of Hall of Mirrors, Barry Eichengreen tells the story of his first lecture as a professor at University of California, Berkeley. The date was October 19, 1987, and he was co-teaching a graduate course on economic history. After the lecture, his colleague Jan deVries complimented him on the his discussion of the Crash of 1929, and asked if he had seen the day's stock market prices—the Dow Jones fell 508 points, or about 23 percent, making the October 1929 crash look puny by comparison.

In 1987, the Federal Reserve knew its job better and there was no repeat of 1929. Liquidity was freely provided, banks and the public were assured of Fed's support, and the economy barely registered the stock market crash. Learning had taken place in the intervening 58 years, so much so that by the mid-1980s, many economists had come to

the conclusion that another Great Depression was no longer possible—the Fed was too knowledgeable and macroeconomics too sophisticated. Or so we thought.

Eichengreen's Hall of Mirrors is an in-depth, parallel economic history of the Great Depression and the Great Recession, told in detail by one of the leading scholars on the Great Depression and financial crises. It deserves to become a classic in the economic history of financial crises. The book is divided into four parts covering before, during, and after the crises, with a concluding section that draws out the lessons for avoiding a similar crisis. Chapters in each section alternate between the two crises so that the stories of each are told in tandem. He begins with the underlying conditions leading up to each crisis, followed by their blossoming into full-blown disasters, the policy responses of national governments, and with a concluding section on the policy lessons for crisis avoidance and the history of post-crisis economic reforms. *Hall of Mirrors* is a book about economic policy, but it is also a detailed narrative filled with stories and personalities, always framed in the context of politics, economic theory, and what policy makers thought they knew about the economy.

Eichengreen is highly qualified to tell this story. His earlier work, Golden Fetters (1992) was the first in-depth history of the role of the gold standard in prolonging the Great Depression. That work demonstrated the limits to Freidman and Schwartz's magisterial *Monetary History of the United States* and changed how economists explain the length of the Great Depression and the timing of its ending. Eichengreen's work on post-World War II Europe, capital flows in the 20th Century, patterns of financial crises, and European integration, come together in this dense book, along with details about people and events, always informed by current economic thinking.

In many respects, Hall of Mirrors, can be seen as a post-Great Recession version of Kindleberger's *The World in Depression.* The latter is a qualitative economic history of the Great Depression from a global perspective, written before the quantitative economic analyses of financial crises of recent decades, but it remains a seminal work on the Great Depression in a global context. Eichengreen shares Kindleberger's perspective, derived originally from Hyman Minsky that prolonged periods of stability inevitably lead to a ratcheting up of risk taking by investors who slowly forget about previous crises and begin to believe in a New Era. In addition to standing on Kindleberger's shoulders, he has the advantage of

having read and contributed to the quantitative analyses of crises as well as recent writing on finance and the Great Recession.

One of the primary goals of *Hall of Mirrors* is to understand how policy makers in 2008-2009 were able to avert another Great Depression, but failed to avoid a serious recession that lasted far longer than it should have. Policy in 2009 was better than in 1929, but not as good as it might have been. The explanation for policy failures during the Great Recession is complex. Partly it has to do with beliefs about the Great Moderation (mid-1980s to 2008), conquering the business cycle, and the assumption that modern, open, market economies tend towards equilibrium in a relatively short time period if governments do not interfere. Another reason for the failure to act more effectively stems from the ways in which policy makers understand the lessons of the past and make use of those lessons to design policies in the present. Reactions to the downturn in 2008 in both Europe and the US were quick. Fiscal stimulus was passed, liquidity was provided, and unconventional monetary and fiscal policies were implemented. Policy makers had learned some of the lessons of the 1930s. Nevertheless, after the stimulus was deployed, they repeated mistakes from the past when they rushed to return unconventional policies to a more normal stance, long before economic conditions returned to normal. Debt reduction became a priority before growth resumed; the Treasury View of the 1930s which hypothesized complete crowding out had its counterpart in recent years in the belief in policy ineffectiveness; and the lessons of the liquidity trap for monetary policy were not absorbed beyond a subset of macroeconomists. In other words, current beliefs about the economy are not completely different from many of the pronouncements of policy makers in the 1930s. We have learned from our mistakes, but not as much as we think nor as much as we need to.

Eichengreen acknowledges that history is contested, that it is used by policy makers in ways that depend on which version they adopt, and that our understanding of history is shaped by the needs we have in the present. When the consequences of alternative interpretations are great, history is more likely to be a battleground of different views. For example, contemporary German policy makers and the creators of the European Central Bank (ECB) interpret the hyperinflation of 1923 as the greatest contributor to interwar instability and, ultimately, the onset of conflict. Hence, they guard against fiscal dominance

with no bail-out clauses for the ECB, and attacked fiscal deficits during the euro crisis even before national economies returned to growth. Other economists, many from the United States, interpret German austerity in the late 1920s and early 1930s as having had a more fundamental role in the rise of militarism, nationalism, and war. These two versions of the 1920s and 1930s shaped our understanding of policies in the Great Recession and the Eurozone crisis and explain the contested perspectives and major tendencies of national governments: worry about debt and inflation first, or restore growth first?

Recognition of the contestation of historical interpretation opens the window to political forces and ideas. Eichengreen is an empiricist and prefers to let data or natural experiments decide between contested economic theories, but in the realm of policy, where politics is an active force and where implementation often determines outcomes, he describes the beliefs of different actors and shows how those beliefs shape their responses to key economic events.

This is particularly insightful when policy gets the economics wrong, but justifies itself with reference to history. For example, the Chairman of the ECB in 2010, Jean Claude Trichet, identified with the German anti-inflation school of thought that derived its views from the 1923 hyperinflation episode. Consequently, he did not believe in the utility of measures of core inflation (inflation minus energy and food prices) and when headline inflation jumped with a rise in food and energy prices, Trichet responded by raising interest rates; the Eurozone responded by falling back into recession. Similarly, when some policy makers converted sovereign fiscal crises into examples of moral failures, it resulted in policies that deepened the recessions in Southern Europe, and weakened the recovery in the United States.

Most economists probably have at least a vague sense of the similarities between the Great Depression and the Great Recession, but the parallels run deeper than commonly recognized. The Hall of Mirrors tells the story of real estate booms in Florida and elsewhere in the 1920s, when the US built more square feet of skyscrapers than in any other decade, along with stories of financial innovation, market deregulation, and bubbles in housing markets in the US and Europe in the 2000s. He describes the role of capital flows under the gold standard, and how German finance depended on US lending which ceased suddenly in 1928 and put enormous strains on banking and finance. The counter-

part is the "global savings glut" of the 2000s, a term first used by Bernanke, before he became Chairman of the Federal Reserve, in a 2005 speech. The desire to balance budgets, to "return to normal," shaped policy in both periods and led to the double-dip recession in the US in 1937, Trichet's misguided raising of interest rates in 2010, and the sequester and tax increases in the US in 2013 which shaved growth off the economy. Financial innovation, exchange rate economics, unconventional policies, and the enduring uncertainty of crisis response, were factors in both periods.

The differences are important as well, beginning with financial technologies and institutional arrangements. Eichengreen explains how much easier it was to adjust mortgages in the 1930s, when all homeowners made down payments of 50%, as opposed to the 2000s, when down payments in the US were often only a few percentage points, or even zero. The complexity of financial instruments today, as opposed to the 1930s, is another important distinction. We learned from the 1930s to focus on the banking sector, but by 2000, the non-bank financial sector was the key source of instability, particularly in the US. And today, there is no gold standard, nor its requirement for exchange rate stability, at least outside of the Eurozone.

There are more differences, but in the end, policy makers and many economists believed they had learned the lessons of the 1930s and that a similar catastrophe could not happen again. In Eichengreen's view, this is precisely why our response was inadequate. Prompt policy response was able to avert another Great Depression and that removed the pressure for more dramatic responses. In the 1930s, strong financial regulations were implemented, particularly in the US where the depression was deeper and lasted longer. New regulations included the Federal Deposit Insurance Corporation which created deposit insurance at a national level, the Securities and Exchange Commission which was the first serious attempt to regulate stock market trading, the Glass-Steagall Act[1] separating commercial and investment banking, and others. In the wake of the Great Recession, the US passed Dodd-Frank[2], a much weaker version of financial regulation, and the Europeans

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[1] The first "Glass–Steagall Act" was passed by the US Congress in 1932, prior to the inclusion of more comprehensive measures in the Banking Act of 1933, now more commonly known as the Glass-Steagall Act.

[2] Dodd–Frank Wall Street Reform and Consumer Protection Act (commonly referred to as Dodd-Frank) was signed into federal law by President Obama on July 21, 2010. For details of Dodd-Frank, see http://www.cftc.gov/lawregulation/doddfrankact/index.htm

tried to strengthen fiscal rules on deficits and debt, but were unable to implement a fiscal union or even a complete banking union. These reforms are weak by comparison with the 1930s and many of the problems responsible for the crisis continue as before.

Have we learned this time? Eichengreen argues that we have but that the obstacles to crisis prevention are still significant. Among them are the failure to address the problem of too-big-to-fail, a continued focus on banking institutions when much of the instability is within the non-bank financial sector, an unstable and unworkable monetary union in Europe, and over-use of leverage to fund financial activities. Dodd-Frank and European attempts at creating a banking union are discussed favorably, but in the end, he argues that they are inadequate and the next time might be even worse.

The physical Hall of Mirrors in the Palace of Versailles is the site where the Treaty of Versailles was signed, ending World War I and leading to Keynes' excoriating and prescient critique, The Economic Consequences of the Peace. In Eichengreen's Hall of Mirrors, the European Union's response to the crisis of 2008-2009 deeply divided member nations, undermined trust and solidarity, and drove a wedge between countries while it converted a recession into an existential crisis for the euro and the European Union. The US, with its own currency and all its debt denominated in that currency, was more successful at avoiding the worst, but in Eichengreen's view, its reform attempts were completely inadequate to avert the next crisis. There is no New Era, and to paraphrase another great work on financial crises, we may believe that the next time will be different, but that is not likely.

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