

Clicker quiz: What happens when you are in a balance of payments deficit and you are tied to the gold standard?

- A. You deflate your economy and reduce imports
- B. You borrow money to pay for imports and hope your economy will get better

How could another Depression be Avoided?

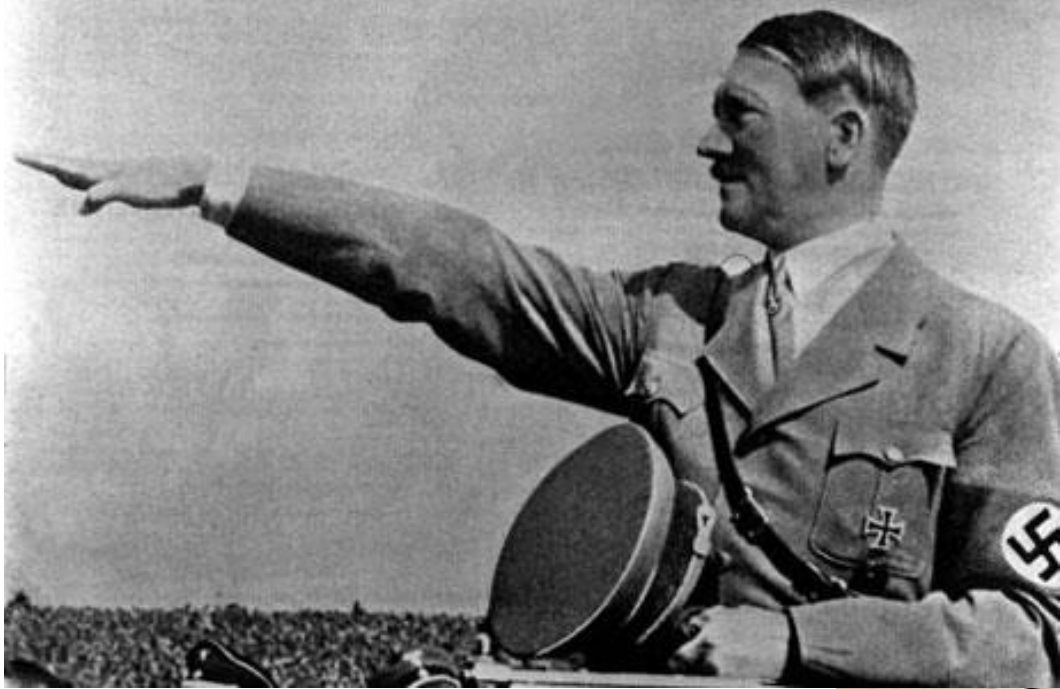
Session 15: Macroeconomics and
Hegemonic Leadership

The Great Depression showed that the liberalism was too risky for governments—democracies failed

The business cycle

The Gold Standard

The Rise of nationalism



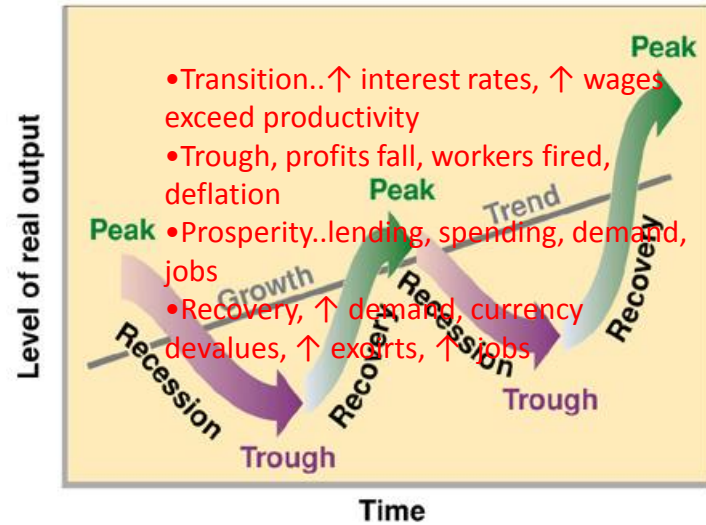
War and Genocide



Marxist and explanations for the Great Depression

– Liberal Explanations

- Peak: employment, easy credit, expansion
- Prosperity..lending, spending, demand, jobs
- Overheated economy (demand outstrips supply) leads to higher prices (inflation)
- Transition.. ↑ interest rates, to dampen inflation leads to reduced investments, jobs
- Trough, profits fall, workers fired, deflation
- Recovery, currency devalues, ↑ demand, ↑ exports, ↑ jobs



• Marxist explanations

- Exploit others
- Grow or Die
- Contradiction: exploitation decreases consumption which hampers growth
- Overproduction and Underconsumption

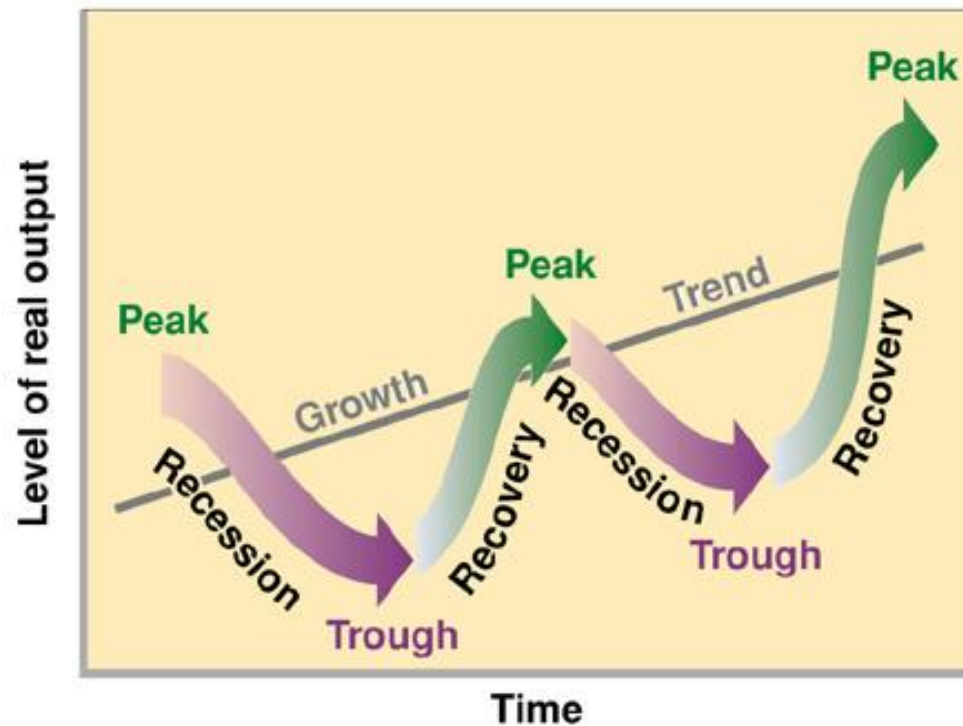
Capitalist exploitation

Wage suppression +
concentration +
expansion

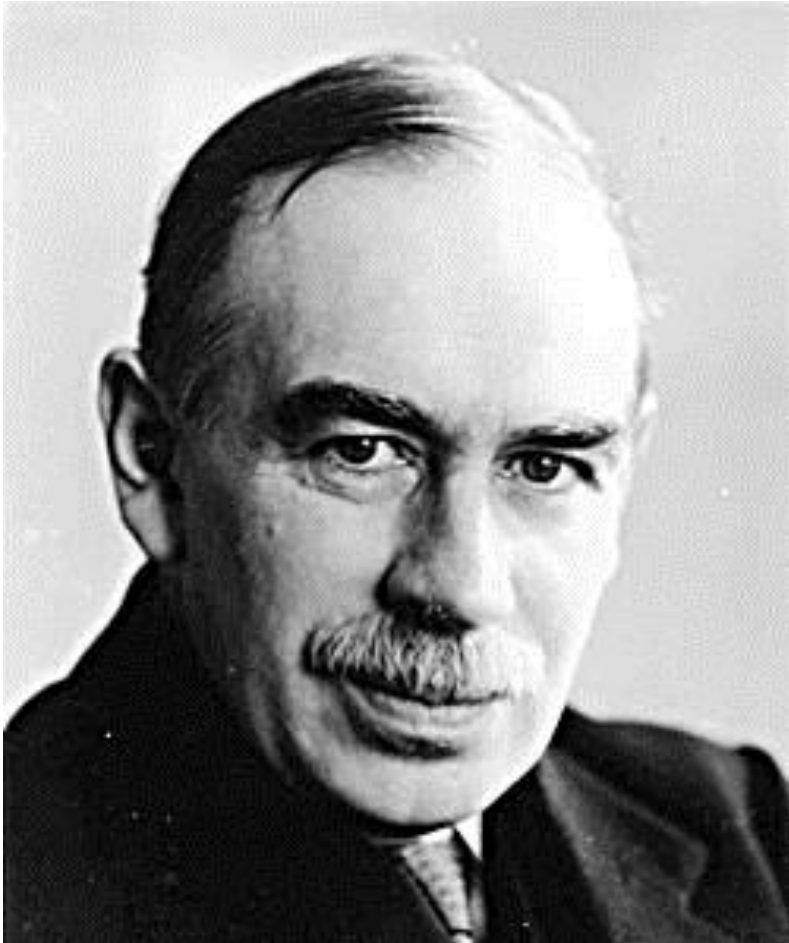
Inevitable decline or
revolution (the ultimate
double movement)

Could this have been avoided? Could Liberalism have been saved?

- Domestic salvation: Macroeconomic Policy
- International salvation: Hegemonic Stability



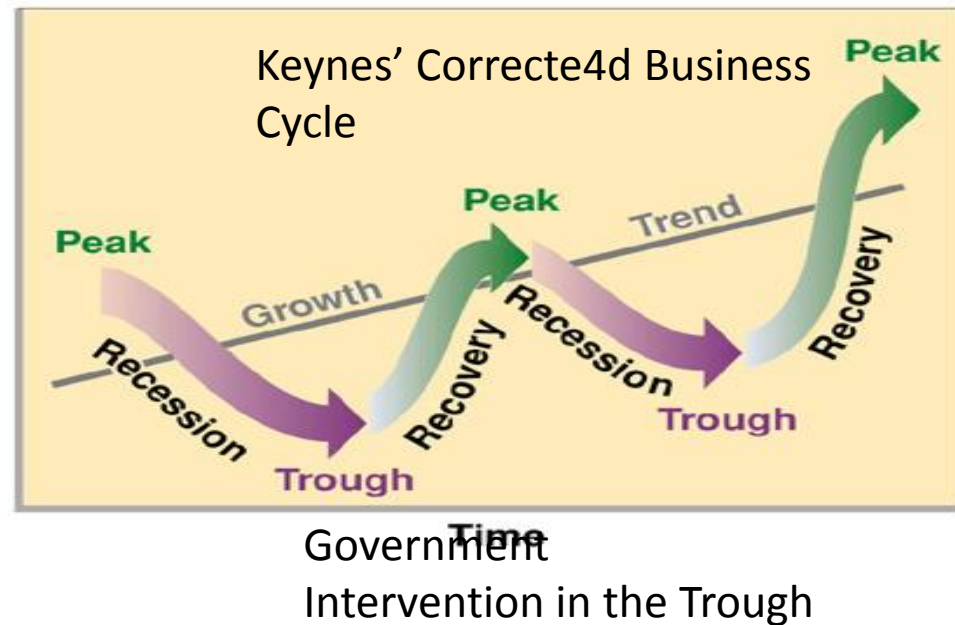
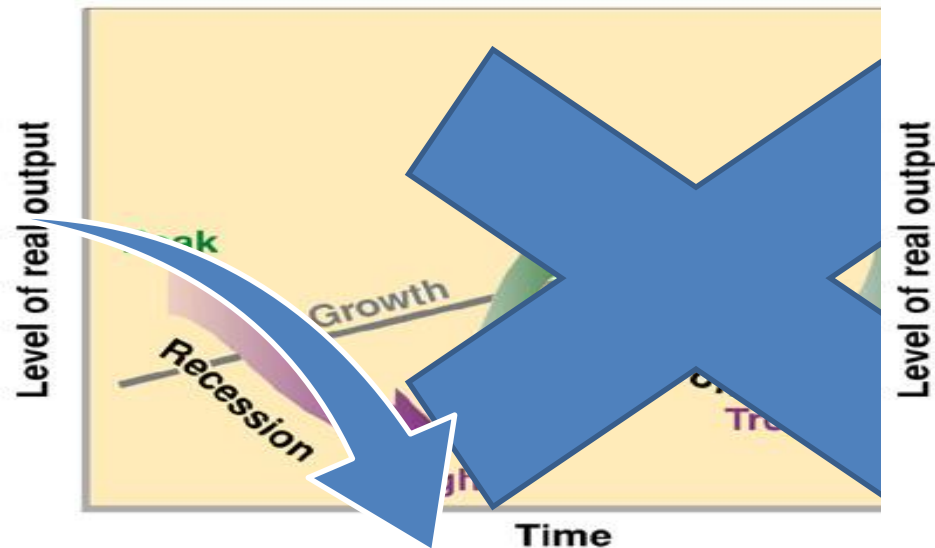
The Keynesian Solution: The Government creates demand



- Individuals are rational but they also want stability
- But Markets are irrational and unstable
- Markets can't provide economic stability
- Economic instability leads to political instability

Keynes and the Limits of the Market

- ↓ employment -> ↓ Demand -> No Market correction and spiral downward
 - ↓ employment -> ↓ Demand -> **Govt. intervention** → ↑ Employment
- Liberal Business Cycle Model is Wrong!



The government creates aggregate demand

- Social insurance: permits those not working to create demand in the economy
- Governments provide bank guarantees to encourage savings and investment
- The government itself creates demand
- Adds up to this: Government intervenes in the “trough” of the business cycle to take over financial institutions and even industry

But still....Free Trade tends to undermine these new roles for the state

- Inefficient industries must fail!
- Employment must fluctuate with supply and demand for labor
- Macroeconomic policies help failing industries and labor
- Efficiency declines and comparative advantage declines
- **If they leave their economies open, what would happen to government policies creating aggregate demand?**
- **And If they create aggregate demand, what happens to Free Trade?**

If they left their economies open, what would happen to Keynesian Macroeconomic policy?

- Open international economy requires trade to balance so that states pay for what they buy from others and get paid for what they sell. So.....
- \uparrow imports + \downarrow exports \rightarrow trade deficit \rightarrow need to pay up \rightarrow no credit? \rightarrow **deflate their economies**—i.e. raise interest rates \rightarrow inefficient economies fail + \downarrow access to credit \rightarrow bankruptcies, +unemployment \rightarrow \downarrow in income \rightarrow **so that imports would slow down \rightarrow trade payments would balance**

And with deficit spending to create demand, what happens to Free Trade?

- Deficit spending costs a lot
- Creates Big government
- Crowding out private investment and competition—distorting the market!
- Inefficiency, loss of comparative advantage
- Stagnant economy
- Balance of payment deficits
- Tendency toward economic nationalism

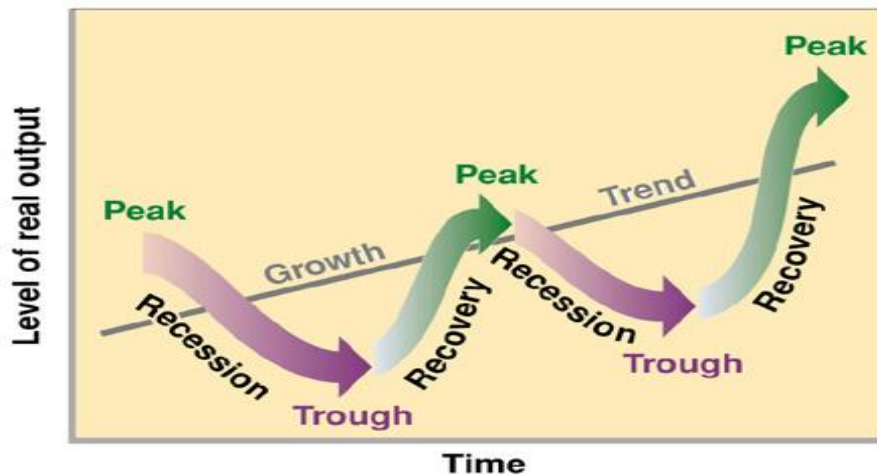
States can borrow to balance payments and keep economies open...

- **But In the “trough,” credit dries up**
- Deflation not possible w/ Keynesian deficit spending and comparative advantage is lost
- So instead.....
- \uparrow imports + \downarrow exports \rightarrow trade deficit \rightarrow need to pay up \rightarrow no credit? \rightarrow deplete reserves \rightarrow \downarrow confidence of others in currency value \downarrow currency value \rightarrow \uparrow exports \rightarrow competitive devaluations \rightarrow all want to export and no one wants to import \rightarrow all erect tariffs \rightarrow global economy closes

Tendency toward economic nationalism

Summary

- Market imperatives



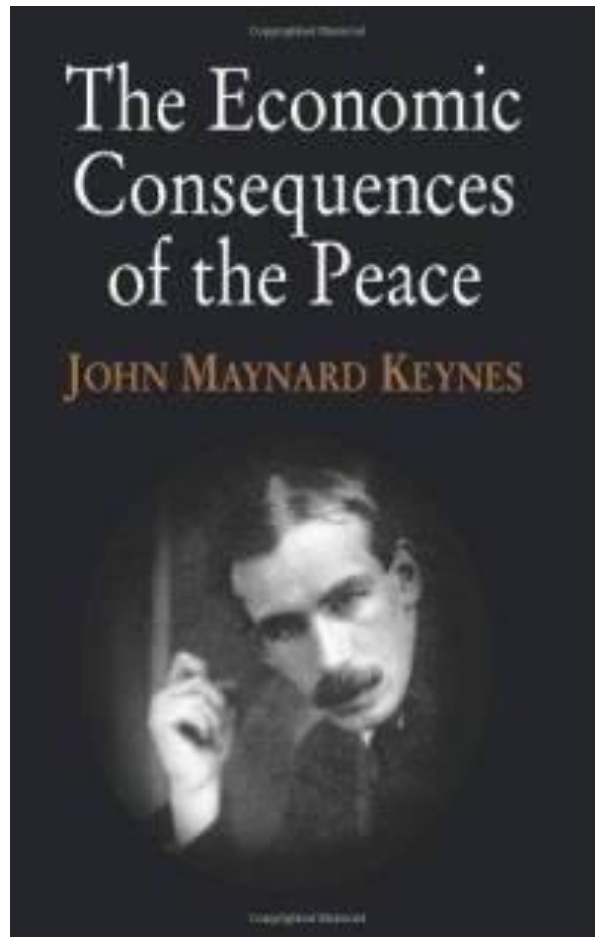
	Wine	Cloth	Total
Engl and	5	6	11
Port ugal	12	4	16
Total goods produced			27

- Political Imperatives
- Governments must intervene in markets but their countries lose comparative advantage

***Can* the contradiction be resolved to overcome economic nationalism?**

- **Can states open their markets AND preserve the political stability? What keeps their markets open in the “trough” of the business cycle?**
- **Open markets need currency stability + promise not to raise tariffs (defect from free trade cooperation)**
- **This will stimulate free trade and maintain stability of the domestic political economy says the liberal**
- **So....Stable politics AND free trade require:**
 - Credits for payment deficits
 - Markets for exports in downturns
 - lender of last resort when exports can't pay for imports
 - And all this enables economies to get back on their feet and be competitive in the international market

In the Great Depression, credit dried up.....and Keynes knew it would happen....but he had a solution!



- Spread of the Great Depression caused by the Versailles Peace Settlement of 1918: Reparations!
- Keynes: International Anarchy a deeper cause!
- Solution: Cancel War debts and create international institutions to loan money and tame anarchy!

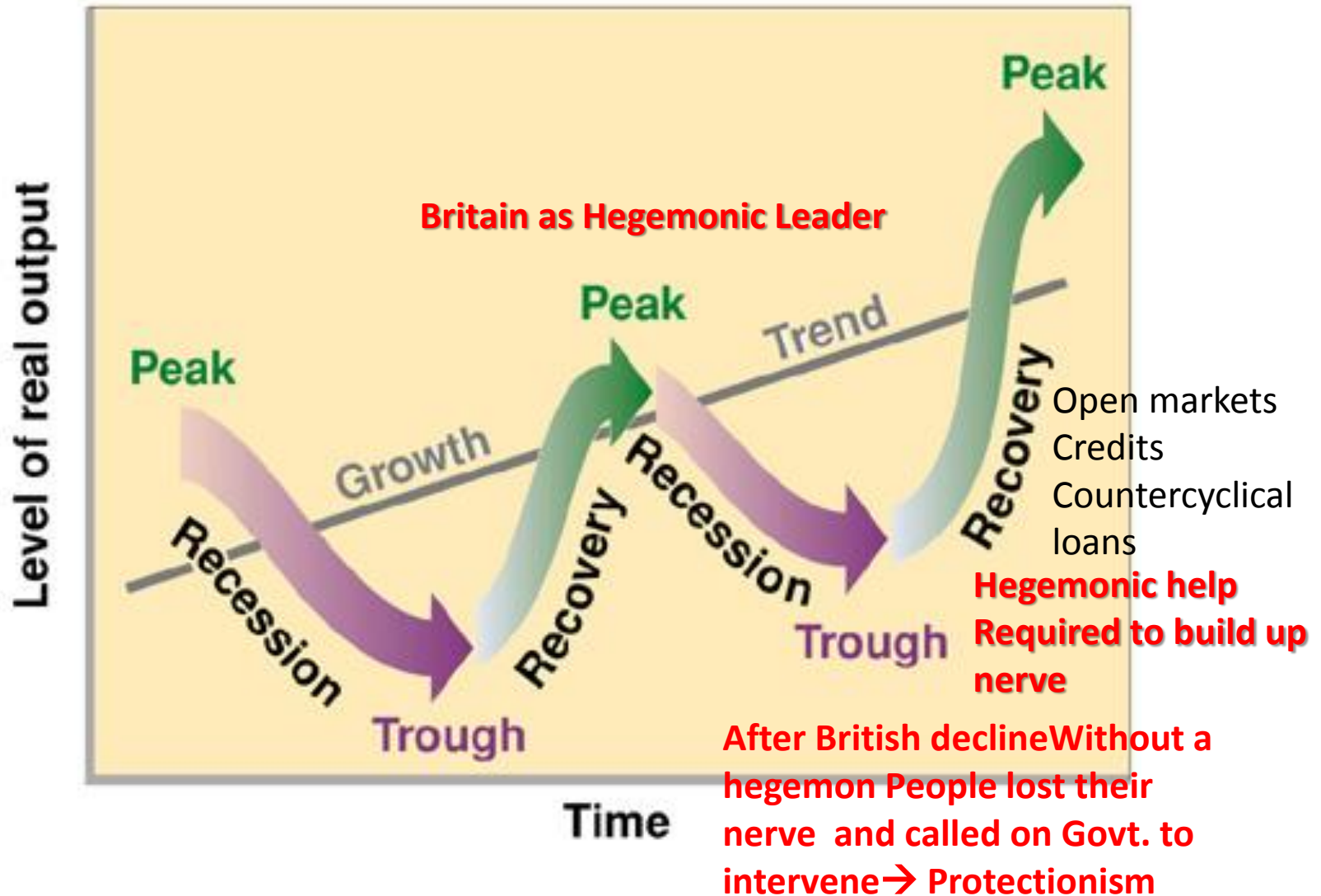
Kindelberger's solution: Liberal Hegemonic Leadership can do what Keynes wanted.....free trade cooperation and stable liberalism

- Hegemonic states have the resources to
 - Open markets even with a trade deficit
 - Extend credits to countries with payments deficits
 - Provide countercyclical lending and be a lender of last resort in the “trough”
- That softens the contradictions.....
- Many argue that a central source of the Great Depression in the 1930s was a lack of British leadership and the unwillingness of the U.S. to provide leadership in the world economy.

It takes power and willingness to be a liberal hegemon

- Britain had both.. the capability to
 - Extend credits for payment deficits
 - Offer a market for others' goods
 - Be a lender of last resort
- But then Britain began to decline
- And the US had the capability but not the willingness

Hypothetical Business Cycle with Liberal Hegemonic leadership



The End!

