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978-1-108-48504-3 — A History of Big Recessions in the Long Twentieth Century
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Introduction

The long twentieth century, from World War I to the second decade of the twenty-first century, has been a period of significant wealth creation and technological breakthrough, but also of booms followed by sharp contractions of output, investment, and employment. The century witnessed two world wars; the rise and fall of Soviet-type socialism; episodes of hyperinflation, depression, and stagflation; collapses of exchange-rate regimes; and a host of financial crises. Extreme monetary episodes were pervasive in different decades. There was hyperinflation in Germany, Austria, Hungary, Poland, and Soviet Russia in the early 1920s; in Greece and Hungary in the 1940s; in Argentina, Bolivia, Peru, and Nicaragua in the 1980s; in Yugoslavia and Bulgaria in the 1990s; in Zimbabwe in 2008; and in Venezuela since 2017. The toll in terms of economic activity, investment, and human welfare of these episodes was large.

The US stock market crash of 1929 was followed by the Great Depression of the 1930s, and then by World War II, which entailed unprecedented destruction of human lives and physical assets, and changed the geopolitical landscape of the world. Postwar reconstruction and recovery in the Western world under US hegemony was followed by a sustained period of steady growth from around 1950 to 1973, the so-called "golden age of capitalism." This was a period of high employment, more balanced labor-capital relations, and virtually no internationally transmitted financial crises. After World War II, a Socialist camp was formed around the Soviet Union although the Sino-Soviet schism in the 1960s and 1970s distanced Communist China from the USSR.

From the 1970s onward, there have been frequent episodes of financial crises and cycles of expansion and output contraction, in the periphery and the center world economy (also affecting Socialist countries in Central and Eastern Europe) culminating in the Great Recession of 2008–2009 and its aftermath.

Big recessions can have complex political repercussions and spearhead changes in dominant paradigms in economics and social sciences. At the political level, hyperinflation and unemployment in the Weimer republic and the economic slump of the early 1930s paved the way for the accession of Hitler to power in Germany. In the United States, triggered by the hardship of the Great Depression, a federal system of social security, deposit insurance, and various legal acts was established to guarantee economic prosperity, security, and price stability. In France, a protracted compression of economic activity between 1930 and 1936 preceded the victory of the left-wing Popular Front.

The Great Depression also prompted revolutions in economic thinking. The previous faith in the self-correcting abilities of the free market system to restore prosperity and employment after an adverse shock was replaced by state intervention to stabilize the economy. Keynesian economics recommended active stabilization policies to guarantee jobs and opportunities for everyone. In contrast, the stagflation of the 1970s was accompanied by a "crisis in Keynesian economics" to borrow the phrase of Sir John Hicks (see Hicks, 1974). The recommendations of Keynesianism were replaced by several brands of free market macroeconomics such as rational expectations, monetarism, supply-side economics, real business cycle theory, and the efficient market hypothesis. These views, often presented in elegant mathematical formulas but without much resemblance to real world situations, became very influential within academia and governments eager to find quick solutions to the maladies of stagnation, inflation, and monetary instability. The policy recipes were market deregulation, privatization, macro stabilization and trade, and financial integration. Left behind were policies of full employment, the strengthening of the welfare state, controlled private capital mobility, and cooperative labor–capital relations. In contrast with the 1930s and 1970s, the Great Recession of 2008–2009 has so far not led to a change in dominant macroeconomic paradigms.[1]

1.1 Intensity and Determinants of Contractive Episodes

A main focus of this book is the frequency and intensity of episodes of recession and slumps. To put these episodes in perspective, it is worth noting that close to 80 percent of the 744 recessive episodes in the

[1] In the 1990s and early 2000s, macroeconomists in center economies proclaimed that we were living in an era of "great moderation." Prevailing macroeconomic approaches were not paying much attention to the ample supply of bank credit, going to speculative real estate activities, soaring asset prices, and high wealth concentration at the top. This complacency ended abruptly with the eruption of the sub-prime crisis of 2007–08 in the United States.

Table 1.1. *Frequency of episodes of recession and depression in the long twentieth century (declines in GDP per capita)*

		1900–2017		1900–1950		1951–2017	
Type of decline		Obs.	Percent	Obs.	Percent	Obs.	Percent
Recessions	Mild recession (less than 3%)	335	45.0%	115	32.7%	220	56.1%
	Moderate to large recession (between 3% and 10%)	261	35.1%	141	40.1%	120	30.6%
	Severe recession (between 10% and 15%)	61	8.2%	42	11.9%	19	4.8%
Depressions	Depression (between 15% and 30%)	59	7.9%	34	9.7%	25	6.4%
	Mega depression (more than 30%)	28	3.8%	20	5.7%	8	2.0%
Total		744	100.0%	352	100.0%	392	100.0%

Source: Author elaboration based on data from Maddison (2013); World Development Indicators, The World Bank 2017; OECD (2017a, b); National Accounts Main Aggregates Database (United Nations); and World Economic Outlook, FMI October, 2018.

period 1900 to 2017 for 56 countries[2] examined in this book correspond to declines in per capita GDP below 10 percent with episodes of decline in per capita GDP below three percent representing 45 percent of the sample, the event of highest frequency (Table 1.1). On the other hand, depressions defined as declines in GDP per capita above 15 percent account for near 12 percent of the sample. Furthermore, very large economic contractions, say "mega-depressions," defined here as cuts in per capita GDP over 30 percent, represent only 4 percent of the sample.

The frequency of mild recessions increased in the second half of the twentieth century and the early twenty-first century. On the other hand, all other categories of recession/depression declined in importance in that period.

[2] Some of these countries are no longer political entities (Yugoslavia, the USSR, and Czechoslovakia)

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This suggests that governments, when it was financially feasible, learned the lessons of the Great Depression and implemented countercyclical demand policies to stabilize the macroeconomy. During the golden age of capitalism, financial markets, a source of economic crisis and financial destabilization when they do not work properly, were better regulated and restricted in their reach particularly at global level. Conversely, the impressive growth and deregulation of international financial markets since the 1970s have been accompanied by many financial crises and episodes of large output contraction.

Not only do the intensity of recessions and depressions matter but also their *frequency*. In the Latin American region, we find the highest frequency of ups and downs in the level of aggregate economic activity. Venezuela, for example, experienced episodes of negative growth in approximately 57 percent of the years between 1970 and 2018. In Argentina, the share of years with negative growth in the same period was 36 percent. Paradoxically, these two economies were among the most prosperous in Latin America in the early to mid 20th century.

1.2 Events and Shocks Leading to Slumps

We can identify several factors of economic and noneconomic nature that prompt cycles of contraction (and expansion) of economic activity. The main noneconomic events that have consequences upon economic activity are *armed conflicts or wars*. The American and British economies were stimulated in the run- up to World War I and World War II by the increase in defense spending. Germany, in the second half of the 1930s, also experienced rapid expansion stimulated by rearmament, although it suffered immense economic and human loss in the final phases of both World War I and World War II. World War I led to economic disintegration and massive output contraction in Russia and the former Austro-Hungarian empire.

Turning to economic causes of slumps in developing countries they are often associated with the final phase of a *cycle of intense external borrowing.*

A debt cycle is a situation of initial borrowing (that helps in sustaining growth) followed by a decline/stop of borrowing that can cause a recession and/or a financial crisis. The borrower may be the state, the enterprise sector and households or a combination of the three. The typical debt cycle runs as follows. In the initial phase, there is an abundance of foreign (and domestic) credit that stimulates demand, production, investment, and employment. Foreign capital arrives to a country following new investment possibilities, ambitious policy reforms, the discovery of valuable natural resources, with a wave of optimism developing on the economic future of the country. The counterpart of the intense foreign borrowing is internal overconsumption and overinvestment. At some point, the boom runs out of steam and the accumulation of foreign debt generates uncertainties among lenders regarding the capacity of a country to repay debt. This is the syndrome of the "*sudden-stop,*" a term used to describe the effects of a sudden cutoff of foreign lending to countries experiencing *unsustainable external current account deficits* (excess of investment over domestic savings) and/or large *short-term foreign debt* relative to the level of international reserves (indicating a liquidity problem). Examples of sudden stops in recent decades include crises in East Asia (1997–1998); Mexico (1994–1995); Argentina (1995 and 2001–2002); Ecuador (1999); and Greece and Latvia (2008–2009). Swings in foreign capital flows were also destabilizing in Latin America, Australia, and Europe in the late 1920s and early 1930s.

When a current account deficit cannot be financed with new external credits and/or by selling international reserves held by central banks, the bulk of adjustment is placed upon the trade balance and internal economic activity. A real depreciation of the national currency often accompanies adjustment to generate a trade surplus (an excess of exports over imports) and improve the current account of the balance of payments.

Another way to look at the adjustment process in the external accounts is the balance between investment and domestic savings. When the former exceeds the latter, the difference is met by foreign savings. If foreign savings are not forthcoming, the domestic economy will have to adjust, and the typical adjustment to a balance payments disequilibrium is through a cut in investment leading to a decline in output and employment, say a recession or a depression. The so-called *smoothing* of adjustment, say a gradual correction of an imbalance supported by external credit is very often a luxury that many developing/emerging economies and the European periphery cannot afford because of constrained access to international financial markets at the time of uncertainty and crisis.

Debt cycles were a crucial determinant of the macroeconomic adjustment process in the 1980s in Latin America, Turkey, the Philippines, Poland, Hungary, Yugoslavia, and other economies in Central and Eastern Europe. In the context of advanced economies, the saving and loan financial crisis in the United States in the late 1980s, and the financial crisis of Sweden of the early 1990s, were also cases of debt cycles.

An important economic factor that causes recession and depression is the occurrence of episodes of *extreme monetary instability*. The lack of control of the printing of paper currency to cover large fiscal deficits can lead to uncontrollable processes of currency depreciation and price increases known as *hyperinflation*. Rampant inflation destroys the contract structure of an economy creating very strong incentives *against* wealth creation, along with un-desired income and wealth redistributions. Extreme inflation, however, is a highly complex process with several intervening causes and a focus only on "purely" monetary factors may be insufficient to fully understand it. History shows that high inflation is often accompanied by unstable external sector conditions and internal disarray. For example, war reparations, economic embargoes, cutoffs in foreign lending, and drops in export revenues can all provoke a sharp decline in the value of local currency that contributes to inflationary impulse. For hyperinflation to take place, of course, requires very rapid money growth, but this may be an accommodating process for other shocks rather than the only and exogenous source of a process of hyperinflation.

The state of public finances is an important factor underlying situations of exacerbated monetary and price instability. Behind the hyperinflation of the 1920s in Poland, Austria, Hungary, Germany, and Russia, there was a *fiscal crisis of the state*. The dismembering of the Austro-Hungarian empire after World War I and the ensuing territorial and asset losses of newly formed countries clearly affected the tax base and increased public spending commitments of Austria, Hungary, and Poland. In Germany, the loss of former colonies and the shrinking of its commercial navy, along with the imposition of war reparations (in kind and money) had a crippling effect on the German economy. This was exacerbated by the distributive conflicts about who would pay for the reparations, say workers or capitalists and renters, and manifested in a wage-price spiral leading to explosive inflation. In Soviet Russia after the Bolshevik revolution, civil war, external intervention, a weak taxation base, and increased public spending contributed to create hyperinflation in the early to mid 1920s.

The stabilization of rampant inflation in Austria, Hungary, and Germany involved legal reforms in fiscal and monetary areas (prohibition of rediscounting of treasury bills by the central banks and policies of fiscal balance). In addition, exchange-rate stabilization was critical for the stabilization of the price level supported by external credits and surveillance missions by the League of Nations. Poland adopted similar reforms but initially without the supervision of the League of Nations. Russia stabilized rampant inflation by introducing a hard currency, the chevornet, and its value was strictly tied to holdings of foreign exchange and gold. To support the stability of the chevornet, the Bolshevik government moved also to reduce fiscal and monetary imbalances.

Another source of economic slumps and crises is the *collapse of fixed-exchange rate regimes and currency boards*. Managed exchange-rate regimes may help to reduce inflation but also can generate overvaluation of the real exchange rate (currency appreciation), creating trade and balance of payments imbalances. In addition, the external imbalance encourages borrowing in foreign currency, making the banking system and the corporate sector that contracted these loans very vulnerable to adjustment in the value of the local currency. When the currency regimes crash, output and investment suffer badly.

Cycles of expansion and contraction in aggregate economic activity can have an origin in *over-expansionary fiscal, monetary, and wage policies* that are adopted in periods of democratization and economic redistribution to low income groups. In the early 1970s, in the southern cone of Latin America (Argentina, Chile, and Uruguay), popular/socialist experiments took place with the objective of rapid redistribution of income and wealth to the urban working class and the rural poor. In Chile, the redistribution of assets was carried out through nationalization policies in industry, banking, and mining, along with agrarian reform. In addition, redistribution of income was attempted through wage policies and aggregate demand measures that created initial gains for wage earners, but after a year or two, redistributive policies were followed by large macroeconomic imbalances that invited sharp policy reversals.

During Salvador Allende's presidency in Chile, in the early 1970s, the balance of payment deficits could not be funded by official lending from multilateral organizations, a policy urged by the US government, unhappy with having a leftist government in south-America. External "strangulation" and internal resistance to redistribution and democratization by company owners, economic elites and the upper middle class often led to disruption of production chains, food shortages and economic sabotage, prompting currency depreciation, and inflation. Eventually, the ensuing economic crises and internal polarization led to a right-wing military coup in September of 1973 and the collapse of democracy in Chile. Once in power, the military and their economic technocracies adopted neoliberal policies of monetary and fiscal restraint that produced slow disinflationary results, but were costly in terms of output losses, investment declines, and unemployment. Political economy factors and geopolitics should not be disregarded when analyzing the adoption of apparently irrational economic policies that contribute to collapses in economic activity.

Summarizing, we can identify a set of causal factors that are associated with economic slumps:

- War and armed conflict.
- Episodes of extreme monetary instability and hyperinflation.
- Adverse external shocks, debt cycles, and cutoffs in foreign credit ("sudden stops").
- Collapse of fixed exchange-rate regimes and currency boards.
- Premature financial liberalization, credit booms, and asset price overvaluation.
- Overexpansionary demand and wage policies that become unsustainable.
- Political destabilization and economic uncertainty.

1.3 Organization of the Book

The book is comprised of nine chapters including this introduction. Chapter 2 provides an overview of theories and empirics of recessions and depressions; examines the conceptual impact of external shocks, inflation, and other factors on economic activity; and looks at the shapes of business cycles (*v*, *u*, *L* and *w* recessions). Chapter 3 studies the impact of World War I, the hyperinflation of the 1920s, and World War II on aggregate economic activity of countries engaged in these armed conflicts. The chapter shows a variety of effects on output (expansions and contractions) resulting from both World War I and World War II across different countries. Chapter 4 focuses on the causes and consequences of the Great Depression of the 1930s; the role of the gold standard in leading to the depression; the period between abandoning the gold standard and the start of recoveries; the severity of the contraction worldwide; and the depression's impact upon industrial production, exports, and the phenomenon of price deflation. The chapter discusses various conceptualizations of the effects of price deflation and the role of fiscal and monetary policy, including war preparation, to take some economies out of the slump. Chapter 5 focuses on the transition from the golden age to the stagflation of the 1970s and then the neoliberal era in the core economies of the USA and western Europe along with economies of the European periphery. The chapter also identifies main recessive episodes in terms of impacts on per capita GDP and investment ratios from 1970 to 2015. Chapter 6 examines two depressions of the early twenty-first century, in Latvia and Greece. It documents the various policy choices faced by these economies at the time of the crisis and effects on output, investment, fiscal budgets, external current account, balance of payments, and private and public debt. The chapter also critically examines the role played by the International Monetary Fund (IMF) and European institutions in the design and implementation of austerity in these two economies and draws lessons from these policies. Chapter 7 focuses on the rise and fall of growth in centrally-planned socialist regimes in Central and Eastern Europe and the former Soviet Union. It studies the period of rapid growth and socialist industrialization in the 1950s and 1960s, the stagnation of the 1970s, and the decade of stagnation in the 1980s. Then it turns to the "transformational recession" of the early 1990s and the causes of these slumps. It also studies how these economies were impacted by the crisis of 2008–2009. Chapter 8 centers upon the episodes of growth crises, recession, and depression in Latin American and East Asian economies, along with other emerging economies from 1970 to 2015. The chapter discusses the cases of Argentina, Venezuela, Chile, Mexico, Indonesia, Korea, and other nations. The book closes with Chapter 9, summarizing and interpreting the main findings of the book.