World Eco-Financial Crisis

Lessons we can draw from t

By Robert J Samuelson

Almost all the errors of the 1930s were rooted in the economic orthodoxies of the time. Could the same be true today?

THE Great Depression of the 1930s was the most momentous economic event of the 20th century. It was a proximate cause of World War II, having fed the Nazis' rise in Germany. It inspired a new American welfare system as a response to mass misery. Everywhere, it discredited unsupervised capitalism. Given today's economic crisis, our renewed fascination with the Depression is natural. But we ought to be cautious in stretching the parallels too far.

It's worth recalling how exceptional the Depression was. As Liaquat Ahmed writes in his engrossing "Lords of Finance": "During a three-year period, real GDP (gross domestic product) in the major economies fell by over 25 percent, a quarter of the adult male population was thrown out of work □ The economic turmoil created hardships in every corner of the globe, from the prairies of Canada to the teeming cities of Asia."

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In this well-researched and elegantly written book, Ahmed - a professional money manager - attributes the Depression to two central causes: the misguided restoration of the gold standard in the 1920s and the massive intergovernmental debts, including German reparations, resulting from World War I.

Up to a point, his narrative builds upon the previous scholarship of economists Milton Friedman, Anna Schwartz, Charles Kindleberger, Barry Eichengreen and Peter Temin. But where Ahmed excels is in evoking the political, social and personal forces that led to disastrous economic decisions. His title refers to the four men who heavily engineered the era's perverse policies: Montagu Norman, governor of the Bank of England; Benjamin Strong, head of the New York Federal Reserve Bank; Émile Moreau, head of the Banque de France; and Hjalmar Schacht, head of Germany's Reichsbank.

Determined to reinstate the gold standard - seen as a precondition of global prosperity -they cooperated and quarreled. But "all the thought and work and good intentions," as Norman wrote years later, "achieved absolutely nothing." Just the opposite: they set the world on the path to ruin.

The gold standard required that paper money be backed by gold reserves. If gold flowed into a country (normally from a trade surplus or a foreign loan), the country's money and credit supply were supposed to expand. If gold flowed out, money and credit were supposed to contract. During World War I, Europe's governments had suspended the gold standard. They financed the war with paper money and loans from America. The devotion to the gold standard presumed that it alone could make paper money trustworthy and, thereby, instill economic confidence.

Unfortunately, the war damaged the system beyond repair. Britain - the key country - was left with only modest gold reserves, 7.5 percent of the world total in 1925. Together, the United States and France held more than half the world's gold. The war had expanded US reserves, and when France returned to gold, it did so at an undervalued exchange rate that boosted exports and gold reserves.

Meanwhile, German reparations to Britain and France would equal $2.4 trillion today, says Ahmed. In turn,

the Great Depression

Britain and France owed the equivalent of $800 billion and $1.4 trillion, respectively, to the United States. The global financial system was so debt-laden and interconnected that it "cracked at the first pressure."

That came after 1928, when a rise in American interest rates forced other countries to follow (no one wanted to lose gold by having investors shift funds elsewhere) and ultimately led to the 1929 stock-market crash. As economies weakened, debts went into default. Bank panics ensued. Credit and industrial production declined. Unemployment rose. Weakness fed on weakness.

Sadly, this tragedy has modern parallels. As in the 1930s, a worldwide credit collapse is a danger. Global stock, bond and bank markets are interwoven. Losses in one may prompt pullbacks in others. Money flows to 28 emerging-market countries in 2009 will drop 80 percent from 2007 levels, estimates the Institute of International Finance. There are currency misalignments that, as in the 1920s, have distorted trade. China's renminbi is wildly undervalued.

Indeed, global industrial production and trade are falling faster now than early in the Depression, report economists Eichengreen of the University of California, Berkeley, and Kevin H. O'Rourke of Trinity College Dublin. Still, striking differences separate now from then. The biggest is the response of governments, which - unencumbered by the gold standard - have eased credit, propped up financial institutions and increased spending to arrest an economic free fall.

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The Federal Reserve and the International Monetary Fund have made loans of dollars and other hard currencies available to emerging-market countries to offset the loss of private credit. Nor is there anything like the international rancour that followed World War I and, at crucial junctures, impeded cooperation: in 1931, the French balked at rescuing Austria's biggest bank (Creditanstalt), whose failure triggered a chain reaction of European panics.

When countries left the gold standard - Franklin Roosevelt effectively took the United States off gold in 1933 - their economies began to recover. Some indicators now imply that the present decline is ebbing ("glimmers of hope," says the president). China shows similar signs of improvement. All this suggests that the dreary comparisons with the Great Depression will remain just that. But if these encouraging omens prove false, a more sombre conclusion could emerge.

The mistakes of the Depression were largely rooted in prevailing economic orthodoxies, which had been overtaken by new and misunderstood realities. The present policies likewise reflect today's economic orthodoxies. But what if they, too, turn out to be misguided because the world economy has moved on in ways that become obvious mostly in retrospect? **COURTESY NEWSWEEK**