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Global Crisis from the Perspective of the Great Depression^{*}

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The fact that the current global crisis originated from the U.S. and followed another intensive wave of globalization, has led to an unprecedented interest towards the Great Depression. These parallels between the two episodes fueled the rapid reaction of governments and central banks with the fear that the current crisis would deepen and last for years. Despite the widespread agreement that the recovery of the world economy has started in the second half of 2009 thanks to these measures, there are worries about its sustainability. Roubini (2009), for example, expects a U-shaped, anemic and below trend growth for at least a couple of years, after a couple of quarters of rapid growth driven by the restocking of inventories and a recovery of production from near Depression levels. According to him, there is even the possibility of a double-dip W-shaped recession due to the risks associated with exit strategies from the massive monetary and fiscal easing policies of 2009. If

policymakers take large fiscal deficits seriously and raise taxes, cut spending and mop up excess liquidity soon, they would undermine the recovery process and tip the economy back into recession. But if they maintain large budget deficits, bond market vigilantes will punish policymakers. Then, inflationary expectations will increase, long-term government bond yields will rise and borrowing rates will go up sharply, leading to stagflation. Large budget deficits also increase the risk of debt crises as the first signs have already appeared in Dubai and then in Greece, which in turn may affect the world economy. As El-Erian (2010) warns, the simultaneous and significant deterioration in the public finances of many advanced economies, which is currently being viewed primarily -and excessively- through the narrow prism of Greece, will soon be recognized as a significant regime shift in advanced economies with consequential and long-lasting effects. Another reason to fear a double-dip recession is that oil, energy, and food prices have been rising faster than economic fundamentals warrant, and could be driven higher by excessive liquidity chasing assets and by speculative demand. Finally, there are worries that some countries may experience an L-shaped recession, i.e. a protracted period of economic stagnation like the one experienced by Japan in the 1990s. However, there are also hopes for a V-shaped recovery as the history shows that rapid contractions -as it is the case during the fourth quarter of 2008 and first quarter of 2009- are followed by rapid returns to growth. The aim of this paper is to discuss the validity of these exit scenarios by studying the root causes of and the policies taken during the current crisis in the light of those of the Great Depression, as the global crisis is the worst recession and financial crisis since then.

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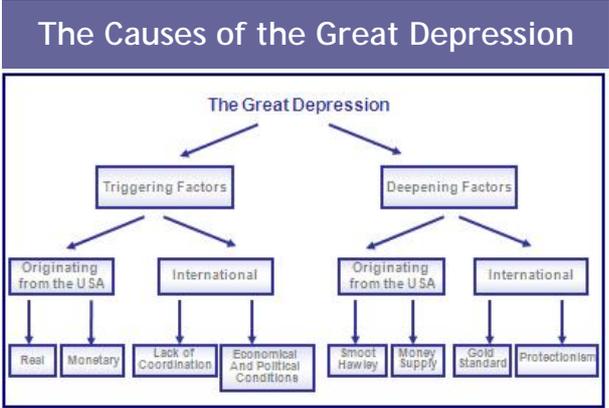
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In order to answer the question on the shape of the recovery from the global crisis, this paper employs a comparative analysis. First, the literature on the Great Depression is surveyed in order to find the possible causes of the Great Depression and then they are systematically classified based on Eichengreen (1988), which decomposes the explanations for the Depression as domestic and international. The domestic explanations, i.e. those related to the US, focus on the causes of the severe decline in US economic activity following the business cycle peak of 1929 and on the channels through which the American contraction was transmitted to the rest of the world. The international explanations, on the other hand, relate to the trade warfare and the international monetary system. However, in order to answer the main question of this paper, it is more appropriate to subdivide the factors as triggering and deepening factors. Finally, the current global crisis is analyzed especially with respect to the deepening factors in order to determine the validity of the argument about the sustainability of the recent recovery in the world economy.

Results

Despite the fact that the explanations of the economists for the Great Depression have been diversified depending on their schools and in the course of the years, initially the business sector, especially the financial sector was blamed. Similarly, major failures in the financial sector and in financial regulation and supervision were noted as the fundamental causes of the 2008 global crisis in the Communiqué from the London Summit of G20, because the global crisis was triggered by the US subprime mortgage turmoil. However, as evident from the studies on the Great Depression, it is necessary to reveal whether there are ongoing

structural changes and/or global imbalances, which might transform a financial crisis into an economic depression in order to determine the validity of the arguments about the sustainability of the recent recovery.



The factors that triggered the recession in 1929 and those that transformed into the Great Depression are summarized in the above chart. Among the former, the factors originating from the US seem to be valid in the 2008-09 crisis as well. The financial and real imbalances in the US that triggered the Great Depression are at work before the 2008 crisis at a global level. Since 2002, the twin deficits of the US –that is, a growing budget deficit along with a growing current account deficit financed by huge current account surpluses of China, Japan and other exporting countries have played an important role in forming the real estate bubble, which in turn triggered the global crisis.

The main international triggering factor behind the Great Depression, namely the lack of coordination in the international financial system, is also valid to some extent at the onset of the global crisis. One of the decisions taken in the G-20 London Summit that international financial institutions should be reformed to overcome the current crisis and prevent future ones reflects the awareness on this subject. In contrast to the political and economical conflicts

that prevented cooperation among countries during the inter war years, today it is not possible to speak of conflicts, at least among the major countries of the world, considering that three G-20 Summits have been held since the financial turmoil in US transformed into a global crisis in 2008.

The deepening factors of the Great Depression originating from US were the bank failures, which resulted in a 33% contraction in the money supply and the 1930 Smoot-Hawley Tariff Act. From the perspective of the former, the failure of Lehman Brothers in September 2008 is widely viewed as the moment in which the financial crisis that began in 2007 turned into a global economic crisis, largely due to the belief that US would repeat the policy errors of 1930s. Fortunately, further bank bankruptcies have been avoided. Similarly, “Buy American” provisions of the first stimulus package, which invoked fears that US trade policy was leaning towards protectionism as in 1930, were left behind. In sum, it is possible to say that the deepening factors stemming from the US were reversed, though they were valid to some extent at the onset of the global crisis.

The first international factor that deepened the Great Depression was the Gold Standard, which linked the money supplies of countries to the availability of international reserves. This system forced the countries to fight for the scarce gold reserves such that as of 1932, France and the US possessed, respectively 28% and 35% of the world total, leaving the other countries with no option but contractionary monetary policies. Today, the widespread use of flexible exchange rates allowed the countries to adopt expansionary monetary policies, and automatic depreciations of the currencies of countries with current account deficits have helped economic recovery by increasing their international competitiveness as

suggested by Newfarmer and Gamberoni (2009). The final factor that deepened the Great Depression, namely the retaliation to the Smoot-Hawley Tariff Act, i.e. a worldwide rise in protectionism with severe consequences in world trade (a decrease of 66%), seems to have been avoided during the global crisis with a 12% drop in the volume of world trade in 2009.

Conclusions

Despite the widespread agreement that the recovery of the world economy has started in the second half of 2009, the shape of the recovery is controversial. While pessimists expect a U-shaped, below trend growth for at least a couple of years or even a double-dip W-shaped recession, there are also hopes for a V-shaped recovery as rapid growth episodes have been followed by rapid contractions in the past. The findings of this paper, whose aim is to discuss the validity of these exit scenarios by studying the root causes of and the policies taken during the current crisis in the light of those of the Great Depression, suggest that the factors that transformed the recession into a Great Depression in 1930s are not valid during the current crisis to a large extent.

The factors originating from the US that turned the recession into a Great Depression, i.e. the bank failures and Smoot-Hawley type protectionist measures have been avoided after a short period of hesitancy at the beginning of the global crisis. Similarly, one of the international factors that deepened the Great Depression –the risk of retaliation– disappeared after the G20 leaders stressed strongly that they would not repeat the historic mistakes of protectionism of previous eras. The second international factor, namely the Gold Standard of the 1930s, is

replaced in general by flexible exchange rates protecting the world economy from falling into a new depression. However, the risks related to a fixed exchange rate system is at work, at least for some of the EMU countries, whose budget deficits and debt burdens are about to reach unsustainable levels. Indeed, countries such as Greece, Italy, Portugal, and Ireland, are not expected to recover soon, because they do not have a local currency to devalue in order to regain easily the competitiveness they have been losing for some time due to labor cost increases in excess of labor productivity. The only way to avoid default seems to accept deflation –the first signs of which have been received from Greece in the form of a wage freeze, which in turn will further depress domestic demand. Considering that there is no room in the budget for expansionary policies due to already unacceptably high levels of public debt, an L-shaped exit from the global crisis seems inevitable for these countries.

Countries that take part in the global economy have been affected almost simultaneously from the financial turmoil that started in the US, similar to what happened during the Great Depression. The recovery seemed to occur asymmetrically though, as the duration and the depth of Great Depression differed across countries. The UK, for example, escaped from a deeper recession by leaving the Gold Standard in 1931 and devaluating its currency, which allowed the use of expansionary policies, while the economies of France, Belgium, Netherlands, and Switzerland who insisted in staying on the Gold Standard continued to shrink until 1936. Similarly, today it seems that the less productive, thus less competitive countries of the EMU, which are in a fixed exchange rate system, though only within EU, will suffer longer from the global crisis.

Furthermore, since the balancing effect of the global crisis on the current accounts of deficit as well as surplus countries seems to disappear towards the end of 2009, the risk of a double dip recession is increasing. Another risk for a W-type recovery is the increase in public debt, especially for developed countries, as a result of the unprecedented expansionary fiscal and monetary policies implemented in the wake of the global crisis. Though debt crises are not expected at least for the major developed countries, the crowding-out effect of public debt will lead at best to a U-shaped recovery. Therefore it can be concluded that the exit from the crisis will likely differ from country to country, depending on their fundamentals and the policies they (can) implement, as it was the case during the Great Depression.

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