Global Financial Systems
Chapter 2
Great Depression

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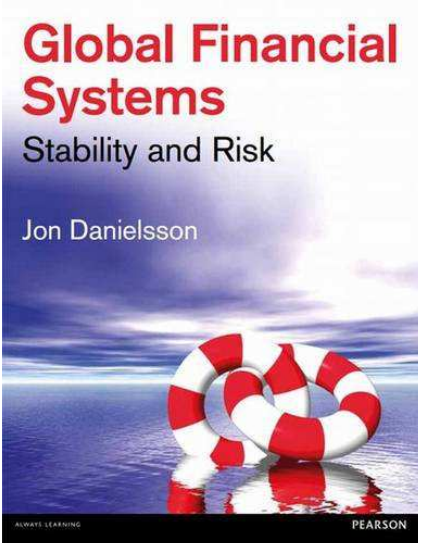
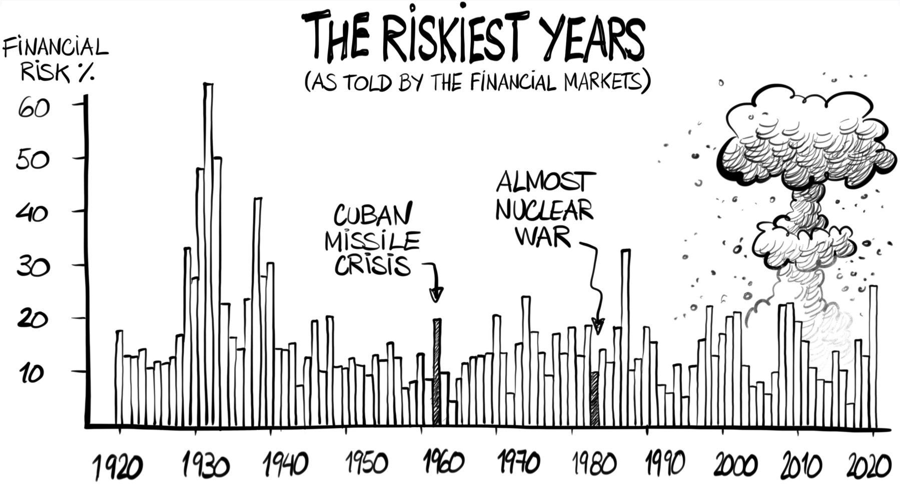
Book and slides



- Updated versions of the slides can be downloaded from the book web page www.globalfinancialsystems.org



illusionofcontrol.org

Background

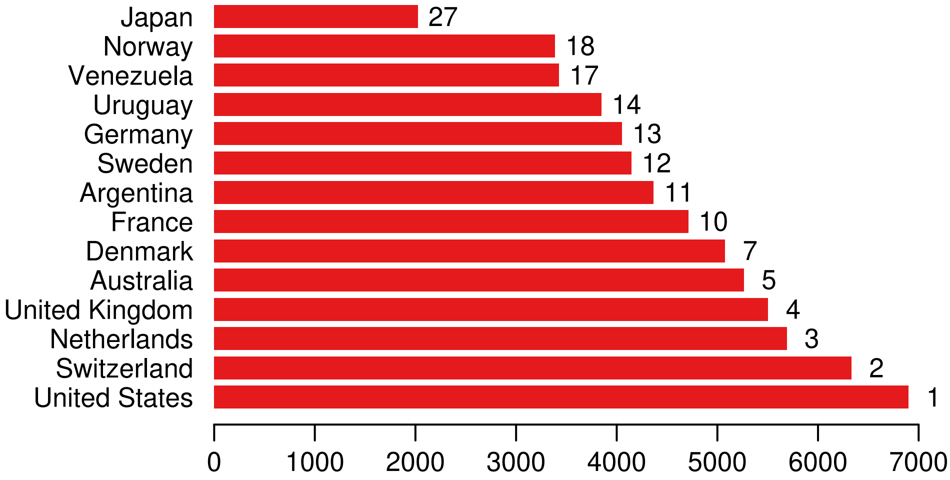
- Kindleberger (1986)
- Friedman and Schwartz (1963)
- Eichengreen (1996)
- Keynes (1920)

Relevance for today

- The biggest economic crisis the world has ever seen, before and since
- Clear policy mistakes were the reasons for the Depression
- Significantly changed how we see the economy
- And had a very strong impact on recent crises: 2008, Euro, Covid
- Europe and North America have pursued middle-of-the-road (non-extreme) economic policies since then
- Are we now returning to the world as it used to be then? (status quo ex-ante)

1929 GDP per capita in constant 1990 dollars

and global rank out of 52 countries. Maddison, Bolt and Zanden (2020)



The Roaring 1920s

Keep that phrase in mind. We have seen and will see similar expressions

The roaring 20s

- Rapid economic growth (with some interruptions)
- Positive demand shock after WWI and Spanish flu
- First time most people had access to markets
- Credit markets played a relatively minor role compared to now
- Rampant *stock market speculation*
  - Stocks bought *on margin*
  - Extremely high levels of *leverage* (often 10 times)
- Recession started in 1929

Currencies

- Germany back on the gold standard in August 1924 after its hyperinflation
- Disastrous attempts to *turn back the clock* (UK, May 1925), next slide
- France suffered instability and speculative attacks (1923–1924), then stabilized but *too low a rate*
- The relative overvaluation of the pound and undervaluation of the franc caused serious frictions (discussed along with currency wars elsewhere)
- France operated a sensible policy for its objectives, not considering the stability of the system or, indeed, French capital abroad
- Lessons for thinking about countries that either keep the currency artificially low or are accused of doing that (we discuss this in the chapter on FX)

UK's mistake

- The Chancellor of the Exchequer, Winston Churchill, on the advice of the Bank of England and against the advice of Keynes, put the UK on the gold standard at *prewar parity* in 1925
- Britain had suffered 40% inflation. Sterling was, hence, significantly overvalued
- Continuous recession and austerity ensued until Britain gave up in 1931
- After which its economy boomed
- This episode has strong echoes today — Is the euro too strong for weaker eurozone members?

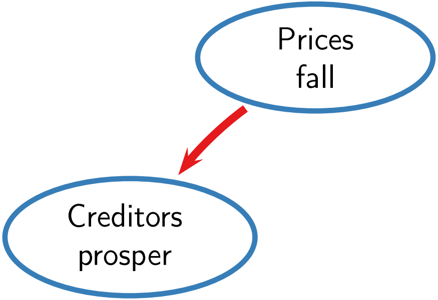
Deflation

- Deflation was a major problem in the 1920s and 30s
- A major culprit was the gold standard
  - note echoes to the euro
- Deflation is much more costly than inflation

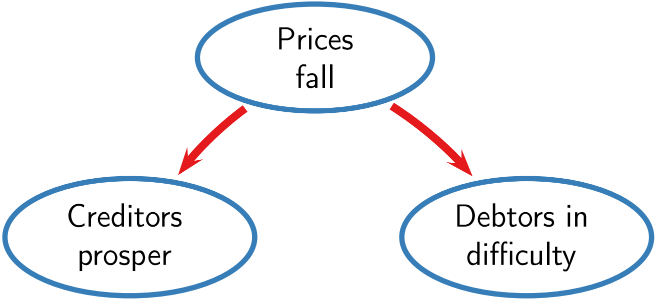
Deflationary cycle

Prices
fall

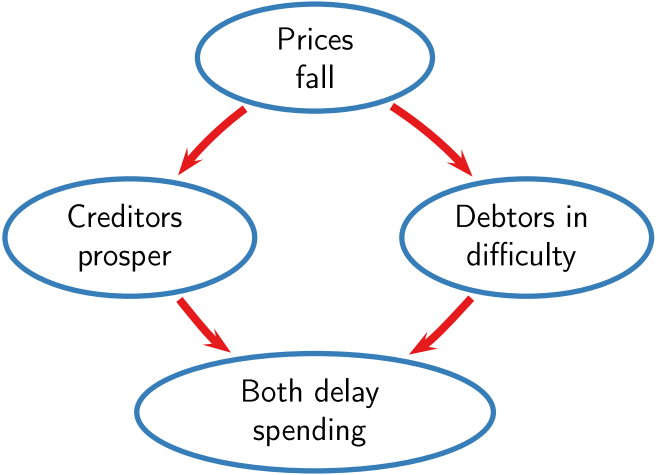
Deflationary cycle



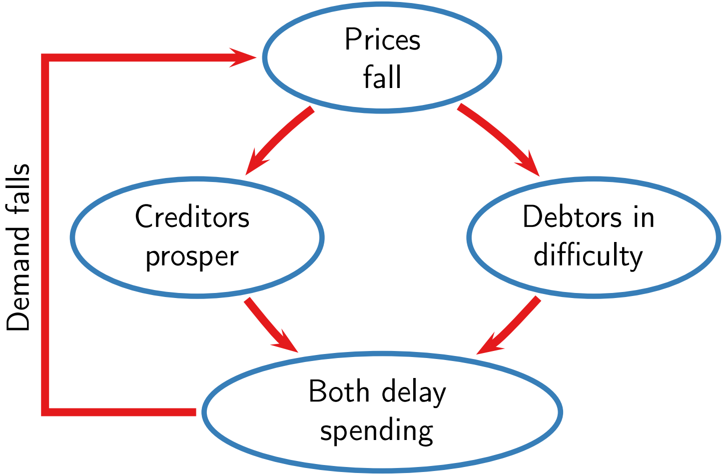
Deflationary cycle



Deflationary cycle



Deflationary cycle



Agriculture

- Agriculture ceased to be important in industrialized countries from the mid–1850s
- However, farming accounted for a quarter of total employment in the US and was important for many countries like Canada, Argentina, Australia, Italy, etc.
- Overproduction due to restoration of production in Europe whilst production increased elsewhere during wartime
  - Prices dropped 30% from 1925 to June 1929, 9% in the second part of 1929
  - Stockpile increased by 75% in the same period
  - Eventually, they had to be sold, depressing prices further

Competitive depreciations

- If your export sector is in difficulty, do you devalue?
  - The hope is to get more domestic money coming in from selling to foreigners without domestic costs — like salaries and interest payments — going up
- Problem is that it was a buyers *not* seller's market
- Highly inelastic demand
  - FX depreciation does not raise prices at home but lowers them abroad
- So the country is worse off
- And everybody is doing it. The world is worse off

Deflation

- Depreciations were deflationary
- Hard to prevent, if one country cuts back on supply, benefits reaped by others
- Deflation spread from commodity to commodity
- Positions of banks and insurance companies loaded with mortgages weakened

Surpluses, liquidity crisis, FX depreciation, bank failure, money collapse

Stock market and capital flows

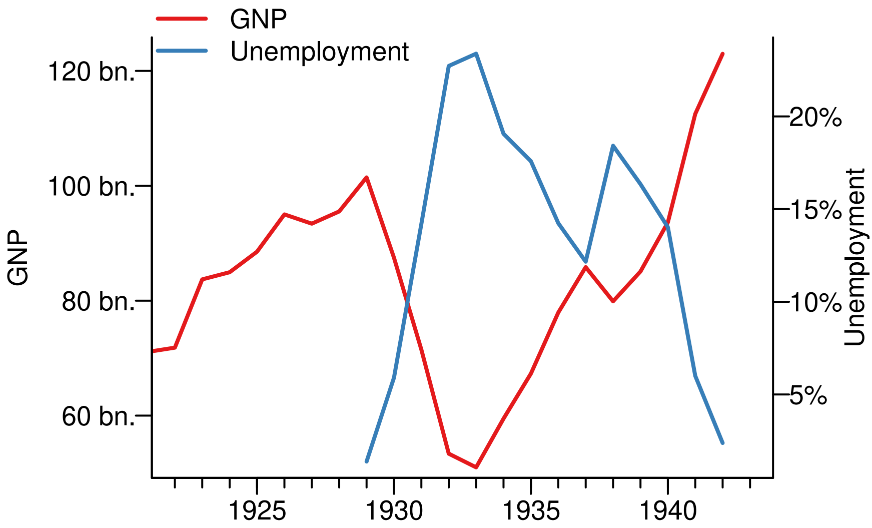
- An increasing amount of US (and global) capital went into the US stock market
- Fed worried that rampant speculation was diverting money from productive uses
- It tightened monetary policy
- US stopped exporting capital
- This caused problems elsewhere. Countries lost gold and had to raise interest rates

US monetary policy

- An important decision was taken following a conference in July 1927 to cut US interest rates
- Objectives were to help the UK
- And support agriculture
- May have been appropriate for the non–financial sector in the US but was highly stimulating for the stock market (echoes of the *Greenspan put*)
- Opposite monetary policy needed for the two main policy objectives

Great Depression

US GNP in constant prices and unemployment



1929 stock market crash

- European markets turned down earlier:
  - Germany 1927, UK 1928, France February 1929, Austria waited until 1931
- But the main place was New York
- Where prices and volume doubled in two years
- The main danger was not the prices or volume but its dependence on the credit markets and its influence on credit around the world
- But business was slipping, business cycle peaked in June 1929 in the US, April in Germany, July in the UK

Dow Jones

Schadenfreude

(pleasure at the misfortune of others)

- After the excesses of the previous years, people cheered
- It was the bankers that suffered
- They got what they deserved
- Banks allowed to fail

Liquidity support after crash

- Immediately after the crash, the New York Fed provided over $1 billion in liquidity support to banks
- Prevented the otherwise inevitable bank crisis
- But generally, the governors of the Fed opposed liquidity support — maintaining the bubble had been caused by too much credit and further easing would be disastrous
- And the Fed stopped easing in early 1930 when the economy was taking a turn for the worse
- Note relevance for today's policy debate

Banking crisis in Europe

- The French government *encourages* French banks to pull money out of Austria to prevent a pending customs union between Austria and Germany (narrow political considerations)
- Run on Credit Anstalt in Austria, becomes a *run on Austria*
- Bank crisis spills over to *Germany*
- And eventually to *UK* which starts losing gold
- Incompatibility between gold standard and lending of last resort
- Countries with large reserves should act responsibly

Banking crisis in the US

- Peculiar structure of US banking system, narrow banking
- No bank crisis in the US until December 1930, *Bank of United States* bank run
- No help given
- *Confidence in banks was undermined*. People could not tell if a bank was sound and started pulling their money out
- Domino effects, as loans are called, scramble for liquidity
- Bank credit collapses — money supply contracts

Government reaction

- The Fed increasingly demoralized and unable to offer a response
- *Contracts money supply* in January 1933!
- The Open Market committee did not meet in February (when the worst was happening)
- President Hoover requests suggestions from the Governors of the Fed on February 25, receives none
- *Bank holidays* become widespread
- Difficulties because Hoover was on the way out and Roosevelt had not taken power
- Nobody in a position to make decisions

Causes of the Depression

Causes of the Depression

- Main causes
  - trade policy
  - monetary policy
- Other causes, including:
  - lack of global leadership
  - lack of international cooperation and narrow focus on national interests
  - (do these two sound familiar today?)
  - foreign exchange instability
  - bank failures

Trade

Tariffs

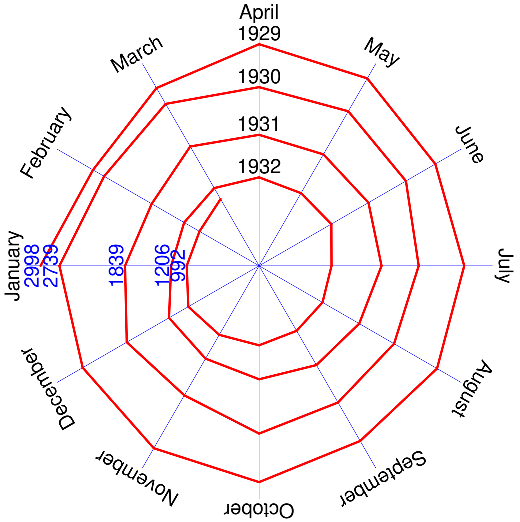
Tariffs increased in the 1920s

- Protect against FX devaluations
- Many international conferences tried to prevent this but to no avail
- Republicans in the US strongly pro tariffs (are they returning to that now?)
- Conservatives in the UK strongly pro-empire preference (are they returning to that now?)

Trade restrictions

- *Smoot–Hawley* passed the US House of Representatives in May 1929 and signed into law in June 1930.
  - Let loose wave of *retaliations* (and *opportunistic* copying)
- Most trade seized
- Countries ran into serious difficulties because they could not export
- Result was that everybody was much worse off

Reduction in global trade 1929 – March 1933

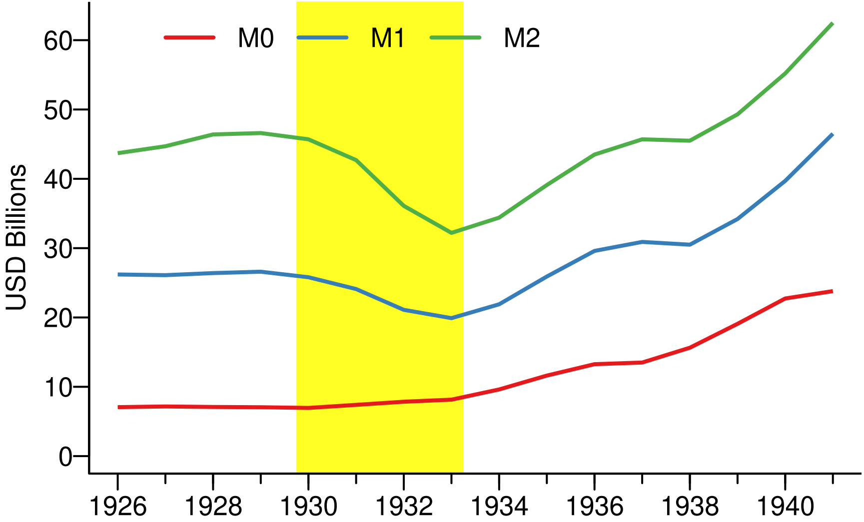


Reduction in trade 1929–1933

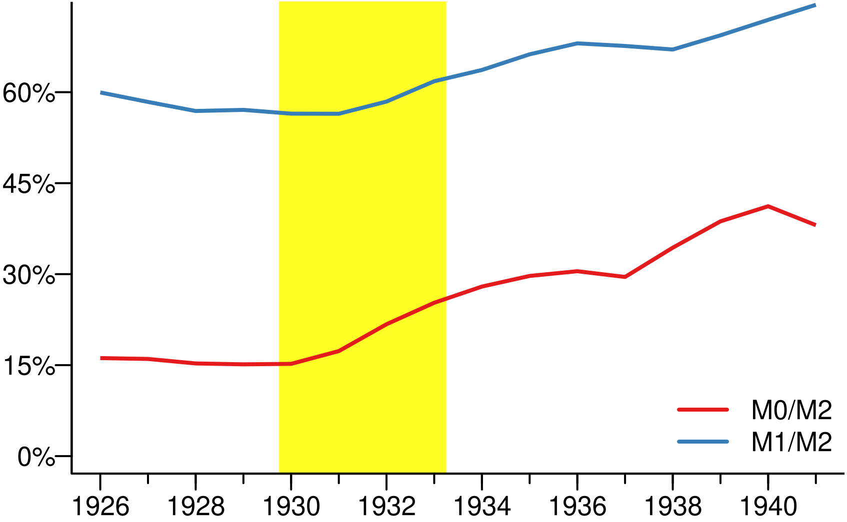
Over 80%	Chile
70%-80%	Cuba, China, Peru,...
60%-70%	Netherlands, Greece, Brazil, Estonia, Spain,...
50%-60%	Denmark, New Zealand, Finland, Columbia,...

Liquidity and Money

US money supply 1926–1941



And ratios to M2



Policy

- Reconstruction Finance Corporation late 1932, for bailouts
- Speaker of the House insisted banks using the fund should be *publicly identified*
- That caused runs, so others stopped applying
- Important argument for *support to be secret*
- By February 1933, widespread bank closures
- The Fed refused in March 1933 to sign off a federal guarantee for bank deposits
- Then President Roosevelt shut every bank in America for more than a week

Friedman & Schwartz critique

Mistakes of the Fed

1. It did too little to counteract the credit contraction caused by failing banks.
2. The Fed actually *reduced* credit between December 1930 and April 1931.

The conclusion of Friedman and Schwartz has *significantly influenced policymaking in the ongoing crisis*, and is a key reason why central banks have provided significant amounts of QE

Lack of global coordination

- Many meetings, producing little
- Focus on narrow national interests
- In a globalized economy, the main economic powers need to cooperate closely

War debt and reparations — April 1929 conference in Paris

- France insisted on reparation payments even if Germany could not pay

> "Almost all the great powers have been negotiating for months about how many billions a year should be paid until 1966, and after that until 1988, by a country that is not even in a position to pay its own civil servants' salaries the next day"
> Felix Somary in a report to the SNB

Parallels with Today

Influence of the Depression

- Many international institutions, policies, rules, regulations and responses derive from the Depression
  - Bretton–Woods (IMF and WB)
- The US took a leading role in maintaining the international order
- The policy response to the crisis since 2007 directly draws from the Depression lessons

Trade

- GATT and then WTO established to prevent a recurrence
- Even if a single country objected, it could not undermine the arrangement
- That is now under threat
- Are the 1920s/30s type trade wars more likely?

1929 and 2007

- Currency wars were common then, mostly prevented now, but one is building up
- International coordination was seriously lacking in the Depression but very effective now
- Widespread bank failures then, not now
- Liquidity contracts (in the US), massively expanded now
- Broadly speaking, governments are cooperating
- Banking is maintained
- Trade restrictions are avoided
- Liquidity is supplied
- Extensive cooperation

Thus, the crisis did not become the Great Depression

Are we going back?

- Attacks on the international order make that more likely
- United States is retrenching
- China is making its world order
- Is the post-WWII setup and stability an anomaly?
- Is so Trump and Brexit and all the rest a reversion to a steady state?
- Is Covid-19, Ukraine war and inflation symptomatic or accelerating this development?
- That is, we are going back to the instability before WWII
- The lessons discussed in this chapter then become especially important

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