Slouching Towards Utopia?: An Economic History of the Long Twentieth Century

X. The Great Depression

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10.1: Understanding the Industrial Business Cycle

10.1.1: Jean-Baptiste Say's Law

Back when market economies emerged, there was great worry that things would not necessarily fit together: Might not the farmers be unable to sell the crops they grew to the artisans because the artisans could not sell the products they made to the merchants who would be unable to make money carrying artisans products to the farmers because the farmers would not purchase anything? Back at the beginning of economics it was Jean-Baptiste Say who wrote that such an idea of a "general glut"—of economy-wide "overproduction" and consequent mass unemployment—was incoherent. Nobody, Say argued, would ever produce anything for sale unless they expected to use the money they earned in order to buy something else.

Thus, "by a metaphysical necessity", as subsequent-generation economist John Stuart Mill outlined Say's argument in 1829, there can be no imbalance between the aggregate value of planned production-for-sale, the aggregate value of planned sales, and the aggregate value of planned purchases. This is "Say's Law".

Producers could certainly guess wrong about what consumers wanted—an economy could easily have an excess of washing machines and a shortage of yoga classes, if producers had mistaken what consumers wanted and so assembled white goods rather than learning how to do the Downward-Facing Dog. Excess demand for and high profits in making commodities in short supply and excess supply of and losses in making commodities in surplus was not a bug but a feature: the market gave incentives to quickly shift resources to erase such imbalances. But an excess supply of well-nigh everything? That, Say said, was impossible. But what if you wanted to buy before you had sold—if the artisan wanted to buy food before the merchant had come around to buy the textiles? That, said Say, was what banks and trade credit were for: "merchants know well enough how to find substitutes for the product serving as the medium of exchange".

10.1.2: The Panic of 1825

Karl Marx dismissed this as the "childish babbling of a Say". One did not just sell in order to buy: one might be forced to sell in order to pay off an old debt if credit that had been extended by some bank was withdrawn. In that case, the demand for goods was in the past, and could not in the present balance out your supply. If everyone was trying to sell in order to pay off old debts, there would indeed be a "general glut". And if those who were calling in loans saw businesses collapsing into bankruptcy around them, they would be unlikely to be wiling to provide "substitutes for the product serving as the medium of exchange".

As John Stuart Mill put it:

> Those who have... affirmed… [the possibility of] an excess of all commodities, never pretended that money was one…. Persons in general, at that particular time… liked better to possess money than any other commodity. Money, consequently, was in request, and all other commodities were in comparative disrepute.... There would seem… no particular impropriety in saying that there is a superabundance of all or most commodities, when all or most of them are in this same predicament…

And if all or nearly all goods and services save money are at one moment in excess supply, factories will be shut and workers will be jobless—and the fact that shareholders then have no dividends, lenders have no interest payments, and workers have no wages will further widen the gap between the aggregate-supply productive potential of the economy and the current level of aggregate demand.

Say came to recognize that Marx and Mill were correct.

After the British Canal Panic of 1825, Say changed his mind. Led by the Bank of England, the banks and merchants of England decided in late 1825 that they had made too many loans to too many counterparties whose investments were not turning out well. Therefore they ceased to be willing to discount as many bills—to advance cash in return for being given title to promises to pay that merchants had received from customers. Thus, Say wrote: "commerce found itself deprived at a stroke of the advances on which it had counted, be it to create new businesses, or to give a lease of life to the old." And the consequence, Say wrote, was financial and economic collapse: a true "general glut": "Businessmen… finding no more advances from the bankers… use[d] up all the resources at his disposal. They sold goods for half what they had cost… a multitude of workers were without work… bankruptcies… among merchants and among bankers… individuals… bankrupt…"

What of Say's 1803 declaration that when there is a shortage of money in an economy, merchants "know well enough how to find substitutes for the product serving as the medium of exchange"? Money and credit are, in the last analysis, liquid trust. And if there is not trust that your counterparty is solvent, the money and credit will not be there.

10.1.3: Central Banking and Other Expedients

There is one organization that always—or almost always—is trusted to be good for the money. The government accepts the money that it itself issues as payment for taxes, and so everybody who owes taxes will be willing to sell what they have in return for the money the government has printed up. Whenever the economy freezes up due to a shortage of demand and of income, the government can fix it—as long as its own finances are trusted over the long term—by boosting the amount of government-issued cash in the hands of the public. People who then needed to buy but could not afford to buy because they would not sell will be able to buy. Their purchases then become extra income for others. Those others will then be able to scale up their purchases. And so the economy will unwedge itself.

What if the government's finances are not trusted over the long term? Then the government itself may need a financial rescue: that is what we have an International Monetary Fund to do. As long as there is one entity somewhere in the world that is trusted to be good for the money, that entity can issue the cash and provide the credit needed for the economy to bootstrap itself out of a "general glut" and back to a normal circular flow of economic activity: production, sales, and then purchases.

There are a number of ways the government can get extra purchasing power into the hands of the public to cure a depression:

1. It can have its functionaries throw bundles of cash out of helicopters—an arresting image coined originally by Milton Friedman, a reference to which earned former U.S. Federal Reserve Chair Ben Bernanke his nickname of "Helicopter Ben".
2. The government can hire people, set them to work, and pay them.
3. The government can simply buy useful stuff.
4. The government can have an arm—a central bank—that trades financial assets for cash.

This last is the dominant expedient. A central bank buys financial assets for cash when it believes that the flow of purchasing power through the economy is too slow for a proper level of employment and economic activity and is risking depression, and that sells financial assets and so pulls cash out of the economy when it believes that the flow of purchasing power through the economy is too rapid for a proper level of employment and economic activity and is risking unwantedly-high inflation.

In making its judgments, central banks are always guided by what the levels of interest rates are in the economy: Are interest rates above the current guess of the "neutral" rate—the rate that would prevail if issues of trust and potential bankruptcy other were not disturbing incentives and willingness to lead and invest? Then the economy needs more cash or there will be pointless high unemployment, and the central bank should provide the cash. Are interest rates below the current guess of the "neutral" rate? Then some people and institutions in the economy have purchasing power that is not backed by realistic expectations of the value of their undertakings, and unless the cash is pulled out there will be either inflation—as the unexpectedly-low quantity of goods that are produced are sold for the higher money values that had been anticipated—or bankruptcies, or both.

In response to the Canal Crisis of 1825, the Bank of England took major steps to boost the cash holdings—and thus the spending—of the banks, businesses, and individuals of England, trying to relieve the "general glut". As Jeremiah Harman, then one of the Directors of the Bank of England, wrote: "We lent [cash] by every possible means and in modes we had never adopted before; we took in stock on security, we purchased Exchequer bills, we made advances on Exchequer bills, we not only discounted outright, but we made advances on the deposit of bills of exchange to an immense amount, in short, by every possible means consistent with the safety of the Bank, and we were not on some occasions over-nice. Seeing the dreadful state in which the public were, we rendered every assistance in our power…"

There was a depression: 16% less cotton was spun into yarn in England in 1826 than had been in 1825. But the depression was short: 1827 saw 30% more cotton spun into yarn than 1826 had. There is good reason to fear that the downturn would have been considerably worse had the Bank of England behaved like the U.S. Treasury and Federal Reserve were going to behave in the early 1930s, and washed their hands of the situation.

10.2: Managing the Business Cycle Before 1929

10.2.1: The Bank of England

10.2.1.1: Robert Peel and the 1844 Recharter

The actions that the Bank of England had undertaken in its own in 1825 had been at the behest of the British government. In the runup to the crisis, the Chancellor of the Exchequer—the Finance Minister—had warned banks that in his opinion they were extending loans to shaky and overspeculative enterprises, and they should not expect to be bailed out by the Treasury: they should not think that they could play the game of "heads we profit, tails the government bails us out". But, of course, when the commercial crisis came and the prospect of many bankruptcies, large scale unemployment, and riots against the government on the streets of London threatened, the Chancellor gave his blessing to the Bank of England's stepping in to do what the Chancellor had promised and threatened that the Exchequer had not.

In 1844 the time came around to reexamine and recharter the Bank of England. The British Parliament took a look at the system of central-bank support for the economy in a financial crisis that the Bank of England's intervention in 1825 had created a precedent for. In the end, the conclusion of the debate led by Prime Minister Robert Peel and the subsequent 1844 Bank of England Recharter was twofold:

1. The Bank of England should definitely not be authorized by Parliament to print unlimited amounts of money to support the banking system in a financial crisis—in fact, it should be illegal for the Bank of England to print extra banknotes in a crisis. Bankers should be on notice that they should not expect a bailout—for that would create too great a risk of substantial losses from "moral hazard",

as the game of heads-we-profit-tails-the-government-bails-us-out was just too tempting to expect bankers to resist.

2. In the event of a real financial emergency, the government could and would request that the Bank of England print as many banknotes as needed to fix the financial crisis.

The reason for (1) was very clear to the Parliamentary debaters back in 1844. Any confident expectation on the part of the financial community that the Bank of England did stand behind them and would intervene to prevent large-scale bankruptcy in a financial crisis would greatly amplify the chances of such a crisis by removing fear and caution. Bankers confident that in the last analysis they were gambling with the public's money would do what bankers tend to do in such situations: the only question, as financier Bill Janeway of Warburg Pincus likes to say, is against which wall bankers will do it. Hence, Robert Peel and his majority in the Parliament thought, it was very important to establish the principle that the Bank of England could *not* be relied upon to bail out the banking system. And, Peel thought, the best way to establish that principle would be to make it *illegal* for The Bank of England to do so.

10.2.1.2: "Moral Hazard" and the "Lender of Last Resort"

But the mere fact that the Act had made what Charlie Kindleberger calls lender-of-last-resort operations in a financial crisis illegal did not mean that they should not or would not be undertaken. As Peel wrote: "We have taken all the Precautions which legislation can prudently take up against the Recurrence of a pecuniary Crisis. It may occur… and if it be necessary to assume a grave responsibility for the purpose of meeting it, I dare say men will be found willing to assume such a responsibility. I would rather trust to this than impair… those measures by which one hopes to control evil tendencies in their beginning."

As Kindleberger puts it: "if the market is sure that a lender of last resort exists, its self-reliance is weakened", and hence it is needed more often, and the real resources thrown down the toilet in the course of what are speculations on a future bailout are increased. This led Kindleberger to the conclusion that: "The lender of last resort... should exist... but his presence should be doubted.... This is a neat trick: always come to the rescue in order to prevent needless deflation, but always leave it uncertain whether rescue will arrive in time or at all, so as to instill caution in other speculators, banks, cities, or countries.... some sleight of hand, some trick with mirrors... [because market] fundamentalism has such unhappy consequences for the economic system."

10.2.1.3: Suspension Letters

Peel's expectations of how the British government would act in what was his future if what he called a "grave responsibility" came to rest on the Governor and Court of the Bank of England were correct. Men at the Bank of England were found willing to act *ultra vires*—beyond their [legitimate] strength—under the principle that in the end—*salus populi suprema lex*—the well-being of the people is the highest law. But they would not print cash and so expand their balance sheet beyond its legal limit purely on their own initiative. They required a blessing from the government of the day. The blessing took the form of a "suspension letter" written by the Chancellor of the Exchequer. First in 1847 and then in 1857 and then in 1866, the Chancellor would write a letter to the Governor of the Bank of England stating that he was suspending for the duration of the financial crisis those provisions of the 1844 Bank Recharter Act of 1844 that restricted the Bank of England's ability to expand its balance sheet. Nothing in the black-letter law or in previous custom gave the Chancellor any such power to at his will suspend provisions of a corporation charter and grant the corporation extra privileges and powers above those Parliament had granted it. Successive Chancellors did so anyway.

10.2.2: Karl Marx's View

Karl Marx loathed Robert Peel: "Peel himself has been apotheosized in the most exaggerated fashion... his speeches… consist of a massive accumulation of commonplaces, skillfully interspersed with a large amount of statistical data". He loathed him not least for the Bank Recharter: "Sir Robert Peel's much vaunted Bank law… adds in difficult times a monetary panic created by law to the monetary panic resulting from the commercial crisis; and… must be suspended by Government interference." And how he did rage! He asked, how it could dare be that:

> the Committee has contrived to simultaneously vindicate the perpetuity of the law and the periodical recurrence of its infraction? Laws have usually been designed to circumscribe the discretionary power of Government. Here, on the contrary, the law seems only continued in order to continue to the Executive the discretionary power of overruling it. The Government letter, authorizing the Bank of England to meet the demands for discount and advances upon approved securities beyond the

> limits of the circulation prescribed by the Act of 1844, was issued on Nov. 12.

Marx did not understand that the suspension was the point—that what was needed for the avoidance of deep depressions was Kindleberger's "neat trick... sleight of hand... trick with mirrors" that made it possible for the "lender of last resort... [to] exist... but [for] his presence [ex ante] to be doubted": "come to the rescue [always] in order to prevent needless deflation, but always leave it uncertain whether rescue will arrive in time or at all, so as to instill caution."

10.2.3: The Magnitude of the Cycle Pre-Great Depression

10.2.3.1: A Chronic Malady Never Completely Cured

Monetary management was not the only way that governments managed the business cycle. Many governments undertook, and many economists including libertarian stalwart Frederic Bastiat approved direct employment of the unemployed on public-works programs, which "as a temporary measure in a time of crisis… [has] good effects... as insurance…. [It] takes labor and wages from ordinary times and doles them out… in difficult times." That governments could always print money and purchase stuff to put lots more people to work was sufficiently demonstrated by observing that unemployment was never high in a serious war.

The business cycle in industrial economies was never cured. Ever since 1825, at least, industrial market economies have been subject to the recurrence of this particular kind of macroeconomic epileptic seizure. Central banks could and did dampen, but not eliminate the cycles.

It may be that you can see this difference looking across the Atlantic Ocean from Britain to the United States. Britain had a central bank: the Bank of England. Until 1913, when the Federal Reserve was established, the United States did not. Indeed, the sharp depression of 1907 was the trigger for the creation of the Federal Reserve.

Before World War II, the typical economic recession in Britain would last for a year or two, and see a perhaps three to six percent decline in national income and a perhaps five to ten percent decline in industrial production—until the severe downturn of 1918-1921 which carried national income per capita down by 21%. British national income per capita did not recovery to its 1914 level until 1929, and then it immediately dropped again, recovering for good only in 1934.

The United States had no central bank to lean against the wind and try to smooth out monetary conditions. At best, it has a few emergency expedients by a U.S. Treasury shipping gold out of its vaults to provide an emergency boost to the money stock, and occasional pick-up committees of the wealthiest and soundest major New York bankers taking coordinated collective action to try to do for New York finance what the Bank of England had done for London finance in 1825. That is quite possibly why, while a typical economic recession in the United States would also last for a year or two, it would see a larger of perhaps five to ten percent decline in national income and a perhaps eight to fifteen percent decline in industrial production—until the catastrophic Great Depression of 1929-1933, which carried American national income per capita down by 29%.

10.2.3.2: Why Wasn't the Cycle Better Managed?: Ideology

Why was monetary and other tools of macroeconomic management not able to flatten out but only to damp business cycles? A first reason was the dominance in the public sphere of the economic doctrine of *laissez faire*: that the government should establish private property rights, markets, courts to enforce contracts, and otherwise let the market economy run itself—that that would be the best: "to the philosophical doctrine that the government has no right to interfere, and the divine that it has no need to interfere, there is added a scientific proof that its interference is inexpedient". This was always much more what journalists and politicians said professional economists taught than what professional economists actually taught.

Ideology was reinforced by experience. As Keynes noted:

> The corruption and incompetence of eighteenth-century government…. Almost everything which the State did in the eighteenth century in excess of its minimum functions was, or seemed, injurious or unsuccessful. [And] on the other hand, material progress between 1750 and 1850 came from individual initiative.

Why should the business cycle be any different?

The market giveth, the market taketh away: blessed be the name of the market. That central banks and relief agencies had the role they did was due to much uphill rolling of the boulder against a strong intellectual and ideological gradient.

10.2.3.3: Why Wasn't the Cycle Better Managed?: Instability
A second reason is that demand for cash was and is very unstable. People talk to each other, and communicate their hopes and fears. Investors', managers', entrepreneurs', and financiers' tolerance for bearing risk, expectations of future profits, and knowledge of opportunities shifted substantially and randomly in waves. With these shifts came rises and falls in how much of their wealth they wish to hold in cash. The central bank's task was to match the economy-wide supply of money to this fluctuating economy-wide demand. When it succeeded, aggregate demand is matched to the potential to produce aggregate supply: Say's Law—that the potential to supply creates its own demand—was then true in practice, even though it remained false in theory.

When they failed on one side, and there was an excess demand for money, the flip side of that excess demand for money was an excess supply of pretty much all goods and services: a "general glut", a depression. When they failed on the other side, there was unexpected inflation. And so the capitalist market economy lurched forward, subject to this chronic and horrible but not catastrophically debilitating malady—until 1929, and the coming of the Great Depression.

10.3: The Slide into the Great Depression
10.3.1: 1929-1933
10.3.1.1: The Initial Trigger
It is straightforward to narrate the slide of the world into the Great Depression. The 1920s saw a stock market boom in the U.S. as the result of general optimism: businessmen and economists believed that the newly-born Federal Reserve would stabilize the economy, and that the pace of technological progress guaranteed rapidly rising living standards and expanding markets. The U.S. Federal Reserve feared continued stock speculation would produce a huge number of overleveraged financial institutions that would go bankrupt at the slightest touch of an asset price drop. Such a wave of bankruptcies would then produce an enormous increase in fear, a huge flight to cash, and the excess demand for cash that is the flip side of a "general glut".

The U.S. Federal Reserve decided that it needed to curb the stock market bubble to prevent the growth of such speculative overleverage that would provide a trigger for a depression. And it overdid it. The Federal Reserve's attempts in 1928 and

1929 to raise interest rates to discourage stock speculation shrunk the money stock, created the first excess demand for cash, and so brought on an initial downturn in demand.

Caught by surprise with production in excess of demand, firms cut back their own plans for further purchase of producer-durable goods; firms making producer durables cut back production; out-of-work consumers and those who feared they might soon be out of work cut back purchases of consumer durables; and firms making consumer durables faced falling demand as well. The Federal Reserve's attempt to head off a depression in the future had brought one on in the present.

10.3.1.2: Vicious Cycles

Falls in prices—deflation—during the Depression set in motion bankruptcies which set in motion further contractions in production, which triggered additional falls in prices. With prices falling at ten percent per year, investors could calculate that they would earn less profit investing now than delaying investment until next year when their dollars would stretch ten percent further: excess demand for cash went up even more, and excess supply of goods and services. Banking panics and the collapse of the world monetary system cast doubt on everyone's credit, and reinforced the belief that now was a time to watch and wait. The slide into the Depression, with increasing unemployment, falling production, and falling prices, continued throughout then newly-elected Herbert Hoover's Presidential term.

At its nadir, the Depression was collective insanity. Workers were idle because firms would not hire them to work their machines; firms would not hire workers to work machines because they saw no market for goods; and there was no market for goods because workers had no incomes to spend. Orwell's account of the Great Depression in Britain, *The Road to Wigan Pier,* speaks of "...several hundred men risk[ing] their lives and several hundred women scrabbl[ing] in the mud for hours... searching eagerly for tiny chips of coal" in slagheaps so they could heat their homes. For them, this arduously-gained "free" coal was "more important almost than food." All around them the machinery they had previously used to mine in five minutes more than they could gather in a day stood idle.

10.3.1.3: Why so Large?

There is no fully satisfactory explanation of why the huge Depression happened when it did. If such huge depressions were always a possibility in an unregulated capitalist economy, why weren't there two, three, many Great Depressions in the years before World War II? Milton Friedman and Anna Schwartz argued that the Depression was the consequence of an incredible sequence of blunders in monetary policy. But those controlling policy during the early 1930s thought they were following the same gold-standard rules of conduct as their predecessors. Were they wrong? If they were wrong, why did they think they were following in the footsteps of their predecessors? If they were not wrong, why was *the* Great Depression the only Great Depression?

The Great Depression has central place in twentieth century economic history. In its shadow, all other depressions are insignificant. Whether assessed by the relative shortfall of production from trend, by the duration of slack production, or by the product-depth times duration-of these two measures, the Great Depression is an order of magnitude larger than other depressions: it is off the scale. All other depressions and recessions are from an aggregate perspective (although not from the perspective of those left unemployed or bankrupt) little more than ripples on the tide of ongoing economic growth. The Great Depression cast the survival of the economic system, and the political order, into serious doubt.

10.3.2: The Stock Market Crash

10.3.2.1: A "Permanent and High Plateau"

The U.S. stock market had boomed in the 1920s. Prices had reached levels, measured as a multiple of corporate dividends or corporate earnings, that made no sense in terms of traditional patterns and rules of thumb for valuation. A range of evidence suggests that at the market peak in September 1929 something like forty percent of stock market values were pure air: prices above fundamental values for no reason other than that a wide cross-section of investors thought that the stock market would go up because it had gone up.

By 1928 and 1929 the Federal Reserve was worried about the high level of the stock market. It feared that the "bubble" component of stock prices might burst suddenly. When it did burst, pieces of the financial system might be suddenly revealed to be insolvent, the network of financial intermediation might well be damaged, investment might fall, and recession might result. It seemed better to the Federal Reserve in 1928 and 1929 to try to cool off the market by making borrowing money for stock speculation difficult and costly by raising interest rates. They accepted the risk that the increase in interest rates might bring on the recession that they hoped could be avoided if the market could be "cooled off": all policy options seemed to have possible unfavorable consequences.

In later years some, Austrian economist Friedrich Hayek for one, were to claim that the Federal Reserve had created the stock market boom, the subsequent crash, and the Great Depression through "easy money" policies:

> Up to 1927 I should have expected that the subsequent depression would be very mild. But in that year an entirely unprecedented action was taken by the American monetary authorities [who] succeeded, by means of an easy-money policy, inaugurated as soon as the symptoms of an impending reaction were noticed, in prolonging the boom for two years beyond what would otherwise have been its natural end. And when the crisis finally occurred, deliberate attempts were made to prevent, by all conceivable means, the normal process of liquidation.

Those making such claims for over-easy policy appear to have spent no time looking at the evidence. Weight of opinion and evidence on the other side: the Federal Reserve's fear of excessive speculation led it into a far too deflationary policy in the late 1920s: destroying the village in order to save it.

The U.S. economy was already past the peak of the business cycle when the stock market crashed in October of 1929. So it looks as though the Federal Reserve did overdo it—did raise interest rates too much, and bring on the recession that they had hoped to avoid.

10.3.2.2: Popping the Bubble

The stock market did crash in October of 1929. "Black Tuesday," October 29, 1929, saw American common stocks lose something like a tenth of their value. That it was ripe for a bursting of the bubble is well known; the exact reasons why the bubble burst then are unknowable; more important are the consequences of the bursting of the bubble.

The stock market crash of 1929 greatly added to economic uncertainty: no one at the time knew what its consequences were going to be. The natural thing to do when something that you do not understand has happened is to pause and wait until the situation becomes clearer. Thus firms cut back their own plans for further purchase of producer durable goods. Consumers cut back purchases of consumer durables. The increase in uncertainty caused by the stock market crash amplified the magnitude of the initial recession.

10.3.3: Making Things Worse:

10.3.3.1: Even a Panic Is Not Altogether a Bad Thing

The first instinct of governments and central banks faced with this gathering Depression began was to do nothing. Businessmen, economists, and politicians (memorably Secretary of the Treasury Mellon) expected the recession of 1929-1930 to be self-limiting. Earlier recessions had come to an end when the gap between actual and trend production was as large as in 1930. They expected workers with idle hands and capitalists with idle machines to try to undersell their still at-work peers. Prices would fall. When prices fell enough, entrepreneurs would gamble that even with slack demand production would be profitable at the new, lower wages. Production would then resume.

Throughout the decline—which carried production per worker down to a level 40 percent below that which it had attained in 1929, and which saw the unemployment rise to take in more than a quarter of the labor force—the government did not try to prop up aggregate demand. The Federal Reserve did not use open market operations to keep the money supply from falling. Instead the only significant systematic use of open market operations was in the other direction: to raise interest rates and discourage gold outflows after the United Kingdom abandoned the gold standard in the fall of 1931. The Federal Reserve thought it knew what it was doing: it was letting the private sector handle the Depression in its own fashion. It saw the private sector's task as the "liquidation" of the American economy. And it feared that expansionary monetary policy or fiscal spending and the resulting deficits would impede the necessary private-sector process of readjustment.

10.3.3.2: Hoover Wished His Administration Had Listened to Him

Contemplating from the 1950s the wreck of his country's economy and his own political career, Herbert Hoover wrote bitterly in retrospect about those in his administration who had advised inaction during the downslide:

> The "leave-it-alone liquidationists" headed by Secretary of the Treasury Mellon felt that government must keep its hands off and let the slump liquidate itself. Mr. Mellon had only one formula: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate". He held that even panic was not altogether a bad thing. He said: "It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people"…

But Hoover had been one of the most enthusiastic proponents of "liquidationism" during the Great Depression. And it had been a common meme in the public sphere.

10.3.3.3: Eminent Economists Were "Liquidationists"

The unwillingness to use policy to prop up the economy during the slide into the Depression was backed by a large chorus, and approved by (some of) the most eminent economists around.

For example, from Harvard Joseph Schumpeter argued that there was a "presumption *against* remedial measures which work through money and credit. Policies of this class are particularly apt to produce additional trouble for the future." From Schumpeter's perspective, "depressions are not simply evils, which we might attempt to suppress, butforms of something which has to be done, namely, adjustment to change." This socially productive function of depressions creates "the chief difficulty" faced by economic policy makers. For "most of what would be effective in remedying a depression would be equally effective in preventing this adjustment."

From London, Friedrich von Hayek found it:

> still more difficult to see what lasting good effects can come from credit expansion. The thing which is most needed to secure healthy conditions is the most speedy and complete adaptation possible of the structure of production.If the proportion as determined by the voluntary decisions of individuals is distorted by the creation of artificial demand resources [are] again led into a wrong direction and a definite and lasting adjustment is again postponed.The only way permanently to "mobilise" all available resources is, therefore to leave it to time to effect a permanent cure by the slow process of adapting the structure of production…

Von Hayek and company believed that enterprises were gambles which sometimes fail: a future came to pass in which certain investments should not have been made. The best that could be done in such circumstances is to shut down those production processes that turned out to have been based on assumptions about future demands that did not come to pass. The liquidation of such investments and businesses releases factors of production from unprofitable uses; they can then be redeployed in other sectors of the technologically dynamic economy. Without the initial liquidation the redeployment cannot take place. And, said Hayek, depressions *are* this process of liquidation and preparation for the redeployment of resources.

As Schumpeter put it, policy does not allow a choice between depression and no depression, but between depression now and a worse depression later:

> Inflation pushed far enough [would] undoubtedly turn depression into the sham prosperity so familiar from European postwar experience, [and]... would, in the end, lead to a collapse worse than the one it was called in to remedy…

For:

> recovery is sound only if it does come of itself.… Any revival which is merely due to artificial stimulus leaves part of the work of depressions undone and adds, to an undigested remnant of maladjustment, new maladjustment of its own which has to be liquidated in turn, thus threatening business with another [worse] crisis ahead…

10.3.3.4: This Was Bats---

This doctrine—that in the long run the Great Depression would turn out to have been good medicine for the economy, and that proponents of stimulative policies were shortsighted enemies of the public welfare—was, to put it bluntly, complete bats---. John Stuart Mill had nailed the analytical point back in 1829: an excess demand for money was what would produced a "general glut", and if the economy's money supply were matched to money demand, there would be no depression. Practical central bankers had developed a playbook for what to do. Yet it was not followed.

Why was it not followed? One reason was that a depression so deep showed itself as a new configuration of asset prices. In previous downturns the excess demand for money had triggered a scramble for *liquidity*: people desperate to have more cash they could spend immediately dumped other assets onto the market, including the government bonds they held; as government bonds fell in price the interest rates they paid rose; central bankers saw such sharp spikes in government bond interest rates as a signal that the economy needed more cash. In this downturn the excess demand for money was so broad and fear was so great that it triggered a scramble for *safety*: people were desperate not just for more cash now but for assets that they would be able to easily turn into cash in the future, for it seemed likely that the troubles would last for quite a while; so they dumped other assets on the market and scrambled for both cash and government bonds. With the government-bond interest-rate spike absent, central bankers were not sure what was going on.

But a second reason was that, somehow, the "liquidationists" had established a degree of intellectual dominance in the public sphere.

10.3.3.5: Against "Liquidationism"

This doctrine—that in the long run the Great Depression would turn out to have been good medicine for the economy, and that proponents of stimulative policies were shortsighted enemies of the public welfare—drew anguished cries of dissent from those less hindered by their theoretical blinders.

British economist Ralph Hawtrey scorned those who, like Robbins and Hayek, wrote at the nadir of the Great Depression that the greatest danger the economy faced was inflation. It was, Hawtrey said, the equivalent of "Crying, 'Fire! Fire!' in Noah's flood." John Maynard Keynes also tried to bury the liquidationists in ridicule.

Later on Milton Friedman would recall that at the Chicago where he went to graduate school such dangerous nonsense was not taught—but that he understood why at Harvard-where such nonsense was taught-bright young economists might rebel, reject their teachers' macroeconomics, and become followers of Keynes. Friedman thought that Keynesianism was wrong—but not crazy.

However, the "liquidationist" view carried the day. Even governments that had unrestricted international freedom of action—like France and the United States with their massive gold reserves—tended not to pursue expansionary monetary and fiscal policies on the grounds that such would reduce investor "confidence" and hinder the process of liquidation, reallocation, and the resumption of private investment. But sure the "liquidationists" believed that something could be done: what? To restore confidence by balancing the government's budget.

10.4 Debt and Deflation

10.4.1: Budget Balance and Deflation

Thus governments strained their muscles to balance their budgets—thus further depressing demand—and to reduce wages and prices—in order to restore competitiveness and balance to their economies. In Germany the Chancellor—the Prime Minister—Heinrich Bruening decreed a ten percent cut in prices, and a ten to fifteen percent cut in wages. But every step taken in pursuit of financial orthodoxy made matters worse.

For once the declines in wages and prices in the Great Depression had passed some critical value, they knocked the economy out of its normal business-cycle pattern. Severe deflation had consequences that were much me than an amplification of the modest five to ten percent falls in prices that had been seen in past depressions.

When banks made loans, they allowed beforehand for some measure of fluctuation in the value of the assets pledged as security for their loans: even some diminuation of the value of their collateral would not cause banks to panic, because if the borrower defaulted they would still be able to recover their loan principal, as long as the decline in the value of the collateral were not too high.

But what happens when deflation reached the previously never seen amount of thirty, forty, or fifty percent—as it did in the Great Depression? Banks became keenly aware that their loan principal was no longer safe: that if the borrower defaulted, they no longer had recourse to sufficient collateral to recover their loan principal. Others knew this. Thus borrower defaults became a signal for bank depositors that it was time for them to withdraw their deposits. In that case the bank would collapse. Hence the banks needed to act first to collect what they could.

10.4.2: Liquidity and Safety

As Keynes had written, once banks realize that deflation had significantly impaired the value of their collateral:

> They become particularly anxious that the remainder of their assets should be as liquid and as free from risk as it is possible to make them. This reacts in all sorts of silent and unobserved ways on new enterprise. for it means that banks are less willing than they would normally be to finance any project.

In looking at the tracks of interest rates in the Great Depression, you can see a steady widening of the gap between safe interest rates on government securities and the interest rates that borrowing companies had to pay. Even though credit understood as *liquidity* was ample—in the sense that borrowers with perfect and unimpaired collateral could obtain loans at extremely low interest rates—the businesses in the economy (few of which had perfect and unimpaired collateral) found it next to impossible to obtain capital to finance investment.

Thus the banking system freezes up. It no longer performs its social function of channeling purchasing power from savers to investors. As a result private investment collapses; falling investment produces more unemployment, excess capacity, futher falls in prices, and more deflation; and further deflation renders the banking system even more insolvent.

Morever, not only past deflation but also expected future deflation depressed investment. Why invest now if you expect deflation, so that everything you might buy this year would be ten percent cheaper next year?

In the end the spiral of deflation continued to depress the economy until something was done to restore solvency to the banking system, and broke the anticipations of further falls in prices. A few economists understood this process at work during the Great Depression—Irving Fisher, John Maynard Keynes, R.G. Hawtrey. But they did not walk the corridors of power at the nadir.

10.5: Global Issues

10.5.1: Golden Fetters

Countries without massive gold reserves did not have the luxury of even attempting to expand their economies, at least not until they abandoned the gold standard, let their exchange rates float freely, and so cast off their "golden fetters." A government that wished to stimulate demand in the Great Depression would seek to inject credit and bring down interest rates to encourage investment. But additional credit would mean higher imports, and lower interest rates would encourage domestic investors to invest abroad. The result would be a balance-of-payments gap: economic expansion at home was inconsistent with gold convertibility. And few countries wished to abandon the gold standard at the start of the Great Depression.

There were exceptions that proved the rule. Scandinavian countries cast off their golden fetters at the start of the Great Depression, pursued policies of stabilizing nominal demand under the intellectual influence of the Stockholm School of economists, and did relatively well. In Japan fiscal orthodoxy and budget balance were abandoned in 1931, when Korekiyo Takahashi became Minister of Finance.

Industrial production in Japan in 1936 was half again as much as it had been in 1928; in Japan the Great Depression was over by 1932.

But these were unusual exceptions.

Before World War I the major industrial economies *might* have had some freedom of action. Before the war major industrial countries' commitment to the gold standard was unquestioned. Whenever an exchange rate fell to the lowest "gold point", the bottom of the band and the point at which it was profitable to begin shipping gold out of the country, capital would flow in betting on the future recovery of the exchange rate to the mid-point of its band, making the central bank's task of maintaining convertibility easy.

In the 1920s, with governments under greater pressure from newly expande electorates to generate prosperity, it was not clear that the country was committed to the gold standard. Speculators, instead, began to pull their capital out of a country facing a balance-of-payments deficit, on the principal that the loss they would suffer should the currency recovery would be dwarfed by their profits if they could take advantage of a full-fledged devaluation.

With the growth of concern about currencies, central bankers wondered if the *gold-exchange standard*—by which they kept their reserves in sterling or in dollars—was wise. What if the pound or the dollar devalued? As the Great Depression gathered force, central banks fell back on gold as their principal reserve, increasing strains on the system.

One might have thought that those countries that had restored their pre-World War I parities would be immune from destabilizing speculation. Had not Britain returned to the gold standard at the pre-World War I parity precisely to give investors confidence that its commitment to the gold standard was absolute? But governments like Britain and the United States that had maintained pre-World War I parities found themselves lacking credibility. Because they had not experienced the 1920s as a decade of inflation, they lacked the tacit political consensus that inflation was to be avoided at all costs. By contrast countries that had undergone inflation in the 1970s found for the most part that they had high credibility, and that their exchange rates came under little speculative attack.

10.5.2: The Credit-Anstalt

Austria's major bank, the Credit-Anstalt, was revealed to be bankrupt in May 1931. Its deposits were so large that freezing them while bankruptcy was carried through would have destroyed the Austrian economy, hence the government stepped in to guarantee deposits. The resulting expansion of the currency was inconsistent with gold-standard discipline. Savers liquidated their deposits and began to transfer funds out of the country in order to avoid the capital losses that would have been associated with a devaluation.

In order to keep its banking system from collapsing and in order to defend the gold standard, the Austrian central bank needed more gold to serve as an internal reserve to keep payments flowing and an external reserve to meet the demand triggered by incipient capital flight. The Bank for International Settlements began to host negotiations to coordinate international financial cooperation.

It is possible that rapid and successful conclusion of these negotiations might have stopped the spread of the Great Depression in mid-1931. Austria was a small country with a population well under ten million. There was not that much capital to flee. A sizable international loan to Austria's central bank would have allowed it to prop up its internal banking system and maintain convertibility. A month later those whose capital had fled would realize that the crisis was over, and that they had lost a percent of two of their wealth in fees and exchange costs in the capital flight. Other speculators would observe that the world's governments were serious in their commitment to the gold standard, that the potential foreign exchange reserves of any one country were the world's, and thus that the likelihood of a speculative attack succeeding in inducing a devaluation was small.

Perhaps investors would then have begun returning gold to central banks in exchange for interest-bearing assets, would have begun to shrink down their demand for liquidity, and would have begun to boost worldwide investment. The *Economist's* Berlin correspondent thought that it might well have done the job:

> It was clear from the beginning... that such an institution [as the Credit-Anstalt]

> could not collapse without the most serious consequences, but the fire might have been localized if the fire brigade had arrived quickly enough on the scene. It was the delay of several weeks in rendering effective international assistance to the Credit Anstalt which allowed the fire to spread so widely.

We do not know because it was not tried. The substantial loan to Austria was not made. Speculators continued to bet on devaluation, investors continued to hoard gold, the preference for liqidity continued to rise, and investment continued to fall.

The substantial loan to Austria was not made because French internal politics entered the picture. At the beginning of his political career French Premier Pierre Laval had styled himself a politician of the left: the Clarence Darrow of France. But by the early 1930s he was shifting to the position of a strong nationalist. He blocked the proposed international support package for Austria, insisting that if France was to contribute France had to get something out of it. The price that Laval demanded was made up of a series of diplomatic concessions, most important of which was the renunciation of a prospective customs union with Germany. To Laval, playing the nationalist card in French politics, nothing that benefited Germany could be allowed by France.

The Austrian government refused to make the required political concessions fast enough for negotiations to be completed in time to be of use. Austria lost: the support package collapsed, and the Austrian economy abandoned the gold standard and went into recession. In the long run France lost too: what might have been a chance to moderate the Great Depression was lost. The ultimate consequences for France were dire. The rise of Adolf Hitler in Germany is inconceivable in the absence of the Great Depression.

Nine years after the Credit-Anstalt crisis the French government surrendered to the Nazis. Pierre Laval was not greatly inconvenienced at first by the Nazi conquest of Europe. He discovered that he was not a leftist at all, but a fascist. He became the second most powerful figure, and the true focus of decision making, in France’s wartime Nazi-collaborationist Vichy government.

He was executed for treason for having given aid and comfort to the Nazis after the end of World War II.

10.5.3: At the Nadir

Back in 1931, speculators observed that the international financial community did *not* support currencies that came under pressure. They wondered which country would be next to devalue—and thus which country to pull their money out of fast if they did not want to lose the thirty percent or so of gold value that would be lost in a devaluation. The wave of bear speculation moved on to Hungary, Germany, and Britain. By the fall of 1931 Britain had abandoned the gold standard.

Thus international capital flows—in this case driven by fear of being caught in a devaluation—triggered devaluations and brought down the interwar gold standard. In a well-functioning gold standard, such impulses would have been damped by the credibility of the commitment to gold and by international cooperation. But in the early 1930s the commitment to gold had no credibility. And there was no international cooperation.

In the absence of international cooperation, the legacy of the gold standard was to make it impossible for any country to fight the Depression within its borders. Stimulative monetary and fiscal policies were inconsistent with the gold standard. And efforts to contain domestic banking crises were thwarted and rendered counterproductive because of the fear that rescuing the banking system or lowering interest rates was the prelude to devaluation.

10.5.4: The Absent *Hegemon*

As Eichengreen has pointed out, once countries had cast off the golden fetters of the interwar gold standard, the crisis was transformed into an opportunity. Policies to expand demand and production no longer required international cooperation once the gold standard framework had been abandoned. But as he has also pointed out, "liquidationism"—and fears of financial and political chaos—kept governments from beginning to fight the Depression in a serious manner for much of the 1930s.

The Great Depression is the greatest case of self-inflicted economic catastrophe in the twentieth century. As Keynes wrote at its very start, in 1930, the world was "... as capable as before of affording for every one a high standard of life.... But today we have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand.” Keynes feared that “the slump” that he saw in 1930 “may pass over into a depression, accompanied by a sagging price level, which might last for years with untold damage to the material wealth and to the social stability of every country alike.” He called for resolute, coordinated monetary expansion by the major industrial economies to “restore confidence in the international long-term bond market... restore [raise] prices and profits, so that in due course the wheels of the world’s commerce would go round again.”

Charles Kindleberger has pointed out that such action never emerges from committees, or from international meetings. Before World War I the international gold standard was kept on track because there was a single, obvious, dominant power in the world economy: Britain. Everybody knew that Britain was the “hegemon”, and so everyone adjusted their behavior to conform with the rules of the game and the expectations of behavior laid down in London. Similarly, after World War II the “hegemon” for more than a full generation was the United States. And once again, the existence of a dominant power in international finance—a power that had the capability to take effective action to shape the pattern of international finance all by itself if it wished—led to a relatively stable and well-functioning system.

But during the interwar period there was no hegemon: no power could shape the international economic environment through its own actions alone. Britain tried, attempting to restore confidence in the gold standard by the restoration of sterling, and failed. America might have succeeded had it tried—but successful policy requires that the hegemon recognize its leading position, which the interwar U.S. did not do. Thus "resolute, coordinated" action to expand demand and halt the depression did not emerge from the leading industrial power. And it was very unlikely to be generated by any committee operating via consensus.

So the action was not forthcoming. And Keynes’s fears came to pass.