‘Afterword’: Counterfactual Histories of the Great Depression

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As Dr Balderston notes in his introduction to this volume, history is necessarily written in terms of a model, whether implicitly or explicitly, and a model invariably suggests counterfactuals. In this note, we first review our model of the Great Depression (‘the ET model’ as it is referred to by Balderston) and then explore the counterfactuals that flow from its application to the monetary, macroeconomic and political history of the 1930s.

1 The Depression as it was

It is necessary to understand the causes of the Great Depression in order to answer the question of whether things could have turned out differently. The simultaneous fall in production and prices in the early 1930s strongly suggests that the initiating factor for the Great Depression was a series of negative aggregate demand shocks. But how could so many countries have experienced a negative demand shock at the same time? The answer is that all of these countries, faithful to the dictates of the gold standard, pursued deflationary policies at the same time. The essence of the gold standard was the free flow of gold between individuals and countries, the maintenance of fixed values of national currencies in terms of gold and therefore one another, and the absence of an international coordinating and lending organization like the International Monetary Fund. Under these conditions, when the United States and Germany adopted deflationary policies, other countries had little choice but to do likewise. As confidence in this system waned, central banks and governments swore their allegiance to the gold standard even more loudly. But their actions betrayed the words; fearing for the stability of the system they shifted their reserves out of US treasury bonds and British consols into gold. The international reserve backing for global money supplies collapsed between 1928 and 1932: the share of foreign exchange in reserves of 24 European countries fell from 42 per cent to 8 per cent. This was how deflation in two countries, which between them accounted for no more than a third of the world economy,
could produce a vast deflationary shock that quickly engulfed the entire world economy.

This recession began at the end of the 1920s in the United States and Germany. Their economies began to contract, partly as a result of central-bank pressure. But while their initial downturns had some independent roots, their economies were connected, allowing tightening by the Fed to make it harder for Germany to maintain its customary level of capital imports, which in turn forced the Reichsbank to tighten. In any case, it was clearly gold-standard policies that turned the downturn into the Great Depression and pulled down the rest of the world.

The choice of deflation over devaluation was the most important factor determining the course of the Depression. Contemporaries clearly saw this as the key decision of the authorities, and they supported it wholeheartedly. Policy-makers in all industrial countries insisted that the way out of depression was not to ‘debase’ the currency but instead to cut wages, lower production costs, and reduce the prices of goods and services. Devaluation did not become a respectable option until much later – until after an unprecedented crisis had rendered the respectable unrespectable, and vice versa. For the time being, however, deflation remained the only accepted option.

Governments and central banks could not easily deflate their economies in the early 1930s. Given the sacrifices they had made in the Great War, workers who once had mutely borne the burdens of financial stability now expected, indeed demanded, a voice in policy. The inability of economic policy-makers to force down wages was at the core of the period’s economic strains. As a result of the difficulty of forcing down wages, labour demand was depressed. Profitability was squeezed. Credit was tight (the real value of the global gold stock, which provided the backing for money supplies, was low because price levels were high). The political strains created by attempts to cut wages caused investors to fear for the stability of the gold standard even as policy-makers struggled to maintain it. And as those investors grew less confident about the depth of political support for and therefore the operation of the system, the destruction of international reserves quickly got under way, as central banks shifted out of foreign exchange in favour of gold.

At its inception, the Great Depression was transmitted internationally as a result of the hegemony of the gold-standard ideology, a mentality that decreed that external economic relations were primary and that speculation, like that manifest in the booming stock market in New York, was a threat to economic stability. US, British and German policy-makers thus acquiesced in the deflation and liquidation that set in at the end of the 1920s. And as the US, British and German economies contracted, they depressed other economies through the mechanism of the gold standard. These countries reduced their imports as they contracted, reducing the