

DOES THE CURRENT GLOBAL CRISIS
REMINDE US OF THE GREAT DEPRESSION?

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CONTENTS

<i>Abstract</i>	1
Introduction	2
The build-up of the crisis	2
Policies in response	5
Repercussions	7
Conclusion	8
References	10

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*Sunanda Sen**

[Abstract: One identifies strong parallels between what happened during the Great Depression of the 1930s and what the world is passing through this day. While the build up of the crisis shared a similar pattern, subject to payments imbalances and capital flows directed to channels which failed to contribute to real growth in the capital importing debtor nations, official policies as precipitated the crisis also were similar. These included Britain's move to re-incarnate pre-war gold standard in 1925 with overvalued gold parity for Pound Sterling and a dear money policy, both to attract funds from abroad none of which finally worked. In US free use was made of funds to stimulate the country's stock market transactions with a boom which finally came to an end in October 1929. Likewise, Alan Greenspan's strategy of high interest rate and overvalued dollar during the years preceding the financial crash in 2008 certainly worked as factors precipitating the collapse. Notwithstanding the acceptance of Keynesianism in post-war Europe, policymakers swung back by mid seventies to pre-Keynesian neo-liberal ideas of monetarist variety. The unprecedented boom in stock markets, with leveraged finance supporting the securitized assets, and the continuing flows of capital to finance the trade and fiscal deficits of US had to give way to unfulfilled expectations in the market. Again, as for reactions, the protectionist wave has re-emerged in Europe and USA, with economic nationalism ruling over notions of multilateralism and free trade. Racial discrimination which led to fascist upheavals during the thirties today remain much camouflaged, garbed in the language of economic nationalism. As for the magnitude of the loss in terms of output and employment, the current scene certainly overtakes the thirties in terms of absolute magnitudes. One only hopes that duration of the slump will not be as long as it happened earlier and also that the world will witness the revival of progressive new ideas, as it happened with the Keynesian revolution in the 1930s!]

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This paper was presented earlier as a public lecture at History Department of *Jamia Millia Islamia* in a conference under the theme of "Writing of Economic History". A revised version will be presented in a session at a Workshop organized by the European Society for Economic History on "The Recession of 2008. Do Economists ever agree on Analysis and Prescriptions?" to be held in University of *Castilla La Mancha* Spain on January 21-22, 2010.

Introduction

As recently claimed by the present Fed Chairman, Ben Bernanke¹, the intensity of the current global economic crisis, in terms of its damaging effects over a decade or more, will be far less than that of the Great Depression of the 1930s. Recalling the past, it resulted in a drop of GDP by one-third (with proportionate losses in terms of jobs) in advanced countries which included USA, with the crashing of banks by one-third, and a total collapse of the stock market in US and elsewhere. Bernanke points at an absence today of what prevailed earlier as “social safety net”.

Bernanke’s position as above contrasts a claim by George Bush, the former President of US. While defending his rescue plans for the US financial sector Bush disagreed with Bernanke, with a warning that the current crisis could be even more serious than what took place in the thirties. However, predictions as these do not tell us much, given that the unfolding of the current crisis is not yet over. Its intensity in terms of the severe crash in the financial sector and the output and job losses over a time span of less than one year do not convey the message that the crisis is of a less serious nature, despite the slow process of recovery in the financial sector as have started.

Incidentally, neither Bernanke and nor Bush notice that the Great Depression also led to a revolutionary change in economic theory, with Keynes offering a theory of underemployment in his 1936 book on output, employment and prices.

It may however, be relevant to compare the state of the depression in the thirties with the current crisis we are witnessing today. This requires first, a look at the build-up of the respective crises and second, an analysis of the set of policies as were adopted to address the failing systems at the respective points of time. Third, one needs to look at the global spread of the respective crises, and their repercussions, not just on the macro-economic aggregates but on policy changes at national levels which include protectionism, exchange controls and the related moves. The following three sections of this paper deal with the aspects mentioned as above.

The build-up of the crisis

Let us first look at factors precipitating the crises in the two periods. The one during the thirties was preceded by uneven economic power among the major industrial nations; with disparate output growth rates and major imbalances in international trade and

¹ “Bernanke says crisis no comparison to Great Depression” December 01, 2008
<www.worldnetdaily.com>

payments. Among these, USA was the major industrial country, contributing 42% and 33% of world output respectively during 1928 and 1933. US was also the major provider of international loans and the chief source of import demand for Europe. The country received large gold inflows USA out of her trade surpluses during the (pre-WW I) years of gold standard, which in turn were absorbed within the country without much of an impact on domestic prices. At other end there was Germany, subject to heavy reparations at end of the first World War, the value of which was 1.5 times its national income. Germany was also a major borrower from overseas, absorbing 50% of all international loans while its economy was subject to hyper-inflation. Of the remaining industrial countries, the Allied Nations were supposed to pay War debt to US at end of World War I; while the defeated nation, Germany was subjected to reparation payments to the Allied Powers which included Britain and France. To provide a solution to the imbroglio which arose with Germany's inability to meet the reparations, US started lending to Germany (in terms of the Daws Plan of 1924), aiming to avoid a disruption of the German reparations to the Allied Powers which was needed by the latter to continue their payments to US. In another move a new scheme came up with the launching by US of the Young Plan (1929), providing for loans to Germany. As can be expected, the plan failed with the crash in the stock markets of Wall Street which rendered the cross-border capital flows at a standstill.

As for the recent events, US today ranks first among countries in terms of GDP. It also happens to be a major importer and the largest international borrower. USA today is the major international borrower while a new set of countries, in the developing area (China, and to some extent India) and Germany and Japan as well are the major lenders. China has invested heavily in the past in the dollar denominated US Treasury Bonds, given the rating of dollar as the most reliable store of value. China's growth rate, along with those for other emerging countries in Asia, has been as high as 10% over the five years ending in 2008, providing a large market for the neighboring countries in Asia . Finances forthcoming from the current account surpluses and the official reserves held by these countries meet the current account and fiscal deficits of US . Current account deficits of some advanced countries have been large, exceeding 6% of GDP in US and 3% in UK in recent years. Simultaneously current account surpluses of other advanced countries, primarily of Germany and Japan, respectively exceeded 5% and 3% of GDP. Also China's current account surplus in recent years has been over 7% of her GDP. Thus flows of external finance from China, Germany and Japan among others (like high reserve countries as India) have of late been flowing to the major international borrowers, the US and UK. US today is a major borrower instead of being the chief lender as during the thirties.

In US the flow of finance was much in use to provide for varieties of debt-financed consumer spendings including those in the housing market and also to provide liquidity in the credit market which often was used for speculation in stock markets. Uncertainty and speculation were rife, along channels of stock market transactions as well as in the property market later, with the debt- financed Asset Backed Securities (ABSs) and Collateral Default Swaps (CDSs) coming up as major vehicles of leverages. Payments imbalance and capital flows as above sustained the high dollar rate, often in the interest of those having a stake in dollar assets, an aspect reflecting the dominance of finance in the world economy.

As it can be gathered from above, current account imbalances among the major industrialized nations, preceding and/or during the crises, eventually proved unsustainable both periods, however different the circumstances had been in the respective periods. As at present, flows of finance was hardly contributing to growth in the real economy during the years of the Great Depression,. These effectively recycled, between USA (with its currency afloat at an overvalued rate of exchange) the Allied powers (the victorious countries) and Germany,the defeated nation, all to make it possible that the war related claims on each other were all settled. But none of those, in effect, were to be channelized to create productive assets to contribute to growth.

Coming to the current financial crisis, one witnesses similar payments imbalances, with the financing of the US trade and fiscal deficit through the current account surpluses and reserve accumulations in China and other developing nations as in Germany and Japan. As during the thirties, these flows often turn out as nominal in terms of their contribution to growth in the debtor country or in the world economy. As for the capital importing countries, especially for those in the developing region, which were receiving inflows of short term finance from foreign institutional investors(FIIs), a similar situation came up since these funds were all directed to secondary stock markets where these were invested for quick returns. On the whole, the delicate balance of continuing cash flows between the surplus nations and those running the deficits did not provide a lasting solution, especially with the flow of finance moving along speculative circuits in the capital importing countries. If one compares the thirties when funds were used by the debtor nation (Germany or Allied nations) to meet the reparations/ War debt, flow of finance during the current crisis has more to do with speculation as the driving force for investment, which swells the stock market for short term gains. These flows have also helped to support the exchange rate of US dollar, the debtor country's currency and keep up its budget deficits.

It can be pointed out that as during the earlier crisis of the 1930s, the current flows of finance have proved useful to the dominant interests of finance in the global economy.

Thus there exists strong parallels between the two periods in factors like major payments imbalances across nations and the dominance of finance over policies contributed to their build-ups.

Policies in response

As for the policies which proved wrong and finally a failure in mitigating the crisis in these two periods, Britain and USA in the thirties could be found pursuing policies which actively played a part in the Great Depression of 1929. These included the launching of an overvalued exchange rate of British Pound Sterling in 1925 with gold backing at the pre-war gold parity. In a bid to attract capital from overseas, the move was matched by a deflationary policy with high discount rates. The reinstating of Gold standard in Britain could continue as long as inflows of capital to the country continued. In 1931 Britain was again off-gold standard since the country was no longer receiving inflows of capital from abroad. A package of policies as above was clearly pro-finance, generating positive benefits to finance as well as rentier capital while opposed to and adverse to interests of industrial capital and labour in the country.

As for US during the thirties, the stock market continued to boom, largely fuelled by speculation and capital inflows, till the onset of the crisis in 1929. Regional banks in the country helped credit expansion with 'perverse flexibility', charging low rates during boom and vice versa during slumps. Also the Fed was continuing with a high interest rate policy, which, as held by Bernanke and endorsed by no other than the Chicago economist Milton Friedman, was responsible for the credit squeeze and the crisis in the thirties!² Credit booms in financial markets were also aggravated as Holding companies were operating on 'margins', which required little cash. However, the boom, largely fuelled by credit flows to stock markets, came to an end in 1929 and the market crashed with unfulfilled expectations of speculators. To arrest the free fall in the stock market the Federal Reserve Board of US raised interest rates without having much effect. The chaos in the stock market also seriously disrupted the cross-border flows of capital. Following Britain's move in 1931 to end the gold standard, US dollar was delinked from gold in 1933 and exchange rates of major currencies started floating again. Attempts in the meantime to achieve exchange rate co-ordination in the World economic conference of 1933 was also abandoned.

² "Bernanke: Federal Reserve caused Great Depression Fed chief says, 'We did it ... very sorry, won't do it again'" Posted: March 19, 2008 9:02 pm Eastern By David Kupelian
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In US, a bid to revive the ailing US economy led President Roosevelt to introduce the New Deal (1934-39) by providing subsidies to help the farm sector. This followed the devaluation of dollar in 1933 and the Glass-Steagall Act of 1933, the latter preventing banks to speculate by investing in securities. However, the short-lived revival of the US economy over a couple of years under Roosevelt administration ended in 1937 when the economy collapsed again, largely due to the re-imposition of fiscal austerity .

Germany, which was the biggest debtor during these years preceding the Great Depression was subject to a hyperinflation by mid 1920s. However, by imposing deflationary policies the country faced, by 1930s, a drop in prices, output, employment along with a debt-deflation. All these finally led Germany to default on reparations in 1932, reacted by Allied Powers with a failure on their part of to pay the War debt to US in the year 1934.

If we now look at the current global economic crisis, we notice some parallels in terms of the policies followed. Discarding the Keynesian policies as were adopted in Europe and also in England during the first two decades following the Second World War, those in charge of devising the course of action chose to go by the neo-liberal precepts which included a tight money policy and overvalued exchange rates to avoid inflationary potentials which harm finance. Thus the Federal Reserve in US was found with a high interest rate of 4% to 5% over the five years which preceded the crisis in 2008-09. Similar tight money policy was followed in other countries including Britain and rest of Europe, inspite of the low or stagnating growth rates of output and employment. One notices tendencies to maintain status quo, say with an overvalued dollar rate of dollar by US, which was contrary to any adjustment related to the country's current account deficits. Attempts at coordination were ruled out by major nations, with resistance rooted in national economic concerns. These include the denials by Germany as well as China to revalue against US dollar, pitted against USA's bid to continue with its exchange rate. In Europe fiscal deficits had to be kept within limits prescribed under the Maastrich Treaty.

On the whole the low growth in these economies was hardly an issue in framing policies which continued to follow the course dictated by conservative macro-economic policies. A shock was felt by fall of 2008 which, with a regime-change in USA, contributed to a temporary move in the direction of a Keynesian stimulus. A similar course of action is observable in other parts of the world, with fiscal expansions, cuts in interest rates and bail-outs for major financial institutions. While these changes are still too early or inadequate in dealing with the magnitude of financial losses and real sector contractions, one can observe a pattern of corrective actions, distancing from the wrong policies of the past.

Repercussions

The repercussions of the Great Depression of the thirties include a sharp fall in world trade and international capital flows, the latter dropping by 9% during 1927-33 and matched by significant declines in primary commodity prices which hit developing countries. These included India and other colonies which faced the brunt of the depression. Migration across nations also fell drastically in the process.

The Great Depression of the thirties also witnessed a revival of economic nationalism, neo-mercantilism and protectionism which was matched by a rise of fascism in Germany (1934) and Italy (1936). with considerable loss of labour status.

On the economic front there was exchange control, especially by Germany in the thirties and trade restrictions, with US raising tariff barriers in terms of the Smoot-Hawley Tariff Act (1930). With Britain initiating the Ottawa Agreement (1932) on tariff preference among the Commonwealth countries and Germany launching exchange control and clearing agreements for external payments; retaliations were not unusual, with economic nationalism dominating policies of most industrialised nations. In 1933 attempts were made to stall these moves, especially by means of an exchange rate co-ordination among nations. However the attempt was soon abandoned. Keynes's attempts to stall the process with his advocacy of debt cancellation, a clearing union and the instituting of bancor as the international currency were not accepted.³ The pace of trade and exchange restrictions continued along with fluctuating exchange rates during the inter-war and the Second World War days, until the allied nations got together to agree on the Charter of the Bretton Woods Agreement in 1944. In the meantime the major industrialized nations were embroiled in a War, which can be viewed as the culmination of the unrest and disruptions in the economic front as was unleashed by the Great Depression.

Comparing the current scene, the immediate impact of the crisis was an end to the financial boom, which was brought about by end of 2007 with a collapse of the sub-prime loan market in US. Losses therein were spread to the rest of the financial business, in US as well as in other advanced countries by October 2008. In US a large number of investment banks and other financial institutions including the mega insurance company AIG felt the heat and were nearly at a point of collapse. Monetary and fiscal measures to bail out and to instill liquidity in the system via banks have not worked sufficiently so far. On the whole the impact has been pervasive, especially as one considers the

³ Shrinking Policy Space, Global Imbalances and World Recession: A Revisiting of Our Troubled Times with an eye on Keynes" Anna M Carabelli and Mario Cedrini (*mimeo*) 2009.

contractions in the real economy, with fall in output and employment all over the world. Thus the GDP of the advanced nations have recorded a negative growth rate while those for the fast growing developing countries have fallen drastically, both with domestic contraction and drop in export demand from abroad.

A direct response of the output and job losses as have followed the financial crisis in the advanced countries has been the emergence of protectionism, which is happening in disguise, thanks to the formal compliance to the WTO regime. The above include the moves initiated in US to "buy American", to scratch H-1B visa for professionals, especially from India, and an end to tax breaks for US companies which outsource jobs. Clearly the WTO has been totally ineffective and even silent in terms of resisting these moves.

As a consequence of above, most countries including the developing ones today are facing sharp drop in exports, output and employment. While many (including the advanced countries) are trying fiscal-monetary expansionary path there has been no effective curb on speculation in any part of the world, including the widespread use of financial derivatives, hedge funds or flows of speculative short term capital flows. Of late there is even a proposal to end the so- called expansionary fiscal moves, on the plea that the recovery has started!

Conclusion

Concluding, one identifies strong parallels between what happened during the Great Depression of the 1930s and what the world is passing through this day. While the build up of the crisis shared a similar pattern, subject to payments imbalances and capital flows directed to channels which failed to contribute to real growth in the capital importing debtor nations, official policies as precipitated the crisis also were similar. These included Britain's move to re-incarnate pre-war gold standard in 1925 with overvalued gold parity for Pound Sterling and a dear money policy, both to attract funds from abroad none of which finally worked. In US free use was made of funds to stimulate the country's stock market transactions with a boom which finally came to an end in October 1929. Likewise, Alan Greenspan's strategy of high interest rate and overvalued dollar during the years preceding the financial crash in 2008 certainly worked as factors precipitating the collapse. Notwithstanding the acceptance of Keynesianism in post-war Europe, policymakers swung back by mid seventies to pre-Keynesian neo-liberal ideas of monetarist variety. The unprecedented boom in stock markets, with leveraged finance supporting the securitized assets, and the continuing flows of capital to finance the trade and fiscal deficits of US had to give way to unfulfilled expectations in the market. Again, as for reactions, the protectionist wave has

re-emerged in Europe and USA, with economic nationalism ruling over notions of multilateralism and free trade. Racial discrimination which led to fascist upheavals during the thirties today remain much camouflaged, garbed in the language of economic nationalism. As for the magnitude of the loss in terms of output and employment, the current scene certainly overtakes the thirties in terms of absolute magnitudes. One only hopes that duration of the slump will not be as long as it happened earlier and also that the world will witness the revival of progressive new ideas, as it happened with the Keynesian revolution in the 1930s!

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