Interest Policies and the 1928 Great Slump

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Would the Great Slump Have Been So Intense Internationally If the US Had Applied Different Interest Policies in 1928?

The decisions made by the US government to maintain relatively high rates of interest both prior to and after the stock market crash of 1929 are often cited as a contributing factor to the onset of both the Great Slump and the subsequent depression by economic historians who subscribe to the views of Milton Friedman and other monetarists who place the onus of responsibility for the Great Depression on a bungling mishandling of the situation by the Federal Reserve [1]. Whilst there is a certain degree of truth in this interpretation, this view fails to appreciate the implications of a large number of structural flaws both within the post-war international economic system and the US domestic economy that simply rendered any conclusive action on behalf of the Federal Reserve essentially impotent. Through assessing the nature of the post-war global economy and the US national economy prior to the Wall Street Crash of 1929, and by considering the extent to which high US interest rates detrimentally affected both the US domestically and other nations internationally, this essay will argue that any change in monetary policy on behalf of the US Federal Reserve would have made little, if any, difference in limiting the world's exposure to a slump that was already developing prior to 1929.

To understand the centrality of US fiscal policy and the US domestic economy to this question, it is important to appreciate the degree to which the US had assumed a central role in the international economic order that had developed in the aftermath of the First World War. Many historians make much of the transition from a British-centric economic order prior to 1914 to a post-war order that arguably had the US at its core [2]. This is certainly credible. Even in 1913, the United States was the dominant industrial nation of the world in terms of percentage of global industrial output, measuring in at 24% to Britain's 18% [3] – by 1929, the US had emerged as the preeminent economic power, approaching and, in some areas, surpassing Britain in terms of the volume of international trade and investment that flowed through its economic centres [4]. Not only had the US become a major international lender as a result of its provision of war loans to the victorious allied powers, it had captured large lucrative export markets previously cornered by British, German and French industrial interests that ceased to compete during the war [5]. As a result of a very profitable war for the US economy, overseas investment originating from the US and the expansion of US industrial interests abroad were prominent features for much of the 1920s [6]. For those European economies that had suffered the ardours of war, the healthy market for consumer goods within the US offered a path to economic recovery through exports. The US thus found itself sat at the centre of a new web of economic inter-relation and co-dependence that had continued to form during WW1, a system consisting of the economies of those nations that had acquired an appetite for US goods and investment, a dependence on US consumption – or, in some cases, all three.

A second element that rendered the post-war economic system vulnerably intertwined was the re-emergence of the Gold Standard. Whilst the European belligerents suspended the use of the Gold Standard during the First World War, it was generally perceived by these powers that the Gold Standard would act as a stabilising influence not only on their domestic currencies, but in world economic relations as it had done in the years of prosperity in the later half of the nineteenth-century and the years before WW1 [7]. However, the return to gold was fraught with difficulty. The US dollar, which had remained pegged to gold during the course of the war, had accrued value as a result of the inflationary effect of WW1 on the main European economies and the predominance of US exports during the course of the war [8]. The pre-war parities of those currencies returning to gold were obsolete. The governments of Europe were faced with the dilemma of either devaluing their currencies against the dollar to meet the new gold parity, or to maintain overvalued currencies in order to attract the foreign investment so needed in post-war Europe. Responses were mixed – whilst France and a select few other European nations undervalued against gold to boost exports, Britain and her dominions, alongside Germany and Austria upon their return to the system, maintained overvalued currencies against the dollar and thus fought an uphill battle to prevent gold and overseas investment from flowing out of their coffers to fill the American treasury [9]. The resurrected Gold Standard hung precariously upon both the ability of these nations to bankroll their respective currencies in maintaining parity with the dollar, whilst the onus was on the US Federal Reserve to adopt and maintain an internationalist stance to fiscal policy.

Within this delicate balance of affairs lies the argument of monetarists, who point to the decision of the US Federal Reserve to hike interest rates in 1928 as a factor contributing to the severity of the Great Depression. Indeed, to some degree this is an accurate assessment. It is clear that US policy-makers had neither the vision nor the desire to act in a manner conducive to the position of centrality to international economic activity held by the US after WWI. The decision of the Fed to raise interest rates in 1928 was, arguably, the one most in fitting with the US national interest, being in response to the apparently endless growth of global trade flowing through Wall Street arising from the increasing US centrality to the international economic system – by raising interest rates, the Fed hoped to quell the prospects of a speculative bubble developing by encouraging investors to shore up the stability of the US economy by banking their assets [10]. The international consequences were, however, to not only draw capital away from a Europe reliant on US investment, but to also precipitate the collapse of the Gold Standard system. Quite simply, those nations struggling to maintain overvalued currencies against gold, particularly a Germany burdened by reparations and reliant on US loans (which, of course, simultaneously dried up as US domestic interest rates rose), found that they were no longer able to do so without bankrupting themselves. The Gold Standard lost what remained of its political and ideological allure with Britain's departure from Gold in 1931.

The collapse of the Gold Standard into competing currency trading blocs and causing a general retraction in international trade is often quoted by critics as a factor that served to propagate the depression of the 1930s [11] – it can thus be argued that the actions of the Federal Reserve in raising of US interest rates to the point of compromising the fiscal policies of other sovereign states had a generally detrimental effect on the nature world economy. It is clear, however, that the world economy was slumping prior to Britain leaving the Gold Standard in 1931 – a situation that high interest rates in the US had little effect on, nor could have any great effect on had a different policy been adopted in 1928 [12]. By 1929, a number of factors had conspired to create a US economy that had not only developed features that meant that US businesses as a whole were vulnerable to financial shocks, but that also made the prospects of a dramatic contraction in production and consumer spending in the US economy very likely. To understand why the US economy was so susceptible to an economic downturn in 1929, one must analyse the very structures and processes developing within of the US economy itself.

The stance adopted by Keynesian analysts point to structural flaws in the system of supply and demand that had been developing in the US even *prior* to the First World War – in many regards, this holds true. The stock market crash of 1929 acted as a catalyst that took an already-teetering US economy and tipped over the edge into depression. Critical thought on this matter highlights the existence of several structural considerations within the US economy. The first we shall consider is perhaps considered as one of the leading contributing factors to the crash of 1929 – the over-exposure of lenders to declining prospects in the agricultural and industrial sectors. As mentioned previously, the US had a very profitable war. Whilst the belligerent European powers faced the challenge of feeding their civilian and military populations as trade routes were cut and frontlines tore across vast swathes of prime agricultural land – namely in France, Belgium and Russia –farmers within the US enjoyed a rise in the global demand for food as European suppliers struggled to meet the ardour of war. Produce prices likewise rose with demand [13]. In industry there existed a similar situation, with European industrial plant either requisitioned to supply the war effort or cut off from international markets. In the absence of the European goods that traditionally held a stranglehold on international trade, American (and other nationalities, notably Japanese) businesses were able to capture precious overseas markets [14]. The situation thus arose where investors poured capital into generous loans for an agricultural sector looking to expand and take advantage of rocketing commodity prices, whilst industry reaped the rewards of new lucrative export markets and found all-too-willing investors for capital to finance plant expansions.

This state of affairs was not to last. With the re-introduction of European agriculture and industry into the international markets after the war, there existed a perennial over-supply problem within the domestic US economy and the world economy as a whole. US suppliers were once more force to compete with Europe for market share. The steady fall of commodity prices lasted the length of the 1920s and resisted all attempts to prop up prices by protectionism and tariff hikes [15] – US farmers who had relied on high commodity values to pay off debts thus faced bankruptcy [16]. Likewise, with the return of European industry to global trade, it soon began to dawn on US businesses previously accustomed to a continuing upward trend of consumer demand that supply and industrial capacity was exceeding the upper reaches of likely consumption – a situation further compounded by a noticeable decline in US birth rates in the post-war period [17]. The US economy simply produced *too much*, exceeding consumer demand. As struggling farmers began to default on loans during the 1920s and as investors in industry were faced with ever diminishing returns year by year, those banks that had over-exposed themselves through the supply of generous loans to both farmers and industrial concerns found themselves staring at the prospect of financial ruin.

Other structural factors must also be considered. Whilst over-exposure to a combined industrial-agricultural contraction certainly had a part to play in rendering the US economy susceptible to both systematic bank failure and unemployment arising from downsizing, arguably it can be seen as merely a part in a general over-exposure to 'bad credit' on behalf of US banks and the US economy *as a whole* that naturally arose out of the rampant proliferation of investment present within the US economy during the 1920s. Whilst the concept of 'bad credit' is subjective, and this accusation debatable, it is the case that the stock market crash of 1929 led to the cataclysmic collapse of a vast swathe of banking institutions within the US [18] – a situation that would simply end the inwards investment and supply of credit that US consumption had relied on prior to 1929 – a credit supply already suffering from contraction due to the high interest rates adopted by the Federal Reserve in 1928. The US economy had *relied* on this supply of credit. Mortgaged homeowners found themselves hit by higher loan payments, causing consumer spending to fall. This decline in consumer spending was furthered by the nature of US consumption during the post-war years. From the beginning of the post-war period, the composition of consumer spending was gradually shifting towards the purchase of capital-intensive goods – Eichengreen terms this as the growth of the 'consumer durables' market[19]. It is certainly the case that proportion of household expenditure on consumer durables, i.e. one off expenses such as radios or cars, rose steadily during the interwar years from a 4.3% average in the period 1910-1919 to 7.3% in the period 1920-1929 [20]. Whilst a modest increase, it is also important to note two things: first, investment in consumer durables constituted the greatest expenditure of new capital during the 1920s, whilst also accounting for the highest proportion of new jobs created during this period – employment in the manufacturing sector rose by almost 10% in the post-war period up to 1929, arising from a decline of employment in agriculture declined and a population shift away from rural areas into emerging urban industrial centres [21]. Secondly, consumption of consumer durables has a propensity to drop during periods of tight credit, particularly during recession, due to the 'buy-now, pay-later' credit purchase schemes prevalent at the time [22]. The production of durables accounted for an ever-growing share of labour employment in the 1920s, and this, combined with their natural propensity to induce the growth of subsidiary industries, meant that falling demand for consumer durables post-1929 had a disproportionately negative effect on the US economy as a whole.

By the eve of the Wall Street Crash of 1929, the US economy had achieved a considerable degree of centrality and importance within the fragile international economic system that had developed out of the First World War. The extent of the global reliance on the US domestic market as a driver for growth based on the US as a powerhouse of consumption and as a source of investment rendered the rest of the world intrinsically vulnerable to fluctuations in US economy. Had the US continued to act as a strong engine for growth and investment on the international scene, as later experienced in the aftermath of WWII, such connections would have only been beneficial to post-war European economic recovery and the global economy as a whole. Unfortunately, this could not be the case. By this point, the US had developed several deep-rooted structural flaws that rendered it vulnerable to a collapse in consumer spending. The decision to raise interest rates in 1928 did have negative effects internationally – by sapping investment away from European reconstruction efforts whilst simultaneously endangering the already-weakened Gold Standard system, US policy makers failed to adopt the internationalist stance required to shore up the post-war economic system in favour of policy that put US interests first. Even despite this decision, the crash of 1929 still occurred. With a banking sector that collapsed through over-exposure to declining agricultural and industrial prospects, combined with the changing nature of the consumer market and the reliance on bank credit that had developed throughout the post-war years leading up to 1929, what it is important to recognise is the extent to which the US domestic economy of 1929 was structurally vulnerable to a collapse in consumer spending. Given the economic centrality of the US on the world scene in 1929, an economic slump in the US would invariably have global consequences. Interest rate policies in 1928 had nothing to do with the development and consequences of these factors, nor could a different interest rate policy have possibly countered such an inherently hostile range of circumstances. Without a commanding grasp of the US economy, the Federal Reserve had very little chance of averting the slump. Had US policy makers been able to rely on a range of fiscal tools such as were gifted to federal government during the New Deal era, more decisive action could have been taken to avert such a prolonged depression – presuming, of course, the necessary foresight and political will to intervene effectively in the domestic and international economy.

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