

# 1929 and 2009: Two Commensurable Crises?

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**W**E ALREADY HAVE data on the economic activity, income distribution, prices, finance extended throughout the world over the last two centuries in which a market economy has been affirmed. This empirical heritage allows us to draw a historical sketch of the economic instability oriented to the comparison between 1929 and 2009.

It would be useful to move from the distinction of instability respectively concerning prices, production, and finance.

a) *Prices*. For our purposes, more inflation discloses deflation. It is usual to distinguish a “good” deflation, resulting from the expansion of the demand, and a “bad” deflation, which results from a decrease in the global demand. The 1875-95 deflation was a good Great Deflation, not a “Great Depression”. The consumer prices fell by approximately 20% in the industrial countries. But the world GDP grew by 2 percent per year, compared with the thinner 1 percent of 1820-70. The bad deflation followed, instead of the demand collapse of 1929-33. It was much stronger: in just 4 years the world wholesale prices fell by approximately 40%, and the consumer prices of industrial countries decreased by 25%.

But from the point of view of its interaction with the financial and actual crises, even the good deflation... is extremely bad! It is so from the macroeconomic point of view, beyond the effects of distribution that are favorable to the fixed income it tends to provoke. In deflation, although the nominal interest is next to zero, the real cost of the debt escalates. The debtors become insolvent and are still forced to sell off assets to avoid repaying their creditors with a revalued currency. The companies cut their investments.

Today the bad deflation remains only a risk, although, with an estimate of inflation for 2009 (proposed by the International Monetary Fund on 28 January) of 0.3%, the advanced economies are skating on really thin ice. The central bankers, those European in the first place, are called to combat the risk of deflation with the same commitment with which they have opposed inflation, having succeeded in raising interest rates just last summer, when the European economy was already recovering from recession. The maintenance of the nominal wages will be decisive in face of the thrust toward a decrease in prices that will lead to an increased unemployment.

b) *Production*. The trends of productive activities must distinguish between the physiological corridor of fluctuations that are only cyclical, or accidental, and the deep, durable, extended contractions. We must also distinguish the nineteenth century, still very agricultural and already not little tertiary, from the industrial 20<sup>th</sup> century, more than tertiary. In the 1800s, the recessions were more frequent, also acute, but short. In a worldwide scale there were three annual negative points in the deviations from the trend of the actual product: in 1835 (-8%), in 1853 (-8%), and in 1870 (-4%). In the 1900s, strong and prolonged contractions associated to the trend coincided with the end of World War I (-7%) and of World War II (-11%).

The primacy belongs, of course, to the 1929-33 period. The difference between the world GDP and its trend came very close to 12 percent. Between 1929 and the 1932-33 period, the GDP decreased 30% in the United States, 15% in Latin America, 9% in Europe, 5% in Italy. It remained stable in the Soviet Union and Asia. In the world the level of 1932 was 17 percent lower than that of 1929. The factors that precipitated it were especially the investments and the production of capital goods. In the United States - the extreme case - the supply of capital goods decreased 55%, in face of the 20% of that of consumer goods (but the decrease was of 70% on what concerned to vehicles). The industrial production decreased, of course, more than the GDP: 40% in Germany and the United States, 23 percent in Western Europe and Italy. The international trade decreased by a quarter in quantity, and by almost two-thirds in value. Capital movements and migratory flows were reduced to zero. It is estimated – the appraisals are uncertain - that on a global scale the number of the unemployed tripled between 1929 and 1933 and that the industrial unemployment rate, on average, exceeded the 20% detected during the entire span of the 1930s.

The recovery was in fact slow, and rough. The world manufacturing production did not return to the values of 1929, previous to 1937. The recovery was also diversified in terms of the various factors that, in individual countries, supported the demand. In each economy, support derived mainly from the resumption of the credit supply and the competitive devaluations, more than from deficit spending. Keynes was still moving from the ever orthodox *Treatise on Money* (1930) to the revolutionary *General Theory* (1936). In the United States, the somehow confused activism of Roosevelt was less taken into consideration than the need of rearmament on the eve of the war.

Coming closer to the present, from 1950 to 2007 the world GDP has never declined in particular years, although a negative residue from the trend of 2-3% could be detected in 1958, 1975, 1980, and 1991. For 2008, the IMF estimates indicate a slowdown in the world GDP growth, but always within the range of 3.4 percent. Those estimates indicate a 4.1% expansion in trade as well. Some advanced economies, however, have been in a technical recession, with the GDP in decline for at least two quarters. For 2009, the IMF foresees a minimum growth of the world economy: 0.5%. It would result from an expansion of

3.3% in emerging economies (with China in 6.7) and a sharp decrease (-2.0) in advanced economies (with the United States in -1.6). In this sense, the current crisis is more of the OECD area - particularly in the United States, Europe, Japan - than of the global economy, although the volume of the world trade has also been foreseen in decline, of 2.8%. In the fourth quarter of 2009, compared to the same period of 2008, the advanced economies would still experience an attenuated negative variation of GDP (-0.5 percent). In 2010, however, the world product would return to the pace of development of 2008 (3.4%), while inflation would come close to 1%.

The scenario outlined by the IMF is not only a little uncertain, but the sense of its forecast is that a contraction in a global scale would be, in the present situation, unlikely. These projections, it should be noted, do not take into consideration the ulterior expansive policies that can be decided from now on, in 2009, with immediate effects on the expectations. It should be noted as well that, unlike 1929, the movements of capital and migratory flows have not been reduced to zero, there is no trace of competitive devaluations (in fact, the dollar has strengthened), and the actual rates of interest are at normal levels.

Two additional terms of comparison may be relevant. In 1930 - the first year of recession in the crisis of 1929-33 - the GDP decreased 5 percent both in the industrialized area that was the epicenter of the world recession and throughout the whole economy of the globe, despite the resistance in Asia and the growth (of 10%) in Eastern Europe. In terms of the combined difference between the actual product and the potential product - the most accurate measure of the severity of a recession - the loss of income of the advanced economies currently foreseen by the IMF for the 2009-2010 period (6 percent) is similar to those experienced in 1974-75, following the first oil shock, and in 1980-83, after the second one.

c) *Finances*. On the front of the prices and production, the similarity between the current phase and the dramatic crisis of 1929 seems not to be well founded. More complicated is, instead, the comparison between the two crises on what concerns to the instability of values of assets, banking, and finances.

In the framework of the normal fluctuations from multiplier-accelerator, but also independently from the cycle, the mechanics of the financial crises is unique. It is characterized by a standard model, long ago improved, after Henry Thornton (1802), by Bagehot, Wicksell, Hawtrey, Fisher, Keynes, Minsky, and Kindleberger. An unexpected event opens new expectations of profit. The speculation in the stock exchange increases; powered by an inevitably elastic offer of credit, it becomes excessive. When - inevitably - the excess begins to become evident, people start to sell off in a hurry to repay their debts, due to the expectations of deflation and the most expensive actual interest rates. Now the prices of the object of speculation - which can be of any kind: products, real estate, lands, stocks, bonds, contracts, betting - collapse. The vicious cycle is interrupted when trust is restored by the economic policy, or simply returns

by itself. The ultimate meaning of the model is that instability is rooted in capitalism. Crises may result in healing, moderation, deceleration, but certainly never prevention.

In the current crisis the speculative excess has focused on houses and on loans proposed by the banks to five million poor families in America, as well on real state in other Western countries, on derivatives and on the “toxic” securities almost everywhere. Eighty years ago, the speculative excess was based on stocks, mainly the industrial ones. The propensity toward excessive indebtedness – of households, businesses, speculators - found, as always, an offer of credit by banks and other institutions with segments of uncontrollable elasticity.

In a striking contrast to the morphological regularity characterized by the standard model, the empirical casuistry of the crises is of a disarming variety. Each crisis is specific, in its forms, in its times, in its severity, in its political and social repercussions. In this sense, they are a subject of history rather than of theory.

The stages of the really serious worldwide financial crises that preceded the current one have been three: 1873-1878, 1889-1894, and 1921-1933. The first and third coincided and the second did not coincide with a subsidence of the GDP at international level. In fact, historically the financial imbalances that have failed to result in a decrease in income are not rare. The crises were limited by events or measures that reestablished trust in time.

There was a lapse of two centuries between the case of London in 1793 and that of Wall Street in 1987, but an outside intervention was decisive in both occasions. In 1793 the panic spread in the city in response to the crack of banks operating out of London. The demand for the Bank of England tickets grew beyond measure, for precautionary reasons; the constraint quickly became extremely harsh. But the chain of bank disruptions was broken and did not extend to the world of production. All it took was the Parliament announcement to make available solvent merchant titles of the exchequer, which could be quickly and easily liquidated: currency with paper money. In October 1987, the collapse of the historical supremacy of the races to Wall Street for stock – worse than in October 1929 - was blocked by the prompt sign correction of the American monetary policy, implemented by Greenspan. The input of liquidity avoided damage to the productive activity.

Other episodes of financial tension, which had reappeared by accident or by outside intervention, occurred in England in 1797, 1810, and 1825; in France in 1818; in the United States and Europe in 1857; again in England in 1866 and 1890; in Italy in 1907, despite an 80% decrease in the stock exchange index between that year and the so-called “radiant days” of May 1915.

For not going so back in time, after 1987 the damage to the international economy resulting from the financial crises in Asia, Latin-America, Eastern Europe, of the EMS (European Monetary System), the LTCM (Long Term Capital Management), was restrained. Also in these cases, there was a valuable contribution from the Federal Reserve of Alan Greenspan.

On the contrary, when a sharp productive contraction occurred – especially if combined, as in 1929, to a price deflation - it has not failed to interact with a financial crisis. The so-called “1929 crisis” was the heaviest in scale and duration, also in the financial dimension. It can be quantified with the sum of the increased bank losses for the GDP of a representative year and with the decrease of the rates to stocks, which were deflated for the consumer prices. Between 1921 and 1933, in the two countries that, until then, presented the higher financial instability among those that are developed today - Italy and the United States -, the bank losses – which were ascertained years after by accountants and courts - were equal to 5% of the GDP in the United States and to 8.5% in Italy; the stock exchanges collapsed, 50% in Italy from 1925 to 1932, as in the United States in 1929-33 (-85% the nominal values, -30% the consumer prices). In Italy it was necessary to resort to the heterodox solution of the IRI (Internationalized Resource Identifier), which avoided the bank panic experienced in the United States and that today, *mutatis mutandis*, is arousing interest again, even outside Italy.

For individual small or emerging countries the picture is in fact greatly varied, with much more serious aspects than the two cases mentioned above. Austria, already in 1931, acknowledged bank losses associated to Kredit-Anstalt – a big bank in a small economy - equal to 9% of the GDP. In the last quarter of the 1900s, in Italy - merit of Via Nazionale - the accumulated cost of the bank crises had not exceeded 1.5% of the GDP for a representative year. But among the industrial countries that in those 25 years have experienced crises, the Italian figure is lower not only to the limit cases of Spain (17% of the GDP), Japan (12%), Finland (10%), but also to those - between 2 and 5% of the GDP - Sweden, Norway, United States, France, Australia. In the same period, a hundred economies in developing countries have experienced financial crises. In those countries the costs of the crises have not been lower than many points of the GDP, with a modal value of 15 points. The costs have come to correspond to a third of the GDP in Thailand and Turkey, a half or a little less in the extreme cases of Argentina and Chile in the early 1980s. It is not easy to situate the current financial crisis in this large scale of severity. The crisis is not resolved, the estimates of the losses are imprecise, part of those already counted - at the fair value – in regard to “toxic” securities that the markets underestimate or even do not evaluate for now. Above all, the crisis has sprung out and, in spite of being concentrated on the Anglo-Saxon finance, assumed also a wide international, if not “global”, dimension.

The drop in the deflated stock prices in the main stock exchanges - 50% - is, today already, similar to that of 80 years ago. According to the IMF, the losses suffered by international banks so far are equal to 780 billion dollars (entirely covered with provisions of capital, the public ones of 350 billion, the private ones of 438 billion). The further anticipated losses will not exceed 500 billion for the banks of the United States and Europe. The global system of

credit intermediaries could lose 2,200 billion only on investments (over a half of them of a hypothecary nature) carried out in the USA. If – although they are not - these latest losses were limited to the American intermediaries, since the American GDP is equal to 14 thousand billion, the relative weight of the losses would be much greater (16% of the GDP) than that of the Twenties and Thirties, always in the United States. But the American GDP does not greatly exceed the 20% of the global one, which is next to 65 thousand billions of dollars. And even 2,200 billion do not exceed... much the 3 percent of 65 thousand. The denominator counts. If you change the denominator, the capital and reserves of the banks of Europe alone exceed 2 thousand billions of dollars. The capitalization of the banking system of the whole world is estimated at over 5 thousand billion. So that this capital, clearly above the total losses, can flow and compensate the negative gains of the intermediaries in difficulty, the strong banks of any country - or the sovereign funds – should be able to recapitalize the weak banks of that country.

We are living, therefore, a complex and particularly extended financial crisis, although not yet the most serious in history. At the same time, this is a crisis of the essential type, which can be inscribed in the standard model. Its specific nature is, as it always occurs in crises, the subject and forms of speculation: simple loans for the purchase of modest homes, complicated “toxic” securities, derivative contracts that most people cannot understand. It also concerns – and this is a real new element - the accounting modality of the fair value: a modality that is conceptually preferable to the historical cost, but based on the assumption that the markets to whose assets it applies do not cease to express quotations, or reasonable quotations. As all financial crises, the current one was not foreseeable - and was not foreseen -, at least not in the times, in the ways, in the entities, or in the sequences. Above all, it was not preventable with rules, economic policies, and controls. Rules and supervision are able to cope with the known risks, historically tested, that are engaged in by commercial banks. Their power, however, is close to inexistent against the risks taken in the financial markets and against the risks of a new type, taken by banks and markets. The banks and, above all, the markets were never, on a global scale, adjusted both for stability and, in particular, for transparency and correctness in the operators’ behavior. But, in the offer of finances, there is always an innovative, opaque, immoderately avid aspect. Furthermore, it is not possible to limit – who could criticize them? - the propensity of businesses and families to load themselves of debt. In face of a serious financial crisis, with an international dimension, manageable but certainly not easily so, it must be observed that, according to the most credited forecasts, a contraction of the world economy, in the 1929 style, should not be feared. Not if we share the forecast, at this time prevailing among the analysts, of a recovery in the course of 2009 and 2010. Why? Where is the deep difference between now and then? One could envisage a double answer. The pre-existing imbalances in the actual economy are different

from those of the 1920s. In addition, both the efficacy of the policies that stabilize the actual economy and the confidence in this effectiveness are, thanks to Keynes, much higher.

The unique severity of the 1930s contraction had its roots in imbalances in the previous decade. The 1920s had seen four structural changes that had shown themselves as seriously and potentially cyclic in the course of the next decade: a) the fragility and lack of cooperation in the reestablished gold standard; b) the imbalances in the balances of payments - including the German retrievals - and the absence of a country that could provide a last resort, in the trade and in the credit; c) the increased weight of the durable consumptions in the United States (financed at rates), the extensive offer of primary products in Canada, Argentina, New Zealand, and in the very United States, as well as an excessive capacity in the industrial production, had multiplied in Europe during World War I; d) finally, the stiffening of the labor market in the United States. These and other structural weaknesses were prospective reasons for the stagnation of the real demand. As Steindl, Sweezy, and Sylos Labini would, by different routes, theorize later, these factors made unsustainable the profits of the 1920s in the long run. Finally, in the economic thinking - with Pigou, Hayek, Einaudi, Robbins - the pre-Keynesian idea prevailed that the crisis would have to follow its natural course and that the market economy, with the flexibility of prices, interest rates and wages, possessed rebalancing mechanisms that it would be wise not to upset. For the practical thinkers and for the persons in charge of the economic policy, therefore, there is no sense in talking about “errors”, as Friedman has done by imputing the 1929 crisis to the premature death of Benjamin Strong, the wise leader of the Federal Reserve System in New York. The theory of reference was wrong. The decisions of the policy makers should not have been based on it, to begin by Herbert Hoover, the unlucky President of the United States during the crisis, the “Great Engineer”, the technocrat ... Unfortunately deeply learned in economics, certainly much more than Roosevelt, the lawyer. The spark that had triggered the potential of crises accumulated in the 1920s, then, was the restrictive orientation assumed by the United States’ monetary policy in 1928. In face of the increasing stock speculation, the Federal Reserve System sterilized the inflows of gold: a small tail wagged by a mastiff.

Today we have reached the financial crisis essentially with a structural macroeconomic imbalance: the huge net indebtedness towards neighboring countries of the leader country, the United States. The potential seriousness of a genuine collapse of the dollar, of a sudden rise of interest rates, of a disruptive and contagious stagflation in the United States, has been denounced for years, in particular by Europeans. In the same Financial Stability Forum, established in 1999 for the coordination of the international financial supervision, the fears were focused on this macroscopic imbalance rather than on the real estate speculation, on hedge funds and on off-shore centers. And, however, the risk was calculated. It was calculated by the currently scorned Greenspan, whose

monetary policy and banking supervision policy have also, moreover, allowed the United States an annual growth of 3% for two decades and has eliminated, on many occasions, potentially acute and widespread financial crises. In face of the European apathy, the development of the United States, together with the Chinese one, has strengthened the world economy. That risk was especially calculated in the actual concert between the foreign policy of the United States - the great debtor - and that of China and Japan, the main creditors. At least so far, this balance, although precarious, is holding, and there was no collapse of the dollar. The spark that has knocked over the expectations of speculators on loans, securities and derivatives was not the dollar, but, perhaps, the unforeseeable and difficult to understand decision of the Bush administration to lead the Lehman financial organization to bankruptcy.

Some considerations, desperately aiming at seeing glimmers of light at the end of the tunnel, may justify the forecast, perhaps relatively benign, of the IMF:

- 1) China, the new engine of the world growth, true provider of the last resort, increasingly aware of being so.
- 2) The downward resilience of the wages, and therefore of the prices, in industrial countries.
- 3) By contrast, the downward flexibility of the international quotations of energy.
- 4) The moderation of the actual real interest rates in the long term, in the absence of price deflation.
- 5) The fact that the companies' condition of debt, unlike that of the families, is relatively contained. In 2007, on the eve of the crisis, in the same United States, the companies' indebtedness was - like in Italy and Germany - less than  $\frac{3}{4}$  of the GDP, compared to values close to or over 100% in Japan, France, United Kingdom, and Spain. The debts of the American companies were also equal to 35% of their liabilities (relationships of leverage, to market prices), - as in France - compared to 40% in the other countries that were mentioned: values, though, not higher than those found on average in the previous decade. Still in the United States, the indebtedness of the families in relation to the available income was equal to 1.45 (1.03 in 2000): a value much higher than average in the euro area (0.93; 0.74 in 2000), although lower than that of the United Kingdom (1.60; 1.03 in 2000) and to that, abnormal, of the Netherlands (2.40; 1.60 in 2000).
- 6) The prevalence of the inside credit over the outside credit. A greater share than in the past concerns financial relations between intermediaries. It does not directly affect the final unit of expenses, families and businesses. Furthermore, the derivative contracts with speculative, and not ensuring, purposes, often take on the form of a betting, with a loser that will perhaps spend less, but also with a winner that can spend more. It is similar to the 1944 criticism by Kalecki -



more inside money than outside money - to the real balance effect of Pigou.

- 7) Finally, a copy of the *General Theory*... It can be found in all libraries, including those of Frankfurt. It is available to government leaders and central bankers, hopefully more pragmatic than the neoclassic economists. Based on Keynes and on our own experience, we know how to avoid a strong contraction in the economic activity. Productive public investments and temporary tax reductions with high progressiveness, combined to the release of the interbank and credit offer that was rendered elastic, providing liquidity, guarantees and capital to intermediaries, constitute the dam, to be consolidated and raised at the earliest, to contain the recession wave. The *Ultima Thule* is the “theorem of Haavelmo”, inherent in the fact that, today, the public expenditure is of around 40% of world GDP, not less than 20% as in the 1930s. A really special non-Keynesian skill would be required, so that the policy makers of the United States, Europe and Japan fail to prevent a deeper and longer contraction than that, already serious, foreseen today.

Not even the more reasonable optimism, of course, can fail to recognize that this crisis may prove strongly recessive. The final outcome is unpredictable, as the crises of capitalism have always been. Keynes has definitively clarified that capitalism is *intrinsically* unstable, as well as unfair, contaminating, often ungovernable. It is still socially and politically accepted because, in two hundred years, it has proved itself able to multiply by 10 the average income per capita of mankind: that income that, in the course of the previous eighteen centuries, from Caesar Augustus to Robert Malthus, had never risen more than 40%.

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