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**Economic Crises in the Thirties and Today**

*In the context of the ongoing financial and economic crisis reference is frequently made to the Great Depression of the 1930s and fears are voiced that we may have embarked on a similar path. This article looks at the conditions prevailing back then and compares them with the present economic environment. From this some conclusions are drawn as to the likelihood of a recurrence of the disaster.*

In the first quarter of 2009 industrial production in major economies sharply declined compared to its maximum one year before. In the United States and the United Kingdom it fell by about 12 per cent, in France by 15 and in Germany by 20 per cent. On average industry in the four countries suffered even more than at the start of the Great Depression, when in 1930 their production was about 10 per cent lower than in 1929 (unweighted average). However, the slump did not come to an end in 1930. Its main characteristic was not the speed of the downturn in the first year; the recession of 1920/21 in the USA, in the UK and in France, for example, had been more severe than that of 1930, but in 1922 an upswing was already under way again. What made the Great Depression exceptional was mainly its long duration. It lasted for three years with average production declining more in every consecutive year. Therefore when the lower turning point was finally reached in 1932, industrial production had been halved in the USA and Germany compared to 1929 and had fallen by a third in France. Only Britain was saved from the worst with a total decline of less than 20 per cent. Another remarkable fact about the Great Depression was that before the outbreak of war the United States and France did not recover their pre-crisis level of industrial production in any year; Britain and Germany did, but this was due to exceptional factors.

In this article we shall first deal with these observations concerning the Great Depression in some more detail. It will be demonstrated that they can largely be explained by peculiarities of monetary, fiscal and economic policy at the time. Next, the fundamental changes which have occurred in the general pattern of these policies since then will be tracked. With that in mind a short conclusion will be presented about the possible outcome of the current economic crisis.

*Christoph Buchheim*

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1 OECD: Key short-term economic indicators, online.
2 National Bureau of Economic Research: Macrohistory database, online; Konjunkturstatistisches Handbuch 1936, p. 52.
3 National Bureau of Economic Research (NBER): Macrohistory Database online (provides all figures on pig-iron production cited in this paper).
proaching end of the crisis. Unfortunately, that proved to be utterly wrong. During the summer pig-iron production turned around again; from then on until the summer of 1932 it fell in the USA by three quarters, in Germany by about half, in France by more than a third. In Britain pig-iron production declined, too, after May 1931; until September it fell by almost 30 per cent, but then, in contrast to the other three countries mentioned, it suddenly increased somewhat and then stabilised. With hindsight one can state that the British economy had reached the trough of the cycle in the autumn of 1931; in 1932 industrial production stagnated and thus its total decline during the Great Depression was, as shown above, much lower than in the other three countries.

What factors were responsible for this course of events in Great Britain? In fact, in September 1931 capital flight forced Britain off the gold standard. The pound sterling was left floating with the effect that it quickly devalued by 20 per cent and more. British exports immediately became more competitive and, in an environment of declining volumes of world exports, Britain managed to increase its share of them. In addition, starting in early 1932, the Bank of England lowered its discount rate from 6 per cent, the level attained in the critical period of autumn 1931, to two per cent around mid-1932. Last but not least, deflation, which had led to a decline in wholesale prices by almost 30 per cent from 1929 to September 1931, came to a halt and with it its depressing economic consequences.

The interwar gold standard indeed goes a long way to explain the severity of the Great Depression. Its main features were fixed exchange rates, free international capital flows and the obligation of central banks to hold minimum gold and foreign exchange reserves against their banknote issue. To this came a distorted system of gold parities, a network of huge reserves against their banknote issue. Of course, as long as a country adhered to the gold standard, another policy, by supporting reflation, might quickly have run against the balance-of-payments and gold constraint. However, even after leaving the gold standard in 1931 Britain still followed a rather restrictive fiscal policy; neither did the German governments before Hitler make much use of their greater fiscal autonomy after foreign exchange rationing had been introduced as a result of the financial crisis in mid-1931. This shows that in the 1930s there still existed an international consensus about the desirability of a balanced budget.

Fiscal policy generally did not support economic recovery a lot; even less could be hoped from exports. Protectionism had already been much more pronounced in the 1920s than before 1914, not least as a consequence of disturbances arising out of the war itself. Increased barriers to external trade negatively affected volumes of manufactured exports as well as prices of primary goods on the world markets.

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In fact, in Germany and in the United States such banking crises occurred. In both cases capital flight played an important role. Capital flight in turn was largely caused by a loss of confidence in the stability of the currency. While in Germany the reasons for that were principally political, in the USA it was the withdrawal of Britain from the gold standard which led to doubts about the dollar. In both countries capital flight caused a loss of reserves in central banks which then, in order to defend their legal gold cover ratios, raised discount rates and applied quantitative restrictions. Therefore defending the gold standard meant that central banks could not fulfil their lender-of-last-resort function. As capital flight also went with deposit withdrawals, banks were further weakened and without central bank support severe crises of the whole financial system now occurred. Thus in both countries the economic crisis was aggravated after mid-1931, as is indicated by the development of pig-iron production. France did not experience a full-fledged banking crisis. However, because it remained on the gold standard until 1936, it suffered from repeated deflationary shocks for a particularly long time. As a result, before the war industrial production hardly recovered at all.

Generally, fiscal policy also was not employed to relieve the crisis in the early 1930s. Rather, except for some rare and short-lived instances, it made the situation still worse. The prevailing attitude towards budget deficits was negative. Irrespective of the depression tax rates were increased and spending was cut, and thus even the built-in stabilisers were inhibited. Of course, as long as a country adhered to the gold standard, another policy, by supporting reflation, might quickly have run against the balance-of-payments and gold constraint. However, even after leaving the gold standard in 1931 Britain still followed a rather restrictive fiscal policy; neither did the German governments before Hitler make much use of their greater fiscal autonomy after foreign exchange rationing had been introduced as a result of the financial crisis in mid-1931. This shows that in the 1930s there still existed an international consensus about the desirability of a balanced budget.
Great Britain and Germany particularly suffered from the former development. Overseas countries chiefly producing primary products were heavily affected by the latter and as a result some of them restricted their manufactured imports already in the late 1920s with further negative repercussions especially for British exports. Massive deglobalisation, however, was a feature primarily of the Great Depression and its aftermath. Many countries increased their tariffs, among them most prominently the USA with the infamous Smoot Hawley Tariff Act of 1930. Deflation also contributed to an increase in tariff protection, as in that period most countries still employed specific and not ad-valorem tariffs, the former becoming more restrictive when prices declined. Some countries resorted to quantitative import restrictions; France, for instance, made extensive use of them. Others engaged in bilateralism, as did Germany under the Nazi regime. Even Great Britain, the foremost free trader of the 19th century, introduced tariffs on all important manufactures in 1932 and concluded the Ottawa Agreement with Empire states thus discriminating against third countries. With all that in mind it is hardly astonishing that world trade remained far below its pre-crisis maximum during the whole of the 1930s. Consequently exports did not act as a powerful engine of growth as was the case after the Second World War. Rather, economic growth, as far as it occurred, derived primarily from domestic causes. However, in the USA and in France these, too, remained weak in the 1930s; therefore both countries, as already indicated, could not recover the level of their real product from before the crisis until the Second World War began. Only then did vigorous growth start again because of full-scale rearmament, which by now to a large extent was financed through budget deficits; with it unemployment quickly disappeared.

The deficit-financed rearmament expenditure, which in Nazi Germany already began on a massive scale in 1934, was also the sole reason for the exceptional speed at which the economic upswing out of the Great Depression proceeded in that country. Furthermore, Germany was unique in that not only was full employment attained there in the second half of the 1930s, but even a shortage of labour arose. The latter, however, is to be seen as an indicator of the massive distortions caused by the rearmament-driven recovery in Germany as private businesses, afraid of huge overcapacities after the prospective end of the state-propelled upswing, were quite reluctant with regard to risky investments. Productivity therefore hardly rose during the 1930s. Furthermore the living standard of the working class more or less stagnated despite the vigorous upswing. And finally, the huge budget deficits which financed war-related state purchases led to signs of repressed inflation already before 1939. Although the German economy at first sight appeared to be growing in a healthy way after 1932/33, in actual fact this growth was artificial and already bred the next major crisis which, however, was masked by the war.

In Great Britain the upswing was triggered by a housing boom which in turn was supported by low interest rates, not least due to a generous monetary policy after the pound sterling had left the gold standard. However, the dynamics of the construction boom also partly derived from one-off factors: a large number of families were started because of the specific age structure of the British population at the time and there was a change in income distribution favouring the middle classes. Moreover, economic growth was still far too weak to fully absorb unemployment. Rather, on average, this was even higher in the 1930s than it was in the 1920s, when it had already been unusually high compared to the period before World War I. In Britain, too, full employment was only achieved after massive rearmament had set in and was fast extended through great budget deficits.

In a way therefore in the later 1930s the missing export dynamics was substituted by deficit-financed military expenditure. However, that could not be a long-term solution for otherwise weak growth, because on the one hand such spending is unproductive in itself and on the other ever-rising budget deficits ultimately endanger the stability of the fiat money in circulation after the gold standard had generally been left.

**Fundamental Changes in Economic Policy Principles**

The Great Depression actually led to a far-reaching process of social learning. After the Second World War that resulted in a consensus about economic policy principles which were fundamentally different from those followed before the war. However, this new consensus already had its roots in the 1930s and in the period of the war itself.

A first step towards a more liberal international trading system was taken by the USA, i.e. the very country which, despite being the principal global creditor nation, had been among the most protection-
would be better than nothing.”

and practical difficulties in the way of this, the above

employment and, with the help of the repercussions, the
real income of the community, and its capital wealth

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concluded, if effective demand was too low the state
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payments deficit insofar as internal deflation was no longer necessary; rather, a full employment policy through deficit spending and appropriate monetary growth should not be impeded by considerations regarding exchange-rate stability – a really big difference to the regime of the interwar gold standard with its disastrous consequences during the Great Depression. It also shows that by 1944 Keynesian-style macroeconomic policy had become an integral part of the new international consensus about economic policy principles. That might have had to do with the observation that only deficit-financed war expenditure finally had overcome unemployment and slow growth.

The GATT/WTO in turn acted as an important agent for the direct promotion of liberal and multilateral trade on the basis of the most-favoured-nation principle. In quite a few rounds of negotiations about tariffs and other trade barriers it has brought about freedom of international trade to a far greater degree than existed at any time between the world wars. Thus it has much supported the re-globalisation drive in the second half of the 20th century, which brought the world economy into a condition similar to the one it once had before World War I. Exports became a very important factor for economic dynamics again, so much so that the 1950s and 1960s generally are labelled a period of “export-led growth”. And that exports today still play an important role for economic growth can be clearly seen in the current crisis, which is so very bad exactly because all major economies are severely hit and therefore imports are stifled everywhere, which has choked the export engine on a global scale.

Conclusion

Today the economies of major countries are about where they were in the first half of 1931. There is a pause in the crisis, some signs exist which seem to indicate that the lower turning point is near, for instance rising prices on stock exchanges and an improvement of business expectations. The question is whether the economic upswing will really set in again soon or whether, as in 1931, the crisis will restart and continue perhaps in an even more powerful way than before.

The reason for the aggravation and prolongation of the crisis in 1931, which only then became the Great Depression, was primarily, as has been shown, a misguided economic policy. Above all the defence of the gold standard against the consequences of capital flight through monetary restrictions and fiscal conservatism in major countries contributed to the renewed dynamics of the crisis leading to a breakdown of banking systems and to further deflation. In contrast, the Bretton Woods system was purposely intended to avoid similar balance of payments constraints for domestic economic policy. Even though the adjustable peg has today been replaced by flexible exchange rates of major currencies in their relationship to each other, nothing has changed with regard to the greater autonomy of internal economic policies from international considerations compared to the gold standard period. Therefore central banks in their fight against the financial crisis this time were able to lower their interest rates to almost zero and to pump liquidity into the banking system and the economy as a whole. As a result, in important economies money stocks have increased during the current crisis, whereas in the Great Depression they declined conspicuously. Massive deflation has been avoided so far and no second-round banking crises have occurred. In addition, fiscal policy reacted to the crisis largely with deficit spending, which also is a very big difference to the early 1930s. Therefore, under the present circumstances an economic policy-induced aggravation of the slump is highly improbable. In other words, a repetition of the experience of the Great Depression, namely three years of continued severe economic downswing, is not to be expected.

What about the dynamics of the coming upswing? Will it be as slow and as imperfect as that of the 1930s before deficit-financed rearmament began on a huge scale? Here, too, a note of optimism seems to be in order. Even if the current crisis has already led to a few additional barriers to trade in some countries, full-fledged high protectionism on the scale experienced in 1930s is still far away. Moreover, it is to be doubted that it will develop in the future, even if the crisis lasts for some more months. For free trade today is firmly institutionalised; the WTO, the European Community and other international and supranational organisations act as powerful commitment mechanisms which make it difficult for member countries to withdraw from the principle of multilateralism. Moreover, the intra-trade of multinational firms today accounts for a major share of international commerce, so these firms have a big vested interest in liberal trade. A dynamic rise of world exports after the end of the acute crisis can therefore be expected, so that this important engine of growth will function again. Thus a new military adventure will be unnecessary in order to bring economies back onto an ascending path of development.