IS RÖPKE'S CONCEPT OF SECONDARY DEFLATION CLARIFIED BY KOO'S CONCEPT OF BALANCE SHEET RECESSION?

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Abstract

The 'secondary' deflation (or depression) concept was developed by German economist Wilhelm Röpke in the 1930's, who saw this phenomenon as something different from normal depressions. While a primary deflation is a necessary reaction to the inflation from a boom period, the secondary deflation is independent and economically purposeless. Röpke argues this vicious process could be observed in America and Germany as well as in France and Switzerland during the 30's. However, Röpke is vague on what makes secondary depressions follow from primary depressions. In recent time, Taiwanese-American economist Richard C. Koo claims to have found the 'Holy Grail' of macroeconomics, i.e. what made the Depression so deep and long. The deflationary spirals during the Great Depression was caused by a private sector shifting from maximizing profits to minimizing debt due to having more debt than assets after the bursting of the asset price bubble, which lead to debt-deflation process shrinking the economy. According to Koo, a balance sheet recession like this is the same disease that has also infected today's western economies. Strengthened by the notion of balance sheet recession, Röpke's long lost insights might advance our understanding of the business cycle in general, and, more specifically, what sort of crisis the U.S. and Eurozone are struggling with today.

Keywords: balance sheet recession; secondary deflation; the great depression; austrian school of economics; business cycles; monetary disequilibrium; fiscal policy; debt deflation.

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1. Introduction

From August 1929 to March 1933, the U.S. industrial production fell by 53 percent, and real and nominal GDP respectively 50 and 33 percent. In 1932, unemployment levels peaked at 25 percent. In Germany, the situation was even worse. Following the Great Crash of 1929, American lenders withdrew vast amounts of money from German banks

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placed there for reviving the country's economy. As German economist Wilhelm Röpke wrote at the time (1933, p. 427), the 'terrible weight of the world crisis falls upon a Germany that for nearly two decades has gone through sufferings which cannot be adequately described in cold statistical figures.'

A couple of years earlier, Röpke had served as a member of the German National Commission on Unemployment proposing rapid credit expansion as a means for combating the crisis. Although very aware of the dangers regarding government intervention in the economy during a recession, Röpke was convinced that if no action was taken, hostile feelings towards the free market would evolve and make liberalism – 'or what is left of it' – disappear into a museum (Gregg 2010, p. 16). Röpke soon after received a letter from his Austrian friend the economist Friedrich A. Hayek, who was writing Röpke after reading Commissions' report. Hayek believed the prescribed medicine to be wrong: As a response, Hayek had penned down his objections in the form of an article, but did not send it off to a journal. Instead, it ended up on Röpke's desk along with the letter that requested credit expansion not to be, not yet at least, initiated. 'But if the political situation is so serious that continuing unemployment would lead to a political revolution,' noted Hayek, 'please do not publish my article' (de Soto 2009). The article was left unpublished.

Alas, German Chancellor Henrich Brüning did not understand what his country was up against and his decision of following an austerity policy, not too different from the one the EU and The European Central Bank is insisting on today, pushed the unemployment rate up to 28 percent. A high number of desperate people was propelled into the Communist and Nazi movements; the German government's poor handling of the economic crisis helped paving the way for the Nazis' political journey towards power.

The classical economic doctrine had up until now not considered the possibility of involuntary unemployment. In the years preceding what British economist G. L. S. Shackle calls 'the years of high theory,' mainstream economists believed the market was able to adjust itself back to full employment without government intervention. What was needed was to 'purge the rottenness out of the system' through liquidating labor, stocks, farmers and real estate, as the Secretary of the Treasury Andrew Mellon advised President Herbert Hoover. However, as Shackle (2009, p. 167) comments, the unemployment in the

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beginning of the 30's was not voluntary -- vast numbers of men in U.K. and the U.S. were *despairingly* unemployed: 'There can be, there was, such a thing as a massive, general, involuntary unemployment.'

Using another phrase by Shackle (p. 439), the things the world experienced in this period 'were not cycles but cataclysms.' Never before had there been such a violent economic crisis, and the economic profession did not understand what was causing it or how to escape it. The economist who came closest was perhaps Röpke with his concept of a 'secondary' depression or deflation. Still, it is not until recent years it has been possible to fully grasp what lays behind the Great Depression, when Taiwanese-American economist Richard C. Koo started writing about the kind of economic crisis he calls *balance sheet recession*.

2. Keynes and the Austrian School of Economics

Like Hayek, Röpke is today better known as a social philosopher -- most notably as one of the intellectual muscles behind *Wirtschaftswunder*, the reforms that liberalized the West-German economy after World War II -- than as a 'pure' economist. The other feature he had in common with Hayek was nevertheless the interest taken in business cycle research during the beginning of his academic career.

In 1936, he wrote the little-known book on business cycles in which he synthesized fruitful elements of theories from different economic theories and schools. Among them the so-called Austrian school of economics and its business cycle theory (ABCT), developed by Ludwig von Mises and Hayek -- as well as the writings of British thinker John Maynard Keynes.[1] Röpke found himself in agreement with the 'Austrian' explanation where the boom period initiated the crisis that developed into the Great Depression. For Röpke it is important to recognize that

> the low rate of interest prevailing at the beginning of the upward swing increases the readiness to invest. Projects which were not profitable at a rate of interest of 5% become profitable when the rate of interest falls to 4%, and the further the rate of interest falls, the wider becomes the range of profitable investments for capital (Röpke 1936, p. 24).

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As Hayek (2008) notes, 'the primary cause of cyclical fluctuations must be sought in changes in the volume of money, which are undoubtedly always recurring and which, by their occurrence, always bring about a falsification of the pricing process, and thus a misdirection of production.' What the ABCT teaches is that the economy can by responding to cheap-credit policies find itself in a boom that is inconsistent with the underlying economic fundamentals. A bust must follow this unsustainable boom.

Put in different words, what caused the Great Depression was an artificial boom period with low interest rates, heavy credit expansion and what the 'Austrians' call malinvestments. In this story, writes Röpke (1936, p. 28), the depression 'represent in general a reversal of the boom.' It is characterized by 'the fact that the collapse of the towering edifice of prices, production, and credit, erected by the boom, is gradually retarded and finally brought to a standstill.' After a while, the liquidation is complete, even though the upward trend does not immediately follow.

When there is a loss of confidence, which is the essence of a credit crisis, central banks fail to realize that this crisis is nothing but the sudden change of preference on the part of the public for one sort of money (cash) instead of another (bank money). Röpke called this a 'momentary metamorphosis' that can have disastrous consequences (p. 36-37). In 1930, 'the crisis expanded with uncanny inexorability into a disaster from which, in the end, scarcely a country or a single branch of economic activity escaped, and the sad result was a crisis which in completeness, intensity, and spaciousness surpassed all previous historical examples' (p. 53).

Even though Röpke regarded Hayek's analysis of the boom-period put forward in *Prices and Production* (1931) as a theory containing 'elements which represent a real advance,' he considered Hayek's explanation of the depression 'unsuccessful to the point of being positively misleading.' Instead, he found a more plausible thesis in the writings of Keynes. But Keynes, who was vague on how overinvestments disturbs the structure of production, and 'evidently inclined to deny the necessity of a painful process of readjustment brought about by the crisis,' neither saw the whole picture. His theory did not satisfy Röpke in explaining the phase of the cycle Hayek emphasized the most in his writings (the boom period), just as the ABCT was 'thin' on the phase that occupied Keynes (the depression).

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Taking 'the cumulative process of depression,' according to Röpke it cannot be better stated than in the terms of the saving-investment approach elaborated by Keynes: As soon as savings gets ahead of investments, it discourages the recovery of enterprise and sets up a vicious circle by its adverse effects on profits. If investments carries on, wealth accumulates whatever may be happening to savings; and if investments are absent, wealth decays. For investments to be active there must exist an expectation of profit, as well as a possibility for enterprisers to obtain command of enough resources to execute their projects.

Keynes' contribution must 'be highly appreciated even by those who prefer other explanations for the boom period,' and Röpke (p. 108-09) insists that the upward swing 'must be characterized either by a rise in the volume of money and credit or by an increase in the velocity of circulation or by both at once.' It is Hayek's monetary theory that 'is capable to explain even the otherwise incomprehensible American boom,' and it is 'indeed the only trade-cycle theory which can really explain it satisfactorily' (p. 112-13).

3. The Secondary Deflation

Not every expansion of credit, though, is inflationary, especially not when there is 'heavy unemployment of factors of production brought about by a previous credit deflation.' That, explained Röpke, was the situation during the Great Depression in the 30's. Warnings against credit expansion was at this time 'really ill-timed and dangerously apt to retard the process of recovery which can only be initiated by credit-expansion breaking the vicious circle of depression and reabsorbing the idle factors of production.' Röpke (p. 117-18) calls this a '*compensatory* credit expansion,' a kind that must be distinguished from the previous one. He is 'not in the least scared by the fact that expansion does mean an enlargement of the volume of money and credit, and ardently hope, moreover, that it will be so, since it is the only way to get out of a depression' (p. 192).

Under certain circumstances, the depression may grow to dimensions 'quite out of proportions of the preceding boom, so that it loses more and more its function of readjustment and degenerates into a *secondary depression* void of any function whatsoever except to test the strength of patience of the people in enduring a cumulative process of senseless and murderous economic destruction' (p. 119). What this secondary

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depression does is lead to a new disequilibrium that has nothing to do with the former set of disturbing factors. Therefore, unlike a *primary* deflation, which is a necessary reaction to the boom inflation, i.e. the disturbance of equilibrium by an excess of credit creation, the secondary deflation is a contraction of total demand, an 'independent and economically purposeless' process that develops out of the 'unavoidable deflation' (p. 135-36) of the primary depression, which can and should be combated. This 'vicious circle set in motion by excess of savings over investment' could be observed in America and Germany as well as in France and Switzerland.

In 1932, Hayek did not agree using expansionary policy could help the economy. October 19th, together with T. E. Gregory, Arnold Plant and Lionel Robbins, Hayek wrote in an open letter to the editor of *The Times* that even though no one thinks 'deflation is in itself desirable,' the authors did not wish to see 'imprudent borrowing and spending on the part of the public authorities.' For contemporary economists observing the distressing situation unfold, this proposition was hard to defend. Years later, economist Gottfried Haberler (The Austrian Economics Newsletter 2000) described the letter as 'very damaging,' and he believed it was 'responsible to some extent for the success of Keynesian theory.' As Professor Emeritus of economics at University of Georgia George Selgin (1997) writes, it is difficult to resist concluding that Hayek's policy recommendations 'embody a general indifference to deflation, whatever its cause.' And in the words of John Hicks (1967) the Hayekian theory is at its worst when applied to deflationary slumps like the ones of 1931-32, 'In such conditions its diagnosis was wrong; and its prescription could not have been worse.' Richard Kahn (Samuelson 2009) was even more to harsh and exclaimed, 'If Hayek believes that the spending of newly printed currency on employment and consumption will *worsen* our current terrible depression, then Hayek is a nut.'

Was Hayek at the time unaware the secondary depression? No. As a matter of fact, Ludwig Lachmann, a young German economist who began working for Hayek as his research assistant in 1933, was mainly concerned with the secondary depression, 'that kind of depression that would not be an adjustment process in the Hayekian sense' (The Austrian Economics Newsletter 1978). In addition, secondary depressions was a popular topic in the seminars held by Hayek and his colleague Lionel Robbins at London School of Economics. At this time, remembers Lachmann, it was 'admitted that a depression of

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this kind could develop and I think everybody admitted that by 1933 the world was in a process of secondary depression'. What seems to be the issue is rather that Hayek was *not in favor of facing this crisis with expansionary policy*. In his essay 'The Present State and Immediate Prospects of the Study of Industrial Fluctuations' (1933), Hayek maintained that wage and price rigidities 'tend to delay the process of adaption and … cause a 'secondary' deflation which at first will intensify the depression but ultimately will help to overcome the rigidities' (Klausinger 2004).[2]

Joseph A. Schumpeter (2012, p. 246) made a similar distinction, where he separated the 'normal' from the 'abnormal' course of events. The Great Depression was not a normal depression, and one cannot read into it the standard business cycle, an error often made. As Hayek, Schumpeter did not wish to combat the abnormal (or secondary) kind, even though the losses and destruction that accompanies it really are 'meaningless and functionless' (p. 253). There are two reasons behind this political stoicism. First, the economic system needs a complete destruction of all the elements that cannot adjust to the new equilibrium position. Secondly, Schumpeter (p. 255) did not believe it was possible for politicians to differentiate between normal and abnormal depressions: Which businesses do we leave to themselves, and which ones do we grant credit?

So why are not the equilibrating forces at work? The problem can be ascribed to 'the disastrous destruction of that harmony between the process of formation of incomes and the process of the utilization of incomes which constitutes an essential condition of general economic equilibrium' (Röpke 1936, p. 122). Röpke believed the contraction in aggregate demand to be caused by businesses holding themselves as liquid as possible (instead of using their funds for replacing old machinery or making additional investments) and households hoarding money.

Therefore, a secondary depression 'calls for expansion as the logical remedy instead of restriction' (p. 185). As a way to reach a new state of equilibrium, Röpke noted that the banking system has to be prepared to give credit. Nevertheless, it also depends on entrepreneurs who are willing to *lend* credit for new investments 'so as to render the credit expansion really effective by enlarging the volume of circulating media instead of merely enhancing the liquidity of somebody' (p. 125). However, making credit easier available

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might not be sufficient. One might need a 'public initiative in enlarging the volume of credit and demand':

> If the private entrepreneurs do not make use of the new credit facilities, in other words, if private borrowers are not to be found in a sufficiently large number, then the State must step in as an extensive borrower in order to make credit expansion really effective and thus to help drag the market economy out of its present deadlock. Or … the public sector of the national economy has to be enlarged to make up for the contraction of the private sector and to start a process leading to the re-expansion of the latter (p. 199).

As soon as the re-expansion of the private sector is sufficiently under way so that the economy is working again, the expansion of the public sector must be stopped and must even be turned into contraction if private expansion assumes anything approaching inflationary dimensions.

4. Balance Sheet Recession

In later years, the notion of two types of deflation has gotten some but not much attention. The Swedish economists Axel Leijonhufvud (1972) compares the economic system to a 'corridor'. Inside this corridor, 'multiplier-repercussions are weak and dominated by neoclassical market adjustments,' while outside the corridor, 'they should be strong enough for effects of shocks to the prevailing state to be endogenously amplified.'

What still needs an explanation is the mechanism that lies behind such a secondary deflation. When Röpke (1936, p. 122-24) pointed out 'money is withheld from expenditure on consumption goods, without any compensation for this no-consumption taking place in the form of investment in capital goods,' he was on to something. Nonetheless, the cause cannot be reduced to what Keynes identified as 'money hoarding' or what Röpke called 'a crisis of confidence.'

When Röpke tried to unravel the backdrop of the continuous contraction of demand, he points to the 'disastrous *destruction of that harmony between the process of the formation of incomes and the process of the utilization of incomes* which constitutes an essential condition of general economic equilibrium.' This is a discrepancy that tends to become cumulative and leads to 'a continuous fall of demand on commodity markets,

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which in turn tends to bring about a yet further fall.' Something is missing. In trying to understand the Great Depression, we are searching for what former Federal Reserve Chairman Ben Bernanke (1995) has called 'the Holy Grail of macroeconomics.' Half a century after Röpke participated in the quest for this grail, someone seems to have found it.

After formulating his theory on balance sheet recessions, Taiwanese-American Chief Economist of Nomura Research Institute Richard C. Koo has become a popular speaker not only in the U.S. and Asia but also in Europe. With his 2008 book *The Holy Grail of Macroeconomics* Koo's theory has had a great impact on politicians and academics. It has created light bulb moments for and been read by influential people such as Bernanke and economist Paul Krugman. For new members of the Council of Economic Advisers, which advises the President on financial matters, his book is said to have become required reading, and the balance sheet recession concept has been picked up and written about by institutions like the International Monetary Fund and the Bank for International Settlements. Koo (2009, p. xiv) has given a plausible explanation for what made the Great Depression so severe: Like Japan's Great Recession, America's Great Depression was 'a balance sheet recession triggered by businesses striving to minimize debt.'

An important part of the problem is what American economist Irving Fisher (1933) wrote about already during the depression, and which he coined 'debt-deflation'. Following this theory, what made the crisis so destructive was '*over-indebtedness* to start with and *deflation* following soon after'. Fisher writes that 'if debt and deflation are absent, other disturbances are powerless to bring on crises comparable in severity to those of 1837, 1873, or 1929-33.' Debt and deflation affects 'circulating media, their velocity of circulation, price levels, net worths, profits, trade, business confidence, interest rates.' In this story, each dollar of debt still unpaid becomes a bigger dollar: '*The more the debtors pay, the more they owe*.' What Fisher did not understand is that the economy might suffer from a problem on the *borrower* side and not just the *lender* side. And that is why his purely monetary remedies for the Depression, unlike Keynes' advocacy for fiscal policy, will fail. The impact of corporate debt minimization on both aggregate demand and the money supply is the 'long-overlooked key that is essential to integrating the diverse ideas developed in macroeconomics since the late 1930s' (Koo 2008, p. 86).

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Why monetary will not do the trick can be explained by the existence of two types of recessions. One of them, a *yang* phase, is triggered by the typical business cycle, and another, a *yin* phase, is triggered by deleveraging and debt minimization in private sector. It is the latter, which is absent in economic textbooks, Koo refers to as balance sheet recessions. These are rare and must be treated if one wants to stop it from developing into a depression.

Before the stocks and other assets plunged in 1929, Americans borrowed heavily to purchase everything from shares to consumer durables. Then came the bust. Suddenly only the loans remained, and everyone rushed to reduce outstanding debt, triggering a plunge in aggregate demand. This left monetary policy impotent because 'a company suffering from a debt overhang will not ask to borrow more just because loans have grown cheaper.' Even though repaying loans is the responsible thing to do on an individual level, it leads to a 'disastrous fallacy of composition' when it is pursued by the whole private sector. Koo explains that when

> no one is borrowing money, and all firms are striving to reduce debt despite zero interest rates, the fundamental economic mechanism responsible for channelling household savings into corporate investments ceases to function. This is exactly what happened seventy years ago in the U.S. during the Great Depression, when GNP plunged by 46 percent in just four years (p. 18).

This is the same kind of recession Koo claims the western world is witnessing today, and he warns that a passive government will make sure the economy falls into 'the kind of catastrophic deflationary spiral seen in the U.S. between 1929 and 1933.' There is only one way to stop the vicious circle, and that is for the government to do precisely the opposite of what the private sector is doing, which means 'it must borrow (and spend) the savings that the private sector can no longer use (p. 33). If not, the economy will continue shrinking.

Does not this balance sheet recession resemble Röpke's secondary depression? As we see, Koo also operates with two qualitatively different types of recessions and not, like most other economists, with just one consisting of various degrees (going from weak to strong). Moreover, by dividing the recessions in *yin* and *yang* phases, Koo is able to

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explain when monetary and fiscal policy can be most effective and when it will be counter-productive. In his latest book, Koo (2014) mentions the ‘Austrian’ approach, which he sees as preferable if those whose balance sheets were ‘impaired as a result of mistakes made during the bubble represent only a small portion of the broader economy’ (so that those who participated in the bubble are punished and less likely to repeat their mistakes in the future). However, this approach will only work if a small portion of the economy is damaged and a large part still is healthy.

Even Keynes, who attempted to break with the neoclassical framework with his concept of aggregate demand, assumed that firms always are maximizing profits. Koo points out that Keynes did not understand that a balance sheet recession was taking place; Keynes did not understand that he in *The General Theory of Employment, Interest, and Money* (1936), he in fact was explaining a *yin* world. Still, his proposed weapons for battling what he called an ‘underemployment equilibrium,’ were the right picks. The same can be said for Röpke and his *Crises and Cycles*. The self-feeding secondary depression he described and feared was actually caused by balance sheet recessions. By incorporating the concept of debt minimization, assures Koo, the economics profession ‘will finally be freed from its reliance on gimmicks such as price and wage stickiness and rigidity to explain long-term recessions’ (p. 121).

5. Conclusion

None of the economists in the 30’s, that be Keynes, Fisher or ‘Austrians’ like Hayek, Mises and Röpke, fully got their heads around what was happening at the time. In fact, what made the Great Depression so deep and long has not really been understood or explained until Koo’s influential concept of a balance sheet recession. In return, Koo might have something to learn from the writings of ‘Austrian’ economists Hayek, Mises and Röpke. Koo (2011) does not take into consideration the low rates and the significant money and credit expansion prior to balance sheet recessions. Instead, ‘every several decades, the private sector loses its self-control in a bubble,’ an explanation not too different from Keynes’ unsatisfactory concept of ‘animal spirits’ where investors suddenly lose their nerve (and starts hoarding cash to keep themselves liquid in the face of an uncertain future).[3]

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One of the key elements for understanding what triggers an unsustainable boom is the natural rate of interest concept developed by the Swedish economist Knut Wicksell. The interest plays a crucial role in the ABCT, the natural rate of interest, an unobservable theoretical construct, being the rate that equates saving and investment. New money injected into credit markets leads to deviations from the natural rate. As 'Austrian' school economist Roger Garrison (1989) explains, 'a cyclical pattern in observed interest rates is not essential to the Austrian theory,' and 'the effects of an artificially low interest rate are not so much *over*investment as *mal*investment.'

As economist Steven Horwitz (2011) notes, from a 'Hayek perspective, much of the Keynesian analysis starts in the middle of the story, where the resources are already idled and thus appear to be "abundant."' In contrast, Hayek and the 'Austrians,' assume in their model full employment and explains how money creation distorts the production structure and therefore relative prices. Still, they have little to teach us about what happens after the bust. If we are to quote the English economist W. H. Hutt (1978), 'the pre-Keynesian or "Austrian" policy was more of *avoiding* depressions than curing them.'

Being one of the economists that came closest to understanding the Great Depression at the time, Röpke is a most important figure in the history of economic thought. His unique insights was achieved not by choosing an eclectic but a synthetic approach to the business cycle -- by fusing the ideas (what creates the boom) from the Austrian school with concepts (savings run ahead of investments) and tools (aggressive monetary and fiscal expansion) presented by Keynes.[4]

Therefore, by connecting the idea of a secondary depression to Koo's concept of a balance sheet recession -- the *yin* phase of the business cycle -- we arrive at a more comprehensive theory of boom and bust cycles that has room for both Keynes and the Austrian school. Such a synthesis can serve to explain not only how to combat economic crises like the one the western world are facing now, but also how to avoid the next one.

Notes

[1] Röpke is here concerned with the theories elaborated in *A Treatise on Money* (1931). *The General Theory* (1936) had not yet been published at the time *Crises and Cycles* (1936) was written.

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[2] Hayek did change his mind later, as did Robbins. In the 1970's, Hayek admits that contractionary monetary policy has a tendency of bringing about a secondary deflation that is worse than the boom ahead of it made necessary. He then started making arguments for fighting these sorts of depressions with all necessary means.
[3] The theory of an unsustainable credit fueled boom in asset prices is increasingly gaining support outside traditional 'Austrian' circles, see for example David Beckworth (ed.), *Boom and Bust Banking: The Causes and Cures of the Great Recession* (2012), Claudio Borio & Piti Disyatat, 'Global Imbalances and the Financial Crisis: Link or no link?' (2011), Axel Leijonhufvud, 'Keynes and the Crisis' (2008), William White, 'Modern Macroeconomics is on the Wrong Track' (2009), Guilermo Calvo, 'Puzzling Over the Anatomy of Crises: Liquidity and the Veil of Finance' (2013) and John B. Taylor, 'The Financial Crisis and the Policy Response: An Empirical Analysis of What Went Wrong' (2009).
[4] Reading Keynes' writings in *The Times* in 1937 it becomes obvious he did not -- unlike the so called 'Keynesians' that followed him -- see his tools as relevant for every economic downturn.

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