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Voices from Afar: The Next Depression? TNI Web EXCLUSIVE
by Joergen Oerstroem Moeller
As the U.S. economy slows and the dollar loses value, Washington faces a tough choice: letting the market right itself or succumbing to the rising protectionist tide. Will policy makers act responsibly or try to score cheap political points?

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Is history going to repeat itself? Most people think that we have all learned from the disastrous chain of events that led to the Great Depression. But it looks more and more likely every day that bad monetary policy will undermine the global economy—just as the mismanagement of currency rates did in the early 1930s. This time, however, instead of measures to protect domestic industries, we may see something far more dangerous: protectionism to prevent foreign control of American financial institutions and manufacturers. And that could lead to global financial ruin.

The parallel to the disastrous U.S. gold policy of the 1930s, which eroded what remained of continental Europe's economic strength, is all too obvious. Then it was the gold standard that was deemed indispensable. Today keeping inflation down is the holy grail. Of course central banks must maintain price stability, but at what cost?

In September 1931, Great Britain surrendered to reality and abandoned the gold standard, letting the market depreciate the overvalued pound. That step, though necessary, made life uncomfortable for the rest of the industrialized world. Two years later, the United States did the same and the dollar duly depreciated against what was left of the gold block (France and a few other European countries). By September 1936, after much suffering, the remaining gold-standard holdouts were forced to give in to the inevitable and allowed their currencies to depreciate. The world economy hit bottom, and the political implications were equally debilitating: the dire financial straits of the French government prevented Paris from meeting Hitler's 1935 invasion of the Rhineland with military action.

Throughout the whole process of economic decline, no real attempts to coordinate currency policy among governments were made, with predictably disastrous results. Countries tried to safeguard their own interests without regard for others; the lure of gold as the foundation for the currency policies of all the major economic powers was only put aside after harsh lessons to the contrary.

The current pressure emanating from Congress to appreciate the yuan and reduce Chinese exports to the United States is all too reminiscent of American silver policy during the

1930s. It totally ignores the fact that overinvestment and rising property prices have put the Chinese economy on a knife-edge between inflation and growth. To maintain balance, Beijing must carefully fine tune its economic policy. And if China stumbles, the global economy will lose its main driver. For that to happen at the same time that United States is losing steam would be a catastrophe.

From 1933–1934, Congress enacted legislation that pushed up the price of silver, justifying this by saying it would increase China's national purchasing power and stimulate Chinese-American trade. This misguided U.S. policy had the unintended effect of destroying the Chinese economy, whose currency was based on a silver standard. Beijing's attempts to dissuade Washington were ignored. Quite predictably, China was hit by deflation and, in the midst of a global depression, the value of the yuan rose steadily against the U.S. dollar, the British pound and the Japanese yen. Chinese banks, having committed themselves to real estate in the preceding years, ran into trouble when what would today be called a "credit crunch" ensued.

Today the European Central Bank (ECB) is talking about keeping inflation down and maintaining interest rates, even if that leads to recession. There are indications of rising inflation, but this is due to the rising cost of manufacturing in China and more expensive raw materials, food and energy—not overheating. All of these factors are beyond ECB control; high interest rates will do little to damp their influence on European economies. Yet this hasn't stopped the American Federal Reserve from coming to the conclusion that inflation is still manageable, despite the falling value of the dollar.

The subprime crisis has forced the Fed to embark on a monetary policy that seems destined to end with zero interest rates, where Japan has languished for years. Making recriminations over how we got into this mess is useless, so all in all cutting rates may be the only way to stop the rot in financial markets from spreading too fast and too deep through the economy. That may be how it looks from the U.S. perspective, but what about the rest of the world?

Divergent national monetary policies could very well unsettle global capital markets, as the combination of low interest rates and a weak U.S. dollar makes it profitable for foreign investors to borrow in U.S. dollars and buy American businesses. Fundamentally there is nothing wrong with that. The problem, though, is political: will the U.S. government allow that to happen or succumb to economic nativism?

Today the United States faces an important choice: it can enact legislation that keeps control of U.S. enterprises in American hands—with the inevitable and foreseeable consequence of disrupting international capital movements—or let natural market forces act unimpeded. If Washington decides on the former course (and there are clear signs that it may), the global economy will slide into stormy, uncharted waters. That would jeopardize the gains of globalization and raise the specter of another Great Depression. Is it worth it?

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