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Economics 115
The 20th Century World Economy
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First Midterm Guide
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Part I.

1. Bondholders Committee

●Bondholders committees were formed to resolve problems associated with debt defaults.

●These committees were formed with the approval of the governments of creditor nations.

●They were effective in two key respects:
(1) They worked to negotiate repayment
(2) They blocked borrowers until satisfactory restructuring agreements were formulated.

●Bondholders committees were vitally important in the pre-1914 period—they facilitated the creation of insurance networks to protect agents from defaults.

2. Gold-Exchange Standard

●In a gold-exchange standard, "central banks hold foreign securities convertible into gold at foreign central banks as well as gold bullion" (lecture feb 1 slide 7)

●The gold standard eventually evolved into a gold-exchange standard due to worries of a worldwide gold shortage. Foreign securities were used to supplement the reserves of central banks because countries feared that global gold supplies were inadequate to meet worldwide demand (*Globalizing Capital*, p. 61).

●The student can also compare the gold-exchange student with the other two variations of the gold standard mentioned in lecture: the gold coin standard and the gold bullion standard. (lecture feb 1 slide 7)

3. Liquidity Trap

●In the classic story of a liquidity trap, monetary policy is ineffective because the nominal interest rate has fallen close to its zero lower bound. Hence, bonds and money become perfect substitutes for one another and the ability of monetary authorities to stimulate the economy through expansionary open market operations is constrained. An example of a country in a liquidity trap is Japan in the 1990s

●Some economists argue that the United States was in a liquidity trap near the end of the depression and hence, that monetary policy could not have been effective. Deflationary expectations were of such a large magnitude that they brought the nominal interest rate close to zero. Since the nominal interest rate was so close to its lower bound, monetary policy was rendered ineffective. This is known as the "liquidity trap critique" of the relative merits of monetary policy during this period. However, the leading empirical evidence on the nature of the U.S. recovery from the Great Depression indicates that devaluation and large gold inflows in the post 1933 period engineered high inflationary expectations. In turn, these high inflationary expectations caused ex ante real interest rates to drop, rendering monetary policy very powerful.

4. Unemployment Insurance:

- Main sources: Benjamin and Kochin, 2/15 Lecture
- In the 1920s, unemployment in Britain rose to ten percent (even when the economy was growing).
- Unions expanded after WWI and increasingly advocated for unemployment insurance.
- In Britain, laborers who worked for thirty weeks received a fixed amount of money without needing to provide proof they were actively looking for a new job.
- Contributions paid by workers were unrelated to past unemployment, benefits did not differ by wages, and waiting periods were small (Benjamin and Kochin 446).
- Replacement rate (fraction of previous wages paid to unemployed) was correlated with the unemployment rate. Unemployment benefits were high relative to wages. Benjamin and Kochin estimate unemployment insurance raised unemployment by about five percent in Britain.
- Questions of causality and the fact that unemployment insurance agencies collected unemployment data create possible critiques of Benjamin and Kochin. Additionally, the correlation is driven almost entirely by one data point.
- Ultimately, it is likely that policies did help contribute to high interwar unemployment, but other factors such as hysteresis are needed to adequately explain high unemployment. Insurance results in some prevention of labor market adjustment.
- This term is important to the modern economy because of parallels to modern Europe.

5. **Marshall Plan**

- Main sources: Geiger and 2/20 Lecture
- The Marshall Plan was the plan of conditioned United States foreign aid aimed to help Europe rebuild after WWII. The United States spent nearly 14 billion dollars over a five-year period – amounting to 2 percent of GNP annually.
- The Marshal Plan is an example of policy conditionality on foreign aid.
- The United States was motivated to gain alliances against the Soviet, to help Europe, and to build markets for U. S. goods.
- Large increases in growth were not generated via investment or developing infrastructure. The increase of growth from relieving import bottlenecks was also minimal.
- The Marshall Plan encouraged liberalization, eliminated price controls, created social consensus, and helped encourage European integration. Policy conditionality allowed organizations to form to accept and divide aid throughout Europe.
- Intra-European trade was essential to growth; the European Recovery Program's encouragement of liberalization and integration made trade more feasible (Geiger).

- It is easy to wonder if new "Marshall Plans" would work today. It is important to remember that most of Europe was willing and able to accept the conditions for aid.

6. **General Agreement on Tariffs and Trade**
   - Main sources: Howlett and 2/20 Lecture
   - GATT was one of a series of international "institutions" that emerged after WWII to promote a free and stable Europe.
   - Bretton Woods originally proposed the International Trade Organization. The U. S. did not approve the ITO on national sovereignty grounds.
   - GATT was the substitute for the ITO. From 1947 to 1956, countries agreed to reduce a majority of their tariffs under GATT. GATT worked very well in encouraging international trade at a time where intra-country trade in Europe was needed.
   - Liberalization of trade (through GATT and other agreements) encouraged economic growth. Increased trade helped to further integrate Europe. This growth encouraged investment and confidence and helped demonstrate benefits of integration (Geiger 35).
   - GATT was important to solving coordination problems during Europe's Golden Age.
   - GATT has now evolved into the WTO. The WTO has many parallels to the ITO and one can speculate if the WTO is a good idea based on these experiences.

7. **Path Dependence**
   - Main Sources: David and 1/16 Lecture
   - According to Paul David (332), "A path-dependent sequence of economic changes is one of which important influences upon the eventual outcome can be exerted by temporally remote events, including happenings dominated by chance elements rather than systematic forces."
   - In other words, the probability of each economic outcome being attained is a function of the previous historical outcomes.
   - An example of path dependence is the QWERTY Keyboard. The QWERTY keyboard was "locked in" because of past technological needs and high costs of reversal.
   - Path dependence implies the outcome today may not be the most efficient outcome given today's conditions (technological, economic, political, etc.).
   - Solutions must describe a historical example of path dependence other than QWERTY. Some examples:
     - Return to the gold standard
     - Institutional inheritance from imperialism
     - Memories of post-WWI era influence on WWII recovery.

Part 2

1. **According to Patricia Clavin, it is impossible to understand the Great Depression that erupted in 1929 without placing it in the context of the profound economic changes affecting the U.S. and world economies in the preceding 15 years. Do you agree or disagree, and if so why? Be sure to specify the economic changes that you either think were important or whose importance you believe that Clavin exaggerates.**

Many economists view World War I as the first trigger in a series of events that ultimately led to the Great Depression. According to this view, the War set in place a series of structural changes that profoundly affected the worldwide response to the Great Depression. Patricia Clavin discusses these structural changes in her book *The Great Depression in Europe* and connects these developments to the onset and severity of the downturn. The principal structural changes she emphasizes include:

a. The rise of the United States as the world's chief financial power and the shift in the worldwide distribution of wealth following World War I
b. The severe experiences of inflation and hyperinflation that gripped Europe during the 20's

Parts (a) and (b) explained in greater detail:

(a) Following the War, the United States displaced Britain as the "world's banker"—a shift in world power that dramatically affected the performance of the newly reconstructed gold standard. The period that ended in 1914 was the age of credibility and cooperation. Central banks' commitment to maintaining gold convertibility was viewed as credible and the monetary policies of countries were formulated in a cooperative manner to preserve the system. Countries played by the rules of the game and were willing to bail one another out in times of crises. Prior to the war, Britain assumed the leadership position and in times of crisis, intervened to ensure the stability of the international monetary system. When Britain faced a crisis, the other major European players in the system—such as France and Germany—came to the rescue. Unfortunately, in the aftermath of World War I, with the decline of Britain and the emergence of the United States as the preeminent economic superpower in the world, the reconstructed gold standard proved to be far more poorly managed than its prewar predecessor: international cooperation was replaced by conflicts over war debts and reparations claims and domestic considerations were given priority over international considerations.

Largely as a direct consequence of trade disruptions and wartime debts, gold flowed to the United States during much of the twenties. In 1928 and 1929, the U.S. Federal Reserve became preoccupied with excessive stock market speculation and raised the discount rate—a policy decision that violated the gold standard's rules of the game. Unlike its predecessor, the United States central bank was far more concerned with domestic conditions and rather than lower the discount rate in response to gold inflows, the Fed raised the discount rate. In reaction to the Fed's monetary tightening, central banks throughout the world increased their interest rates to offset additional gold outflows. Hence, a modest monetary contraction in the U.S. was transmitted to the rest of the world via the gold standard, ultimately engulfing the globe in a worldwide depression. Therefore, the rise of the United States as the world's chief financial power and the increased indebtedness of European nations were two key structural changes following World War I that ultimately paved the way for the worldwide decline into depression.

(b) Countries' responses to the worldwide depression were also very heavily influenced by their experiences during the 1920s with inflation. After the War, high debts and high government and wartime expenditures fueled inflation in many European countries. Countries such as France, Italy, Belgium, Czechoslovakia, Hungary, Austria, Poland, Germany and the USSR all suffered from severe inflation. Consequently, countries resurrected the gold standard, in the hope that it would ground inflationary expectations and secure price stability. When deflation and depression finally engulfed the globe, countries were hesitant to sever ties with gold, remembering their painful experiences with inflation during the 1920s. This reluctance to abandon gold arguably delayed recovery and prolonged both deflation and depression.

Note: The key concepts that the student should incorporate into his or her answer are the following: (1) the rise of the United States as the world's chief financial power, (2) the shift in the worldwide distribution of wealth following World War I (including a brief reference to war debts, reparations claims, and trade disruptions), and (3) experiences with inflation and hyperinflation.

If the student disagrees with Patrica Clavin, he/she should still receive credit, assuming the argument is well formulated and based on a sound understanding of the Great Depression and the economic experiences of the 1920s.

2. **In modern accounts, the two most important factors explaining the severity of the global depression of the 1930s were the collapse of the banking system and the collapse of the international monetary system. Explain how these two forces contributed to the severity of the depression. Which of the two was more important for the depression in the United States, and why? Which was more important for the depression in other countries, and why?**

The collapse of the banking sector was more important in the United States, while the collapse of the international monetary system was more important for other countries.

How the collapse of the international monetary system contributed to the depression: Please see Slide 32 from lecture Feb 8th

How the collapse of the banking sector contributed to the depression: Please see Slide 33 from lecture Feb 8th

Other useful observations:

The U.S. had 3 or 4 serious banking crises (slide 35 from lecture February 8th lists 3 banking panics: 1930, 1931 and 1933. Others sometimes argue that there were four banking panics: fall 1930, spring 1931, fall 1931, spring 1932/beginning of 1933). Approximately 50% of the banks in operation at the beginning of the depression disappeared by 1933.

Moreover, while Bernanke and James document that countries that had more severe banking crises also had more severe depressions, few countries had banking crises as severe as the crisis that afflicted the U.S.

Part of the explanation for the severity of the U.S. banking crisis rests on the "limited geographical diversification due to restrictions on branching" (lecture Feb 8 slide 34) that ultimately left banks vulnerable to panics.

Many economists argue that liquidationist ideologies during the thirties ultimately worsened the severity of banking panics in the United States—by failing to act as a lender of last resort, the U.S. Federal Reserve committed a fatal blunder. Arguably, with more interventionist policies, the Fed could have mitigated banking panics.

Moreover, since there are constraints imposed by the gold standard on countries' abilities to intervene and act as a lender of last resort to stabilize its banking system, the gold standard clearly played a pivotal role in the severity of banking panics throughout the world.

Nevertheless, from a comparative perspective, banking panics were clearly far more serious in the United States than almost anywhere else in the world.

We can decompose the magnitude of the effects of banking panics and the collapse of the gold standard on a country's money supply in the following fashion:

M1 = (M1/BASE) x (BASE/INTRES) x (INTRES/GOLD) x GOLD

M1/BASE → banking crisis effect
INTRES/GOLD → gold standard collapse effect

Excluding the U.S. and U.K., the two principal reserve-currency countries, reveals that the INTRES/GOLD ratio falls from 1.60 to 1.23 between 1929 and 1931, a 23% decline.

M1/BASE declined by 25% in the United States from 1929 to 1931, indicating a large banking crisis effect. For other countries, the corresponding statistic is roughly 10%.

Hence, these calculations show that the collapse of the banking sector was more important in the United States, while the collapse of the international monetary system was more important for other countries.

Note: The student does not need to remember these statistics or calculations; however, to receive full credit, he/she should at least reference this equation and its decomposition into the banking crisis effect and gold standard collapse effect.

3. **Economic and political reconstruction displays many similarities following World War I and World War II: the League of Nations after WWI and the United Nations after WWII, the reconstructed gold standard after WWI and the Bretton Woods System after WWII. But there were also important differences between the two historical episodes. What were they, and what explains them?**

- Main sources: 2/6, 2/20, and 2/22 Lecture, Schulze, Eichengreen (chapter 3)
- The extent of damage from WWII was much greater. (Schulze 18-19)
  - Loss of life was three times greater. The loss of life included large decreases in skilled and able-bodied workers, which implies a larger loss of human capital.
  - Mass migration of people after WWII was the largest seen in Europe (including movement out of Germany, but also including Germans migrating back to Germany).
  - Due to extensive bombings, the destruction of physical capital was greater after WWI.
  - All of this implies different conditions for economic and political recovery.
- After WWI, the victors levied high reparation payments. The settlement after WWII did not contain large reparations and, in fact, even saw large amounts of foreign aid being transferred.
  - The memory of damages caused by reparations from WWI explains this, in part.
  - Additionally, trade with Germany was much more important in the post-WWII era. The rest of Europe required Germany's capacity in coal production and industrial strength to grow.

    - Reparations after WWI prolonged political rivalries. The lack of payments and the Marshall Plan after the Second World War facilitated integration.
- To finance the reconstruction after WWI, European banks borrowed money from American banks. After WWII, less European countries borrowed money. ERP was more important.
    - In a large part, this was due to unwillingness of American banks to lend money to Europe because of the interwar economic crisis (Schulze 39).
- The post-WWI era saw a strong desire to "turn back the clock" and return to the policies of the previous era (despite dramatic changes in the political climate). The desire to return to the gold standard in the interwar years is an example of this.
- The post WWII era featured the creation of new institutions and a new monetary system created at Bretton Woods. The 1940s and 1950s saw less desire to "turn back the clock."
    - A high amount of path dependence existed after WWI. After WWI, people wanted to return to a system that worked despite a changed political climate (extension of franchise, international alliances, and new pressures on governments).
    - After WWII, little desire existed to return to the experience of the interwar years that was marked by high unemployment, political instability, and economic instability.
    - Conditions of the Marshall Plan helped to create an integrated Europe.
- Although the two periods saw the creation of international organizations (League of Nations after WWI and a plethora of organizations after WWII), these organizations were vastly different in number and in authority.
    - After WWI, the U. S. Senate failed to approve the League of Nations. Although the U. S. did not approve the ITO after WWII, the U. S. was instrumental in helping to establish other institutions as conditions of the Marshall Plan.
- The nature of the recovery was also vastly different. Both wars saw similar drops in GDP levels; however, the recovery of the 1920s was much more turbulent and filled with recessions. Additionally, growth after WWI was not as sustained as after WWII.
    - High investment encouraged the adoption of new technologies. Rapid export growth allowed for specialization along the lines of comparative advantage after WWII.
    - These conditions depended on functioning markets, wage moderations, and integration of Europe.
    - The conditions of the Marshall Plan explain these in part. Marshall Plan eliminated the belt tightening of government budgets, price controls and other restrictions. Indicative planning also helped to place these necessary conditions in place.

4. **In the third quarter of the 20th century, Europe enjoyed a golden age of rapid economic growth. At the simplest level, the explanation is that Europe had fallen behind the United States: incomes per capita and capital/labor ratios were barely half of U.S. levels in 1950, creating scope for rapid catch-up growth. But catching up had prerequisites. What made it possible for Europe to close the gap?**

- Main sources: Craft and 2/22 Lecture

- According to Abramovitz, a country that is behind in income, which has the necessary social capabilities, will have a tendency to converge on the leader country.
  - Large part of growth in Europe was due to TFP growth (technology advancements) because Europe had “social capabilities” to allow for their adoption (Crafts 55). Europe also had a “technological backlog.”
- Europe was in a favorable position to grow because it was behind the United States but had the prerequisites to grow.
  - Europe had a long experience with markets.
  - A well-defined system of property rights existed.
  - Labor was highly educated (although there was some migration from Europe resulting in losses to human capital).
  - Europe had an existing system of institutions.
  - Europe had high social capability. (Recall, Abromovitz and Crafts acknowledge social capability is hard to measure and determine.)
- Europe lacked capital investment, but great variations in conditions existed across Europe. Europe also faced coordination and information problems.
- Gershenkron speculates that countries lacking some necessary prerequisites can substitute institutions for market based mechanisms.
- Europe created domestic institutions as substitutes for where markets failed to work and send the necessary signals within and across sectors.
  - Labor Agreements
    - Management and labor reached agreements to have wage moderations for future income growth.
    - Labor made agreements not to strike.
    - Systems of codetermination and workers councils facilitated this process.
  - Indicative Planning
    - Government bureaucrats created incentives and sent passive signals for investment targets.
    - It helped start different industries that were interrelated and dependent on each other.
    - The planning helped to overcome “Big Push Theories of Industrialization” coordination problems.
    - Bureaucrats knew where to invest by following technological investments of the leader.
  - International Cooperation
    - Political cooperation was needed to overcome fears of German aggression and to overcome international tariff barriers preventing intra-Europe trade.
    - Marshall Plan encouraged European integration.
- While Europe made many of these substitutions, the UK did not; the UK also had a slower rate of growth.
- Crafts acknowledges other conditions in place contributing to growth in Germany: corporate governance, industrial policy, taxation, and vocational training (Crafts 61).