# JOURNAL FÜR ENTWICKLUNGSPOLITIK

herausgegeben vom Mattersburger Kreis für Entwicklungspolitik
an den österreichischen Universitäten

vol. XXV 4–2009

## 25 JAHRE JOURNAL FÜR ENTWICKLUNGSPOLITIK

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mandelbaum *edition südwind*

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Journal für Entwicklungspolitik XXV 4-2009, S. 105-108

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# The global impact of the Great Depression of the 1930s and of the present financial crisis: A study in contrast

The encounter with the present financial crisis has evoked reminiscences of the Great Depression. At this stage it may still be too early for a conclusive comparison of the two phenomena. Nevertheless, a preliminary attempt at identifying similarities and differences may be made so as to prepare the ground for comparative studies. A common feature is undoubtedly the contagious credit contraction after a period of expansive economic growth. In both instances the crisis originated in the USA and then affected the whole world. The contributing factors were, however, very different and it is important to trace them in detail.

## The Great Depression: financial speculation and agricultural overproduction

The causes of the Great Depression of the 1930s converged around 1929 to precipitate a major crisis. First of all, there was the tragedy of the international gold standard, which had worked well before the First World War when London was the financial centre of the world. Its stabilising effect was based on a free flow of gold, which was interrupted after the war, when the gold standard was restored and the USA hoarded gold so as to neutralize its inflationary impact. The Federal Reserve System, which was originally established as a lender of last resort, also devoted itself to the task of maintaining internal American price stability – and this endeavour upset the international gold standard to which more and more countries returned in the hope of restoring global financial stability.

The 1920s were a period of rapid economic growth in the USA. One of the elements of this growth was the enormous expansion of agricultural production by means of new agricultural machinery. This led to overproduction. For some time the effects of this development could be concealed by storing grain. Such storage provided good collateral for credit, which accordingly expanded by leaps and bounds. At the same time, industrial production also expanded. The industrialists obtained their capital from the stock market. People who had money to spare invested it in stocks. This created a speculative bubble. In order to satisfy the appetite of the speculators, holding companies were established which did not produce anything but only controlled other companies. This was quite similar to the 'asset backed' bubble which caused the present crisis.

The conservative bankers managing the Federal Reserve System wished to stop this perversion of the stock market by tightening credit. However, this did not discourage the speculators as long as their stocks increased in value day by day. On the other hand, the tightening of credit severely affected the financing of grain storage. Finally, an avalanche of wheat inundated the world market where prices for all agricultural commodities – not only wheat – were about halved within a few months. This feature is missing in the present crisis, as will be discussed later.

The 'asset bubble' of the stock market burst in October 1929. Initially, the conservative managers of the Federal Reserve System watched this with grim satisfaction. What they did not know was the extent to which speculators had borrowed money from banks by using their depots of stocks as collateral. Many banks were now stuck with devalued stocks – the equivalent to the 'toxic papers' of our times. This led to an increasing series of bankruptcies of banks. This could have been prevented if the Federal Reserve System had intervened as lender of last resort – the purpose for which it had been originally established. However, it had worshipped at the altar of price stability for so long that it had forgotten its original mandate. Moreover, at this stage the lender of last resort faced a herculean task. It could have performed this task, given its huge reserves of gold, but it was mentally not equipped to do so.

The European banks were vitally affected by the American crisis and many of them caved in. Most countries now abandoned the gold standard and then subsequently had recourse to competitive devaluation and national protectionism – a policy which the British economist Joan Robinson called 'beggar thy neighbour'. World trade contracted along with the credit contraction. Yet, as far as raw materials and agricultural produce were concerned, this affected the value rather than the volume of trade. This meant that the income of the producers in what was later called the 'Third World' dwindled. In fact, decolonization was inaugurated by the Great Depression, as it was no longer profitable to hold on to colonies as producers of raw materials. However, since most colonies were indebted to their 'owners', colonial rule was tightened at this stage so as to control the debtors.

Economists used to measure the impact of the Great Depression on various countries in terms of the deficit in their balance of payments and their rate of unemployment. The 'Third World' and its suffering peasantry escaped their attention. This is why the real global impact of the Great Depression has only been identified in recent years.

## The causes and consequences of the present financial crisis

If we now turn to the present crisis we must first of all look at the different nature of the 'asset bubble' which precipitated it. This time it was not the stock market and holding companies but 'asset backed securities' (e.g. houses) and the ingenuity of banks in creating new 'financial products' which cleverly camouflaged the assets by which they were supposed to be backed. Among these new financial products which were introduced only in recent years were the Credit Default Swaps. They were supposed to be a kind of insurance against the default of debtors, but actually they could be acquired also by people who did not need such insurance but only wanted to take a gamble on bankruptcies. Naturally, such gamblers then had a vested interest in the respective bankruptcy. In a way, such 'swaps' were similar to the 'short selling' of stocks. Financial ingenuity was buoyant in the ocean of liquidity which flooded the American economy.

The American bubble was supported by the perverse economic relationship of the USA with China, a relationship which created an enormous amount of liquidity in the USA and provided China with export earnings. China maintained an artificially low exchange rate and deprived its workers of the wages they deserved; it then invested the surplus of its balance of trade in American government securities, of which it holds huge amounts. In fact, China 'owns' a great part of the USA. It could unleash an avalanche of dollars on the world, but since it would devalue its reserves in this way, it will not follow such a course.

The American bubble spawned a large amount of 'toxic papers' which were eagerly absorbed by European banks which now have to face the consequences. Asian banks seem to have been more cautious in this respect, but Asia is also affected by the global credit contraction. The American Federal Reserve System has performed its role as lender of last resource time very effectively. Its boss, Ben Bernanke, has done research on the Great Depression and has avoided earlier mistakes. Governments around the world have also been more active this time and so far they have not fallen prey to the self-defeating game of 'beggar-thy neighbour'. Another saving grace is the absence of a fall in commodity prices – except for the price of oil, which, however, had reached an absurd peak just prior to the financial crisis. Nevertheless, it would be too early to announce the end of the present crisis. Moreover, the basic problem, the problematic relationship between the Chinese and the American economy, has not yet been changed. As long as the Chinese go on exploiting their own workers and buying US-government securities, they will provide America with surplus liquidity, which may again spawn bubbles. It is only to be hoped that bankers worldwide will become more aware of the dangers of 'financial products' which are as treacherous as the proverbial Trojan horse. Unfortunately, fancy bonus payments have motivated bankers to peddle 'financial products' whose nature they themselves hardly understood. Research in this field must be pursued so as to prevent further crises. Financial globalization is irreversible. Nevertheless, it should be accompanied by more transparency and by concerted action against perverse economic relationships.