



UNIVERSIDAD
COMPLUTENSE
MADRID

FACULTAD DE CIENCIAS ECONÓMICAS
Y EMPRESARIALES

**SOME DIFFERENCES BETWEEN THE GREAT
DEPRESSION AND THE RECENT CRISIS: LEARNING
A LESSON**

Andrés Fernández Díaz

Working Papers / Documentos de Trabajo. ISSN: 2255-5471
DT CCEE-1506 Septiembre 2015. Versión revisada Junio, 2016
<http://eprints.ucm.es/33183/>

Aviso para autores y normas de estilo: <http://economicasyempresariales.ucm.es/working-papers-ccee>



Esta obra está bajo una licencia de Creative Commons: Reconocimiento - No comercial.

SOME DIFFERENCES BETWEEN THE GREAT DEPRESSION AND THE RECENT CRISIS: LEARNING A LESSON

Abstract:

In this paper we try to point out the lost opportunity on how to address the current crisis, forgetting principles and theories that were successfully applied in the Great Depression. After some considerations about the Stock Market Crash that began on October 24, 1929 and their catastrophic consequences, we analyze the reaction of European authorities to the present crisis, highlighting the financial costs and the loss of welfare that has led to the rescue of peripheral Eurozone countries. Our analysis is based on the interpretation in the framework of the present time of the work and thought of John Maynard Keynes. In this comparative analysis we find a strong contrast between the economic policy outlined in those times by our honorable English economist, and the presence of a recalcitrant single thought and the reductionist determinism that have characterized the economic policies bring about in the crisis years in our country and, in general, in the Eurozone area, given rise to an avoidable situation of austerity and recession we have suffered between 2008 and 2013. In the article we stand out the fact that the Great Depression was harsher and more terrible than the Financial Crisis of these last years, but it was better managed by the American Authorities, otherwise happening with the crisis that we are undergoing.

Keywords: Great Depression, Financial crisis, Rescue, Keynes, Single thought, Reductionist determinism, Austerity, Recession.

DIFERENCIAS ENTRE LA GRAN DEPRESIÓN Y LA CRISIS ACTUAL: APRENDIENDO UNA LECCIÓN

Resumen:

Este artículo pretende poner de manifiesto la oportunidad perdida que ha supuesto el tratamiento de la crisis padecida en los últimos siete años por los países de la Eurozona al olvidar, al llevarlo a cabo, principios y teorías fundamentales de la Ciencia Económica que, sin embargo, se aplicaron y surgieron sus efectos en los tiempos de la Gran Depresión. Como no podía ser de otra manera, el análisis se basa en una recuperación e interpretación en el marco de referencia de nuestros tiempos de la obra y el pensamiento de John Maynard Keynes, apreciándose un fuerte contraste entre la política económica diseñada por el ilustre economista inglés y la que Europa, de forma impuesta e indiscriminada y basada en la incorregible tendencia al pensamiento único, ha aplicado de forma simple y extremadamente reduccionista, provocando una situación evitable de recortes y austeridad, así como la recesión que hemos padecido entre los años 2008 y 2013. En este trabajo también se pone de manifiesto el hecho de que la Gran Depresión fue más dura y terrible que la Crisis Financiera de estos últimos años, pero estuvo más acertado el tratamiento aplicado entonces por las Autoridades Americanas, en claro contraste con lo que está sucediendo en la Unión Europea a lo largo de estos años.

Palabras clave: Gran depresión, Crisis financiera, Rescate, keynes, Pensamiento Único, Reduccionismo, Austeridad, Recesión.

Materia: Crisis financiera

Andrés Fernández Díaz

Professor of Economics. Facultad de Ciencias Económicas
y Empresariales. Universidad Complutense de Madrid
Emeritus Member of the Spanish Court of Accounts

Junio 2016 (fecha de recepción versión revisada)

Este trabajo ha sido editado por la Biblioteca de la Facultad de CC Económicas y Empresariales de la UCM, de acuerdo con los requisitos de edición que figuran en la [Web institucional](#). Las opiniones expresadas en este documento son de exclusiva responsabilidad de los autores.

Introduction

This article is written mainly thinking of the Spanish economy, but can be applied also to the set of Eurozone countries. The principal aim looks to compare two very important and serious crises in the history of economy, with outstanding differences and similarities and the various measures taken to deal with each of them. At the same time, we shall see that the treatment of the present crisis constitutes a lost opportunity to ascertain what kind of economic policy is needed to combat the disequilibrium that restrains the growth and development of the modern economies. We shall begin with a short reference to the Great Depression in the first three decades of XX century, and highlighting the causes and consequences that were most relevant both in United States and in the main European countries. Subsequently and in the same epigraph we shall deal with the very important and worrying financial crisis suffered by the European Union, and most specifically by the Eurozone, during the last seven years. The later also had the same origin, again the United States, although in this occasion Europe has clearly been the most affected, perhaps because it assumed the crisis too late and also due to the fact that always is more difficult to manage eighteen countries than just one.

The next epigraph is dedicated to the analysis of *The General Theory of Employment, Interest and Money*, published in 1936 by the famous British economist John Maynard Keynes. We need, to start with, a few terms and relations which will be defined precisely later and that we find in the Keynes's book. The main idea of our work is looking for the possibility of conciliating austerity with expansion, hard measures in the financial ambit and variables with the need to consider also the real side of economy, using as principal tool the concept of effective demand. In our answer to whether it is possible to achieve both objectives compatible, after some considerations about it, we enter the case of Spain taking into account the peculiarities of our role and experience during the last crisis.

Following the corresponding analysis we arrive, in general lines, to the next proposition. In the framework of a fiscal reform with changes especially in corporative tax and in the treatment given to the Investment Companies with Variable Capital (SICAVs), and with another version of the last labour reform carried out in 2012, with a new and dramatic change in the way of contracting employment, without subvention to trade unions or large amount approved in the budget officially for "actuacions of formative character", we are sure is possible to maintain the present level of effective demand (domestic demand) and the rate of growth of our economy, all that complying with our obligations with the European Union in the matter of financial stability, that is, achieving the fixed percentages of public deficit and debt defined for each year, and going on with the necessary structural reforms.

Anything about the crises

In the United States the Great Depression began after the Stock Market Crash on October 24, 1929, which sent Wall Street into a panic and wiped out millions of investors. By 1933, when the Great Depression reached its nadir, some 13 to 15 million Americans were unemployed and nearly half of the country's banks had failed. The American GDP fell for four consecutive years, from an index of 163,0 in 1929 to 115,0 in 1933 (1913=100), or by almost 30 per cent. There are numerous reasons to affirm that The Great Depression was a severe worldwide economic crisis, or with other words, the longest, deepest, and most widespread depression of the 20th century, don't arriving the recuperation until after 1939, just when United States entered World War II in late 1941.

In 1929 there were about 25.000 banks in the United States, whereas in 1933 were only 14.000, provoking the failure of so many banks, together with the reduced level of money and credit provided by those banks remained open, a powerful pressure for reduced economic activity. In the view of some economists, the decline in the money supply between 1929 and 1933, by itself accounted for the severity of the Great Depression, but although it was clearly a major contributing to the crisis in 1933, many others economists feel that this monetarist explanation is not complete. The main argument is the impact which finance losses and the loss of confidence had on the behaviour of consumers and investors in the economy. In this framework, the interrelationship of income, consumption, and investment, along with the pessimistic expectations following the financial collapse, acted to discourage spending and thus to hinder the recovery of income. As wrote Douglas Greenwald, *not until government spending increased dramatically following the 1937-38 slump, did aggregate spending return to a level sufficient to restore employment to a full-employment level.*¹

In the Great Depression we had a triangle formed by the America of Roosevelt, of course, whose New Deal introduced major changes in the structure of his country, the Germany of the Chancellor Brüning, and the France of Léon Blum, with his Popular Front of 1936-37. The inflation in Germany and some other countries in the early 1920s was, in some ways, more devastating than anything that happened in the 1930s. The trade cycle boom of 1937 was extremely weak and carried many signs of turning into a further severe depression, which was avoided only by the preparation for war.

If we consider some consequences of the war that followed to depression, we have the international debts, the reparation imposed on Germany, and the creation of new small non-viable states in Europe, all of which engendered a hostility that gave place to the protectionist and *beggar-my-neighbour* reactions of government to depression so that trade was reduced, real costs rose, and the world became divided into several currency blocks, of the pound sterling, the dollar, the franc and the mark, severely restricting trade and payments between them. Of course, the British currency had lost its role, at the same time that United States had emerged from the war as the leading economic power.²

¹ Greewald, Douglas (1982): pp. 460-463.

² Pollard, Sidney (1998): pp. 809-812.

It is well known that the Keynes's view on the depression was dominant, but at the same time was also object of discussion and not always accepted by all economists. But this one is another matter that we shall consider the next section. Now, successively and without interruption let us enter in the analysis of the crisis that in the last seven years has convulsed again the world economy.

The financial crisis that began, at least in its external manifestation, on Monday January 21, 2008 as consequence of the subprime mortgages commotion, has been the most damaging economic event since the Great Depression, affecting the lives of hundreds of millions of people. In its resolution, United States and the European Union, especially the Eurozone, have followed different ways, giving, of course, distinct results. The convulsed situation asks for short-term responses. The U.S. Federal Reserve took steps to expand money supplies to avoid the risk of a deflationary spiral, in which lower wages and higher unemployment lead to a self-reinforcing decline in global consumption. The U.S. executed two stimulus packages, totaling nearly \$ 1 trillion during 2008 and 2009. The Federal Reserve's new and expanded liquidity facilities were intended to enable the central bank to fulfill its traditional lender-of-last-resort role during the crisis while mitigating stigma, broadening the set of institutions with access to liquidity, and increasing the flexibility with which institutions could tap such liquidity.³

While this was happening in America, in the Eurozone, at least in a first phase, confusion prevailed, but after a valuable lost time, the so call Troika, that is, the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF) took seriously the problem and began a set of meetings, actions and measures that appear something like an inevitable *mélange*.

The European answer to the crisis can be summarized in three moments or points:

- 1.-The urgent analysis of a group of countries with many difficulties and problems and a very justified and serious preoccupation by the existent state of affairs. These countries were Greece, Ireland, Portugal, Cyprus and Spain.
- 2.-The creation and implementation of regulatory and financial institutions with ability to find large amounts of funding to deal with the immediate future.
- 3.-To proceed successively to the rescue of Greece, Ireland, Portugal and Cyprus, besides to provide the amount necessary to restructure, save and regulate the Spanish banking system, hitherto mistakenly considered healthy and worthy of emulation.

Since the beginning of the reaction, the European authorities, and most concretely the Troika, turned their attention to countries in a delicate situation, which they called peripheral countries. With the purpose of acquiring and to dispose of the capacity and resources for attending the help and needs of the mentioned member of the Eurozone, it was essence to establish the institutions that could undertake this task. In that way in 2010 there was created the European Financial Stability Facility, substituted one year later by the European Financial Stabilization Mechanism, until finally being approved in 2013 the *European Stability Mechanism (ESM)*.

³ Fleming, Michael J. (2012): pp. 4-10.

Respect to the essential subject of the rescues, we limit ourselves to indicate without stop countries, data and amounts corresponding to the bailouts carried just:

- Greece (first rescue): October 2010, 110.000 Million euro.
- Greece (second rescue): October 2011, 130.000 Million euro
- Ireland: November 2010, 85.000 Million euro.
- Portugal: May 2011, 78.000 Million euro.
- Cyprus: March 2013, 10.000 Million euro.

It is necessary to add that in the very moment of writing these lines, August 14, 2015, the Eurozone has approved the third rescue of Greece, which it represents 86.000 Million euro for three years.

In the case of Spain, that as already we have said, it was not a rescue itself, the quantity effectively received in June 2012 to help the bank system amounted to 52.000 Million euro.

Having accepted the severity of the crisis, and outlined the three pillars, the heads of the Eurozone, and in general of European Union, that is, the Troika, designed an economic policy based on an incontestable austerity plan and a set of reforms and measures, due especially to the countries of the periphery that had been rescued or received financial aid. But the other side of coin was the high price paid by these countries, members of the same club. Effectively, the austerity policy has meant great sacrifices in the middle and lower middle classes of the rescued countries, which has caused a sharp fall in consumption, and therefore effective demand, the key variable for economic growth and employment. The reforms needed and required have been carried out with the exception so far of the conflictive Greece, which has been on the verge of leaving the euro.

In this second crisis we are treating, in contrast with that one of the first decades of XX century, that is, the Great Depression, the different approaches adopted by United States and the European Union, that have ended also in different results. So, we can see the evolution of the rate of growth of the Gross Domestic Product (GDP) in the 011-2015 periods, both of United States and the Eurozone:

Table1. Gross Domestic Product Growth Rate

	2011	2012	2013	2014	2015
Unites States	1.8	2.6	1.6	2.9	3.0
Eurozone	1.6	-0.9	-0.4	0.8	1.5

Sources: Eurostat.

It is very easy to recognize the relation between the results overtake and the model of economy policy choice by each one area or block that we have considered in our comparative analysis, and it seems logical if one considers that the first bloc, the United States, had opted for an expansive approach, while the second, i.e. Eurozone, had focused exclusively without attenuating a policy or set of measures accompanied by strong austerity spending cuts.

It is evident that especially in the European space, monetary policy mistakes played a key role in the run-up to this crisis, and the arguments made in defence of the policy actually followed are unconvincing. But at the same time it is necessary to take notice of the fact that the regulators made mistakes before and during the crisis, and because of this we need to be acutely aware of this before giving them even more power and to ensure that lessons are learnt.⁴ In our opinion, and thinking now of Spain, the most negative and open to criticism measure has been to introduce in our Constitution in the year 2011, following the Eurozone criterion, the prohibition of having deficit in the public accounts, with the qualifications set out in the new wording of Article 135. The real mistake is to *leave jailed* in the constitutional framework a very important instrument of economic policy, more yet, the only tool available to be managed by the policy-maker of the respective countries.

We know very well the ineludible necessity of controlling public deficit and the volume of debt, but also it is true that Economics propose other ways to achieve it. That is the question!, and precisely in it consists not only the science but the art of the economic policy. But we have had neither science nor art, and would like to express our sincere excuses if this sentence appears too hard.

For us seems clear that the recent crisis that we have lived through is a lesson we must not overlook, and could draw useful conclusions. But previously we need to remember some basic propositions of Keynesian thinking that serve as support for our considerations, taking into account the disagreement of many economists, especially at present, and the pernicious tendency towards the single thought dominating for years making economic policy decisions.

In the concise view of the Keynes's works and thought we shall operate with the help of the main and basic concepts and variables used in *The General Theory*, and also with the mathematical formulation of the multiplier applied to the public expenditure, as a part of the aggregate demand, and its impact on the growth of the National Income and the employment.

Keynes versus the single thought

*When in the fifties of the last century we began to study Economy we worked basically this known and famous book *The General Theory on Employment, Interest and Money*, published in the year 1936. After placing the emphasis of the prefix **general**⁵ in the title of his book, and leaving clear*

⁴ Wadhvani, Sushil B. (1983): pp.130-147.

⁵ It is necessary to remember that renowned economists such as Perroux, Marchal, Hicks or Kalecki, thought that the Keynes's theory was not a general one, although Dillard was right saying it is general because it deals with all levels of employment, as distinguished from the classic theory; because it explains as much the inflation as the unemployment, and because the volume of employment and the production are referred to the economic system considerate as a whole.

since the first lines of the chapter 1 that the postulates of the classical theory are applicable to a special case only and not to the general case, Keynes starts with the key principle of effective demand.

Let $Z=f(N)$ the *Aggregate Supply Function*, and similarly, let $D=f(N)$ the *Aggregate Demand Function*. If D is greater than Z , there will be an incentive to entrepreneurs to increase employment beyond N and, if necessary, to rise by competing with one another for the factors of production, up to the value of N for which Z has become equal to D . In this way, the volume of employment is given by the point of intersection between the aggregate demand function and the aggregate supply function. The value of D at the point of the aggregate demand function, where it is intersected by the aggregate supply function, was called by Keynes the **Effective Demand**.⁶

The base of the General Theory can be summed up in the following propositions that we express in an easy way:

$Y=f(N)$	The income depends of total employment.
$C=\phi(Y)$	Consumption depends of the level of income.
$N=\psi(D)$	Total employment depends of the effective demand.
$D= D_1+D_2$	Effective demand is the sum of consumption and the expected amount devote to new investment. This one constitutes, as already we know, the key variable of the model.
$D=Z$	In equilibrium the total demand is equal to the total supply, and the total supply exceeds to demand for consumption in the amount to investment.
$N=\phi(Z, \Delta C/\Delta Y, I)$	Volume of employment in equilibrium depends on supply function, the propensity to consume, and the volume of investment. This is the essence of the General Theory of Employment and Money.
$I=f(i, r_m)$	The volume of investment depends on the rate of interest and the marginal efficiency of capital.
$r_m= \phi(e, k)$	The marginal efficiency of capital, in his turn, depends on expectations of entrepreneurs and the cost of reposition of capital.
$i=\psi(M, L)$	Interest rate is given by the volume of money and liquidity-preference.
$W=W_0$	Money-Wages are rigid to fall.

⁶ Keynes, John Maynard (1961): pp. 23-26.

Now we are going to complete this short exposition about the more fundamental notions and definitions introduced by Keynes in his main work, adding the concept of multiplier that establishes a precise relationship, given the marginal propensity to consume, between aggregate employment and income and the rate of investment.

But here and looking for our proposals, we shall use the multiplier in a special manner, considering the increase of the public expenditure as part of the aggregate demand, in a given amount, and at the same time a growth of taxes in a similar volume. Then we know, based in multiplier effect, that there is a positive result in the income equivalent to the growth of spending. The idea is to point out the key role of any component of demand to achieve the economic growth and the creation of employment. This is formalized by Trygve Haavelmo in *Econometrica*⁷, October 1945, whose content we expose here in a simple and easy way using the follow macroeconomic model:

$$\begin{aligned} Y &= C + I + G + X_n \\ C &= a + b(Y-T) \\ T &= T_0 + tY \\ X_n &= X - m(Y-T) \end{aligned}$$

where $G = G_0$; $I = I_0$; $0 < b < 1$; $0 < t < 1$

Substituting the distinct equations in that one of equilibrium, we would be:

$$\begin{aligned} Y &= a + b(Y-T) + I_0 + G_0 + X - m(Y-T) \\ Y &= a + bY - b(T_0 + tY) + I_0 + G_0 + X - mY + m(T_0 + tY) \\ Y(1 - b + bt + m - mt) &= a - bT_0 + I_0 + G_0 + X + mT_0 \end{aligned}$$

Given that we are working with a function of two variables, this is,

$$Y = f(G, T)$$

the correspondent differential would be:

$$dY = \frac{\partial Y}{\partial G} dG + \frac{\partial Y}{\partial T} dT$$

and supposing constant all the others variables, then we would have:

⁷ Haavelmo, Trygve (1945): pp. 311-318.
See for our exposition:
Fernández Díaz, Andrés (1987): pp. 174-178.

$$dY = \left(\frac{1}{1-b+bt+m-mt} \right) dG + \left(\frac{-b+m}{1-b+bt+m-mt} \right) dT_0$$

If we do $t=0$, the equation remain so:

$$dY = \left(\frac{1}{1-b+m} \right) dG + \left(\frac{-b+m}{1-b+m} \right) dT \quad (1)$$

The hypothesis of departure implicates that is complied the condition

$$dG = dT = dT_0$$

and then,

$$dY = \left(\frac{1-b+m}{1-b+m} \right) dG \rightarrow dG = dY \quad (2)$$

what make evident, effectively, that although the expenditure increase come offset by the equivalent growth of taxes, there is a positive variation in the levels of income of the same amount that the initial increase of the public spending.

The key of positive impact on income of a growth of expenditure, in spite of the apparent neutrality derived of the hypothesis of equilibrated budget, is found in the fact that the multiplier of spending is always greater that the tax multiplier, that is:

$$\left(\frac{1}{1-b+m} \right) > \left(\frac{-b+m}{1-b+m} \right)$$

Of course, this summary is only something like a *Pro Memoria* of the most important and outstanding of the famous book and the subsequent thought of our distinguished member of the Bloomsbury Group.⁸

Taking it into account we can understand the content and the success of the economic policy applied to fight during and after the Great Depression, and to consider how far such economic policy could and can still be made in the treatment of crisis suffered in recent years.

As we have said, there are without doubt many economists who are opposed to Keynesian thinking, expressing something almost corrosive about: *The General Theory is a complicated and subtle book, covering vast territory in remarkably few pages. Keynes did not regale his reader with long list of assumptions and qualifications-they are often dealt with in a*

⁸ See, for a complete, rigorous, careful and minutely study, the very book of :
Keynes, John Maynard (1961): pp. 28-34, 107-145.
See also: Fernández Díaz, Andrés (1976): pp. 103-106.

*mere phrase. And ideas which have developed into major areas of research are dealt with in a sentence or two; for example, the distinction between short-run and long-run consumption behaviour, later developed at length by Duesenberry (1959) and Friedman (1957), is the subject of a short paragraph.*⁹ Others works, less emphatic and more reflexive and objective seek to understand Keynes as an historical personality and as an economist whose work is still influencing both academic research and popular economic ideas.¹⁰

We cannot forget other relevant authors such as John Hicks and Dennis Robertson that spoke and wrote unequivocally about the thought and work of our illustrious professor of Cambridge. In effect, it is important to point out the Hick's contribution to macroeconomic theory in those respects in which it constitutes a response to, or a development of, the work of John Maynard Keynes.

It can be said that Hicks had attempted to gain first an analytical, later a historical, and finally a practical perspective on the General Theory. But we can think that one outstanding way of interpreting Hick's position is to say that he was comparing the performance of the Classical approach with the potential of Keynes's one. In reality, as affirms Alan Codington, Hicks found himself with a foot in both camps. On purely intellectual grounds, he was with Robertson, and on the wider view, he was with Keynes. The only question that remains is whether he would see the debate in purely intellectual terms or, as we might say, pragmatically, in the light of existing circumstances.¹¹

Regarding this matter it is interesting to stand out in relation with our analysis the Joan Robinson's thought to the effect that Hicks complains that Keynes's argument on several issues relative the process of accumulation is not set wholly in historical time because the multiplier theory is couched in terms of equilibrium. According to the eminent economist this is quite untrue, affirming that the original purpose of the multiplier was to work out what increase in income could be expected over the immediate future if the level of home investment were to be stepped up, beginning from a particular date. ***Admittedly the time-scheme was not very clearly worked out, but the main topic of the General Theory was the consequences of a change in the level of effective demand within a short-period situation with given plant and available labour.***¹²

Respect to the Great Depression we must say that are wrong those who claim to discredit and detract from saying that Keynes published his General Theory in 1936, when the worst of the crisis was over, as years before, in 1933, defined clearly and unequivocally what was meant by full employment: ***A situation that, under normal market wages, who seeks finds a job***. Broadly, from the end of the 1930s until the early 1970s, with the beginning of the oil crisis, the capitalist or competitive enterprise system functioned fairly smoothly and normally, without

⁹ Chick, Victoria (1983): p.27.

¹⁰ Johnson, Elizabeth S; Johnson, Harry G. (1978): pp. 109-120, 234-249..

¹¹ Codington, Alan (1979): pp. 970-980.

See also:

Hicks, John R. (1936): pp. 238-253.

Robertson, Dennis (1940).

¹² Robinson, Joan (1977): p. 1325.

experiencing the economic trauma of the Depression, and that, in our opinion, is due to the practical application of the fundamental ideas and content of Keynes's General Theory.

In his fight against the background of persistent unemployment during the Depression of the 1920s and 1930s, Keynes pursued two objectives in the General Theory, and something has already been said: to identify and explain the failings of the prevailing classical orthodoxy and to set out an alternative explanation of the determination of output and employment levels. This is neither the moment nor the context to analyze the Keynes's refutation of the classical school, and because of this we prefer to do some considerations about Keynes's alternative framework, given that can be related to the measures taken during the great crisis.

In this sense we can say that the essential message of the General Theory is that in the short run the extent to which firms employ labour to operate existing productive capacity depends on the level of aggregate demand, something that leads to a reversal of the direction of causation contained in classical thinking. Effectively, in the classical framework discussion of the real economy begins with their analysis of the labour market and then, having determined the level of full employment, establishes the associated level of output by reference to the production function. Keynes, in contrast, accepting the production function as a determinant of the aggregate supply function, employs the concepts of aggregate demand and aggregate supply to determine output and associated derived employment levels.¹³

And now, without more excuses the main question is coming. It is possible to reconcile the iron discipline which is in Europe to achieve financial stability with a policy of growth and employment based mainly on the Keynesian concept of *effective demand*? Our answer is positive, and we shall try to explain it, dividing our explanation in two parts clearly differentiated.

The answer (First part)

In 1988 the professor and friend G.K. Shaw showed how Keynesianism provoked two major reactions first in the doctrine of Monetarism and later in the more extreme form of the New Classical Macroeconomics. Besides he describes the Keynesian response to the theoretical counter-revolution and argues that Keynesian theory not only resisted the challenge but also underwent a fundamental metamorphosis, emerging ever more convincing and ever more resilient.¹⁴ We know that traditional Keynesian analysis rested upon the notion of non-clearing behaviour, especially in labour markets, with no inherent tendency for any automatic adjustment. But although this point of view possessed the convenient property of appearing to be in accord with the observed facts and evidence, particularly during the Great Depression, it was not without certain drawbacks.

First of all we must point out that it lacked a micro-theoretic foundation deemed consistent with utility-maximizing behaviour, and secondly, that the conventional Keynesian analysis grounded in short-run nominal wage rigidity, exhibited a decidedly asymmetric appearance in that disequilibrium situations were characterized by labour being displaced from its supply curve whilst

¹³ Love, James (1991): pp. 145-156.

¹⁴ Shaw G.K. (1998): pp. 1-6.

business firms remained firmly fixed on their labour demand curves at all points in time.¹⁵ These and other drawbacks Shaw rightly reminds us has not gone unnoticed, as they are consequences of the evolution of economic thought, on the one hand, and the limitations and assumptions starting Keynes himself had been imposed, on the other. But let us not forget that there is a question waiting for an answer, and such a question have to do with the possibility of fight against a crisis controlling the financial variables, public deficit and debt, without proceeding to numerous cuts and reductions in public expenditures that affecting the welfare and the social policy as soon as the renounce to economic growth.

In practice, the reason for reductions in the State expenditure budget and the other public administration budgets may be the result of a supply-side economic policy based on large and sustained cuts in personal tax rates and business taxes to induced increased production and capital investments and other desired behavioral changes. If an increase in the public sector deficit is to be avoided, such cuts go hand in hand with reductions in public expenditures and particularly in social ones. But a decrease in public spending, and consequently in expenditures on social services and transfers, could also be desired in order to reduce the budget deficit, given a burden of taxation. That would give us two origins of social policy restrictions. On the one hand we should ask ourselves whether the outcome of supply-side economics is really worth the cost in terms of a lower social wage; while, on the other hand we should consider the objective reasons and arguments that make certain reductions in public spending advisable to lessen the deficit.¹⁶

As already mentioned, the restriction in social outlays might be due simply to a constraint of the budget deficit and not to the application of a supply-side economic policy. The consequences might be the same but the cause and justification are completely different. We will stop at the second point mainly because it is the one with a more direct relationship with the central issue at hand. It is clear that budget deficits have grown at an astonishing rate over recent years, not only during the financial crisis, but before it. However to ponder on the true extent of a deficit not only must the pattern of growth be taken into account but also its structure and the way it needs to be financed. Structural and/or conjectural causes exist which determine a situation of deficit and, logically, it makes all the difference which of the causes predominate. In any case, it seems clear that it is neither surprising nor inappropriate that budget deficit increase in times of cyclical weakness.

Nevertheless, the tax burden and the structure of the expenditure must necessarily be borne in mind when considering these deficits. If a maximum limit has been reached in the tax burden, the key will be in configuration and distribution of the expenditure. It stands to reason that the increases in public spending are less distorting when dedicated to real investments which could contribute to the growth of income and employment. But it should be remembered that precisely in time of crisis, current transfer outlays do not diminish but increase very considerably.

Within the functional classification of public expenditures, some categories fall within the framework of the social policy, and they should in no case be the target of cuts consequential to a

¹⁵ Shaw, G.K. (1988): pp. 108-115.

¹⁶ Fernández Díaz, Andrés (1985): pp. 171-172.

deficit constraint policy, not only for political and social reasons but also because, for instance, improved health, education and economic and social infrastructure can contribute to the productivity and flexibility of the economy.

Finally, the way the budget deficit is financed also matters when deciding on the consequences of the deficit for the economy as a whole and the subsequent indirect effects on social policy. As we well know, the government deficit can be financed by tax receipts, money creation, or borrowing. Of course, we do not fall here into the controversy on whether the effect will be the same financing the expenditure by taxes or by borrowing, that is, on the so-called Ricardian equivalence theorem.¹⁷

The answer (Second part)

We don't like to use habitually the example for explaining something. But in this occasion we shall do an exception taken the case of Spain to go on in the treatment of our matter, and that is so because our country constitutes a very especial experience in the framework of this crisis that now seems to be finished. Effectively, Spain has also assumed what the consequences of the banking rescue, severe budget cuts, copayments in the field of health, reductions and/or freeze the salaries of officials, and so on, all supported while it undertaken major reforms structural. This set of actions in compliance with the commitments made to authorities of the Eurozone has shown its positive side, when the Spanish economy will reach the highest growth rate of GDP in the year 2015 (3,3%), with a domestic or effective demand of the 3,3%, which is about 3,4% growth in private consumption, showing that this one constitutes the strategist variable for the economic growth. But for such a growth to be sustained and once abandon this outrageous and somewhat unexplainable sense unemployment rate that refuse to fall decisively, it is necessary to undertake a comprehensive and decisive tax reform and a new labour reform that substantially modify the approved by Royal Decree-Law 3/2012. In both initiatives we can find the key of the question we must to answer.

Regarding the tax reform we will limit ourselves to pointing out the main subjects and issues we considered necessary to structure a tax system while ensuring coverage of public expenditure permits, without unfair and unnecessary cuts, would meet the objectives of financial committed to the Troika. That is possible if we concentrate our attention, among other issues, in the Corporation tax, in the Wealth tax and in the Investments Companies with Variable Capital (SICAVs).

Corporative tax is regulated by Law 27/2014, November 27, and according to article 29, for some companies from 2015 and other since the beginning of 2016 the corporative tax rate fell from 30% until 25%. This could be considered a good measure, but the very problem with this type of tax is that neither before 30% was paid, nor now, with the new law corporations actually pay 25%, which is due to the numerous deductions, allowances and exemptions that have taking place place at the end to the fact that tax rate have actually been paid significantly below the legally approved percentages.

¹⁷ Fernández Díaz, Andrés (1985): pp. 174-175.

Another question relative to the fiscal system is that one that deals with the importance and weight that we must grant to the wealth tax, something to which we have not paid the necessary attention nor taken a clear position in the matter. Because of this we think that would be very interesting to make a deep analysis from the point of view of the distributive justice and as another source of tax receipts, always inside reasonable limits. Restored by Royal Decree-Law 13/2011, September 16, this tax is overlooked by the Central Administration and even by the very Tax Agency (the last date published arrive only to the year 2011), having some interest only for the Autonomous Communities, where constitutes a marginal receipt. However, taken seriously and with full information and revising the different parameters would be again a type of tax to consider.

We take for granted that the two most important chapters of our tax system, that is, the personal income tax and the value-added tax, are given in our approach and that more or less can be compatible with the attainment of the proposed objectives.

The other reform mentioned refers to what must be done in the labour market, and that is really of the maximum relevance and indispensable if we want to reach our macroeconomic objective, that is, to maintain the rate of growth of the economy through the effective demand, and the public deficit and debt levels required by European authorities. The starting point is found, as already we have seen, in the Royal Decree-Law 3/2012, February 10, a very slanting and nothing successful legal disposition that only has been useful for protecting a side of the scale in detriment of the worker, that is, of employment.

In effect, it is enough to read the articles numbers 4, 5, 6, 7 and 8 of the Decree to verify our affirmation, given that in these articles are defined the different types of contracts that, essentially, are four: indefinite time contract only for enterprises with less of 50 workers; partial time contract; temporary contract; apprenticeship contract. It is important to point out that is forbidden to chain temporary contracts that exceed 24 months, and that may be one of the causes of the high percentage of temporary contract at Spain (25%) at the same time that explain something difficult to understand, that is, that our country has simultaneously the highest rate of GDP growth in the European Union and the most elevated rate of unemployment. The precarious contracts and the high turnover that occurs in the labour market are sufficient reasons to explain our recalcitrant volume of unemployment. Besides, in the new normative we find the falling of prices and all kind of facilities to proceed to dismissal.

Recently the International Monetary Fund (IMF) has recognized that at Spain the recovery has gathered speed and job creation has accelerated, but is also noted that more five million people remain unemployed and new jobs still rely heavily on temporary and part-time contracts. Owing to it the Fund requires more reforms that allow correcting the deficiencies observed and indicated that are in the present legal normative. Between these changes IMF has suggested to consider a single contract based on years of services without high seasonal turnover and the reduction of legal uncertainties in the case of collective dismissals.

For us something is clear, and that consists in the idea tested by the facts that promoting cheap dismissal and temporary contracts neither solve anything nor guarantee the creation of employment, go on the level and percentage of unemployment. We think that the solution would

be a single indefinite time contract conditioned by a first year (or six months) test period taking it last seriously and with all guaranties, and in their moment, a reasonable indemnity that could be in function of the years of service. This single contract would unify the causes of dismissal, keeping only the judicial protection for dismissals due to discriminatory reasons.¹⁸

Besides these two main reforms it is necessary to complete the already started reform of the Public Administration, especially avoiding duplicities that not yet have been solved due to the excessive competences permitted to the Autonomous Communities. Spain is the most decentralized country in the world, and because of this we have an Audit-Office or Chamber of Accounts in each Community, a Social and Economic Council, an Ombudsman, something so ridiculous like a State Council in "miniature", and so many others, and all that when the country has, as high Institutions of the State, a Court of Accounts of Spain, a Social and Economic Council, an Ombudsman, and a very State Council. All this *clonic administrative infrastructures* must to be eliminated if we are looking for a better allocation of the expenditure with the correspondent savings of resources and a major efficiency.

In the matter, in June 2013 the Commission to Reform the Public Administration (CORA, in Spanish), created by agreement of the Council of Ministers of October 26, 2012, published a Report with 218 measures to achieve greater efficiency in all the levels of the public sector. This Report estimated that the implementation of those measures supposes a saving of the public expenditure around 17.543 Million euro in the years 2013-2015, an amount of sufficient importance to take into account.

Before concluding this headline it is important not to forget that there is something that we must not avoid considering. It is the fact that in all State Budgets each year includes a chapter dedicated to credits for activities of formative character, and those such amounts, that in the 2016 budget reach the 2.087,73 Million euro, are principally managed by the trade unions with doubtful results, and sometime given rise to scandals of corruption. Given the experience in our country would be commendable to reconsider the opportunity of this outlay and the saving that could be to involve.

Again about the crises

Hitherto, and regardless of the final conclusions, we can highlight something of interest, and is the fact that the Great Depression initiated in 1929 was harsher and more terrible than the Financial Crisis of these last seven years (2007-2014), but was better managed by the American authorities, otherwise happening with the crisis that we are undergoing, very serious and important, but without reaching the extreme situation of those times. However, the reaction of the European Union, perhaps the area most fortunate of world, has been late and mistaken, showing in this and others questions at present a certain incapacity of answering.

There are several strategic factors that played a decisive role in the recovery of the United States economy. The common view among most economists is that Roosevelt's New Deal (1933-1938) policies either caused or accelerated the recovery, although his policies were never aggressive

¹⁸ Fernández Díaz, Andrés (2010): pp. 37-39.

enough to bring the economy completely out of recession. In her turn, Christine Romer said that the money supply growth caused by huge international gold inflows was a crucial source of the recovery of the United States economy, due such gold inflows to devaluation of the U.S. dollar and also to the deterioration of the political situation in Europe.¹⁹

In this matter, Milton Friedman and Anna Jacobson Schwartz too attributed the American recovery to monetary factors, as we can see in their complete and detailed book published in 1965.²⁰ The extent of our work don't permits to dedicate the space and time to deep in this outstanding book, but we recommend the chapters that treat the Great Contraction (1929-1933) and the New Deal changes in the banking structure and monetary standard. There is ample literature existing on this so important subject, but we must continue to remember the most relevant issues about the other crisis, that is, the financial one that took by surprise a certainly unconcerned Europe.

Effectively, the European Union was amazed when the first crash took place because of the subprime mortgages in United States, but without reacting rapidly in the first place, and outlining a set of measures and instruments of economic policy, later, characterized by its hardness and its pronouncement in favor of the most rigorous austerity. After many sacrifices the result has been expressed in the fall of consumption and welfare, with some intermittent periods of recession. In the meantime the European authorities, that is, the Troika, was keeping a close watch upon the fulfillment of the commitment relative to the objectives of public deficit and debt, especially in the cases of the Southern countries.

But as we saw before, besides the restrictive measures in the financial system and in the fiscal policy, the European institutions had conditioned the rescues of the different countries to the fact of carrying through the structural reforms considered most urgent and necessary. In this sense is clear that Spain has been the country that, besides the cutting and the policy of austerity has complied with the obligation of going ahead with numerous and outstanding reforms. Indubitably these reforms have contributed to recover the confidence, the rise of consumption and of domestic demand, leaving behind the recession and being the European country with the highest rate of growth of the GDP in the year 2015. All that supposes a point of inflexion in the Spanish policy against the crisis, although always under the supervision of the Troika, than governs the group of eighteen.

We have had occasion to emphasize the need to apply and go ahead with further structural reforms, highlighting the Tax system, on the one hand, and Labor reform that our economy and the country really needs. Otherwise we could not be able to achieve a sustained growth of GDP, nor could we meet the targets established by the Troika.

From what we have described hitherto the moment is derived the need to wonder whether Spain and also the countries that were rescued could have applied a distinct economic policy, without so sacrifices and cutting. We think that the advisable solution could have been what we name a

¹⁹ Romer, Christian d. (1982): pp. 757-784.

²⁰ Friedman, Milton and Schwartz, Anna Jacobson (1971): pp.301-493.

middle brow approach and that is to consider the most successful and essential of all measures taken in both crises following, of course, a clear thread.

Obviously we do not propose a simple mixture of austerity measures to ensure fiscal stability with an expansionary economic policy based primarily on the growth of domestic demand. Nor do we intend forcibly to combine theories or schools of thought that at first seem incompatible. What really we consider more appropriate is to design a policy that clearly raises the most important objectives as well as the instruments, the objectives being budgetary stability and the growth of income and employment, on the one hand, and the instruments consisting of a set of measures and reforms already discussed, on the other hand.

Given the difficulty of applying this complex economic policy, it is necessary to use decision models as quantitative techniques that guarantee the viability and coherence of such a policy, because otherwise the measures to be taken would lack a solid foundation. Of course, all we are saying about Spain can be extrapolated to the whole of the Eurozone and the European Union, and more concretely to the countries that were rescued during the financial crisis.

Finally, and returning to the universe of ideas and schools inspiring these policies, we must remember that although considerable controversy always remains concerning Keynes's fundamental theoretical achievement, what became readily identified as Keynesian economic policy, however, is far less problematic and permits identify a broad consensus of policy activities which may denote as being in the spirit of Keynes, spirit that has been in the antipodes of the way choice in the fight against the recent crisis, at least in the European Union. This leads us to think that we have lost the chance to learn a lesson that was learned many years ago.

Conclusions

We have incorporated with a special emphasis any parts and considerations of the seminal work and the thought and ideas of the great economist John Maynard Keynes given the fact that constitutes the spine in our analysis about the relation between the recent crisis and the Great Depression, in spite of its clear differences. Besides, the shadow of Keynes is always present. By the way professor Harry G. Johnson wrote years ago: *When I returned to Cambridge as an Assistant Lecturer in 1949, thereafter a Lecturer and a fellow of King's College, Keynes's shadow continued to dominate, his influence being mediated through Richard Kahn, Joan Robinson, and Austin Robinson. Their roles were complementary in the service of Keynes's memory.*²¹

²¹ Johnson, Elizabeth S.; Johnson, Harry G. (1978): p. 153.

We recommend the very interesting article published by Kahn, Richard (1978): pp. 545-559.

Don Patinkin, another recognized economist, said as well many years ago talking about the trilogy integrated by *A Tract of Monetary Reform* (1923), *A Treatise on Money* (1930), and *The General Theory of Employment, Interest and Money* (1936), that in so far as the last one (*The General Theory*) is concerned, this is the book that made the revolution which has continued to mould our basic ways of thinking about macroeconomic problems. Then, adds Patinkin, the reading of it, at least in part, become an intellectual experience that no aspiring economist even today can afford to forego.²²

Keynes contended that the market economy was fundamentally flawed from a macroeconomic perspective, in that it could not guarantee that full employment and the full utilization of resources could be maintained, and he could not see how the market economy would be able to bring about a restoration to equilibrium once a substantial departure from full employment had occurred. Keynesian economic policies thus reflected a combination of both interventionists and laissez-faire philosophy. As said Shaw, this is probably the reason why Keynes has earned disapprobation from both sides.²³

Of course, our purpose in this work is none other than to highlight the role played by the main Keynes's ideas to deal with the Great Depression, first, and consider how far his thought should have been taken into account in the current crisis, in second place. Then we not enter in doctrinal controversies, although remains clear and is convenient to stand out that Keynesians argue, among other measures, that the authorities need to increase effective demand for goods and services (e.g. by increasing public sector expenditure) in order to increase output and employment, while New Classical economists recommend the authorities to pursue microeconomic policies directed to increase aggregate supply.²⁴

But after these previous considerations we must continue with our most outstanding conclusions, beginning by remembering that financial crisis of the last seven years has been the most damaging economic event since the Great Depression, constituting one of the more immediate problem now how best to prevent a repeat performance.

The Great Depression and the Financial Crisis have their differences and similarities, as we have seen in the course of our exposition. In both unfortunate experiences the point of departure was the pernicious behaviour of the banking system at United States extended rapidly by the main European countries. Thinking in the present crisis, as we know, failures in finance were at the heart of the crash, although it is necessary to remember that bankers were not the only people to blame. Certainly, Central bankers and other regulators bear responsibility too, for mishandling the crisis, for failing to keep economic imbalances in check and for failing to exercise proper oversight of financial institutions.²⁵ In this sense some authors consider that the regulators' most dramatic error was to let Lehman Brothers go bankrupt, given that this multiplied the panic in markets and provoked, to stem it, that regulators were required to rescue scores of other companies.

²² Patinkin, Don (1975): p. 269.

²³ Shaw, G. K. (1988): p.3.

²⁴ Vane, Howard & Caslin, Terry (1987): pp. 45-54.

²⁵ The Economist, September 7, 2013.

It is important to point out the fact that if the eclosion produced in 1929 affected in different ways to several countries (Germany, France or Great Britain), the financial convulsion initiated in 2007 came to disturb the very important group of countries that constitutes the Eurozone. This last crisis gave rise to a strong reaction, although rather late, affecting principally to the south countries, that is, to Greece, Cyprus, Ireland, Portugal and Spain, being rescued the four first, and needing Spain an exclusive rescue for our banking system. But the important amounts of money that these countries required as aid had as compensation to fulfill a really hard economy policy and concrete measures in relation to the respective public deficit and debt, suffering several years of spending cuts and economic recession.

Spain has complied with all the obligations imposed by the European authorities, including the several structural reforms realized. In 2014 and 2015, in spite of the policy of austerity applied during the five precedent years the Spanish economy has passed from an disquieting recession to a strong recovery of consumption and investment, that is, of the effective demand achieving, as consequence of it, a greater rate of GDP growth in the European Union.

However something else is necessary to guarantee the existence of a sustained growth of our economy and the definite fall of unemployment in long or middle term, respecting at the same time the rules established by the Troika. As we have point out, it is necessary, among other measures, to tackle the problem of making a decisive tax reform, on the one hand, and to undertake the task of carrying through an efficient, feasible and just labour reform, on the other hand. To these two indispensable tasks it is necessary, for the reasons we had expressed before, to deep in the reform of the Public Administration, eliminating the institutions whose existence is neither justified nor does it represent an improvement of the public management.

As we have seen in the precedent headline it would be of great interest and necessary to ask about the cost of opportunity of the choice of the set of measures and policies applied in their respective crises that we have been analyzing in this article, and it is for this reason that we have carried out a comparative vision of the two crises considered, that is, the Great Depression and the Financial Crisis of recent years, highlighting the decisions and policies adopted in each case, and to some extent, our opinion about it. And now, dear reader,... *take your pick*.

Madrid, June 1, 2016

REFERENCES

- CHICK**, Victoria (1983): "Macroeconomics after Keynes", Philip Allan, Oxford.
- CODDINGTON**, Alan (1979): "Hicks's Contribution to Keynesian Economics", *Journal of Economic Literature*, Volume XVII, Number 3.
- FERNÁNDEZ DÍAZ**, Andrés (1976): "Introducción y Metodología de la Política Económica", Ediciones ICE, Madrid.
- FERNÁNDEZ DÍAZ**, Andrés (1985): "Consequences of Budgetary Restraint for Social Policy", (edited by Guy Teryn and A.J. Culyer), *Public Finance and Social Policy*, Wayne State University Press, Detroit, Michigan.
- FERNÁNDEZ DÍAZ**, Andrés (1987): "Política económica coyuntural", Editorial AC, Madrid.
- FERNÁNDEZ DÍAZ**, Andrés (2010): "Cara y cruz de la política económica española: Un dispositivo para la salida de la crisis", *Revista Española de Control Externo*, nº 34, Tribunal de Cuentas, Madrid.
- FRIEDMAN**, Milton and **SCHWARTZ**, Anna Jacobson (1971): "A Monetary History of the United States (1867-1960)", Princeton University Press, Princeton.
- HAAVELMO**, Trygve (1945): "Multiplier Effects in a Balanced Budget", *Econometrica, Journal of the Econometric Society*, October, Volume 13, Issue 4.
- HICKS**, John R. (1936): "Mr. Keynes's Theory of Employment", the *Economic Journal*, 46 (182).
- FLEMING**, Michael J. (2012): "Federal Reserve Liquidity Provision during the Financial Crisis of 2007-2009", Federal Reserve Bank of New York, *Staff Report* No. 563, New York.
- GREENWALD**, Douglas (1982): "Encyclopedia of Economics", McGraw-Hill, Book Company, New York.
- KAHN**, Richard (1978): "Some Aspects of the Development of Keynes's Thought", *Journal of Economic Literature*, Volume XVI, Number 2.
- KEYNES**, John Maynard (1961): "The General Theory of Employment, Interest and Money", MacMillan & Co LTD, New York.
- JOHNSON**, Elizabeth S., **JOHNSON**, Harry G. (1978): "The Shadow of Keynes", The University of Chicago Press, Chicago.
- LOVE**, James (1991): "The Orthodox Keynesian School", (edited by Douglas Mair and Anne G. Miller), *A Modern Guide to Economic Thought*, Edward Elgar

LSE REPPORT (2010): "The Future of Finance", The London School of Economics and Political Science, London.

PATINKIN, Don (1975): "John Maynard Keynes: from the Tract to the General Theory", *The Economic Journal*, Vol. 85, N°. 358., Cambridge University Press.

POLLARD, Sidney (1998): "Depression", *The New Palgrave*, The Macmillan Press Limited, London.

ROBERTSON, Dennis (1940): "Mr. Keynes and the Rate of Interest", *Essays in monetary theory*, London: P.S. King.

ROBINSON, Joan (1977): "What Are the Questions?", *Journal of Economic Literature*, Volume XV, Number 4.

ROMER, Christian D.(1982) "What Ended the Great Depression", *Journal of Economic History*, Vol. 52, n° 4.

SHAW, Graham Keith (1988): "Keynesian Economics: The Permanent Revolution", Edward Elgar.

THE ECONOMIST, September 7, 2013.

VANE, Howard & **CASLIN**, Terry (1987): "Current Controversies in Economics", Basil Blackwell, Oxford.

WADHWANI, Sushil B. (2010): "What Mix of Monetary Policy and Regulation Is Best for Stabilizing the Economy?", in The LSE Report, *The Future Of Finance*, The London School of Economics and Political Science, London.
