DOI: 10.1007/s10272-009-0299-6

Christoph Buchheim*

Economic Crises in the Thirties and Today

In the context of the ongoing financial and economic crisis reference is frequently made to the Great Depression of the 1930s and fears are voiced that we may have embarked on a similar path. This article looks at the conditions prevailing back then and compares them with the present economic environment. From this some conclusions are drawn as to the likelihood of a recurrence of the disaster.

In the first quarter of 2009 industrial production in major economies sharply declined compared to its maximum one year before. In the United States and the United Kingdom it fell by about 12 per cent, in France by 15 and in Germany by 20 per cent.[1] On average industry in the four countries suffered even more than at the start of the Great Depression, when in 1930 their production was about 10 per cent lower than in 1929 (unweighted average). However, the slump did not come to an end in 1930. Its main characteristic was not the speed of the downturn in the first year; the recession of 1920/21 in the USA, in the UK and in France, for example, had been more severe than that of 1930, but in 1922 an upswing was already under way again. What made the Great Depression exceptional was mainly its long duration. It lasted for three years with average production declining more in every consecutive year. Therefore when the lower turning point was finally reached in 1932, industrial production had been halved in the USA and Germany compared to 1929 and had fallen by a third in France. Only Britain was saved from the worst with a total decline of less than 20 per cent.[2] Another remarkable fact about the Great Depression was that before the outbreak of war the United States and France did not recover their pre-crisis level of industrial production in any year; Britain and Germany did, but this was due to exceptional factors.

In this article we shall first deal with these observations concerning the Great Depression in some more detail. It will be demonstrated that they can largely be explained by peculiarities of monetary, fiscal and economic policy at the time. Next, the fundamental changes which have occurred in the general pattern of these policies since then will be tracked. With that in mind a short conclusion will be presented about the possible outcome of the current economic crisis.

* University of Mannheim, Germany.

Why the Great Depression Lasted So Long

In order to explain why the Great Depression lasted so long and, as a consequence, generally was so severe, more information on the course it followed over time is needed than is supplied by a series of annual values of industrial output. This supplementary information is provided by the figures for monthly pig-iron production in the four countries. Because pig-iron itself or in its manufactured form as steel was an almost universal input, the respective pig-iron series are a good proxy for the development of total industrial production in the four countries considered during the 1930s. An additional advantage is that pig-iron production had the property of being a leading business cycle indicator.

Starting in summer or autumn of 1929 pig-iron production declined severely until the beginning of 1931[3]. In the USA, Britain and Germany it fell by more than 50 per cent; only France, because of special circumstances, initially fared better with a decline of less than 20 per cent. However, in spring of 1931 pig-iron output stabilised in all four countries and, for several months, even improved a bit. In Germany this was paralleled by an increase of monthly industrial production to the amount of 13 per cent between February and June 1931, whereas in the USA a composite index of six leading business cycle indicators constructed by the National Bureau of Economic Research rose by seven per cent from January to February of that year and then stayed more or less stable until May. There were contemporary observers who saw in these and other developments more than a seasonal adjustment and even diagnosed the ap-

[1] OECD: Key short-term economic indicators, online.

[2] National Bureau of Economic Research: Macrohistory database, online; Konjunkturstatistisches Handbuch 1936, p. 52.

[3] National Bureau of Economic Research (NBER): Macrohistory Database online (provides all figures on pig-iron production cited in this paper).

proaching end of the crisis. Unfortunately, that proved to be utterly wrong. During the summer pig-iron production turned around again; from then on until the summer of 1932 it fell in the USA by three quarters, in Germany by about half, in France by more than a third. In Britain pig-iron production declined, too, after May 1931; until September it fell by almost 30 per cent, but then, in contrast to the other three countries mentioned, it suddenly increased somewhat and then stabilised. With hindsight one can state that the British economy had reached the trough of the cycle in the autumn of 1931; in 1932 industrial production stagnated and thus its total decline during the Great Depression was, as shown above, much lower than in the other three countries.

What factors were responsible for this course of events in Great Britain? In fact, in September 1931 capital flight forced Britain off the gold standard. The pound sterling was left floating with the effect that it quickly devalued by 20 per cent and more. British exports immediately became more competitive and, in an environment of declining volumes of world exports, Britain managed to increase its share of them. In addition, starting in early 1932, the Bank of England lowered its discount rate from 6 per cent, the level attained in the critical period of autumn 1931, to two per cent around mid-1932. Last but not least, deflation, which had led to a decline in wholesale prices by almost 30 per cent from 1929 to September 1931, came to a halt and with it its depressing economic consequences.

The interwar gold standard indeed goes a long way to explain the severity of the Great Depression. Its main features were fixed exchange rates, free international capital flows and the obligation of central banks to hold minimum gold and foreign exchange reserves against their banknote issue. To this came a distorted system of gold parities, a network of huge political debts which had arisen out of the war and a not very cooperative spirit in international political relations. In such a system, with central banks having to defend their gold cover ratios, deflation in one major nation proved to be contagious and was quickly transmitted to other countries. Thus, after 1929 deflation became a common feature. It not only discouraged investment activities and by doing so deepened the economic crisis, but it also structurally weakened bank balance sheets, increasing the probability of a financial crisis triggered by a loss of confidence in the banking system.

In fact, in Germany and in the United States such banking crises occurred. In both cases capital flight played an important role. Capital flight in turn was largely caused by a loss of confidence in the stability of the currency. While in Germany the reasons for that were principally political, in the USA it was the withdrawal of Britain from the gold standard which led to doubts about the dollar. In both countries capital flight caused a loss of reserves in central banks which then, in order to defend their legal gold cover ratios, raised discount rates and applied quantitative restrictions. Therefore defending the gold standard meant that central banks could not fulfil their lender-of-last-resort function. As capital flight also went with deposit withdrawals, banks were further weakened and without central bank support severe crises of the whole financial system now occurred. Thus in both countries the economic crisis was aggravated after mid-1931, as is indicated by the development of pig-iron production. France did not experience a full-fledged banking crisis. However, because it remained on the gold standard until 1936, it suffered from repeated deflationary shocks for a particularly long time. As a result, before the war industrial production hardly recovered at all.

Generally, fiscal policy also was not employed to relieve the crisis in the early 1930s. Rather, except for some rare and short-lived instances, it made the situation still worse. The prevailing attitude towards budget deficits was negative. Irrespective of the depression tax rates were increased and spending was cut, and thus even the built-in stabilisers were inhibited. Of course, as long as a country adhered to the gold standard, another policy, by supporting reflation, might quickly have run against the balance-of-payments and gold constraint. However, even after leaving the gold standard in 1931 Britain still followed a rather restrictive fiscal policy; neither did the German governments before Hitler make much use of their greater fiscal autonomy after foreign exchange rationing had been introduced as a result of the financial crisis in mid-1931. This shows that in the 1930s there still existed an international consensus about the desirability of a balanced budget.

Fiscal policy generally did not support economic recovery a lot; even less could be hoped from exports. Protectionism had already been much more pronounced in the 1920s than before 1914, not least as a consequence of disturbances arising out of the war itself. Increased barriers to external trade negatively affected volumes of manufactured exports as well as prices of primary goods on the world markets.

Great Britain and Germany particularly suffered from the former development. Overseas countries chiefly producing primary products were heavily affected by the latter and as a result some of them restricted their manufactured imports already in the late 1920s with further negative repercussions especially for British exports. Massive deglobalisation, however, was a feature primarily of the Great Depression and its aftermath. Many countries increased their tariffs, among them most prominently the USA with the infamous Smoot Hawley Tariff Act of 1930. Deflation also contributed to an increase in tariff protection, as in that period most countries still employed specific and not ad-valorem tariffs, the former becoming more restrictive when prices declined. Some countries resorted to quantitative import restrictions; France, for instance, made extensive use of them. Others engaged in bilateralism, as did Germany under the Nazi regime. Even Great Britain, the foremost free trader of the 19th century, introduced tariffs on all important manufactures in 1932 and concluded the Ottawa Agreement with Empire states thus discriminating against third countries. With all that in mind it is hardly astonishing that world trade remained far below its pre-crisis maximum during the whole of the 1930s. Consequently exports did not act as a powerful engine of growth as was the case after the Second World War. Rather, economic growth, as far as it occurred, derived primarily from domestic causes. However, in the USA and in France these, too, remained weak in the 1930s; therefore both countries, as already indicated, could not recover the level of their real product from before the crisis until the Second World War began.[3] Only then did vigorous growth start again because of full-scale rearmament, which by now to a large extent was financed through budget deficits; with it unemployment quickly disappeared.

The deficit-financed rearmament expenditure, which in Nazi Germany already began on a massive scale in 1934, was also the sole reason for the exceptional speed at which the economic upswing out of the Great Depression proceeded in that country. Furthermore, Germany was unique in that not only was full employment attained there in the second half of the 1930s, but even a shortage of labour arose. The latter, however, is to be seen as an indicator of the massive distortions caused by the rearmament-driven recovery in Germany as private businesses, afraid of huge overcapacities after the prospective end of the state-propelled upswing, were quite reluctant with regard to risky investments. Productivity therefore hardly rose during the 1930s. Furthermore the living standard of the working class more or less stagnated despite the vigorous upswing. And finally, the huge budget deficits which financed war-related state purchases led to signs of repressed inflation already before 1939. Although the German economy at first sight appeared to be growing in a healthy way after 1932/33, in actual fact this growth was artificial and already bred the next major crisis which, however, was masked by the war.

In Great Britain the upswing was triggered by a housing boom which in turn was supported by low interest rates, not least due to a generous monetary policy after the pound sterling had left the gold standard. However, the dynamics of the construction boom also partly derived from one-off factors: a large number of families were started because of the specific age structure of the British population at the time and there was a change in income distribution favouring the middle classes. Moreover, economic growth was still far too weak to fully absorb unemployment. Rather, on average, this was even higher in the 1930s than it was in the 1920s, when it had already been unusually high compared to the period before World War I. In Britain, too, full employment was only achieved after massive rearmament had set in and was fast extended through great budget deficits.

In a way therefore in the later 1930s the missing export dynamics was substituted by deficit-financed military expenditure. However, that could not be a long-term solution for otherwise weak growth, because on the one hand such spending is unproductive in itself and on the other ever-rising budget deficits ultimately endanger the stability of the fiat money in circulation after the gold standard had generally been left.

Fundamental Changes in Economic Policy Principles

The Great Depression actually led to a far-reaching process of social learning. After the Second World War that resulted in a consensus about economic policy principles which were fundamentally different from those followed before the war. However, this new consensus already had its roots in the 1930s and in the period of the war itself.

A first step towards a more liberal international trading system was taken by the USA, i.e. the very country which, despite being the principal global creditor nation, had been among the most protection-

[3] Angus Maddison: Monitoring the World Economy 1820-1992, Paris 1995, pp. 148-151.

ist until the beginning of the 1930s. In 1934, however, Congress accepted the Reciprocal Trade Agreements Act. That law enabled the administration to offer tariff reductions of up to 50 per cent if other countries were willing to conclude a tariff agreement with the United States on the basis of the most-favoured-nation clause. An important motive for the act was obviously the American resentment of the discrimination the Ottawa Agreement implied for US exports. Although the impact of the Reciprocal Trade Agreements Act on the development of world trade in the 1930s was weak, not least because important trading nations such as Great Britain and Germany did not conclude such an agreement with the USA, it was of great importance for the establishment of a liberal trading network after the Second World War.

Another very important basis for different economic policies in the post-World War II period which was already created in the 1930s was the publication of John Maynard Keynes' "The General Theory of Employment, Interest and Money" in 1936. In this book Keynes attacked an axiom of classical economics, namely that at the going wage there could not be such a thing as involuntary unemployment. Instead he maintained that an equilibrium was possible with many unemployed people which in principle were willing to work for the existing wage, and alluded to the situation prevailing then in Britain as an example. In his view effective demand and not wages primarily determined the level of unemployment. Therefore, he concluded, if effective demand was too low the state should increase it by way of additional public expenditure financed through budget deficits. In a famous paragraph of his book, in order to make his point very clear, he even took to absurdity: "If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coalmines which are then filled up to the surface with town rubbish, and leave it to private enterprises on well-tried principles of laissez-faire to dig the notes up again (the right to do so being obtained, of course, by tendering for leases of the note-bearing territory), there need be no more unemployment and, with the help of the repercussions, the real income of the community, and its capital wealth also, would probably become a good deal greater than it actually is. It would, indeed, be more sensible to build houses and the like; but if there are political and practical difficulties in the way of this, the above would be better than nothing."[4]

Ironically it was the Second World War which first gave the USA the opportunity to press upon Great Britain its rejection of discrimination in international trade. Because for warfare Britain was dependent on American supplies, in the respective agreement she had to pledge, in return for the aid given, to engage in action, together with the United States, "directed to the expansion, by appropriate international and domestic measures, of production, employment, and the exchange and consumption of goods, which are the material foundations of the liberty and welfare of all people; to the elimination of all forms of discriminatory treatment in international commerce, and to the reduction of tariffs and other trade barriers."[5] Thus the purpose of the Reciprocal Trade Agreements Act had now practically become a part of an international treaty between the USA and Great Britain; and the Mutual Aid Agreement of 1942 indeed was the basis from which in 1943 negotiations started about a new architecture for the post-war international trade and monetary system which on the British side were led by Keynes. The Bretton Woods Agreement of 1944 emanated from these negotiations, as did the establishment of the International Monetary Fund (IMF) as well as, indirectly, the General Agreement on Tariffs and Trade (GATT) of 1947, today's World Trade Organisation (WTO). These laid the foundations of a new consensus on principles of economic policy which still influence reactions to the current economic crisis.

Through the Bretton Woods Agreement an international monetary system was designed which explicitly should promote liberal and multilateral trade. Therefore the convertibility of currencies was to be established for current international transactions and exchange rates generally were to be kept stable. However, contrary to the system under the gold standard, in the case of fundamental balance of payments disequilibria exchange rates could be, and were to be, altered provided the IMF agreed to it. "The Fund shall concur in a proposed change [...], if it is satisfied that the change is necessary to correct a fundamental disequilibrium. In particular, provided it is so satisfied, it shall not object to a proposed change because of the domestic social or political policies of the member proposing the change."[6] In that way a kind of divide was created between the domestic and international economic policies of member countries. The former were to be shielded from the effects of a balance of

[4] John Maynard Keynes: The General Theory of Employment, Interest and Money, London 1936 (first edition), chapter 10.

[5] Article VII, Mutual Aid Agreement between the United States and the United Kingdom, 23.2.1942.

[6] Art. IV, 5f, Articles of Agreement of the International Monetary Fund, 22.7.1944.

payments deficit insofar as internal deflation was no longer necessary; rather, a full employment policy through deficit spending and appropriate monetary growth should not be impeded by considerations regarding exchange-rate stability – a really big difference to the regime of the interwar gold standard with its disastrous consequences during the Great Depression. It also shows that by 1944 Keynesian-style macroeconomic policy had become an integral part of the new international consensus about economic policy principles. That might have had to do with the observation that only deficit-financed war expenditure finally had overcome unemployment and slow growth.

The GATT/WTO in turn acted as an important agent for the direct promotion of liberal and multilateral trade on the basis of the most-favoured-nation principle. In quite a few rounds of negotiations about tariffs and other trade barriers it has brought about freedom of international trade to a far greater degree than existed at any time between the world wars. Thus it has much supported the re-globalisation drive in the second half of the 20th century, which brought the world economy into a condition similar to the one it once had before World War I. Exports became a very important factor for economic dynamics again, so much so that the 1950s and 1960s generally are labelled a period of "export-led growth". And that exports today still play an important role for economic growth can be clearly seen in the current crisis, which is so very bad exactly because all major economies are severely hit and therefore imports are stifled everywhere, which has choked the export engine on a global scale.

Conclusion

Today the economies of major countries are about where they were in the first half of 1931. There is a pause in the crisis, some signs exist which seem to indicate that the lower turning point is near, for instance rising prices on stock exchanges and an improvement of business expectations. The question is whether the economic upswing will really set in again soon or whether, as in 1931, the crisis will restart and continue perhaps in an even more powerful way than before.

The reason for the aggravation and prolongation of the crisis in 1931, which only then became the Great Depression, was primarily, as has been shown, a misguided economic policy. Above all the defence of the gold standard against the consequences of capital flight through monetary restrictions and fiscal conservatism in major countries contributed to the renewed dynamics of the crisis leading to a breakdown of banking systems and to further deflation. In contrast, the Bretton Woods system was purposely intended to avoid similar balance of payments constraints for domestic economic policy. Even though the adjustable peg has today been replaced by flexible exchange rates of major currencies in their relationship to each other, nothing has changed with regard to the greater autonomy of internal economic policies from international considerations compared to the gold standard period. Therefore central banks in their fight against the financial crisis this time were able to lower their interest rates to almost zero and to pump liquidity into the banking system and the economy as a whole. As a result, in important economies money stocks have increased during the current crisis, whereas in the Great Depression they declined conspicuously. Massive deflation has been avoided so far and no second-round banking crises have occurred. In addition, fiscal policy reacted to the crisis largely with deficit spending, which also is a very big difference to the early 1930s. Therefore, under the present circumstances an economic policy-induced aggravation of the slump is highly improbable. In other words, a repetition of the experience of the Great Depression, namely three years of continued severe economic downswing, is not to be expected.

What about the dynamics of the coming upswing? Will it be as slow and as imperfect as that of the 1930s before deficit-financed rearmament began on a huge scale? Here, too, a note of optimism seems to be in order. Even if the current crisis has already led to a few additional barriers to trade in some countries, full-fledged high protectionism on the scale experienced in 1930s is still far away. Moreover, it is to be doubted that it will develop in the future, even if the crisis lasts for some more months. For free trade today is firmly institutionalised; the WTO, the European Community and other international und supranational organisations act as powerful commitment mechanisms which make it difficult for member countries to withdraw from the principle of multilateralism. Moreover, the intra-trade of multinational firms today accounts for a major share of international commerce, so these firms have a big vested interest in liberal trade. A dynamic rise of world exports after the end of the acute crisis can therefore be expected, so that this important engine of growth will function again. Thus a new military adventure will be unnecessary in order to bring economies back onto an ascending path of development.