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Partying Like It’s 1929

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If Ben Bernanke manages to save the financial system from collapse, he will — rightly — be praised for his heroic efforts.

But what we should be asking is: How did we get here?

Why does the financial system need salvation?

Why do mild-mannered economists have to become superheroes?

The answer, at a fundamental level, is that we’re paying the price for willful amnesia. We chose to forget what happened in the 1930s — and having refused to learn from history, we’re repeating it.

Contrary to popular belief, the stock market crash of 1929 wasn’t the defining moment of the Great Depression. What turned an ordinary recession into a civilization-threatening slump was the wave of bank runs that swept across America in 1930 and 1931.

This banking crisis of the 1930s showed that unregulated, unsupervised financial markets can all too easily suffer catastrophic failure.

As the decades passed, however, that lesson was forgotten — and now we’re relearning it, the hard way.

To grasp the problem, you need to understand what banks do.

Banks exist because they help reconcile the conflicting desires of savers and borrowers. Savers want freedom — access to their money on short notice. Borrowers want commitment: they don’t want to risk facing sudden demands for repayment.

Normally, banks satisfy both desires: depositors have access to their funds whenever they want, yet most of the money placed in a bank’s care is used to make long-term loans. The reason this works is that withdrawals are usually more or less matched by new deposits, so that a bank only needs a modest cash reserve to make good on its promises.

But sometimes — often based on nothing more than a rumor — banks face runs, in which many people try to withdraw their money at the same time. And a bank that faces a run by depositors, lacking the cash to meet their demands, may go bust even if the rumor was false.

Worse yet, bank runs can be contagious. If depositors at one bank lose their money, depositors at other banks are likely to get nervous, too, setting off a chain reaction. And there can be wider economic effects: as the surviving banks try to raise cash by calling in loans, there can be a vicious circle in which bank runs cause a credit crunch, which leads to more business failures, which leads to more financial troubles at banks, and so on.

That, in brief, is what happened in 1930-1931, making the Great Depression the disaster it was. So Congress tried to make sure it would never happen again by creating a system of regulations and guarantees that provided a safety net for the financial system.

And we all lived happily for a while — but not for ever after.

Wall Street chafed at regulations that limited risk, but also limited potential profits. And little by little it wriggled free — partly by persuading politicians to relax the rules, but mainly by creating a "shadow banking system" that relied on complex financial arrangements to bypass regulations designed to ensure that banking was safe.

For example, in the old system, savers had federally insured deposits in tightly regulated savings banks, and banks used that money to make home loans. Over time, however, this was partly replaced by a system in which savers put their money in funds that bought asset-backed commercial paper from special investment vehicles that bought collateralized debt obligations created from securitized mortgages — with nary a regulator in sight.

As the years went by, the shadow banking system took over more and more of the banking business, because the unregulated players in this system seemed to offer better deals than conventional banks. Meanwhile, those who worried about the fact that this brave new world of finance lacked a safety net were dismissed as hopelessly old-fashioned.

In fact, however, we were partying like it was 1929 — and now it's 1930.

The financial crisis currently under way is basically an updated version of the wave of bank runs that swept the nation three generations ago. People aren't pulling cash out of banks to put it in their mattresses — but they're doing the modern equivalent, pulling their money out of the shadow banking system and putting it into Treasury bills. And the result, now as then, is a vicious circle of financial contraction.

Mr. Bernanke and his colleagues at the Fed are doing all they can to end that vicious circle. We can only hope that they succeed. Otherwise, the next few years will be very unpleasant — not another Great Depression, hopefully, but surely the worst slump we've seen in decades.

Even if Mr. Bernanke pulls it off, however, this is no way to run an economy. It's time to relearn the lessons of the 1930s, and get the financial system back under control.