The Great Systems Debate and the Great Depression

Academia Engelberg: Future Economic Systems

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Overview

Did we learn from the Great Depression?

- Great Depression: long lasting economic downturn in the 1930s (USA: unemployment rate %25)
- Lack of/wrong policy responses exacerbated the downturn and prevented a fast recovery
- Experience of the Depression led to a significant change
  - in the response toolkit
  - in regulatory intervention
- ... but not to a general switch to economic planning

Overview

Economic Turbulences in the 1920s

- Literature: e.g. Feinstein *et al.* (2008)
- Economic consequences of WWI
  - Difficult switch to peacetime production
  - Growing inflexibility of wages and prices
  - Vulnerable financial sector
  - Fragile international monetary system
- Orthodox economic policy measures cannot cope with these new challenges → crises
  - Hyperinflation
  - Great Depression

Overview

The Great System Debate

- Literature: e.g. Sandmo (2011, Chapter 14)
- Starting point: Ludwig von Mises (1920)
- Central question: what are the relative merits of decentralization and central planning?
- Empirical facts:
  - Economic reality ↔ textbook models
  - Socialism as realistic political alternative

1920s: Orthodox Policy Recommendations

- Classical Gold Standard (1870-1913): time of prosperity and stability
- Turmoils in the 1920s → return to pre-war stability
- Macroeconomic policies (Schumpeter [1954] 1984, p. 769-771):
  - Fiscal policy:
    - Balanced budget ("*fundamental article of financial faith*")
    - Taxes are only a source of revenue
    - Expenditure: 'necessary' purposes
  - Monetary policy: Gold Standard

Gold Standard Mentality

Fear of Inflation

- Gold Standard: (long-run) price stability
  - David Hume [1752] (1898): Price-Specie-Flow Mechanism
  - $P \uparrow \rightarrow$ gold outflow $\rightarrow P \downarrow$
- Perceived reality: periods with unconvertible currency are characterized by inflation
- Extreme example: hyperinflation in Germany 1922/23 (monthly inflation rate: 335 %)

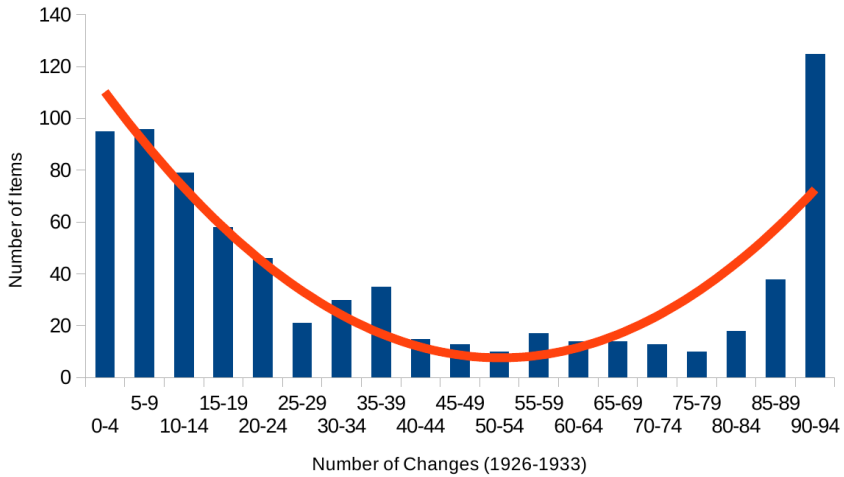
Gold Standard Mentality

Ideology

- Schumpeter [1954] (1984, p. 405-406)
- "*An 'automatic' gold currency is part and parcel of a laissez-faire and free-trade economy.* [...] *It is extremely sensitive* [...] *to precisely all those policies that violate the principles of economic liberalism.*"
- "*From this standpoint a man may quite rationally fight for it, even if fully convinced of the validity of all that has ever been urged against it on economic grounds.*"

1920s/30s: Some Empirical Facts

Concentration, Market Power, Price Rigidities: Perfect Competition?



747 items from BLS wholesale price index distributed according to frequency of price change (Means, 1935, p. 402)

Means (1935, p. 402):

- "[...] *prices of the right hand group of items are for the most part made in the market and are the type of prices around which traditional economic analysis has been built.*"
- "[....] *prices of the left hand group of items are established administratively*"

1920s/30s: Some Empirical Facts

Great Depression: Self-Healing Mechanism of the Business Cycle?

Traditional View:

(e.g. Haberler, 1937, p. 12)

1920s/30s: Some Empirical Facts

Great Depression: Self-Healing Mechanism of the Business Cycle?

Great Depression:

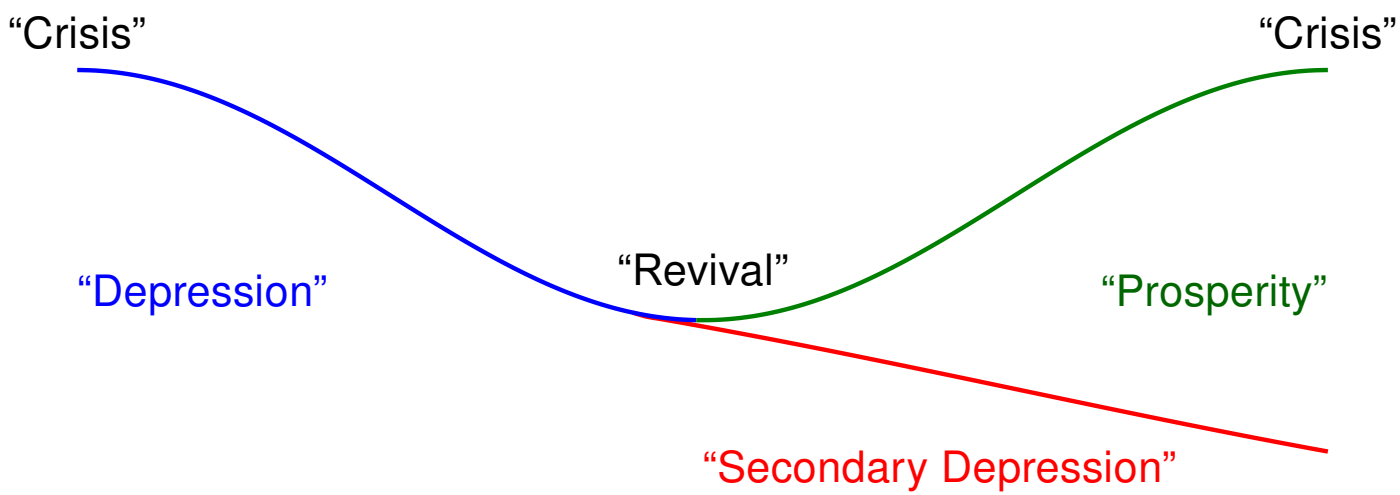
Peak	Trough	Duration in Months			
		Contraction	Expansion	Cycle	
				P → P	T → T
	Mar 1919				
Jan 1920	Jul 1921	18	10	28	17
May 1923	Jul 1924	14	22	36	40
Oct 1926	Nov 1927	13	27	40	41
Aug 1929	Mar 1933	43	21	64	34

NBER Business Cycle Chronology (`www.nber.org`)

(Contraction after Dec 2007: 18 months)

1920s/30s: Some Empirical Facts

Great Depression: Self-Healing Mechanism of the Business Cycle?



(e.g. Röpke, 1933, p. 434)

Economists: Pessimism

Keynes (1931), *The World's Economic Crisis and the Way of Escape. Halley Stewart Lecture 1931*

" *There is now no possibility of reaching a normal level of production in the near future. Our efforts are directed towards the attainment of more limited hopes. Can we prevent an almost complete collapse of the financial structure of modern capitalism? With no financial leadership left in the world and profound intellectual error as to causes and cures prevailing in the responsible seats of power, one begins to wonder and doubt.*"

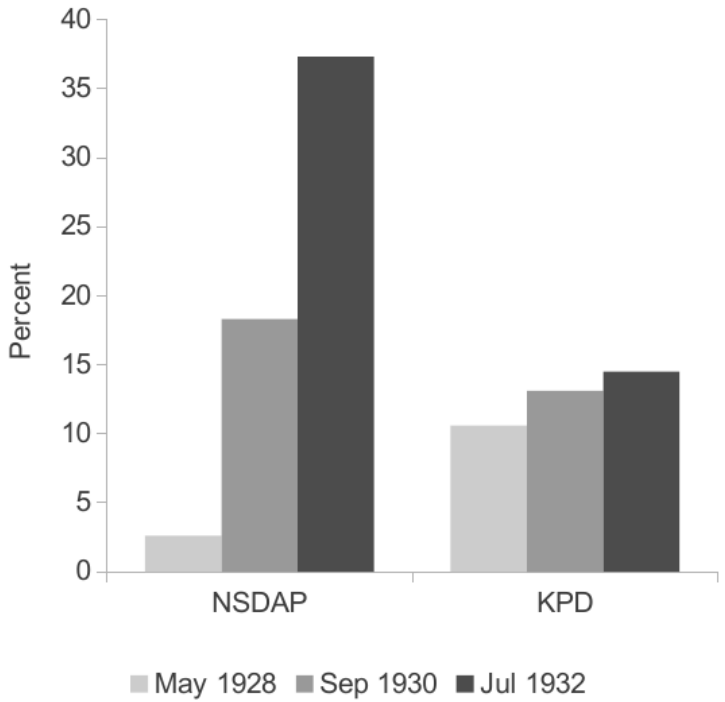
Economists: Pessimism

Roepke (1933, p. 427), *Trends in German Business Cycle Policy*

"*All who have shared the experience of the present author of growing up amid the splendour of the easy-going pre-war period, and then going through the unspeakable hardships of the war, the breakdown of the old political and social order, and the economic disintegration and wholesale impoverishment brought about by the after-effects of the war, by merciless peace treaties, and by the greatest inflation of history, may well come to the conclusion that Dante had witnessed next to nothing.*"

Danger: Political Instability

"*Angesichts der im Volk weitverbreiteten antikapitalistischen Stimmung und der beinahe allgemeinen Auffassung, daß die Banken an der Katastrophe erhebliche Mitschuld trugen, erschien es innenpolitisch fast zwingend, die Selbständigkeit der Banken in gewissem Umfang einzuschränken; auf jeden Fall mußte der Anschein vermieden werden, als ob das Reich durch die Bankenstützung einseitig den 'Kapitalisten' mit Steuergeldern helfe, ohne sich um die Verwendung dieser Mittel zu kümmern.*" (Luther, 1964, p. 232)



Elections to the *Reichstag*; source: (Petzina *et al.*, 1978, p. 174)

Digression: Keynes and the Great Depression

Keynesian Influence on New Deal Policies?

- John Maynard Keynes (1936) *The General Theory of Employment, Interest and Money*
- John R. Hicks (1974, p. 2): "*[t]here was no time for the teaching of that book (generally regarded nowadays as incorporating the essential Keynesian doctrine) to make a deep impression on any but professional economists before the war began. It was during the war, and immediately afterwards, that people who had had time to absorb that doctrine began to come into positions of authority.*"
- Keynes on Roosevelt (1934): "*I don't think your President Roosevelt knows anything about economics.*" (in Schlesinger [1960b] 2003b, p. 406)

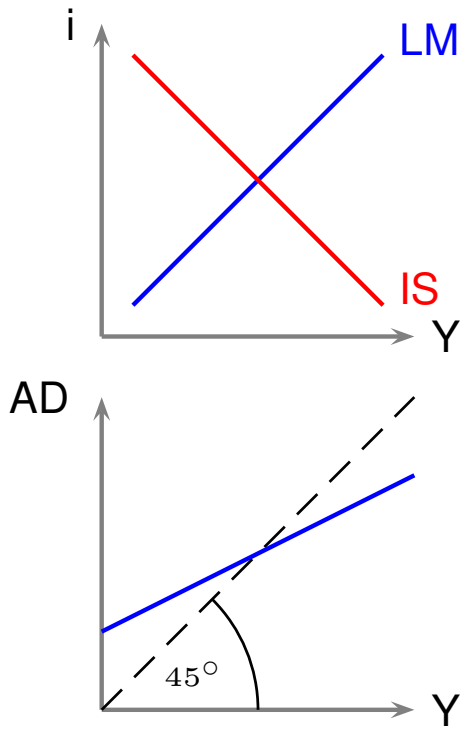
Digression: Keynes and the Great Depression

Textbook Treatment

- Hicks, John R. (1937), "Mr. Keynes and the 'Classics'; A Suggested Interpretation", *Econometrica*, 5, 147-159 → IS-LM-Model

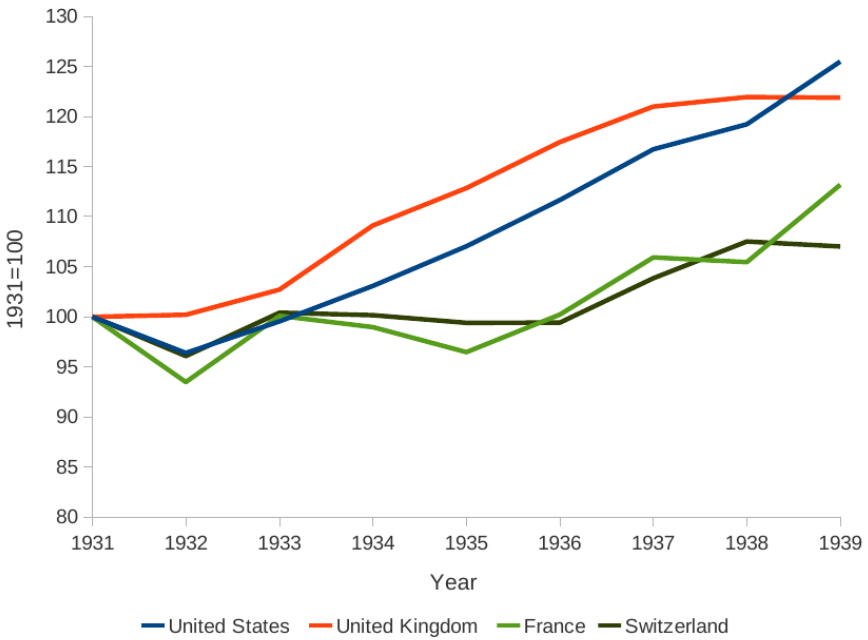
- First "Keynesian" texbook: Tarshis, Lorie (1947), *The Elements of Economics*. Boston: Houghton Mifflin

- Samuelson, Paul A. (1948), *Economics: An Introductory Analysis*. New York: McGraw-Hill → Keynesian Cross



Examples for Policy Responses: Monetary Policy

Changes in Per Capita GDP,1931-1939



- Positive experience of early exit
- Why did countries stay on gold?

Data Source: Maddison (2007)

Examples for Policy Responses: Monetary Policy

- USA: off gold in 1933 (July 3: Roosevelt's "Bombshell Message")
- Germany: constrained by international contracts (Dawes plan, Young plan → Borchardt controversy, e.g. Kruedener 1990)
- Other European countries:
  - UK: off gold September 21, 1931 (lack of reserves)
  - Sweden: follows trading partner UK some days later → recovery because of the undervalued krona
  - Switzerland:
    - Member of the gold bloc
    - Swiss franc overvalued → protracted depression
    - Follows trading partner France off gold September 26, 1936 → recovery

Conclusion

"To understand the Great Depression is the Holy Grail of macroeconomics. Not only did the Depression give birth to macroeconomics as a distinct field of study, but also - to an extent that is not always fully appreciated - the experience of the 1930s continues to influence economists' beliefs, policy recomendations, and resarch agendas. And, practicalities aside, finding an explanation for the worldwide economic collapse of the 1930s remains a fascinating intellectual challenge."
(Bernanke, 1995, p. 1)

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Appendix: General Theory

Summary by Paul Krugman (in Keynes [1936] 2007, p. XXVII):

- *Economies can and often do suffer from an overall lack of demand, which leads to involuntary unemployment*
- *The economy's automatic tendency to correct shortfalls in demand, if it exists at all, operates slowly and painfully*
- *Government policies to increase demand, by contrast, can reduce unemployment quickly*
- *Sometimes increasing the money supply won't be enough to persuade the private sector to spend more, and government spending must step into the breach*

July 3, 1933: Roosevelt's "Bombshell Message"

"**The sound internal economic system of a nation is a greater factor in its well being than the price of its currency in changing terms of the currencies of other nations**.
It is for this reason that reduced cost of government, adequate government income, and ability to service government debts are so important to ultimate stability. So too, **old fetishes of so-called international bankers** *are being replaced by efforts to plan national currencies with the objective of giving these currencies a continuing purchasing power which does not greatly vary in terms of the commodities and need of modern civilization.*" (United States Department of State, 1933, p. 673)

Keynes: "*President Roosevelt is magnificently right.*" (in Schlesinger [1958] 2003a, p. 223)

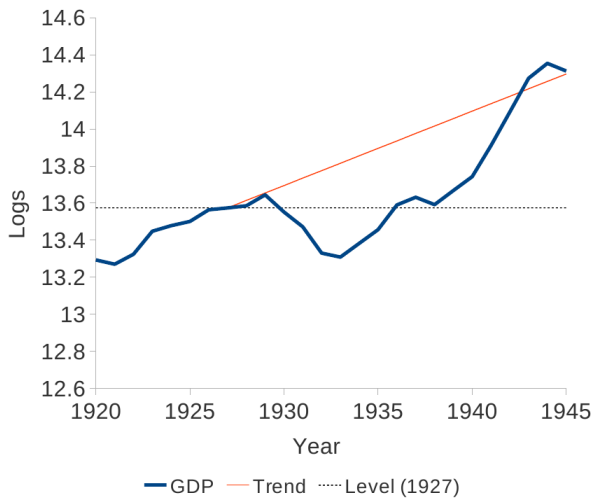
July 3, 1933: Roosevelt's "Bombshell Message"

- Roosevelt: "*So too,* **old fetishes** *of so-called international bankers are being replaced by efforts to plan national currencies with the objective of giving these currencies a continuing purchasing power which does not greatly vary in terms of the commodities and need of modern civilization.*"
- Schumpeter's [1954] (1984) defense of the gold standard: "*At present we are taught to look upon such a policy as wholly erroneous - as* **a sort of fetishism** *that is impervious to rational argument.* [...] *An 'automatic' gold currency is part and parcel of a laissez-faire and free-trade economy.* [...] *It is extremely sensitive* [...] *to precisely all those policies that violate the principles of economic liberalism.*"

New Deal Recovery

"*The recovery of the United States from the Great Depression has been alternatively described as very fast and very slow.*" (Romer, 1993, p. 34)

- Growth rates: industrial production increases by 79 per cent between March 1933 and July 1937
- Levels: GNP stays below pre-Depression level until 1937 and pre-Depression growth path until 1942



GDP (1990 Geary-Khamis Dollars); Trend: average growth rate 1921-1927); Data Source: Maddison (2007)