Explaining the Great Depression

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

But People lost their nerve and called on Govt. to intervene → Protectionism

Adjustment Required

If prices are low enough, demand will increase

Level of real output

Time
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 loan exaggerated the economic/financial crisis.
Resulting in The Failure of Classical Liberalism

**Economic Causes**
- Agricultural overproduction
- Widening gap between rich and poor
- Stock market crash due to buying stock on margin.

**Political Causes**
- Hoover follows hands-off policy towards business
- Few regulations in place over companies

**Economic Effects**
- Deflation
- Unemployment at 25%
- Drop in production

**Foreign Affairs**
- Hitler takes power in Germany in part due to hyperinflation.

**Political Effects**
- FDR elected in 1932
- New Deal programs increase govt. role in economy
Economic Nationalism Replaced Liberalism

Classical Liberalism at work
Britain is
The World’s Creditor

Economic Nationalism At Work
Dropping the Gold Standard, Smoot-Hawley Protectionism

Great Depression
Time
the tendency toward economic nationalism
Big contradiction between liberal international economy, state power, and stable political systems

- Markets are global, politics are local. Can the two be reconciled?
- Stable Politics require
  - Full employment
  - Safety nets
  - Protection of
  - Govt. intervention in the economy
- States in the international system require:
  - Sovereignty
  - Sovereignty requires national wealth translated into power
  - And the power to produce wealth (List)
- But liberal international economy requires
  - Open markets $\rightarrow$ aggregate growth
  - Need to allow inefficient business to fail
  - Need for "adjustment" meaning fluctuations in employment
  - Need for states to remain small: spending on social services, defense, etc. takes productive resources out of the economy and out of the hands of private actors
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

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<thead>
<tr>
<th></th>
<th>Cooperate (free trade)</th>
<th>Defect (protectionism)</th>
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<tbody>
<tr>
<td>Cooperate</td>
<td>5, 5</td>
<td>0,3</td>
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<td></td>
<td>Comparative advantage</td>
<td>I keep my market open but you close yours;</td>
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<td></td>
<td>Growth for all, I keep my market open even with BOP deficits</td>
<td>I lose so eventually I will retaliate</td>
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<td></td>
<td>because I know things will get better</td>
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<tr>
<td>Defect</td>
<td>3,0</td>
<td>1,1</td>
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<tr>
<td></td>
<td>You keep your market open, I close mine, I win, you lose and eventually you retaliate</td>
<td>We both close our markets; you close yours, I retaliate, you retaliate, and so on.....no more free trade</td>
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<td>Contradictions</td>
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<td>between needs of the domestic political economy and the International economy</td>
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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......
- ▲ imports + ▼ exports → trade deficit → need to pay up → no credit? → deplete gold reserves → ▼ confidence of others in currency value → ▼ currency value → ▲ exports → competitive devaluations -→ all want to export and noone wants to import → all erect tariffs → 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
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

• Could a Marxist explanation and liberal solution be combined?
• Modified Liberalism: Create a climate for a tamed liberal economy to thrive
• Government intervention and the welfare state
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 Four Freedoms are goals famously articulated by United States President Franklin D. Roosevelt in the State of the Union Address he delivered to the United States Congress on January 6, 1941. In an address also known as the Four Freedoms speech, FDR proposed four points as fundamental freedoms humans “everywhere in the world” ought to enjoy:

• Freedom of speech and expression
• Freedom of religion
• Freedom from want
• Freedom from fear

His inclusion of the latter two freedoms went beyond the traditional American Constitutional values protected by the First Amendment, and endorsed a right to economic security and an internationalist view of foreign policy that have come to be central tenets of modern American liberalism. They also anticipated what would become known decades later as the “human security” paradigm in social science and economic development.
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-Steeghal 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?

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<td>• Credit → ease balance of payments</td>
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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

But People lost their nerve and called on Govt. to intervene → Protectionism
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?