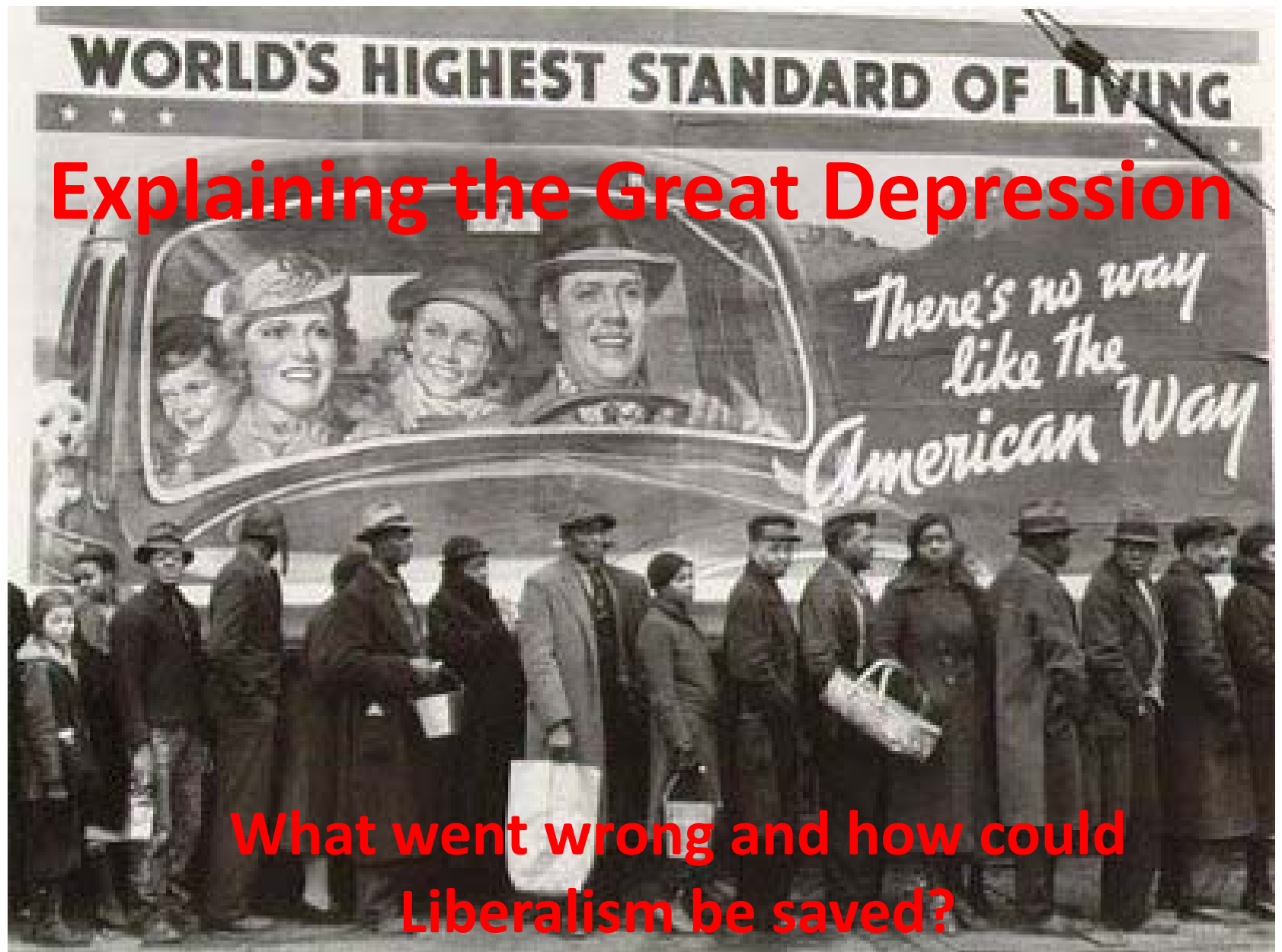


WORLD'S HIGHEST STANDARD OF LIVING

Explaining the Great Depression

*There's no way
like the
American Way*

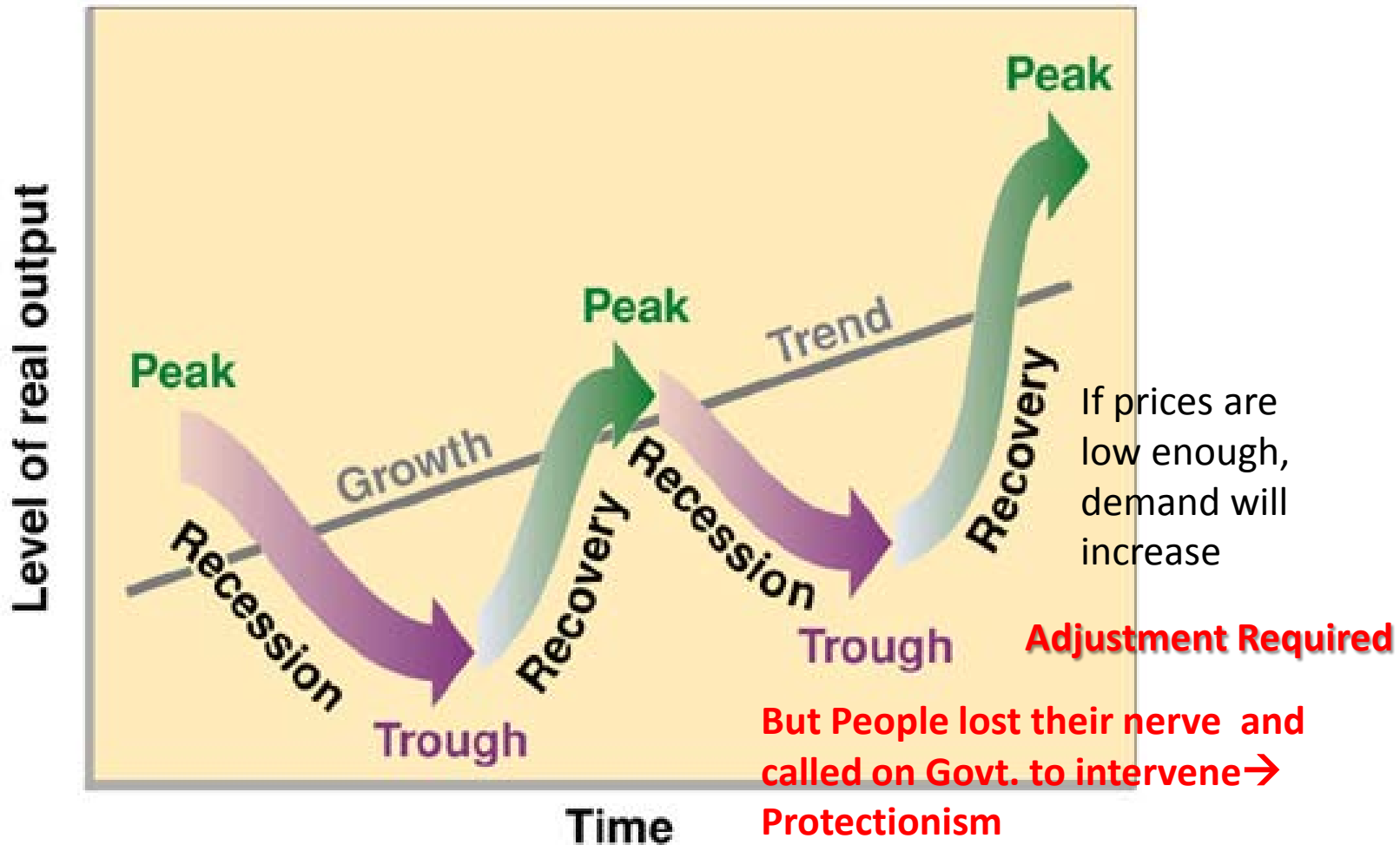
**What went wrong and how could
Liberalism be saved?**



Today's Menu

- Review
- I. Protectionism and its consequences
 - Tendency toward Economic Nationalism
 - Backlash: Extreme Community (Fascism) and War
- II. Explanations
- III. Domestic Solutions
 - Keynes repairs Liberalism
 - Four Freedoms
- IV. International Solution: Hegemonic Leadership

Liberals believed that Depression was low point in the Business Cycle



Market solution: “purge rottenness out of the system”

- After the 1929 crash, Treasury Secretary Andrew Mellon advised the government to cut spending to balance the budget, and leave desperate banks, businesses, and families to fend for themselves because the market alone would "purge the rottenness out of the system."

Role of the IDEAS of the classical liberals

- "... the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil." --John Maynard Keynes
- “There is nothing in the latest antics of the exchanges that requires modification of the views expressed last week by President Hoover and the Treasury Department—namely, that business conditions in the United States are basically sound and that the trend of industry and trade is likely to continue upward.”

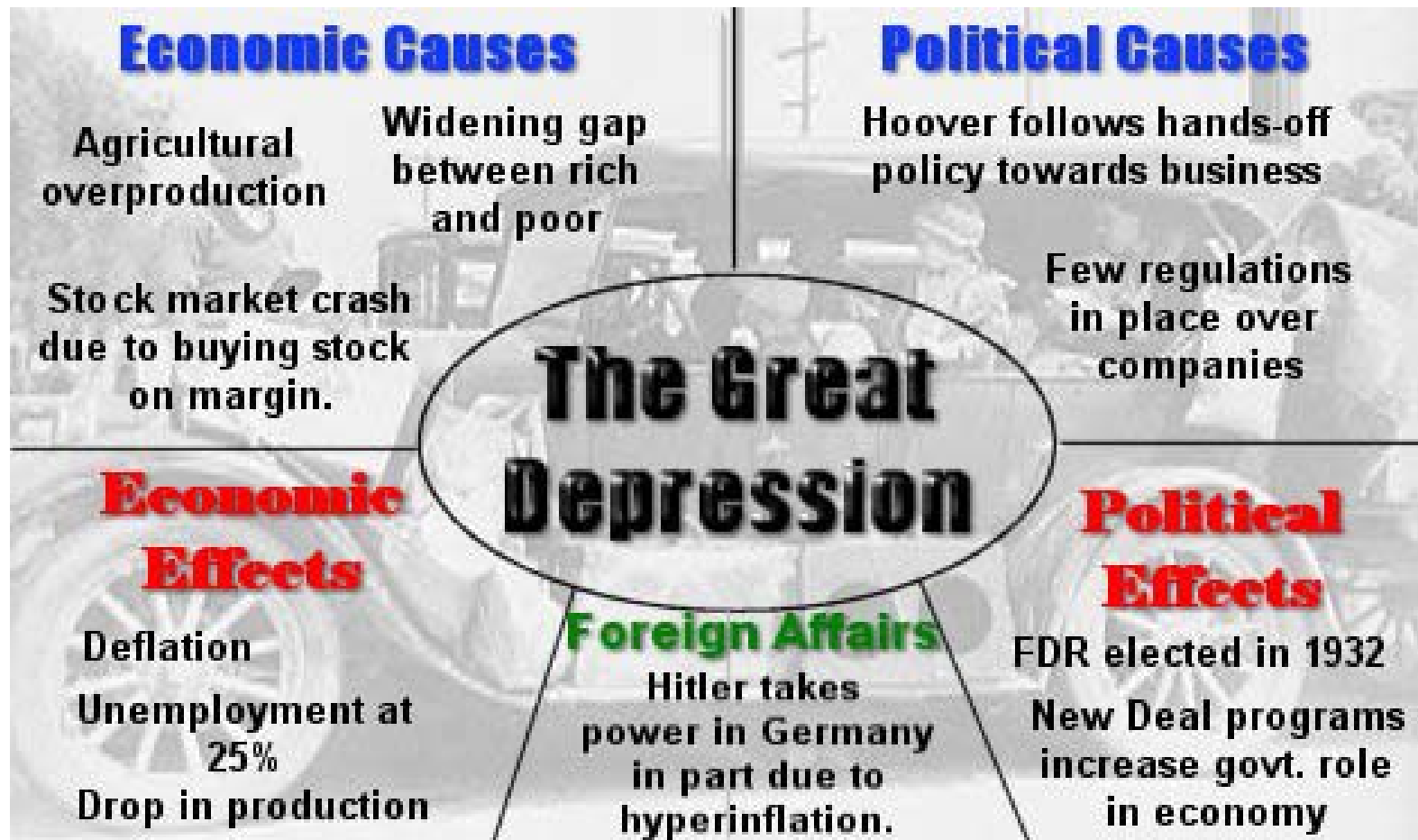
Chicago Daily News,
October 30, 1929

Stock Market Crash in October 1929

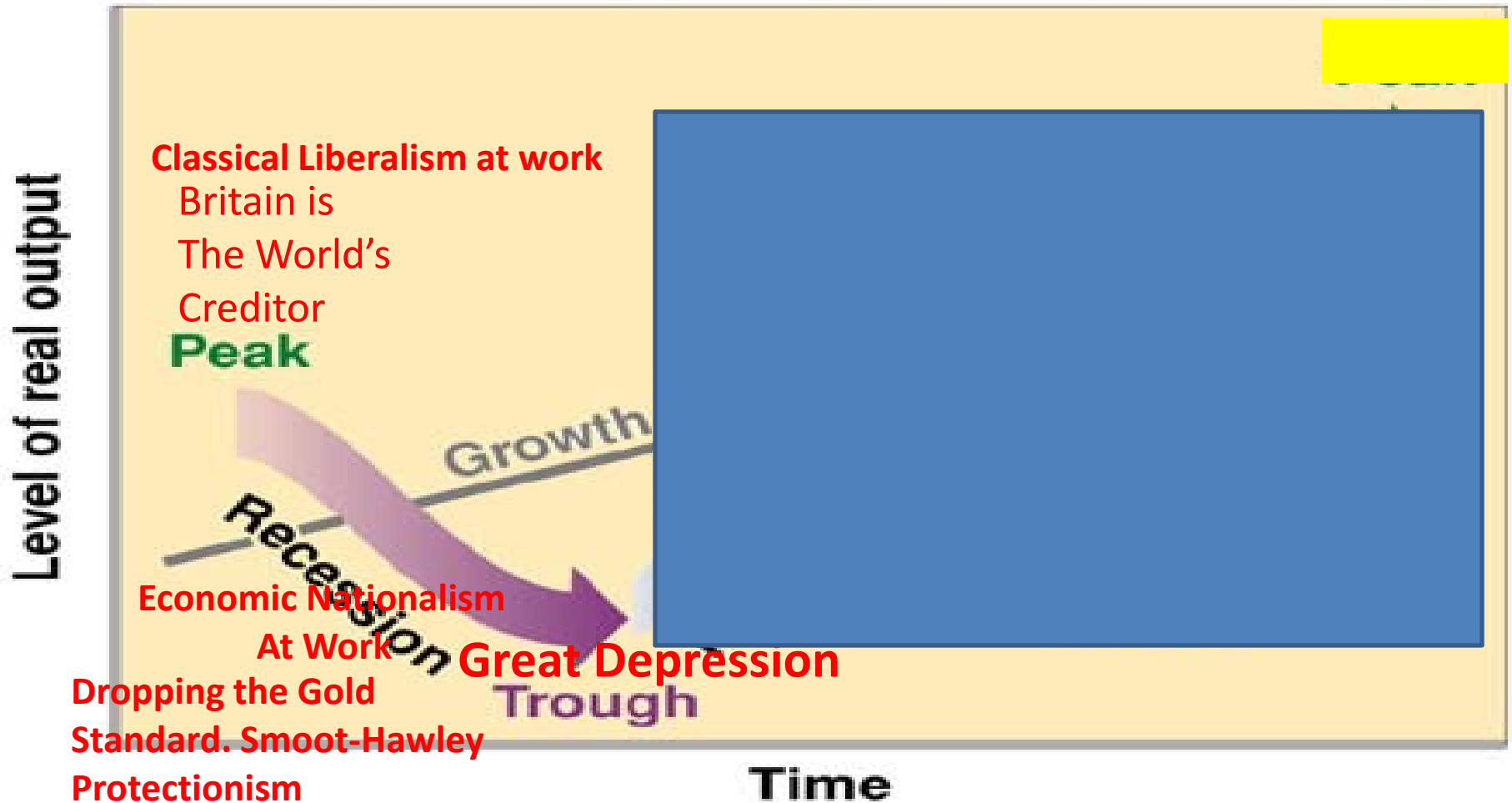
- During the stock market boom in 1920's, many individuals bought big houses with large mortgages.
- But, after the 1929 crash, companies went bankrupt, and unemployment reached historical high (25%).
- Many households could not repay the “balloon” at mortgage maturity.
- Then many banks and lending institutions went bankrupt.
- Therefore, the “balloon” structure of mortgage loans exaggerated the economic / financial crisis.



Resulting in The Failure of Classical Liberalism



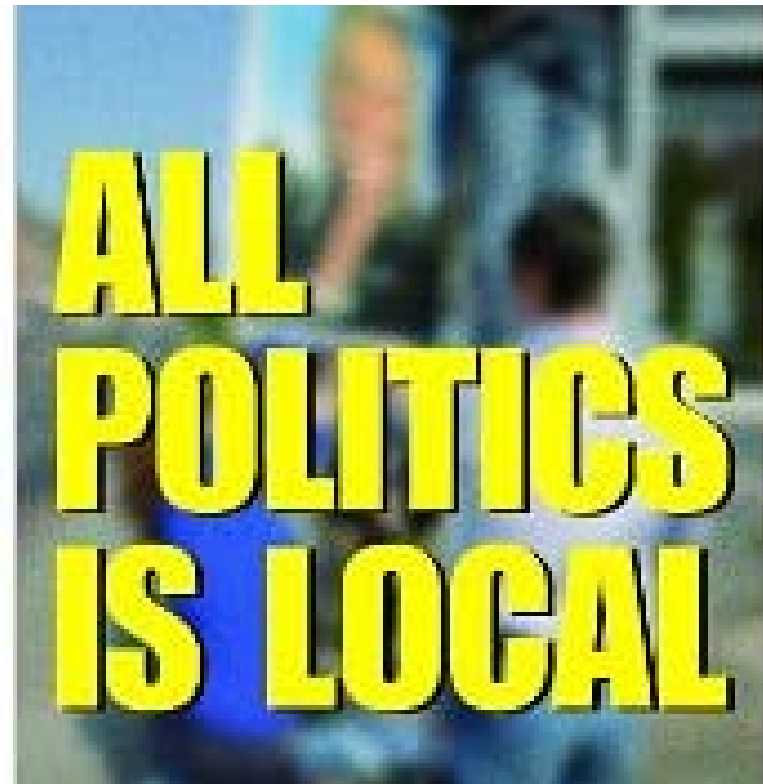
Economic Nationalism Replaced Liberalism



the tendency toward economic nationalism



Big contradiction between liberal international economy, state power, and stable political systems



Tendency toward Econ. Nationalism: market imperatives vs. needs of the national community

- Market imperatives
 - The business cycle: the economy inevitably moves to the trough
 - And even in the prosperity phase Free Trade creates losers and requires “adjustment”
 - Losers are free to fail
- Political Imperatives
 - Losers are Political actors
 - Nations and states need political and social stability—losers must have a safety net because they are citizens of the “nation”
 - The political need for stability and the requirements of the market are contradictory under the above conditions
- Governments must intervene in markets
 - to protect the “nation”
 - They can topple when society is unstable



The contradiction means a Tendency toward economic nationalism: a PD Game

	Cooperate (free trade)	Defect (protectionism)
cooperate	<p>5, 5 Comparative advantage Growth for all, I keep my market open even with BOP deficits because I know things will get better</p>	<p>0,3 I keep my market open but you close yours; I lose so eventually I will retaliate</p>
Defect (protectionism)	<p>3,0 You keep your market open, I close mine, I win, you lose and eventually you retaliate</p>	<p>1,1 We both close our markets; you close yours, I retaliate, you retaliate, and so on.....no more free trade</p>

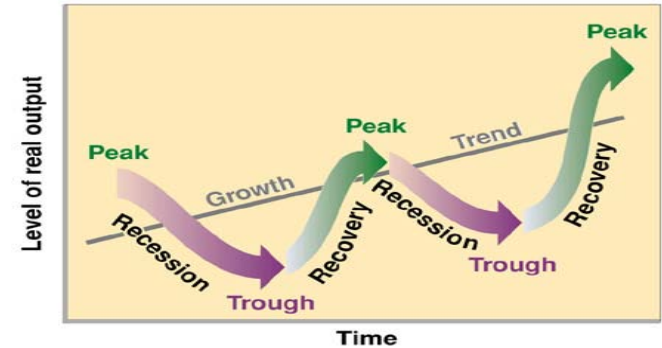
Contradictions between needs of the domestic political economy and the International economy

Is there a way out? Under the Gold Standard, states avoided the contradiction and **borrowed** to keep economies open

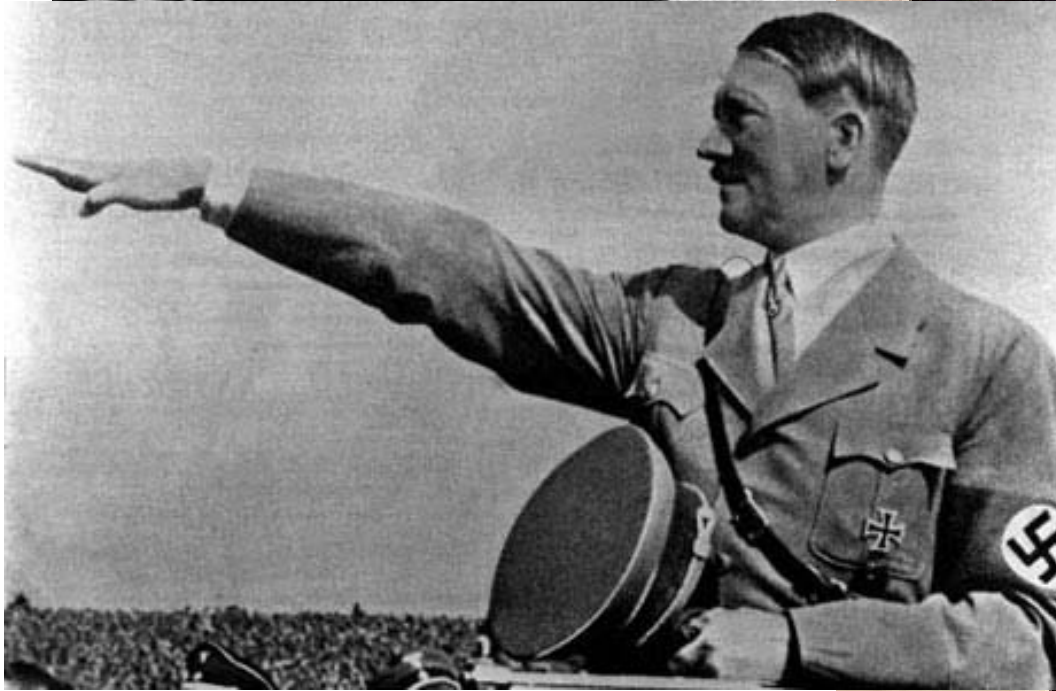
- But In the “trough,” credit dries up

- So instead.....

- \uparrow imports + \downarrow exports \rightarrow trade deficit \rightarrow need to pay up \rightarrow no credit? \rightarrow deplete gold reserves \rightarrow \downarrow confidence of others in currency value \rightarrow \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



The Great Depression showed that when credit dried up, the classical liberal response was too risky for governments



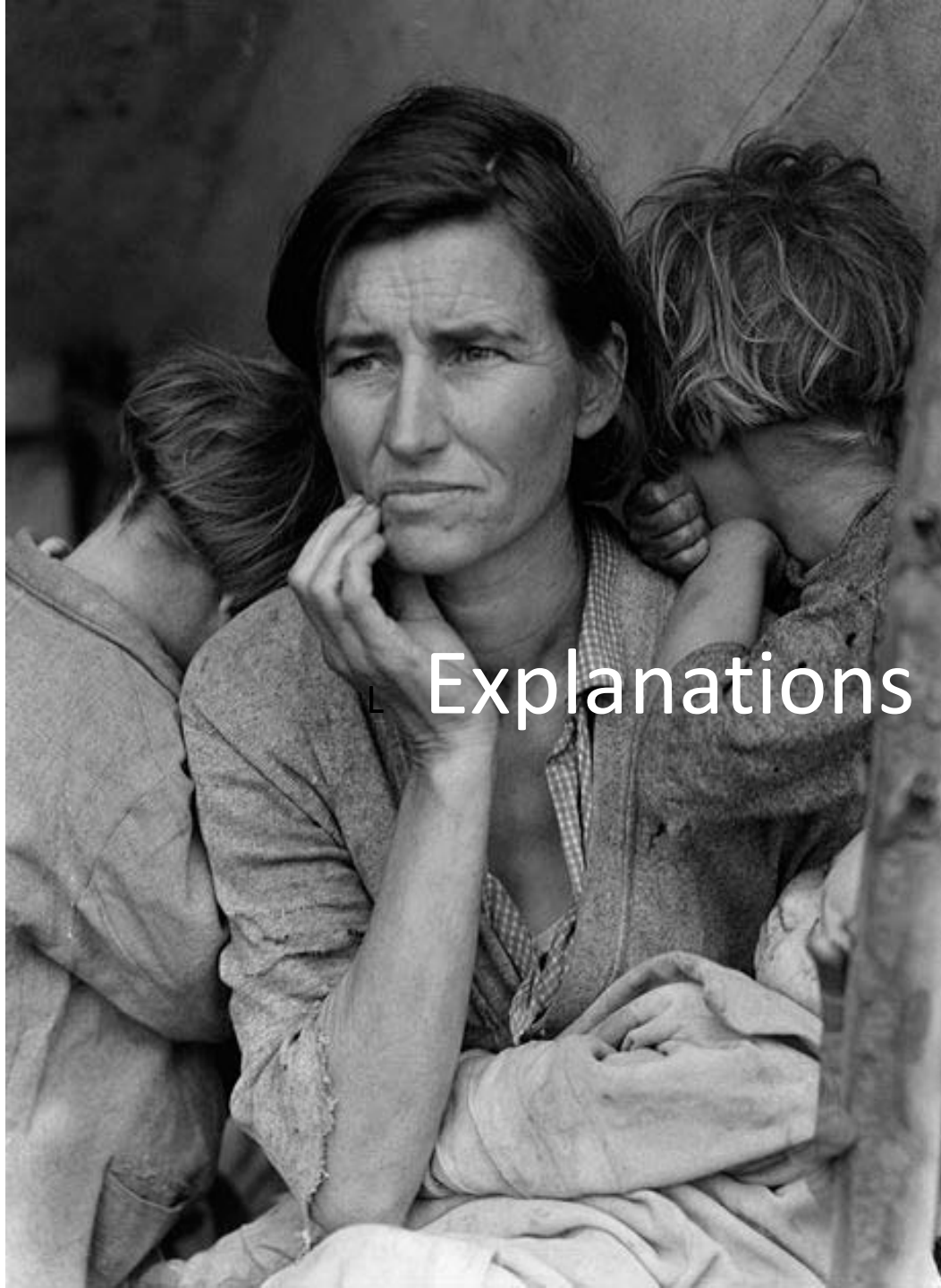
Rise of Fascism in Germany

- Fascism and the State
- State and Nation
 - Remove the opposition
 - Supreme rule by the state
- War and Heroism
 - War makes us noble
 - Nations must struggle



Econ. Nationalism + Fascism Led to War and Genocide





Explanations

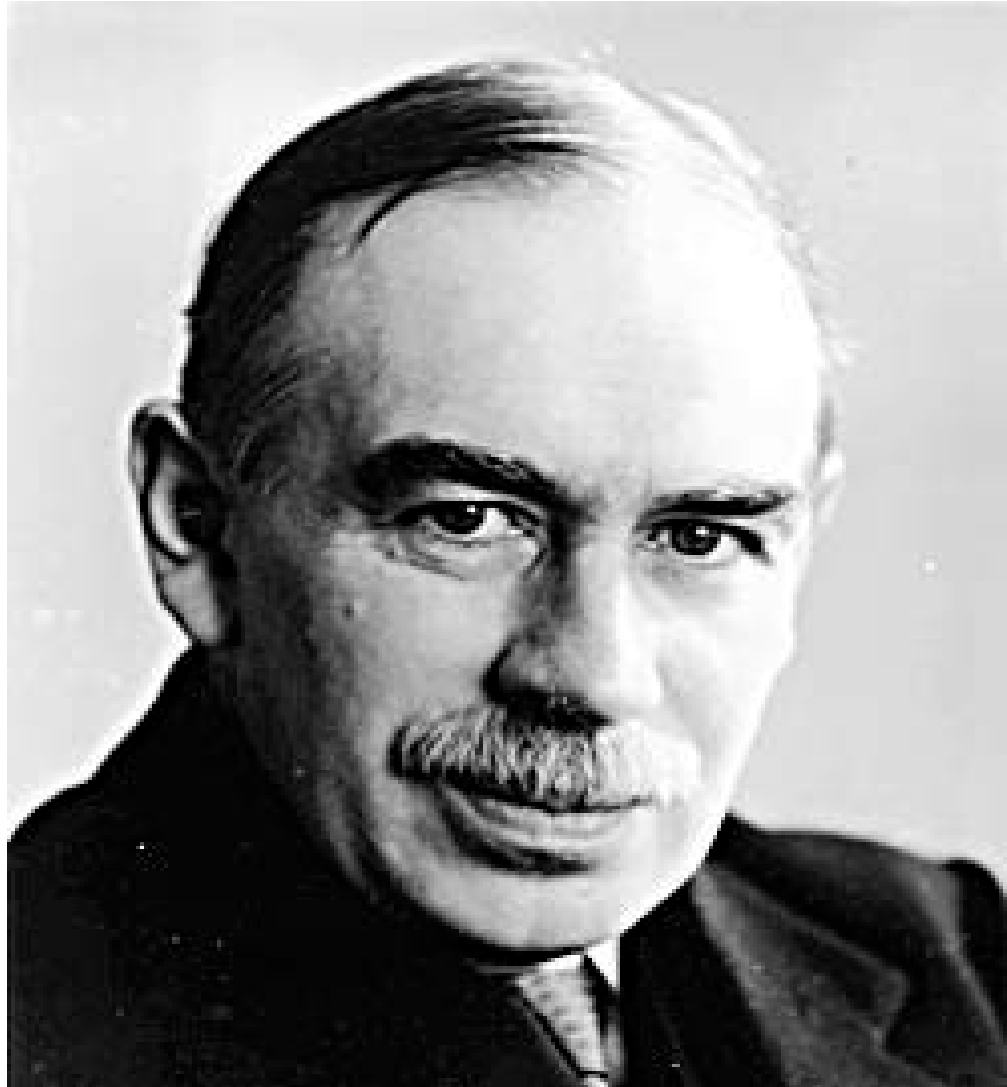
Marxist explanations

- Exploit others
- Grow or Die
- Overproduction
- Underconsumption
- **Communitarian explanations**
 - **National solidarity**
 - **War and heroism**
 - **Communal security**

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

- Domestic salvation: Keynes
- International salvation: Hegemonic Stability

The Domestic Solution was a Keynesian Solution: Macroeconomics

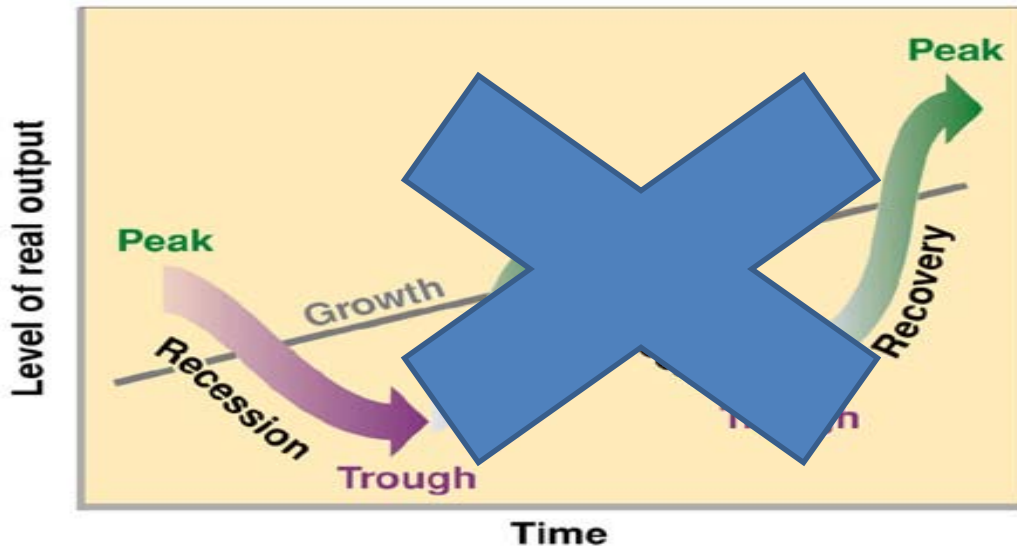


Keynes repair of classical liberalism

- Theory of macroeconomics grew out of the Great Depression
 - Classical liberal models built on assumptions of individual behavior (rationality)
 - This might work for individuals but not for whole economies
- Economic stability is not assured through market forces
- Political stability requires state intervention to achieve economic stability

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!



Keynes' views bolstered by Expansion of Political Liberalism: Four Freedoms



The welfare state and 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

The New Deal in the United States: Domestic Embedded Liberalism + regulation

- WPA
- Social Security
- Minimum Wage
- Banking regulations
- FDIC, Glass-Steegal Act
- SEC



WPA employed Artists!



***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

For the Liberal, It's a Collective Action Problem: How do you get cooperation?

	Cooperate (free trade)	Defect (protectionism)
cooperate	<p>5, 5</p> <p>Comparative advantage</p> <p>Growth for all,</p> <ul style="list-style-type: none"> •Credit → ease balance of payments deficits •Liquidity: counter-cyclical lending •discount lending in crisis 	<p>0,3</p> <p>I keep my market open but you close yours; I lose so eventually I will retaliate</p>
Defect (protectionism)	<p>3,0</p> <p>You keep your market open, I close mine, I win, you lose and eventually you retaliate</p>	<p>1,1</p> <p>We both close our markets; you close yours, I retaliate, you retaliate, and so on.....no more free trade</p>

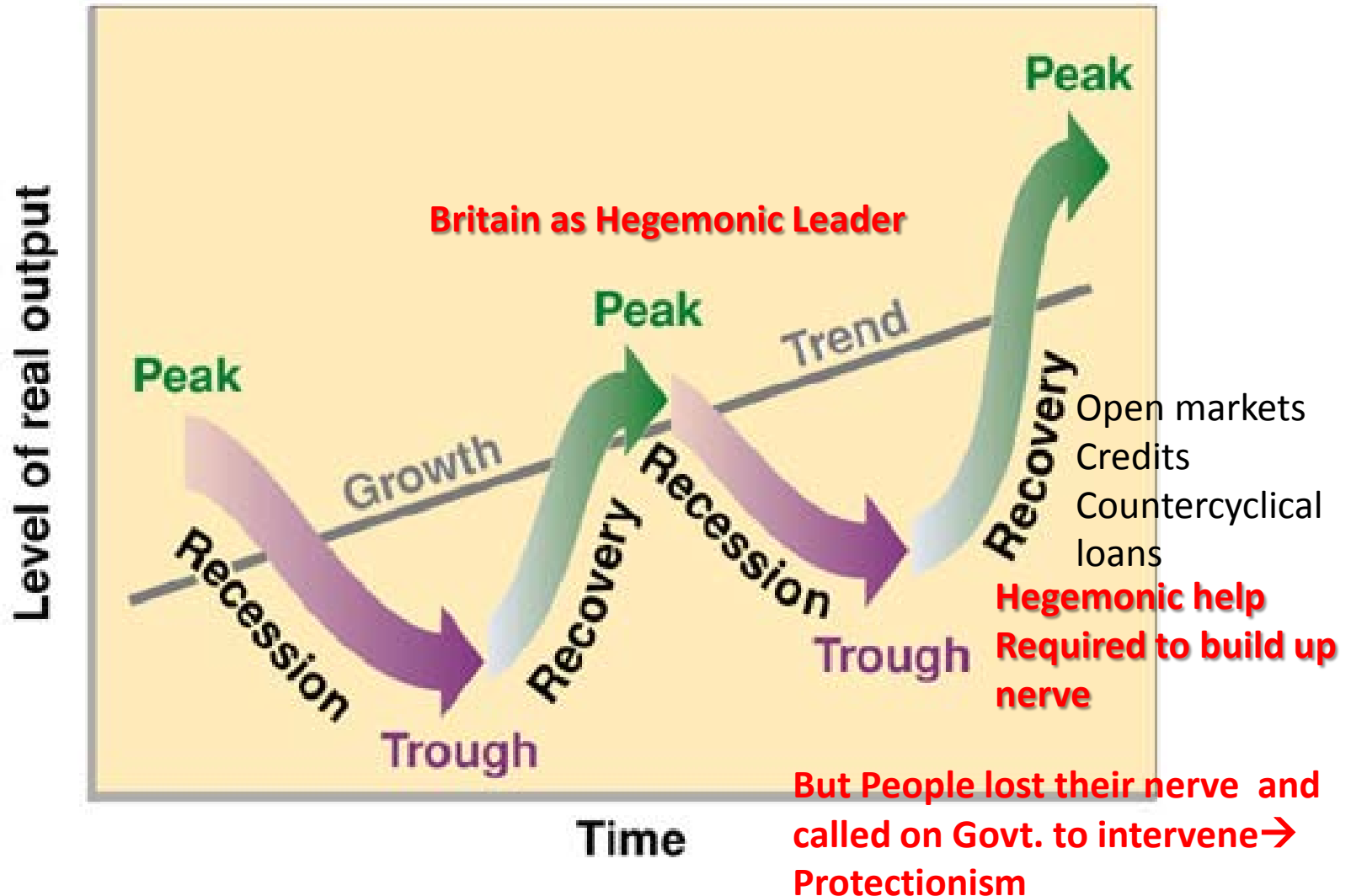
Kindelberger says that Hegemonic Leadership is required for cooperation to create stable liberalism

- 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.

Hegemonic Leadership

- What does “leadership” mean
- It means assisting others in a liberal world economy
- Britain did this until it began to decline

Hypothetical Recovery with Hegemonic leadership



It takes power and willingness to be a 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

Could it happen again?

