Heed the lessons of the collapse of the ‘golden age’

By Ilian Mihov

It seemed like it was never going to end – the rise of the economy, the increased prosperity, the bull stock market. Forbes magazine said it would be ‘recognized as a golden age of American industry.” This was in the summer of 1929, but then the US economy collapsed. From growth rates of between three and 10 per cent in per capita terms, the US economy imploded: contracting 11 per cent in 1930, another 9.5 per cent the following year, and then shrinking a further 15 per cent in 1932. Who would have thought that the Roaring Twenties would transform into the worst economic disaster of all time?

After surging during the 1920s, share prices on Wall Street plummeted, with the Dow Jones Industrial Average falling to a low of 41.22 points in July 1932 from 381.17 points in September 1929. To put that in context today, it would be like the Dow falling to 1,666 points from a peak of 14,164 (October 9, 2007) within three years.

While the stock market fell some 90 per cent, the output of the US economy fell by a third during the Great Depression of 1929-1933, unemployment shot up to 25.2 per cent from 3.2 per cent, and one in three of the 24,000 banks in the US closed down. This is a partial, yet telling view of the magnitude of the Great Depression.

When I teach my macroeconomics class for the MBAs at INSEAD, I always discuss the Great Depression and the lecture ends on an optimistic tone with a simple statement: “The Great Depression will never happen again”. I firmly believed this because there is a widespread consensus that the Great Depression was a result of a sequence of policy mistakes. Economists have learned what policies should be applied to avoid the Great Depression.

Unfortunately, I have to revise my optimism now. It is not because what we learned was wrong, nor because we have unlearned the big lessons from the Great Depression. Optimism fades because it turns out that political bickering and petty re-election agendas can wipe out the lessons of more than 70 years ago.

What is the biggest lesson from the Great Depression? In my view, it is that monetary policy and the financial sector play a crucial role in economic development. Let me put it more precisely: good monetary policy is unlikely to accelerate the speed of economic growth – after all we have more income year after year because mankind comes up with new ideas, with new products, with more efficient ways of producing output. However, bad monetary policy can easily derail economic development. It is true for rich and poor countries alike.

Why are financial markets and the banking sector so important? Banks fulfill a very important role in the economy by matching borrowers and lenders. When we deposit $100 in a bank, the bank keeps, at most, two to three dollars in its vaults (in fact the money is often in the central bank), the remaining $98 or so is lent to a borrower.

Most businesses require loans for their normal perations. When the banking sectordoes not work properly, businesses cannot get loans and they have to curtail their production and lay off workers. As they curtail production, they demand fewer products from their suppliers and therefore their suppliers have to reduce their output and fire workers. If manufacturers cannot sell their goods because the firm downstream does not need as many products as before, they cannot generate enough revenue to repay their earlier loans. Businesses go bankrupt and banks experience further problems as their balance sheet deteriorates due to non-performing loans. At this point, banks want to lend even less because of the uncertainty generated from bankruptcies. As they lend less, the vicious circle continues – with producers cutting production and firing workers. On the top of this, depositors start worrying about their deposits because the non-performing loans have made some banks go belly up – your bank has lent out your money to borrowers who cannot return it. Depositors start withdrawing their cash and banks have even fewer possibilities for lending as they have to hoard cash in case there is a run on the bank. If the financial sector does not work, the real economy can go into a deadly spiral and shrink by 30 per cent as during the Great Depression.

It is unlikely this will happen today. But I used to think that it was impossible. The lessons of the Great Depression are so clear and vivid that it was unimaginable that someone would risk the stability of the economy just to gain votes from his or her constituency. Are these CEOs overpaid? Should they go to jail? Maybe the answer to both questions is “yes”, but it’s important to understand that penalising greedy CEOs has nothing to do with saving the macroeconomy. Many of the issues raised by politicians recently have to be addressed, but it is a separate debate and will involve separate legislation.

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