Lecture 2:
The Great Depression and Its Legacy
Gresham College

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Outline of Arguments

- Economic Crisis Led to Developments in Monetary Theory and Policy
- British Monetary Orthodoxy managed the crisis relatively well
- Considerable degree of freedom for Bank of England in 1920s followed by ‘cheap money’ of 1930s
- Recall fiscal burden after Great War placed considerable constraint on policy
- Individual conflict between ‘Treasury View’ of Hawtrey and Keynes ‘unorthodoxy’
- What causes the recessions and how did economic policy change?
Classical Position

- Monetarists versus Keynesians or Expansionists versus Contractionists or Sound Money versus Austerity
- Production, income and expenditure all sum to the same quantity
- Savings from income are passed through financial intermediaries to provide means of expenditure for investors
- The market for savings and investment clear at the ‘natural interest rate’
- Dislocations in financial intermediation may prevent market clearing and lead to deviations in the ‘market rate’ from the natural rate
- Generally, sufficient flexibility in interest rates will ensure output and expenditure can be brought into line
Outlined three principles of central banking in a crisis

CB ought to lend freely at a high rate of interest to borrowers with good collateral
Value the assets at between panic and pre-panic prices
Institutions with poor collateral should be allowed to fail

Compare with BoE’s asset purchase facility started in 2009 and absence of central bank in the US until 1914

Adoption of Glass-Steagall (1933) and Banking Act (1935)
The Keynesian Challenge

- Not interest rates that adjusted to clear the market for loans but income
- Excess savings do not require lower rates but will set up feedback loop involving lower expenditure
- Expenditure will tend to adjust so that the planned level of savings equals the lower level of investment
- Income is the variable that adjusts to bring savings into line with investment
- The goods market can clear at a variety of possible points
- Policy can be directed at more favourable points
Primary and Net Fiscal Balance to GDP ratio

Primary Surplus

Net Surplus

Years: 1919, 1922, 1925, 1928, 1931, 1934, 1937
Price Levels and Terms of Trade

Terms of Trade

GDP Deflator

Consumer

Year:
1919 1922 1925 1928 1931 1934 1937

Price Levels and Terms of Trade Chart
Unemployment and Real Earnings

Real Earnings

Unemployment
“[I]t is common to speak as though, when a government pays its way by inflation, the people of the country avoid taxation. We have seen this is not so. What is raised by printing notes is just as much taken from the public as is beer-duty or an income tax. What a government spends the public pays for. There is no such thing as an uncovered deficit. But in some countries it seems plausible to please and content the public, for a time being at least, by giving them, in return for the taxes they pay, finely engraved acknowledgments on water-marked paper. The income tax receipts, which we in England receive from the surveyor, we throw into the wastepaper basket: in Germany they call them bank-notes and put them in their pocketbooks; in France they are terms Rentes and are locked up in the family safe”, Keynes (1924).

- Austria, Poland, Hungary and Germany lost monetary control in the early 1920s.
Keynes versus the Treasury View (aka Hawtrey and Norman at the BoE)

Economic fluctuations were a revelation of nature or something that could be tamed?

Were the exchange rate or the Budget considered tools of economic policy? No.

And yet both helped the 1930s recovery from the Global Recession

‘Nobody told us we could do this’ - said one member of the Labour Cabinet in 1931

Employment White Paper of 1944: ‘the Government accept as one of their primary aims and responsibilities the maintenance of a high and stable level of employment after the war’
The Multiplier and IS-LM

How might changes in expenditure increase income by more than the initial increase?

The feedback process became known as the multiplier, named by Kahn (1930)

Subsequently debated heavily with estimates continuing to generate considerable interest

If changes in the demand for goods had to be effected through money, then there would be also a need for the money market to clear

Hicks (1937) suggested interpretation of Keynes (1936), as a mechanism for clearing money and goods market simultaneously endures

Set the terms of the post war battles on monetary and fiscal policy
Expenditure: $C+I+G+NX$

$\Delta G$

$\Delta Y$

output

The Multiplier
Expenditure:
$C+I+G+NX$

The Multiplier Mechanism

$\Delta G$

$45^0$

$\Delta Y$
The IS Schedule – goods market equilibrium
The LM Schedule – money market equilibrium
The Keynesian Position
The ‘Treasury View’
Output and Interest Rates, 1919-1939
LM versus IS Shocks
Should we believe the estimates?

(i) can we assume that the slopes of the schedules were the same throughout this exceptional period?
(ii) what if the data on output is measured with error or noise?
(iii) surely the high levels of unemployment must have meant that shifts in spending played an important role in explaining output growth
(iv) can we proxy economy-wide interest rate by Bank Rate alone?
(v) how do we deal with expectations of income and interest rates in this static framework?
(vi) what about the possibility that changes in the aggregate price level may have induced shifts in output that are not well explored in this simple framework?
The job of getting money to work is the job of the state (I).

The job of getting people to work is also the job of the state (II).

Classical prescriptions and financial market stability seemed insufficient.

Economic theory and policy now had to encompass employment, output or aggregate demand.

The 1944 White Paper and Bretton Woods set the scene for postwar economic policy.

What became an opportunity to alleviate insufficient demand soon evolved into an obligation.