

Economic policy in sweden during the great depression economics essay



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When the Great Depression swept across Europe in the early 1930s the impact of the economic downturn varied across countries. While for example Germany, Austria and most of Central Europe experienced a long and deep economic crisis, the economies of the Nordic countries – Sweden, Denmark and Norway – were not only affected later and more mildly by the Depression, but also recovered earlier. The crisis in Sweden for example only lasted a little more than two years (in Germany and Poland it lasted for more than 4 years, see graph 1) and peak decline in industrial production was at 10.3% while for example Germany or Poland had declines in industrial production of more than 40% (see graph 2). Even when looking at comparable GDP figures, Sweden was with a decline of 6.5% well below countries such as Germany (25%) or Austria (23.4%, see graph 3). Moreover – and of greater interest for this paper – is the fact that Sweden did not only perform better during the Great Depression but also pursued a different economic policy. Most prominently cited amongst economic historians are two distinctly Swedish policy measures:

First, looking at Sweden's monetary policy, scholars point out, that the country left the gold standard very early and – unique at that time – simultaneously put the preservation of the domestic purchasing power of the krona on top of the political agenda.

Second, it is often mentioned, that the Social-Democratic government, which came into power in 1932, invested heavily in public work programmes following a Keynesian-type fiscal policy.

The present paper seeks to analyse whether these two factors are a) sufficient and b) withstand a closer empirical evaluation when it comes to explain the better development of Sweden during the Great Depression. In order to do so, the paper will, as a first step, outline the economic situation in Sweden and the corresponding economic policy prior to the crisis. This is necessary, as it provides an overview of the nature of Sweden's economy, its degree of integration into the international market and accordingly its general contagion risk at the time of the crisis. Secondly, the above mentioned policy measures during the Great Depression will be outlined. Thirdly and most central in this paper is an analyses of the effectiveness and consequences of these policy measures. The last chapter will then draw the attention to other factors outside the control of government policy that might have helped Sweden to ease the effects of the Great Depression.

Literature

Immune to crisis? Sweden's economic development prior to the Great Depression

Even though Sweden's macro-economic policy is often seen as the major contributor to the countries positive development during the Great Depression, one must not fail to see, that some of the reasons for this development are rather to be found in specific characteristics of Sweden's economy prior to 1929/31 than in any explicit policy measure thereafter. Two " pre-existing conditions" can be outlined, that seemed to have stabilized the economy during the crisis. Firstly, a constantly undervalued krona made Swedish exports cheap on the international market. Secondly, the banking

sector in Sweden was centralized and crisis-prone. Thus, a banking panic never occurred. The following paragraphs explain these specifically Swedish conditions in greater detail.

Traditionally, Sweden's economy was based on the country's rich endowments of iron and timber. Its main trading partner was Britain and later on Germany and the United States. During the beginning of the 20th century Sweden also became a major exporter of technologically sophisticated goods such as telephones (e. g. Ericsson) or appliances (e. g. Electrolux). As Sweden was - at least on paper - a neutral power during World War I (WWI) many investors sought to acquire Swedish assets at that time, as the country seemed to be a safe haven for capital. Additionally, by mainly exporting raw materials, Sweden could take advantage of the increase in foreign demand for those goods caused by WWI. By the end of the war Sweden had transformed from a major international borrower to a creditor to the rest of the world. While the export industry could profit from these developments, inflation increased mainly due to increasing costs for imports. Between 1915 and 1918 the cost of living rose by as much as 90%. This inflation was eventually condemned between 1920 and 1924 when prices declined by 55% due to a restrictive monetary policy. After 1924 a slower, but persistent deflation continued until 1931. With such low domestic prices, Sweden was highly competitive on the international market. That is why during most of the 1920s Sweden experienced a strong export-led economic growth. This is why after WWI Sweden reinstated the gold standard as one of the first industrialized countries in 1924. Many economic historians believe that this return to the gold standard occurred at a rate that

left the krona undervalued well into the 1930s. As a consequence Swedish exports remained highly competitive even in times of economic crisis.

The domestic market also stabilized during the 1920s. Due to export bans and high import taxes during and after WWI, Swedish consumers, whose purchasing power constantly increased during the 1920s, substituted imports with domestic products. Additionally, demographics played a role. During the 1920s and 1930s there was a rapid rise in the number of young people of working age (especially those aged 20-29). Respectively, demand for housing, food, clothes and other consumer products increased which contributed to a strong growth of domestic production as well.

When the stock market crash of October 29, 1929, triggered the Great Depression, another factor for Sweden's low proneness to crises became obvious. Sweden's banking structure was very concentrated. This was much in contrast to for example the United States, where the banking structure was highly fragmented and decentralized. According to Ben Bernanke, such a structure is much more likely to cause banking panics. Sweden however was characterized by a branch banking system, where risks were dispersed. It is argued that especially in the case of Sweden, earlier experiences with failing banks in the 1920s had led to reforms that had put the banking system on a sound footing. That is why at the beginning of the 1930s the banking sector in Sweden did not experience widespread panics.

Putting all these facts together, it can be argued, that Sweden was from the very beginning less likely to be effected by the Great Depression than those countries whose banking sector collapsed. This especially holds true when

considering the fact that trust in the economy never vanished in Sweden due to a generally stable banking structure. Additionally, even though exports declined from 1931 until 1932, Sweden's export industry always remained highly competitive. This was not least due to an undervalued krona, whose parity remained stable well into the 1930s. Nevertheless, analyzing the characteristics of Sweden's economy prior to the Great Depression only answers part of the question to why Sweden performed considerably better during the crisis than other nations. Especially when Sweden left the gold standard in 1931, specific policy measures as described in chapter two played an equally significant role.

What was so special? Sweden's response to the Great Depression

Prior to the Great Depression, the political mainstream of the Western industrialized world followed a laissez-faire ideology that propagated the free play of the market. It was believed that capitalism had a self-equilibrating tendency, leading to an optimal level of resource utilization. Hence, economic policy at that time simply meant that governments should balance their budget, maintain the gold standard and let businesses reequilibrate themselves. However, while many countries had to reconsider their economic policies during the Great Depression, Sweden had already made this step beforehand. During the late 1920s, Sweden's economic policy was already based on the advice of trained economists who did not solely propagate the contemporary neo-classical view on economics but rather pursued their own theories on how the state should react during an economic crisis. This so called Stockholm School was a loose group of economists whose most important figures were Knut Wicksell, Eli Heckscher, <https://assignbuster.com/economic-policy-in-sweden-during-the-great-depression-economics-essay/>

Gustav Bagge, Bertil Ohlin and David Davidson. Especially Knut Wicksell's findings at the beginning of the 20th century inspired most of the works of his followers.

Wicksell is best known for *Interest and Prices*, his contribution to the fledgling field now called macroeconomics. In this book and in his 1906 *Lectures in Political Economy*, volume 2, Wicksell sketched out his version of the quantity theory of money (monetarism). The standard view of the quantity theory before Wicksell was that increases in the money supply have a direct effect on prices—more money chasing the same amount of goods. Wicksell focused on the indirect effect. In elaborating this effect, Wicksell distinguished between the real rate of return on new capital (Wicksell called this the “natural rate of interest”) and the actual market rate of interest. He argued that if the banks reduced the rate of interest below the real rate of return on capital, the amount of loan capital demanded would increase and the amount of saving supplied would fall. Investment, which equaled saving before the interest rate fell, would exceed saving at the lower rate. The increase in investment would increase overall spending, thus driving up prices. This “cumulative process” of inflation would stop only when the banks' reserves had fallen to their legal or desired limit, whichever was higher.

In laying out this theory, Wicksell began the conversion of the old quantity theory into a full-blown theory of prices. The Stockholm school, of which Wicksell was the father figure, ran with this insight and developed its own version of macroeconomics. In some ways this version resembled later Keynesian economics.

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Wicksell also argued passionately for making price stability the supreme goal of monetary policy. A stable price level, he maintained, made planning easier for participants in both financial and labour markets. In an 1898 analysis, Wicksell's key recommendation for central banks was to increase interest rates whenever prices were rising and to lower them when prices were falling—a monetary policy that he considered to be straightforward. He argued that low interest rates would tend to increase prices. A low rate of interest would lead a borrower to “ buy some commodity which otherwise he would not have bought at all” and would lead someone who “ wishes temporarily to keep some or all of his goods off the market . . . [to ask] . . . the Bank for money with which to meet his immediate or pending liabilities without having to sell his goods.” Thus, demand would rise and supply would fall, thereby ensuring an increase in prices. ¹⁸ This meant that the stabilization of prices required only that interest rates be increased when prices were rising and reduced when prices were falling.

Wicksell stressed that movements in the price level exerted a particularly large effect on borrowers because an increase in all prices made it easier to repay debts while a reduction made it harder. He also noted that real wages could be affected if nominal wages (in kronor) did not keep up with changes in prices.

Even though Wicksell died in 1926 his followers such as Eli Heckscher, Bertil Ohlin, Gustav Cassel and Gunnar Myrdal, could build upon his theoretical work and formulate concrete policy advice in 1931, when the Great Depression finally reached Sweden. The following paragraphs reveal how

their influence and advice on the Swedish central bank (Riksbank) and on the political elite helped Sweden through the crisis.

Monetary policy

During the early months of 1931, Sweden was the recipient of capital inflows. However, the German standstill led many international investors to withdraw their funds from Sweden both because they lacked access to their German funds and because they feared that the crisis would spread. These withdrawals contributed to a drastic reduction in Swedish reserves. By September of 1931, reserves had fallen to less than one-tenth of their January level. Similar pressure was placed on the British financial system, and on September 21, Britain abandoned the gold standard. On September 27 Sweden, too, abandoned the gold standard. The Riksbank and the minister of finance immediately announced that the new monetary goal for the country would be to preserve the domestic purchasing power of the krona " using all available means." The next day, September 28, the Riksdag gave its official assent by relieving the Riksbank of its responsibility to convert notes into gold at a fixed rate. People who wished to exchange kronor for foreign exchange could still do so at commercial banks, whose representatives met daily (along with a Riksbank official) to set exchange rates.

In making price stability the primary objective of its monetary policy, Sweden pursued an internationally unique agenda. Based on Knut Wicksell's argument that stable price levels made planning easier for participants in

both financial and labor market, the Riksbank new role was to maintain price levels within a certain range.

In order to do so, the first step the Riksbank undertook was to develop a new, weekly index of consumer prices. This was necessary as the goal was to “ give the public certain definite stand points for estimating future developments in prices.” Consequently, the new index was designed to include a wide range of goods and services that reflected purchases made by average families in Sweden. This ensured that the purchasing power of the Krona could be measured for most individuals correctly. The weekly inflation was then computed by weighing the percent change in each good and service consumed by the fraction of total consumer expenditure that households allocated to this item. Instruments used by the Riksbank in order to fulfill the price stability target were changes in the discount rate and operations in the foreign exchange market. Accordingly, the Riksbank changed the discount rate from 8% to 6% in 1931 as there were no longer signs for a continuing inflation. After that, the discount rate was lowered to 2.5% in 0.5% steps until 1937.

In retro perspective the monetary policy of the Riksbank proved to be very effective. Statistics show a considerably stable level of consumer prices between 1931 and 1938 (see graph 7). Most importantly however is the fact, that “...the monetary program of 1931 ... maintained public trust and confidence in the banking sector. One can therefore conclude, that not only did the centralized branch system of the banking structure prevented Sweden from the experience of a fully scaled banking panic, but also a sound monetary policy based on the theoretical findings of the Stockholm School.
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Nevertheless, the price stabilizing policy of the Riksbank did not remain unchallenged. For example, Bertil Ohlin, who wrote an article entitled “ The inadequacy of price stabilization.” There he acknowledged that “ the economic situation would most undoubtedly have been still worse if prices had been allowed to fall as they did in countries that kept to the old gold parity,” and that “ the knowledge that the Riksbank would endeavor by every means in its power to prevent any appreciable fall in prices has exercised a reassuring influence on trade.” However, Ohlin went on to argue that stabilization of prices could not prevent reductions in investment and hence in GDP. The next chapter explains how this argument was also put forward by the Social Democrats in 1932.

Public deficit spending

In the 1932 elections, the Social Democrats obtained the highest number of votes and formed a government. The new minister of finance, Ernst Wigforss, held that a monetary policy focused on price stability was insufficient to obtain an acceptable outcome for Sweden. The new finance minister had long championed the idea of intentional deficit spending in recessions. Wigforss had been a professor of linguistics at Lund before he became one of the leading intellectuals of the Social Democratic Party, and he worked closely with a number of Swedish economists, including Gunnar Myrdal, Erik Lindahl, and Bertil Ohlin. The group developed theories justifying the use of fiscal policy as a stabilization tool that were quite similar to those developed by John Maynard Keynes. In a 1928 article, for example, Wigforss wrote: “ If I want work for 100 people I do not need to put all 100 to work. . . . [I]f I can get an unemployed tailor work, he will get the opportunity to buy himself

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new shoes and in this way an unemployed shoemaker will get work. . . . This crisis is characterized above all by a relationship which is called a vicious circle. . . . One can say the crisis drives itself once it begins, and it [will] be the same once recovery begins." Wigforss's advocacy of deficit spending in response to the Depression was a radical departure from the policies of previous governments. Prior to 1933, government borrowing was primarily limited to loans for "productive" purposes, that is, for investments that would generate future government revenue, such as the postal service, telephones, electrical power generation, and railroads. Income derived from these activities would then cover the interest payments on the public debt while also generating additional income for the state. 36 In contrast, "nonproductive" government expenditure was supposed to be paid for with current government revenues. Since it was impossible to predict current revenues or nonproductive expenditures accurately, Sweden had reserve funds that accumulated any unanticipated surpluses. These funds were then available to cover unanticipated deficits. In the fiscal years 1931-1932 and 1932-1933, for example, the budget was balanced by reducing the reserves of the Alcoholic Drink Account. Thus, while budget deficits in the modern sense occurred, they were not acknowledged, and they were not the result of any policy aimed specifically at creating or allowing a deficit.

One of the more controversial issues amongst economic historians is the questions whether public deficit spending and public work programs really helped Sweden out of the economic slump or whether they were merely a side note during the Great Depression. The reason for that is that the coming to power of the Social Democrats in 1932 are widely perceived as a turning

point in Sweden's economic policy and sometimes even as the global "birth of modern macro-economic policy". However, empirical evidence proving that a special Social Democratic economic policy caused Sweden's quick recovery is scarce. As a matter of fact, the debate about the future fiscal policy of Sweden under Social Democratic rule already circled around issues much similar to those that John Maynard Keynes dealt with four years later in his magnum opus "the General Theory of Employment, Interest and Money". Sweden's financial minister Ernst Wigforss argued that price stabilization would not be enough to fight the depression. He rather proposed a public work program designed to put unemployed back to work even if this meant budget deficits. Much like the policy advocating stable prices, this one was again based on advice put forward by contemporary economists. This was a radical departure from the policies of previous governments. A balanced budget had always been the highest maxim. Usually, government loans were only used for investments that were expected to generate future profits such as postal services, railroads or electric power supply. All other "nonproductive" expenditures were paid for by reserves the government had built up. Unsurprisingly, this radical change in policy went not without fierce debate and controversy in parliament. The first unbalanced budget proposed by Wigforss for the years 1933 and 1934 was criticized for causing inflation and "depriving businesses of capital necessary for their development". To counter these arguments, the Social Democrats moved away from financing public work programs through deficits and proposed an inheritance tax used to finance their plans. Additionally, the Agrarian Party did not agree to the budget as they feared a negligence of the population working in the agrarian sector. As a consequence, the Social Democrats had to include high subsidy

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payments for the agricultural sector in the budget. When it finally passed the parliament in 1933 much of the planned deficit spending policy had disappeared. Moreover, most of the funds still allocated to public work programs could not be put to use as a nationwide lockout of employees in the construction sector blockaded the building industry. This lockout took place because the employer association SAF wanted to enforce lower wages for the industry. This conflict was solved in 1934 and only then could the government finally make use of the allocated funds for public works.

Did they find the Holy Grail? The effects of Sweden's economic policy

Renowned economist and chairman of the Fed, Ben Bernanke, wrote in his essay collection on the Great Depression that " Understanding the Great Depression is the holy grail of macro-economics". He thereby referred to the very difficult but ultimately rewarding task of finding a definite answer to the question of the real causes of the Great Depression. This, he argues, could help to identify future crisis better and address them more effectively.

When looking at the fact that Sweden had overcome the Depression rather well by applying certain types of policies, the question arises whether the Holy Grail might have already been found long before Bernanke published his book. This chapter will therefore look more closely at the real effect that the Swedish economic policy had from 1929 to 1937.

The range and depth of the several above mentioned policy measures varied significantly. It is therefore convenient to divide the chapter into the several policy fields that were addressed between 1929 and 1937. The evaluation is mainly done by using statistics of key figures that are in direct relation to the <https://assignbuster.com/economic-policy-in-sweden-during-the-great-depression-economics-essay/>

executed policy. By drawing on secondary literature it is then elaborated whether the figures in the statistics did or did not change due to a specific policy or due to other factors.

When looking at the debate on the cause of Sweden's recovery the author argues that according to one view the increasing demand and thus increasing exports led to a recovery. Hence, monetary policy was the most powerful contributory factor. The public works policy could not have had any significant effect, since the works were not started on any substantial scale until recovery was well under way. On the other hand, the expansion of the export market at first did not have an extensive impact on the labor market as at first large pile of build up stock were used for exports. No increase in production or employment took place. The author concludes that it was a mixture of growing demand abroad, monetary policy, deficit spending and support of the agriculture that led to Sweden's recovery. Even if it is clear that the public works did not lead to recovery it is unclear whether exports alone did the trick.

Just lucky? External factors fostering Sweden's recovery

Leaving the gold standard

After Great Britain left the gold standard on September 21st 1931, Sweden followed six days later as one of the first countries. The effects on both the domestic markets and the foreign sector were at first positive. Leaving gold meant that the Swedish Riksbank could lower the interest rate, therefore practicing an inflationary monetary policy rather than a deflationary policy as before. This let the money supply increase and accordingly aggregated <https://assignbuster.com/economic-policy-in-sweden-during-the-great-depression-economics-essay/>

product demand. As Sweden experienced a deflation prior to 1931 the increase in money now turned the economic situation into a mild inflation. This proved to be a rather favorable constellation, as with lower interest rates at the central bank and accordingly low real interest rates for businesses, investments increased. Hence, optimism amongst entrepreneurs never fell to a point where all investments were put on hold. Rather, trust in the economy always remained at a substantially high level, while prices remained at level that did not seem to hurt the economy too much.

Another important factor was the effect of an inflationary monetary policy on the export sector. Leaving gold was followed by a depreciation of the Krona. This meant that Swedish products became cheaper and did not decrease significantly, which is remarkable when looking at global trade statistics during the Great Depression. Graph 6 shows that Swedish exports did quite well during the 1930s, while a lot of other western economies had to face significant declines in exports. Additionally, a depreciation of the Krona also meant that imports became more expensive for Swedish consumers. As a consequence import substitution occurred, strengthening domestic enterprises. All put together, it becomes evident (see Berry Eichengreen), that leaving the gold standard early played an important role for the depth of and the recovery from the Great Depression.

Conclusion

This paper examined the economic policy of Sweden during the Great Depression. The primary question was to find out which factors contributed to the relatively mild course of the crisis. Accordingly, the first chapter

outlined the basic condition the Swedish economy was in prior to the crisis. This was a necessary entrance into the subject as it revealed that Sweden's exposure to contagion was - at least with respect to the banking sector - limited. On the other hand, the chapter revealed as well that the decrease of foreign demand due to the crisis had a definite negative impact on Sweden's export industry. Nevertheless, it can be argued that under these circumstances, Sweden was from the very beginning less likely to be effected by the Great Depression than those countries whose banking sector collapsed. This especially holds true when considering the fact that trust in the economy never vanished in Sweden due to generally stable, basic economic parameters. Hence, the specific characteristics of Sweden's economy prior and during the Great Depression already answer part of the question to why Sweden performed so well.

As Sweden was nevertheless hit by the crisis through the export market and the collapse of the international trading system, the second part of the answer can be found within the internationally unique policy measures Sweden pursued between 1931 and 1937. In chapter two it is argued that Swedish politicians deliberately followed an economic policy outside the neoclassical mainstream. This is mainly due to the so called Stockholm school, whose followers very early acknowledged that the state had to play a vital role during an economic crisis. As this group of economist and their advice was very well accepted within the political elite, policy measures could be put into practice without having to make too many concessions to third parties. Thus, policy reaction to the crisis was quick and effective.

In chapter three, several major policy measures that helped Sweden to recover from the Great Depression quicker than others are analysed in detail: the early abandoning of the gold standard, the stabilization of the purchasing power of the krona and public work programmes.

While the suspension of the gold standard was merely a reaction to the fact that one of Sweden's major trading partners, the UK, abandoned gold, the other two measures can clearly be traced back to the Stockholm School. It is argued in the paper, that stabilizing the purchasing power of the krona definitely helped to maintain trust in the economic system and provided planning reliability for businesses. The role of the public work programmes however remains somewhat blurry. Even though Sweden seems to be an early if not the first country to follow Keynesian-like policies, the effects of the deficit spending policy is somewhat disputed by scholars. There is however consensus on the fact that the policies of the Social Democrats in the early 1930s paved the way for true deficit spending and broad government intervention in the following decades, leading to the today renown Swedish welfare state.

Lastly, Sweden's quick recovery is looked upon in chapter four. As available statistics do not reveal a significant success of the government work program, outside factors might explain more accurately why Sweden recovered so quickly. Looking at exports statistics one can clearly see that a general upswing in the global business cycle was very well received by Sweden's export industry. Especially the booming housing market in Great Britain pampered the export sector.

Putting all pieces together, this paper showed that a mixture of internal and external factors helped Sweden to overcome the Great Depression better than others. While a relatively low exposure of the banking sector to the international market helped to maintain trust in the economy, the stabilizing monetary policy of the Riksbank strengthened the planning reliability for customers and businesses alike. The quick recovery at the end of the Depression however can mainly be traced back to external factors. Nevertheless, the fact that businesses could quickly react to the growth in foreign demand at all is in great parts due to the stabilizing policy of the government.