

The 1930s and the 1980s: Parallels and Differences *

Economists, like generals, often fight the last war or the last depression. Maginot line psychology in an ever-present danger. None theless I think the profession can take some pride that the aftermath of World War II was different from that after World War I. The approach to war debts, reparations, exchange-rate stability, and the imposition of tariffs represented a distinct improvement. The change can be attributed to the growth of economic knowledge, or to a different international political set-up under United States leadership, or both. There was a strong parallel between the Roosevelt administration of the 1930s and that of President Truman after World War II: no ideology, but relentless pragmatism. If the AAA, NRA, changing the gold price, or whatever doesn't work, try something else. After World War II there were the settlements under Lend-lease, the Bretton Woods institutions, the British loan, and ultimately the Marshall plan. In this connection I have propounded a law of economic alternatives: after debating which of alternative policies a country ought to pursue — for example, import tariffs *vs* exchange depreciation in Britain in 1930 and 1931, or world institutions such as Bretton Woods *vs* the key-currency approach of the British loan, the world often ends up doing both — which spoils the experiment as a test of economic theories. I do not mean to applaud simple pragmatism with no theory behind it, but in recent years I have lost some of my admiration, if I ever had much, for dogma or ideological approaches to economic issues.

Fifty years ago, 1938 was a year of recession in the United States, the relapse from four years of recovery that surprised us all when the stock-market fell sharply in September 1937. I do not believe that anyone tried to explain that recession on monetarist grounds. The

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quantity theory of Irving Fisher had long been set forth, and had distinguished practitioners such as Lloyd Mintz of Chicago, but there was nothing by way of attempts to explain short-run fluctuations by the behavior of the money supply as current disciples of Milton Friedman are wont to do. There were the Keynesian views of Marriner Eccles at the time and Kenneth Roose later, that the recession was caused by a massive change in the government budget following the payment of the Veterans bonus in 1936. This is somewhat different from the post-war Keynesian model with autonomous changes in investment that were magnified by changes in consumption through an investment multiplier. And the later model left room for autonomous changes in short-term investment in inventories. Fear of inflation because of rising wages — a response to the organizing efforts of John L. Lewis and the new industrial union, the C.I.O., led to inventory accumulation that could not be sustained and suddenly collapsed when its ephemeral nature was recognized. This explanation is strong psychological and related to what may be called the Fisher-Minsky model in which investment behaves from time to time in an unstable manner.

From 1945 to 1988, the United States experienced only recessions, as contrasted with the Great Depression, including some “growth recessions”, in which the rate of production change remains positive, but at a lower rate. This is a remarkable achievement when one contemplates that the Great Depression of the 1930s set in a little more than a decade after the end of the war, whereas if we move into a real recession or a depression in 1988, or 1989, as some fear, it will be more than four decades after V-E and V-J days.

1938 was important in the United States also in that it persuaded American officials to take the Keynesian revolution seriously. It is true, as my colleague E. Cary Brown argued after the war, that while Keynesian fiscal policy was talked about in the 1930s it was never applied in a determined way. That remained for the postwar period after the demonstration of prosperity brought about by wartime spending — what Joan Robinson used to call “military Keynesianism” —, and the helpful formalization of the model by Alvin Hansen and Paul Samuelson in the $Y=C+I+G$ formula and the diagram with the 45° ray from the axis.

It will interest the reader more, I suspect, if instead of comparing 1988 with 1938, I choose 1930, a span of 58 instead of 50 years, and a comparison that takes salience from comparing Black Monday on October 19, 1987 with Black Thursday of October 24, 1929 and Black

Tuesday of October 29, 1929. I will not discuss why these dark days fell on the United States economy, although I hope it would come as no surprise to the reader that I am unwilling to accept a Keynesian, monetarist or rational-expectations explanation of those stock-market collapses, but one based on Fisher-Minsky instability or what Adam Smith and John Stuart Mill called “overtrading followed by revulsion” — in modern terms a change of expectations, rational or irrational. Let me ask instead whether 1988 will be like 1930.

First a slight digression. It is a commonplace that the 1987 stock-market crash started in New York but instantly spread all over the world, perhaps less to Japan than elsewhere, although Tokyo had price/earnings ratios three or four times those in the United States that made many observers believe that if trouble should arise it would start there. In 1987 all markets imploded together, leading pundits to assert that this was the result of the integration of financial markets of the last decades. It is infrequently noticed, however, that comparable simultaneity occurred in 1929, with security markets all over the world following New York down within a matter of a day or two. Markets are connected not only through monetary movements, through income spillovers via the foreign-trade multiplier and of course through arbitrage in identical commodities assets, but psychologically as well. There need be no transactions: demand and supply curves both shift, and with them prices, as traders in one market observe, without actual contact, what is happening elsewhere.

But let me return to 1929. In 1929, as in 1987, the Federal Reserve responded immediately to the stock-market crash by loosening credit. In 1987 under Alan Greenspan, there was complete agreement on the need for such action. In 1929, George Harrison at the New York Bank acted on his own and was rebuked by the Board in Washington. In 1929, President Hoover called business leaders to the White House and outlined a program of government action that in retrospect looked Keynesian. It was only later that he became catatonic and unable to decide or act. By contrast, President Reagan seems to have ignored the danger to the economy posed by the October 19 *débâcle*, whether because of assurance that the Federal Reserve was taking the appropriate action, or through inattention, is not clear to this observer.

Financial markets recovered rapidly after the 1929 crash. The discount rate at the New York Fed which had been raised to 6 percent in August of that year was quickly lowered — to 5 percent on November 1, $4\frac{1}{2}$ percent on November 15, 4 percent on February 7,

1930, 3½ percent on March 14, 3 percent on May 2 and 2½ percent on June 20. It was lowered once again in the banking crisis of November-December 1930 to 2 percent on Christmas eve. The foreign bond market came back: from a low of \$80 million in new issues in the third quarter of 1929, foreign issues rose to \$430 million in the second quarter of 1930, including the barely successful New York *tranche* of the Young Plan loan to prime the pump of German reparations for the second time. The recovery was the result of taking up of loans that had been postponed under the high interest rates generated by the stock market boom that began in 1928, that cut off foreign lending and put deflationary pressure on Germany, Australia, Argentina and other countries dependent on loans from the United States. But the recovery of the bond market in the second quarter of 1930 was febrile. Echoing a remark of Lord Overstone on November 1, 1845, two years before the financial crisis of 1847 "We have no crash at present, only a slight premonitory movement of the ground under our feet", Schumpeter described the position in the second quarter of 1930 in terms of "People felt the ground give way beneath their feet". In effect, he said, the money and capital market had been more or less restored, but confidence had not been.

The problem, in my judgement, lay in commodity prices. High interest rates from early summer of 1929 had set back automobile sales and house construction, so that the cyclical peak of business occurred in June 1929. The causes of the downturns were financial, I assert, rather than the real factors seen by others — a decline in the rate of population increase explaining housing, or satisfaction of the first generation of automobile sales, and their related investments in tires, gasoline, roads, suburbs. Stock-market speculation had soaked up credit in brokers loans, and when the crash came, the banks were totally engaged in unravelling the resultant complications. In consequence, they clamped down on credit for automobile sales, for example, leading to a precipitous plunge in production far larger than can be explained in monetarist, Keynesian or real terms, and they cut off credit to internationally-traded commodities, which, in those days, were shipped to New York on consignment to be sold to commodity brokers financed with bank credit. With credit unavailable commodity prices plunged. It is significant that export commodities, financed at the point of production fell much less, as did import commodities produced on U.S. company plantations, notably sugar, also financed in the interior. Such imported commodities as coffee, cocoa, copper, hides, rubber, silk, tin

and zinc fell 10 to 25 percent, and dealt a stunning blow to the exporting economies on the one hand, and to confidence in the United States on the other.

There ensued what is now known as a "flight to quality", apparent in foreign bonds as early as March 1930, as low-grade issues fell in price while high-grades did not. A similar wedge developed in domestic bonds in September 1930. September was a bad month for international confidence as the Nazis made substantial gains in the German elections, and foreign capital withdrawals forced German borrowing through a new Lee Higginson market issue that failed. The flight to quality in the United States extended to municipal bonds and to home mortgages. New and thrusting banks that had taken on the riskier loans because borrowers with high credit were already served by the older established institutions found themselves struggling for cash as their shaky loans tended to stop paying and their depositors sought safety by transferring funds to the respected older banks. In farming areas, the banks had been failing by the score and hundreds since 1925 when farm prices worldwide started to slip after the comeback of European production, but the mountain of debt acquired during the war and post-war boom remained. In November 1930, despite easy credit conditions, a banking crisis led to the collapse of Caldwell & Company in municipal securities, and the next month of the Bank of the United States in mortgages. Collapse spread at home and abroad, as commodity and asset prices failed to come back, leading to debt default, capital flight, and a widening circle of financial collapse. In May 1931 another round of spreading failure started in Austria, and spread relentlessly to Germany, Britain, Japan, back to the United States, and finally in 1936 to the gold bloc led by France.

We may usefully spend a paragraph on the Hawley-Smoot tariff act, especially as its memory is evoked by the rising tide of protectionist sentiment in the United States, abetted by one of the Democratic candidates for the presidency. There is also the interesting theory of Jude Wanniski that the crash in 1929 was caused by the rejection in a subcommittee of the Congress of an attempt to lower a tariff on a carbide product, which he, a believer in rational expectations, held was the force that led investors to revalue their securities on the expectation that a highly protectionist tariff would be passed, signed into law by President Hoover, as happened nine months later, and lead to widespread retaliation that was fateful for the world economy. The same line of reasoning has led a few isolated observers to hypothesize that Representative Gephardt's protectionism is what precipitated the col-

lapse of October 19, 1987. Note that ordinary tariffs are regarded in the Keynesian model as expansionary, not deflationary; it is only when retaliation is widespread that the sign of the income change is reversed in the model that presumably rational expectors use. The Hawley-Smoot tariff with retaliation by some forty-plus countries was a disaster in the spiralling deflation of 1930 and 1931, but to blame it as the trigger of the stock-market crash and subsequent, and as I think, consequent deflation, stretches belief.

In October 1987, the stock-market crash put only moderate pressure on commodity prices. These had been falling in United States during the appreciation of the dollar from 1982 to 1985, and continued to slide gently when the dollar depreciated until the spring of 1987 when they picked up again. Farm prices and the price of farm land were especially depressed after a run-up earlier in the course of which farm mortgages had increased sharply, but by the summer of 1987 farm prices were coming back. The weak points in the system lay elsewhere, in corporate debt, especially so-called "junk bonds", those of less than trustee-investment grade issued to finance company takeovers or to resist such takeovers; in Third World debt that swelled in a binge of lending from 1971 to 1982; in mortgages issued to finance the speculative construction of office buildings and luxury apartments; in the oil industry, and in consumer debt. Part of the rise in the long bull market from August 1982 to August 1987 lay in the shrinkage of company equities, financed by large increases in corporate debt issued at high interest rates. Banks did not hold junk bonds directly but made loans to help industrial companies and their investment houses in takeover operations.

Consumer debt and a great deal of construction loans were held by banks, but some of them have been "securitized", that is, bundled into packages that are then sold off to retail investors. Whether securitization has been applied to the better loans, to facilitate their sale, or to the poorer ones to keep the good loans for the banks is not known to me. It also makes a difference whether the bank has an explicit or implicit obligation to stand behind the packaged loans and mortgages, a condition that will differ among institutions. Regional differences also have importance, and the Southwest of the United States is considered to be in an especially weak state of bank health because of the decline in oil prices since their peak in the year or two after 1979, but not significantly since October 19, 1987, and the overbuilt condition of such cities as Houston, Dallas and Austin, in Texas. The real-estate boom of the 1970s in that area led to a rapid pile-up of loans and mortgages at

low rates of interest that were still on the books when disintermediation set in in 1982, and banks had to replace their dwindling deposits by certificates of deposit at high rates of interest. In the money-center banks, as distinct from the regionals, the principal problem would appear to lie in Third World debt, where muddling through has been going forward since August 1982 when the New York banks and the Bank of America in San Francisco belatedly discovered that they had overdone syndicated bank loans to sovereign states.

Such is the position in the quarter of 1988, 58 years after the first quarter of 1930. It is not one of great strength, with weak if recovering farm mortgages, strenuous disintermediation in thrift institutions in Texas, Oklahoma and Louisiana, a slow, uneven and painful recovery in Third World debt, and weakness in junk bonds, speculative mortgages, and consumer debt. It is hard to compare the situation with the first quarter of 1930 in terms of strengths and weaknesses in the domestic U.S. position. In addition, the international picture was different, with a drastic change from a net creditor position to a debtor one, on the part of the United States, a floating dollar instead of the gold-exchange standard, and low interest rates in the United States dependent upon Japan, Taiwan and Germany funding the balance-of-payments deficit of the United States by investing their surpluses of dollars in United States treasury obligations. Thirty-three economists from thirteen countries signed a report of the Institute of International Economics in Washington, D.C. last December signalling their alarm that October 19, 1987 might produce a loss of confidence in the dollar, a revulsion against further lending at relatively low interest rates, and the necessity for the Federal Reserve system to raise rates drastically to attract foreign capital and prevent a free fall. These high interest rates, it was felt, would produce a depression by dealing a blow to house construction, consumer borrowing, and the level of bond prices. In 1930, low interest rates could not revive spending in the face of damaged confidence. In 1988 the fear is rather that high interest rates may be needed to overcome the loss of confidence of the rest of the world in the dollar.

In 1988 as in 1930, the weakness of the position lies in the possibility of financial flight — in domestic quarters out of various types of securities and bank deposits into money, in the international field out of the dollar into strong currencies such as the Deutsche Mark, Swiss franc and yen, and perhaps the precious metals. But there is one important positive difference between 1988 and 1930 — in the increase in our understanding of how financial crises have to be handled to prevent them turning into depression. They need a lender of last resort

to halt the rush out of real assets and less liquid securities into money, by assuring that there is sufficient liquidity for all. In the United States we have, in addition, deposit insurance for banks, savings and loan institutions, farm banks and the like, to prevent liquidation in one sector of the banking system spreading through contagion to other sectors. The lender-of-last-resort function is not without problems of its own: as in moral hazard in insurance, confidence of major banks that they will be saved in case matters go dreadfully wrong encourages them to be less prudent than if the chance of failure were higher. This moral hazard is thought by some observers to have contributed to the rather carefree manner in which the money-market banks, stuffed with money in 1970 and 1971 as the Federal Reserve undertook to promote low interest rates before the 1972 presidential election, began lending to the Third World well before the 1973 OPEC price increase. In addition, when the institutions that provide the safety net under thrift institutions, farm banks and mortgage lenders become stretched, they must be replenished — a political process which renders last-resort lending possibly problematic. The Federal Savings and Loan Insurance Corporation ran out of funds in 1987 and had to go to the Congress for more. There was a debate as to how much was needed, and a political compromise was reached that may fall short of the total need, especially to rescue thrift institutions in the Southwest and West, which would put the issue back into politics again. It must be acknowledged, of course, that all rescue operations are inherently political. Choices must be made as to what institutions and people are saved, and who is allowed to fail.

In addition to the slight cloud over the domestic lender-of-last resort function in the United States, there are threats there of rising protectionism, if nothing like the legislative free-for-all that led to the passage of the Hawley-Smoot tariff act in June 1930 and its signature by President Hoover over the protests of 1,028 economists, and ensuing widespread retaliation. It seems clear that if something on the order of the Gephardt bill should pass the Congress, which is unlikely, it would be vetoed by President Reagan who is ideologically opposed to tariffs, and would fail of passage (by a two-thirds vote) over such a veto.

While understanding of the lender-of-last-resort function abounds at the national level, and institutions to carry it out exist, especially central banks, the matter is not so clear internationally. In 1931 when exchange markets seized up and spread inconvertibility through capital flight throughout Europe, Japan and the United States, there was no international lender of last resort. The Bank for International Settle-

ments had just been founded, and was too small as well as too new, though it tried to mobilise rescue loans for Austria. Britain was too weak, the Bank of England said, to lend more to Central Europe, and the United States and France had not awakened to their international, as opposed to national responsibilities. In 1988, the United States after forty or more years of international leadership is faltering in economic strength. The International Monetary Fund is not set up for crisis management. Its decision-making process is time-consuming, and a last-resort lender may have to move in hours. The swap-network which sprang into being in 1961 at a time of British crisis is ideal, but must be led into action by the central banks with strong currencies, and can be undermined, as has occurred from time to time, when it seems clear that one or more of the leading central banks is holding back. For a long time up to September 1985, the Reagan administration adopted an attitude of benign neglect of the dollar exchange rate, which encouraged private speculators and discouraged public institutions trying to provide the public good of stability. The Plaza and Louvre Agreements under the leadership of James Baker turned matters around for a time, but more recently other countries appear to have been hanging back.

The swap arrangement, moreover, is not appropriate for meeting a crisis in Third World debt because the central banks of the Group of 10 (leading financial centers, plus Switzerland) could not count on being repaid in their own currency if they were to make them available to Third World debtors against pesos, escudos, cruzeiros and the like. In August 1982, the Federal Reserve System made a bridging loan of \$1 billion available to Mexico while the IMF tried to work out new loans from the commercial banks (and the U.S. Government bought \$1 billion worth of oil for storage in its underground facilities as protection against an embargo). The more substantial BIS, as compared with 1930, further made a bridging loan for Hungary, that tied it over until an IMF solution could be reached. These operations and the less automatic and more contrived operation of the swap system give an impression of ad hocery and improvisation that is less than reassuring.

The possibility of crisis in the years ahead, as in the years that followed the first half of 1930, lies in private revulsion against the dollar — say, by Japanese insurance companies with their vast savings and limited investment opportunities at home, unmatched by public governmental efforts in support of the dollar as lenders of last resort. It is sometimes argued that Japanese savers have no other place to invest.

The World Institute of Development Economic Research in Helsinki suggested in 1986 that Japan lend directly to the developing world rather than to the United States (memorandum by Saburo Okita, Lal Jaywardena and Arjun Sengupta) but evoked little response. At the November 1985 Kemp-Bradley Summit on exchange rates in Washington, one observer found it obscene that savings in Japan, a country of limited and cramped housing, should be investing in office buildings and luxury apartments in the United States with high vacancy rates. But most investors like intermediaries between them and weak debtors, at least until they determine at some point that the intermediaries are themselves poor credit risks, and stop suddenly and convulsively to produce a financial crisis.

If the leadership of the United States in providing economic stability is waning, as appears possible, what follows? is there a successor in the wings ready to take over, as there was not in 1931 when Britain abdicated, and the United States hung back? In 1929, the British Treasury economist, Ralph G. Hawtrey wrote (I quote from my review of the second — 1952 — edition):

“Any balance of power is inherently unstable. Changes in relative power occur and are dangerous... Rivalry between large powers renders situations of power vacuum dangerous”.

Milton Friedman and Anna Schwartz, thinking of the shift of power from the New York Fed to the Board in Washington, and possibly of the transfer of authority from Hoover to Roosevelt in 1932 and 1933, also observe that transitions are dangerous. But the position now as in the early 1930s is not one of a leader challenged by ambitious rivals so much as a faltering leader with no heir apparent ready and willing to take the job. The Federal Republic of Germany and Japan have been faithful followers of United States leadership for most of the four decades since the end of World War II, but show little inclination to take over the leadership. Lately, to be sure there has been some decline in followership, along with the decline in leadership. Coordination of fiscal policy has been weak since the failed attempt in the Carter administration to get the three locomotives pulling together. Coordination of monetary policy has been somewhat better, but the semi-annual summit meetings of the Group of Seven seem to produce little more than photographic opportunities. Coordination of fiscal policy and most of that in monetary policy deal with periods of relative tranquility, when the critical issue in the several years ahead may lie in crisis management. Can the political will to assign roles of leader and followers and make them stick be found?

It is awkward that 1988, like 1932, finds the United States mired in one of its quadrennial presidential campaigns. An election diverts public attention from international economic responsibilities to more parochial issues. Apart from the Republican Congressman Jack Kemp, whose views about returning to the gold standard are idiosyncratic, only Senator Bill Bradley who is not a candidate for the Democratic Party nomination has spoken forcefully on world issues of free trade, the Third World debt problem, foreign aid, and exchange rates. Most candidates agree on the necessity to produce a substantial reduction over the next years in the government deficit, and thereby in the deficit in the United States balance of payments, but there is virtually no unanimity as to how that should be done. Business, politics and most economists unite in willing the ends, but every distributional coalition, to use the term of Mancur Olson in his *Rise and Decline of Nations* is resolved to ensure that the means levy the burden on others.

It is not enough, therefore, to diagnose what needs to be done to enhance world economic stability. There must be the political will to apply the appropriate therapy. This calls for agreement among groups under strong political leadership at the national level, and among countries. One of the sad lessons of the 1930s, and especially of the months ahead of the convening of the World Economic Conference of June and July 1933, is how little value good ideas have without the political clout and will to put them into effect. It is a lesson discouraging for individual academic economists on the one hand, and for small countries on the other. Proposals from individuals, from institutions such as the International Labor Office, and from a long list of countries — Poland, Belgium, Japan and even Great Britain — fell on deaf United States ears so long as they were others' suggestions that the United States should spend its money. It is a well-known principle of political science that the leader bears a disproportionate share of the burdens of joint expenses because of the presence of free riders, beneficiaries of public goods that believe they will get the benefit of the good whether they pay or not.

It is possible that the habits of cooperation built up during the period of United States leadership will ensure, forming what the political scientists call a “regime”. Such is the hope. My prediction, however, is that the path ahead stretches out uncertainly, with twists and turns, surprises, some perhaps unpleasant. I suspect we are subject to what I am told is a Chinese curse: “May you live in interesting times”.

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