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WILHELM RÖPKE, THE DEPRESSION, AND THE 2008 CRISIS: REFLECTIONS FROM THE PAST, LESSONS FOR TODAY*

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Introduction

Thank you. It is good to be here with you at ESADE today. My subject today is "Wilhelm Röpke, The Depression, and the 2008 Financial Crisis: Reflections from the Past, Lessons for Today." When it became evident that the financial crisis that began engulfing the world in 2008 was going to precipitate a severe global recession, many people began looking back to the Depression as a point of comparison. Many expressed relief that the Chairman of the Federal Reserve, Ben Bernanke, had done extensive research on the Great Depression as part of his doctoral work.

The persistence and extent of the Depression spawned much frantic activity by economists and politicians in the 1930s as they sought solutions to a downturn that left millions unemployed and susceptible to the populists of the extreme left and extreme right. Some viewed the Depression as confirming Marx's theory that capitalism would eventually implode. Others insisted that preserving political liberty in these conditions required radical curtailments of economic freedom.

The Depression also stimulated discussion about whether it was possible to proactively address the fluctuations of investment, growth, employment, and consumption that occurred in business cycles. Active contra-cyclical policies designed to smooth the boom-bust rollercoaster are usually associated

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with John Maynard Keynes. Hence it is not surprising that many contemporary scholars and policy-makers have suddenly become very interested in Lord Keynes's work over the past three years.

There were, however, other economists writing in the 1930s who took a different view to Keynes. These included the Austrian economists, Ludwig von Mises and Friedrich von Hayek, both of whom were skeptical of the efficacy of government intervention to address the Depression. Somewhat less well-known, however, are the reflections of another German-speaking economist, Wilhelm Röpke.

Röpke's writings, which number over 800 books and articles in multiple languages, embrace subjects ranging from philosophy and economics to the shape and form of the international economy. Today Röpke is remembered for many things. These include his effort to develop the moral case for the market economy that went beyond typical classical liberal formulations. He is also remembered for his major role in the establishment of the Mont Pèlerin Society in 1947. Röpke is, however, perhaps known for his decisive intellectual contributions to Ludwig Erhard's liberalization of West Germany's economy in 1948.

Less well-known, however, is that much of Röpke's thought in the 1930s was consumed by the effort to understand and overcome the Depression. Indeed, Röpke was writing about business cycles long before the 1929 Crash. His 1922 *habilitation* dissertation, for example, addressed the economics of business-cycles. He subsequently published several long studies on the subject. Röpke's work in this area was further stimulated in 1930 and 1931 when he served on a government inquiry chaired by former employment Minister Heinrich Brauns into measures to reduce Germany's catastrophic unemployment levels. Though willing to defend the Commission's work in public, Röpke was shocked when Brauns stated that the causes of unemployment were outside the Commission's terms of reference. How, Röpke wondered, could one seriously propose solutions if there was no discussion of causes?

In many respects, Röpke's 1936 book *Crises and Cycles* represents the culmination of his reflection on these matters. It elaborated upon his 1932 book *Krise und Konjunkter* which itself had been expanded in a subsequent Swedish translation in 1934. As late as 1944, Röpke's writings still contained extended reflection on the Depression's causes and potential solutions.

Röpke's contributions to business cycle theory and his reflections about how to address severe economic downturns are analyzed in detail in Chapter 5 of my new book, *Wilhelm Röpke's Political Economy*. So today I will limit myself to doing three things. First, I want to examine Röpke's thoughts about the Depression's causes. Second I want to examine his proposed solutions. Third, and far more briefly, I want to examine what insights Röpke offers us today for addressing the 2008 financial crisis and subsequent recession.

The Depression and its Causes

In 1924, Röpke was appointed professor of economics at the University of Jena. He was 24 years old –the youngest professor ever appointed in Germany. His intellectual abilities and his early success as an economist soon brought him to the attention of German politicians seeking to stabilize Weimar Germany as its foundations were subject to relentless attrition from the Communist-left and the nationalist-right.

When it came to understanding the Depression's causes, Röpke did not limit himself to purely economic analyses. It was a mistake, he believed, for economists to examine the Depression purely as an immediate economic event. In his view, understanding the Depression's causes required historical perspective. In *Crises and Cycles*, Röpke presents the Depression as the logical culmination of business-cycle crises in modern Western economies which had became graver and graver since the 1870s. Governments had responded to each crisis, he argued, with measures such as tariffs, monopolies and subsidies. Such policies, alongside wage-increases secured by trade unions but unmatched by productivity increases, had diminished Western economies' ability to adapt. Hence each successive crisis became more and more serious.

These systematic causes, Röpke insisted, was further worsened by the sheer amount of economic destruction caused by the First World War – perhaps the most significant being the effective end of the gold standard. He also argued that the extension of government control over the economy which is inevitable in war-time introduced new inflexibilities into the global economy and national economies that made the natural turn of the business cycle more difficult and more painful each time.

When it came to more proximate causes of the Depression, Röpke listed an unusually severe agricultural downturn, as well as the acceleration of protectionist and interventionist measures in Europe and the United States after World War I. But he also argued that the Depression was worsened by the crisis on money and capital markets that began unfolding in 1929. This had been precipitated, he argued, by the extraordinary and ultimately unsustainable American stock-market fuelled boom between 1925 and 1929. Though Röpke did not believe in psychological theories of the business cycle, he did argue that there was an element of what we would call today "irrational exuberance" in stock exchange investment. This, he stated, provided the immediate trigger for an economic downturn of unprecedented severity.

But, Röpke noted, there was also an economic reality beneath the frantic investment of the 1920s that had produced such a devastating collapse. And this fundamental reality, Röpke argued, was "the overinvestment… caused by credit expansion" –most notably by the Banque de France and the Bank of England as well as Germany's enormous capital imports in the interwar period.

Typically, Röpke wrote, economic upswings are financially sustained primarily through "increased savings during the boom period and, above all… credit expansion". This "credit creation", he argues, eventually results in what Röpke calls a *monetary over-capitalization* which disturbs the economy's equilibrium. "The evil", Röpke wrote, "is not that too little has been saved but that too much has been invested".

Röpke's analysis of the Depression's causes is very similar to what we find in the work of other free market economists of the period. But Röpke also devoted time to explaining why the downturn of this particular business cycle resulted in a recession so severe that the slump could no longer be designated as simply a reaction to the boom. In Röpke's view, economic downswings can grow to dimensions disproportionate to the preceding boom. In this instance, the economic correction degenerates into he called a "secondary depression". While the secondary depression is marked by falling prices and shrinkages in the volume of currency, Röpke argues that these elements are driven by the contraction of total demand –especially as expressed in the contraction of credit money. Contraction of total demand is connected to the contraction of incomes. This results in a general contraction of production that in turn contributes to the contraction of demand and incomes. A vicious cycle of economic decline thus takes hold.

This vicious cycle was self-maintaining, Röpke notes, "and constantly interferes with the attainment of a new equilibrium" because of two lags. The first is the lag in the contraction of production behind the fall of prices. The second is in the contraction of costs behind falling prices. Thus two disproportions are maintained in place: one is between supply and demand; the other is between costs and prices. This creates disharmony between the formation of incomes and the process of utilizing incomes. Money is withheld from expenditure on consumption goods. But no compensation for this non-spending takes place in the form of investments in capital goods. Thus the rate of savings remains continuously greater than the rate of investment. Stagnation thus occurs because the reserves of productive resources, savings, and cost-reductions are not accessed for new investment.

In these conditions, Röpke suggests, not even injecting additional credit into the economy seemed to have an effect. Drawing upon the American experience, Röpke contends that the banking system's willingness to give new credit is insufficient in these circumstances to facilitate a credit expansion. Entrepreneurs need to be *willing* to take these new credits. It is difficult to persuade entrepreneurs to do this in a secondary depression. The depressed stock market and the lack of any sign of recovery indicate to entrepreneurs that neither banks nor the public are interested in long-term investments. Entrepreneurs wanting to make long-term investments are reluctant to rely on short-term funds. Hence economic recovery is stalled.

Out of Depression

Let us turn now to the more controversial subject of how Röpke believed economies could escape the Depression. Normally, Röpke argued, recessions should largely be endured because they should be primarily understood as a process of correction. The best thing governments could do was to allow the economy to adjust in as frictionless a manner as possible. In Röpke's view, this mostly involved governments undertaking a subsidiary role. They could, for example, establish legal frameworks to make business and factory closures more efficient and orderly. He also thought that laws encouraging futures-trading could assist businesses in navigating business cycles. In his more mature schema, Röpke held that governments could accelerate the recovery from the downturn through removing obstacles to recovery, especially those obstacles created by state-intervention.

Röpke adds, however, that there may be scope for actions such as unemployment relief or supporting major banks on the verge of failure. He insists, however, that these should be regarded as palliative measures rather than part of an active business-cycle policy. Röpke also cautions that some of the palliative measures may actually introduce new frictions into the recovery process.

When it came, however, to addressing secondary depressions, Röpke was heavily influenced by the fact that Germany's 1929 economic crisis, and mistakes made by Germany's political leadership in addressing it, helped facilitate the Nazis' rise to power. Escalating unemployment propelled large numbers of desperate people into the Communist and National Socialist movements. While Röpke saw drawbacks to intervention during a recession as severe as the Depression, by 1931 he was convinced that if no proactive measures were taken, anti-market sentiment would become so widespread that "Liberalism – or the remnants of it which still exist– will disappear into the museum".

In short, by 1931, Röpke considered it politically unwise to simply let the business cycle associated with the Depression take its course. Some government intervention was necessary because of the immediate political consequences for Germany of failure to act. Röpke's ideas here were clarified by his experience of serving on the Brauns Commission. Reflecting on these circumstances ten years later, Röpke wrote:

> a fatal vicious cycle had arisen which ought to be broken at all costs by bold and energetic measures of business-cycle policy, so that together with the economic crisis *the political situation could be controlled*. We realized that we had to deal with an emergency with which it would no longer be possible to cope on the familiar orthodox lines of the accepted business-cycle policy and that an "active business-cycle policy" would have to be embarked upon. …I can remember very well that evening when the basic idea of this business-cycle policy became clear to us, but we all immediately agreed that it was dynamite which we were handling and that it ought not to be allowed to fall into the wrong hands.

Röpke's caution expressed in that last sentence may reflect his awareness of the potential mischief that might result from policy-makers deciding that it was possible not just to alleviate but actually to control business cycles. He was disturbed that many politicians and economists were increasingly willing to promote extensive interventionism. He was also perturbed by the fact that most schemas for intervention contained no guiding set of principles that limited the scale of intervention and allowed policymakers to distinguish between helpful and disruptive interventions.

Moreover, Röpke had only modest expectations of attempts to intervene. Any direct interference with the structure of production, costs and prices, he stated, is normally a dubious exercise. This was why, Röpke argued, socialist solutions failed because socialist economies lack mechanisms that alert people to the need to end unsound investments. The subsequent persistence of these poor investments results in economic downturns and increasing unemployment.

Röpke's overall approach to the Depression distinguished between measures that actively addressed secondary depressions; and those measures that sought to relieve the symptoms. Concerning active measures, Röpke articulates an alternative to what he called the "restrictionist" approach and the “expansionist” approach. Restrictionists, Röpke states, insist that the process of liquidation and adjustment should be allowed to take its cause. This means nothing should be allowed to obstruct the adaption of the whole structure or prices and costs to the lower economic level. Expansionists, by contrast, believe that secondary depressions contain their own vicious cycle that undermines the economy’s ability to recover equilibrium. Proactive measures by the state must therefore be taken to break out of these conditions since the private sector appears unable to do so.

In 1936, Röpke stated that restrictionists were right in their diagnosis of the primary crisis and in insisting that the economy be cleared of obstacles to growth such as subsidies, monopolies, and tariffs. They were also correct to observe that wage and labor market inflexibilities must be addressed. He slightly qualifies this by suggesting that further lowering wages during the secondary depression’s low point is unlikely to have much effect, except further decreasing demand just when it needs to grow.

Röpke subsequently calls for using the state to re-expand the economy in secondary depressions, but without interfering with the market’s competitive processes. He called this “conformable” business-cycle policy. Interestingly Röpke outlines a rather minimal picture of what such measures might entail, and underlined the drawbacks of these policies. In certain instances, Röpke argues, such policies could involve the state stimulating private initiative via a “cheap money policy” and offering special incentives for new investments, such as tax-exemptions.

If these measures of stimulating the private sector failed, Röpke contemplated –as a last resort– direct public initiatives that involve enlarging the volume of credit, thereby compensating for the private sector’s rigid immobility. One method was to borrow while simultaneously running a public sector budget-deficit by reducing taxes. The other was to borrow money to fund large public works. Röpke favored the first approach because it expanded credit via state borrowing while also creating incentives for private business to recommence borrowing. It also represented the least departure from the market’s normal ways and was thus likely to dampen expectations that a “new economy” was being created.

Röpke, however, found it difficult to suppress his reservations about such measures. Budget-deficits and increases in public indebtedness were not, he commented, normally to be encouraged. They should only be employed in extraordinary circumstances; that is, when doing nothing is not feasible and then only for short periods of time. Röpke worried that what would otherwise be defined as reckless government spending might become viewed as normal. Röpke is even more dubious about public works programs. These normally required creating new and difficult-to-dismantle administrative bureaucracies. Public works, he noted, also take time to implement and the impact of any positive effects takes even longer.

Röpke's persistent worries about governments attempting to re-ignite the business cycle become even more apparent in his treatment of the "palliative measures" that governments might undertake to mitigate the secondary depression's social impact. He viewed unemployment relief as a matter of "political common sense" insofar as it may help prevent sudden breakdowns in social order. But, he notes, it "has the drawback of making the wage system more rigid". Such benefits, Röpke cautions, should not be so high that they discourage people from wanting to work for reasonable wages. While other measures such as productive relief works had some potential to address the secondary depression's psychological effects, Röpke underlined their economic ineffectiveness and high costs.

Then there are those palliative measures Röpke considers without any redeeming features. Suppressing "unwarranted double earning", he commented, is an especially futile exercise. It falsely assumes that we can define what constitutes "double-earning" and would require a bureaucracy to control the distribution of labor. Nor does Röpke have any time for what he called labor nationalism –the notion that foreign workers withhold a job from native workers– and tight immigration restrictions. Such policies, he said, ignore the fact that immigrants are often enterprising and energetic workers and a source of specialist skills lacking in many economies. Labor nationalism also implies a zero-sum outlook regarding employment insofar it accepts work shortages as a static situation. Lastly labor nationalist policies effectively deny that "the interchange of men is not the least part of our complicated economic system, to say nothing of its spiritual implications". Here Röpke may be referring to Nazi Germany's racially-oriented employment policies, which involved expelling Jews from most professions.

Second Thoughts

Though Röpke did not change his mind concerning the nature and causes of business cycles, his repeatedly-stated cautions about using the state to combat downturns soon deepened into profound skepticism. He appears to have concluded that most anti-cyclical measures actually generate more uncertainty by artificially prolonging booms, thereby making an inevitable downturn more painful. Such policies, he wrote, rarely addressed the critical problem of poor investments. Röpke regretted that some of his early work on these matters could be interpreted as supporting the postwar tendency to use the state to pump-prime the economy. "I am ashamed", he wrote, "to say that I must take my share of the blame for creating this concept of 'functional finance'… but I am forced to admit now that it has stood the test neither of counter-argumentation nor of experience". In short, Röpke concluded, severe recessions owe much to the state previously pump-priming the economy, thereby breaking the link between the level of voluntary private savings and investment.

Here Röpke's position drew closer to the Austrian analysis of the business cycle. For Mises, the very practice of fractional-reserve banking overseen by a central bank inevitably gave rise to the creation of money –or, more precisely, fiduciary media– not backed by real savings. This results in artificial growth in the money-supply. As Jesus Huerta de Soto notes, "loans are created *ex nihilo* at artificially reduced interest rates, it inevitably causes an artificial unsustainable 'lengthening' of productive processes, which thus tend to become excessively capital intensive". The inflationary process created by credit expansion thus eventually provokes an economic crisis which reveals the investment errors alongside the necessity of liquidating and reallocating all the wrongly-invested resources.

Röpke's thinking was also affected by the failure of Roosevelt's New Deal to reignite the American economy. According to Röpke, "it turned out that the original calculation that the Government's boost of purchasing power would set off the private investment drive that was due, was wrong. Every time the Government's injections were withheld, it was as if there was no private initiative which could take the place of public initiative". America's choice, it seemed, was now between wholesale economic collectivization or liberating business so that it could react to the business cycle's normal stimuli. In the end, the indecision was only overcome when America adopted a war economy in 1941 and an armaments boom ensued.

Röpke was also perturbed at how active business-cycle measures were increasingly used for ends other than escaping severe recessions. They should not, he emphasized be "misemployed for the neck-breaking attempt to keep the boom inflated for ever". This was very much a critique of Keynes. Here we should note that Röpke was not adopting an entirely restrictionist position. He did not favor completely abandoning active business-cycle policies altogether. But any "pump-priming", Röpke reiterated, should be guided by three conditions: first, it must not diminish the capital from other investments; second, the objects of public investment must be chosen and policy managed so as to avoid all unfavorable repercussions to private investment; third, it must not be combined with measures that increase costs, especially wages. Most interwar active business-cycle policies aimed at combating the Depression, Röpke argued, had failed because these cautions had been ignored. Instead "only an artificially continued prosperity developed which was bound to come to an end the moment the state injections of purchasing power upon which it depended, ceased". Bad investments had driven out good investments, meaning that governments were not only bound to keep injecting purchasing power, but to increase them. Such, Röpke wrote, was "the slippery slope of collectivism".

Lessons for Today

Having considered, then, Röpke's analysis of the Depression's causes and his thinking about how to address it, I will now briefly consider what lessons we might glean from his work that might be useful for understanding our present circumstances and how we might escape them more quickly. To this end, I have identified 5 lessons.

The first lesson is that we need to establish whether the 2008 financial meltdown qualifies as what Röpke would describe as a "secondary depression", or whether it represents part of the normal cycle of economic growth and contraction which has been with us in intensified form since the mid-19th century. This is not merely an academic question. Röpke's willingness to contemplate certain forms of limited intervention in times of secondary depression was clearly driven by his fears concerning the success of Communists and fascists in capitalizing on these circumstances. In retrospect, it seems fair to say that the circumstances of the late 1920s and 1930s made such an exercise almost inevitable. One of Röpke's closest intellectual collaborators and founder of the ordo-liberal school of economics, Walter Eucken, later recalled that in 1931 he reversed his position in favor of a deflationary policy and specifically advised the German government to adopt measures such as credit-expansion and lowering interest-rates. His reason for doing so was not economic. It was political. Given the reality of five million angry unemployed German men, the alternative, Eucken said, was "the end of the Republic".

Even Mises, in retrospect, recognized that the political dynamics of the time made such policy-shifts unavoidable. As Mises later remarked:

> We may admit that for the British and American governments in the thirties no way was left other than that of currency devaluation, inflation and credit expansion, unbalanced budgets and deficit spending. Governments cannot free themselves from the pressure of public opinion.

Mises believed, however, that government officials should resign rather than carry out such policies.

So, does the 2008 financial crisis qualify as a secondary depression? Are economies around the world locked into a spiral of collapse, or trapped in a situation whereby the purchasing power of money and capital is sterilized? I think we can say that, at this point, there are few economies in this situation. Growth has returned throughout most of the world in a way that it did not after the Depression. There is high unemployment in many countries, but nothing like the 23% unemployment we saw in America for much of the 1930s. To this extent, I suspect Röpke would regard the 2008 financial crisis as serious but not so serious as to merit the interventions he advocated in the 1930s to address secondary depressions.

A second lesson from Röpke's work is that measures that involve pump-priming economies during recessions are usually ineffective –not just in the long term, but also in the medium term. As far as I can tell, Röpke was one of the first economists of international repute to observe that the various interventionist measures adopted in the 1930s had failed. In 1939, for example, Röpke pointed out that the Nazis' pump-priming of the German economy throughout the 1930s had not resolved its fundamental problems. In short, sooner or later, one either has to allow the corrections to occur, or one has to keep on pump-priming the economy –something that will eventually result in high inflation and high unemployment, or extensive curtailments of economic liberty. The National Socialists chose the second course of action as early as 1934.

A third lesson from Röpke is that we should think long and hard before we allow governments to embark upon particular forms of intervention. Röpke noted, for example, how calls for temporary intervention eventually morphed into economists such as Keynes and politicians such as Roosevelt imagining that they could somehow abolish the boom-bust cycle through governments skillfully managing the economy. And is that not exactly what we see today? Extensive interventions into the American and West European economies are already morphing into arguments that the State needs to take an even bigger, permanent role in the economy. We also see little sign of governments being willing to retract their new interventions once the financial crisis and subsequent recession is over.

The fourth lesson from Röpke's analysis of the Depression and proposed solutions is that perhaps the most important thing for governments to do in recessions is to remove as quickly as possible all impediments to a faster recovery. In this regard, Röpke insisted that we should distinguish between economic and political problems. The downward spiral of the secondary depression, in his view, was an economic problem. He took a quite different view of the issue of wage stickiness. As you all know, Keynes insisted that the phenomena of wages not falling during a recession had discredited previous theories about the market economy's ability to self-adjust to downturns. Wages, Keynes argued, did not fall. Therefore high unemployment persisted. This meant, Keynes stated, that the connection between wages and employment levels need to be somehow circumvented.

Röpke disagreed. He insisted that wage stickiness was not an economic problem. Wage stickiness, Röpke stated, proceeded from, first, the refusal of powerful unions to entertain wage cuts, and, second, many governments' unwillingness to confront unions who adopted intransigent positions on wage reductions. In Röpke's view, Keynes's error was his refusal to acknowledge that the cause of wage stickiness was primarily political rather than economic. In Röpke's view, all of us should have the intellectual courage and honesty to point out the difference between essentially political and essentially economic problems –not least because it is necessary if we are to formulate sound policy responses.

The fifth and last lesson that I think we can draw from Röpke's analysis is that a primary cause of recessions –mild or severe– is to be found in the realm of monetary policy. It is difficult at the best of times for central banks to calibrate interest rates to stimulate or restrain an economy. Over-investment in any number of economic sectors –such as the American housing industry or mortgage-based securities– remains as big a problem today as it was in the 1930s. The severity of a recession depends very much upon the extent to which this over-extension of credit has occurred, how long it takes to unwind, how much collateral damage occurs in the process, and the attitude that governments choose to take towards this. Röpke reminds us that until investment is more backed up by real savings rather than an expansion of fiduciary media, we can expect to relive the same problems on a regular basis.

Conclusion

So to conclude: when I was researching my book on Röpke I was especially struck by the similarities between what he understood to be the political and economic problems underlying the Depression and our present situation. Indeed, it initially made me wonder whether we have really advanced in our knowledge of the causes of recessions, both mild and severe. But then I came to a more depressing conclusion. We actually know a great deal about the causes of recessions, but we are reluctant to take the long-term steps that would significantly diminish their scope and impact.

As Röpke himself observed, part of the problem is that people want mutually-exclusive things. If people want to combat the boom-bust cycle, they have to decide if they are willing to reduce the acceleration of economic development that occurs during booms through the expansion of credit money. Do they prefer steadier but slower growth, or irregular bursts of frantic economic energy? Booms allow tremendous economic progress, but contractions bring with them considerable evils, especially unemployment's damaging social effects. Part of the difficulty, Röpke wrote (in almost exasperated tones), is that people want the boom's benefits without the inevitable "bitter medicine" of contractions. This, Röpke noted, makes the economist's task "extremely thankless".

This was not, however, Röpke argued, a reason to cease making the argument. On the contrary it is a reason to keep on arguing. As Röpke later wrote, his views on the Depression's causes and potential solutions had "meant speaking against most of the groups and policies that prevailed in the field of economics between the wars". But taking such stands was, Röpke believed, the intellectual's non-negotiable moral responsibility. "Society", he wrote, "is in supreme danger if the [intellectuals] remain dumb, if… from fear or confusion [they] commit the treachery of silence, or what is the worst of all, when they speak against their inward and better conviction". This exhortation to moral courage and intellectual honesty might well be the most important lesson that Röpke has to bequeath to us today. Thank you.

As the old joke has it, Iâ€™ve predicted five of the last two financial crises. But this time Iâ€™m not the only person getting alarmed about the current volatility in financial markets. Plenty of â€œseriousâ€, congenitally bullish commentators are getting anxious too. One thing everyone seems to agree on is that the current crisis â€“ if thatâ€™s what it is â€“ looks a bit different. We are in the proverbial uncharted waters, it seems. Does history offer a guide in such circumstances? A number of big lessons emerged from the Great Depression, even if they have generally been studiously ignored by subseque