A Sustainable Global Economic System after the "Great Recession"? Some Lessons from History

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The "Great Recession" has sparked a renewed interest among scholars and policy makers in the study of past financial crises (generally divided into banking, currency, debt, and combinations of the three), their origin, unfolding, and consequences. Historical precedents show that lasting solutions are reached by having a clear understanding of both "monetary" and "real" determinants of a crisis as well as of its international implications. Crises then become an opportunity to implement reforms at the domestic and international levels to put the global economy onto a sustainable path of growth. In the immediate aftermath of the 2008 crisis, governments around the world have been collaborating to prevent a complete meltdown of the global financial system. G-20 meetings, increased reliance on (and funds to) the International Monetary Fund, implementation of large fiscal stimuli, and expansionary monetary policies have, for the time being, signaled a willingness to stabilize the world economy and prevent a rush to "beggar-thy-neighbor" types of policies. However, history shows that this encouraging trend can be readily reversed if countries are not able to maintain expansionary policies while implementing reforms at both domestic and global levels.

The fall of Lehman Brothers in September 2008 has changed our perception of the workings of global finance and of the stability and sustainability of the type of growth the world has experienced since the 1980s. First, the growth of the world economy in the last two decades was based on vast global current account imbalances. On the one hand, the United States accounted for most of the deficit, and on the other, Japan, Germany, China, and other emerging economies accounted for most of the surplus. Second, the international expansion of financial and credit markets was rooted in the assumption that the U.S. banking and financial systems were sound

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and that the Federal Reserve would act as a lender of last resort in case of a major financial crisis in the United States. The reliance on this system was so widespread that countries with less sophisticated banking and financial systems were often advised to follow similar paths of deregulation and openness to innovation in financial services. In fact, it was precisely the excessive reliance on this system that contributed to its extreme leverage and ultimate collapse.

Most likely, the U.S. financial system, albeit on the mend, will not regain the same international role and relevance that it had during the credit boom of the last two decades. The spillover effect on the real economy and dramatic decline in world trade have raised the specter of deep recession followed by mild recovery. The severity of the recession is already evident in the collapse of world trade and slowdown in international capital flows. The Great Recession has changed the debate from how to manage globalization to how to prevent deglobalization. It has also sparked debates about the future of market economies and capitalism in general and about whether government presence will increase and rein in the instability of markets.[1]

One of the consequences of this state of affairs is a renewed interest among scholars and policy makers in the study of past financial crises, their origin, unfolding, and consequences. The vast literature on the subject ranges from historical overviews to analyses of the determinants of specific types of financial crises (generally divided into banking, currency, debt, and combinations of the three) to case studies (by country, region, sectors, and financial instruments). The most influential contributions include a combination of these approaches, as, for instance, in the now classic Kindleberger's *Manias, Panics, and Crashes* (Kindleberger 1989; Kindleberger and Aliber 2005) and more recent Reinhart and Rogoff's *This Time Is Different* (Reinhart and Rogoff 2009).[2]

In this paper I focus on two historical cases that show why, at a time of major financial and economic crises, it is important to focus on solving problems in the underlying structure of the economy. Crises often emerge because countries fail to adapt their economies to changes in the structure of the international economy, including the inability of their institutions to cope with such changes. That was the case in the Kingdom of Naples in the seventeenth century, as I explain in the first section. I focus in particular on the work of a contemporary observer, Antonio Serra, against the backdrop of a series of financial and economic crises that plagued the Kingdom of Naples for several decades. In contrast to the mainstream interpretation of the time, which emphasized the monetary origins of these crises, Serra identified "real" factors—from an absence of manufacturing and "entrepreneurial spirit" to a lack of credit and good governance—as the primary causes of the kingdom's series of crises. With this example, I show how, in a distant past, debates about economic crises revolved around their causes as well as their solutions, with a clear distinction between "monetary" (including exchange rate) and "real" factors. The policy implications of this dichotomy were evident then as now, contributing to the emergence of analyses that, by focusing on a country's economic structure and position in the international economy, seek to promote long-term growth and reduce the exposure to crises.

The focus on real rather than simply financial factors at times of crisis is also central to another seventeenth-century analysis, which I present in the second section of this paper. In this case an Italian mathematician, Geminiano Montanari, challenged the common practice of blaming financiers and financial innovations for all evils at times of financial crisis. According to Montanari, it was the distortion and misallocation of resources and human capital caused by excess profits in financial activities that contributed to the decline in investments in manufacturing and commerce in the economies of the Italian city-states and ultimately to their demise. He concluded that as the contemporary virtuous example of Holland showed, a country could achieve more sustainable growth by using finance to support investments in real activities, while being less exposed to the vagaries of financiers' practices.[3]

In the third section, I briefly outline one of the lessons from the Great Depression, which has important implications for the current debate on the design of policies to weather the Great Recession and of exit strategies. On the basis of existing literature, I stress how lack of coordination at the international level contributed to a chaotic demise of the gold standard, the implementation of "beggar-thy-neighbor" policies, and an uneven recovery across the world. Countries that abandoned the gold standard first—and thus were able to devalue and implement expansionary policies—recovered more rapidly than those that broke their "golden fetters" later in the decade (Eichengreen 2008). Within the former group, countries such as Brazil, Great Britain, Colombia, Germany, and Japan, which implemented import substitution policies and channeled investments in real activities, recorded impressive rates of growth (Feinstein, Temin, and Toniolo 2008).

The economic history of the 1930s also shows that lack of international cooperation and the widespread adoption of "beggar-thy-neighbor" policies bore enormous geopolitical and economic costs later in the decade and in the early 1940s. The lesson from this example, in line with the two previous, is that historically, major crises have provided opportunities to rethink a country's economic structure. Given the current integration of the world economy and the current account imbalances that preceded the Great Recession, perhaps one should consider the world as a large economy and rethink the role of countries as that of regions within one nation. We need to "think outside the box" and adjust long-standing practices, institutions, policies, and international agreements to reflect the new structure of the global economy.

As a historian dealing with the daunting title of this plenary session, "The Road Ahead to a Sustainable Global Economic System," I chose a few examples from a distant past that, despite differences in the underlying economic structure, historical context, and origin of crisis, give a sense of how certain features of crises are, as Charles Kindleberger has shrewdly remarked, "hardy perennial." History can provide examples of what did or did not work in specific historical settings, but, more important, it can also teach us to seize the moment, to sense the relevance of the times we are living through. It is during uncertain economic times like the present that governments are required to act decisively and to implement reforms that could set the world economy on a more sustainable path of growth.

The renewed interest among scholars and financial institutions such as the International Monetary Fund in the history of money, financial institutions, and crises, as witnessed by the recent publication of several studies and the formation of new data sets, is a positive development. As well put by Larry Neal in a recent paper, there is a tendency among decision makers in the past as well as today "to spurn the insights developed by historians, feeling that they are irrelevant in the context of modern technology and institutions" (Neal 2009), or, as Gregory Mankiw remarks in assessing the impact of the current crisis on the future teaching of economics, the study of financial institutions "will need to become more prominent in the classroom" (Mankiw 2009). The hope is that decision makers and the financial sector will learn from past mistakes and pay attention to the lessons from history.

Money Is Not the Problem

At the beginning of the seventeenth century, the Kingdom of Naples—a viceroyalty under Spanish control—experienced a series of economic crises whose origins sparked lively debates among Neapolitan and Spanish administrators, merchants, foreign merchant-bankers, and observers of political and economic events.

Over the course of the previous century, the population of the kingdom had grown so much that Naples, with its population of 300,000 at the start of the seventeenth century, rivaled Paris and London, the largest cities in Europe. Population explosion meant an increase in the consumption of commodities such as wheat, wine, and oil that, together with silk, had traditionally constituted the largest share of Neapolitan exports. Increased consumption combined with a decline in manufacturing activities during the same period translated into a worsening of the trade balance and a net outflow of silver and gold. The primary role that agriculture played in the kingdom also meant that bad harvests, such as those occurring in 1593, 1595, 1598, and 1607, weighed heavily on Neapolitan finances because they meant a reduction in export revenues and an increase in payments for the import of wheat and other basic commodities.

The existence of a large public debt exacerbated the precarious financial situation of the kingdom, in particular since most of the interest on the debt was paid to foreign merchants and bankers, thus increasing the outflow of gold and silver coins. The Neapolitan government tried to cope with the ballooning public deficit by rescheduling and negotiating lower interest on the existing debt, but with mixed success. Other attempts to reduce the outflow of precious metals for the repayment of the debt and to inject liquidity in a kingdom plagued by money shortages also failed. Thus the shortage of money and rapid depreciation of the exchange rate were major symptoms of a deteriorating economic situation.

In the early modern period, the exchange rate was at the center of a complex system of international payments involving the conversion of multiple metal, gold, and silver currencies as well as money of accounts throughout Europe. The exchange rate not only enabled the conversion of foreign prices into domestic ones and vice versa but also contributed to the widespread use of credit instruments such

as bills of exchange, which by the end of the sixteenth century had become the most widely used instrument of international payments in Europe. Bills of exchange incorporated the concept of the exchange rate to enable the settlement of accounts among merchants from different states. The existence and diffusion of bills of exchange constituted an expansion of credit (without the physical transfer of metallic money) and contributed to the development of trade and the transfer of wealth throughout Europe (De Rosa 1994; Rosselli 2000). However, over time they became speculative instruments that enabled bankers to amass large profits. This transformation was facilitated by the fact that a handful of international bankers, mainly from Genoa, exercised a de facto monopoly on the international market of these products. These bankers not only held a network of banks throughout Europe but also were in control of the organization of international fairs where a restricted group of European bankers met every three months to settle their accounts, including bills of exchange.

Decrees and treatises from the first decades of the seventeenth century show how monetary issues worried the Neapolitan government as well as experts of the time. Gio Donato Turbolo, an officer of the mint, computed that of the 13 million ducats minted in Naples during the period 1599–1629, only 3 million were still in circulation in the late 1620s. More worrisome for the observers was the poor quality of the circulating money. Attempts to address this problem through a complete overhaul of the monetary system, such as the reforms of 1609 and 1622, failed. Other attempts to inject liquidity into the state, such as a series of debasements (depreciations), resulted in a devaluation of the Neapolitan coinage by 30 percent in the course of the 1610s (Calabria 1991).

Dismissing objections that an appreciation of Neapolitan currency would hurt trade, advisers to the Neapolitan government believed that an aggressive revaluation of the Neapolitan currency would solve the monetary and economic problems of the kingdom. For one of these advisers, the businessman De Santis, the kingdom's exports were so vital to the life and well-being of people in other states that higher prices would not deter foreign demand. Similarly, the appreciation of the Neapolitan currency would attract foreign capital because foreigners would perceive the Neapolitan securities as less risky and more trustworthy (De Rosa 1994). These views held a strong influence on the Spanish administrators of the Kingdom of Naples and were incorporated into a series of economic reforms that not only failed to tackle the liquidity and credit crisis but also contributed to the worsening of the trade balance.

These views and policies came under attack, in particular in a short treatise, *Brief Treatise on the Causes Which Can Make Gold and Silver Plentiful in Kingdoms Where There Are No Mines,* written in 1613 by Antonio Serra, a doctor confined to the prison of Vicaria in Naples under indictment of counterfeiting (Serra [1613] 1994). Serra challenged the dominant view that the kingdom's economic crisis was the consequence of monetary disorders and that monetary and fiscal measures, including manipulation of the exchange rate, could suffice to address the crisis. In his view, the level of the exchange rate was the consequence rather than the cause of monetary shortages (Monroe 1924; Grilli 2006).

To support his views, Serra presented an ideal model of an economy and compared it to the reality of the Kingdom of Naples. For Serra the economic success of a country was dependent on growth in manufacturing and agriculture, an internal process in which a series of factors, including quality of people and good government, played a crucial role. Serra supported his claim by pointing to the lasting economic success of the Venetian Republic. Venice had the most advanced manufacturing sector of the time, the result of investments and ability to retain "the most skilled workers of Europe," excellent trading capabilities including a credit and monetary system that was the envy of the rest of Europe, and an efficient administration. According to Serra, the combination of these factors had ignited a self-reinforcing process of growth, a virtuous cycle with manufacturing at its center.

The good esteem of the Venetian economy and government was reflected, according to Serra, in the low interest on public debt (4 percent a year), which was in contrast to interest of 8–10 percent in Naples. To make matters worse, foreigners held a large portion of the Neapolitan public debt, which represented a constant drainage of reserves (via service on the debt) and, given the deficit in the balance of trade, a constant increase in consolidated debt. In contrast, Venice's current account surpluses contributed to the public treasury.

The success of Venice could be ascribed to several factors. The Venetian government had removed major "impediments" to the smooth work of trading and manufacturing activities and created opportunities for merchants and artisans to develop their own businesses—by providing the right incentives and a good environment in modern economic terms. But for Serra, institutional continuity was the most powerful explanation of Venice's success. Monarchs change, and with them objectives and policies, while in the Venetian Republic the commonwealth had been consistently pursued over time through a constant improvement in the working of various institutions, such as the Senate, and in the selection and management of magistrates, administrators, and officials. The interaction among institutions and across generations (as, for example, in the Senate, where old and young senators learned how to cooperate) and the development of institutional mechanisms (as, for instance, the passing of laws in the Senate, which required a majority of votes) guaranteed the necessary institutional stability and yet allowed for the frequent and necessary renewal of the governing bodies.

Venice represented the model for what to do in Naples, where structural economic and political problems had contributed to the economic decline and monetary crises. For Serra, all the measures suggested by Neapolitan officials—an overvalued exchange rate, a ban on the export of money, and increased taxes on foreigners—went in the wrong direction because they were based on a faulty assessment of the economic reality of the kingdom. He supported government intervention in the real sector of the economy, in particular in manufacturing, but minimal intervention on the monetary side: no exchange rate manipulations, no barriers to capital movements.[4]

The *Brief Treatise* ends with a list of proposals to help sovereigns and policy makers in their "difficult task" of steering the economy of their states. Rather than seizing the income realized by foreigners in the kingdom or appreciating the exchange

rate, Serra supported the overtaking of foreign-controlled production by local entrepreneurs, in a slow manner to avoid any disruption in trade. But to achieve this goal—through what today would be called an import substitution strategy—it was necessary to invest, "to introduce in the kingdom" those factors that would support the development of manufacturing and devise regulations that would attract foreign capital and skilled labor. Serra believed there was room to change the course of events, the economic position of a country, with good government and good policies. It was this capacity to change the fate of a country that made "good government" the most powerful of all factors and yet "the most difficult and unpredictable of all" (Monroe 1924).

This case study shows how, at times of major economic crisis, it is important to think beyond the containment and to question the economic structure of the economy in which the crisis is taking place. Contrary to mainstream interpretations of the time, Serra argued that only a complete overhaul of the economic system would prevent the recurrence of crises in Naples. This lesson is still meaningful today. The famous Japanese "lost decade" can be attributed in part precisely to the unwillingness, at least in the 1990s, to undertake radical reforms in the banking sector as well as to boost domestic consumption. The ongoing crisis in the United States can also be attributed in part to the postponement of reforms in the U.S. economy, despite the warning signals at the beginning of the decade, including the dot-com bubble, the Enron collapse, and the rise of unsustainable twin deficits.

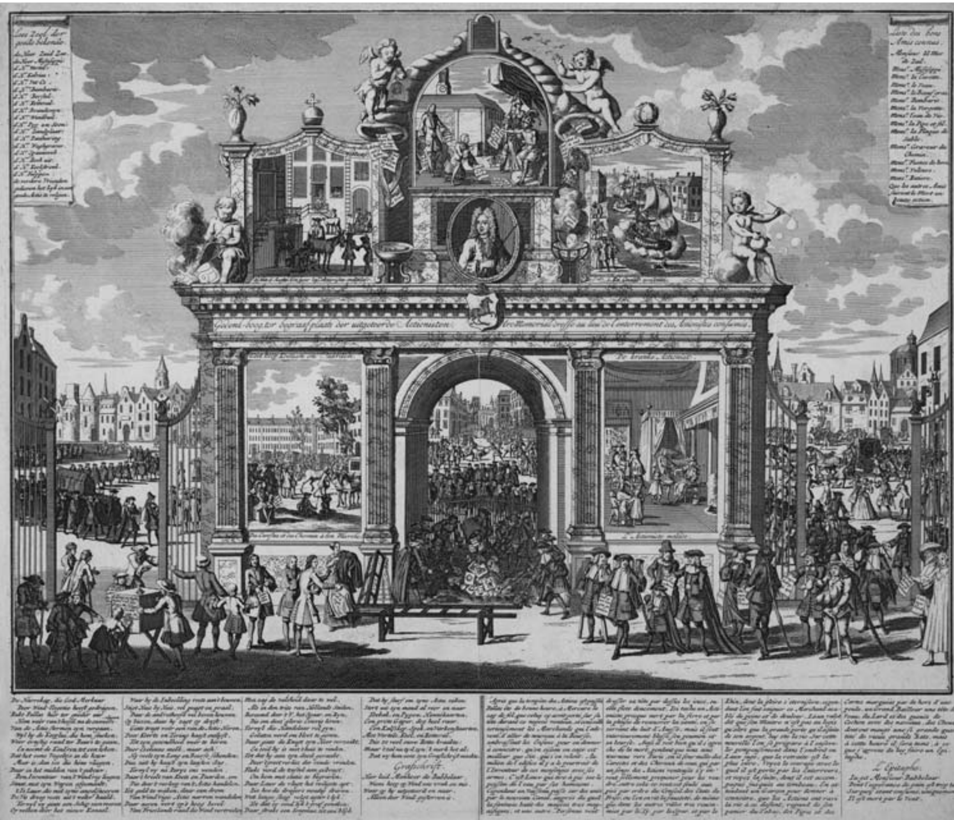
At times of major financial crisis with fallout on the real economy, governments should pay attention to analyses of the crises that challenge the structure of the underlying economy, the theories behind them, and the existence of interest groups whose main objective is to maintain the status quo (Johnson 2009). It was in such an environment that Serra advanced his interpretation of the Kingdom of Naples's economic crisis. His views fell on deaf ears, and the kingdom continued to suffer from recurrent crises. After presenting his views before the viceroy and his cabinet and failing to convince them, Serra was sent back to prison where he died in 1617. In contrast, when monetary and financial troubles emerged in Venice and Holland later in the course of the same century, these governments managed to contain them and to prosper using strategies that would have been very familiar to Serra.[5]

Blame the Bankers

Throughout time, public esteem of money traders, bankers, financiers, and financial institutions has fluctuated between admiration and loathing, the latter sentiment prevailing at times of crisis. Today, public opinion in advanced and emerging economies blames Wall Street, banks, hedge funds, and credit-rating agencies for having issued, backed, and flogged around the world arcane financial products such as mortgage-backed securities. Those who were considered "masters of the universe" are now shunned and ridiculed; financial products that were heralded as "innovations" are now called "toxic assets." Likewise, in the eighteenth century speculative bubbles in various asset categories (such as extravagant schemes involving future prices of tulip

bulbs in Holland, state-backed securities in France, and trading of company shares in France and England), and the consequent financial havoc gave rise to public scorn of bankers, institutions, and administrators involved in these debacles. Contemporary satirical representations went from commiseration for the victims of these debacles, such as in the plate “Memorial Arch Erected at the Burial Place of Ruined Shareholders” (figure 1), which depicts the rise and fall of John Law’s Mississippi scheme in France, and in “Many Became Crazy Because They Believed in Schemes” (figure 2), an allegory of speculators’ fate. Other plates describe the peril of trading securities with no real backing other than wind (figure 3) or the public scorn of failed stock jobbers (figure 4).[6]

FIGURE 1.
Memorial Arch Erected at the Burial Place of Ruined Shareholders



Source: Het Groote Tafereel Der Dwaasheid [The Great Mirror of Folly] (Amsterdam 1720), from Bancroft Collection, Baker Library Historical Collections, Harvard Business School.

FIGURE 2.
Many Became Crazy Because They Believed in Schemes

Source: Het Groote Tafereel Der Dwaasheid [The Great Mirror of Folly] (Amsterdam 1720), from Rare Book, Manuscript, and Special Collections, Duke University.

The sentiment against financial speculation and its negative impact on the real economy were aptly described by an Italian mathematician, Geminiano Montanari (1633–87), in his analysis of the relationship between financial crises and economic decadence of numerous Italian states in the seventeenth century. Montanari was professor of "mathematics and astronomy" at the University of Bologna and later professor of "astronomy and meteors" at the University of Padua. Like other seventeenth-century scientists—Isaac Newton, for instance, was master of the Royal Mint—Montanari became increasingly interested in money, credit, and finance. In addition to writing a series of treatises on money, he advised the government of the Republic of Venice on the reorganization and management of the mint.

In his comments on the causes of the Italian economic decline in the seventeenth century, Montanari noticed how bankers and foreign exchange traders had enjoyed a high "rating approval," at a time of economic prosperity in the previous century, despite the church's moral condemnation of profit. In contrast, financial activities became ostracized when Italian merchant-bankers lost their leadership in commerce and credit to Northern European states. Likewise, he remarked how arbitrage activity had become

FIGURE 3.
The Wind Buyers Paid in Wind, or Those Who Are Last Will Remain Hanging on

Source: Het Groote Tafereel Der Dwaasheid [The Great Mirror of Folly] (Amsterdam 1720), from Rare Book, Manuscript, and Special Collections, Duke University.

FIGURE 4.
The End of the Stock World

Source: Het Groote Tafereel Der Dwaasheid [The Great Mirror of Folly] (Amsterdam 1720), from Rare Book, Manuscript, and Special Collections, Duke University.

so pervasive that "all throughout Italy the wealthiest merchants" were getting wealthier by investing most of their resources and time in financial speculations (Montanari [1683] 1804).

But for Montanari, it was unfair to consider bankers as the main cause of recurrent monetary crises and general economic decline. In fact, they had switched their capital from manufacturing to finance in response to increasing costs of labor and uncertainty about the future of Italian cities' economies. Financial activities enjoyed higher returns and fewer risks than "manufacturing of textiles" and commerce of "silk, spices, wool, and other commodities," sectors with a "much more complicated organization" and in which "most of the profit would go to workers." Businessmen acted rationally since activities like arbitrage enabled them to maximize profit and minimize risk. They achieved this goal by exploiting information advantage, such as knowledge of credit instruments, and implementing shrewd schemes. Montanari ([1683] 1804, 151) described this state of affairs, a picture that bears an interesting resemblance to more recent cases of financial speculation, in the following passage:

> I personally praise the shrewdness of those who having only to consider their own personal return choose the category of business that produces the quickest and least risky profit; and I say that they commit no crime by standing with their eyes wide open ready to spot new opportunities in any place [and] to profit from sending coins in exchange for other coins; nor by maintaining correspondence and keeping informed about any public deliberation and decree related to monetary affairs enabling them to promptly exploit with their sharp arithmetical approach any possible exchange of different types of coins; I even admire when in order to conduct their transactions they diligently and rapidly borrow money at interest from others, or when they stay particularly vigilant about neighboring markets.

These speculators followed a particular sequence to lure investors who wanted to make ready profits. First, traders identified and gathered in neighboring states coins that they knew commanded a greater premium in their own market. They introduced these coins in their own market and supported their "credit" at a value higher than the official price by using and accepting them even when that entailed a loss. With these actions, traders persuaded city dwellers and artisans to accept these coins. At this stage, speculators "readily import[ed] a large quantity of these overvalued foreign coins from the state where they [were] minted," and before authorities could intervene, in general with a decree banning the circulation of such coins, they had flooded the entire state while hoarding and exporting the best coins—a typical case of Gresham's Law.

Returns on monetary financial activities were so high that governments could do very little to prevent the constant drainage of capital and talents. Money traders and bankers could easily double the initial capital in one year, "not a small gain" in Montanari's words, and could even increase their profits by "borrowing from others." This behavior, though justifiable from speculators' point of view, had devastating consequences for Italian cities, the centers of earlier Italian success, since manufacturing and commercial activities "used to employ half the population," while trading in money and credit instruments "employed few people" (Zanalda 2009).

Italian merchants' behavior had to be seen in the larger context of Italian decline during the seventeenth century. The gradual rise of nation-states such as France and the growth of trading powers such as England and Holland, Italy's sporadic participation in the new trading routes in the Atlantic and in Asia, internal divisions, wars, foreign occupations, and territorial struggles still plaguing the peninsula during the seventeenth century contributed to the decline. Montanari also identified other specific factors: lack of government support, migration of skilled artisans, struggles and disputes between merchants and workers, guild power and regulations, fiscal pressure (duties) that hampered commerce, and the tendency among wealthy merchant-bankers to invest their capital in land and estates rather than in productive activities. On the latter, Montanari remarked that by "investing their capital in earldoms and marquisates . . . conducting the leisurely life of princes" while breeding "distaste for the exercise of the once esteemed merchant profession," this "urban mercantile nobility" transformed the common perception of the merit and social standing of commercial activities, inflicting a "fatal blow to manufacturing and commerce in most cities" (Zanalda 2009).

In a few passages Montanari summarized the main structural problems that plagued Italian economies over the course of the century. He had lived through what historians now consider the most critical period, 1620–80, for the Italian economy of the early modern era. The lesson was clear: several factors, including excessive speculation on credit and financial instruments, had contributed to the misallocation of resources and the loss of competitiveness of Italian economies. As has been the case in several instances throughout history, it was a self-inflicted wound. Credit and financial instruments that had been invented to expand credit, reduce transaction costs, and spread risk—with a positive impact on real activities—had become increasingly the object of speculation, detached from their original purpose.

Then as now, a return to a more responsible use of financial innovation is a *conditio sine qua non* to enhance the availability of credit and efficient allocation of capital. Calls for new regulations and a more conservative use of financial leverage both at the domestic and international levels are part of an ongoing discussion in the United States, in the European Union, and at the G-20 level.

The other related challenge for policy makers is to restore trust in the financial system, while not hindering innovation in finance, an essential feature of market economies. A generalized backlash against finance and sometimes, by affiliation, against capitalism—whether in eighteenth-century Europe, during the Great Depression, or now—could stifle the introduction of new financial and credit instruments. For instance, resistance to the introduction of new credit instruments after the collapse of John Law's system in the early eighteenth century might explain why France's transformation into a commercial society was slower than that of England and Holland (Atack and Neal 2009). Likewise, the association between financial speculation and capitalism has often characterized public outcry against bankers and finance at times of crisis, whether in Germany in the 1920s, in the United States and Europe in the 1980s, or in Asia in the 1990s when, "in the midst of its homegrown financial crisis, capitalism as practiced in that continent was everybody's favorite punchbag" (Pilling and Atkins 2009).

Off Gold

The current crisis has often been compared to the Great Depression, and policy makers, in particular in the United States, have been trying to avoid the policy missteps that exacerbated the downturn after the stock market crash in October 1929. The chairman of the Fed, Ben Bernanke, one of the foremost experts on the Great Depression, has often referred to events and policies of that period in testimonies and speeches and acted to avert a global financial meltdown. Among the numerous lessons from the 1930s that can be drawn from a vast body of research, I focus here on a brief overview of the different paths to economic recovery experienced by countries after the abandonment of the gold standard. The relevance of this decision for the recovery process has been analyzed with different nuances in various studies (Kindleberger 1986; Temin 1989; Bernanke 2000; Eichengreen 2008; Feinstein, Temin, and Toniolo 2008).

After the 1929 crisis, policy coordination among the United States and European nations would have enabled the implementation of a coordinated program of macroeconomic reflation, lower interest rates, and expanded money supply in all countries, with the result of stimulating economies without destabilizing exchange rates. Lack of cooperation among governments and their central banks instead characterized countries' response in the early 1930s, which in turn generated further deflationary pressure on the world economy and exposed weak currencies, mainly the pound sterling and the mark, to speculative attack (Feinstein, Temin, and Toniolo 2008). Central banks and governments believed in the monetary orthodoxy of the gold standard, which prevented countries from embarking on countercyclical policies and in some cases, such as in the United States and France, intensified the economic downturn (Temin 1989). Given the lack of coordination and urgent need to implement expansionary monetary and fiscal policies, some countries, like the United Kingdom in 1931, took the step of going off gold and embarked on a program of unilateral reflation. This implied that countries improved their economies at the expense of other countries, through what it is known as "beggar-thy-neighbor" devaluation. Once off gold, the Bank of England lowered interest rates and devalued the currency, with beneficial effects on the trade balance. Scandinavian countries took the same step in 1931 as did countries with colonial or trade (like Argentina) relationships with England, which went off gold and pegged their currencies to the pound sterling. Germany also abandoned the gold standard, but only after Hitler rose to power and the government adopted expansionary policies including a vast program of military expenditure, while maintaining controls on capital movements. Latin American countries abandoned the gold standard the same year. The ensuing expansionary fiscal and import substitution policies helped most countries in the region to recover rapidly (Feinstein, Temin, and Toniolo 2008).

Only after experiencing the devastating effect of the financial, banking, and economic crises in 1931–32, the United States abandoned the gold standard in 1933. The devaluation of the dollar, fiscal and monetary expansionary policies, restructuring of the banking sector, together with other New Deal measures helped the recovery of the U.S. economy until 1936 (Kindleberger 1986; Bernanke 2000). That year, the Fed, concerned about future inflation, began to withdraw liquidity, while President Roosevelt, concerned with the ballooning federal budget deficit, supported a tightening of fiscal policy through tax increases and spending cuts. The combination of tight monetary and fiscal policies transformed the fiscal deficit of 1936 into a surplus the following year but also pushed the United States back into recession—the real GDP contracted more than 3 percent in the next two years. That experience explains why in the United States today numerous economists inside and outside the administration are advising the Fed and President Obama to dismiss calls for a tightening of monetary and fiscal policies because of the apparent risk of inflation down the road (Blinder 2009).

France and other countries of the "Gold Bloc" (Italy, Belgium, Switzerland, Poland, and the Netherlands) maintained the gold standard until 1936. Until that year, these countries followed deflationary policies that hampered the recovery process. Even worse, trade among members of this bloc was hampered by the over-

valuation of their gold standard parities. After going off gold in 1936, these countries devalued their currencies and began to recover.

Overall, the best solution for the world economy would have been a coordinated effort among countries to dismantle the gold standard in an ordinate manner. This did not happen, and countries that began to use exchange rate devaluation early in the decade together with other strategies such as expansionary policies (United Kingdom, Sweden, and Japan), protection and import substitution (Brazil and Colombia), and capital controls and domestic expansion (Germany) outperformed those that abandoned the gold standard a few years later (the United States, France, and the Gold Bloc countries). Table 1 summarizes with "a good dose of oversimplification," the economic recovery paths that followed the abandonment of the gold standard and the implementation of other policies (Feinstein, Temin, and Toniolo 2008).

TABLE 1. Exchange Rate Policies and Paths to Economic Recovery in the 1930s

GDP per person: 1929 = 100				
Policy and Country	**1929**	**1932**	**1935**	**1938**
Early devaluation and domestic expansion				
United Kingdom	100.0	93.5	105.0	113.9
Sweden	100.0	94.8	109.4	122.1
Japan	100.0	96.8	104.6	120.8
Early devaluation, protection, and import substitution				
Brazil	100.0	89.5	101.1	112.2
Colombia	100.0	100.4	111.4	122.5
Controls on capital movements and domestic expansion				
Germany	100.0	83.0	101.7	123.3
Italy	100.0	95.3	101.8	107.2
Central planning and autarky				
Soviet Union	100.0	103.8	136.3	155.1
Late devaluation				
United States	100.0	71.1	77.5	87.0
Gold Bloc (deflation and late devaluation)				
France	100.0	84.0	86.8	94.8
Belgium	100.0	91.1	96.8	95.6
Switzerland	100.0	90.2	93.3	100.9

Source: Feinstein, Temin, and Toniolo 2008, 136.

The lesson is that at times of major financial crises, including currency crises, governments should keep an open mind with regard to solutions that go against the orthodoxy of the time. Postponing decisions, such as abandoning the gold standard in the early 1930s or maintaining unrealistic exchange rates, as happened during the financial and currency crises of the 1990s, worsens the crisis and hampers the recovery process. In the latter case, currency devaluation and the establishment of flexible exchange rate regimes contributed to contain the crisis and reassert within a few years the strength of Asia's economies (Eichengreen 2008).

Conclusions

In the end what can we say about the road ahead after the current crisis? How can we prevent a world "lost decade" or a Great Depression redux and put the global economy onto a sustainable path of growth? Peter Temin, in a study published before the current crisis, argued that the 1990s had features of a postwar decade such as the 1920s and 1950s. He worried that given the size and type of pre-crisis problems—stock market exuberance, excessive financial leverage, and international imbalances created by international differences in saving and spending behavior—the 1990s looked very similar to the decade that preceded the 1930s (Temin 2006). Events have proved him right, at least for the initial relevance and global reach of the crisis. It is hoped that because of our knowledge of the 1930s and other crises—overall the depression became "great" to a large extent because of the initial (and again in 1936) mismanagement of the crisis in the United States, the absence of stabilizers, and the lack of international cooperation—we will not look back at the 2010s as a new 1930s. On the positive side, governments around the world have been collaborating to prevent a complete meltdown of the global financial system. G-20 meetings, increased reliance on (and funds to) the International Monetary Fund, implementation of large fiscal stimuli, and expansionary monetary policies have, for the time being, signaled a willingness to stabilize the world economy and prevent a rush to "beggar-thy-neighbor" types of policies. However, this encouraging trend can be readily reverted if the steep downturn in both world trade and capital flows of the last year continues, and the United States, Japan, and other Asian and European countries are not able to maintain expansionary policies.

To achieve sustainable growth at the global level, it is important to apply one of the main lessons stressed throughout this paper: governments should consider this crisis as an opportunity to implement reforms, even structural reforms, and, as Martin Wolf puts it, "adapt the market economy to their own traditions" (Wolf 2009). This does not imply a rejection of the great achievements of the last two decades, but an effort to recapture and sustain the rapid growth of the world economy without recreating the same type of global imbalances.[7]

Likewise it is important to address the problems that have emerged in financial sectors in the United States and Europe. As in several historical examples, the level of leverage and profits and the lack of supervision and transparency of the banking and financial systems (this time around in the United States and Europe) are used to indict

the excesses of the prevailing form of capitalism. Influencing the debate on the future of Western economies are the U.S. origin of the current crisis together with the realization that Asian economies, excluding Japan, have succeeded in recovering from past crises on the basis of a softer version of capitalism characterized, among other things, by more protected credit systems and a greater focus on the real economy. In essence, the pendulum is swinging back toward a market economy in which the government plays a greater role and maintains a stricter control on private finance. This swing has different nuances—in particular, with regard to use of the term "socialism"—similar to what Peter Temin argues in *Lessons from the Great Depression,* "If there is a renewed depression . . . then we should expect a swing of the policy pendulum back toward socialism. Capitalism thrives during economic stability. It wilts in depression. Socialism appears to be the reverse. It fades during stability . . . but it flowers in depression with its support of economic planning and distribution of social dividend" (Temin 1989, 136).

Where do we go from here? In line with the idea that it is time to adopt bold actions to prevent a globalization backlash in both trade and capital and the recurrence of new crises, it is essential to address the imbalances between China and the United States. Signals in both countries are encouraging. The U.S. president and his administration seem committed to implementing reforms that will have a profound effect on the U.S. economy, although all attempts could derail if the U.S. fiscal position becomes untenable. In contrast, China, to make up for declining global demand, has begun to implement measures and commit resources to create inner dynamism as a complement to export-driven growth (Kynge 2009).

The fate of the U.S. dollar represents an important issue for the stability of the world economy. Again, this area is open to bold proposals for reform, such as the one recently advanced by the governor of China's central bank, Zhou Xiaochuan. Zhou questions the long-run sustainability of an international monetary and financial system with the U.S. dollar at its center. An alternative, according to Zhou, would be to revise an old Keynes idea of an international reserve currency, another version of special drawing rights. This is an interesting proposal, an attempt to answer a legitimate question about the future role (and value) of the U.S. dollar as well as that of the China renminbi. This ought to be addressed sooner rather than later to avoid the devastating effects on the global economy of either a collapse of the dollar or a dramatic increase in interest rates, which would hamper the recovery process in both advanced and emerging economies.

In their recent analysis of eight centuries of financial crises, Reinhart and Rogoff conclude that severe financial crises have deep and lasting effects on asset prices, employment, and output. On average, housing prices decline for six years, unemployment rises for five, and output declines for two. Massive increases in government debt are the norm at the end of recessions created by financial crises (Reinhart and Rogoff 2009). It seems that the current crisis is following the same path, at least in the United States, Europe, and Japan. Asian economies as well as Brazil seem, at the moment, poised to emerge in a stronger position for reasons that bring us back to issues previously discussed. In a recent interview, Kishore Mahbubani, dean of Singapore's Lee Kuan Yew School of Public Policy, argues that the current form of Asian capitalism is

the result of Asians having adopted the basic features of Western capitalism, such as reliance on free markets, navigated through the 1990s crisis, listened to International Monetary Fund advice, and added their own lessons, which include "do not liberalize the financial sector too quickly, borrow in moderation, save in earnest, take care of the real economy, invest in productivity, focus on education." To which he added, "While America was busy creating a financial house of cards, Asians focused on their real economies" (Pilling and Atkins 2009). It is a sign of the times that the economic agenda President Obama is trying to implement in the United States focuses on similar principles or maybe it is simply, as I show in the case of Naples in the seventeenth century, that at times of crisis governments are forced to address the foundation of their economies (Leonhardt 2009). And as Serra pointed out in the case of Naples in the seventeenth century, the "quality" of the government is a crucial factor, including its ability to implement and sustain reforms. Hence, the stability of the global economic system will depend in large part on the ability of the United States and Europe to reform and the ability of emerging economies to manage a new global economy in which they will have a greater economic and political role.

Notes

1. The origin and dramatic unfolding of the Great Recession in advanced economies has also raised questions among economists and policy makers about the suitability of current economic theories and models that have been constructed for a different world. As well put in a *Financial Times* editorial, "Most models depict economies kept close to equilibrium by smooth adjustments. But we face a very real danger of large, abrupt changes, bank collapses, or currency crises. And unlike what most models assume, prices are not properly clearing all markets" (*Financial Times* 2009).
2. For further examples of historical overviews, see, among others, Garber 2000; Bordo and Eichengreen 2002; Eichengreen 2002; Neal and Weidenmier 2003; Caprio, Hanson, and Litan 2005; Ferguson 2008.
3. Although Holland experienced one of the first recorded cases of asset bubbles in the second half of the seventeenth century, the famous Tulipmania, the resilience and depth of the Dutch financial system of the time contributed to lessen the impact on the real economy (Garber 2000).
4. Serra opposed all forms of monetary alterations, in particular debasement, but also conceded that contrary to general opinion, the circulation of coins with no intrinsic value did not affect the volume of commerce within a state. This observation carried an important lesson about the relationship between quantity of money and economic activity. Carlo Cipolla, and more recently Thomas Sargent and François Velde in their research on the role of the parallel circulation of coins with intrinsic value (silver and gold money) and low or no intrinsic value (alloy coins and later paper money), concludes that the vast circulation of devalued coinage provided the necessary liquidity for the rise of market economies in European states after the fourteenth century (Cipolla 1958; Sargent and Velde 2002).
5. The novelty of Serra's contribution was singled out by Joseph Schumpeter. The Austrian economist praised Serra for his demonstration that natural resources, quality of people, industry and trade, and the efficiency of government, more than money, determined the success of production and commerce and that "if the economic process as a whole functions properly, the monetary element will take care of itself without requiring any specific

therapy." In Schumpeter's view, for decades to come, "There [had been] nothing like this [analysis] anywhere" (Schumpeter 1954).

6. All these plates come from *The Great Mirror of Folly,* a famous early eighteenth-century volume published in Amsterdam (Cole 1949).
7. This can be seen as a continuation of the debate about the benefits and costs of the globalization process. It can be reduced to two main positions, as summarized by Andrei Shleifer. On the one hand, there are those, like Stanley Fischer, who believe that market forces, open economy, macroeconomic stability, and good institutions explain rapid economic growth in emerging economies—a positive view of the process. On the other hand, there are those, like Joseph Stiglitz, who criticize free market policies and advocate a greater role for the state, extensive regulations, and some form of capital control—a view that globalization has to be managed and customized to countries' traditions (Shleifer 2009). Perhaps the crisis will help to reconcile these two views.

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