

Breaking from Orthodoxy: Responses to the Great Depression

Lecture Outline

- Pre-1929 Orthodoxy
 - Laissez Faire
 - Self-correcting business cycles
 - Liquidationism in the early 1930s
 - Golden Fetters
- Keynes and the countercyclical demand management
 - Investors “expectations” and problems of orthodoxy
 - New role for monetary and fiscal policy
- Summary of national responses
 - Autarchic-Authoritarian (variants in Latin America, Central, South, Eastern Europe, Soviet Union)
 - Social-Democratic (variants in Scandinavia and U.S.)

Orthodoxy

- Pre-1929 orthodoxy (prevailing wisdom) was that economy was self-correcting. Rested on:
 - **Laissez faire** doctrine traced to A. Smith that opposed governmental regulation of or interference in the economy beyond the minimum necessary for a free-enterprise system to operate according to its own economic “laws.”
 - **Business cycles** - alternating periods of economic growth (recovery) and decline (recession) - were a natural part of the economy
 - “Recession” of the 1930s had to follow inevitably from the recovery of the 1920s. In the 1930, prices and wages had to fall from levels reached during the 1920s
 - Orthodoxy attributed the severity of Depression to the excesses of the boom that preceded it (“Roaring Twenties”). Liquidationists (e.g. Treasury Sec Mellon) argued that economy had to liquidate all the bad investments, bad loans, and useless products before recovery could take place.

Orthodoxy (cont.)

- How should the govt respond to the deflation, unemployment, negative growth? Do nothing.
 - Once prices fell far enough, consumers would start buying
 - Once wages got low enough, capitalists would start hiring back workers
 - As prices and wages dropped, demand would rise, until balance was restored
 - All this was fairly true before 1929 (Figure 1).
- But economies did not recover. Prices, wages, and employment kept falling but demand did not increase (Figure 2).
- What was wrong with Orthodoxy?

Breaking from Orthodoxy

- John Maynard Keynes figured it out in his *General Theory of Employment, Interest, and Money* (1936)
 - Investment was at the center of Keynes' view. Orthodoxy said that investors responded simply to profit opportunities: if wages got low enough, new investment would be forthcoming and the economy would revive.
 - But Keynes understood that investment depended also on expectations of the behavior of others. No individual capitalist would expand his factory if there was no serious prospect of demand for the new products, no matter how low wages or interest rates went.
 - Generalize this expectation to all capitalists and economies can get stuck in depression. With all capitalists expecting demand to stay low, factories stay idle, workers stay unemployed, and workers don't have income to consume products. Demand therefore stays low
 - A "vicious circle" created by investors acting rationally as individuals, but irrationally as a group. Implied a role for government to help shift investor expectations en masse.

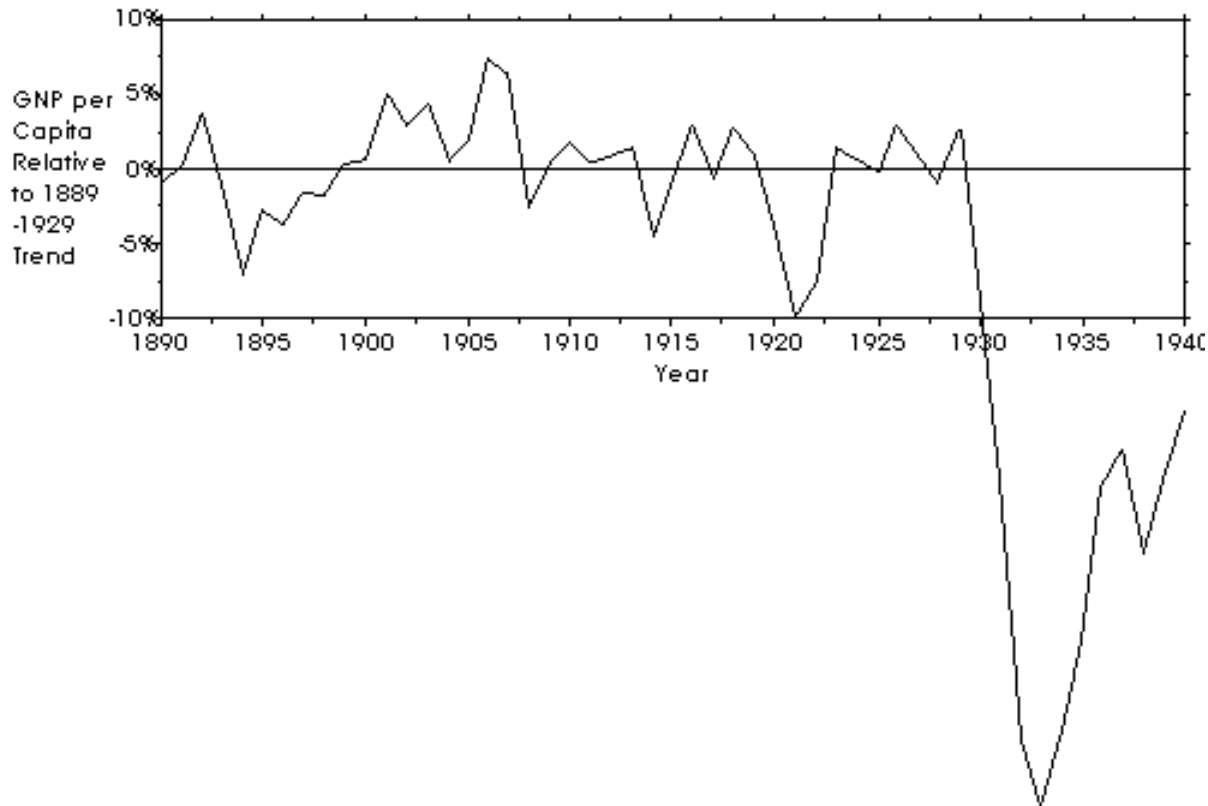
Breaking from Orthodoxy (cont.)

- Keynes saw a new role for government called countercyclical demand management
 - Govt would aim to reduce the amplitude of swings in the business cycle and the frequency of cyclical downturns. Govt would use two policies for this purpose:
 - Monetary policy to keep prices from falling or rising too much. Required breaking with Gold Standard (Figure 4)
 - Fiscal policy to use government spending and taxation to sustain the pace of economic activity
 - Keynes emphasized fiscal policy because interest rates might be pushed to zero and capitalists would still not invest if they expected demand to stay low
 - Fiscal policy stimulates demand directly: govt creates projects and hires workers (e.g New Deal programs (WPA etc.)

National Responses to the Depression

- **Responses to the Great Depression**
 - Autarchic-Authoritarian (common among debtors)
 - Developmental Nationalism (Latin America)
 - Fascism (South, East, and Central Europe)
 - Communism (Soviet Union)
 - Social-Democratic (common among creditors)
 - Scandinavian variant (e.g Sweden)
 - U.S. variant

Figure 1: U.S. Business Cycle, 1890-1940



- All other depressions and recessions are little more than ripples on the tide of ongoing economic growth.
- Great Depression is an order of magnitude larger than other depressions: it is off the scale
- The Great Depression cast the survival of the economic system, and the political order, into serious doubt.

Source: J. Bradford DeLong, “Slouching Towards Utopia?: The Economic History of the Twentieth Century” (forthcoming).

Figure 2: U.S. Unemployment Rate 1929-1940

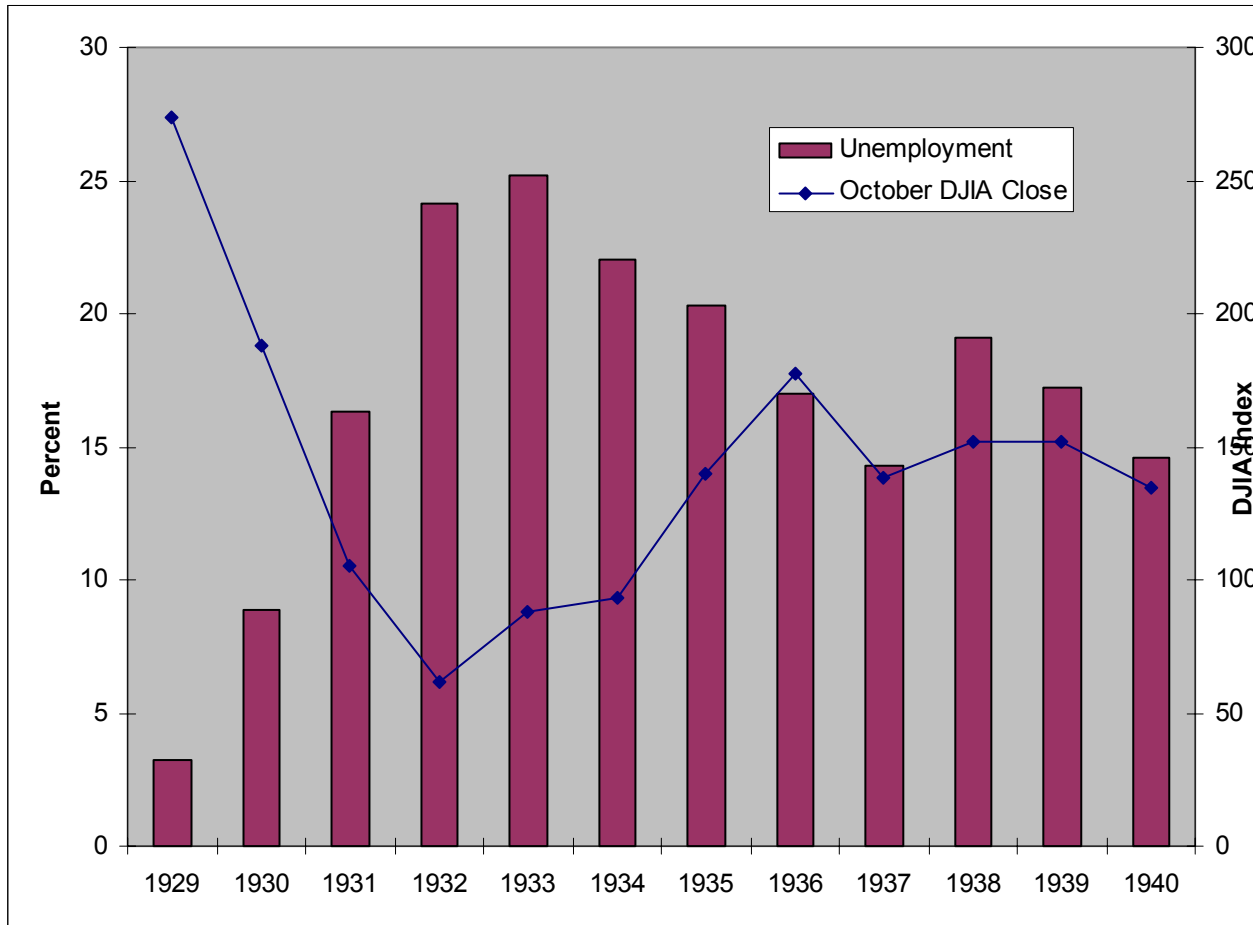
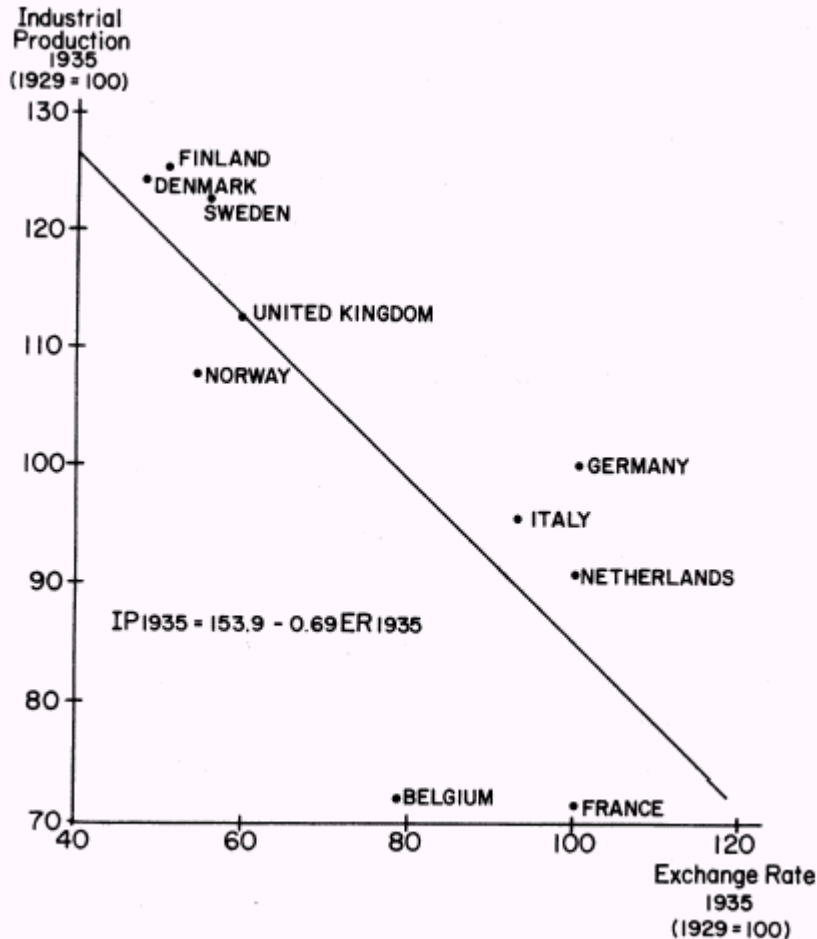


Figure 3: Golden Fetters, 1929-1935



Source: Barry Eichengreen and Jeffrey Sachs, "Exchange Rates and Economic Recovery in the 1930s," *Journal of Economic History* 45, 4 (Dec 1985).

- Golden Fetters on monetary policy: A govt that wished to stimulate demand in the Great Depression would seek 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 deficit: economic expansion at home was inconsistent with gold convertibility
- Indeed, nations that broke with the Gold Standard did better!
- The figure plots the % change in the exchange rate between 1929 and 1935 (horizontal axis) against the % change in industrial production. There's a negative relationship between the level of the exchange rate and the extent of recovery from the Depression