

Devaluation and economic recovery during the 1930s.



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a) Evaluate the evidence of the relationship between devaluation and economic recovery during the 1930s.

b) Evaluate the mechanisms by which devaluation had an impact on economic recovery during the 1930s.

Although a wide range of uncoordinated policies were implemented in the 1930s, including devaluation, it is possible to classify the major trading nations into different trade policy regimes (Kitson and Solomou, 1990): the sterling bloc that devalued with or soon after Britain and linked their currencies to sterling; other countries which also devalued either early (before 1932) or later (1932 and after); the exchange control group, that was reluctant to devalue for fear of inflation; and the gold bloc countries which remained, at least in the short term, committed to the system.

During the 1929-32 depression, 'world' output declined by more than 6% per annum. The sterling bloc exhibited the mildest contraction, with GDP falling by an annual rate of less than 2% per annum, and just 0.5% if Canada is excluded from the sample (Canada was particularly adversely affected by its large agricultural sector and its links with the United States). This suggests that devaluation policies may have helped to mitigate the adverse effects of the depression. Leaving gold provided less help for the 'other devaluers' group although there is evidence that those who devalued early experienced a milder depression than those who delayed and devalued late. Thus, the timing of the policy response was important.

The positive relationship between devaluation and the economic recovery in the 1930s is depicted in specific countries and some groups of countries.

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Eichengreen and Sachs (1985), claim that devaluation benefitted initiating countries, and Bernanke and James (1991) demonstrate a strong link between deflation, depression and adherence to gold in their analysis of 24 countries. Shibamoto and Shizume (2014) find that exchange rate shocks independently had strong influences on the real economy in Japan. Their historical decomposition demonstrates that the exchange rate contributed to production growth after Japan left Gold in December 1931. However, a limitation is that their results may contain measurement error because their effective exchange rate is constructed using 1917 weights.

On the other hand, Reinhart and Reinhart (2009) argue against the hypothesis of a positive relationship between devaluation and the economic recovery in the 1930s. They find that their timing variable is insignificant and the date of exit from gold does not help to explain the depth or duration of the downturn when examining 37 countries. However, a limitation is that their results posit having a large number of countries does not necessarily improve the reliability of results. Other literature argues that national heterogeneity played an imperative role in determining the relationship between devaluation and recovery. Later when Reinhart and Reinhart repeated Eichengreen's 14 country 1929-37 analysis but using real GDP per capita rather than Industrial production as a proxy for growth, they found significant results supporting a positive relationship between devaluation and the economic recovery during the 1930s. It can be affirmed that devaluation was a beggar-thy-neighbour policy, in which one country attempts to remedy its economic problems by means that tend to worsen the economic problems of other countries, and thus explains why we see the

relationship between devaluation and recovery vary for different groups of countries.

For the period of recovery, from 1932-37, most countries exhibited reasonable cyclical growth. The exception was the gold bloc countries. Constrained by their commitment to their exchange rate parities they had to adopt tight monetary and fiscal policies to maintain internal and external balance. Thus although output was depressed, the French government in the early 1930s adopted contractionary fiscal policies to prevent destabilising exchange rate speculation. Reinhart and Reinhart (2009) states that the benefits of competitive devaluation went to the first movers and for those that devalued later it merely allowed for 'catch-up' for lost competitiveness. It can be seen that US monetary policy was hampered by beggar-thy-neighbour problems as almost all devaluations relative to gold produced an appreciation relative to the dollar.

A simple comparison of growth performance during recovery can be misleading, as it will include both a cyclical component (the automatic recovery from a deep depression) and policy induced effects. An alternative is to examine inter-period, peak to peak growth performance. Looking at the change in the annual rate of growth of GDP during 1929-37 relative to 1924-29, the results for the 'world' economy indicate a retardation of the growth path. This is consistent with other findings that the shock of the Great Depression had persistent effects on the level of output. The performance of the different policy regimes, however, provides important contrasts. The countries that devalued, particularly those that devalued early, experienced only a small (or zero) fall in trend growth. Those countries that had the <https://assignbuster.com/devaluation-and-economic-recovery-during-the-1930s/>

limited benefits of exchange controls experienced a deterioration in annual growth of 3.3%. The poorest performing group was the gold bloc, which had little flexibility to initiate policies for domestic recovery.

Further evidence of the striking contrasts in performance of different policy regimes is shown in figures for annual growth of industrial production. These indicate that those countries which devalued, and to a lesser extent those that introduced exchange controls, had a milder industrial depression, faster recovery and a better inter-period growth performance. Evidence on the unemployment performance of the different policy regimes shows that the high unemployment that developed during the depression persisted throughout the period of recovery. Only for the sterling bloc was there any fall in the unemployment rate; for the other regimes unemployment increased during 1933-37. In part this reflects employment lagging output, plus changing activity rates and demographic shifts. But it is also evidence of the persistent effects of the Great Depression, the long-term unemployed having difficulty re-entering the labour market.

As always, there are some authors (Beenstock et al, 1984) who argue that it was wage movements that accounted for the cyclical fluctuations in output, both for the Great Depression and subsequent recovery. It is true that real wages (adjusted for price changes) did move counter-cyclically over the 1929-37 cycle in Britain - rising relative to trend during the recovery - but the causes of the output fluctuations lay elsewhere, and the timing of the wage fluctuations do not actually fit the claim that recession was caused by wage rises and recovery caused by wage cuts. We have shown elsewhere (Michie, 1987) that this wage-output correlation itself does not, in any case, <https://assignbuster.com/devaluation-and-economic-recovery-during-the-1930s/>

hold outside those particular years - a finding which reinforces the argument that the output and wage series are independently generated, with output influenced crucially by the level of demand for output and wages by factors such as productivity levels and bargaining strength.

Growth and improved economic performance during the 1930s was dependent on countries untying themselves from strictures of the gold standard and adopting independent policies, with different exchange rate regimes created and with some countries also reaping the advantages of increased protectionism and fiscal expansion. What is apparent, however, is that the cooperative regime failed and uncoordinated policies were a vast improvement. Almunia et al (2010) finds large defence spending multipliers of 2.5 on impact and 1.2 after the initial year. These demonstrate the large potential impact fiscal spending could have on the economy. Moreover, in Japan real gross national expenditure rose by 45% 1931-36 alongside which the economy approached full employment. However, Almunia's findings have limitations as multipliers reduce to 0.43 on impact and 0.13 when total government spending is used instead of defence spending. The absolute size of fiscal expenditure in countries was actually relatively small and thus despite potentially large multipliers, was unable to drive the economic recovery in the 1930s.

The use of uncoordinated policies may have led to some resource misallocation effects. The overriding impact, however, was positive as independent policies overcame the deflationary bias of the gold standard and led to increased resource mobilisation. Despite these economic gains some commentators persist in identifying the 1930s as a period of '
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economic nationalism' which helped to usher in totalitarian and fiscal political regimes. This is a complete misreading of history. The rise of racism and fascism in the 1920s and 1930s was fuelled by mass unemployment and the destructive economic policies imposed on Germany at Versailles and on the rest of the world by the gold standard. Keynes had warned as much in 'The Economic Consequences of the Peace' (1919) and 'The Economic Consequences of Mr Churchill' (1925), but to no avail. Currency stability was of greatest importance.

Devaluation can have beneficial impacts through a number of mechanisms. First, it can directly alleviate the balance of payments constraint on growth. Shifts in relative prices and improved competitiveness can raise exports and depress imports. The conventional account of this process is that it is a 'beggar-my-neighbour' policy (Healey and Levine, 1992), as the improvement in trade performance is reflected in an improving trade balance for the initiating country and a deteriorating trade balance for trading partners. This account, however, ignores the effects of an independently pursued trade policy on the level of economic activity. Increasing exports and reducing the propensity to import will raise the level of demand in the domestic economy. With unemployment and excess capacity, such a policy initiative will raise output and employment as well as leading to an income-induced increase in imports, so that there need be no change in the actual trade balance. Indeed, this is precisely the reason why, although Britain devalued and adopted widespread protectionism in 1931, the current account deficits persisted throughout the 1930s. If countries get locked into a pattern of trade which constrains domestic expansion, an active and independent trade

policy provides one means of overcoming the problem without necessarily affecting adversely other trading partners. Empirical support for this mechanism is found in Eichengreen and Sachs (1985) where they found that countries who devalued were successful in raising their Tobin's Q. However, there is a limitation, Tobin's Q represents the 'incentive to invest' as opposed to actual investment, hence this does not actually tell us if investment had a real effect on the economic recovery. Nevertheless, increased investment demand which resulted from devaluation is likely to have had significant effects on economic recovery.

The second benefit of devaluation is that it removes the exchange rate constraint on domestic policy, encouraging expansionist policies. In particular, monetary policy can be relaxed and therefore interest rates can be determined by domestic economic conditions rather than by the need to maintain the exchange rate or by the need to prevent excessive loss of reserves. For instance, Britain's suspension of the gold standard allowed the government to pursue a more expansionist policy after 1932. This 'cheap money' policy has been identified as a permissive policy for economic revival, especially important in stimulating a housing boom. Conversely, the reason that the British Government's claims on September 16, 1992 (that it would remain in the ERM by raising interest rates as far as was necessary) lacked credibility was that raising interest rates by 5% in one day in the midst of the longest economic recession for 60 years was not believed to be a feasible policy option. Eichengreen and Sachs (1985) explore a more general model and depict that devaluation might give rise to interest rate differentials among countries, creating not only the expenditure-increasing

effect but also an expenditure-switching effect. Due to data limitations in the 1930s it is hard to draw strong inferences regarding the impact of devaluation on interest rates. Eichengreen and Sachs (1985) do however find a positive relationship between exchange rates of countries and changes in the CB discount rate. Support for this is provided by Almunia (2010) who finds that countries abandoning Gold were quicker to cut interest rates in response to the slump. However, Eichengreen and Sachs (1985) find that the CB discount rate does not reflect market conditions. Therefore, devaluation is likely to have reduced interest rates in devaluing countries boosting investment and spending.

The positive effect of devaluation on export growth is likely to have given a positive short term gain effect to economic recovery. Bernanke and James (1991) find large and statistically significant results on output growth for real export growth. Shibamoto et al (2014) argue that anticipated devaluation generated expansionary expectational effects in Japan. However, their use of railway traffic is a very poor proxy for GDP and thus their results are unreliable given that they are generated from poor quality data. Instead, we support the thesis that expectational effects were seen with a lag of 1 to 2 year as it took time for people to learn the effects of devaluation. Hence, in the US we can explain the lack of a lag in expectational effects as US agents had learnt from the European experience of devaluation. Thus, there is support for an expectational mechanism through which devaluation impacted on economic recovery but with a 1 to 2 year lag. Devaluation and the accompanying introduction of other expansionist policies also led to a third, less mechanistic, benefit. Under the prevailing world conditions of

uncertainty and monetary and financial turbulence, the reorientation of policy towards the domestic economy improved business confidence. The prospect of a stable and growing economy encourages home producers to increase, or at least bring forward, investment and expand production.