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The 1930s, the 1980s and Beyond

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Since the October stock market crash much has been written, as if depressions were mechanistically ordained, about the likelihood or impossibility of another Great Depression. The Great Depression did not happen; it was caused by governments. Folly can always be repeated---especially by governments---nevertheless, a forthcoming AIPP paper argues that the errors of the 20s and 30s are fairly well understood and they will not be repeated on a sufficient scale to re-run the years 1929/1933.

Recessions become depressions only when adjustment to them is delayed. Booms and busts follow each other with the certainty, but not the regularity, of night and day. By revealing things the auditors miss recessions are the basis of each new spurt of economic growth.

The business cycle may be accentuated or smoothed when governments increase or reduce the money supply. If all prices, including wages, were perfectly flexible the effect of money-supply changes would be upon inflation or deflation alone---there would be no effect on business activity. However, prices are not perfectly flexible: when people find themselves with more money, they can buy more because it takes time for costs and the prices of goods to catch up with the new higher demand. Conversely, if the money supply is reduced the ability to purchase is diminished because prices do not fall immediately.

Recessions cannot be avoided for ever, or a permanent boom achieved, by pumping money into an economy. Once people become accustomed to a steadily expanding money supply, prices (including wages) are raised ahead of inflation. Inflation becomes built into the system and the expanding (accelerating) money supply has little, if any, stimulatory effect on economic activity. The economy is said to suffer 'stagflation' and it becomes impossible to stop expanding the money supply without at the same time causing a recession.

Since only an unanticipated monetary expansion will increase business activity, and the pain of removing inflation from an economy is usually more than the pleasures of introducing it, monetary authorities should aim to maintain a steady money supply (relative to the size of the economy, which may be expanding). As money is notoriously difficult to measure, this is more easily said than done but, if a national currency is to be maintained, the responsibility cannot be avoided.

Depressions are caused when the economic adjustments which recessions would normally cause are inhibited or long delayed. Therefore depressions can be caused by governments when their actions require faster adjustment than can be managed---eg. a massive contraction of the money supply or massive national bad debts. And they can be caused when governments prevent economies adjusting---for instance by resort to tariffs, wage fixing, occupational licensing, statutory monopolies, etc. The Great Depression was caused by the coincidence of unusual amounts of both mistakes.

From 1919 to 1929 the world suffered relatively poor economic growth. When macro-economic errors were piled on top of the regulations, particularly trade barriers, that were already making economies sclerotic, the result was the Great Depression. Put another way: the 1929 recession was turned into the 1930's depression because current and previous bad policy meant that there was a lot of adjustment needed, and the most important governments, particularly the U.S., would not allow it to take place.

In the late 20s credit had been expanded carelessly and several banks carried too much doubtful debt. The resemblance with the 1970s and the early 1980s is striking. Then, in the United States, between 1929 and 1933, the quantity of money---at least as measured by the broader aggregates---was caused to fall by one third.

Some leading private banks held portfolios of doubtful loans made to people engaged in highly geared and speculative stock market trading as well as to what would today be called Third World governments. The severe credit squeeze, the inaction of central banks, and their refusal to allow their banking fraternities to take their own action, caused some normally sound banks to fold. This caused credit to shrink further.

Prices, particularly nominal wages, did not fall fast enough to accommodate the sharply declining money supply. Government and union interference, encouraged in the United States by Herbert Hoover and later Franklin Roosevelt, further delayed the necessary adjustments.

Politicians, not only in the United States, enacted further barriers to the free exchange of goods and services. The situation snowballed as countries followed each other raising trade barriers. American trade barriers made it even more difficult for international debtors to service loans in American dollars.

Thus the Great Depression was caused by the conjunction of several circumstances: a world-wide background of economic stagnation; an extended period of easy money and investment in activities that were, in the long run, unsound; an extreme and sustained monetary squeeze exacerbated by the collapse of several banks; and further regulation which had the intention and the effect of preventing necessary adjustments. Together these events prevented the United States, the world's leading economy, from adjusting to the recession. Then the American recession spread to other countries. Most of the United States' mistakes were repeated in Europe.

We have several of the pre-1930s circumstances now: a period of excessive credit creation, poor growth, excessive debt, a shift in political opinion towards protectionism and, though it may not be important, a stock market crash after a wild ride upwards.

However, the 'buts' are important:

! 'Authorities' are better informed about the nature of money supply now than they were in 1930. Commentators generally agree that no country large enough to affect the world economy is again likely to allow its money supply to contract by so much for so long.

! A run of bank closures is also unlikely.

! Although national debt remains a big problem for the world monetary system, it seems as though the national debts which posed the greatest threat to the banking system have been made more manageable.

! Moves are already afoot to educate the U.S. Congress and the Economic Community to the dangers to themselves of increased protectionism. However, xenophobic border protectionism remains the greatest single danger.

! Unlike the interwar period there is a world-wide move toward deregulation and privatisation which will enable necessary adjustments to be made more easily.

! The U.S. balance of payments deficit is one circumstance that is quite different from the late 1920s. In the 20s the USA had a huge balance of payments surplus.

Clearly politicians and bureaucrats could turn the next recession into a depression but, because they know more than they knew in 1929, they probably won't.

Australia's real problems are to be found not in world markets, and business cycles but in our own economy. Put plainly: our industries are not productive enough to keep us in the manner we have lately maintained by borrowing. These problems would be temporarily exacerbated by a world depression, but they are in fact far more serious in the long term than a depression.