The Consequences to the Banks of the Collapse of Money Values: 1931 and 2009: Some Comments

Elise S. Brezis

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Introduction

This paper by R. Dimand presents some of Keynes' views on the Great Depression. It focuses more specifically on the collapse of the nominal values of debt, money, prices and wages, and their effects on the reduction in output. The second subject this paper takes a stand about is a comparison between the period of the Great Depression and the crisis of 2009.

The Real Effects of Changes in Nominal Variables

In his paper, Robert Dimand stresses that Keynes has focused on the effects of a reduction in nominal variables on real output. He first puts an emphasis on the effects of the debt value on output demand, what is coined the "debt–deflation dynamics." Then, he analyses in a broader way the relationship between nominal and real variables.

The world of Keynes is vast, and one may arbitrary focus on many different aspects of his theories, but I like Dimand's emphasis on these two sub-subjects, because they are certainly the one that should be emphasized when one talks about Keynes and the Great Depression.

The first interesting point about Keynes is that his view goes against what we call the classical model. Indeed, the classical model states that unemployment can be reduced by a reduction in real wages, so that a good therapy against unemployment would be to start reducing nominal wages, which would be transmitted to a reduction in real wages.

R. Dimand stresses in this paper that Keynes was against this view. He clearly points out the danger of nominal values going down. First, prices going down increase the value of debt and, through a wealth effect, reduce demand. Second, lower money wages lead people to have lower income.

The most significant aspect of Keynes' analysis is that a decrease in a nominal value does not necessarily mean that real values will decrease. The dynamics can lead the system to be such that, despite a reduction in wages and debt, we end up with real wages and debt going up.

This brings us to what has been coined "disequilibrium dynamics." Following Keynes analysis, each business cycle can be divided into two main elements. The first one is the shocks which lead the system to get out of its full-employment equilibrium and to enter a stage of unemployment.

The second and main element of the business cycle is the dynamics of the whole system. The question asked by Keynes is whether the dynamics will lead the system to return to the full-employment equilibrium, or, whether the forces of the system will lead the economy to stay where the first shocks took them to, or even beyond.

While it is clear that the financial crisis was the primary shock of the great depression, it was only the trigger. What makes the Great Depression so different from other business cycles is not the size of the shock or even that there were a series of negative shocks on the side of the financial market as well as the real side. What makes it so different are the dynamics of the system.

As emphasized by Friedman and Schwartz: "An initial mild decline in the money stock from 1929 to 1930 was converted into a sharp decline by a wave of bank failure beginning in late 1930" (Friedman and Schwartz, *A monetary history of the US*). The dynamics did not work as it was supposed to. In Fig. 10.1, I present the regular AS-AD graph. We start from a full-employment equilibrium (point A).

Then, some shocks on the side of the demand (and we can even add on the side of the supply) lead the economy to move to a point of unemployment. The classic theory analysis is that the dynamics of the system are shown by the spiral curve showing how the economy comes back to the full-employment equilibrium.

Theses forces were not in place during the Great Depression. The dynamics of prices, wages and output were not working. This is Keynes' presentation (or at least as developed by Tobin) of the crisis. It is not that the system was unstable. But, after the different shocks, which led the system to enter unemployment, there were no dynamic forces to let it move back to full-employment equilibrium.

> "It is an outstanding characteristic of the economic system in which we live that, whilst it is subject to severe fluctuations in respect of output and employment, it is not violently unstable … Indeed, it seems capable of remaining in a chronic condition of sub-normal activity for a considerable period without any marked tendency either towards recovery or towards complete collapse." Keynes, *General Theory. p. 249*

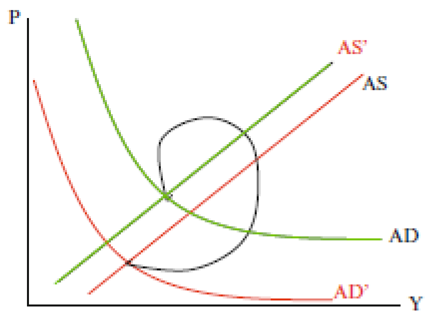

Fig. 10.1 The dynamics of the system

What are the reasons that the system became amorphic and the dynamics did not bring back to full-employment equilibrium? Some scholars have accused the International system to be guilty of the wrong dynamics, as Dimand has mentioned. Indeed, Temin has seen in the Gold Standard the main reason for the system not to return to full-employment equilibrium.

Keynes accused the *animal spirits* of human beings to be the main culpable:

> "There is the instability due to the characteristic of human nature, that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations ... Our decisions to do something positive, can only be taken as the result of *animal spirits* – a spontaneous urge to action, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities." Keynes (1936)

In the terminology of today, the herding which exists in the financial markets is some sort of animal spirit, and was a main element of the crisis of 2009. This brings us to the second point raised by Dimand in his paper: the comparison between the Great Depression and the crisis of 2009.

The Comparison Between the Great Depression and 2009

In his paper, R. Dimand makes a comparison between the Great Depression and 2009. I agree with him that the crisis which started to be felt in 2007 was a financial crisis. I also like the fact that R. Dimand points out that the differences in monetary policy in the US and the UK during the crisis can be due to the difference of points of view of Mervyn King, governor of the Bank of England and Ben Bernanke, head of the Fed, on the causes of the Great Depression, King focusing on redistribution of wealth and Bernanke on the breakdown of financial intermediation.

However, I would like to make a comparison between these two periods following the analysis of the disequilibrium dynamics explained above. It seems evident that the 2009 crisis started with the sub-prime crisis, which, when Lehman Brothers collapsed, led to a main disruption of financial intermediation. There was the possibility of a new Great Depression. Indeed consistent with the model we presented in the previous part, in 2008 like in 1930–1931, there was a continuation of shocks, mostly in the financial market but also in the real economy which could have given place to a strong depression. Not only the first shocks were somehow similar (disruption of financial intermediation), but the herding effects led to the beginning of the disequilibrium dynamics.

However, the main difference between these two periods was the policy of governments. Probably, the fact that Ben Bernanke is a specialist of the Great Depression, led him not to procrastinate and to take very strong measures.

Three factors which went wrong in 1929 went right in 2009. The fiscal policy was correct. Presidents Bush and Obama did not focus on the size of the budget deficit and despite some questions raised on the inflationary dangers of an increase in the deficit, both understood that they have to increase the budget, and the deficit; and they did it.

Second, monetary policy was the correct one. Not only interest rates were reduced rapidly, but the Fed made it clear that big banks and financial firms will not be allowed to go bankrupt. They have learnt the consequence of Lehman Brothers, while in 1931, governments did not know what to do after the collapse of some of the big banks. We can all try to imagine the path of the economy if AIG was going bankrupted as Lehman did.

The third point, and not least, is that the crisis of 2009 occurs at a time of flexible exchange rates, unlike 1929, time of the gold standard. Flexible exchange rates are important at time of crisis. This was maybe an important element of the stability mechanism of this decade. Of course, one could ask about the Euro, whether the EU will suffer from having one currency among countries so different as Greece, Germany and France. It is clear that the single currency does not make life easy for policy makers.

In conclusion, it is clear that even if the financial and housing markets displayed some similar shocks in both periods, the monetary and fiscal policies were very different. Therefore, the Great Depression will still stay a unique phenomenon in the modern period of the Western world. Although 2009 gave us the taste that financial crises are not dead; the collapse did not happen.

Despite this some sort of optimistic conclusion on the crisis of 2009, I believe that the crisis of 2009 has led seeds for a longer and more latent crisis, the solutions of which are not evident. I refer to the problem of income inequality between the financial sector and the rest of the economy.

The crisis of 2009 has made it clear that the new financial intermediations are leading to more harm than to benefits for the economy. As in the phase before the great depression, the economy has developed rapidly and with no doubt the financial market had a part in this growing economy. The same can be said about the period 2003–2008. The financial market and these new financial tools were oiling the economy.

However, when one looks at the inequality in the economy, the working class did not enjoy the fruits of this growth: The financiers kept it all for themselves. While when the market boomed, they enjoyed the fruits thereof, yet on the downturn, the entire economy suffered, but not them. The intervention of governments led to the fact that the financiers did not pay for their mistakes. Not only they did not loose from the crisis, they continue to take huge bonuses.

In conclusion, while the Great Depression led to a restructuration of the wealth, to what Pareto calls: "circulation of elites," the 2009 crisis did not enable a change in the financial markets, due to government intervention. It is clear that letting the economy enter into a huge crisis in order to get structural changes is not a good solution. But, the fact that the financial intermediation sector continues to enjoy the whole benefits of economic growth, is not a good solution either. I would like to remind us that Pareto claimed that if circulation of elites will not come in a natural way, then crisis will make it happen in a costly way through revolts and revolutions. Governments should be aware that the situation nowadays is not a social equilibrium. Crafting good social policy is not less important than continuing with the correct monetary and fiscal policies. Reducing the power of the new financial intermediation sector is a must. The crisis of 2009 emphasized that the new financial-intermediation firms are leading to more harm than benefit for the whole economy. There is a need for new government regulation in order to reduce the power of the financial elite.

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