Overview (AS and AD shocks)
Unemployment
Demand management: exchange rate and tariff
Demand management: domestic monetary and fiscal policy
Conclusions

——————————————————————————————
Overview (AS and AD shocks)
——————————————————————————————

We've left the comfortable world of pre-1914, when Britain was the richest country in the world, and it is very much WW1 which disrupts that. We shift from a world where Britain is doing relatively well, to one where it starts to struggle. Narratives about decline start becoming more serious and it is in the interwar period where we learn 80-90% of our economics lessons- The Great Depression/ Policy responses to this big, international event.

(3) Last class, we finished with the pre-1914 world of favourable conditions for Britain
European peace
Accessible markets
Stable exchange rates

Interwar period is much more hostile
International breakdown of financial order
Great Depression

Done with the favourable pre-WW1 world which favoured Britain. Pre-1914, Britain operated in a context which was amenable to the types of industries which Britain participated heavily in: International services work better in a big, integrated world market then in small, fragmented, national markets. There *was* European peace, which was helpful for Britain, with the world's largest market at its doorstep and stable exchange rates- this is the last heyday of the international gold standard, (where everyone knew that relative values of currencies because they were convertible into gold at fixed rates). This was a predictable system that Britain operated- it was anchored by British banks (inc. BoE) and British monetary policy where all transactions ran through London. However, in the interwar period basically none of this is true- Europe becomes increasingly chaotic and hostile & the financial order, which used to revolve around London now becomes unanchored. And by 1930s we have the ultimate crash of international order: the Great Depression, where world trade blows up and 70% of debtor countries in the world default at the same time, where the gold standard (this peg of the value of the pound to a fixed quantity of gold, is abandoned. So two very different world, and WW1 is what separates them.

(4) **Dowie (1975)**: break in relationship between productivity and real wages
As result of 13% fall in hours worked (from 54 to 47 hours per week) for constant weekly wage in 1919-20

Increases in productivity matched by increases in wages
Good for workers, not so good for employers
Lowers Aggregate Supply (AS) of labour

Aggregate supply shocks. This is not only a period of chaos and depression, it is also a period of transformation and social change. You have progressive political movement which argued for worker's rights advocates: Work week drops from 54 to 47 hours/ week and the amount paid stays the same/ week. So the labour supply shrinks and the wage paid per hour goes up - great for employed worker, bad for employers and unemployed because getting a job is now harder as the wage you need to be paid is higher.

(5) Labour relations deteriorate
Union-industry non-cooperative solution to bargaining over real wages and productivity
Resulting in sticky wages

Other possible explanations for high rate of unemployment:
Unemployment benefits
Structural change

Labour relations deteriorate markedly. This is the period of the only general strike in British history. There is intense bargaining. This is the period immediately following the Russian Revolution: there is a sense of international hostility between labour and management. Britain, while relatively immune from these forces compared with Russia or Germany, this is still a hostile period for bargaining. Here is where the union system of Britain, with multiple small craft unions, who all negotiate separately, starts to become a problem. Pre-1914 they were fine, post-1914 not so clear. Wages start to become very inflexible. Bargains are struck between management and labour unions about pay rises and demarcation and benefits, and this makes employers more reluctant to hire people- unemployment starts to go up.

(6) **Benjamin & Kochin (1979)** claim that high unemployment in the interwar period in Britain is a function of generous unemployment benefits (B/W), which induced voluntary unemployment

Benefits led to higher unemployment. There are other potential reasons apart from labour relations why unemployment may be high, including increasing benefits and also structural changes in the economy. **Benjamin & Kochin** (1979) argued that unemployment was high because benefits were generous. Start of benefits programmes as we know them meant that the amount of benefits per worker went up, which induced voluntary unemployment (people were content to stay out of the labour market because they were content not to participate.

(7) Aldcroft & Richardson cite the following as key reasons for interwar unemployment:
Over-commitment to old staple industries in the pre 1914 period
Regeneration between wars with big structural adjustment
And labour wasn't mobile between old and new industries

Other key reasons interwar unemployment. More nuanced explanations come from **Aldcroft & Richardson** (1968), who suggest that **1**. Britain was overcommitted to staple industries: too much was left in textiles, ship-building and coal mining and not enough in chemicals and automobiles and new industries. **2**. There is a lot of structural adjustment which has to be done: wars not only destroy a lot but also kill people, destroy capital and change the political situation. The markets which used to be open to Britain are no longer, causing a re-orientation - exports which used to go out to the Continent are now being produced in those countries because they have adopted more protectionist policies - and so Britain has to change as well. **3.** That rebuilding and restructuring of the economy causes transitional unemployment: Workers go from one job to another as factories are built in new locations rather than old ones (disruptions). Wasn't clear that labour was super mobile between these industries- people had homes, families, existing jobs/ skills- this wasn't the US where people had a regular pattern of uprooting and moving.

(8) AD shocks
Export crash
Matthews et al: main reason for fall in output between the wars was a decline in exports
International markets collapse after WW1

Investment crash
During housing boom of 1930s, net IH > total net I
Housing does well, other investment does not
There is net disinvestment in rest of economy during 1933-34

Demand side shocks: the demand world in 1920/30s is *very different* from the world of demand pre-1914. Markets that Britain used to make a lot of money out of, used to be a good soak for exports, and that Britain had very carefully integrated itself into (in terms of providing both ships, and shipping; providing customised textiles, financial services)- all of these things which Britain had concentrated on become way harder after WW1 because of the collapse of international markets. *Partly* a policy thing: rise of nationalism means countries start to go their own way & industrialise within their borders; and *partly* just the destruction of WW1. / There is also domestically an investment crash, probably related to the same phenomenons. The only sector which does well is housing: there is a boom in the 1930s which is triggered by some policy choices. If you leave housing out of the picture, however, there is actually net disinvestment- Britain is not investing enough to even maintain its capital stock. Investors panic and won't invest because they aren't content about future prospects. Policy implications can be seen in a few countries: investors flee to safety - they don't invest in equipment, factories or R&D. They try to invest in safe and neutral things like gold or bronze; and they stay out of the investment market (this does not do good things for aggregate demand).

(9) AD shocks
Money demand drops
Shift in liquidity preference in early 1920s meant that increased demand for money was matched by reduced willingness to hold bonds
Government concern about borrowing throughout interwar period

Money market side of the investment story. This can be seen in the money markets. There is a shift in liquidity preferences- people want to hold cash whereas before people were content to rely on flows coming in, so people hold bigger stocks of cash. They are less willing to lock in their money in investments. Part of economic history where MP, FP and investment all come together. Government is very concerned about borrowing, they are concerned that if they let the debt increase, so they're borrowing more, it will panic the markets and won't be able to borrow.

(10)
——————————————————————————————
Overview (AS and AD shocks)
——————————————————————————————

Overview. Aggregate supply shocks, labour relations, a new policy environment in terms of work and workers (how many hours you're allowed to work), and also aggregate demand shocks - people are spooked, markets are collapsing, investment is low.

(11) Unemployment rate: way back in 1920 UK still pulling out of a war-time economy, which isn't a command economy to the same extent as WW2, but there is still full employment. After the war unemployment shoots way up over 15% and continues that way until the 1930s, when it shoots up into the 20% range - so this is a crisis in terms of the overall economy as a lot of workers are left idle, it is also a social and personal crisis.

(12) Aggregate unemployment
Interwar period clearly one of high unemployment!
Compared with full employment between WWII and the late 1960s (rarely > 2%)

Most other countries also suffered from high unemployment during the 1920s

Virtually all countries suffered from high unemployment during 1930s
Some of which was even higher than in Britain

Aggregate Unemployment. The experience of workers in this period was rough - you begin to see an awful lot of labor militancy in this period, because now markets are tight (it is hard to find and keep a job). Employers know workers need the jobs and workers will use whatever force they have to keep them. The bargain over wages becomes very hard. This period was characterised by 10, or even 20% unemployment in some years. And this was true of most countries in the world, not just Britain. The international demand shock, where British exports fail - foreign consumption drops as unemployment is -20% abroad too. Selling high quality luxury shirts to people who don't have jobs didn't work out well. This issue is bad in the 1920s and awful in the 1930s. Before the Great Depression this is not a good economic period- the Great Depression this has serious international effects. Almost all countries do worse than Britain- WW1 hit Britain very hard and the 1930s are comparatively mild.

(13) Key difference not shown in aggregate results
Aggregate unemployment considerations conceal:
Differences by industry
Differences by region
Differences by gender and age groups
Differences in duration for various groups at various times

Key differences not shown in aggregate results. Unemployment is complicated and official figures aways conceal some truth. It does not always classify men/women or old/young, what industry, or whether they've retired early. We'll go into some of these differences that will maybe tell us soothing about who is not in the labour market anymore, and who re-enters it.

(14) Differences by industry
Unemployment rates varied enormously between industries
With generally higher rates in declining old staples

Caution: tough to measure the inter-industry migration of the unemployed
Unemployment shocks (1927-1932) more pronounced in old staples versus new industries

Old staple industries do worse. This is the beginning of the end for British textiles- 1914 was the high point. Britain produces more textiles in that year than they ever would & it has been decreasing in terms of share and absolute number since then. Other staple industries which Britain used to be very good at are the ones that declined in terms of employment the most. Makes sense: the British economy was super well adapted to the pre-1914 world - that world is ending and thus the industries which were supported by that world are vanishing. Unemployment per industry is tricky: if someone leaves the labour force it's not clear if they are still unemployed in that same industry or whether they're looking for work in different industries: Not entirely clear how people are moving between industries.

(15) Differences by region
Inner Britain (London, South East, and the Midlands) had much lower rates of unemployment than outer regions (North)
Again, problem of how to treat migration of unemployed

If redundant labour force of declining industry/ region did not move to new industries/regions, then unemployment rate rose with decline of industry/region

Unemployment varies by region. It's also not necessarily clear how people are moving between places. A lot of people migrate because, just as it's the beginning of the end for staple industries, it's also the beginning of the end for the North (this is where the North/ South divergence starts to kick in. Unemployment in North far more worse than that in South- so many move to London (we don't know what industries/ sectors/ how many, though). If they didn't move we know that those who were fired in the declining industries were unemployed in the places where those industries work (shipbuilding (Glasgow), textiles (Lancashire)).

(16) Differences by gender and age
Unemployment generally higher for men than for women
Although this is partly a registration problem (discouraged worker effect)
For both men and women, unemployment rates increased by age group

Unemployment higher for men than women. Although, there is this question about being in/out of the labour force, and it may well be that women in this period had other alternatives in terms of domestic work that would pull them out of the labour force, so they would stop searching for a job - (they're just as unemployed as men). Women probably much more active in labour force from 1900-1920 than in 1950s. This separation primarily occurs because jobs are scarce and men tend to get preferential treatment. Unemployment everywhere increases, though.

(17) Differences by gender and age
While rise in unemployment between 1927 and 1932 hit all age groups fairly equally, recovery did not
Unemployment amongst men aged 18-24 returned to 1927 level by 1937
Unemployment amongst older men remained persistently high
This led to the emergence of a stock of long term unemployed
"Structural unemployment"

Unemployment differences by gender and age. While shock hits both groups, the recovery only hits men. As new jobs are created, male workers get the positions (young) on a 'breadwinner concept'. Older men no longer competitive against younger men, who are hired more frequently. This creates stock of long term unemployed people. As people stay out of labour force they are more outdated and less hireable. **Hysteresis:** Transitional unemployment turns into structural unemployment.

(18) Macroeconomics of interwar unemployment
Three reasons suggested in literature for increase in natural rate:
Over-generous unemployment benefits
Rapid structural change
Real wage too high

Unemployment- Reasons For. There are 3 reasons in the literature which is why we move to a higher natural rate of unemployment (a larger stock of unemployed people relative to the labor force.) 1) **Benjamin & Kochin** (1979) talked about over-generous unemployment benefits. 2) There is a question of rapid structural change, old to new industries, the reorientation of world trade. 3) Real wages too high (policy reasons/ union bargains fix the real wage at a level where employers hire fewer people than would empty the pool of unemployed. The market does not clear: supply does not meet demand, price is too high. Evaluate

(19) Reason 1: Over-generous unemployment benefits.
Benjamin and Kochin (1979) argue that overly generous unemployment benefits per worker (B/W) increased equilibrium rate of unemployment.
Major piece of evidence is a time series regression, which they claim proves that benefits raised unemployment by about 10%.

Unemployment Reason 1. **Benjamin & Kochin** (1979) argue that it's benefits: too much is being paid to workers in 1920s. They use a time series regression where they say benefits raised unemployment by 10%.

(20) Reason 1: Comments on Benjamin & Kochin
Ormerod & Worswick: claim that B&K's equation is unstable, with regard to the sample period
If observations for 1920 and 1921 dropped, (B/W) becomes statistically insignificant
Effect on unemployment depends crucially on inclusion of 1920 and 1921 observations
But during this period, benefits were too low to have created benefit-induced unemployment…

Unemployment Reason 1. **Ormerod & Worswick** () say 'this doesn't work'. They claimed it seemed to rely on data from high unemployment periods in 1920 and 1921 to make the statistical claim that this is true. This was before any major benefits packages had been passed, however: this doesn't fit in well with causal ideas. Pulling these observations out the effect (statistical significance) vanishes.

(21) Reason 1: Comments on Benjamin & Kochin
Collins: B&K's model cannot explain variation of unemployment rates across industries
Given nationally set benefit levels B of (B/W) is fixed, and
W of (B/W) varied across industries
B/W varied from industry to industry
Given different wage rates by industry

Unemployment Reason 1. Collins has also attacked this story, saying that this doesn't actually explain variation. Industries that give benefits don't actually seem to experience worse unemployment then those that don't. There is a nationally fixed set of benefits but unemployment changes depending on industry. Since wages were different and benefits were the same, and we see different outcomes- it's not clear whether this explains anything.

(22) Reason 1: Comments on Benjamin & Kochin
Cross: system not generous in terms of the way it was administered.
Clauses actively used to disqualify suspected "malingerers"
Most authors accept that benefits had small effect on short term unemployed
Other authors highlight that B&K's story is grossly at odds with much of the historical microeconomic evidence

Unemployment Reason 1. This was harshly means-tested. The govt was not happy to give out benefits, they called people 'malingerers' to try and actively get people off benefits. Benefits had a small impact and were stingy & hard to get. This doesn't work when we start to look at the micro-evidence: in terms of what's actually happening worker to worker, industry to industry. Evidence seems to suggest its not benefits increases which are increasing unemployment.

(23) Reason 2: Structural change
Aldcroft & Richardson: interwar period saw regeneration of British industry, with transfer of resources from old staples to new industries
A&R see this as causing higher unemployment
Because, according to A&R, new industries are less labour-intensive than old staples

Unemployment Reason 2. **Aldcroft & Richardson** (): Maybe a story of transition from old, labour intensive industries into new, mechanised, high-tech industry. This death march updating Brit industry in 1920/30s is what's doing it; the new industries are less labour intensive- new machines, more tech, fewer workers.

(24) Reason 2: Structural change
However, von Tunzelmann shows that new industries were not less labour-intensive than old staples
In fact, the reverse true:
Ratio of (share of labour):(share of K) = 2 in new industries, but only = 1.5 in old staples

New industries would have made the unemployment problem worse, not better

Unemployment Reason 2. Unfortunately this argument also doesn't work very well: old industries were actually less labour intensive. Brit Industry in 1914 was as well capitalised as it needed to be. Brit was capital market of the world. Looking at the share of labour to capital; the ratio is 2:1 in new industries (need 2 workers for every block of capital); and in the old industries, its 1.5:1, less labour for the same amount of capital. Thus if, counterfactually, if Britain had transitioned to new industries, those would have been more labour intensive, unemployment would have been lower.

(25) Reason 3: Real wage (W/P) too high
Critical change was the reduction in hours worked during 1919-20 (Dowie)
Weekly hours fell by 13%
From 54 to 47 hours
The increase in wages relative to labour productivity represented a substantial distributional shift in favour of labour
Once established, it proved very difficult for any firm or person to move to a different equilibrium

Unemployment Reason 3. The third possibility is that the real wage (W/P) was too damn high! You had to pay workers too much & if you tried to pay them less either the govt or unions would get upset with you. Firms just accepted higher wages and fewer workers: if this meant higher unemployment then so be it. The fall in the workweek, (a key labour demand that had been on the books of labour trade slogans for ages: 'fair, short, workweeks', which lets them hire more workers, evens out the burden of work and means better conditions, but also more unionised workers. 54 -> 47 hrs redistributes in favour of labour, which means employers are less happy to hire: thus unemployment, but if a 47 hr workweek contract becomes standard it's very hard to revert it. Individual firms have a hard time getting out of this.

(26) Graph. Productivity (output per labour) is going up. Real wages are even higher in the 1930s, however, but plateau and in fact even shrink- the jobs that are protected have good wages, which can't be lowered because of contracts

(27) Reason 3: Real wage too high
Productivity relative to W/P did improve in the 1920s
Firms fired the least productive workers, who were then unable to price themselves back into work
These long term unemployed then became 'outsiders' in the labour market

Unionized 'insiders' set industry wages, to the disadvantage of 'outsiders'
As a result, natural rate of unemployment remained high

Unemployment Reason 2. We also that labour productivity increases in this period: employers are paying more but they are getting more value per worker: **long-tail effect** - if you have a labour force and wages spike, forcing you to fire some, you will not fire the most productive workers- you'll fire the least productive, forcing the second least productive into action because the threat of being fired is real. The least productive workers go into the unemployment pool, one of the reasons why employers may look dubious about hiring unemployed people. This creates an **insider/outsider problem**, where those that have and keep their jobs have good wages, benefits and protection by unions, and those that are outside have a much harder time getting back in. Political and social reasons prevent Walrusian mechanisms of employment clearing, where better paid workers would take pay cuts to fund employment of others.

(28) Aggregate demand: Keynesian unemployment
Once natural rate of 8% had been established, fluctuations around this level occurred due to fluctuations in AD

Reasons for decline in AD:
Decline in world trade
Deflationary policy in 1920s
The Great Depression

Unemployment: Aggregate Demand. You get unto a natural rate of 8% (high) and demand fluctuations cause this the oscillate, at least unto the Great Depression. Demand fluctuates a lot during this period- world trade collapses, policy shocks around that world (era of Hitler, Mussolini etc.), there is also deflationary policy as well as the Great Depression.

(29) Microeconomic factors
Crafts criticises B&K for providing an explanation of interwar unemployment that is grossly at variance with the historical evidence
And which fails to provide plausible model of labour market
Now look beneath macro evidence to a more plausible micro-based view…

Unemployment: Microeconomic factors. **Crafts** goes after **Benjamin & Kochin** by suggesting that their view is inconsistent with how the labour market is actually functioning.

———— PART II ————

(29) cont…

Microeconomic factors. What's increasing unemployment is that benefits are just too high. Benefits are introduced in the interwar period and this creates a disincentive for workers to work. Nick Crafts has said that this is problematic: it doesn't represent what happened in the labour market. What we need is a view which made sense a the micro level, which tells us something about the macro story:

(30) Microeconomic factors
Eichengreen: uses microsurvey data from the 'New Survey of London Life and Labour' conducted by the LSE, starting in 1928

Sequel to Charles Booth's (1899-1903) study of social and economic conditions of working class in late Victorian London

Microeconomic factors. **Eichengreen** (God) went back and used data for a really extensive survey on poverty- it was done in the 20s and was a sequel to the studies of Charles Booth.

(31) Microeconomic factors: Eichengreen
Interviewers collected data on earnings (or earnings in a normal week if you were unemployed) and variety of other characteristics,
Respondents were distinguished between household-head and non-household-heads earnings

Microeconomic factors. **Eichengreen** got data on earnings and expected earnings, on household and individuals, on breadwinners and non-breadwinners.

(32) Microeconomic factors: Eichengreen: Results
Unemployment rate was 8.6%
Slightly lower for household heads

Key finding: if there was any voluntary unemployment, it was not among household heads, but only among secondary workers

Even then, the effects are small
Benefits were not a major factor in explaining high unemployment in interwar Britain

Microeconomic factors. **Eichengreen** find unemployment rate is 8.6% at this time - slightly lower for household heads (if you were the breadwinner you were more likely to be working. You are more likely to be hired if you are a perceived bread inner in this time. He finds that there really isn't any voluntary unemployment at this time among household heads. When you look at this viewpoint that "it's benefits what did it", it doesn't really hold up that well. It's clearly something other than the relatively generous (to pre-1914) unemployment benefit which which is causing unemployment, which isn't all that surprising considering there is high unemployment amongst Europe generally, but not all countries are introducing benefits.

(33) Microeconomic factors: Crafts
Group of long term unemployed workers emerged during 1930s, which is difficult to reconcile with 'search' model of unemployment that underpins B&K approach

In search model: longer you search → gains from further search fall → more likely to accept job offer and re-enter employment

Microeconomic factors: Crafts. So, it's difficult to reconcile the idea that workers are staying longer unemployed voluntarily (which is what a search model of unemployment would tell you) with having a gigantic army of unemployed people, many of whose skills are deteriorating (**insider/outsider problem**).

(34) Microeconomic factors: Crafts
Crafts' review of microeconomic data reveals that the longer you are unemployed, the less likely you are to re-enter employment

Transitional unemployment becomes structural unemployment

Microeconomic factors: Crafts. As **Crafts** argues, the longer you are unemployed, the harder it is to become employed (hysteresis - temporary unemployment becomes structural unemployment.)

(35)
——————————————————————————————
Demand management: exchange rate and tariff
——————————————————————————————

(36) Return to the Gold Standard
Literature centres round formal return to gold in 1925
Key questions asked are:
Was there any alternative?
What was scale of over-valuation in 1925?
What were the effects of over-valuation of sterling during 1925-31?

Gold standard. The second half of this is about demand management. Here's where a lot of the policy questions pop up - the biggest question being about the gold standard: this idea that currency *should be* based on something tangible - that people should be allowed to trust their money, it should mean something. Britain is driven off the gold standard during WW1 - no one is crazy enough to run a gold standard during a war. It is then assumed that they will re-enter: *but when and on what terms?*
They re-enter in 1925 in a bad economic policy decision. They tried to go back on gold at a high value rather than a low one- pegged too high- went off again in 1931.

(37) Was there any alternative?
The establishment were united behind the decision to return to Au so there wasn't much alternative for the government
There were, however, significant minority dissents from this view
Pollard argues authorities at fault in believing that bankers were the best judges of monetary policy in a capitalist society

Was there any alternative? Returning to gold was seen as a key part of bringing back pre-war prosperity. **Keynes** dissented/ criticised this notion that return to gold was necessary. **Pollard** argued that policymakers were far too appeasing to banking interests. Bankers had an idea that the gold standard was fundamental to working of the financial system. But having a gold standard was in their interest- it made banking easy. However, macro economically probably not the best decision.

(38) Scale of Overvaluation in 1925
Consider £ against 5 major currencies ($US, FF, German mark, Italian lire and Japanese yen)
Also consider currencies weighted by their importance in UK trade
Although £-$ exchange rate declined, £ versus other European currencies rose
Because other Euro countries suffered even higher inflation than UK, and hence depreciated against Au by even more

ER and tariffs: Scale of overvaluation. Other alternatives but not widely discussed. Went back on gold at an overvalued rate. Looking at 5 major currencies it turns out that the pound was overvalued. The £/$ ER does decline - because $ is strengthening during this period. Other European currencies are falling even faster: Europe is descending into monetary chaos and the pound is pegged at a high level compared to these European countries. That hurts Britain in these European markets, just as they need them to restore economic growth. There is thus a competitive devaluation of some kind, which Britain plays very badly.

(39) What were the effects of over-valuation?
Moggridge: uses an elasticities approach to calculate the effects of an 11% appreciation of £ from its 1924 level

Makes assumptions about:
Exporter reduced profits
Importer increased profits
Elasticity of D

The effects of over-valuation: So, **Moggridge** has tried using various elasticities to calculate what would have happened as a result of an 11% appreciation, (which is what happened after they went back on in 1924. And he makes assumptions about how importers/ exporters behaved and the elasticity of demand both locally and abroad.

(40) Using these assumptions, Moggridge finds that exchange rate appreciation caused worsening of visible trade balance by £64 million
Combined with deterioration of invisible trade balance of £16 million
Overall deterioration on current account of £80 million

The effects of over-valuation. **Moggridge** finds that appreciating the exchange rate caused the trade balance to deteriorate by £80m. (64m is visible, 16m is after/ indirect effects.) Overall trade balance got worse by £80m because of the overvaluation.

(41) Exchange rate policy was an important factor in explaining fluctuations of unemployment around the natural rate
Unemployment increased immediately after adoption of tight money policy in 1919
Exchange rate appreciation during 1920-21 had a dramatic effect on unemployment

The effects of over-valuation. This also has a lot to do with unemployment- having an overvalued currency in a period of high unemployment is akin to policy suicide: unemployment increases very rapidly after tight money is reintroduced in 1919 to try to get back on gold. There has been too much inflation, the pound is too devalued- and you see the effect in unemployment. As the ER increases in 1920/21, unemployment stays high- which is bad for the unemployment situation.

(42) Floating £ and tariffs in 1930s: floating £
Britain forced off gold in Sept 1931 during major international financial crisis that started in Central Europe

Accominotti: Merchant banks exposed to counterparty risk from bankers' drafts from trade with Germany
Sudden stop of capital flows leads to a run on the Bank of England, forcing Britain to abandon convertibility

Floating £ and tariffs in 1930s. This situation continues until the Great Depression. In September 1931, there is a financial crisis which breaks out all over Europe, starting centrally with **Creditanstalt** in Austria and then spreads very rapidly. The Germans, partly burnt by reparations payments, close of capital flows. **Accominotti** had found the channel by which Britain gets forced to abandon the Gold Standard (to devalue its currency), which is: Britain is doing lots of trading with Germany in this period, and as soon as that trade is cut off by Germany stopping all capital exports - all those counter parties (of those German merchants) who have guaranteed their contracts, suddenly find themselves short. The German merchant counter parties have the money, but they can't send it. The British counter parties don't have the money and have someone really eager to get paid on their end, and so they go to the BoE for emergency funds. And they go all at the same time. The BoE is worried about paying up, and so they break the link with gold. They devalue the currency - Britain is forced off in Sept 1931, which is a major blow to British pride and British Banking.

(43) Floating £ and tariffs in 1930s: floating £
Freed from the constraints of maintaining gold parity, Britain adopted looser monetary policy
Allowed exchange rate to float downwards

End of the interwar gold standard
Britain leaves relatively early (1931)
Timing of recovery across countries correlated with leaving gold, adopting loose monetary policy

Floating £ and tariffs in 1930s: floating £. But, as soon as Britain is off the Gold Standard, the currency can depreciate, so ER can float downwards, and Brit becomes one of the first major countries to leave the gold standard. This is fortuitous, because leaving the Gold Standard early is correlated with pulling out of the Great Depression. The countries that left early do well, those that leave late (France) get mauled. **Eichengreen's** book 'Gold Fetters' describes just how bad it was to stay on gold because you couldn't devalue your currency. It's not just about the effects abroad, it's about the effects domestically: you can'y conduct loose money operations if people can just go to the central bank and exchange this loose money for gold. They will arbitrage the heck out of your CB and you'll have to go on gold anyway.

(44) Floating £ and tariffs in 1930s: General Tariff
Just after £ allowed to float in 1931, the government also adopted General Tariff to protect domestic industry
To the extent that tariff improved BOP, it also led to exchange rate appreciation
Offsetting gains of earlier exchange rate depreciation
Since exchange rate began to appreciate from 1932, there is possibility that government had adopted contradictory policies

Floating £ and tariffs in 1930s: General Tariff. After the decision to float there was some attempt to offset some of these effects by raising tariffs to protect domestic industry. This pulled in both directions: tariffs reduced trade, just as lower exchange rates, just as lower exchange rates encouraged it. There's some ambiguous effect here, it's clear the government were not thinking of this in the same way we were. It might have been pulling in two different directions at once. And so, to some extent the increase in tariffs offsets some of the gain that Britain would have seen from going off gold. Nevertheless, going off gold improves Britain's situation and the Great Depression is fairly mild in the UK.

(45) Floating £ and tariffs in 1930s: summary
Interactions between exchange rate and tariff make it difficult to compare impacts
Findings of Broadberry, Morridge, etc, is that the exchange rate depreciation was a much more powerful boost to the economy than policy

Floating £ and tariffs in 1930s: Summary. ERs and tariffs interact in complicated ways, and when they move simultaneously it's difficult to dissect the effects of each respectively. **Broadberry, Morridge**, etc have found that it's the monetary channel that really matters. ER depreciation is the thing that gave a boost to the UK economy, which is consistent with what Keynes thought. Monetary orthodoxy: when times are bad devalue the currency to reduce exports and increase growth. So these were forced on govt by the necessities of international capital flows (notably Germany stopping theirs), but they had unintended beneficial effects.

(46)
——————————————————————————————
Demand management: domestic monetary and fiscal policy
——————————————————————————————

(47) Middleton (2010): In Britain (and most countries) fiscal policy was not used
Low public infrastructure spending, balanced budgets

Keynes proposed public spending in 1933
Serious political obstacles, questions about debt sustainability prevented large-scale spending

Likely would have been effective
Hatton suggests multipliers of 1.25 to 1.75
Broadberrry suggests 1.22
Dimsdale and Horsewood suggest as high as 2.5

Domestic MP and FP. On fiscal policy, **Middleton** (2010) reiterates what's now a consensus about the Great Depression and the Keynesian possibility that Govts can deficit spend their way out of depression, which is a hugely contentious but nevertheless important idea in modern fiscal policy theory. **Middleton** says, it didn't work - not because there anything wrong with the idea - but because they didn't do it. Britain did not use fiscal stimulus during the Great Depression. Keynes suggested that maybe you might be able to get people back working by spending, but the government ignored it - they kept budgets balanced, infrastructure spending fairly low - this was not a period of deficit spending. Where we did see it, it was effective & where people **(Broadberry, Hatton, Dimsdale and Horsewood)** have done counterfactual exercises on how it would have worked, they get significant results: fiscal multipliers seem to be somewhere in the range from 1.2 - 2.5 (suggesting there was enormous scope for government spening). There is thus evidence that the government could have done something, but didn't. Keynes was not influential enough, yet.

(48) Exchange rate
Deflationary monetary policy of 1920s had a negative effect on output
Sharp rise in exchange rate during 1920-21
Reduced competitiveness of British industry

Expansionary monetary policy of 1930s had a positive effect on output
Leaving gold and pursuing independent monetary policies (i.e. cheap money)

Exchange Rate. The ER has a very deflationary effect on output. In the 1920s they try very hard to get back on the gold standard. They crank interest rates up to try and raise the value of the currency, which causes big problems for British Industry: they now deal with an overvalued currency with high interest rates - it is hard to compete. This interest rate hike is being pursued by the government, for policy reasons, not to help out business, which makes them less competitive in a time where it needs to be competitive. Meanwhile, the accidentally expansionary monetary policy of the 1930s (not entirely accidental: once they leave gold they do intentionally loosen credit) by leaving gold and lowering interest rates has a huge positive impact. These are the two big factors which push Britain down in the 1920s and up in the 1930s.

(49) Housing Boom
Howson concentrates on role of cheap money in initiating and sustaining the housing boom
Main piece of evidence is fact that private unsubsidised house-building increased after Sept 1932, following reductions in borrowing rate between Feb and June 1932, following independent monetary policy after leaving gold in 1931

Housing boom. **Howson** has emphasised the big effect of monetary expansion in the 1930s is seen through a housing boom. Lower interest rates that try to stimulate the economy, end up doing so through the housing sector. There's a lot of scope for secondary earners to own houses. In the 1930s lower interest rates trigger a gigantic housing boom in Britain. Regulations are dropped, new houses are built and this is one of the main things that pulls Britain out of Depression and keeps it at 'mild' rather than 'severe'. Once borrowing rates go down in 1932 you have increased building.

(50) Broadberry claims that Howson overstates the importance of the housing boom
Claims there is no evidence provided on interest elasticity of investment in housing, and that there are other possible explanations for the housing boom
Other important factors:
Rising real incomes
Falling building costs
Demographic factors
The role of building societies…

Housing boom. **Broadberry** claims **Howson** is talking a little too boldly about housing as the only factor behind all this. He claims there is no evidence it it just housing: there are other things that might be helping Britain to recover from the Depression: real incomes are going up, building costs are falling, demographic factors (households are slowly changing). There is the emergence of building societies.

(51) Role of building societies
Humphries stresses the importance of the emergence of competition among building societies
Might be expected that cheap money caused housing boom because fall in interest rates led to an increase in demand for mortgages
However, building societies were often slow to decrease mortgage rates following BoE adjustments
…..So how did housing boom happen, given that building societies financed > three-quarters of house purchases?

Role of building societies. **Humphries** has looked at these building societies that underwrite mortgages - these are the financial intermediaries that run the housing market in Britain in this period. Before they had been fairly sleepy, this period they were spurred on by lower interest rates and become a competitive market. Building societies try really hard to build more houses, underwrite more loans, push more money out the door. This is a period where people can borrow much more cheaply and they are passing that on to consumers who want to build. So, this is one channel for how interest rates end up in economic recovery.

(52) Answer: building societies lowered their liquidity ratio, lending out a larger proportion of existing funds
Why? This seems to have been due to an outbreak of competition among building societies, culminating in breakdown of cartel that set interest rates
Societies began charging different rates, advertising with builders for house-buyers, etc.

Role of building societies. So, there was some question as to how fast this interest rate lowering is actually being translated into building society policy on the ground. How it is exactly that building societies managed to finance all of this if they weren't adjusting their prices as quickly as the BoE would like. Well: the answer is they're taking on more risk: they are operating with less funds, which produces better margins for them; expands the credit supply. Idea of societies holding mostly mortgages, lowering their capital, increasing their leverage, taking more risk were associated with recovery from the Great Depression in Britain. Expansion of credit at a time when it was desperately needed.
So, they start competing with each other: they used to be cartelised (profits were made from cooperation rather than a big housing boom), but as soon as ir start dropping, they start competing with each other. This becomes a big, consumer driven housing market. Inflation of the housing market not a bad thing: economic growth is low, unemployment is really high, housing prices have dropped, so what you really want is to reinvigorate that market, and if you start setting low ir, building societies see an opportunity: they start competing with each other, they build more houses, people go to work in the construction sector, now they have wages…
Supply and demand both increase because credit increases.

(53) Fiscal policy
During whole interwar period governments aimed to balance budget
This does not mean, however, that fiscal policy was neutral
Deflationary nature of policy was amplified by the fact that unemployment was high from 1921 onwards
Against this, however, must be set effect of substantial fall in price level (in the early 1920s)
If we account for change in price level it suggests an expansionary effect, which offsets contractionary effect of maintaining balanced budget during recession

Fiscal policy. In general nothing happens - **Middleton** is right - markets stay balanced. Balanced budgets were the norm. There are aspects of fiscal policy that do actually change during this time, however. Things are moving in different directions in this period- there is deflation (in 1920s) and if we account for the fact that monetary policy was tight, this is masking some of the real increase, even though there's no nominal increase in spending.

(54) Fiscal policy: Yellow Book programme
Liberals in 1929 proposed "Yellow Book" programme of public works
Proposed to increase public spending by £100 million for 3 years

Fiscal policy: Yellow Book programme. Lib Dems proposed larger programmes, along the lines that Keynes suggested. And they have this yellow book programme as which advocates the construction of (bridges, infrastructure) - 'shovel ready projects' with the idea to increase public spending by £100m a year, for 3 years.

(55) Thomas: impact of this on unemployment would not have been very large
Multiplier of about 1 in short run and only 1.5 in long run
Estimates reduction in unemployment at only 359,000 by 1933, on a total of 3,100,000
Broadberry (1986): claims that even 11% may be too optimistic

Fiscal policy: Yellow Book programme. **Thomas** has gone back and asked counterfactually, 'what would this Keynesian policy have done if enacted?' He suggests it wouldn't have been that huge, you might have seen 360,000 people employed, in the context of an unemployment figure that was 9x that size. This would not have solved Britain's woes, but it might have made them a little better. **Broadberry** has said that even 11% may be too optimistic. Although, by modern standards this would not have been an enormous Keynesian programme. This never happened though, and the budget stayed balanced.

(56) Rearmament
Lloyd George fiscal schemes proposed to increase government spending during early 1930s
During later 1930s, in fact, such an increase in government spending actually took place as a result of rearmament
Thomas assesses role of government spending on rearmament in the recovery of 1930s…

Rearmament. This is where a lot of the fiscal story hits. You have, in the mid 1930s, an increase in defence spending led by **David Lloyd George** (DLG), who proposes to re-arm Britain and respond to the increasing threats on the continent. By late 1930s, Britain is increasingly spending more on defence, which creates fiscal stimulus, which reduces unemployment.

(57) Annual spending on rearmament increased from
£103m in 1932/33 to
£400m by 1938/39
Big rise dates from 1935, when war with Germany was a serious threat
Sectors that benefited most from direct spending were: shipbuilding, engineering, aircraft, construction
Largest proportion of increased employment is in engineering

Rearmament. **Thomas** assesses role of government spending on rearmament and sees in early 1930s it wasn't that high, (£103m), by late 30s that is >£400m a year, which is much larger than the liberals proposed in the yellow book package. In 1935 it was clear that Europe would not remain demilitarised and Hitler was rearming Germany; Russia's winter war. International turmoil creates incentives for defence spending and this creates stimulus. This is prominent in heavy industry sectors like shipbuilding, aircraft, etc.

(58) Crafts and Mills use "defense news shocks" to estimate the effects of rearmament
Multipliers were low: 0.5-0.8
Little scope for short-run stimulus through defense spending

Rearmament does substantially increase GDP after 1935, when the government commits to long-term military spending

Rearmament. Interestingly, **Craft and Mills**'s recent research, which relies on defence news as an exogenous shock, calculate what the multiplier would have been, has said that in early 1930s multipliers on defence spending weren't actually that great. It puts people in jobs but it doesn't actually create much value in terms of stimulus. 0.5-0.8% means you would be losing money if you taxed £1 out of the economy and spent it on defence. This is inefficient, fiscally. After 1935 the government commits, not just to spending in response to short term shock, but in the LR commits large chunks of money (£400m) a year. Private sector respond to this. The SR stimulus is not all that effective but the rearmament programme does have a large effect on the economy and does start to pull Britain out of the Depression, reduce unemployment, increase GDP (although this is not consumer goods, just tanks etc.)

(59)
——————————————————————————————
Conclusions
——————————————————————————————

(60) Unemployment was the most important macro problem of interwar period
Although there were problems on supply side, too crude to see this in terms of generous benefit system creating voluntary unemployment
Natural rate rose to 8% with reduction of working week in 1919-20 for constant weekly wage

Conclusions. What was happening in 20s/30s in the interwar? Macro invented in 1930s by scholar thinking about these structural unemployment problems for the first time. So, unemployment was the biggest problem by far - not an issue pre-1914 or post-1945 - it was high and remained so: lost labour, lost output, social effects etc. Govt did try and do some things about this, but this is not a benefits laziness story. Not a **Kochin** story - more about lack of aggregate demand; labour market frictions (some extent union problem); NAIRU rose to 8% (high - this was the *floor, not the ceiling!*) and this happens at same time as reduction in work week, (54 -> 47 hrs).

(61) Negative shocks to AD raised unemployment above this level
Particularly with Great Depression of early 1930s
Exchange rate policy also played important role, with return to gold in 1920s exacerbating situation
And policy of floating in 1930s allowing more reflationary policy stance
Although, be careful not to overstate the contribution of cheap money

Conclusions. There are negative shocks to AD, especially the Great Depression; the ER policy is critical - overvaluing the currency in the 1920s was a high mistake, keeping unemployment high and recovery low; and when Britain is unintentionally forced off gold in 1931, this was the best thing to happen to it - this enabled recovery though loose monetary policy, which starts a housing boom - this is what pulled Britain out of the Depression. There are other things than cheap money involved here: there is also rearmament spending; policy changes to allowing housing to be built (regulation is amended); competition among building societies matters: there wouldn't have been a boom if the cartel had held firm and just used the cheap money to brook customers. But, nevertheless, the change in MP stance is huge and these are the predominant lessons which people have drawn from the Great Depression for Britain- Britain leaves gold early and this worked.