**Introduction**

The Great Depression deserves its title. The economic crisis that began in 1929 soon engulfed virtually every manufacturing country and all food and raw materials producers. In 1931, Keynes observed that the world was then ‘in the middle of the greatest economic catastrophe . . . of the modern world . . . there is a possibility that when this crisis is looked back upon by the economic historian of the future it will be seen to mark one of the major turning points’ (Keynes, 1931). Keynes was right; Table 1 shows some of the dimensions.

**Table 1**

The Great Depression vs Great Recession in the advanced countries

|  | **Real GDP** | **Price level** | **Unemployment (%)** | **Trade volume** |
| --- | --- | --- | --- | --- |
| 1929 | 100.0 | 100.0 | 7.2 | 100.0 |
| 1930 | 95.2 | 90.8 | 14.1 | 94.8 |
| 1931 | 89.2 | 79.9 | 22.8 | 89.5 |
| 1932 | 83.3 | 73.1 | 31.4 | 76.5 |
| 1933 | 84.3 | 71.7 | 29.8 | 78.4 |
| 1934 | 89.0 | 75.3 | 23.9 | 79.6 |
| 1935 | 94.0 | 77.6 | 21.9 | 81.8 |
| 1936 | 100.6 | 81.4 | 18.0 | 85.7 |
| 1937 | 105.3 | 91.5 | 14.3 | 97.4 |
| 1938 | 105.4 | 90.4 | 16.5 | 87.0 |
|  |  |  |  |  |
| 2007 | 100.0 | 100.0 | 5.4 | 100.0 |
| 2008 | 100.5 | 102.0 | 5.8 | 100.6 |
| 2009 | 97.3 | 102.9 | 8.0 | 85.0 |
| 2010 | 99.6 | 103.7 | 8.4 | 93.3 |

*Sources*: 1929–38: Real GDP: Maddison (2010) western European countries plus western offshoots; Price level: League of Nations (1941); data are for wholesale prices, weighted average of 17 countries; Unemployment: Eichengreen and Hatton (1987); data are for industrial unemployment, weighted average of 11 countries; Trade volume: Maddison (1985), weighted average of 16 countries.

2007–2010: IMF, World Economic Outlook Database, April 2010.

What are the key questions that we should ask about the Great Depression? Why the crisis began in 1929 is an obvious start, but more important questions are why it was so deep and why it lasted so long? Sustained recovery did not begin in the United States until the spring of 1933, though the UK trough occurred in late 1931 and in Germany during the following year. Why and how did the depression spread so that it became an international catastrophe? What role did financial crises play in prolonging and transmitting economic shocks? How effective were national economic policy measures designed to lessen the impact of the depression? Did governments try to coordinate their economic policies? If not, then why not? Why did the intensity of the depression and the recovery from it vary so markedly between countries?

Even in recovery, both the UK and the USA experienced persistent mass unemployment, which was the curse of the depression decade (Table 2). Why did the eradication of unemployment prove to be so intractable? In 1937–8 a further sharp depression hit the US economy, increasing unemployment and imposing further deflation. What caused this serious downturn and what lessons did policy-makers draw from it?

**Table 2**

The Great Depression in the United Kingdom and the United States

|  | **Real GDP** | **GDP deflator** | **Unemployment (%)** | **Stock market prices** |
| --- | --- | --- | --- | --- |
| **UK** | | | | |
| 1929 | 100.0 | 100.0 | 8.0 | 100.0 |
| 1930 | 99.9 | 99.6 | 12.3 | 80.5 |
| 1931 | 94.4 | 97.2 | 16.4 | 62.8 |
| 1932 | 95.1 | 93.7 | 17.0 | 60.2 |
| 1933 | 96.0 | 92.5 | 15.4 | 74.3 |
| 1934 | 102.8 | 91.7 | 12.9 | 90.3 |
| 1935 | 106.6 | 92.6 | 12.0 | 100.0 |
| 1936 | 109.9 | 93.1 | 10.2 | 115.9 |
| 1937 | 114.7 | 96.6 | 8.5 | 108.0 |
| 1938 | 118.2 | 99.3 | 10.1 | 88.5 |
| **USA** | | | | |
| 1929 | 100.0 | 100.0 | 2.9 | 100.0 |
| 1930 | 91.4 | 96.4 | 8.9 | 69.4 |
| 1931 | 85.6 | 86.3 | 15.6 | 35.8 |
| 1932 | 74.4 | 76.2 | 22.9 | 30.8 |
| 1933 | 73.4 | 74.2 | 20.9 | 46.2 |
| 1934 | 81.3 | 78.4 | 16.2 | 45.8 |
| 1935 | 88.6 | 79.9 | 14.4 | 63.1 |
| 1936 | 100.0 | 80.7 | 10.0 | 79.8 |
| 1937 | 105.3 | 84.1 | 9.2 | 50.5 |
| 1938 | 101.6 | 81.7 | 12.5 | 61.7 |

*Note*: Unemployment based on the whole-economy series constructed by Weir (1992).

*Sources*: UK: Real GDP: Feinstein (1972); GDP deflator: Feinstein (1972); Unemployment: Boyer and Hatton (2002); Stock market prices: Mitchell (1988). USA : Carter *et al*. (2006).

By the late twentieth century, the memory of international financial seizure in the US and Europe, mass unemployment, and severe deflation had receded. However, during 2007–8, an astonishing and unexpected collapse occurred which caused all key economic variables to fall at a faster rate than they had during the early 1930s. As Eichengreen and O’Rourke (2010) report, the volume of world trade, the performance of equity markets, and industrial output dropped steeply in 2008. Moreover, a full-blown financial crisis quickly emerged. The US housing boom collapsed and sub-prime mortgages, which had been an attractive investment both at home and abroad, now became a millstone round the necks of those financial institutions that had eagerly snapped them up. In April 2007, New Century Financial, one of the largest sub-prime lenders in the US, filed for Chapter 11 bankruptcy. In August, Bear Stearns, an international finance house heavily involved in the sub-prime market, teetered on the verge of bankruptcy. The US Treasury helped finance its sale to J. P. Morgan during the following year. During 2008 the financial crisis developed with a sudden and terrifying force. In September, Freddie Mac and Fannie Mae, which together accounted for half of the outstanding mortgages in the US, were subject to a federal takeover because their financial condition had deteriorated so rapidly. At the same time Lehman Brothers, the fourth largest investment bank in the US, declared bankruptcy. It seemed as if financial meltdown was not only a possibility, it was a certainty unless drastic action was taken.

The crisis was not confined to the US. In August 2007, the French bank, BNP Paribas, suspended three investment funds worth €2 billion because of problems in the US sub-prime sector. Meanwhile, the European Central Bank was forced to intervene to restore calm to distressed credit markets which were badly affected by losses from sub-prime hedge funds. On 14 September 2007, the British public became aware that Northern Rock, which had moved into sub-prime lending after concluding a deal with Lehman Brothers, had approached the Bank of England for an emergency loan. Immediately the bank’s shares fell by 32 per cent and queues formed outside branch offices as frantic depositors rushed to withdraw their savings. Such was the pressure that Northern Rock was nationalized in February 2008. The run on Northern Rock was an extraordinary event for the UK. During the Great Depression no British financial institution failed, or looked like failing, but in 2007 there was immediate depositor panic. It was clear that without some assurance on the security of deposits other institutions were at risk. In 2009, UK GDP contracted by 4.8 per cent, the steepest fall since 1921.

A comparison of the catastrophic banking crisis in 1931 with that of 2007–8 shows that the countries involved in 1931 accounted for 55.6 per cent of world GDP, while the figure for the latter period is 33.5 per cent (Reinhart, 2010; Maddison, 2010). This is the most widespread banking crisis since 1931 and it is also the first time since that date that major European countries and the United States have both been involved. The financial tidal wave was totally unexpected and was of such severity that immediate policy action was required to prevent total meltdown. For a while it seemed that the world stood at the edge of an abyss, a short step away from an even greater economic disaster than had occurred three-quarters of a century earlier.

In these circumstances, it has been natural to ask what the historical experience of the crisis of the 1930s has to teach us. The big lesson that has been correctly identified is not to be passive in the face of large adverse financial shocks. Indeed, aggressive monetary and fiscal policies were immediately implemented to halt the financial disintegration. Fortunately, countries were not constrained by the oppressive stranglehold of the gold standard. Both monetary and fiscal policies could be used to support economic expansion rather than to impose deflation or try to restore a balanced budget. Flexible exchange rates gave policy-makers the freedom to use devaluation as an aid to recovery. The exception was in the Eurozone, where weak member states, for example, Greece, Ireland, and Portugal, were forced to deflate their economies (Eichengreen and Temin, 2010, this issue).

In the United States, the Fed began aggressively to lower interest rates in January 2008 and by the year’s end had adopted a zero-rate policy. Quantitative easing was used on a massive scale during 2008 through to early 2010 and, as a result, the money supply rose dramatically. The American Restoration and Recovery Act, which became law in early 2009, earmarked $787 billion to stimulate the economy and was described by Christina Romer, distinguished economic historian of the great depression and Chair of the President’s Council of Economic Advisors, as ‘the biggest and boldest countercyclical action in American History’ (Romer, 2009). In the UK, the Bank of England adopted the lowest interest rates since its foundation in 1694, quantitative easing was used aggressively, and bank bail-outs were funded where necessary. In October 2007 the guarantee for UK bank deposits was raised to £36,000 per depositor and further increased to £50,000 during the following year. In both countries, monetary and fiscal policies were pursued on a scale that would have been unacceptable during the 1930s but, crucially, these bold initiatives prevented financial meltdown. Fortunately, the crisis did not encourage the adoption of the beggar-thy-neighbour policies that helped to reduce the level of international trade so drastically during the 1930s.

This represents a dramatic contrast with the policy stances of 80 years ago. Thus far, the upshot is that a repeat of the Great Depression has been avoided (Table 1). A dramatic financial collapse has been averted, economic recovery, though tenuous, is progressing, and unemployment has not reached the levels that some commentators feared when the downturn began. As we shall see, the ‘experiment’ of the 1930s shows only too clearly the likely outcome in the absence of an aggressive policy response.

The 1930s has more to offer. In particular, we can look not only at the downturn but also the recovery phase. Here the issues that had to be addressed included re-regulation of the banking system, avoiding a double-dip recession, and dealing with the various legacies of the depression which included long-term unemployment and the need for a new, post-gold-standard, macroeconomic policy framework.