

Response of economic policymakers to the great depression of the 1930`s

[History](#)



David Pattinson ' Industrialisation, Imperialism and Globalisation: The World Economy since 1800' Professor John Singleton Compare and contrast the response of economic policymakers to the Great Depression of the 1930's and the Great Financial Crisis today. Essay 2 10/1/13 Word count: 2, 299 The financial crisis that began in 2007-8 was the first time since the 1930's that both the major European countries and the US had been involved in a financial crisis.

In comparison, the disastrous 1931 banking crisis involved countries that accounted for 55. 6 per cent of world GDP, whereas the banking crisis of 2007-8 only involved countries that accounted for 33. 5 per cent of world GDP. Though, all the key economic variables fell at a faster rate during the first year of the later crisis. Keynes had argued in 1931 that ' there is a possibility that when this crisis is looked back upon by the economic historian of the future it will be seen to mark one the major turning points. ' Keynes was correct.

As a result of the lessons that were learned, policy in response to the Great Financial Crisis has contrasted sharply with policy during the Great Depression era. I will examine how national policy responses and international co-operation have differed, as well as highlighting how in creating the Euro, policymakers have unwittingly replicated many of the structural weaknesses of the Gold Standard. I will also consider how policy in the recovery phase has so far compared to policy during the recovery from the Great Depression.

The Great Depression was marked by bank failures. A total of 9, 096 banks failed between 1930 and 1933 amounting to 2. 0% of GDP. Friedman and <https://assignbuster.com/response-of-economic-policymakers-to-the-great-depression-of-the-1930s/>

Schwartz highlight the failure to increase the money supply whilst liquidity was tight as the primary cause. Bordo and Landon-Lane provide econometric analysis using examiners' reports on failed banks that support this argument. Epstein and Ferguson have suggested that Federal Reserve officials understood that monetary conditions were tight but believed that a contraction was a necessary corrective. The notion that governments should 'let nature take its course' formed a central pillar of the contemporary economic orthodoxy. However, other economic historians have pointed out that Federal officials believed that monetary policy was actually loose, due to them conflating low nominal interest rates with low real interest rates (which were high as a result of deflation). Wicker argues that Federal Reserve officials feared that open market purchases would renew gold outflow by bring into question the Federal Reserve's commitment to maintaining gold convertibility.

When faced with a policy choice the Federal Reserve always opted to support the Gold Standard. Rather than shore up the battered banking system, the Federal Reserve raised interest rates during late 1931 and the winter of 1932-3 to protect the dollar from speculation in order to halt gold losses. Regardless of the deficiencies of Federal Reserve policy, the US entered the 1930's with a poorly regulated banking system that was undercapitalised and based on unit banking. Calomiris and Mason argue that eventually, banking collapse would have been inevitable.

In general, economists argue that the depth of the downturn is explained by the monetary shocks interacting with the dramatic falls in demand (that emanated from the collapse in investment and consumption). Loss of income

and uncertain employment conditions combined to undermine consumer spending, whilst there was little incentive to invest while prices were falling. Deflation also increased the burden of existing debt. Fiscal policy did not fill the gap in demand as belief in the Gold Standard and balanced budgets prevailed.

A coherent theoretical justification for expansionary fiscal policy was absent from the contemporary economic discourse. Expansionary fiscal policy remained unused, even after states left the Gold Standard. In Europe, fears of inflation weighed heavy on the minds of policymakers. The dominant view in Washington was that over-production was responsible for the crisis. Consequently, the New Deal spending was funded by tax increases. Roosevelt concentrated on limiting competition, sharing work and promoting high wages in order to increase purchasing power.

Cole and Ohanian argue that these policies undermined the recovery by raising real wages and unemployment. The consensus view is that, by subordinating monetary and fiscal policy towards maintaining gold parity, the Gold Standard transmitted the crisis to the rest of the world. The return to the Gold Standard, after the First World War, was unbalanced. Countries such as France and Belgium joined at exchange rates that were well below their 1913 levels which gave them a substantial competitive advantage. Conversely, after a deflationary squeeze, the UK re-joined at its 1913 exchange rates, leaving the sterling over-valued.

The US and France exasperated the problem, by sterilising (so not to inflate the money supply) the gold that they accumulated (sixty per cent of the world's gold supply by 1928). The lack of reserves forced many countries
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into further deflation. The world economy could only be kept going by the US economy continuing to absorb imports and provide international lending to cover gold shortages. By 1928, the US proved unwilling to do the latter and was eventually unable to do the former. During the depression, this austerity debilitated economies and resulted in banking collapses, notably in Germany and Austria.

In response to the systemic threat posed by the imminent German banking collapse, the nations in a position to offer assistance acted unilaterally. President Hoover proposed a one year moratorium on reparations and war debt. The French, furious at the lack of consultation opposed the measure, believing that they lost more than they gained. Instead, they made an offer of help to the Germans that attached political conditions that made it impossible for the Germans to accept. Ultimately, international co-operation proved impossible as states that were able to help were unwilling to risk their own privileged positions.

Between 1929 and 1932, the volume of world trade fell by 25%, about half of which was due to higher trade barriers. The Smoot-Hawley Act in 1930 is often cited as the genesis of protectionist policies, but Irwin points out that the protectionist avalanche did not begin until the world financial crisis struck in 1931. Irwin locates the incipience of this round of protectionism in the 'open economy trilemma' which limits countries to choosing two of three objectives: a fixed exchange rate, an independent monetary policy, and open trade policies.

In attempting to marry membership of the Gold Standard with independent monetary policy, policymakers adopted protectionist measures. Countries <https://assignbuster.com/response-of-economic-policymakers-to-the-great-depression-of-the-1930s/>

that maintained gold parity such as France and Switzerland used import quotas on 50-60% of their imports. Whereas, the Sterling block countries which allowed their currencies to devalue, only used import quotas on 5-10% of their imports. In the wake of the financial meltdown, policymakers in the US attempted significant banking reform with the Emergency Banking Act in 1933 followed by the Banking Acts of 1933 and 1935. Deposit insurance was created, and it brought an end to bank runs.

The Reconstruction Finance Corporation was formed to provide capital to banks. It was successful to the extent that it owned stock in nearly half of all commercial banks by March 1934. Investment and commercial banking were separated, though White has provided evidence that banks that engaged in both commercial and investment banking were better diversified and were less likely to fail than banks that specialised in just one area. Calomiris also sees the legislation as flawed, as it preserved unit banking, which was a major source of instability in the banking system.

The Great Depression altered economic thinking and policy. Hannah and Temin argue that it led to an emphasis on correcting market failures through government intervention. Federal spending rose, and inter-state transfers became acceptable. Though, unlike the UK, there was no move to Keynesian demand management in the US. The Great Depression also left a legacy in terms of the macroeconomic trilemma. Controls on international capital movements remained with the return to pegged exchange rates under the Bretton Woods Agreement which allowed independent monetary policy.

Economists such as Wray have seen the policy legacy of the Great Depression as having constrained the destabilising role played by finance.
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Moreover, it provided the framework for an unprecedented period of prosperity after the Second World War. In response to the Great Financial Crisis, policymakers have been largely cognisant of the lessons of the 1930's. The Federal Reserve officials of the 1930's argued that they could not increase credit by purchasing government securities as they were not eligible as collateral.

In contrast, based on Bernanke's view that banking collapse leads to a failure of the credit allocation mechanism, the Federal Reserve combining with the Treasury created a range of extensions to its discount window to encompass every kind of collateral in the hope of unblocking the credit markets. States co-ordinated massive injections of liquidity (double digits fractions of GDP in advanced economies). The Bank of England, the Bank of Japan and the Federal Reserve undertook large scale quantitative easing. Interest rates were reduced to almost zero in the US and Britain and to very low levels in Europe and elsewhere.

Governments nationalised insolvent institutions deemed 'too big to fail' such as Freddie Mac and Fannie Mae in the United States, BNP Paribas in France and Northern Rock in Britain. Despite China's minimal direct exposure to the financial crisis, its response to the downturn in demand has been sweeping. Focusing on developing infrastructure it undertook a stimulus package that amounted to 14% of GDP in 2008. Keen notes that the massive amount of government spending in 2010 meant that government debt was responsible for 12% of aggregate demand in contrast to only 1. % of aggregate demand between 1930 and 1932. Furthermore, unlike the 1930's, governments have not tried to over-ride, the now much larger, automatic stabilisers. However,

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the experience of the 1930's has not effectively militated upon the policy makers of the Eurozone, where a dramatic collapse in employment and living standards has mirrored the Great Depression. Like the Gold Standard, the Euro was unbalanced from its inception as the weaker economies joined at a relatively high rate of exchange on the premise of avoiding inflation.

The gap in competitiveness has widened due to Germany suppressing nominal wages much more effectively than the rest of the Eurozone. Easy credit provided to peripheral areas by German banks created markets for German exports and saddled those areas with debt. Monetary and fiscal policy has focused on creating an international currency to rival the dollar. Consequently, monetary policy has targeted inflation through low interest rates. As monetary policy is unitary, the peripheral economies are denied the opportunity to reflate their economies.

Furthermore, unlike other major advanced economies since the crisis began, the Eurozone has required that Fiscal policy be placed under tight constraints via the Fiscal Stability Pact. The retrenching of the crisis on to sovereigns has exposed a central weakness of the Eurozone project. The ECB supports banks but lacks the power to support states. Similar to the deflation that was necessary under the Gold Standard, the peripheral economies of the Eurozone are locked into a mutually reinforcing cycle of debt and austerity.

Having pursued national self-interest from the euro's inception, Vines argues Germany is unwilling to provide the hegemonic leadership that its responsibilities in Europe require of it. Though, Lapavistas et al argue that abandoning fiscal discipline would be incompatible with the avowed aim of <https://assignbuster.com/response-of-economic-policymakers-to-the-great-depression-of-the-1930s/>

maintaining a currency that attempts to compete with the dollar. The value of the euro would probably fall, destroying the large Eurozone banks' ability to operate internationally. If German policy has followed narrow self-interest to the detriment of others, it has not been alone. China has held down their exchange rates over a long period of time.

It is widely estimated that Chinese currency is 30% to 40% overvalued. Martin Wolf of the Financial Times has asserted that Chinese interventions to keep the exchange rate down are tantamount analytically to trade protectionism. Judging by its reserves it has '...kept its exchange rate down to a degree unmatched in economic history. ' States have also been quick to ' ring-fence' assets in their own jurisdiction. For example, the fear of the imminent collapse of the Icelandic banks led UK supervisors to resort to using the Anti-Terrorism, Crime and Security Act to ring fence Icelandic bank assets in the UK.

Claessens et al point out that in general, national interventions have been uncoordinated and driven by pure national interest. However, the major international banks have co-ordinated massive injections of liquidity into the system at various points. Moreover, protectionism has not been a feature of the current crisis in the way that it was during the great depression. Research has shown that only 2% of falls in world trade in 2008-9, can be attributed to trade barriers. This can be primarily attributed to the system of flexible exchange rates, the lessons learnt from the great depression and the system of trade rules overseen the WTO.

As of yet following the great financial crisis, there has not been significant banking reform. Attempts at co-ordinated international regulation have <https://assignbuster.com/response-of-economic-policymakers-to-the-great-depression-of-the-1930s/>

proved difficult. The former governor of the Bank of England Mervyn King attributes this to the heightened awareness that global banks are global in life and national in death. The draft proposals for the Basel III accords put forward some significant reforms which were ultimately watered down. Key elements such as a mandatory countercyclical capital buffer were omitted from the final agreement.

Although the accords raised the minimum capital requirements, they are still held by many economists to be too low. Attempts at reform including the Dodd-Frank Act have not addressed the problem of ‘Too Big to Fail Banks’ (whose size necessitates that they be bailed out in the event of insolvency due to the systemic risk that they pose). A situation of moral hazard thereby exists where banks know they can engage in any risky behaviour they like. If anything should go wrong they know they will be bailed out by the state.

In summary, the response to the Great Financial Crisis has differed from the Great Depression as a result of the increased understanding of macroeconomics. The scale of the policy response to the Great Financial Crisis would have been unthinkable during the Great Depression era. Despite the unprecedented response, the economic crisis that began with the financial crisis in 2007-8 is far from over and many problems remain. In the advanced economies, growth has been weak and fears of a triple dip recession persist. The Great Depression precipitated a reappraisal of policy by policymakers and resulted in considerable changes in policy.

This has not happened so far to the same extent in response to the Great Financial Crisis. Many of the policy mistakes of the Great Depression have been avoided. The challenge now is to construct a macroeconomic
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framework that can aid the recovery and eventually facilitate a new period of economic expansion. The change in policies as a result of the Great Depression had some success in this respect. Banking regulation proved inadequate prior to both crises. In response to the Great Financial Crisis, this has yet to be rectified. This time policymakers will have to tackle the issue of 'too big to fail' banks.

In the Eurozone, Germany has taken on the role of both the US and France during the Great Depression by failing to shore up weaker areas and by pursuing policies to the detriment of everybody else. During the Great Depression, the most important factor in the recovery was the abandonment of the Gold Standard. The countries that devalued in 1931 performed much better than those who had continued with exchange controls. The cost of reverting back to a national currency makes leaving the Euro and devaluing a less viable option for the Eurozone states.

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