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The Great Depression – Retro

Part 1

This study was written because the economic crisis of 2008 had been compared by many, including renowned economic experts, with the one in 1929–1933. Dealing with the latest literature on the subject, I drew the following surprising lessons for myself. Firstly, the literature available for the Hungarian professional public is rather poor compared to what can be found out from leading foreign research on the subject that combine economic theory and history. Secondly, the thesis that the lesson has been drawn from the historical experience of the Great Depression is only partly true. Only one of the reasons for this incompleteness is that 'retrograde' institutional changes took place. The other reason is that there are really serious question marks, which can be considered epistemological, concerning the way the Great Depression evolved and ended. In other words, it is sensible to treat our knowledge of the events of that time with proper humility, considering its limits; it does not hurt to be aware of the puzzles that still exist. One should be restrained when harping on the question 'Can it happen again?'. I believe that one can better understand this lesson, if I do not tell the new, linear story that can be reconstructed according to the new framework of attitude, but I present the difference between the earlier and newer approaches in connection with individual problems.

This study presents the paradigm of interpreting the Great Depression that can be connected to the names of Kindleberger, Temin and Eichengreen. These authors are far from agreeing on everything, but an important common factor is that they emphasise the global context of the crisis, the problematic nature of causality, the embeddedness of economic phenomena and measures in a framework and that they can only be understood within that framework, as well as the close interrelationship and inseparability of the financial-economic and political aspects of events. The comprehension focuses on the framework (regime), rather than on the developments in macroeconomic variables that can be found in textbooks (consumption, investment, money supply, demand for money etc.), i.e. it focuses on the system of the actions and situation assessment by economic and political agents and their interactions. Moreover, this regime seems to be more extensive than the monetary or fiscal policies of national states, and can only be interpreted in the interrelationships among global flows and political cooperation.

LIMITS OF UNDERSTANDING THE GREAT DEPRESSION

The attitude represented in this study is different from the approach of macro textbooks that suggests an arranged nature of our knowledge, typically moving the IS-LM curves (for their

criticism, see Temin, 1976, page 11 and Kindleberger, 1986, p. 5). It diverges from the Marxist schemes using the *clear-for-themselves interests* of groups believed to be identified sociologically (the interests of capitalists or the financial oligarchy) for explanation (Varga, 1978, pp. 323, 385 and 440–441). It also goes beyond the point of view suggested by the classical work by *Friedman* and *Schwartz* that economic theory was able to clearly identify the reasons for the Great Depression and the defects in system control, as a result of which we possess, or at least may possess, the philosophers' stone to avoid the evolution of similar crises.[1]

Reading the literature about the Great Depression is excellently suitable to make us realise the *problematic character of the notion of causality* again, which seems to be simple in everyday life but always represents a challenge for philosophers, in connection with understanding a given historical period that is very exciting in terms of economic theory as well. Researchers representing different schools named different reasons. One may 'select' from them on the basis of one's preconception, preliminary studies or other factors, or may be puzzled because of this variety. One might assume the point of view that each explanation contains 'a piece of the truth', and that it is not worth looking for one final reason. (Botos, 1986, p. 341 ff.) In this respect, I consider Kindleberger's (1986, p. 6) attitude as authoritative. He states that one thing is to identify factors that are possible reasons for economic problems, and another no less important question is why the system was unable to give an adequate answer to them with automatic, market correction mechanisms or with adjustment measures of governing authorities. It includes the fact that perfectly exogenous, necessary and sufficient reasons entailing unambiguous consequences can hardly be found. Reasons like this especially do not exist in the world of social-economic events, but problems of an origin that is hard to trace back and pose a challenge appear as a surprise to the authorities; it also means that these problems exert their effect only in the given historical situation, through the answers given to them according to theoretical and interest schemes existing in an arrangement in line with defined institutional as well as political and power relations.

A positive consequence of the theory of rational expectations, which is useful in the interpretation of the Great Depression as well, is the distinction between the *regime* and *individual* economic policy measures (raising the key rate, deficit financing): the people and economic agents do not react to individual, isolated actions of government; they have assumptions regarding authorities' efforts that have significance beyond individual measures. The *proceeds of the theory of rational expectations* is that it calls the attention to the *regime* that justifies *certain concrete* actions and decisions of national authorities, and affects the outcome of such actions and decisions. With the transformation of the system, the impact of the same actions and decisions becomes fundamentally different, or even opposite, than earlier, embedded in another framework. (Temin, 1989, p. 5) This makes it impossible to apply universal causality schemes in understanding as well as to provide general recipes that can mechanically be issued when giving economic advice. An important element of the theory of rational expectations – although in fact the Keynesian perception of the importance of expectations has already also reacted to it – is the interaction between economic agents and economic management (the state and the central bank).

At the same time, one may *dispute* the assumption of rational expectations that, on the one hand, the government and the authorities have a clear conception of the regime and their task is to convince the private sphere to keep to it and, on the other hand, that the pri-

vate sphere has a similarly clear set of decision-making rules, from which it 'pulls out' one, depending on the economic policy framework represented by the government, and acts accordingly. This is not the way regimes come into being, even if sometimes the contours of a regime become visible from the course of events.[2] The government does not have a clear notion of the new regime, and cannot see why the old one was problematic either; it progresses forward, or sometimes steps back, on the basis of (confused) impulses coming from theoretical and political interest groups that argue with one another. The events of the Great Depression confirmed this pattern. The signals and feedback coming from the players of the private sphere, which are otherwise also based on unstable convictions, play an important role in developing the new regime: this is not about forcing a pre-conceived regime through the expectations of the passive private sphere; on the other hand, the expectations of economic agents also change, not to mention the differences between their knowledge, expectations and interests as well as influence on the course of events. There is no single equilibrium that should only be found in this process; something system-like evolves in the interaction of economy and politics that has an unpredictable outcome. (Temin, 1989, p. 132; cf. Botos, 1987, p. 57) The problem with Sargent's concept of a regime is that it narrows down the features that allow the description of a regime, for example the method of deficit financing, upon the examination of which one may speak about changing the regime, or it mentions overly general things: preferences of the private sphere and production technique. (Sargent, 2005, pp. 19–24) Private players are able to put their trust in more than one regime;[3] therefore, a government's economic policy has ample room for manoeuvre. There are many serious debates between economic agents as well as social and political groups (whether in the private sphere or the regulatory/public sphere); there is an ongoing fight of concepts and interests, where the details that would facilitate understanding are often missing, for example, when we examine the motivation of the US economic policy that foiled the World Economic Conference in 1933. Temin (1989, pp. 85–91) rightly rejects the idea that stakeholders' expectations are well-founded projections ('informed predictions') that equal the – 'relevant' – theory to be applied. Exactly, *the always recurring problem is what the relevant theory is.* Ordinary people of a given era do not think the way we do here and now, and their way of thinking is also different from that of – today's or yesterday's – economists. The regime also means ideology and mass beliefs as well as the institutions functioning within their frameworks. Emphasising the conviction of the latter, the crowd, the population (the economic actors) (in addition to the market) points out the significance of democracy and public opinion.

The reason and explanation, if there is any at all, for the crisis and its unprecedented magnitude and protraction should not be interpreted at the level of *individual* steps taken by the authorities (for example, the tightening of monetary policy in a given year, the slight tightening of the Fed in 1929), but in the features of the functioning of the *regime* and in the attitude of the authorities towards this regime. Finding the solutions did not mean the application of recipes that lead to success under all circumstances, but that the authorities were able to revaluate – even if not at all with the ability of completeness and sure comprehension – the context in which the measures have an effect, and, *all things considered*, to contribute to an abatement of the problems (unemployment, economic recession), although not necessarily with each partial measure. In this case the nature of the decision maker's *responsibility* is fundamentally different from what Friedman

missed at the Fed: it is not that the decision maker failed to carry out an understood and known, proper, routine-like action, but it shows the lack of a kind of intellectual ability, of one that is supported by the strength of the regime. Intellectual ability or the lack of it is mainly a collective thing; it is not possible to terminate the lack thereof individually, although the position of the individual is very important here. (Cf. Eichengreen, 1992, p. 17)[4]

One of the two main schools of research of the Great Depression prevalent in the 1970s is the *spending* explanation of the crisis. This explanation dominated after the Second World War and referred to *Keynes*. The other, *monetarist* one is its alternative, related to Friedman. (Temin, 1976, pp. 174–176) The authors used by us as leaders are sceptical about their arguments and explanations. In one of the interpretations, the monetarist and spending theory tries to explain the phenomenon with a unicausal, single factor (Kindleberger, 1986, p. 4), while according to the other it relies on the unclarified notion of causality. Friedman was looking for *solutions* to the crisis that were different from the ones found by his contemporaries, which suppressed and misguided understanding. He disregarded the factors that were exogenous for the financial authority and the possibility that the clarification of the reasons for the crisis may at least theoretically be independent of the proposed cure (which, at the same time, also means that he finds the reason where he sees the lack of the cure).[5] He did not take account of important consequences of implementing the proposed cure either; for example, that the monetary expansion proposed in order to manage the bank panic or the application of open-market operations would have most probably meant the termination of the international monetary framework, the gold standard.[6] Which, of course, is a *theoretical* possibility for politics, but in terms of its magnitude this matter has a greater weight and affects more stakeholders than the usual monetary policy decisions. It raises the issue of global, intergovernmental cooperation. Friedman, from the comfortable position of the *ceteris paribus* condition, assumes the constancy of the behaviour of economic agents, although it can hardly be assumed that actors would not have changed their behaviour as a result of the monetary measures applying Friedman's cure. The contemporary authorities had to face a number of unexpected and unpredictable reactions. This is the reason why Friedman and Schwartz considered the increase of money supply a suitable solution for all the problems that arose in the years of the crisis, as they disregarded the mechanisms that prevail independently of authorities' measures and the reactions of economic actors to authorities' measures. They assumed in an implicit manner that even if such reactions existed, the authority would be – or would have been – able to offset them through the means at their disposal for liquidity expansion.

Friedman and Schwartz rather only hinted at exogenous factors. In the case of Friedman and Schwartz the factors of money supply and demand that are partly independent of one another become subordinated to money supply, and the autonomy of developments in income becomes terminated by the use of the technical term 'money stock', in which, of course, the ex post congruence between money supply and demand is expressed, just the *really interesting ex ante aspects* and with them the expectations concerning the future *get lost*.[7] In their justification, Friedman and his followers bring up arguments that are contrary to the facts. For example, if the Fed had not tightened and had not reduced money supply in 1928–1929, the recession at the end of 1929 would not have taken place in the USA, but they do not, and cannot, claim that the decline in money stock *caused* the fall in production and prices. *Namely, contrafactuals do not actually prove anything*; contrafactuals, as shown by

their name, are not about facts, they are not explanations of facts. The absence of the cure is not the same as the reason for the illness. (Temin, 1976, p. 14–30)

In addition to the contrafactuals, Friedman and Schwartz had a penchant for mentioning the correlation of certain phenomena and their simultaneous appearance, for example, when they noted that 'the bank crisis is a remarkable attribute of the (1932) recession'. *Of course, on the basis of the correlation it cannot be decided what the cause and what the consequence is*; nevertheless, the authors – furtively – take the co-movement as a proof of the ability of the money stock to influence income.[8]

Problems arose not only in connection with Friedman's monetarist theory, but also with regard to the spending theories following in the presumed footsteps of Keynes. In the econometric analyses following Keynes, the decline in investment turns to a fall in income. The interest rate spread above risk-free investments did not display any significant increase during the crisis, and the developments in long-term interest rates were hardly explained by the developments in short-term ones. Therefore, investment *seemed to be insensitive to monetary conditions*. The fall in incomes seemed to be independent of the financial sector. Keynes' followers attributed the decline in the demand for investment to the 'deterioration in future business prospects'. The parameter values estimated with their models for 1929 significantly deviated from the actual values, which they 'concealed' in a sort of artificial manner, by including a quasi-dummy for this year. (Temin, 1976, pp. 31–50) From *A Treatise on Money* by Keynes they gathered that in the pre-crisis period the magnitude of investment was 'excessive', which turned to a shortage of investment in the period of expensive money,[9] and from the *General Theory* that the marginal efficiency of capital declined because of the significant earlier investment. Although in the *General Theory* Keynes said that it is difficult to speak about investment overshooting in an 'absolute' sense irrespective of the interest rate policy of the monetary authority and its monetary policy in a wider sense when there was no shortage of labour in the USA in 1928–1929, it would have been possible to develop the condition of homes, the transport sector and public services, and there were investment opportunities in agriculture as well. At the same time he also expressed, *suggesting some kind of mechanical causality*, that investors 'could *only* (my own italics – L. O-Sz.) expect rapidly declining yields', *in view of the investment boom of the previous five years*. That is, he also emphasised the *deterioration in profitable* business *expectations*. (Keynes, 1965, pp. 340, 345–347)[10]

This argumentation of Keynes' theory regarding the 'deterioration in future business prospects' did not prove sufficiently convincing. Especially, because *it is unlikely that the unprecedented depth of the crisis can be deduced from it*. The idea arose that the deterioration in future business prospects hindered investment through the fall in stock exchange prices. Indeed, recent researches suggest that the fall in stock market prices in the USA was greater than the decline observed in dividend flows; nevertheless, the crash was not a cataclysmical change. (Temin, 1989, p. 45)[11] Several facts contradict the dramatic and noteworthy deterioration in expectations at the onset of the crisis. In Temin's opinion there is no evidence that expectations turned more gloomy in the USA before the end of 1930. Although it is often mentioned ironically that *Hoover* described the business life of his country as firm and sound before the stock market crash of 1929. (Kaposi, 1998, p. 32) However, this conviction was not shaken by the events for at least one year. Therefore, it is not possible to prove the relationship between macroeconomic data and the decline in business confidence, unless the thing is that the shaking of confidence subsequently

gave another meaning to the data. Although it is usual to interpret the crisis of 1929 and the stock market crash as the collapse of a world, in fact, a strong consensus prevailed among contemporaries in those months regarding the possibility of a rapid recovery. Not only the authority, which aimed at it knowingly, but the wider professional public opinion as well interpreted the stock market crash as a justified reaction to unreasonable speculation. In the middle of November 1929, business people interviewed by *Business Week* expected a 7 per cent decline, and only a 2 per cent decline two weeks later. In May 1930, Hoover believed that the worst was over for the economy. (Kindleberger, 1986, p. 117) In July 1930, the low inventories, the rapid bank loan expansion (in international loans as well) and the low import prices all seemed to be the early signs of a recovery for the general public. Credit rating agencies were not pessimistic about the future either: the rating of corporate bonds – excluding the effect of the maturing and newly issued ones – deteriorated to a lesser extent in 1930 than in 1921 or 1937, which were also considered crisis years. The spreads – the interest rate differentials between both the long- and short-term as well as the risky and risk-free securities – started to increase as late as in 1930–1931; then not only the premium of certain specific securities increased, but of the whole rating class as well, which suggests the appearance of system-level risks like the business cycle. (Temin, 1976, pp. 63–80 and 105–108) Well after the Second World War, at the end of the 80s, modelers (*Dominguez, Fair* and *Shapiro*), equipped with the then best statistical means, attempted to find out whether they would have been able to predict the deepening of the crisis using the database available for the analysts of the 1920s, moreover, extending it until 1907 retroactively. Their conclusion was the same as that of contemporary researchers (Harvard Economic Service and *Irving Fisher* at Yale), i.e. that deflation would end soon (Temin, 1989, pp. 58–59; cf. Mankiw, 1999, p. 393). In Kindleberger's opinion the most important effect of the stock market crash was not the deterioration in US economic agents' expectations, but that it reinforced the already downward spiral of global commodity prices.[12] Although following the crash the Fed started easing, deflationary forces had become stronger by then.

For a long time, expectations had not reflected the unusually widespread recession – which was more threatening than the crises following the First and prior to the Second World War – in the still uniquely prospering USA, which was *subsequently* perceptible on the basis of the data of the US economy for 1929. Now we can see that, based on the developments in income and the wealth effect, a much greater than justified fall in consumption – amounting to 3 per cent of GDP – took place during the crisis of 1929 in the USA.[13] Comparing the crisis of 1929 with the other two crises between the two world wars (in 1921 and in 1937) the difference is that *both* investment *and* consumption – including that of non-durable goods – *as well as* exports fell, resulting in a 4 per cent decline in GDP. Moreover, the fall in investment was also greater than in 1921 or 1937, and it mainly affected the permanent elements (construction investment), unlike in 1921, when public investment had declined with the war coming to an end, and not only inventories, as in 1937. While in 1929 there was a *lack of aggregate demand*, in 1920 a significant change took place only *in the structure of demand*. (Temin, 1989, pp. 60–62) Taking everything into account, the role played by the deterioration in business expectations in *launching* the crisis is doubtful, although it may have had a role in the *deepening* of the crisis.

From today's point of view, too little is mentioned in the *General Theory* about the partly global and political factors that play a role in

the deterioration in expectations and marginal productivity and about the conventions that constituted an obstacle to successful macro management. And we can learn only a few facts about the historical conditions under which the changing of conventions considered to be detrimental – the importance of which was realised by Keynes and other contemporary reflationist economists – may (have) take(n) place. Keynes' *General Theory is not identical with the discussion of the problem of the global cooperative regime of the 1930s*, especially not when he deduced the stagnation in employment and in the economy from the fate of the marginal efficiency of capital that was made up to be trend-like in a barely comprehensible way and from the proprietary classes' selfishness that opposed the rate cut. (Keynes, 1965, p. 333) Nevertheless, Keynes' *General Theory* is a complex work because subsequently one can also easily see in it the preliminaries thinking in the framework of an attitudinal regime, if other chapters of it are emphasised.

It is to be noted here that in the global economic policy framework *the differences between monetary policy and fiscal policy become secondary*. There are monetary policy conditions of achieving fiscal policy targets; the multiplier cannot be estimated without the assumption regarding the behaviour of monetary policy. (Mankiw, 1999, p. 303) However, this does not necessarily mean that we devalue the budgetary, redistributive and welfare measures of crisis management programmes (New Deal). Even if, for example, *Bernanke*, repeating the opinion of Friedman and Schwartz, does so, allowing himself the assertion – which otherwise has seemed empirically unfounded recently (see Fishback et al., 2001) – that financial rehabilitation was the only important measure of the New Deal that led to an upswing. (Friedman – Schwartz, 1986, p. 97–98; Bernanke, 2000, p. 62)[14] Nevertheless, during the Great Depression it was observed in many cases that if a country did not leave the restrictive international monetary regime – see the efforts of the French civil radical or popular governments preceding the Blum government –, it was unable to pursue permanent fiscal expansion. Some of the reflationists, for example *Kalecki*, who proposed the increasing of public investment or aids, i.e. budgetary means, formulated the monetary conditions of their proposals: the banking sector must be able to serve the increased credit demand of the economy that was turned on by the increasing of public expenditures, and the growing interest rate entailed by the upswing should not offset the impact of the increase in income. Nevertheless, the implicit political conditions – which meant a change in the regime – of these conditions were not necessarily clarified as deeply as it is done by today's analysts. (cf. Kalecki, 1980, pp. 50 and 73) As opposed to monetarists, we emphasise that *restoring the confidence necessary for changing the regime was only possible with budgetary and other economic regulatory measures that attempted to ease the social tensions that cracked internal cohesion and to reduce the risk of investment*. Not every measure achieved its objective, or measures were not always efficient; in some countries it worked, in others it did not – the Blum government that copied the New Deal of the United States was unable to achieve similar success.[15] However, on the whole, we do not have proper grounds to ignore their contribution to the recovery.

THE GLOBAL FINANCIAL REGIME OF THE 1920S

According to the authors that are looking for global and system-level explanation, one may gain a deeper insight into why a sharp drop in demand took place in so many countries simultaneously, by understanding the determinants of the *system of the global gold standard* and the

gold exchange standard that *had evolved by the 1920s*. (Bernanke, 2000, p. 277) This regime, with its institutions, ideology, rules and the individuals in a decision-making position committed to them, was the propagator and strengthening factor of an unplanned global monetary restriction that *individual* monetary authorities were unable to manage. The main trouble was the asymmetrical operation of this system in the direction of deflation.[16] *Asymmetry* means that while *the country losing gold had to use deflation to fight against the outflow of gold*, to defend the exchange rate of its currency, the country that was increasing its gold reserves *had no obligation to issue money equaling the magnitude of inflows*. (Bernanke, 2000, p. 74)

Looking at the history of several decades of the gold standard as a whole, the form of the gold standard that evolved by the 1920s is a *special* case of the gold standard. *The gold standard as a global economic-political regime was significantly reshaped by the First World War*, as the international (economic and military) balance of forces also underwent a fundamental change. (Temin, 1989, pp. 6 and 35) Following the war, the pound sterling – and together with it the currency of the English colonies, for example the Indian rupee – was taken back to the gold standard at the pre-war, excessively high exchange rate, which forced the British to continuous deflating in the 1920s. The franc, in turn, was considerably devaluated, and the USA and France became countries with excess amounts of gold.

Earlier, when the Bank of England (BoE) had been the strongest (hegemonic, according to Kindleberger) factor in the international monetary system, it was not typical – due also to the British central bank's interest in profit – of central banks to keep more gold than necessary. However, the US and French central banks, which started to play a decisive role in the 1920s, were not influenced by the considerations that guided the BoE.[17] The practice in the 1920s was that the central banks of countries with a deficit deflated even in the case of losing a small amount of gold. Important change: after the First World War the phenomenon of central banks rounding out their gold reserves not only with gold, but with the currencies of important economic powers as well, gained ground. The fear, which was in fact less well-founded according to recent researches, that there was not enough gold in the system played a role in it. The regulation of the gold/reserve ratio strengthened the deflationary stance of the monetary system, as the statutes of central banks required a minimum threshold for it, but they did not require a maximum one. They usually applied a 40 per cent lower limit, which meant that the effect of the flow of gold – deflationary effect in the case of outflow – on money supply had a 2.5-fold multiplier, while the contrary effect did not succeed at the gold importer (typically at the US and French central banks), as they were not anxious to get rid of their surplus gold reserves. (Bernanke, 2000, p. 75; Rothermund, 1996, p. 87) Under these circumstances, more significant rearrangements in the volume of monetary gold carried the potential danger of deflation.[18] Later, recovery from the crisis was made possible by measures that searched for a solution to the correction of the deflationary bias of the global regime, although initially these corrections appeared in the form of measures implemented at the level of national authorities, not at a global level. Theoretically, it would have been possible to launch monetary expansion and contain deflation through efficient international cooperation as well, but not all factors were in place for this. (Bernanke, 2000, p. 276) Monetary restriction that has become self-inducting is the central element of the crisis. Nevertheless, this is not what Friedman and his followers talked about: the Fed was not the single (responsible) manager of the process, even if it was a decisive co-author of the story.

The problem of the regime was not that it was linked to 'gold'. And even being linked to something is not a problem, i.e. it does not mean that there is any problem with fixed exchange rate regimes in general. (Cecchetti, 1997, p. 20) Some of the contemporaries believed that the absolute lack of gold was the reason for the crisis, but today the *absolute* lack is no longer considered to be a serious factor. In spite of its distribution problems, the increase in the globally available quantity of gold significantly exceeded the increase in M1. Nevertheless, in certain phases of the crisis – but not in the initial one – the *distribution* of the existing volume of gold, which, on the whole, was sufficient, pointed to global monetary tightening. (Bernanke, 2000, pp. 135 and 154–155)

Due to the foreign trade surplus of the USA that accumulated during the war, large trade surpluses and deficits developed in the system, which increased the significance of flows of money and capital that had not been negligible in the financial intermediary system earlier either. (Temin, 1989, p. 17; Eichengreen, 1992, p. 12) These flows of money and capital, in turn, departed even further from the idea of self-regulation, due to the fact that loans and debts *came into being on a political basis* in order to reactivate the system and be able to pay war reparations. (Polányi, 1997, p. 292) The problem of bribery and asymmetrical information probably appeared as prominent distorting factors in providing international loans. (Botos, 1987, pp. 48, 59 and 84) In the meantime, a significant number of economists remained the prisoners of conceptions concentrating on goods turnover, going back to *David Hume*.

The gold standard, contrary to its ideology, which attempted to interpret the regime as a self-correcting mechanism free of politics, required international coordination and cooperation even when the British Empire seemed to be unquestionably the leading power in the world. Following the world war, the global convergence of politics and economy became even more apparent. Attention was called to the importance of the political-economic nature of the global monetary system and system operation, as opposed to the purely economic nature (in the sense as understood by Friedman), already by Kindleberger. Upon analysing the Great Depression, he did not emphasise the mistakes made by a national authority that can be interpreted within a national framework, but underlined the fact that the earlier global playmaker, the British Empire, was not able to and the authorities of the new hegemon, the USA, were not yet willing to assume responsibility for the developments in the global economy, or were not adequately aware of their relevant responsibility or the possible consequences of the impact that the USA had on the external world.[19] According to Kindleberger, the hegemon of the international system does not simply guide the other participants in the regime, but is also *willing to bear the burden of* the adjustment of the global system. This means that it keeps its own markets open to others' goods, extends counter-cyclical long-term loans, ensures stable exchange rates, conducts macroeconomic coordination, and acts as lender of last resort. (Kindleberger, 1986, pp. 11 and 289–300) Eichengreen and Temin disagree with Kindleberger, and are of the opinion that the gold standard cannot be interpreted as something under the influence of a single dominating power.[20] According to Temin, since all significant central banks accepted the gold standard as an unquestioned regime, it is hard to believe that another hegemon's assuming the position would have meant a solution.

An important condition of central bank cooperation in the gold standard was the unquestionability of the international monetary élite and its decisions as well as the subsidiarity – and the unformed nature – of mass demands displayed on the national platform, i.e. the credibility of the gold standard was pro-

vided by the understanding that internal political democracy and interest relations should not be against international monetary cooperation. However, by the 1920s/1930s economic and social groups and interests within national states became articulated enough on a political plane to be able to formulate a clear-cut opinion on monetary matters. (cf. Eichengreen, 1992, page 6; Polányi, 1997, p. 290; Botos, 1987, p. 91) In the opinion of the strengthening money markets, the influence of politics on wage and labour matters as well as the intransparency of whether the balance of payments or employment issues are given preference made central bank behaviour more unpredictable than before, greatly increasing the volatility of money and capital movements. (Eichengreen, 1992, p. 10) *The pillars of credibility that match the newer, mass democratic political system have not yet appeared in the international monetary system.*[21]

The process of the convergence of economy and politics is clearly expressed by today's analysts of the crisis, for example, when Bernanke (2000, pp. 8 and 276) interprets the uniquely destructive crisis as the 'unintentional consequence of the interaction of poorly designed institutions', and talks about an 'incorrectly and poorly managed gold standard'. It means that he considers the international monetary system a matter of planning and management, as opposed to the ideology that was still strong in the 1920s and 1930s and – in spite of the anomalies that have been present for decades – interpreted this regime as an automatic mechanism that is untouchable, or at least not to be touched, by politics.

THE ROLE OF NATIONAL FACTORS

The spending, then monetarist theory appearing after the World War overshadowed global/international expectations in the interpretation of the Great Depression (as well), [22] although it was still more revelational and useful than the Marxist economic historiography, which, as world capitalism is a global system, talked about the global nature of the Great Depression in a self-evident manner. However, global aspects meant only a meaningless generality.[23]

Although we direct the attention from individual national authorities' 'mistakes' to the international system, one cannot disregard that the defects of the international system do not occur independently of the choices and strategies of national authorities; after all, the authorities of major nations would have been (and later they were) able to reconstruct the international system and manage its problems. Bernanke attempts to express this duality when – to some extent in a USA-centric way, but looking at the United States in the global course of events – he talks about the periods of '*self-inflicted wounds*' and then of '*forces beyond our* [i.e. the Fed's] *control*'. (Bernanke, 2000, p. 110)

In view of its consequences, he considers the tightening policy conducted by the Fed in 1929 negative, although the negative opinion *is given with regard to the global context and not the national one*, because at that time the economy was still growing dynamically in the USA, although the signs of recession were already observed at global level; international wholesale prices started to fall as early as in the summer of 1929. In fact, there are still some who consider the behaviour shown by the Fed in 1929 improper with regard to domestic economic activity as well: in *Cecchetti*'s opinion, the conception behind the restriction carried out in order to contain stock exchange dealings was a misinterpretation of the phenomena experienced in the US economy.[24] Bernanke's (2000, p. 153) interpretation is different: He considers the criticism of Friedman and his followers verifiable *to the*

extent that the USA is the only country where the *discretionary* element of monetary policy played a significantly *destabilising* role at the beginning of the *global* crisis. *Botos* (1986, p. 338) points out a similar asymmetry in the situation of the European countries and the USA. As Eichengreen puts it, inexplicable optimism, independent of the monetary authorities, evolved in the USA in the 1920s, and 'very optimistic' investment expectations carried the economy forward (Eichengreen, 1992, p. 14). It also means that the Fed had at least some ground for stepping on the brake. Being of a somewhat different opinion, Bernanke strikes a more critical tone when he says that the Fed's policy of sterilising gold inflows was 'inconsistent' with the rules of the gold standard. (2000, p. 153) In fact, the practice of sterilisation already existed before the First World War, i.e. actually, there is no 'inconsistency'.

The decline in *global* real money balance in the period of 'self-inflicted wounds', i.e. in 1929–1930, is attributable to the tightening policy of the USA.[25] In 1931–1932, the Fed was already the prisoner of forces beyond its control, i.e. of the deflationary forces of the gold standard. By then, the developments that played a role in the narrowing of global money supply included the reduction of central banks' foreign exchange reserves and the deposit/cash ratio, which was declining mainly – although not exclusively – because of the bank panic as well as the money multiplier that was decreasing as a result of a more cautious bank lending policy. As a consequence of the devaluation of the pound in 1931, some central banks recorded substantial losses on their foreign exchange reserves; to avoid the recurrence of this problem, they started to replace foreign exchange with gold in their reserves. The ensuing gold outflows resulted in declines in reserves and, through that, monetary restraint in the countries losing gold. Bankruptcies of banks and companies meant the reaction of the real economy crisis to the financial intermediary system. The effect of the deterioration in real economy prospects was reflected in a decline of lending by banks. The US monetary policy had already became expansionary by then. The Fed already tried to offset – sterilise – the tightening effect of gold outflows, although instead of that the effect of the distortion of international gold distribution that cannot be considered discretionary (the fleeing of gold to France, the Netherlands, Belgium and Switzerland) as well as the decline in the money multiplier became the main problems. It is to be known that the gold flowing into the countries that were increasing their gold reserves *ceteris paribus* should have resulted in ample liquidity inside these countries and thus, indirectly, globally as well, but local, mainly the French, monetary policies sterilised the inflow of gold, as foreign exchange was replaced by gold in the reserves. This was only partly offset by the loosening that can be measured on the increasing of the base money/reserve ratio. The policy of the Fed aiming at increasing liquidity, reducing the money multiplier and offsetting the negative effect of bankruptcies could only be limited in this phase of the crisis (following the devaluation of the pound, in spite of the significant US gold reserve) because pursuant to the rules of the gold standard it would have raised the otherwise already existing pressure on the dollar, which stemmed from central banks' aforementioned sales of foreign exchange, including the dollar. (Bernanke, 2000, pp. 126–155; Eichengreen, 1992, p. 293) The global monetary regime played a role not only in the fact that incomes started to decline, but it also hindered the application of state policies against the crisis, including the bank crisis (devaluation, rate cut, budgetary incentives, saving of banks): when central banks started to pump funds

into the banks that had become weaker, the only thing they achieved was that depositors liquidated their savings, withdrew their gold from banks, i.e. pumping 'fresh air' in only widened the already existing tear. (Eichengreen, 1992, p. 18)

The difference between the descriptions by Friedman and Schwartz (1986, pp. 85–93) as well as Friedman and Friedman (1998, pp. 74–83) and that of Bernanke is that in their opinion the Fed could have followed an alternative path *all along* between 1929 and 1933; it had the power to do so and possessed the necessary knowledge as well; the feedback working in the complex economy would not have prevented it. Until October 1931 it should not even have had to collide with the rules of the gold standard, only later, at the worst. The problem was not with the international monetary regime, but with the fact that the monetary policy of the USA systematically neglected the interest of the domestic economy, i.e. the whole crisis is a homogeneous period of self-inflicted wounds.

Although making a distinction between 'self-inflicted wounds' and 'forces beyond our control' is unavoidable from the aspect of global events, it is USA-centric in the sense that it does not have great importance in many countries of the world. Monetary policy in a great number of underdeveloped countries was cont-rolled by colonial powers or great powers that did not have formal colonial means. Although the British sentenced India to deflation, influential countries did not act in concert at all when forcing the world to conduct tightening monetary policies. China was rescued from the crisis by the British using the monetary policy with the new attitude applied in Great Britain, and the devaluation of the pound usually created a more advantageous situation for the British colonies, while the insistence of the French on the gold standard usually terminated the earlier advantage of their colonies. (Rothermund, 1996, pp. 77, 90 and 113) In many Latin-American countries, the country's élite behaving as an independent actor was able to defend the interests of the country with monetary policy instruments as well. (Rothermund, 1996, pp. 99–108)

The directions followed by individual countries cannot directly be understood from the internal interest relations, only through the transmission of the strategy of the political leadership and the decisive expert conceptions as well as of the convictions living in the population. In principle the strong financial services sector meant a heavy counterweight against leaving the gold standard and devaluation, but the interests of the City could eventually be overshadowed, since by that time the conviction strengthened that the strong exchange rate had been the cause of the recession in the 1920s. Farmers and exporters suffering from the debt deflation comprised the vanguard of devaluation in the USA and in the Scandinavian countries. Nevertheless, France, where agricultural orientation is strong, committed itself to the gold standard to the very last, and the problem of those with an interest in agriculture was treated with radical market protection measures. It proved to be decisive that after the war in the countries that experienced hyperinflation, including France, the fear of inflation – which of course was ironic in an environment of deflation – motivated the authorities, and the event of returning to the gold standard became the synonym of (price) stability. In addition, Brüning's leadership in Germany wanted to get rid of the burdens of reparation, demonstrating the 'unbearableness' of the economic-social crisis to the creditor countries. (Temin, 1989, p. 77; Eichengreen, 1992, pp. 23–24, 303 and 308–310)

Notes

[1] Essentially in this spirit, Cechetti (1997, p. 22–23) and Mankiw (1999, page 318) were optimistic upon drawing the lessons, excluding the possibility of a crisis of a magnitude similar to that in 1929–1933.

[2] In fact, Sargent too must admit that the identification of economic policy regimes is subject to debate, but he searches for the task of the theory of rational expectations in developing an algorithm about the reasons and consequences of economic events that functions in a routine-like manner. (op. cit., pp. 27 and 29)

[3] For example the one with which, according to Sargent (2005), it was possible to curb inflation in the Central East European states in the early 1920s.

[4] Some textbooks still interpret the responsibility of the Fed in the spirit of Friedman: for example, Mankiw (1999, pp. 511–512) in connection with the bankruptcies of banks.

[5] Temin, 1976, p. 7

[6] As pointed out by Eichengreen (1992, page 294 ff.): at the time of the bank crisis in 1932 the Fed had enough gold reserves to offset the *actual* (*ex post*) fall in the M1; the decline in the M1 amounted to two billion USD, equaling two thirds of the total gold reserves of the central bank. Nevertheless, the situation was completely different *ex ante*: although the decision-maker may have hoped that saving the banks would have led to the restoration of confidence, which would have prevented the outflow of gold, on the other hand it may also have occurred that foreign, especially French dollar depositors would have considered the open-market operations as stretching/violating the rules of the gold standard, which would have added to the outflow of gold, i.e. there would not have been sufficient gold coverage to offset the fall in M1.

[7] Friedman (1986, page 154) himself admitted in his study written later aimed at the clarification of the theory that expectations do not have an autonomous role in it, they only make the system closed; it is completely the past values that determine the permanent value of the key variables of the model, and it poses a 'problem' that these expectations (the permanent values of variables) equal their long-term equilibrium values.

[8] Temin, 1976, p. 26

[9] For example, this is how Kindleberger thinks, 1987, p. 43

[10] Keynes did not explain 'future business prospects' as mechanically everywhere as he did when he assumed pessimism following a longer boom necessarily and in a determined manner. In several parts, he presented the developments in marginal efficiency as understandable in a wider social-political context of a given historical situation. (Keynes, 1965, pp. 160–186, 221 and 229) Emphasising the importance of such correlations makes the regulatory mistakes that play a role in the evolution and inflation of bubbles, the underlying business interests as well as the awkward efforts to amplify the asymmetry of the inevitably asymmetrical information apparent. (cf. Stiglitz, 2005, pp. 44–48, 50, 80, 111, 134–139 and 143–148)

[11] By contrast, the stock market crash is still described by Ciepielewski et al. as the extinction of the belief in the future of US economy, 1974, p. 287.

[12] Kindleberger (1986, pages 112–115) Kalecki called the attention to this correlation as early as in 1931. (1990/1931, pages 37–38)

[13] Based on the slight monetary tightening and the developments in real economy, a downswing of this magnitude is incomprehensible. However, there is debate regarding the inexplicability of the decline in consumption: while Temin considered three quarters of the decline in consumption unexplainable, according to Mishkin's calculations two thirds of the decline in consumption in 1929 is explained by the wealth effect of the stock market crash. (cf. Cecchetti, 1997, p. 8; Temin, 1976, p. 72)

[14] There is an obvious difference compared to the descriptions that praise the novelty and courage of certain measures taken in order to mitigate the social crisis and misery. [cf. Botos, 1987, pp. 62–72; Cs. Szabó (1985/1935, p. 51) about the NIRA as the 'backbone of the experiment']

[15] cf. Kalecki, 1990/1938; Eichengreen, 1992, p. 374–385

[16] According to Bernanke's tests (2000, pp. 117–122), the use of the wholesale price index – in which deflation was most perceptible – Granger-causes the fall in industrial production in each country under review (except Germany) at a high significance level, while it is not true for the M1 money stock. In Bernanke's own interpretation, the result confirms the non-monetarist crisis theory.

[17] Or when profit considerations came to the fore at the French central bank as a response to the loss due to the devaluation of the pound in 1931 (and they started to sell their foreign exchange reserve in exchange for gold), it had a destabilising effect on the international monetary system, which was facing a crisis.

[18] It was Irving Fisher at that time who called the attention to deflation as a danger, but Friedman and his followers and the post-war econometric analyses did not pay adequate attention to it (i.e. neither the monetarist nor the spending theories).

[19] The commitment of the USA to the gold standard was not as strong as that of the then leading states at the end of the 19th century either. Kindleberger (1986, pp. 11 and 289), Kindleberger (1987, p. 49), Eichengreen (1992, pp. 30–31), Hobsbawm (1998, p. 98) and Mankiw (1999, p. 269) indicate that in the 1870s, when, following a sharp debate, the USA gave up the greenback introduced during the civil war, it sank the economy into the longest recession up till that time.

[20] Temin (1989, pp. 35 and 84), Eichengreen (1992, pp. 4–5) Without the help of other central banks, the convertibility of the pound sterling to gold should have been suspended twice in the quarter of a century prior to the First World War. (Eichengreen, 1992, pp. 8 and 391) Eichengreen's story confirms Károly Polányi's post World War II analysis (without referring to him), when he emphasises the international political aspects of the gold standard, pointing out that liberal economists did not really understand it. (Polányi, 1997, p. 30)

[21] Perhaps it is worth mentioning that for Marxist contemporaries acting on behalf of democracy and the working masses the aforementioned problem did not exist: they simply considered it a fact that 'financial capital' had control over the developments before, during and after the crisis. (Varga, 1978, p. 220)

[22] Eichengreen, 1992, p. 3

[23] See Ciepielewski et al. (1974, p. 286) However, Cecchetti's (1997, pp. 14–15) otherwise up-to-date analysis still attributes the deflationary effects directly to the bad policy of the Fed, as Friedman and his followers do.

[24] In the late 1920s, speculators that expected an increase in stock exchange prices devoted significant bank loans to stock purchases. According to Cecchetti (1997, p. 5), the Fed went to war against this process on the wrong basis: speculation meant harmless portfolio reallocation, but the Fed misjudged it, believing that stock purchases divert resources from real investment. The problem with the reasoning is that on this basis the expansion of broker loans could not have any real economy impact. On the other hand, if it is true, *then* limitation thereof could not have any serious effect on real economic developments either. A significant share of the orders were given to the brokers by American manufacturing companies that financed their stock purchases from loans, which forced interest rates up. In view of this, one may think that speculation diverted funds from the real sector. On the other hand, however, financing the investment of firms that were looking for funds at the stock exchange became easier. (see Kindleberger, 1986, p. 100) The net effect is not clear.

[25] It is to be noted that Bernanke calculated the real money balance with the consumer price index, which declines to a much lesser extent than the wholesale price index. Deflation using the wholesale price index presents the monetary conditions of the crisis years as much looser. In the past Temin (1976, pp. 141–143) also referred mainly to the developments in the money supply calculated using the wholesale price indices, when he brought up counter-arguments against the monetarist interpretation of the crisis with regard to the USA. However, strangely enough, the authors do not deal with the reasons for the notable difference between the two types of price indices on their merits.

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