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Lessons for Europe from the 1930s

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The Great Depression taught us a number of lessons. The first is that central banks must be ready to provide ample liquidity to save the banking system. Present-day central banks did just that. They did not repeat the mistakes of the 1930s, when their predecessors tightened money in the face of a banking crisis. The second lesson is that governments should not try to balance the budget when economic activity collapses. Similarly, the governments of today did not repeat the mistakes of many governments in the 1930s, which desperately tried to balance their books when the economy crashed.

Yet there is one area of policy-making where authorities may not have learned the lessons of history, and are in the process of repeating the same mistakes. During much of the 1930s, a number of continental European countries, the so-called 'gold bloc' countries (France, Italy, Belgium, the Netherlands and Switzerland) kept their currencies pegged to gold. When in the early 1930s the UK and the US went off gold and devalued their currencies, the gold bloc found their currencies to be massively overvalued. This had the effect of depressing exports and prolonging the economic depression in these countries.

Incredibly, the same mistakes are being made today involving some of the same countries as during the Great Depression. This time it is the continental west European countries tied together in the eurozone that have seen their currency, the euro, become strongly overvalued. The two countries that in the 1930s responded to the crisis by devaluing their currencies, the US and the UK, have today also allowed their currencies to depreciate significantly. Since the start of the financial crisis, pound sterling has depreciated against the euro by about 30%. After having strengthened vis-à-vis the euro prior to the banking crisis of October 2008, the dollar depreciated against the euro by close to 20%.

Thus, as in the 1930s, the dividing line is the same. The US and the UK have allowed their currencies to depreciate; the continental European countries tied into the euro area have allowed their currency to become significantly overvalued. Even the numbers are of the same order of magnitude. During the 1930s, the overvaluation of the gold bloc currencies amounted to 20-30%. Today, the euro is overvalued by similar percentages against the dollar and the pound.

So why are the euro area countries employing the same policies as the gold bloc countries did nearly eighty years ago? The answer is economic orthodoxy. In the 1930s it was the orthodoxy inspired by the last vestiges of the gold standard. Today the economic orthodoxy that inspires the ECB is very different, but no less constraining. It is the view that the foreign exchange market is better placed than the central bank to decide the appropriate level of the exchange rate. A central bank should be

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concerned with keeping inflation low and not with meddling in the foreign exchange market. As a result the ECB has not been willing to gear its monetary policy towards some exchange rate objective.

As in the 1930s, the euro area countries will pay a heavy price for this orthodoxy. The price will be a slower and more protracted recovery from the recession. This will also make it more difficult to deal with the internal disequilibria within the eurozone between the deficit and the surplus countries (Martin Wolf, 2010).

One could object to the analysis that the central bank is powerless to affect the exchange rate. This is a misconception. A central bank can always drive down the value of its currency by a sufficiently large increase in its supply. And that is what the US and the UK have done with their policies of quantitative easing, which have gone further in flooding the US and UK money markets with liquidity than in the euro area. True, since the start of the crisis the ECB has injected plenty of liquidity into the euro money markets to support the banking system. Yet it has been much more timid than the US Federal Reserve and the Bank of England in creating liquidity. While the latter more than doubled the size of their balance sheets since October 2008, and thereby more than doubled the supply of central bank money, the ECB's balance sheet increased by less than 50%.

Such an imbalance in the expansion of central bank money inevitably spills over into the foreign exchange markets. The massive supply of dollars and pounds created by the US and UK monetary authorities was transmitted to other financial markets in search of higher yields and in so doing put upward pressure on the value of the euro. Thus, the greater timidity of the ECB in providing liquidity is an important factor in explaining why the euro has rallied since the start of the banking crisis, and why it is now excessively overvalued.

Ultimately a central bank has to make choices. The Federal Reserve and the Bank of England chose massive programmes of liquidity creation, attaching a low weight to the possible inflationary consequences of their actions. The ECB has been more conservative in its liquidity creating programmes; attaching a low weight to the consequences for the exchange rate and to the chances of a quick recovery. Only time will tell us which of these choices was right.

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