Economic History

SER

The Failure of International Multilateralism and the Great Depression

Melissa Barrett, Senior Freshman

Almost 90 years after its beginning, the causes of the great depression remain contested and uncertain. In this paper Melissa Barrett attempts to decipher the chain of effects which caused the initial deflationary episode to propagate into a deep depression. She explains how the gold standard monetary became a catalyst of the deflationary crisis. This was a symptom of an inadequacy in policymakers' toolkit of response, due to a lack of understanding and acknowledgement of the business cycle, and international coordination. She concludes that these key failures which were the root of policymakers' miserable failure to mitigate the crisis.

Introduction

This essay will argue that the primary causes of the Great Depression were the deflationary conditions of the mid 1920s, caused mainly by incompetency in monetary policy. By extension, it is my contention that the international resentment caused by deflation was a reason behind the deep severity of the Great Depression. Furthermore, any limited response was muted by the lack of coordination between the world's economy, and the prevailing attitude of narrow national interest, rather than acknowledgement of the interdependent nature of the global economy.

Deflation was incredibly problematic during the 1920s as it caused a rise in the real value of debts, which brought already strained creditors to breaking point. Deflation made paying back intergovernmental debts even more unfeasible, and this exacerbated the existing strain between countries in the post war period. This strain was further worsened by debtor nations' unrealistic expectations and so it is the case that by 1923, the French still believed that the Germans would make their reparation payments (Kemp, 1972).This was despite the fact that the German mark was not stabilised until 1924, after a period of hyperinflation (Zacchia, 1976). Hjalmar Schacht, President of the Reichsbank from 1923 to 1930, wrote in 1931 that 'the French attack upon German currency … was the seed of that ever-growing lack of confidence which today hangs over the entire world' (Kindleberger, 1973).

Origin of deflation

A pertinent question to pose at this point is where did these deflationary conditions come from? I will discuss two main causes of deflation, the housing sector in the U.S and the Gold Standard. Both causes will be related back to a European context. A single example which illustrates the immense importance of the U.S to the international economy is seen in the fall of U.S exports when the Federal Reserve raised interest rates in 1927. The fall in U.S exports was due to other countries raising their own interest rates to keep in line with the dominant currency of the world, the U.S dollar(Eichengreen, 2004). This was not an advisable move for European countries. Their interest rates were now threatening to exceed their sluggish economic growth rates, making paying back debts even less feasible.

The geographical origins of deflation in the housing sector lie in the U.S. In 1928, the American demographer P.K Whelpton published a projection of the U.S population which 'showed 16.3 per cent growth of the 1920s, falling to under 12 per cent in the 1930s and in succeeding decades to 9.7 per cent, 7.3 per cent and 5.4 per cent.' (Barbar, 1978). In reality, the percentage increase was 16.1 per cent for 1920-1930, and in the succeeding decades the increases were 7.2 per cent, 14.5 per cent and 19 per cent, respectively(US Census Bureau, 2000). While Whelpton's projection is obviously erroneous in hindsight, it contributes to an understanding of the outlook of economic planners of the time. The idea that investment should occur in areas with rapidly growing populations can be inferred from the writings of the economist John Hicks of the LSE (1926-1935). Hicks argued in his book Value and Capital that 'one cannot repress the thought that perhaps the whole industrial revolution of the last two hundred years has been nothing else but a vast secular boom, largely induced by the unparalleled rise in population' (Barber, 1978). The increase in housing supply and prices, driven by the roaring economy of the 1920's and the anticipated endless demand, caused a crash in prices in 1929 when these expectations failed to materialise.

The Gold Standard, with its ideals of a fixed exchange rate and free flowing capital, transferred this deflationary shock to European economies faster than otherwise would have been the case. The return to the Gold Standard, starting with Germany in 1925, after the war, precipitated a pushing down of prices so that currencies would be able to return to their pre-war value on the Gold Standard (Feinstein et al., 2008). The Gold Standard encouraged a balance of trade surplus. This was because goods would be exported in order to buy foreign currency and gold which could then be used to back up a domestic currency. The irrational attachment to a balance of trade surplus in the European psyche is summarised in a quote from the German Chancellor Leo von Caprivi. Caprivi is reported as saying 'we must export. Either we export goods or we export people' (James, 2009). Restrictive U.S immigration laws passed in 1921 and 1924 meant that European countries no longer had emigration to act as a pressure valve for its unskilled labour during times of economic hardship (Steiner, 2005). These laws worsened the impact of unemployment in Europe in the period from 1929 to 1932.

Agricultural prices fell due to a reduction in the rate of population growth, and hence a reduction in demand. This reduction in demand coincided with a glut in supply. Temin argues that this glut in supply was caused by non-European agricultural sources (which had expanded during the war period) continuing to supply food in the post-war period (Temin, 1976). The idea that France became an independent source of deflation is justified in the high percentage of the active population employed in agriculture in 1920 in France at 42 per cent, versus Germany at 31 per cent and Britain at a meagre 8 per cent .

Policy failure

Another cause of deflation was mismanagement in monetary policies and fatal flaws in the structure of central banks. The Bank of France was vulnerable because it was highly sensitive to the whims of public confidence due its dependence on short term borrowing (Kemp, 1972). There were also significant differences between the pre-war global economy and its successor. Prior to the war, global monetary power had been concentrated in London. The pre-war structure of the Bank of England was a profit-making institution (Kemp, 1976). This meant that the BoE had an incentive to sell gold and not hoard it, a feature which was lacking in both the post-war Banque de France and the Federal Reserve. By 1932, France had 32% of the gold used in monetary transactions (James et al. 1991). To understand the economic crisis in Europe, a detour must be taken into U.S economic policy. Maddison puts forward the point that 'the severity of the crisis was probably mainly attributable to the fact that the USA was trying to run a major capitalist economy with the financial institutions of a rural frontier economy'

(Maddison, 1976). This point is supported by the saving of the U.S financial system by two private financiers in the late 1890s. J.P Morgan and the Rothschilds provided gold to a near bankrupt New York Federal Reserve. The U.S did not even have a centralised central banking system until 1913, with the creation of the U.S Federal Reserve System. E.H Carr argued that 'in 1918, world leadership was offered, by almost universal consent to the United States… and was declined' (Kindleberger, 1973). The inability of American leaders to see the links between a healthy American economy and therefore a robust world economy is seen in the first inaugural speech of President Franklin D. Roosevelt. Roosevelt stressed that 'our international trade relations even though vastly important, are in a point of time and necessity secondary to the establishment of a sound national economy' (Kindleberger, 1973).

Among European leaders there was such caution towards implementing inflationary measures that they maimed their own economies in their own inaction. Brüning, (Chancellor 1930-1932), was so affected by the hyperinflation of the early 1920s that he failed to inflate prices a decade later, even when the Institut fur Konjunkturforschung's index of world industrial production fell by 10% between 1929 and 1930 (Eichengreen, 2004).

Inadequacy of International Institutions

The increased strain between countries led to a deficit of belief in the capabilities of international organisations. The Treaty of Versailles had set a negative precedent for inter-war international relations due to its exclusion of Germany from participation in the talks. Clavin argues that the League of Nation's implementation of effective policies came too late when she writes that 'only by the mid- 1920s did the League's Economic and Financial Organisation have sufficient resources to make a genuine contribution to the prosperity of the region (Europe)' (Clavin et al., 2009). The growing scepticism towards international organisations came from both the ever increasingly more powerful far right and far left. In the election campaign of July 1932, Hitler characterised international co-operation as against the German national interest. He said publicly that there were 'so many international contracts, there's the League of Nations, the Disarmament Conference, Moscow, the Second International, the Third International - and what did all that produce for Germany?' (James, 2009) There were also grumblings from the centre ground. Benjamin Strong, the Governor of the Federal Reserve Bank of New York warned Montagu Norman that 'no surrender of sovereignty' could be tolerated and that 'anything in the nature of a league or alliance, with world conditions as they are, is necessarily filled with peril'. This lack of belief in the capabilities of international organisations led to the Great

Depression because governments acting on a national level attempting to solve a globalized and international problem, such as deflation, were ineffective.

Even when positive action was taken, such as the Tripartite agreement between the U.K, U.S.A and France, other major countries such as Germany were not brought into the fold and the action often came too late to be effective. The Tripartite agreement (1936) had promised to 'relax quotas and exchange controls and to avoid competitive devaluations' between the three countries (Feinstein et al., 2008). Another example of the failure of inter war international organisations to execute co-operation is seen in the failure of the so-called 'prohibition conferences', which were organised by the Economic Committee of the League of Nations. These conferences took place from 1927 to 1929 in Geneva (Zacchia, 1976). The effort to abolish restrictions on imports and exports was abandoned when one of the eighteen countries involved in the agreement failed to ratify it by January 1930. The agreement subsequently fell apart. This lack of resolute action by international authorities meant that trust in co-operation resulted in little.

Denial of crisis

International relations policy was not unique in its inadequacy. Fiscal policy directed by governments was also found to be seriously lacking. President Hoover wrote in his memoirs that his U.S Treasury Secretary Andrew Mellon 'had only one formula- "liquidate labour, liquidate stocks, liquidate the farmers, liquidate real estate"' (White, 2008). The prevailing economic orthodoxies of the time insisted that the state should not consistently intervene in an economy. In 1913, German government expenditure represented 12.1 per cent of GDP at factor cost, in 1970 that figure was 36.7 per cent (Maddison, 1976). According to White, 'Hayek's theory viewed the recession as an unavoidable period of allocative corrections' (White, 2008). It is my view that this policy gave an excuse to central bankers not to take positive action and allowed a sense of resignation and laziness to prevail, worsening the impact of the Great Depression. Hoover tried to keep the federal budget balanced in 1930-31 'because they (the Hoover administration) adhered to the Hayekian theory of the business cycle' (White, 2008). There is a sense in Hoover's writings of the Great Depression being a purifying process. Hoover reports Mellon as saying 'it will purge the rottenness out of the system… People will work harder, live a moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people' (White, 2008). This excessively conservative moralistic view of economics helped to deepen the Great Depression by creating a reluctance to participate in public investment. If public investment had been carried out earlier, employment would have risen and inflation would subsequently have risen also.

Imperialist International relations

International tension was also present in monetary policy. A flaw in the ideology of European central bankers was the amalgam of imperialism and monetary policy. The French central banker Moreau wrote in his diary - 'would it not be useful to have a serious conversation with M. Norman (Chancellor of the Bank of England), with a view to dividing Europe into two zones of financial influence which would be attributed respectively to France and Britain' (Kindleberger, 1973). This imperialistic view was designed to antagonise Germany. The European desire to maintain an empire is echoed by Jack Eloranta and Mark Harrison who note that 'the old colonial powers had failed to give way to the aspirations of the new imperialists' (Eloranta, 2010). The importance of colonies in the post-war period is seen in the superior performance of the U.K in maintaining its foreign assets in comparison to France or Germany. France suffered losses of about two thirds of its pre-war foreign assets and Germany lost most of its £1.2 billion foreign investments which were seized as reparation. The U.K however, received 'substantial war gifts from Canada and India' (Maddison, 1976). The competition that had existed between imperialist European economies could no longer be maintained due to the increased integration of European markets. In short, a broader attachment to the economic orthodoxies of antebellum years was a cause of the Great Depression. As Lundberg summarises 'in the 1920s … there were various policy aims that today would largely be considered as intermediate, secondary, irrelevant or irrational targets' (Maddison, 1976). The fact that responses were therefore fragmented, ill targeted or mostly non-existent allowed the crisis to develop into deep depression. The poorly informed, contradictory and rivalrous policies implemented in the wake of the crash in 1929 did not serve to lessen the crisis, but rather these policies allowed the recession deepen and in fact accelerated its decline to depression.

Conclusion

The great tragedy of the Great Depression was that the desire for stability ironically caused instability on a scale that was dissimilar to any economic downturn that preceded it. The Gold Standard, previously a sign of good economic housekeeping, became a reason for the near collapse of European economies. The value of goods and services in America fell by almost 50 per cent in the early 1930s (Temin, 1976). It is true that internationalism was operating in difficult circumstances. Steiner writes that 'ethnic nationalism, whether in victorious or defeated countries, above all in Eastern Europe, was heightened in the scramble for territory' in the early post-war period (Steiner, 2005). However, this does not excuse the error of Western leaders in their calculation that a return to normality needed to be a return to the past. The lack of acknowledgement of the crisis, the ignorance in its causes and the failure to coordinate and cooperate in a response were failures which mostly laid at the feet of western leaders.

References List:

1. Barber, Clarence L., 'On the Origins of the Great Depression', Southern Economic Association, Vol.44, No.3, (January 1978), 432-456
2. Bernanke, Benjamin and James, Harold, 'The Gold Standard and financial crises in the Great Depression: An International Comparison', in R. Glenn Hubbard (ed.) Financial Markets and Financial Crises (Chicago, 1991)
3. Briggs, Isaac and Clavin, Patricia, Modern Europe 1789-present (New York, 2005) Eloranta, Jack and Harrison, Mark, 'War and Disintegration' in Stephen Broadberry and Kevin O'Rourke (eds), The Cambridge Economic History of Modern Europe; Volume 2: 1870 to the Present (Cambridge, 2010)
4. Eichengreen, Barry, 'Understanding the Great Depression', The Canadian Journal of Economics/Revue Canadienne d'Economique, Vol. 37, No.1 (Feb 2004) 1-27 Feinstein, Charles, Peter Temin, Gianni Toniolo, The World Economy Between the World Wars (Oxford, 2008)
5. James, Harold, The End of Globalisation: Lessons from the Great Depression (Cambridge MA, 2009)
6. Kemp, Tom, The French Economy 1913-39; The History of a Decline (London, 1972)
7. Kindleberger, Charles, The World in Depression 1929-1939 (London, 1973) Maddison, Angus, 'Economic Policy and Performance in Europe 1913-1970', in , (ed. Carlo M. Cipolla), The Fontana Economic History of Europe: the Twentieth Century Part 2, (Glasgow, 1976)
8. Steiner, Zara, the Lights that Failed: European History 1919-1933, (Oxford, 2005)
9. Temin, Peter, Did Monetary Forces Cause the Great Depression? (New York, 1976)
10. White, Lawrence, Did Hayek and Robbins Deepen the Great Depression? Journal of Money, Credit and Banking, Vol 40, No.4, (June 2008) 751-768
11. Zacchia, Carlo, 'International Trade and Capital Movements 1920-1970' in Carlos M.Cipolla (ed.), The Fontana Economic History of Europe: The Twentieth Century; Part 2 (Glasgow, 1976).