

# Global Financial Systems

## Chapter 2

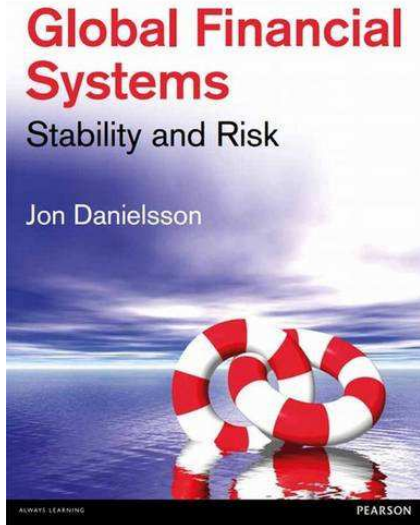
### Great Depression

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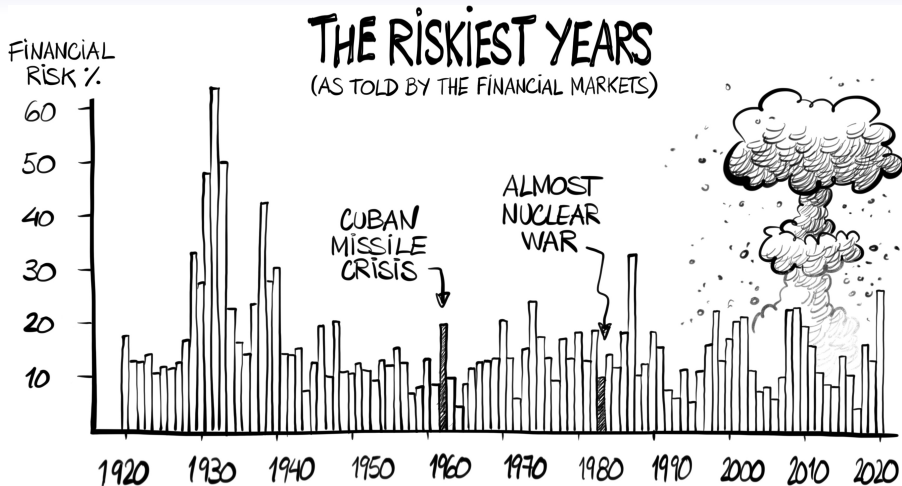
To accompany  
*Global Financial Systems: Stability and Risk*  
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## Book and slides



- Updated versions of the slides can be downloaded from the book web page [www.globalfinancialsystems.org](http://www.globalfinancialsystems.org)

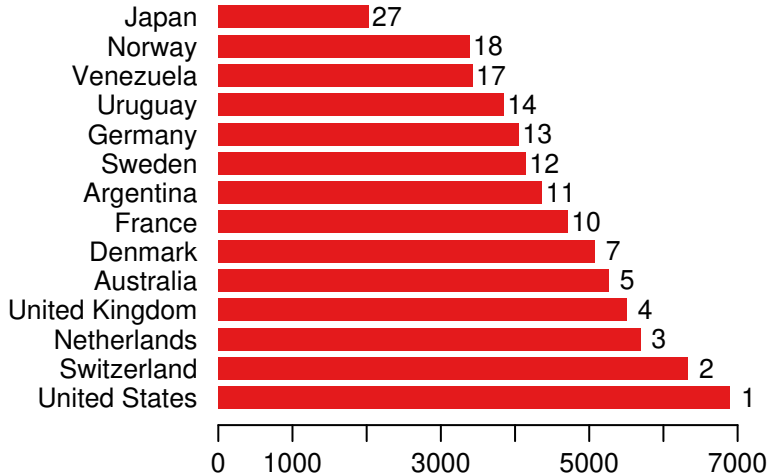


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## Relevance for today

- The biggest economic crisis the world has ever seen, before and since
- Clear policy mistakes were the reasons for the Depression
- Significantly changed how we see the economy
- And had a very strong impact on recent crises: 2008, Euro, Covid
- Europe and North America has pursued middle-of-the-road ( non-extreme) economic policies since then
- Are we now returning to the world as it used to be then? (status quo ex-ante)

# 1929 GDP per capita in constant 1990 dollars and global rank out of 52 countries



# The Roaring 1920s

Keep that phrase in mind, we have seen,  
and will see similar expressions

# The roaring 20s

- Rapid economic growth (with some interruptions)
- Positive demand shock after WWI and Spanish flu
- First time most people had access to markets
- Credit markets played a relatively minor role compared to now
- Rampant *stock market speculation*
  - Stocks bought *on margin*
  - Extremely high levels of *leverage* (often 10 times)
- Recession was starting in 1929

## Currencies

- Germany back on the gold standard in August 1924 after its hyperinflation
- Disastrous attempts to *turn back the clock* (UK, May 1925), next slide
- France suffered instability and speculative attacks (1923–1924), then stabilized but *too low a rate*
- The relative overvaluation of pound and undervaluation of the franc caused serious frictions (discussed along with currency wars elsewhere)
- France operated a sensible policy for its own objectives not considering the stability of the system or indeed French capital abroad
- Lessons for thinking about countries that either keep the currency artificially low or are accused of doing that (we discuss this in the chapter on FX)



## UK's mistake

- The Chancellor of the Exchequer, Winston Churchill, on the advice of the Bank of England, and against the advice of Keynes, put the UK on the gold standard at *prewar parity* in 1925
- Britain had suffered 40% inflation, sterling was hence significantly overvalued
- Continuous recession and austerity ensued until Britain gave up in 1931
- After which its economy boomed
- This episode has strong echoes today — Is the euro too strong for weaker euro zone members?

# Deflation

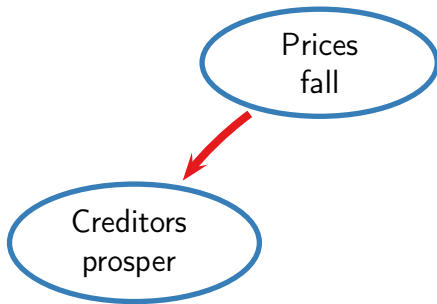
- Deflation was a major problem in the 1920s and 30s
- A major culprit was the gold standard
  - note echoes to the euro
- Deflation is much more costly than inflation

# Deflationary cycle

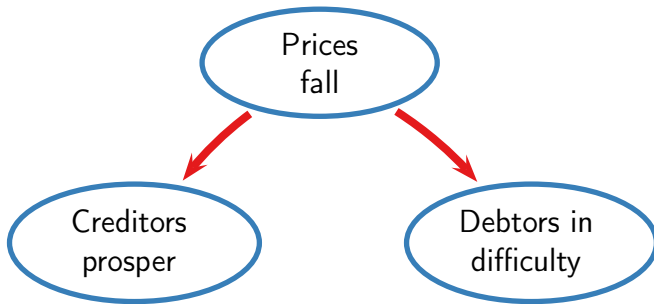


Prices  
fall

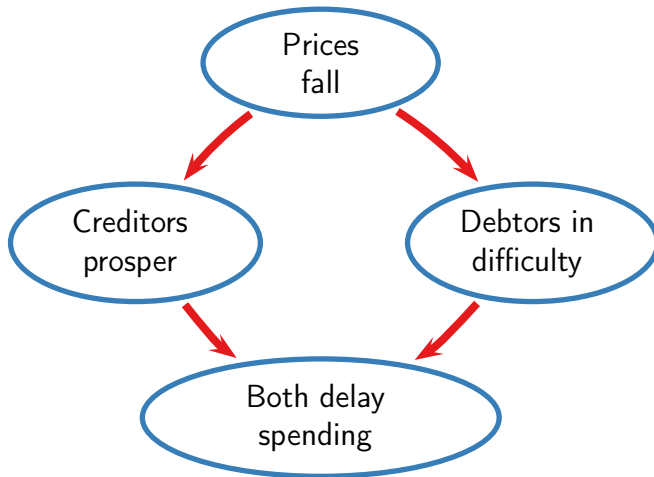
## Deflationary cycle



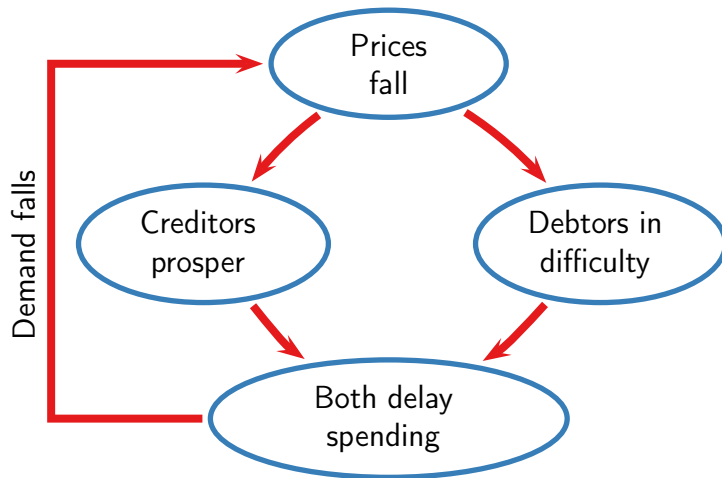
## Deflationary cycle



## Deflationary cycle



## Deflationary cycle



# Agriculture

- Agriculture ceased to be important in industrialized countries from the mid-1850s
- However farming accounted for a quarter of total employment in the US, and was important for many countries like Canada, Argentina, Australia, Italy, etc.
- Overproduction due to restoration of production in Europe whilst production increased elsewhere during wartime
  - Prices dropped 30% from 1925 to June 1929, 9% in the second part of 1929
  - Stockpile increased by 75% in the same period
  - Eventually they had to be sold, depressing prices further



# Competitive depreciations

- If your export sector is in difficulty do you devalue?
  - The hope is to get more domestic money coming in from selling to foreigners without domestic costs — like salaries and interest payments — going up
- Problem is that it was a buyers *not* sellers market
- Highly inelastic demand
  - FX depreciation does not raise prices at home but lowers them abroad
- So the country is worse off
- And everybody is doing it the world is worse off

# Deflation

- Depreciations were deflationary
- Hard to prevent, if one country cut back on supply, benefit reaped by others
- Deflation spread from commodity to commodity
- Positions of banks and insurance companies loaded with mortgages weakened

Surpluses, liquidity crisis, FX depreciation, bank failure, money collapse

# Stock market and capital flows

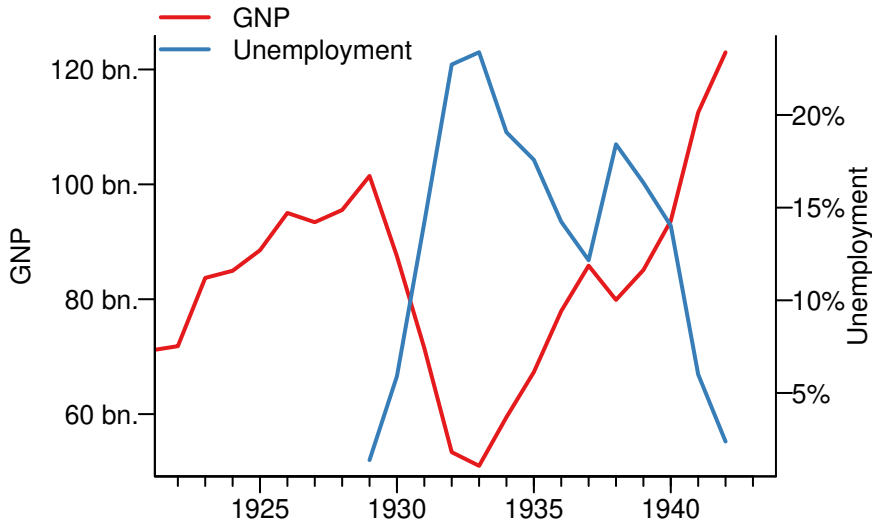
- An increasing amount of US (and global) capital went into the US stock market
- Fed worried that rampant speculation was diverting money from productive uses
- It tightened monetary policy
- US stopped exporting capital
- This caused problems elsewhere, countries lost gold and had to raise interest rates

## US monetary policy

- An important decision was taken following a conference in July 1927 to cut US interest rates
- Objectives were to help the UK
- And support agriculture
- May have been appropriate for the non-financial sector in the US but was highly stimulating for the stock market (echoes of the *Greenspan put*)
- Opposite monetary policy needed for the two main policy objectives

# Great Depression

# US GNP in constant prices and unemployment



## 1929 stock market crash

- European markets turned down earlier:
  - Germany 1927, UK 1928, France February 1929, Austria waited until 1931
- But the main place was New York
- Where prices and volume doubled in two years
- The main danger was not the prices or volume but its dependence on the credit markets and its influence on credit around the world
- But business was slipping, business cycle peaked in June 1929 in US, April in Germany, July in UK

## Dow Jones





# Schadenfreude

(pleasure at the misfortune of others)

- After the excesses of the previous years, people cheered
- It was the bankers that suffered
- They got what they deserved
- Banks allowed to fail

## Liquidity support after crash

- Immediately after the crash the New York Fed provided over \$1 billion in liquidity support to banks
- Prevented the otherwise inevitable bank crisis
- But generally the governors of the Fed opposed liquidity support — maintaining the bubble had been caused by too much credit and further easing would be disastrous
- And the Fed stopped easing in early 1930, when the economy was taking a turn for the worse
- Note relevance for today's policy debate

## Banking crisis in Europe

- The French government *encourages* French banks to pull money out of Austria to prevent a pending customs union between Austria and Germany (narrow political considerations)
- Run on Credit Anstalt in Austria, becomes a *run on Austria*
- Bank crisis spills over to *Germany*
- And eventually to *UK* which starts losing gold
- Incompatibility between gold standard and lending of last resort
- Countries with large reserves should act responsibly

## Banking crisis in US

- Peculiar structure of US banking system, narrow banking
- No bank crisis in the US until December 1930, *Bank of United States* bank run
- No help given
- *Confidence in banks was undermined*. People could not tell if a bank was sound and started pulling their money out
- Domino effects as loans are called, scramble for liquidity
- Bank credit collapses — money supply contracts

## Government reaction

- The Fed increasingly demoralized and unable to offer response
- *Contracts money supply* in January 1933!
- Open market committee does not meet in February (when the worst was happening)
- President Hoover requests suggestions from the Governors of the Fed on February 25, receives none
- *Bank holidays* become widespread
- Difficulties because Hoover was on the way out and Roosevelt had not taken power
- Nobody in a position to make decisions

# Causes of the Depression

# Causes of the Depression

- Main causes
  - trade policy
  - monetary policy
- Other causes, including:
  - lack of global leadership
  - lack of international cooperation and narrow focus on national interests
  - (do these two sound familiar today?)
  - foreign exchange instability
  - bank failures

# Trade



# Tariffs

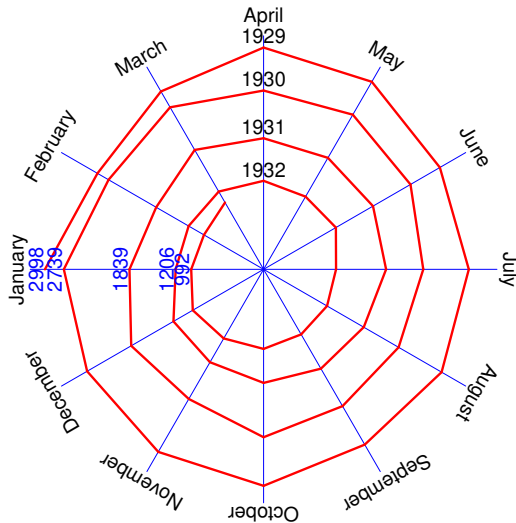
## Tariffs increased in the 1920s

- Protect against FX devaluations
- Many international conferences tried to prevent this but to no avail
- Republicans in the US strongly pro tariffs (are they returning to that now?)
- Conservatives in the UK strongly pro empire preference (are they returning to that now?)

## Trade restrictions

- *Smoot–Hawley* passed the US House of Representatives on May 1929, signed into law June 1930.
  - Let loose wave of *retaliations* (and *opportunistic* copying)
- Most trade seized
- Countries ran into serious difficulties because they could not export
- Result was that everybody was much worse off

# Reduction in global trade 1929 – March 1933



## Reduction in trade 1929–1933

Over 80% Chile

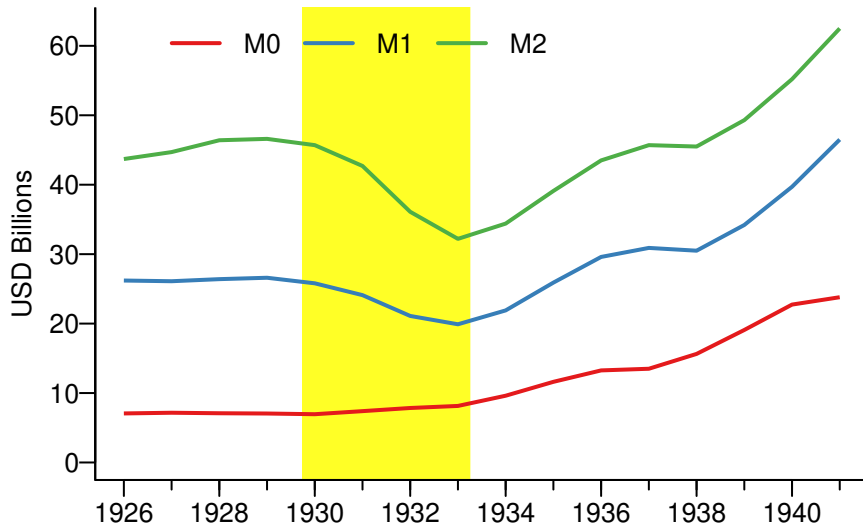
70%-80% Cuba, China, Peru,...

60%-70% Netherlands, Greece, Brazil, Estonia, Spain,...

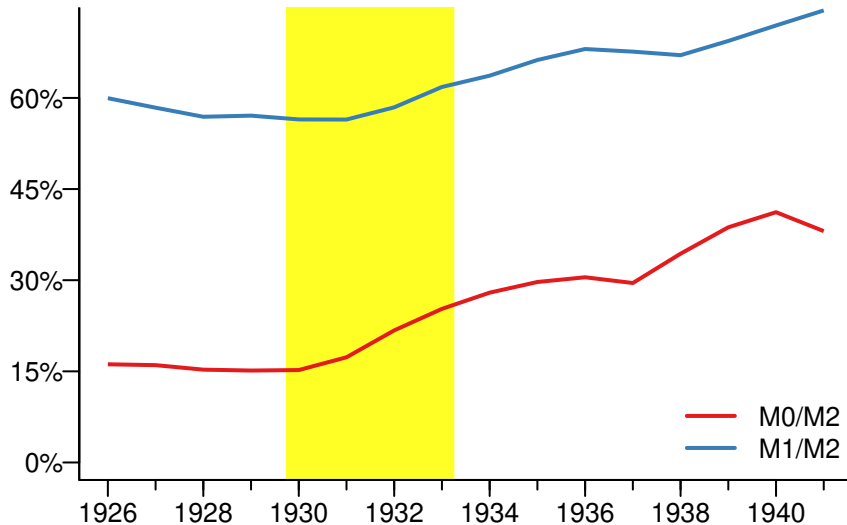
50%-60% Denmark, New Zealand, Finland, Columbia,...

# Liquidity and Money

## US money supply 1926–1941



## And ratios to M2



# Policy

- Reconstruction Finance Corporation late 1932, for bail-outs
- Speaker of the House insisted banks using the fund should be *publicly identified*
- That caused runs, so others stopped applying
- Important argument for *support to be secret*
- By February 1933, widespread bank closures
- Fed refused in March 1933 to sign off a federal guarantee for bank deposits
- Then President Roosevelt shut every bank in America for more than a week



# Friedman & Schwartz critique

## Mistakes of the Fed

1. It did too little to counteract the credit contraction caused by failing banks.
2. The Fed actually *reduced* credit between December 1930 and April 1931.

The conclusion of Friedman and Schwartz has *significantly influenced policymaking in the ongoing crisis*, and is a key reason why central banks have provided significant amounts of QE

# Lack of global coordination

- Many meetings, producing little
- Focus on narrow national interests
- In a globalized economy, the main economic powers need to cooperate closely

# War debt and reparations — April 1929 conference in Paris

- France insisted on reparation payments even if Germany had no ability to pay

“Almost all the great powers have been negotiating for months about how many billions a year should be paid until 1966, and thereafter until 1988, by a country that is not even in a position to pay its own civil servants’ salaries the next day”

Felix Somary in report to the SNB

# Parallels with Today

# Influence of the Depression

- Many international institutions, policy, rules and regulations and responses derive from the Depression
  - Bretton–Woods (IMF and WB)
- US took a leading role in maintaining the international order
- The policy response to the crisis since 2007 directly draws from the Depression lessons

# Trade

- GATT and then WTO established to prevent recurrence
- Even if a single country objected, it could not undermine the arrangement
- That is now under threat
- Are 1920s/30s type trade wars more likely?

## 1929 and 2007

- Currency wars common then, mostly prevented now, but one is building up
- International coordination seriously lacking in the Depression, very effective now
- Widespread bank failures then, not now
- Liquidity contracts (in the US), massively expanded now
- Broadly speaking governments are cooperating
- Banking is maintained
- Trade restrictions are avoided
- Liquidity is supplied
- Extensive cooperation

Thus the crisis did not become the Great Depression

## Are we going back?

- Attacks on the international order makes that more likely
- United States is retrenching
- China is making its own world order
- Is the post WWII setup and stability an anomaly?
- Is so Trump and Brexit and the all the rest a reversion to steady state?
- Is Covid-19, Ukraine war and inflation symptomatic or accelerating this development?
- That is, we are going back to the instability before WWII
- The lessons discussed in this chapter then become especially important