A Comparative Institutional Perspective on the Great Depression: Japan and the U.S.

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The current “once-in-a-century” financial crisis has roused people’s interest in the Great Depression of the 1930s. With regard to Japan, the Showa Crisis, which occurred as part of the Great Depression, has come to be mentioned frequently. The focus of recent discussion of the Showa Crisis is on macro economic policy, and with good reason. The history of macro economic policy in this period was very dramatic. Two Finance Ministers with clearly different views on the economy and economic policy were successively appointed in a short period, which resulted in drastic changes in Japan’s macro economic policy and the macro economy.

Junnosuke Inoue, appointed as the Finance Minister of the Hamaguchi Cabinet in July 1929, considered the return to the gold standard to be a key to rescuing the Japanese economy from the long depression after the First World War. Tightening the fiscal and monetary policy, he returned Japan to the gold standard in January 1930, three months after Black Thursday. On the other hand, Korekiyo Takahashi, who became Finance Minister of the Inukai Cabinet in December 1931 after the assassination attempt on Prime Minister Hamaguchi and the collapse of the Wakatsuki Cabinet, immediately abandoned the gold standard and expanded the fiscal and monetary policy, issuing deficit-covering government bonds with underwriting by the Bank of Japan. This clear-cut policy change stimulated exports as well as government expenditure, which in turn substantially accelerated economic growth. This is the widely accepted view of Japanese macro economic history of this period, and I do not intend to make an objection to it. Rather, I am going to point out the micro and institutional factors behind these macro economic phenomena and discuss their implications.

First, it should be noted that the depression in Japan, including the period of the Inoue policy, was relatively slight particularly when compared to the U.S. The growth rate of Japan's real GNP fell from 6.5% in 1928 to 0.5% in 1929, and remained at around 0 to 1% until 1931. It is true that three years of zero growth was unprecedented in modern Japan, but at the same time it is notable that the growth rate never became negative during this period.

Meanwhile, in the U.S. real economic growth fell to minus 9.6% in 1930 and remained negative from 1930 to 1933, with minus 10% from 1930 to 1932. In his classic book with Anna Schwartz, Milton Friedman emphasized the decline of money supply as the reason for this serious contraction of the U.S. economy. Indeed, M2, the sum of base money and deposits, declined 33% from $63.4 billion 1929 to

$42.2 billion in 1933 in the U.S. In Japan on the other hand, M2 declined 8% from 1929 to 1931, and increased again after 1932. The difference in the movement of money supply between the two countries corresponds with the difference in the performance of the real economy.

Accepting that the increase in money supply after 1932 was a reflection of Takahashi's policy, one might also be led to wonder if the moderate decline of M2 in Japan up until 1931 was because the Inoue policy was not so tight. However, this was not the case. In Japan, base money, the basis of M2, declined 16% from 1928 to 1931, while in the U.S. it declined only 3% from 1927 to 1930. In other words, base money, which the financial authorities controlled directly, contracted far more sharply in Japan. Indeed, looked at from an international perspective, the Inoue policy was one of drastic tightening.

The next question is why this sharp decline in base money did not cause a sharp decline in M2. The ratio of M2 to base money is called the money multiplier, and the data above implies that the money multiplier went up during the great depression in Japan. The money multiplier basically reflects how financial institutions and the non-financial sector evaluate risk in the financial system. That is, if banks, companies and individual consumers think that risk in the financial system is increasing, the money multiplier goes down. This was the case in the U.S. during the Great Depression, whereas it was not so in Japan.

We cannot understand this surprising phenomenon without taking into account the institutional evolution that occurred in the financial system in the late 1920s. There is an institutional characteristic that has long been stressed in literature on Japanese financial history. It is the “organ bank” relationship. This refers to a bank that was controlled by a group of industrial firms and consequently concentrated loans to those firms. Organ banks tended to take excessive risk, as was the case with Taiwan Bank, the organ bank of Suzuki Shoten Co., which collapsed in the financial crisis in 1927.

Indeed, according to research by Professor Michiru Sawada (Nihon University), Professor Kazuki Yokoyama (Nagoya City University) and myself, in those banks connected to industrial companies through director interlocking, profitability was lower and the probability of bank runs was higher. However, according to research by Professor Sawada, Professor Ke Wang (formerly University of Tokyo) and myself, not only did director interlocking decrease through bank exits and mergers, its negative effect on profitability also disappeared by the early 1930s.

The lower risk evaluation of the financial system occurred in the process of this institutional evolution. In other words, the reorganization of banks from the late 1920s mitigated the damage of the Great Depression in Japan and prepared the basis for the high growth of the 1930s.

The above discussion implies that it is not sufficient to explain the growth performance of the Japanese economy in the 1930s only from the standpoint of macro economic policy, and that the stability of the financial system and its institutional foundation were also particularly important.

Fortunately, the current financial crisis has not developed into a great depression like that of the 1930s, and a large part of the reason for this is that the stability of financial systems around the world has managed to be maintained thus far. For a resolution to the current economic crisis, it is necessary to restore confidence in the financial systems of the world's major economies.

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