History of Economic Thought I
10：V. Crises and Opportunities (2)

School of Political Science and Economics
Waseda University
Masazumi Wakatabe
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Key Points of This Lecture

- What are the characteristics of the Great Depression and the economics that were established after it?
- (1) From the Theory of Money and Business Cycles to the Formation of "Macroeconomics". Keynesian "Revolution".
- (2) Emergence of Econometrics
- (3) Implications of the Socialist Economic Calculation Controversy
- (4) The Transformation of Microeconomics. Imperfect Competition and Innovations in Welfare Economics (New Welfare Economics)
- Overall, an increased role for government: a tremendous impact on the post-World War II world.

Current State of the Great Depression Research

- The difficulties of the Great Depression Research
  - "The Holy Grail of Macroeconomics" (Bernanke 2000, p. 5).
- What is the cause?
  - We have not seen a complete consensus.
  - However, at present, the most influential is the international school Cf. Eichengreen (1992), Bernanke (2000)
  - The Great Depression happened only in countries on the gold standard. Exit from the GS = the end of GD.
  - Focuses on the role of the gold standard as a mechanism for the international propagation of the Great Depression.
  - Characteristics of the Gold Standard as a "Policy Regime
    - We are forced to exercerbate recession when we are in a recession.

The Road to the Great Depression

- October 17, 1928: Death of Benjamin Strong
  - Fed ‘s “Bubble Busting”; Concerned About Overheated Stock Markets
  - “Bubble busting" in Germany at the same time.
    - Schacht Cf. Ahmed (2009)
- U.S. economy enters recessionary phase in the summer of 1929
- October 24, 1929: ”Black Thursday"
- Response of the U.S. Hoover Administration at the time
  - It was not necessarily inept. Fiscal stimulus, wage maintenance, the Reconstruction Finance Corporation (RFC), the so-called zero-interest-rate policy, and quantitative easing (government bond-buying operations from April to October 1932).

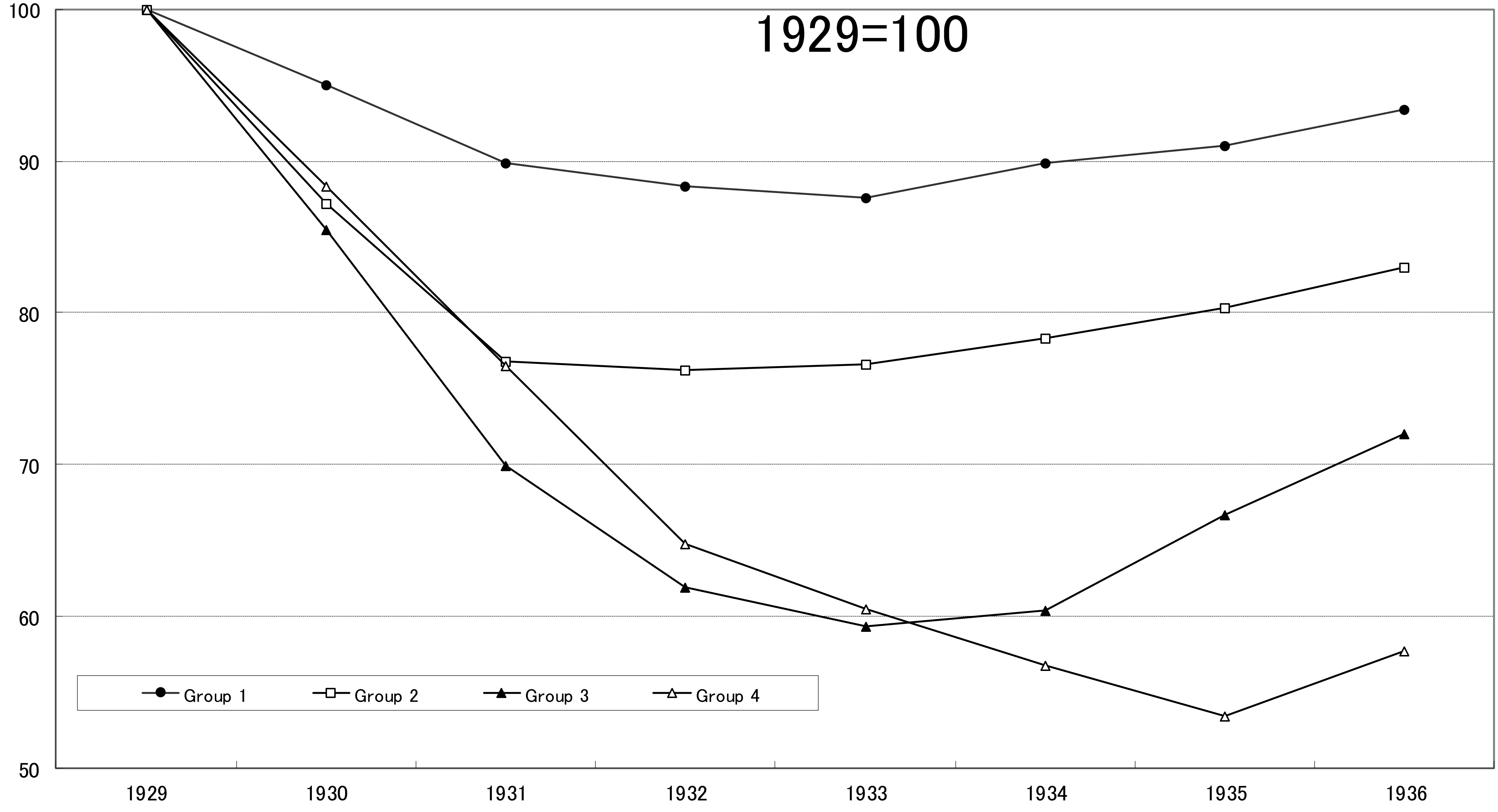
What was happening?

- Stock market crash ⇒ Fall in asset prices ⇒ Decline in consumer confidence ⇒ Decline in consumption due to asset effect ⇒ Aggregate demand contraction ⇒ Deflation and deflationary expectations ⇒ Rise in real interest rate and real wages ⇒ Further aggregate demand contraction
- Policy Failure
  - Under the constraints of the gold standard,
    - Government: Austerity
      - Expansion is possible if constraints are loose
    - Central Bank: Monetary tightening
      - Fed allows one-third decrease in M1
        - » Base money is constant, but circulation speed decreases

Escape from the Great Depression

- Off the gold standard: a "regime" shift in fiscal and monetary policy
  - The faster a country leaves the GS, the faster and more rapid the recovery.
    - Group 1: Countries that have not returned to the gold standard or left it by 1931
      - Spain, Australia, New Zealand
    - Group 2: Countries that left in 1931
      - 14 countries including UK, Germany, Sweden, Japan, etc.
    - Group 3: Countries that left between 1932 and 1935
      - 4 countries including U.S.A. and Italy
    - Group 4: Countries that did not secede even in 1936
      - France, Netherlands, Poland and 3 other countries
- Triggering of expansionary fiscal and monetary policies
  - Did planning and controlled economies work? Possibly delayed recovery.
  - Until February 1936, Japan was an honor student: an "isolated island of prosperity".

Figure Wholesale Price Index (WPI)



Deflation and Its End: An International Comparison

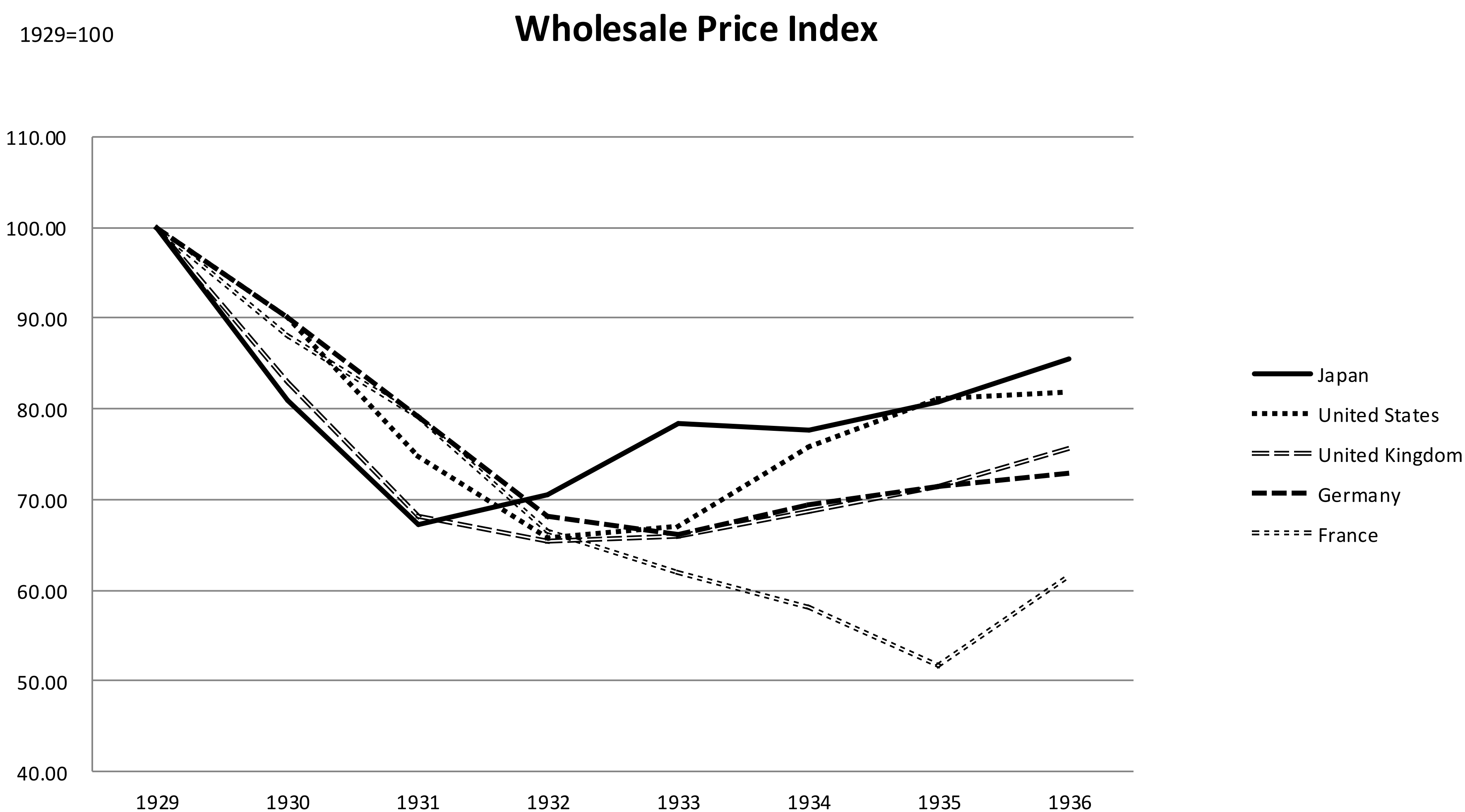
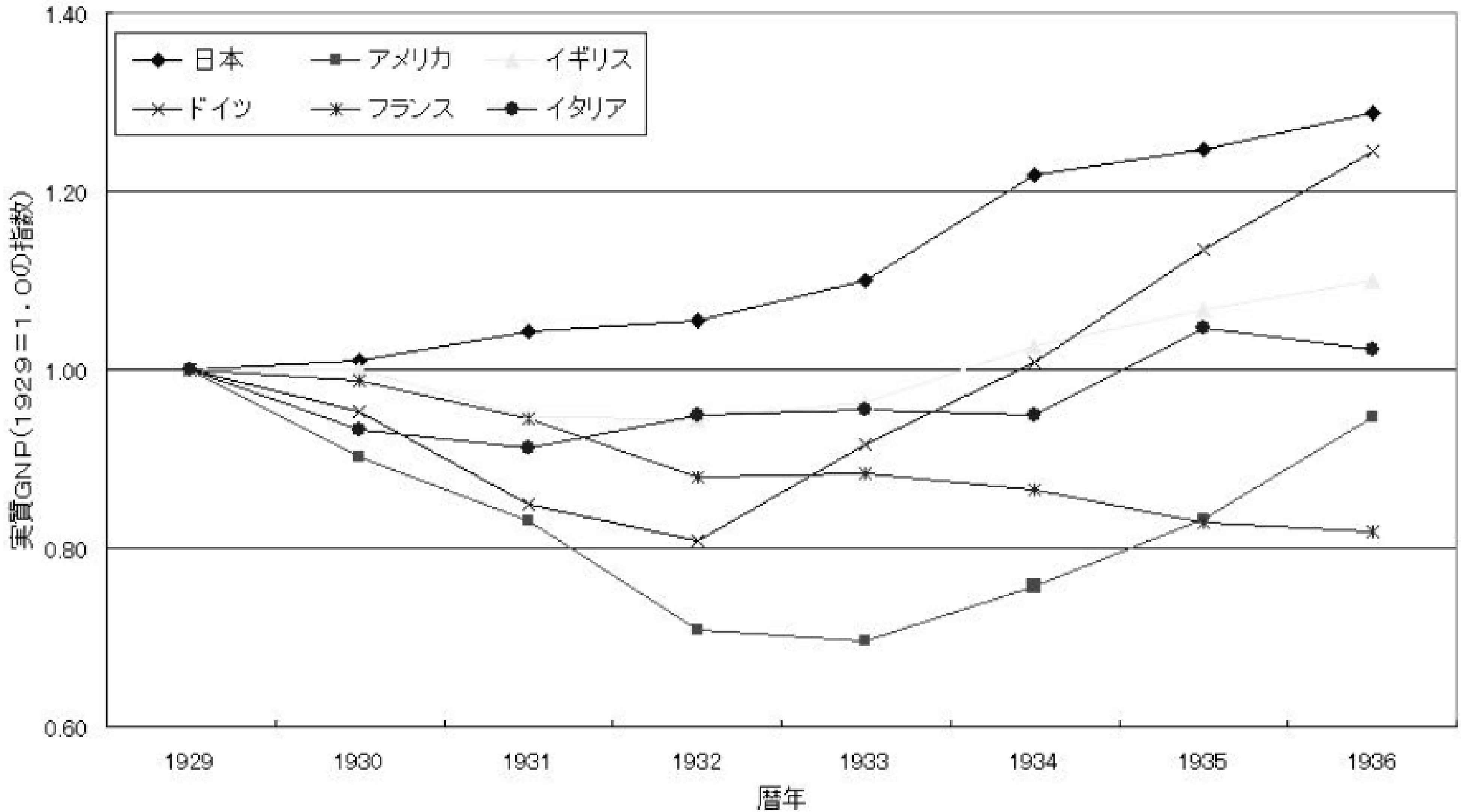
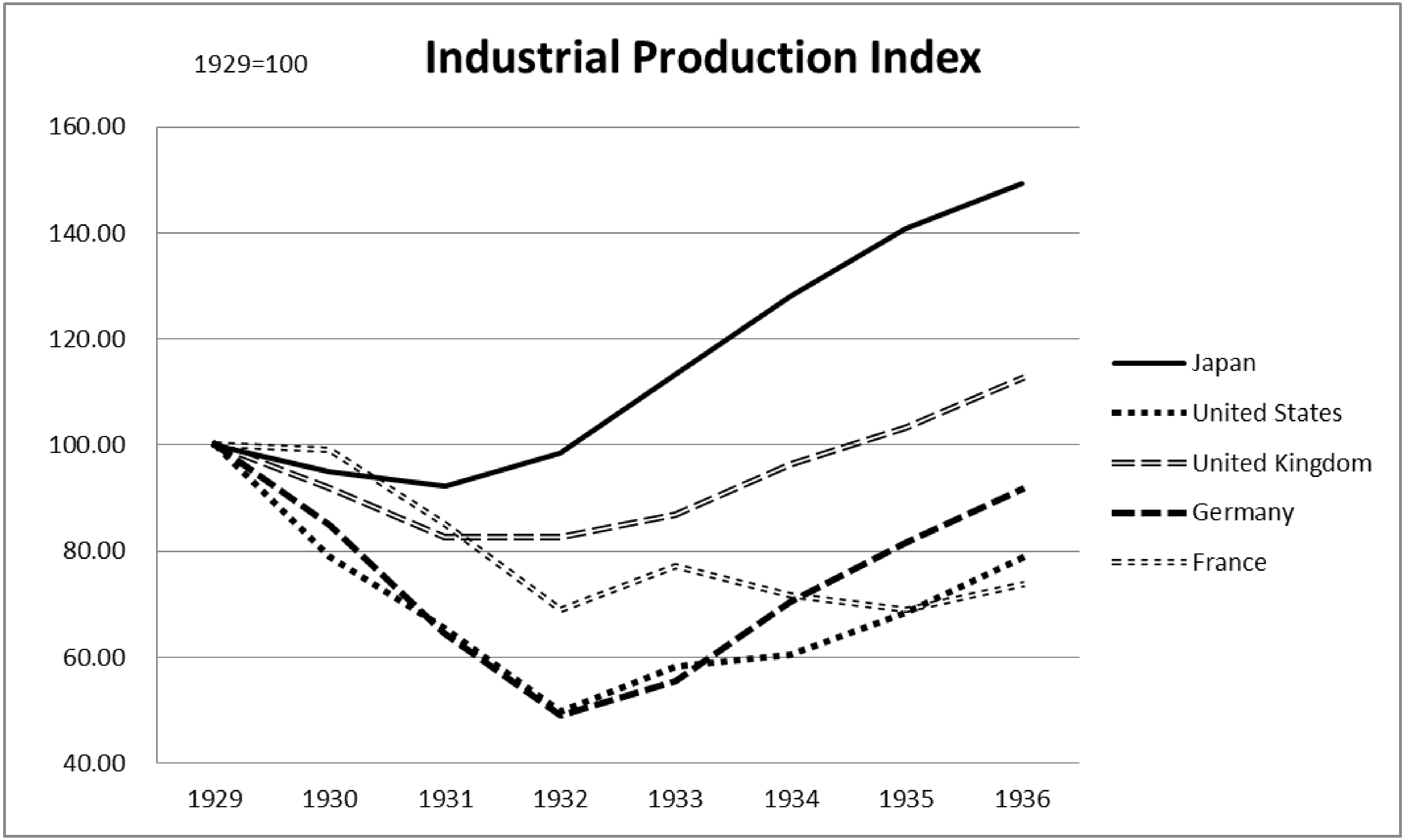


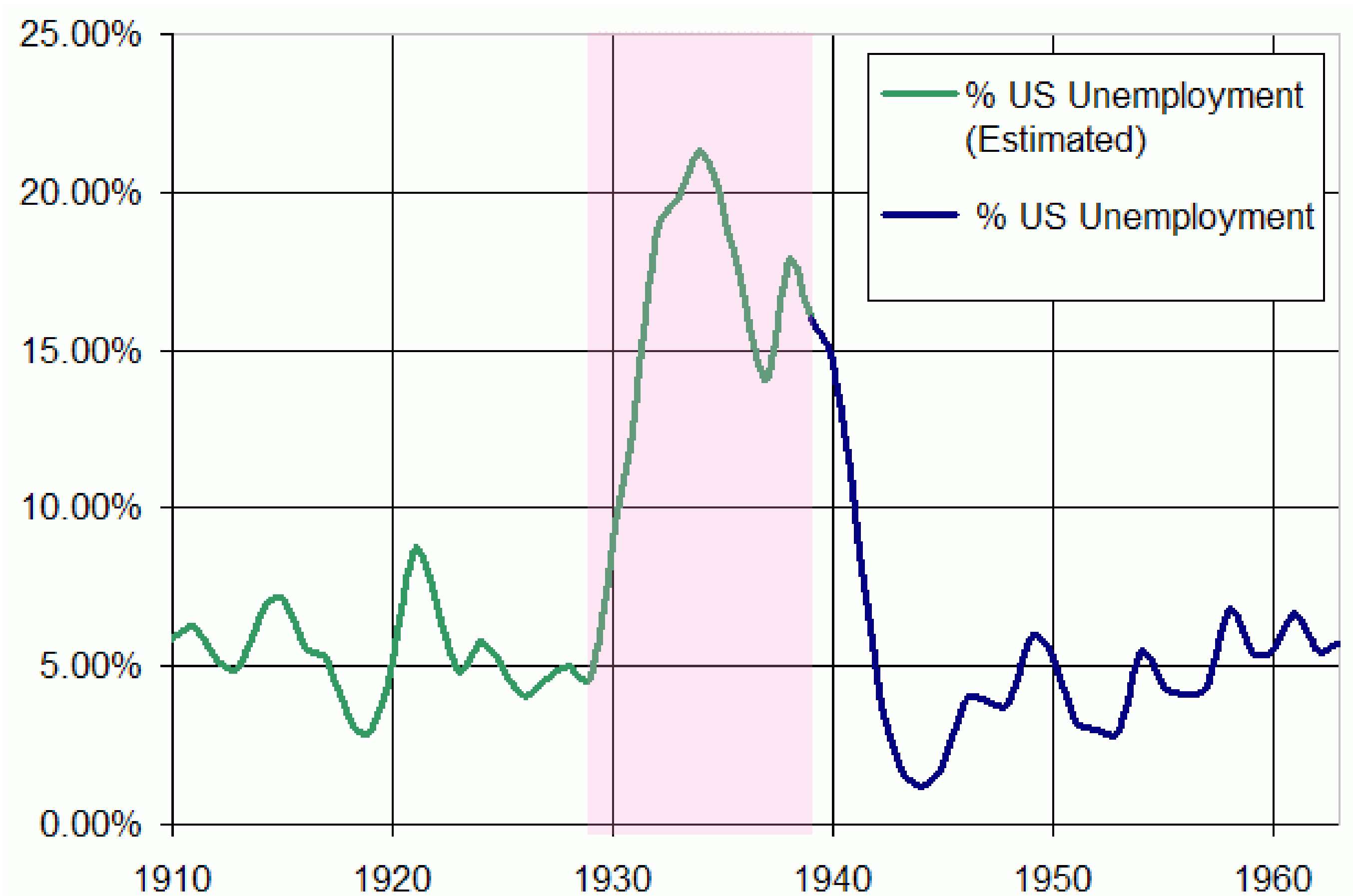
図3　世界大恐慌時の主要国における実質GNPの推移

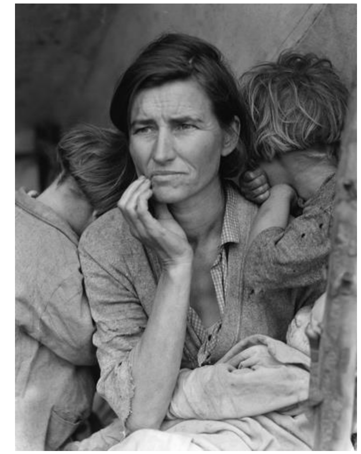


Industrial Index: "Isolated Island of Prosperity" Japan



Unemployment Rate Surged: U.S.





The “golden fetters”: the case of the United Kingdom

- Wage and exchange rate rigidities
- Further increase in unemployment
  - 1929: 1 million unemployed
  - Unemployment rate of 15% or more in 1931 and 1932
  - Rapid increase in unemployment benefits (Unemployment Insurance Act of 1920)
- The City’s instinctive reaction: austerity measures
- Rise of Protectionism
- From Control to Fascism
  - May 32, 1931: Oswald Mosley's resignation from cabinet ⇒ formation of British Union of Fascists
- July 31, 1931: May Committee report: concerns about budget deficit

Breaking the "Golden Fetters": The Case of the United Kingdom

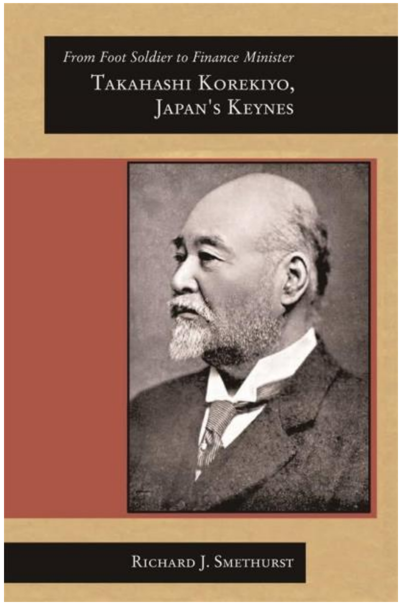
- 1931: Outbreak of the "financial crisis
  - May: Austria
  - July: Germany
  - August: UK: May Committee recommendation => sailor "mutiny" at Invergordon
- Logic of currency crisis: Anticipate devaluation at some future point ⇒ convert to gold at present ⇒ decrease gold reserves
- September 21, 1931: Departure from the gold standard
- September 27: "There are few Englishmen who do not rejoice at the breaking of our golden fetters".

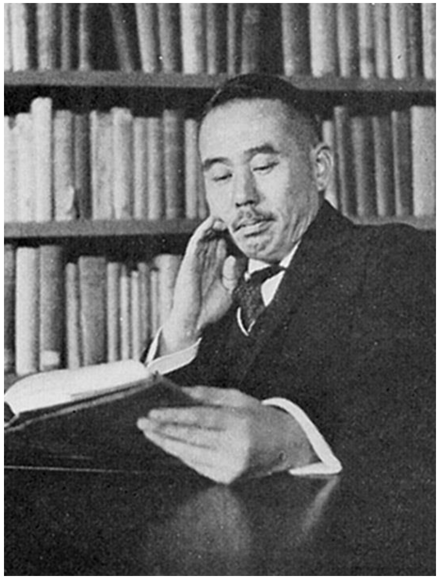
Emerging from the Great Depression: The Case of the United Kingdom

- The size and effectiveness of fiscal policy is small.
- It was monetary policy that enabled the country to emerge from the Great Depression.
- 1932: The departure from the gold standard allows the official discount rate to be lowered.
  - Since June, it has remained at 2% until 1951, except for a brief period. Real interest rates fell as prices rose.
- Investment boom since 1934.

Escape from the Great Depression: Japan ‘s “Golden Fetters” Cf. Wakatabe (2014)

- The "gold ban debate": the debate over returning to the gold standard
  - lifting of the gold export ban with old parity versus lifting of the ban with new parity
- November 1929: Decision to return to the gold standard, at the old par value.
- January 1930: Return to gold standard
- November 14, 1930: Attack on Prime Minister Osachi Hamaguchi
  - April 13, 1931: Resigned as Prime Minister; died August 26
- September 18, 1931: Manchurian Incident
- December 13, 1931: Change of government; Prime Minister Tsuyoshi Inukai and Minister of Finance Korekiyo Takahashi
  - Same day: Departure from the gold standard
- February 9, 1932: Assassination of Junnosuke Inoue, former Minister of Finance
- March 1932: Bank of Japan directly purchases government bonds
- May 15, 1932: Navy coup attempt, Inoue assassinated
- February 26, 1936: Army coup attempt, Takahashi assassinated
- July 7, 1937: Marco Polo Bridge Incident, outbreak of Sino-Japanese War





Why did Japan succeed and consequently fail to escape?

- Success
  - Japan went off the gold standard too quickly.
    - Immediately after the gold ban controversy
  - Fiscal policy through increased military spending?
    - It only worked in 1931.
  - The existence of Korekiyo Takahashi
    - Minister of Finance 7 times, also handled the Showa financial panic of 1927
- Failure
  - Regime competition between party government and military
    - Recession, public support for military, mounting criticism of party politics
  - Failure to control the military

(1) Toward Macroeconomics: The Framework of the Controversy

- We should do something proactive.
- Stabilizers
- Emphasis on monetary factors
- Reflation through monetary easing (recovering falling prices to the original price level): I. Fisher, R. G. Hawtrey
  - debt deflation theory
- Also fiscal policy: Chicago School (Jacob Weiner, Frank Knight), Pigou
- Keynes' delicate position

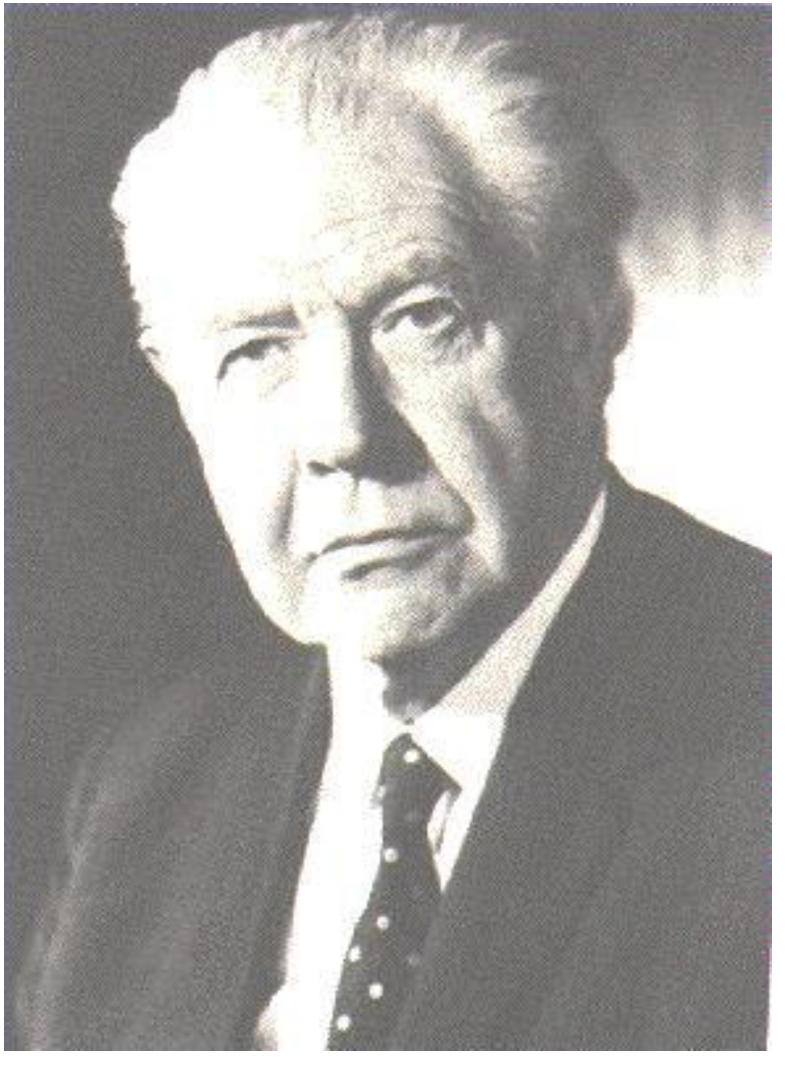
- Do nothing (liquidationists).
- Emphasis on real factors. A "normal" adjustment after a boom is a recession. The business cycle is the heartbeat for capitalism.
  - However, measures for the Great Depression
- It is natural that after inflation comes deflation. *In fact, before the Great Depression, there was no inflation in many countries.
- Schumpeter, Hayek, Lionel Robbins (Robbins' first front)

Keynes during the Great Depression

- Subtle balancing
- Accept the gold standard as a political fait accompli.
- Acknowledge wage rigidity as a reality.
- It then calls for stimulation of the domestic economy as a means of unemployment relief.
  - Public investment as a truly productive investment
- 1930 "Macmillan Commission on Finance and Industry."
  - *Treatise on Money* (1930): ambitious but unsuccessful. Keynes' last work on price stabilization theory.
- Economic Advisory Committee, Committee of Economists
  - Debate over the pros and cons of protection tariffs: Keynes turns to protectionism. Robbins rebuffs.

Robbins, *The Great Depression*

- Lionel Charles Robbins (1898-1984)
- *Professor, London School of Economics (LSE)*
- *The Great Depression* (1934)
- The logic behind this is Hayek's Austrian School of business cycle theory
- Free markets and the defense of the gold standard



Robbins' argument (1)

- (1) On the gold standard
  - Failure with respect to the return to the gold standard in 1925
  - But the gold standard can be successfully maintained.
  - Rather, a return to the gold standard is the way to restore "confidence.
- (2) Causes of the recession
  - Digesting Austrian School Theories
  - Monetary causation is insufficient
  - Money supply was not tight.
  - Inflation ⇒ Deflation
    - *In reality, deflation was already in place before the Great Recession.

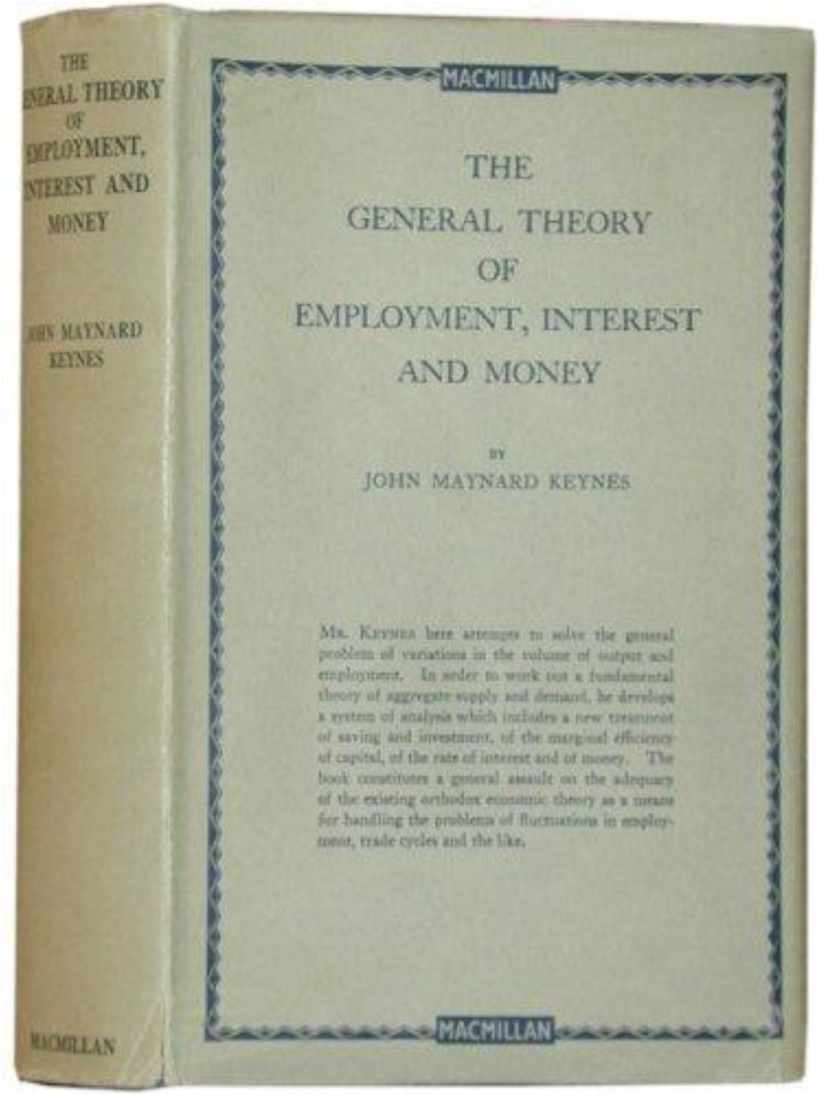
Robbins' argument (2)

- (3) Opposition to control and planning
- Similar to Hayek's *The Road to Serfdom* (1944)
- Wary of the Nazis, who were on the rise at the time
- Conclusion: in a recession, no artificial policies should be implemented at all. Liquidationism, or policy nihilism.

- Already in this period, the gold standard is settled. The idea that deflation and liquidation are desirable is defeated.
- Later Robbins immensely regretted it cf. Robbins 1971

Keynes, *General Theory* (1)

- *The General Theory of Employment, Interest and Money* (1936)
- What is the "general" theory?
  - Contrast with the Classical School
  - Note its definition.
- Two Postulates of the Classical School
  - Types of Unemployment
  - Determination of monetary wages
  - Say's law



Keynes, *General Theory* (2)

- I. General Theory of Employment: determination of the quantity of employment by aggregate demand in the goods market. Principle of effective demand
  - Aggregate demand = consumption + investment + government spending
  - Consumption: propensity to consume. The impact of the interest rate is small.
  - Investment: Marginal Efficiency of Capital and Rate of Interest
  - mass or mob psychology
- II. Theories of interest and money: money as an asset and liquidity preference theory

Keynes, *General Theory* (3)

- Interesting Book VI. Especially Chapter 24.
  - Two economic and social problems: underemployment and inequality.
  - Change in the importance of savings. Demand-deficient economy.
  - Euthanasia of interest earners.
  - Moderately conservative in other respects. Wants to defend the expansion of government functions "as the only feasible means of averting a total collapse of the present economic pattern, as well as a condition for the effective functioning of individual ingenuity." It is "the cure for ills while preserving efficiency and freedom."
  - “Sooner or later, for better or worse, the danger is not vested interests but ideas."

Keynes, *General Theory*, Chapter 24

- At the present moment people are unusually expectant of a more fundamental diagnosis; more particularly ready to receive it; eager to try it out, if it should be even plausible. But apart from this contemporary mood, the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Madmen in authority, who hear voices in the air, are distilling their frenzy from some defunct economist. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new ideas. are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil.

What is the "essence" of Keynes' *General Theory*?

- The Book of Revolution? Self-aware.
- The debate still rages on.
- IS-LM model (Hicks, 1937)? Most successful formulation. Nominal value rigidity.
- Keynes was certainly not "classical or neoclassical". *The General Theory* does not assume nominal value rigidity.
  – Chapter 19: Rather, price and wage devaluation => firms refrain from investment => acceleration of price and wage devaluation.
  – Prices and wages should be stable.
  – However, this explanation has not been successful.

What is the "essence" of Keynes' General Theory?

- Emphasis on Psychology: Irrational?
  - herd mentality
- Expectations, Emphasis on Uncertainty
  - Chapter 12: State of Long-Term Expectations
  - Speculation vs. enterprise
  - Criticism of the so-called casino capitalism
- Emphasis on habits and customs
  - Moral philosophy

Policy recommendations for *The General Theory*?

- This is not a book of policy recommendations. Introduction.
- There are few policy recommendations.
- However, he is skeptical about monetary policy through interest rate manipulation.
  - The so-called "liquidity trap"? Keynes is skeptical about that too.
- On the other hand, "socialization of investment"
- Although he was inclined toward fiscal policy, he stated that it was an empirical issue.

A Strange Conclusion: On Keynesian policy theory

- Stabilization Idea won
- However, it diverged from the tradition of price stabilization as the main focus.
- Skepticism about Reflation: Skepticism about the Quantity Theory of Money as a Strictly Proportional Proposition
- Hesitation about leaving the gold standard. Immediately after the exit, he is pleased that the "golden fetters" has been removed, but aims to stabilize the exchange rate.
- Assign monetary policy to a different goal: the "comfort of the interest-bearing" = defense of the active class (entrepreneurs, workers) through the continuation of ultra-low interest rate policy.
- What are the short-term economic stimulus measures? ⇒ Fiscal policy. Advocacy of constant planning. Socialization of investment.

(2) Development of Econometrics

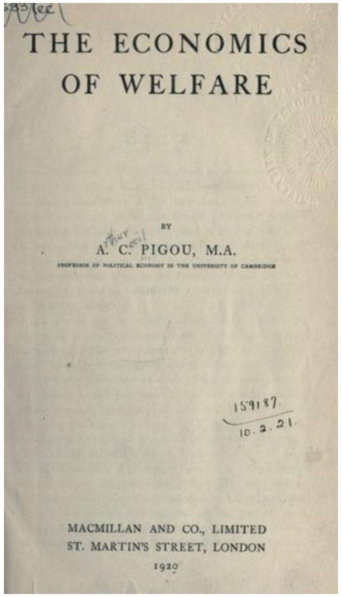
- Necessary tools for planning and macro-policy
- The first econometric model (1936: Jan Tinbergen)
- National Accounts (Richard Stone and Simon Kuznets): 1940s.
  - Keynes' *General Theory* discusses determining the amount of employment
  - Keynes himself was skeptical of econometrics
- Input – Output Analysis (Wasily Leontiev)
  - Succeeding Quesnay, Marx, and Walras

(3) Transformation of microeconomics

- Departure from Marshall's *Principles* + Pigou's Welfare Economics until then
- Major introduction of general equilibrium theory (Robbins' second front)
  - Hicks, *Value and Capital* (1939).
  - Continental economists (von Neumann, A. Wald)
- Imperfect competition
  - Problems with Marshall's *Principles*: compatibility of internal economy and competitive conditions.
    - P. Sraffa, "The Law of Harvest under Competitive Conditions" (1926).
  - Something in between monopoly and competition?
    - Joan Robinson, *The Economics of Imperfect Competition* (1933).
    - Edward H. Chamberlin, *The Theory of Monopolistic Competition* (1933).
  - However, these will develop even later => 1970s

From Welfare Economics to New Welfare Economics

- Welfare Economics: Henry Sidgwick, A. C. Pigou
  - Pigou, *Wealth and Welfare* (1912), *Welfare Economics* (1920)
- Measurability of utility, possibility of inter-individual comparison
- law of diminishing marginal utility
- Three propositions of welfare economics
  - (1) Other things being equal, the greater the average amount of the national distribution (national income), the greater the economic welfare.
  - (2) Other things being equal, the greater the average acquisition of the national distribution attributable to the poor, the greater the economic welfare.
    - Advocacy for income redistribution
  - (3) Other circumstances being equal, the less the variation between the annual amount of the national distribution and the annual acquisition attributable to the poor, the greater the economic welfare.


THE ECONOMICS OF WELFARE

BY

A. C. PIGOU, M.A.

MACMILLAN AND CO., LIMITED
ST. MARTIN'S STREET, LONDON
1920

Market Failure

- Market economy: equalization of marginal net product
- Social marginal net product and private marginal net product
- Market mechanism equalizes the latter
  - Divergence between the social and the private due to the existence of an external economy
  - Failure to improve efficiency of resource allocation in the market
  - Government subsidy and taxation policies
    - Pigou policy, Pigouvian tax
      - Still used for environmental issues such as CO2 gas emissions

New Welfare Economics

- Robbins, Hicks, Nicholas Kaldor, Paul A. Samuelson.
- Measureability of utility and possibility of inter-personal comparisons are thrown out.
  - Can income redistribution be justified?
  - Studied Pareto (Vilfredo Pareto, 1848-1923) in Italy
  - Indifference curve: Contour line of utility function, no need for diminishing marginal utility
  - Pareto optimum: you can't increase the satisfaction of one without decreasing the satisfaction of another: but there is more than one such point
  - Interindividual comparisons of utility do not completely disappear (expected utility theory: Pigou's third proposition)
  - Compensation principle

(4) Socialist economic calculation controversy

- Development of control and planning in the economy
  - The Second Industrial Revolution and the Larger corporations
    - Management as discipline
  - World War I as Total War
  - Birth of the Socialist State of Soviet Russia
- The Great Depression was seen as "the failure of the capitalist economy.” In contrast, the "success" of socialist planning
  - Japan: “Reform bureaucrats” (including Nobusuke Kishi of the Ministry of Commerce and Industry) and control faction officers in Manchuria ⇒ Total war system, postwar MITI industrial policy
  - Germany: Nazi Party (National Socialist German Workers' Party)
  - Italy: Fascism
  - USA: Controlling and planning part of the New Deal

Structure of the controversy

- Fred Taylor, Oskar Lange.
- Planned economy is possible
  - Lessons Learned from the Wartime Economy
- Economic calculations are possible.
- desirable
  - Efficient resource allocation
  - Stabilization of economic fluctuations
- Confidence and optimistic outlook for planning

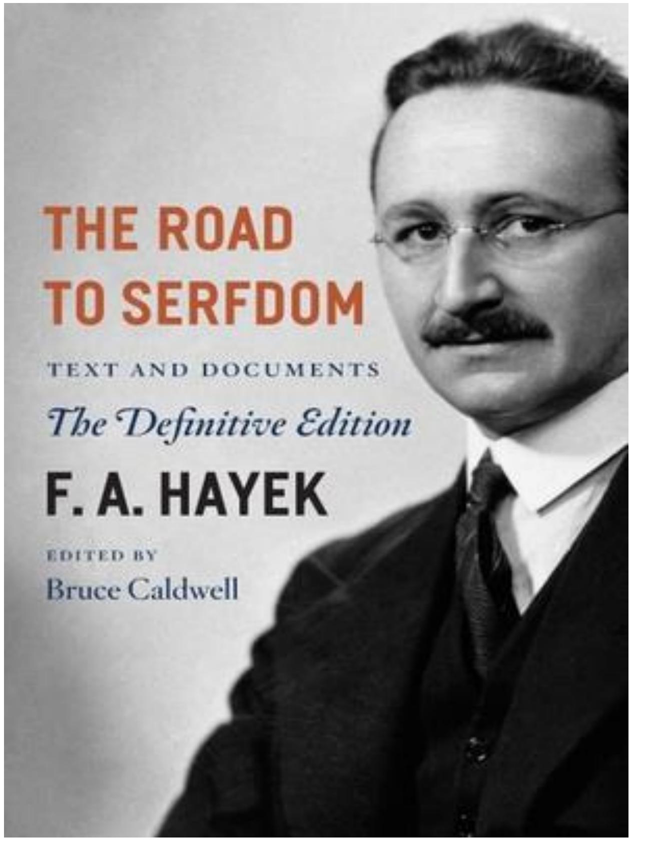
- Von Mises, von Hayek.
- Planned economy is impossible.
- Market prices cannot be "economically calculated" unless using a market economy
- Dispersion of knowledge and ignorance in the marketplace
- Emphasis on market process
- Planning = rationalism, the conceit of designism

Conclusion of the controversy (Phase I)

- Neoclassical (Walrasian) + Keynesian economics triumph
- Market-oriented Socialism by Oskar Lange
  - Mimicking the Walrasian search process. General Equilibrium Theory
  - Keynesian economics guarantees full employment
- Mises, Hayek's total defeat.
- The enormous impact on post-World War II economics (development economics)
- Phase II: Rekindled when it became clear that socialism was in the doldrums; Hayek's return to power from the 1970s onward.

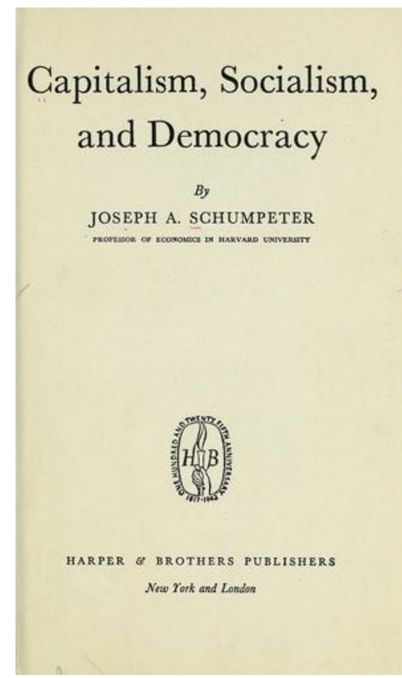
An Intellectual Landscape: Hayek, *The Road to Serfdom* (1944)

- Birth of totalitarian states (Nazi, Soviet)
- Common ideological basis for socialism, Nazism (National Socialism), and fascism
- Liberalism is not laissez-faire, but more competition than planning needed
- Warning to other countries against the snowballing growth of planning



An Intellectual Landscape: Schumpeter, *Capitalism, Socialism, and Democracy*, 1942

- Cf. McCraw 2007
- The Book of Irony
- Capitalism: Cannot Survive
  - Entrepreneurial innovation, "creative destruction," monopoly and innovation
  - Social psychological reasons: fostering a class hostile to capitalism
- Socialism: "Success"
    - Routinization of innovation by large companies
- Democracy: Party Competition



Think Further

- Why were policymakers hesitant to move off the gold standard during the Great Depression?
- Was there a Keynesian revolution? Would it be a paradigm shift?
- Keynes said, "Soon or late, it is ideas, not vested interests, which are dangerous for good or evil." Discuss.
- Read the major papers in the socialist economic calculation debate and form your own opinion as to which argument is more persuasive.

next week

- The Classics:
  - Milton Friedman, *Capitalism and Freedom*, Preface, Introduction, Chapters 1-3, 6, 12

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