

# No Case for Plan B – Lessons for the Great Recession from the Great Depression

IEA Current Controversies Paper No. 34



by

**Kent Matthews**

**December 2011**

**iea**

## About the author

**Kent Matthews** is the Sir Julian Hodge Professor of Banking and Finance at Cardiff University. He is a graduate of the London School of Economics, Birkbeck and Liverpool University. He has held research posts at the LSE, National Institute of Economic & Social Research and Bank of England. He has held permanent and visiting academic appointments at Liverpool University, University of Leuven, University of Western Ontario, Liverpool John Moores University, Humbolt University Berlin and Cardiff University. He was Principal Economic Forecaster for the Liverpool Macroeconomic Research Group 1979-89 and UK Economist at Lombard Street Research Ltd 1994-95. He has been the Secretary of the SMPC since its establishment.

**Institute of Economic Affairs**  
**2 Lord North Street**  
**London**  
**SW1P 3LB**

**[www.iea.org.uk](http://www.iea.org.uk)**

IEA web publications are designed to promote discussion on economic issues and the role of markets in solving economic and social problems. Copyright remains with the author. If you would like to contact the author, in the first instance please contact [rwellings@iea.org.uk](mailto:rwellings@iea.org.uk). As with all IEA publications, the views expressed in IEA web publications are those of the author and not those of the Institute (which has no corporate view), its managing trustees, Academic Advisory Council or senior staff.

---

## Contents

Summary	4
Introduction	5
Lessons from the past	6
The Keynesian multiplier and could Lloyd George have done it?	9
From recession to recovery	10
Conclusion	12
References	13

## Summary

As calls for Plan B mount, it is increasingly being suggested that the UK is making the same mistakes as in the Great Depression of the 1930s by not expanding fiscal policy. This paper demonstrates that the UK government in the 1930s did not make serious fiscal policy errors. The evidence suggests that increasing government borrowing in the 1930s would not have significantly changed the course of the economy.

If looser fiscal policy would not have made much difference to the course of the Great Depression, there are reasons to believe that it would be even less effective in current circumstances. Developed, indebted, open economies with floating currencies respond least well to increased government borrowing: the UK economy fits that description.

Legitimate debate surrounds the conduct of monetary policy. Whilst it is plausible that a loose monetary policy is appropriate in the current circumstances, drawing on a comparison with the 1920s, this paper shows that, if the crash of 2008 permanently reduced the supply potential of the UK economy, loose monetary policy may simply lead to higher inflation with no benefit to output.

There is, therefore, no case for Plan B where such a plan involves raising planned government borrowing. Indeed, if a fiscal stimulus is applied and has short-term benefits, there is a danger that taxes will have to rise to reverse it just as the economy recovers. It is important to note that, regardless of whether the economy has suffered a temporary or a permanent loss of capacity, supply side liberalisation could be a very important complement to fiscal austerity.

---

## Introduction

The slow pace of recovery of the UK economy and the avalanche of bad news coming out of the euro-zone economies has once again increased the calls for a “Plan B” in government policy. Suggestions for Plan B usually means a slowing down in the austerity package of deficit reduction and the use of fiscal policy to offset weak and fragile household spending and corporate investment. The Obama administration opted for a \$787 billion fiscal stimulus package of which \$499 billion was a government spending increase which came into effect in 2009-10. A more modest fiscal package in the euro-zone came to €174.1 billion over 2009 and 2010 of which €61.9 billion was an increase in government spending (Cwik and Wieland, 2011).

The preoccupation with the state of the economy and the slowness of the US Recovery and Reinvestment Plan to yield positive results have reignited the old debate about the effectiveness of fiscal policy and also focused attention on the inter-war years to provide lessons for current economic policy. In particular, by slowing down the austerity measures, suggestions for a Plan B call for the automatic stabilisers to soften the downturn and, by judicious application of additional fiscal injection, the rise in unemployment could – it is argued – be moderated. If Plan B could be implemented without loss of credibility of the long-term objective of reducing the public sector deficit and stabilising the government debt-income ratio, then clearly it is worth considering.

There are three issues for consideration. Firstly, the re-examination of the evidence of the effectiveness of fiscal policy. Secondly, the re-examination of the experience of the 1930s and how recovery occurred while maintaining a neutral fiscal policy. Thirdly, we should ask whether the recovery of the 1930s would have been hastened with the appropriate use of fiscal policy – in other words could Lloyd George have done it?

This paper argues that Plan B is not a viable option in the current economic situation. The automatic stabilisers were in the inter-war period as today, would not have operated in the way expected by some theoretical paradigms because of strong supply-side shocks that reduced potential GDP. Empirical evidence suggests that a Keynesian style fiscal policy would not have worked in the inter-war period and neither would it work now. An expansionary money-financed fiscal policy could have had temporary expansionary effects at a cost of inflation. This may be perceived to have been less of a problem in the 1930s than it would be today but from an historical perspective it was not feasible.

The next section examines the 1930s recession and highlights some common and uncommon factors with the 2008 recession. The following section reviews the evidence on fiscal policy multipliers and the scope for the use of expansionary fiscal policy in the recovery of the 1930s. The fourth section examines the recovery in the 1930s and concludes with policy lessons for today.

## Lessons from the past

The inter-war years throw up both similarities and differences which make the exercise of learning from history an imprecise one. Obvious similarities are the fall from gold in September 1931 and the 25 per cent depreciation of sterling between mid-2007 and end-2008. Another similarity is the period of low interest rates in the recovery period of the 1930s. While Bank rate fell to a constant 2 per cent from 1933 till 1939, Treasury Bill rates were around  $\frac{1}{2}$ - $\frac{3}{4}$  per cent and long-dated gilts between  $2\frac{1}{2}$ - $3\frac{1}{2}$  per cent. Government debt after the First World War was around 175 per cent of GDP over the whole period – well above current levels but something that was a cause for concern and a constraint in fiscal policy, in terms of maintaining credibility with foreign investors, just as current debt levels are.

In other respects there are differences between the two periods. The most obvious is the level of inflation. Inflation was negative 3-3.5 per cent in the 1921-33 period and positive 1.3 per cent in 1934-38, compared with today's rate of around five per cent. The public sector deficit was another striking difference. Although there were instances when public sector borrowing came in higher than expected (particularly in the recession period of 1929-31 – see Middleton, 2010), by and large the period was one of fiscal orthodoxy. Table 1 provides some summary statistics of the period.

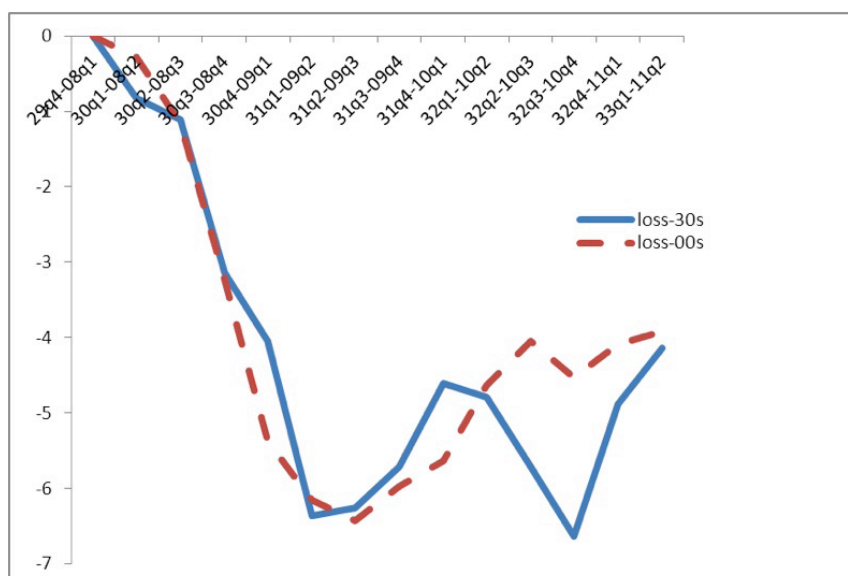
**Table 1: Summary Statistics 1921-38**

Years	Public sector deficit/GDP %	Annual Inflation %	Bank Rate %	Treasury Bill Rate %	Yield on 2½% Consols
1921-29	0.5	-3.7	4.6	3.9	4.6
1930-33	1.1	-2.9	3.8	2.0	4.0
1934-38	0.9	1.3	2.0	0.6	3.2

Source: Feinstein (1972), Capie and Collins (1983)

However, one striking similarity is the way the economy behaved in the aftermath of the downturn in the world economy and the fall from gold. Taking 1929(4)<sup>1</sup> and 2008(1) as base points, figure 1 shows the output loss relative to the base point from 1929(4) to 1933(1) and 2008(1) to 2011(2). What is particularly striking for the current recession is the depth of output loss relative to its peak in the Great Recession and the closeness of the match with the Great Depression of the inter-war years. This pattern is not matched by any other recession since the Second World War.

**Figure 1: Recession and Recovery 1929(4)-1933(1) and 2008(1)-2011(2)**

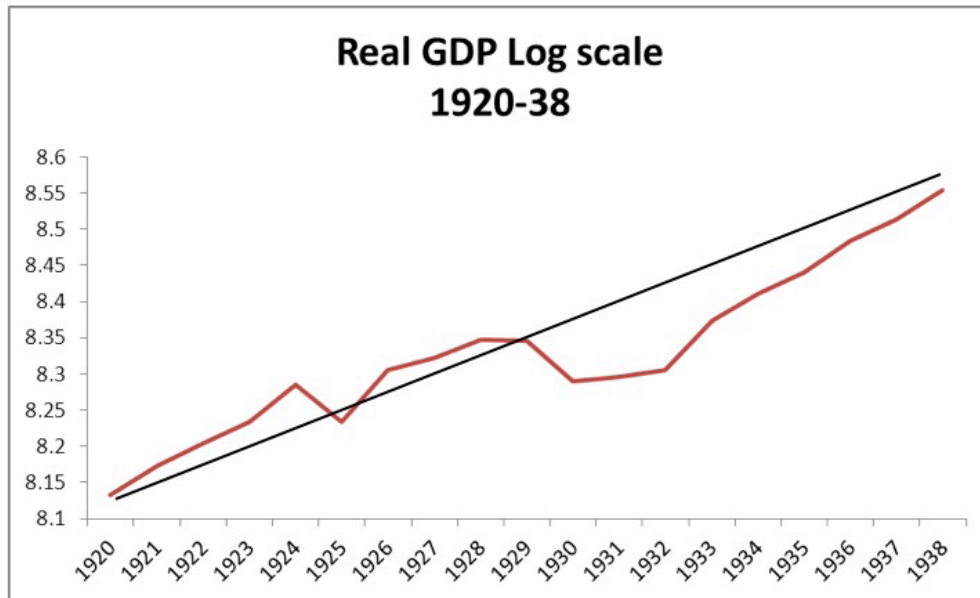


Source: Hayes and Turner (2007) and National Statistics

<sup>1</sup> 1929(4) means 1929, quarter 4 and so on.

Further context is provided by a closer examination of the inter-war period. This shows a path for GDP that was moving along trend until 1929/30 when the economy was engulfed by a wave of deflation following on from the Great Crash in the USA and the downturn in world trade (see figure 2). Recovery was long and drawn out but was close to trend by the time of the Second World War.

**Figure 2: Real GDP 1938 prices**



Source: Feinstein (1972)

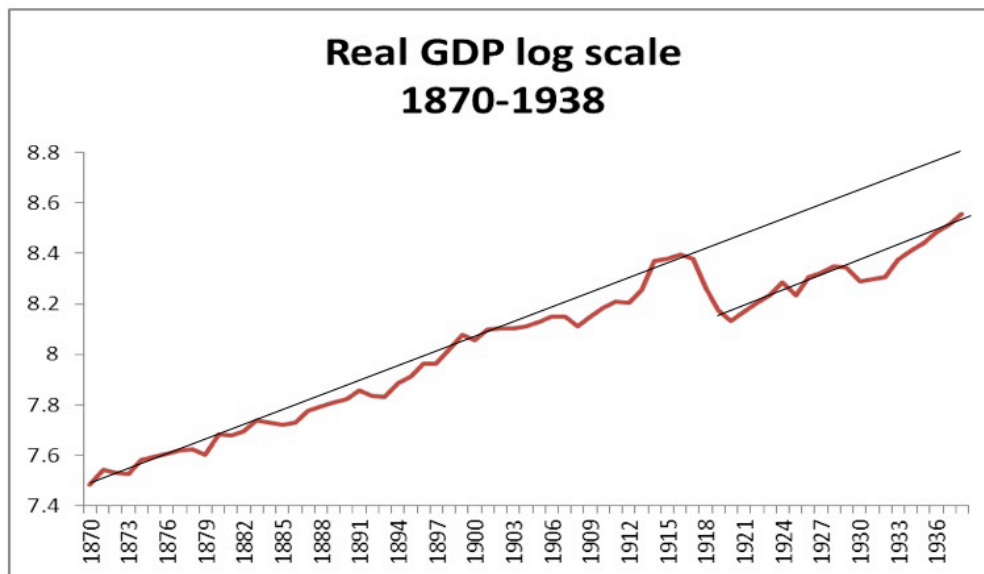
The conventional interpretation of the 1920s is that these were the years of the 'doldrums' and in no way can be equated with trend growth, or low unemployment. However, this view has been challenged by a number of scholars that have explained the high level of unemployment as part of a supply-side problem<sup>2</sup> which as a general equilibrium issue have questioned the overvaluation of sterling on the return to gold in 1925<sup>3</sup>.

But there was more to the inter-war period than the events of these two decades. The UK economy never recovered from its dominant position in the global economy after the First World War because of the permanent loss of export markets to the then emerging economies of the middle- and far-East. The dislocation of the switch back to peace-time production had permanent adverse effects on the economy (Solomou, 1996) which can be interpreted as a 'non-stationary productivity shock'. This is seen very clearly in Figure 3 below.

<sup>2</sup> Benjamin and Kochin (1979) explain the high unemployment as caused by high unemployment benefits relative to wages. Booth and Glyn (1975) explain it as a structural problem of skills mis-match that could not meet the needs of expanding industries.

<sup>3</sup> Matthews (1986) argues that the rising real wages were under-pinned by rising real value of unemployment benefits. In a general equilibrium framework, rising wage costs buttressed the real exchange rate which was close to equilibrium in 1925.

Figure 3: Real GDP 1870-1938



Source: Feinstein (1972)

After 1919, the UK economy continued at the same rate of growth (nearly 2%) as the pre-war economy but at a lower level, as consistent with a major negative shock that led to capacity destruction. Whatever the explanation for this shock, it is consistent with a similar explanation for the current banking crisis as being the outcome of a negative 'non-stationary productivity shock' (see Minford, 2010). This interpretation suggests that the UK economy was at capacity during the 1920s and there was little scope for fiscal or monetary policy that could have been deployed in any effective manner to reduce unemployment. Similarly, it could be argued that the banking crisis was a shock to the UK economy that has reduced the productive capacity of the economy and, therefore, attempts to restore output to previous trend levels by fiscal and monetary policy will fail.



## The Keynesian multiplier and could Lloyd George have done it?

The neo-Classical revolution has ensured that the simple Keynesian multiplier of EC101 textbooks has long been seen as a special case of the neo-classical/Keynesian synthesis with a 'liquidity trap'. Once the government financing constraint, wealth effects and the supply-side is brought into consideration, the short-run multiplier is less than unity even without having to invoke rational expectations. In his review of macro-economic models Ramey (2011) concludes that the fiscal multiplier is in the range 0.8 to 1.5 but admits to no consensus in the literature as to the mechanism of how an increase in government spending increases GDP. The typical New Keynesian model of Smets and Wouter (2007, 2003) type (S-W model) show a low multiplier because it builds a sticky-price edifice on to a neo(new)-classical foundation. The current generation of New Keynesian models, allow for forward expectations, and with government financing constraints, accelerated Ricardian equivalence effects. Higher multipliers are produced only if consumers are assumed to behave sub-optimally or are liquidity-constrained, or workers are willing to supply as many hours as firms are willing to demand. Simulations with the S-W model for the euro-area by Cwik and Wieland (2011) reveal short-run multipliers of 0.5. They caution against the use of discretionary fiscal policy to fight the recession.

Yet it can be argued that the multipliers that the typical New-Keynesian model produces understate the impact of fiscal policy in the context of zero-bound interest rates and/or recession. The basic Dynamic Stochastic General Equilibrium (DSGE) model solves on a local linearised path of a system of non-linear equations thus the effects of fiscal expansion on consumption or output are the same whether the economy is in a roaring boom or a deep recession. Parker (2011) argues that the multiplier should be state-dependent and calls for research into non-linear systems. However, the problem with this argument is that researchers will have to use many more recessions in their sample than the world has hitherto generated in order to produce reliable results and a policy prescription based on unknown outcomes is a risky proposition<sup>4</sup>.

Macro-economic models of the inter-war period have been few. Three studies representing the different theoretical perspectives from simple demand-led Keynesian to supply-dominated New-Classical, and an intermediate case that has a blend of the Keynesian tradition with a supply-side have been estimated for the inter-war period. Thomas (1981) developed a traditional Keynesian demand determined model; Dimsdale and Horsewood (1995) estimated a demand dominated model with a supply-side of the Layard-Nickell-Jackman variety (D-H model)<sup>5</sup> and Matthews (1989, 1986) estimated a New-Classical rational expectations model with a strong supply-side.

In their pamphlet, *Can Lloyd George Do It?*, Keynes and Henderson argued that a £100m a year fiscal boost for three years would have reduced unemployment by 500,000. The New-Classical model of Matthews (1986) simulated a bond-financed fiscal expansion of £100m a year for three years and this produced a multiplier impact of just 0.55–0.65. This was because crowding out was caused by a rise in the real rate of interest and a rise in the real exchange rate although there was no change in the price level. A similar exercise with the D-H model produces output effects consistent with a multiplier of 1.6 – 1.75 and a rise in the price level by 3.6% by year three. Crowding out is negligible in this model because the bond expansion has only a moderate effect on interest rates and the exchange rate and bonds do not appear as a wealth effect in any of the expenditure functions. Importantly expectations in the D-H model are static. Even with the crowding out channel is closed through a fixed interest rate, the multiplier in year three is only 1.95 and employment rises by 300,000 which is insufficient to reduce unemployment by the 500,000 claimed by Keynes and Henderson.

The simulations with the New-Classical model are more consistent with mainstream estimates of the fiscal multiplier but even if the multiplier was larger than the consensus finding of about 0.5-0.6, would judicious use of fiscal policy have aided the recovery in the Great Depression? In other words, are we, as some would suggest, repeating the mistakes of the 1930s? So, did we make a mistake in the 1930s by not pursuing fiscal expansion?

4 In an empirical analysis of the effects of fiscal stimulus packages on household spending in the 2000s, Taylor (2011) concludes by doubting the efficacy of the 2009 ARRA stimulus package.

5 See for example Layard, Nickell and Jackman (1991)

## From recession to recovery

Figure 1 shows the similarity in the pattern of recession and recovery between the 1930s and the Great Recession of the early twenty-first century. Figure 2 shows that the recovery continued from 1934 and was near to trend capacity by 1938. The recovery in the 1930s occurred without the aid of fiscal policy. Based on mainstream estimates of the fiscal multiplier and research done on the interwar period, there must be some doubt that a government expenditure boost that involved more government borrowing could have aided the recovery.

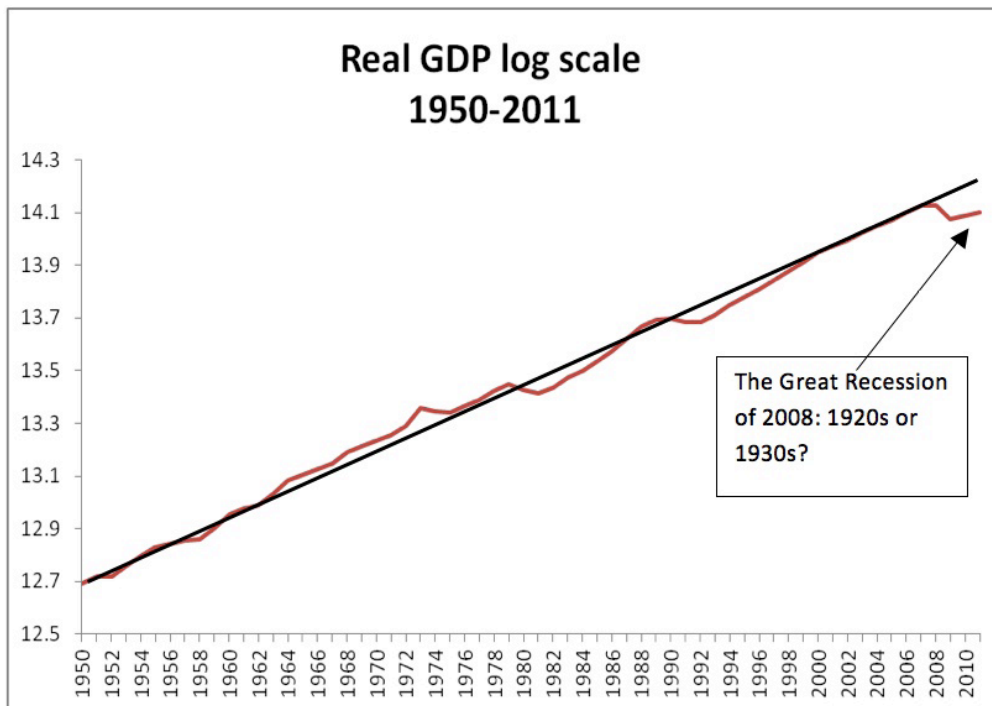
The UK economy in the inter-war period was a very different animal from that today. The government sector was less than half of its current size as a percent of GDP. Having a history of being on the gold standard and returning to gold in the second half of the 1920s created a different environment for expectations than the post-second-world-war history of stop-go and periodic devaluation. It is arguable that the economy was at capacity up until 1931 and scope for discretionary policy was minimal until later in the 1930s. The Treasury view dominated the thinking of economic policy although the attempt to override the automatic stabilisers was not always successful. The public sector deficit averaged 1.1% of GDP during the recession period of 1930/33 – small by current standards but viewed widely as damaging to confidence at the time (Middleton, 2010). The position of Britain in the world economy, the use of sterling as a global vehicle currency, and her heavy indebtedness weighed heavily on the thinking of the policy makers.

The budget of 10 September 1931 was the turning point in fiscal policy (Middleton 1985), involving a rise in taxes (including a rise in the standard rate of tax), expenditure cut-backs and raiding of the reserve (sinking fund). Following the unpopular May Report of 31st July that called for wage cuts to the armed services and cuts to unemployment insurance, the emergency budget was a response. Nine days later Britain left the gold standard and the rules of monetary policy had changed.

After leaving gold, it was possible to change monetary policy. After an initial period of shock and a vacuum in policy, a looser monetary regime was ushered in six months after the fall from gold. This brought with it the benefits of increasing private sector investment, house building and increased consumer spending. At the same time, fiscal orthodoxy was seen as the necessary condition for buying policy credibility and stabilising expectations, particularly after the abandonment of the gold standard. The combination of loose money and tight fiscal policy worked to create the conditions of recovery. Ironically, the simulation of loose money and loose fiscal policy proposed by Keynes-Henderson, would according to Matthews (1989) have created 370,000 extra jobs by year three but at the cost of a 13.5% rise in the price level<sup>6</sup> – the subsequent process of disinflation would, of course, have had costs. In any case, such a policy would not have been feasible given the policy objective of buying credibility and underpinning expectations.

6 This was simulated as an unexpected monetary loosening to support expansionary fiscal policy. An expected monetary loosening would have produced minimal effects on output and employment and higher inflation. The simulation also shows a 14.5% depreciation of sterling in the first year.

Figure 4: Real GDP 1950-2011



Source: Office for National Statistics, 2011 (estimated)

The policy lessons for the current economic situation depend very much on whether the economy post-2008 is more like the 1920s or more like the 1930s. In the 1920s the economy was close to capacity. Neither fiscal nor monetary policy would have been effective and only supply-side policy would have had lasting effects on unemployment and productive potential. The 1930s economy was one of major capacity under-utilisation in the first half, but recovery was obtained by a combination of fiscal orthodoxy and loose monetary policy.

Figure 4 shows the long view of real GDP between 1950 and 2011. The 2008 recession is of a deeper magnitude than the recessions of 1980-81 and 1991-2. However, those previous recessions saw output recovering back on to a trend rate of growth of about 2.5% a year. This is not happening in the Great Recession, so what is the appropriate response?

The appropriate policy response depends largely on whether the drop in trend real GDP represents a permanent downward shift - a non-stationary productivity shock as Minford, 2010 suggests - or temporary one. If there has been a non-stationary productivity shock, then the appropriate response is not to loosen monetary policy as that will simply create inflation and raise inflation expectations. Fiscal policy would have no effect either - and its long-run effects would make the situation worse. "Plan B" of further government borrowing is certainly not appropriate in this situation.

## Conclusion

If the drop in trend output is temporary, as in the Great Depression of the 1930s, then the Bank of England is vindicated in its looser monetary policy and fiscal austerity is the appropriate complement. It has already been noted that expansionary fiscal policy would have had limited impact in the 1930s. The policy response in the 1930s was not a mistake – though the necessary looser monetary policy was too delayed.

Fiscal expansion would not have a beneficial long-run impact today either. Although government debt was higher in the 1930s, government borrowing and spending was much lower. A rise in government borrowing and debt at the current time – especially given the sovereign debt crisis elsewhere in the world – would affect expectations and confidence quite apart from any crowding out and Ricardian equivalence effects. This is borne out by recent research by Ilzetzki et al (2010) which concludes that economies that are highly indebted have fiscal multipliers close to zero; economies on floating exchange rates have fiscal multipliers of zero; and open economies have lower fiscal multipliers. The UK is an indebted, open economy with a floating exchange rate. The lesson from the 1930s is that, if the drop in trend output is not permanent, then the appropriate course of action is loose monetary policy, fiscal austerity and supply side reform.

The alternative scenario is that Britain is in a situation like the 1920s – in which case, there is no case for Plan B either. If the drop in trend output in the Great Recession is permanent then the appropriate course of action is still fiscal austerity, though also combined with a tightening of monetary policy from the current position and the loosening of the supply-side through balanced-budget tax cuts and deregulation.

There is room for debate about the appropriateness of the current monetary policy but, when it comes to deficit reduction, we should not be considering a Plan B if such plans involve raising the expected level of government borrowing.

## References

- Benjamin D K and Kochin L A (1979), 'Searching for an Explanation of Unemployment in Interwar Britain', *Journal of Political Economy*, 87, 441-470
- Booth A and Glynn S (1975), 'Unemployment in the Inter-war : A Multiple Problem', *Journal of Contemporary History*, 10, 611-636
- Capie F H and Collins M (1983), *The Inter-war British Economy: A Statistical Abstract*, Manchester: Manchester University Press
- Cwik T and Wieland V (2011), 'Keynesian Government Spending Multipliers and Spillovers in the Euro Area', *Economic Policy*, July 495-536
- Dimsdale N and Horsewood N (1995), 'Fiscal Policy and Employment in Interwar Britain: Some Evidence from a New Model', *Oxford Economic Papers*, 47(3), 369-96
- Feinstein C H (1972), *National Income, Expenditure and Output of the United Kingdom 1855-1965*, Cambridge: Cambridge University Press
- Hayes P and Turner P (2007), 'Estimates of Quarterly GDP for the Interwar UK Economy', *Applied Economics Letters*, 14(8), 569-572
- Ilzetzki E, Mendoza E. G., Végh C. A. (2010), *How Big (Small?) are Fiscal Multipliers*, NBER Working Paper 16479, NBER, MA, USA.
- Layard R, Nickell S and Jackman R (1991), *Unemployment: Macroeconomic Performance and the Labour Market*, Oxford: Oxford University Press
- Matthews K G P (1989), 'Could Lloyd George Have Done It?', *Oxford Economic Papers*, 41, 371-407
- Matthews K G P (1986a), 'Was Sterling Overvalued in 1925?', *Economic History Review*, 39, 572-587
- Matthews K G P (1986b), *The Inter-War Economy: An Equilibrium Analysis*, Aldershot: Gower Press
- Middleton R (2010), 'British Monetary and Fiscal Policy in the 1930s', *Oxford Review of Economic Policy*, 26(3), 414-441
- Middleton R (1985), *Towards the Managed Economy: Keynes, the Treasury and the Fiscal Policy Debate of the 1930s*, London: Methuen
- Minford P (2010), 'The Banking Crisis as Dynamic Stochastic General Equilibrium', *CESifo Economic Studies*, 56(4), 554-574
- Parker J (2011), 'On Measuring the Effects of Fiscal Policy in Recessions', *Journal of Economic Literature*, 49(3), 703-718
- Ramey V A (2011), 'Can Government Purchases Stimulate the Economy?', *Journal of Economic Literature*, 49(3), 673-685
- Smets F and Wouters R (2003), 'An Estimated Stochastic Dynamic General Equilibrium Model of the Euro Area', *Journal of the European Economic Association*, 1, 1123-1175
- Smets F and Wouters R (2007), 'Shocks and Frictions in US Business Cycles: A Bayesian DSGE Approach', *American Economic Review*, 97(3), 586-606

Solomou S (1996), *Themes in Macroeconomic History: The UK Economy 1919-1939*, Cambridge: Cambridge University Press

Taylor J B (2011), 'An Empirical Analysis of the Revival of Fiscal Activism in the 2000s', *Journal of Economic Literature*, 49(3), 686-702

Thomas T (1981), 'Aggregate Demand in the United Kingdom 1918-45', in R Floud and D N McCloskey (eds) *The Economic History of Britain since 1700*, 2, Cambridge: Cambridge University Press





**Institute of Economic Affairs**  
**2 Lord North Street**  
**London**  
**SW1P 3LB**

**[www.iea.org.uk](http://www.iea.org.uk)**