Crying Wolf over the Great Depression

By Nobuyoshi Namiki

The Great Depression and the oil crisis

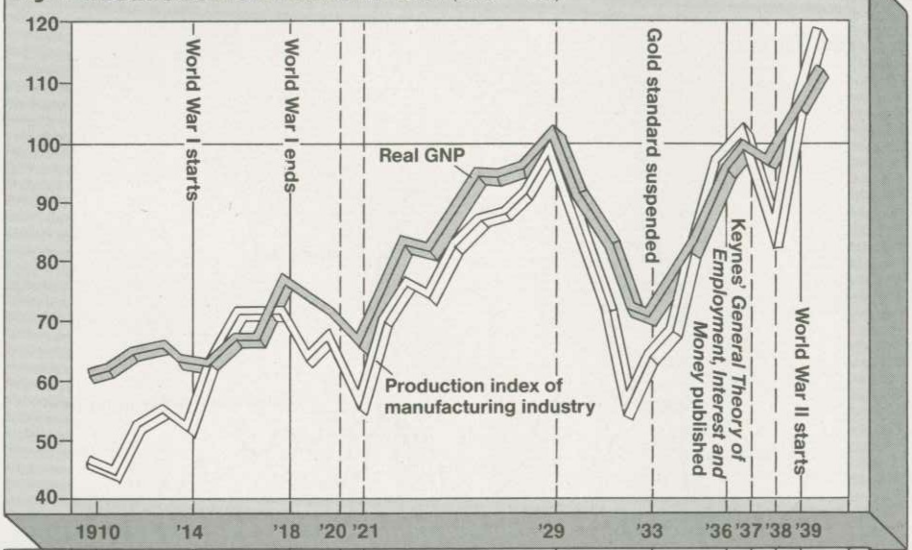
There has been a lot said lately about the danger of the world economy plunging into a depression like that of the 1930s. That possibility, however, needs to be seriously weighed against the vast changes in the world's economic structure since the Great Depression of 1929. The world economy as it existed in the early part of this century was structurally weak. Today it is strong and stable, as evidenced by what happened after the oil crisis of 1973–74. The soothsayers who warn of a second depression are likely crying wolf.

There is ample evidence to support this view. How, for instance, was production in the United States affected by the 1929 crash? The GNP (1929=100) reached a low point of 70 in 1933 (Fig. 1). The production index for manufacturing industries dropped even more sharply, to 50 in 1932. Production plummeted by about 20% following the end of World War I. The American economy of half a century ago was clearly vulnerable to sudden change.

The fragility of the U.S. economy of the day is evidenced by other facts as well. For instance, wholesale prices dropped 30% during the Depression. The unemployment rate soared to 25% (Fig. 2). Unemployment also jumped in other countries–by 30% in Germany, 24% in Britain and 7% in Japan. The U.S. stock price index plunged to an eighth of the prepanic level (it tumbled to 1/4 in Britain and France, 2/5 in Japan and Germany and 1/3 in Sweden). The price of wheat fell to a third of what it was before. World trade in nominal terms shrank by the same margin.

In contrast, the American economy and world economy showed remarkable resilience after the 1973–74 energy crisis.

Fig. 1 **Production Standard in U.S.** (1929 = 100)



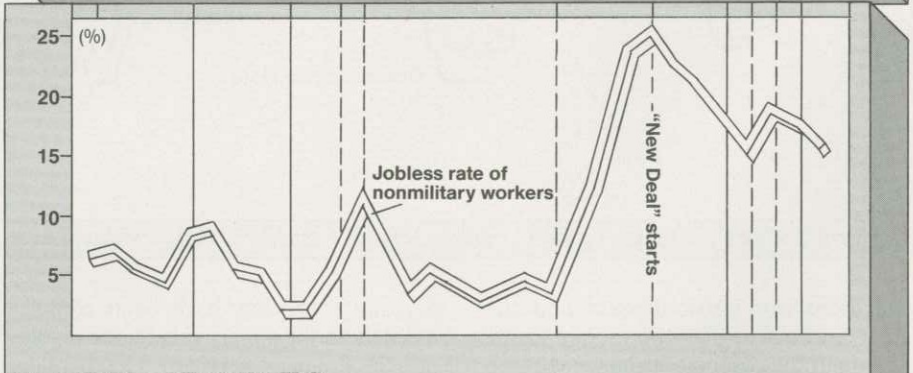


Fig. 2 **Jobless Rate in U.S.**

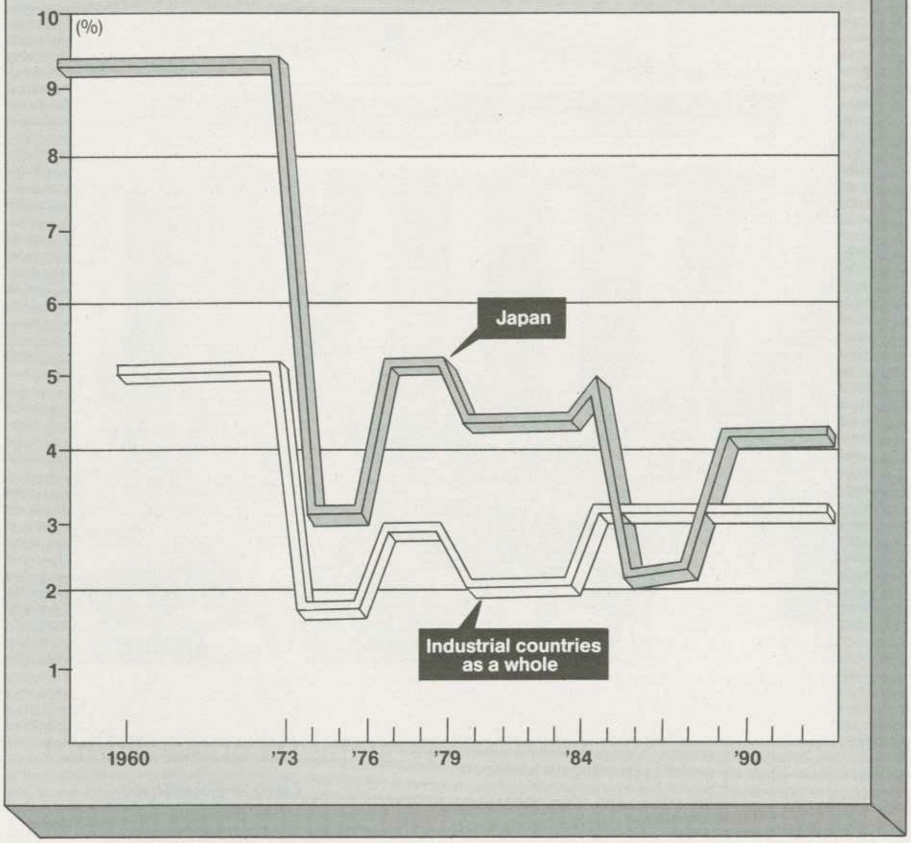
Source: *Genso-no Keynes-shugi* (Illusion of Keynes' theory) by Hirotaka Kato

The average rate of GNP growth in the industrialized world remained on the plus side (Fig. 3). Growth rates in the developing world and the communist bloc during the 1970s actually exceeded the average for the industrialized countries. Of course, the world economy as a whole also recorded a positive rate of growth.

Some countries, to be sure, suffered negative growth between 1974 and 1984. During that time, the world economy was hit twice by sharp increases in oil prices. Britain, for example, recorded year-to-year negative growth rates for four years. Some other countries suffered negative growth for one or two years. However, even negative growth rates were only in the realm of 1–2%. The average rate of ex-

Nobuyoshi Namiki, a director and the chief economist at the Japan Economic Research Center, is a leading expert on Japan's industrial structure. He concurrently serves as an editorial writer for the Nihon Keizai Shimbun.

Fig. 3
Rates of Economic Growth before and after Oil Crises in Japan and Industrial Countries



pansion dropped sharply after 1973, but thereafter remained relatively stable, albeit at a low level (Fig. 3).

In the decade following the first oil crisis, governments adopted tight monetary policies to prevent a resurgence of inflation. Primary commodity prices remained stable thanks to price supports and other factors. Stock markets were generally bullish. World trade expanded. All this was a far cry from what happened in the 1930s.

However, the world economy in this post-oil crisis era is beset with potentially dangerous problems. One is the looming debts of developing countries. Another is continued low economic growth rates. To better understand these problems, it is useful to look at some of the factors that caused the Depression of the 1930s and the 1974-84 recession.

Reasons for economic contraction

Knowing why the rate of growth dropped so sharply in the 1930s and the 1970s and why the rate of contraction was so much greater in the former than in the latter will help understand the magnitude of the structural changes that have occurred in the world economy over the past half century. We are accustomed to thinking of the modern economy in pre-oil crisis and post-oil crisis terms. That has hampered achieving a correct understanding of the present-day economy.

The Depression of the 1930s was not triggered by any single development. It was caused by a combination of factors that, only collectively, exerted a tremendous cumulative effect on world economic activity. This just goes to show the fragility of our economic society.

It is true that we are living in a society economically far more stable than that of half a century ago. Yet that society nonetheless harbors problems which, if mishandled, could still destroy it. The growing threat of a nuclear holocaust is but one such problem. Winston Churchill, it is said, believed that fear of nuclear Armageddon would further increase, rather than harm, world stability. He has yet to be proved right.

A number of factors lay behind the Great Depression:

One was the return of Britain and France to the gold standard, which led to a sharp economic downturn in both countries. This was because the parities, which were maintained at their previous levels, proved too high. The problems arising over war reparations and war bonds also had a negative psychological impact.

Another element was structural disequilibrium in the world economy, a theory expounded by Ingvar Svennilson. The post-World War I recovery of European agriculture created huge surpluses of farm products on the world market. Agricultural production in Europe had slumped during World War I, and production in North America and Oceania had increased to make up the difference. With the end of the war, overcapacity became a serious problem, as was true of shipbuilding and other industries as well.

Economist Alvin Harvey Hansen suggested that a lack of investment opportunities also played its part. There were no investment incentives strong enough to offset other negative factors. New industries, such as automobiles and home appliances, seemed to have only limited growth potential.

Everyone is familiar with the stock market crash that resulted from excessive speculation. Less well understood is how the plunging value of assets held by wealthy individuals cooled off both consumption and investment.

The failure of the monetary policy of the U.S. Federal Reserve Board (FRB) only intensified the panic. Milton Friedman argues that the financial panics–of which there were three, not one–could have been averted if the FRB had conducted appropriate buying operations in 1930-33. Yet that does not explain why the panic occurred in the first place. Policy failure alone seems inadequate to explain the prolonged and sharp downturn in economic activity.

One partial explanation may have been the absence of a country in a position to exercise world leadership. Britain relinquished its leadership position after 1931, while America had the economic power to lead the world but not the will. In 1931 America raised tariffs–something it should not have done–under the notorious Smoot-Hawley Act. Even John Maynard Keynes maintained at the time that British industry needed tariff increases and import restrictions. In that sense, America was simply following the prevailing wisdom of the day.

Wild swings in the inventory cycle exacerbated the panic, even as the high elasticity of prices and wages aggravated the situation, a point few have raised so far. Sharp drops in prices and wages–more than 20% for wages in the United States–likely helped expand disequilibrium rather than reduce it. This not only worsened the downward economic adjustments that followed World War I, but also seems to have had a considerable impact on the Depression.

A final factor that is often overlooked was the minor role of government spending. In 1929 federal spending in the U.S. amounted to $3.13 billion, a bare 3% of the nation's $104.4 billion GNP. Defense expenditures, including pensions for veterans, and goverment bond debt payments (23%) made up one-half of the federal budget. Total public spending, including the expenditures of state and other local governments, stood at $12.44 billion in 1932, or 21.3% of GNP. Federal government employees, excluding military personnel, made up only 1.2% of the labor force. The civilian work force of the federal and local governments represented a modest 6.4%, of which 2.3% were teachers.

Government spending increased during World War II. Although military spending was reduced with the coming of peace, total spending continued to grow. Government spending expanded at an accelerated pace during the 1960s and 1970s, with priority given to welfare expenditures in a trend similar to that observed in Japan in the 1970s. "Big government" was preferred to "small government" as a means of promoting economic expansion.

In comparison, what were some of the factors behind the oil crisis recession? To begin with, the stringent policy pursued by the governments of major countries in 1974–84 helped contain the problem. Some countries did at times institute tax cuts and other stimulative measures, but these were the exceptions rather than the rule. Fiscal and monetary restraint was the only practical policy response to the oil crises, which added fuel to the inflation of the early 1970s.

The downward inventory adjustment in the private sector was another factor. The theory of the "deflationary gap" propounded by some is not correct. It was expected that the massive transfer of purchasing power from oil-consuming developing countries to oil-producing countries would create a wide imbalance between aggregate supply and demand. As it turned out, however, the overall rate of economic growth remained relatively high until 1980. The recycling of petrodollars increased the indebtedness of non-oil developing countries, but it also enabled them to continue their economic and social development programs.

In the 1980s, however, the rate of growth dropped sharply as banks in industrialized countries began restricting lending for fear of debt defaults. Surplus oil funds still flowed into the industrialized countries, and some money was funneled to cash-short developing countries that did not produce oil. But domestic demand in the industrialized countries shrank as a result of inventory corrections. Uncertainty about the future prompted corporations to delay equipment investment and inventory buildups, while the loss of consumer confidence sent sales of housing, autos, furniture, appliances and other durable goods into a slump. This deflationary impact of downward inventory adjustment held the growth rate in the industrialized world to extremely low levels in 1974–75 and in 1980–82. But the growth rate climbed markedly in 1976 and again in 1983–84 as economic prospects improved, leading to expanded demand for durable goods. The overall rate of growth was nonetheless slowed by inventory readjustments.

A last reason for the post-oil crisis recession was the limited capacity of high-tech industries to stimulate growth. Despite talk that the world was entering a "new age" of technological innovation, a "new industrial revolution" or an "advanced information-based society," high-tech industries lacked the punch that the declining heavy industries had once provided. Therefore, once the growth rate had dropped, there were few things going for a rebound.

Photo: PPS

Soothsayers who warn of the return of the 1929 Great Depression are likely crying wolf.

Why the oil crisis did not cause a depression

The oil crisis recession and the Great Depression, although half a century apart, did have one thing in common: the lack of progress in technological innovation. The oil crisis, however, did not cause a depression on a par with that of the 1930s. The overall rate of growth remained slightly above zero even during the periods in which the impact of higher energy prices was felt most strongly. In short, the world economy showed considerable resistance to economic contraction. Why was this?

One of the answers lies in the marked change in industrial structure during the intervening half century. The weight of secondary and tertiary industries had increased, even as oligopolies had strengthened, thus contributing to the downward rigidity of prices. The generalized system of price supports for primary commodities also reinforced the downward rigidity in prices. In addition, advances in inventory management technology had greatly reduced the impact of changes in the inventory cycle.

Another reason was the creation of labor unions in a broad spectrum of industries. The increased bargaining power of unions strengthened the downward rigidity of wages. Continued growth in wages in turn prevented a sharp drop in consumer demand.

It should also be noted that increased public welfare spending had greatly strengthened the capacity of governments to sustain economic growth. In many countries the percentage share of government expenditures in GDP had almost doubled since the 1930s. In the United States under the administration of President Ronald Reagan, benefit payments have made up nearly 50% of the federal budget, while military spending has remained level at below 30%.

Other factors came into play as well. The tools of monetary policy had become more sophisticated. During the oil crisis restrictive monetary policies were followed, a sharp change from the Depression years.

Likewise, the continuing military confrontation between the United States and the Soviet Union sustained military spending at relatively high levels. This exerted a stabilizing effect on the heavy industries that otherwise would have been most susceptible to recession.

And finally, a better system of international cooperation had been developed. U.S. economic leadership of the world was already in decline, yet major countries were still far more willing than half a century before to promote multilateral cooperation. Few politicians dared call for outright import restrictions and tariff increases.

The strong yen and structural adjustment

GNP growth in Japan and the industrialized countries as a whole slowed sharply from the pre-oil crisis period to the time of the oil crises themselves, then stabilized at a low level in the post-oil crisis period (Fig. 3).

Japan's growth rate before the first oil crisis was 9.5%. The figure dropped to an average annual 4% in 1974–84. In the post-oil crisis period the growth rate should be on the order of 4% so long as the economy expands on a stable footing. In fiscal 1986 and 1987, however, the growth rate is expected to drop below 4% because of the deflationary impact of the strong yen. Japan's GNP is projected to expand 2.0–2.5% during the two years. It remains to be seen whether the growth rate will return to the 4% level after 1987. It may be that level will not be reached until between 1988 and 1990, depending on how well the economy absorbs the yen shock over the next year or two.

The average growth rate in the industrialized world before 1974 was 5%. It dropped to 2% during the oil crisis and rebounded to 3% thereafter. According to the World Bank, the industrialized economies registered an average 3.1% rate of growth in 1985. The figures for 1986 and 1987 are estimated at 2.8% and 3.1%, respectively. This post-oil crisis growth rate of around 3% seems appropriate.

What is the basis for projecting the post-oil crisis growth rate at 4% for Japan and 3% for the industrialized countries as a whole? The oil crisis period can be divided into three stages—the first oil crisis period (1974–76), the interim stabilization period (1977–79) and the second oil crisis period (1980–83). The preceding projections are based on the growth rates actually achieved during the interim stabilization period. In the case of the industrialized nations, the 3% growth rate of the interim period was taken as representative of the growth rate in the post-oil crisis period.

In the case of Japan, the 5.2% growth rate in the interim period seemed excessive, and was reduced to 4%. The 5.2% rate was achieved under the expansionary policy of then Prime Minister Takeo Fukuda's government, which issued massive quantities of deficit-financing bonds. Such deficit spending is estimated to have pushed up the growth rate by a full percentage point. In the two years before the inauguration of the Fukuda Cabinet, Takeo Miki's administration issued ¥10 trillion worth of bonds. By contrast, in the next four years ¥48 trillion worth of government debt securities were issued under the administrations headed by Fukuda and Masayoshi Ohira, both former Finance Ministry bureaucrats. In this same period, the United States achieved a growth rate of 4.4% and West Germany 3.4%, despite taking no special measures to stimulate their economies. Japan, too, would still have been able to achieve growth on the order of 4% even if it had not made special efforts to reflate domestic demand.

The stock and land speculation seen in 1986 was of an entirely different character from what happened in the two years or so leading up to the 1929 panic. That stock market crash was triggered by excessive speculation. In 1986, however, the situation of the Japanese economy was fundamentally different.

Adjustments to the second oil crisis were completed in 1984, and the growth rate in and after 1985 was bound to drop below the 1984 level. In 1984, efforts to build up inventories pushed up demand, and the growth rate with it. In 1985, the economy slowed down in reaction to the higher-than-normal growth of the previous year. In 1986, the Japanese economy slowed further because of the deflationary impact of the yen's appreciation. Money demand diminished, yet monetary policy was eased nonetheless to mitigate the yen shock. When the yen rate reached levels far removed from underlying economic realities, interest rates were reduced again to expand the supply of long-term funds and thereby correct the yen's overvaluation. With money demand at a low ebb under this easy-credit policy, surplus money—so-called "excess liquidity"—flowed into the securities and property markets in pursuit of speculative profits. The recent Japanese stock market boom is part of this trend.

Given the prospect of continued excess liquidity, the growth rate is unlikely to drop sharply again for the time being. Nor will the real economy be affected much even if the rate of expansion falls slightly. Speculation in stock and land transactions is simply unlikely to worsen the economic slump.

In fiscal 1987 the Japanese economy will likely remain sluggish. The strong yen, reflecting in part the still large current account surplus, will continue to have a depressive impact on the domestic economy. The prolonged economic slowdown will probably take some steam out of speculation despite the more relaxed monetary policy, and a repetition of the frenzy witnessed in the stock and property markets in fiscal 1986 is not in the cards. The current account surplus reached an estimated $90 billion in the year ending March 1987, and is expected to drop to $80 billion or less next fiscal year. The yen rate will probably rise to the ¥140 to the dollar level, which is considerably higher than the appropriate level of ¥160 to the dollar. The profit squeeze and work force reductions will continue. It is hardly likely that a speculative fever can continue to rage undiminished in such circumstances. The Japanese economy does not have that much wild vitality.

In the days ahead, the government will be coming under greater pressure from the business community to take stronger measures to stimulate the domestic economy. Depressed industries are making great sacrifices to hasten structural adjustments, and the government should take measures that would help them directly, rather than simply expanding overall demand through increased public works spending. Highest priority should be given to measures designed to minimize unemployment. Public works investment is not the best way to do that, because the economy is not now, nor ever likely to be, in as serious shape as it was in the Great Depression. ●