

The Great Depression as a Credit Boom Gone Wrong¹
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1. Introduction

The Great Depression is the macroeconomist's Rorschach test. Every generation views the Depression through the lens of its own particular (conscious or subconscious) concerns. In the 1960s monetary economists, worried by mounting inflationary pressures and convinced that mismanagement of the monetary aggregates could destabilize otherwise stable economies, portrayed the Depression as a consequence of ill-advised central bank policies.² In the 1970s apostles of the neo-Keynesian synthesis, convinced that animal spirits were responsible for cyclical fluctuations, rewrote the history of the Depression in terms of the instability of consumption and investment spending.³ In the 1980s economists impressed by the growing influence of international trade and investment again rewrote that history, this time in terms of the instability of the international monetary and financial system.⁴ And, in the 1990s, a decade of financial instability, they portrayed the Depression as one big banking crisis.⁵

In the aftermath of the credit boom and bust of the 1990s, there is thus a temptation to

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²The classic account is of course Friedman and Schwartz (1963).

³We have in mind Temin (1976), although he clearly had predecessors in the 1940s and 1950s.

⁴See for example Hamilton (1987) and Eichengreen (1988).

⁵An early example is Bernanke and James (1991).

rewrite the history of the Great Depression as a credit boom gone wrong. The credit-boom interpretation of macroeconomic cycles, as informed by the experience of the 1990s, goes something like this.⁶ There is first an upswing in economic activity. As the economy expands, banks and financial markets provide an expanding volume of credit to finance the growth of both consumption and investment. Whether because the exchange rate is pegged or for other reasons such as a positive supply shock, upward pressure on wholesale and retail prices is subdued. Hence, the central bank has no obvious reason to tighten and stem the growth of money and credit, leading to a further expansion of output and further increase in credit, which feeds on itself.

Higher property and securities prices encourage investment activity, especially in interest-rate-sensitive activities like construction. But, as lending expands, increasingly speculative investments are underwritten, and the quality of bank loans declines. The demand for speculative investments rises with the supply, since, in the prevailing environment of stable prices, nominal interest rates and therefore yields on safe assets are low. In search of yield, investors dabble increasingly in risky investments. Their appetite for risk is stronger still to the extent that these trends coincide with the development of new technologies, in particular network technologies of promising but uncertain commercial potential.

Eventually, all this construction and investment activity, together with the wealth effect on consumption, produces signs of inflationary pressure, and the central bank begins to tighten. The financial bubble is pricked and, as asset prices decline, the economy is left with an overhang

⁶This may be labeled for present purposes as the BIS interpretation. See for example Borio and Lowe (2002), Borio, Fufine and Lowe (2001), and Vila (2002).

of ill-designed, non-viable investment projects, distressed banks, and heavily indebted households and firms, aggravating the subsequent downturn.

No single policy implication necessarily flows from this story, but some readers will conclude that the monetary authorities should respond preemptively to the rise in asset prices. Central banks should not be misled, in this view, by the disconnect between asset price inflation and consumer price inflation. They should respond to the inflation of asset prices by reining in credit and preventing the expansion from taking a form that ultimately renders subsequent difficulties more severe.⁷

This tale from the 1990s has obvious appeal for historians of the 1920s. The 1920s was a decade of expansion, reflecting recovery from World War I, new information and communications technologies like radio, and new processes like the motor vehicle production using assembly-line methods. In the United States, a feature of the expansion was abundant supplies of credit, reflecting the ample gold reserves accumulated by the country during World War I, the stance of Federal Reserve policies, and financial innovations ranging from the development of the modern investment trust to consumer credit tied to purchases of durable goods such as automobiles. Credit fueled a real estate boom in Florida in 1925, a Wall Street boom in 1928-9, and a consumer durables spending spree spanning the second half of the 1920s. That these booms developed under the fixed exchange rates of the gold standard meant that they generated little inflationary pressure at home and that their effects were transmitted to the rest of

⁷That this is the right story and the right policy implication is, of course, not universally agreed. On the controversy over the role of asset prices in the conduct of monetary policy, see Bullard and Schaling (2002), Bernanke and Gertler (1999), Cecchetti, Genberg, Lipsky and Wadhvani (2000), Filardo (2000) and Goodhart (2000). This same debate figures prominently in the literature on the Great Depression, as we describe momentarily.

the world. Absent overt signs of inflation, the Fed had no reason to raise the official short-term rate.

Over time, signs developed of a deterioration in the quality of projects – as in the Florida land boom of the mid-1920s – and a growing prevalence of malfeasance and graft, evident in the activities of Charles Ponzi in Florida, Clarence Hatry in London, and Ivar Kreuger in Stockholm. This in turn created concern among central banks about the effects of asset-price inflation on the economy, leading them eventually to tighten. Banks passed along the higher cost of additional reserves to their borrowers, and, in the U.S. case, they further felt direct pressure to limit their lending to securities market participants. Borrowers with highly leveraged positions, stock market positions in particular, experienced financial strain, leading them to compress their spending, and consumption and investment turned down. Ultimately, the resulting deflation became sufficiently severe to threaten the stability of the financial system and the economy more generally. One conceivable implication of this account is that the Fed should have prevented the development of speculative excesses by maintaining a tighter policy stance, despite the absence of overt signs of inflation.⁸ Doing so might have prevented or at least slowed the build-up of speculative excesses that became sources of severe financial stress when the economy eventually turned down. By limiting the extent of the credit boom in the late 1920s, this preemptive policy would have reduced the severity of the Great Depression in the early 1930s.

This “new view” has at least two significant precursors in the literature on the interwar period: the Austrian interpretation of the Great Depression, and the view that attributes the

⁸This is only one conceivable implication in the sense that other authors who insist that the central bank should have focused exclusively on wholesale and retail price inflation characterize Fed policy as too tight rather than too loose in the late 1920s (see e.g. Meltzer 2003).

Depression to the stock market boom and crash.⁹ The Austrian view, with roots in the work of Ludwig von Mises (1924) and Friedrich von Hayek (1925), focused on the divergence between the market rate of interest and the natural rate of interest.¹⁰ When the market rate fell below the natural rate, Mises and Hayek argued, prices rose and investment boomed.¹¹ The source of that divergence, according to Mises, was the banking system, freed from the disciplining influence of

⁹“At least” alludes to the fact that there is also the Liquidationist School in the United States (DeLong 1990, Meltzer 2003), which has much in common with the Austrian view, and the French interpretation of the Depression (Moure 2002), which also echoes the Austrian view. And of course there is the Minsky (1986)-Kindleberger (1978) interpretation of booms, panics and crashes, largely inspired by the experience of the Great Depression, in which the endogenous response of credit plays an integral role. We return to this below. In addition, to the extent that the credit boom of the ‘twenties manifested itself in rising property prices and unsustainable construction activity, there are also parallels with the earlier views of Henry George (1879). The Georgist view acknowledges the role of credit in fueling speculation and argues in particular that “speculative advances in land values” are central to causing business cycles. Rising rents induce speculators to purchase land for capital gains rather than for current use, which in turn causes site values to rise in dramatic fashion, setting off further rounds of speculation that eventually erode the profits of firms by increasing mortgage costs and rents. Eventually, these burdens reduce new investment and aggregate demand, and bring forth a recession. In effect, the high price of land acts to “lock out labor and capital by landowners” (George, 1879, p.270). Only as this cycle is unwound and land prices and rents fall does investment pick up again, allowing the economy to recover toward full employment. The Georgist view differs in terms of the timing of the rise of speculation and the decline of investment and economic activity; George and his followers saw the latter as starting to decline even while the property boom was still underway (albeit in its late states), where the views emphasized in the text see investment and demand generally as declining only after the bubble bursts.

¹⁰In this respect there are parallels between the Austrian model and Keynes’ *Treatise on Money* (1930), a fact appreciated by Keynes and emphasized by Laidler (1999). In addition, there are parallels between the Austrian view and the modern debate about whether central banks should simply concentrate on commodity price inflation or also be concerned about asset price inflation. We return to this below.

¹¹Mises and Hayek did not typically distinguish between asset and commodity price inflation, but when they did, they minimized the relevance of the distinction. Laidler (1999) argues that Hayek in particular saw the rate of interest (which affected the evolution of asset prices) as the key price (since it was what equilibrated or disequibrated saving and investment); by this interpretation, asset price inflation in fact mattered more than commodity price inflation.

the classical gold standard. Excessive credit creation by banks, both central and commercial, encouraged asset price inflation, fueling consumption and investment. The longer that asset-price inflation was allowed to run, the greater were the depletion of the stock of sound investment projects and the accumulated financial excesses.¹² Moreover, the more severe became the subsequent downturn. The credit boom thus contained the seeds of the subsequent crisis. The policy implication was that countries should avoid monetary arrangements that allowed significant divergences between the market and natural rates of interest (in particular, a gold standard of the rigid prewar variety was preferable to the more malleable interwar vintage) and that they should allow the downturn to proceed in order to purge unviable firms and investment projects from the economy, thereby clearing the way for sustainable recovery.¹³

The definitive application of the Austrian model to the Great Depression was by Lionel Robbins (1934) in a book largely responsible for popularizing the name now attached to this episode.¹⁴ Robbins attributed the Depression of the 1930s to the unsustainable credit expansion of the 1920s. Blame for that credit expansion he in turn laid at the doorstep of the Federal Reserve System, which had kept interest rates below the natural rate for too long in the hope that low rates might help Britain surmount its balance-of-payments problems and thereby solidify the reconstructed gold exchange standard, and ultimately on the doorstep of the new gold standard

¹²Although Mises referred not to the build-up of indebtedness but to the inadequacy of saving, his point was essentially the same.

¹³In Hayek's (1932, p.44) words, "any attempt to combat the crisis by credit expansion will...not only be merely the treatment of symptoms as causes, but may also prolong the depression by delaying the inevitable real adjustments."

¹⁴The Austrian views of the early Robbins were kept alive by, inter alia, Rothbard (1975).

itself, which gave central banks more leeway to manipulate policy. This divergence between market and natural rates stimulated the provision of bank credit, allowing the development of financial excesses which, when revealed, led unavoidably to the downturn, the financial crisis, and the Depression.¹⁵ Central banks were misled into inaction by the tendency for the credit boom to stimulate not just aggregate demand but also aggregate supply (through increased production of consumption goods and growing investment in capacity). But the quality of much of that additional capacity was inferior. The credit boom had “the qualitative effect of providing a favourable atmosphere for the fraudulent operations of sharks and swindlers,” which meant that neither the expansion of supply nor the high level of asset prices was sustainable and only set the stage for a disruptive crisis.¹⁶ Moving from diagnosis to prescription, Robbins recommended against monetary and fiscal measures to counter the downward spiral, insisting that the economy needed to be cleansed of financial and nonfinancial excesses to set the stage for a sustainable recovery.

The other significant precursor blames the Great Depression on a bubble in the stock market.¹⁷ Galbraith (1972) describes how what he characterizes as a bubble developed in response to the combination of financial innovation and ample credit in an unregulated financial

¹⁵As Robbins (1934, pp.41-2) put it, “Sooner or later the initial errors are discovered. And then starts a reverse rush for liquidity. The Stock Exchange collapses. There is a shortage of new issues. Production in the industries producing capital-goods slows down. The boom is at an end.”

¹⁶Robbins (1934), p.62.

¹⁷There is clear overlap between the Austrian view and the bubble interpretation; thus, Robbins points to the run-up in stock prices in the United States as a prominent consequence of the expansion of bank credit in the 1920s.

environment. Investor enthusiasm was grounded in the promise of new information and communications technologies; Radio Corporation of America (RCA) was the 1920s equivalent of America On Line (AOL). (Figure 1, which superimposes the price of AOL shares in the 1990s on the price of RCA shares in the 1920s, illustrates the parallel.) In addition, however, the enthusiasm of investors was importantly fueled by financial innovation and ample supplies of credit. The 1920s saw the spread from Britain to America of the investment trust, an entity that had existed in England for half a century, but now in a variant that allowed the manager of the trust to buy stocks on margin, raising the fund's leverage. This anticipates a theme we develop later in the paper – that the consequences of credit expansion and the extent of the boom thereby induced may depend on the structure and regulation of the financial sector. Individual investors were similarly permitted to purchase shares for 10 per cent down, borrowing from their brokers who in turn borrowed from the banks.¹⁸ Capital gains on the representative portfolio of nearly 30 per cent in calendar year 1927 and more than 30 per cent in calendar year 1928 encouraged the belief that stocks could only go up.¹⁹ Share prices and dividends had broadly moved in tandem through the first quarter of 1928. They diverged thereafter, in response it has been suggested to the Fed's cut in interest rates late in the preceding year.²⁰ (See Figure 2.)

¹⁸Eventually they also borrowed from corporations, as nonbank firms shifted funds into the money market in response to rising demand.

¹⁹Estimates of asset returns are from Smiley and Keehn (1988).

²⁰Santoni and Dwyer (1989) and Meltzer (2003) argue that this evidence is not necessarily consistent with the existence of a bubble. Meltzer, similarly, rejects the bubble interpretation on the grounds that the rise in equity valuations in the late 1920s was not out of proportion to the rise of earnings. From the present point of view, the issue is not simply whether earnings rose as rapidly as equity prices in these years but also whether the magnitude of capital gains created expectations of further capital gains which were less obviously justifiable by fundamentals.

There are any number of explanations for what happened next, from investment guru Roger Babson's warning at the National Business Conference that "sooner or later a crash is coming," to the credit squeeze, to the business deceleration, to protectionist rumblings in the Congress. Whatever the cause, the Great Crash bequeathed a legacy of problems for banks, corporations, and households, which had assumed heavy debt loads and packed their portfolios full of speculative and now poorly performing assets. Some policy makers concluded from this experience that central banks should take it upon themselves to deter excessive speculation.²¹

This paper takes these old literatures and gives them a modern cast. It asks how well modern models and measures of the credit boom phenomenon can explain the uneven expansion of the 1920s and the slump of the 1930s. In Sections 2 and 3 we consider quantitative indicators of the development of the credit boom for sixteen countries and ask whether the height of the boom was positively associated with the depth of the subsequent slump. In Section 4 we complement this macroeconomic analysis with three sectoral studies that shed further light on the explanatory power of the credit boom interpretation: the property market and construction industry (where recent experience suggests that credit-boom dynamics should have been particularly apparent), mass-production consumer goods industries (where the role of financial innovation was particularly important), and high-tech industries (where authors like Perez 2002 suggest that the role of the credit boom should have been especially evident). Obviously, the parallels with the 1990s are never far from our minds. Finally, in Section 5 we examine the

²¹Others argued that the authorities should resist the temptation to stabilize commodity prices (which were now falling rapidly, doing considerable damage to the economy), much less asset prices, for fear that this would only encourage the development of another, even larger bubble that would be followed by a still more devastating crash. Thus, Robbins (1934) drew this conclusion, in advice he later came to regret.

hypothesis, echoing Mises and Hayek and advanced recently by *The Economist* (2002), that credit booms have become more of a problem as the world has moved from the fixed rates of the gold standard to more discretionary and elastic monetary regimes. Section 6 summarizes our findings and their implications for modern debates.

To anticipate, we find that the credit boom view provides a useful perspective on both the boom of the 1920s and the subsequent slump. In particular, it directs the investigator's attention to the role played by the structure of the financial sector and the interaction of finance and innovation. We will argue that adequately understanding this cyclical episode requires attending to the roles of financial structure and the finance-innovation nexus. We would be prepared to make the same argument about the macroeconomic cycle of the 1990s.

2. The 1920s as a Credit Boom

As explained in the preceding section, the literature on credit booms is concerned with both the growth of credit and its effects. A significant expansion of the supply of credit is not sufficient by itself to constitute a boom of the sort that was of concern to the Austrians or which today attracts the attention of economists like Borio and Lowe (2002). What is critical is that the growth of credit should be associated with a rise in asset prices and an acceleration in rates of fixed investment relative to trend. In the view of these authors, it is this confluence of factors that might be said to comprise the distinction between credit boom and credit growth. Whether credit booms and credit growth have significantly different implications for the subsequent development of the economy is of course what determines whether this distinction has

substance.²²

A particular difficulty for attempts to analyze credit booms in this period is that we have only limited historical information on credit itself. Goldsmith (1985) provides estimates of total private credit (the sum of loans by financial institutions, consumer credit, mortgages, corporate stocks and bonds, trade credit and other private credit) for two benchmark years: 1913 and 1929, for nine countries. We exclude claims against financial institutions (including currency and deposits) and government debt, on which Goldsmith also includes data, from our aggregates, which are shown in Table 1. These suggest very significant increases in credit supply, so measured, over World War I and the 1920s in the United States, the United Kingdom, Japan, and Norway. Comparable increases are not evident in Belgium, Denmark, France, Germany, or Switzerland. That Germany is an outlier, with a sharp reduction in the stock of outstanding credit over this period, is not surprising, given the massive destruction of credit wrought by the 1923 hyperinflation.

An alternative is to analyze information on money rather than credit. This variable has the advantage of being available for a larger sample of countries and a continuous period of years. In what follows we use data on this measure of credit for a standard sample of 16 countries at an annual periodicity starting in 1920.²³

As emphasized by Brunner and Meltzer (1976), money and credit are not the same. *Bank*

²²And which presumably determines whether central banks should respond preemptively to the development of credit booms independent of their implications for inflation.

²³The countries are, in alphabetical order: Argentina, Australia, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, Norway, Spain, Sweden, the UK and the U.S.

money is not the only source of credit to households and firms; firms, for example, can also obtain credit through securities markets. This is only one of several reasons why the two variables are not the same, albeit perhaps the most important one. Fortunately, our period is one when banks were more important, relatively speaking, as a source of credit -- securities markets in most countries not having gained the depth and liquidity they were to acquire subsequently. Thus, it may do relatively little violence to reality to use M2 (scaled by nominal GDP) as our measure of credit. For the nine countries on which we have data on the growth of both money and credit over the period 1913-1929, the M2/GDP and Credit/GDP ratios have a correlation of 0.70.

M2/GDP also has a variety of other labels: it is Cambridge k and the inverse of the velocity of circulation. This observation has the merit of reminding us that the behavior of credit alone (whether measured imperfectly, as here, or in more sophisticated fashion, as by Goldsmith himself) cannot convincingly distinguish between credit-boom and monetary explanations for cyclical fluctuations. The literature on velocity (e.g. Bordo and Jonung 1987) has shown that this variable can trend downward (as it did in many countries before World War II) or upward (as it did subsequently). Distinguishing a credit boom cum monetary expansion from secular movements in velocity thus requires detrending the latter. We therefore fit a linear trend on data through 1930 and focus on the residuals. As in Borio and Lowe, this allows us to analyze cumulative processes – that is, the cumulative deviation of credit from its baseline or trend level – as opposed to credit conditions in a particular year, which would be the focus if we simply

considered its rate of growth in that year.²⁴

The close parallels between arguments focusing on money and credit also direct our attention to the problem of endogeneity. In what follows, we address it by lagging our credit indicators when considering their association with subsequent business cycle movements. While this procedure is subject to Tobin's *post hoc, ergo propter hoc* critique, we are not convinced that his critique is compelling in our context. In particular, we know of little evidence that contemporaries expected the severe downturn that we now refer to as the Great Depression in advance of the event (a few prescient Austrian-school forecasters to the contrary notwithstanding).²⁵ For those not convinced that timing provides identification, in Section 4 we also relate the development of credit conditions to deeper institutional and structural features of the economy (the monetary regime, the sectoral composition of activity, the structure of the financial sector) that are clearly predetermined with respect to the credit-market developments of the 1920s.

Figure 3 shows the individual country experiences. A contrast with the 1990s is the downward trend of the M2/GNP ratio in the 1920s in half the countries, consistent with Bordo and Jonung (1987). This trend may also be indicative of the intensifying deflationary pressure exerted by the interwar gold standard, which constrained the growth of money and credit as economies recovered from the World War I and expanded through the second half of the 1920s. In a number of countries, M2/GNP ratios then rise relative to this earlier trend in the 1930s as

²⁴We experimented with different filters and with filtering the data only through 1929 without substantively changing the results.

²⁵See Dominguez, Fair and Shapiro (1987), Hamilton (1992) and Cecchetti (1992). We return to this point below.

interest rates decline and the velocity of circulation falls.²⁶

Exceptions to these generalizations include the United Kingdom, where there is a bulge in the M2/GNP ratio in 1921-24, when the Bank of England was seeking to push down prices to facilitate the restoration of the prewar parity but seems to have depressed nominal GNP more than the money supply. While the M2 ratio trends upward in the United States, this is to a large extent driven by the end points of the period over which the trend is estimated (1920-1 and 1929-30). That the ratio otherwise shows little trend one way or the other is consistent with the literature suggesting that the Fed sterilized the gold inflows it received in this period. Nor does velocity trend downward in Germany in the second half of the 1920s, presumably reflecting the slow return of confidence in financial assets following the end of the hyperinflation, a phenomenon that is also evident in France. Spain, for its part, is an outlier by virtue of not having been on the gold standard in the 1920s and 1930s; velocity and therefore M2/GNP consequently display entirely different time profiles.²⁷

Contemporaries focused on the impact of accommodating credit conditions on asset prices, and equity valuations in particular. These are shown in Figure 4, normalized by the overall level of prices, again relative to trend over the period through 1930. Equity valuations rise relative to trend virtually everywhere in the late 1920s and collapse in the 1930s. Although the U.S. boom is the best known, these data suggest that similar fluctuations occurred in a number of other countries. By design, these figures encourage one to underestimate this aspect

²⁶This tendency is documented by Bernanke (2000) and commented on further by Cole, Ohanian and Leung (2002).

²⁷The point is well known; it is at the center of Choudhri and Kochin (1980).

of the credit boom, since the trend in the 1920s, from which deviations are calculated, was strongly upward almost everywhere; in the United States, the classic case, the index of 421 common stocks rose from a base of 100 in 1926 to 130 by the end of 1927, 150 in 1928 and almost 230 at the peak in September 1929, a period when the general price level was stable, even falling.²⁸

Contemporaries also saw the credit boom as stimulating investment, both directly, by making external funding more freely available and reducing collateral constraints, and indirectly, by raising Tobin's q and the incentive to invest. Investment fluctuations are shown in Figure 5. Although those movements are dominated by the collapse in the 1930s, as a result of which fluctuations around trend in the second half of the 1920s hardly stand out, it is still evident that a number of countries experienced surges in investment in the 1920s. There are a few exceptions worth noting. For example, France experiences an investment boom in the late 1920s, which extends through 1930, reflecting its relatively late postwar stabilization in 1926, and the surge of investment initiated with the end of the post-stabilization recession in 1927 (sustained by the large amounts of financial capital that flowed back to the country as the strong franc came to be seen as a safe haven).²⁹

In order to more systematically draw out the connections between equity valuations and investment, Table 2 reports some simple investment equations, where the investment ratio is regressed on $\log q$ (equity prices deflated by wholesale prices, contemporaneous or lagged),

²⁸The U.S. CPI fell by a bit over three per cent cumulative over this period.

²⁹Patat and Lutfalla (1990) observe that M2 continued increasing through the summer of 1930, unusually for the period, as a result of these capital inflows. This sequence of events and their connection with investment are analyzed by Eichengreen and Wyplosz (1988).

lagged output growth (the accelerator term), and a lagged dependent variable (investment tending to be serially correlated because projects take time to complete and are less likely to be abandoned once underway).³⁰ A doubling of q like that which occurred between 1926 and 1929 in the United States results, according to these equations, in an 18 per cent increase in investment, and the collapse in share prices that occurred subsequently would have had an even larger negative effect.³¹

We can ask which of these dimensions of the credit boom phenomenon has the greatest explanatory power for the output collapse that followed. Figure 6 juxtaposes the deviation of each of these three variables relative to trend circa 1928 – which we take to be the peak of the boom – with the subsequent collapse in GDP from 1929 through 1932. (To be clear, it is the *fall* in output that is displayed on the vertical axis; the larger the fall, the greater the value.) Of these

³⁰The regression is run in double-log form.

³¹In addition the collapse of stock market valuations could have worsened the Depression by undermining bank balance sheets and leading to the bank failures that, observers widely agree, were a key engine of deflation in many countries (see e.g. Bernanke and James 1991). In fact, however, there is little correlation between q in 1928 and the incidence of banking crises thereafter. A probit regression of the Bordo-Eichengreen banking crisis dummy on the deviation of q from its 1920s trend, with and without a variety of controls, never yields a coefficient that differs from zero at standard confidence levels. On reflection this is not surprising. Consider, for example the contrast between the United States and Canada. Although both had exceptional stock market booms in the 1920s, one had a banking crisis while the other did not. Evidently, the absence of restrictions on branch banking in Canada and regulations limiting the ability of Canadian banks to lend against real estate dominated the impact of changing asset valuations on bank solvency and stability. Or contrast Britain and Argentina. Neither country experienced a pronounced credit boom or rapid stock market run-up in the 1920s, yet the latter had a serious banking crisis in the spring of 1931, while the former escaped the problem entirely. The reasons are not hard to see: Argentina's terms of trade deteriorated in the Depression, while Britain's improved, and Argentina had been on the receiving as opposed to the sending end of capital flows in the 1920s. The behavior of stock markets mattered for the subsequent evolution of output and employment, and for the banking systems whose stability was an important determinant of macroeconomic fluctuations, but they were not the only thing that mattered.

three variables, only equity prices are strongly related to subsequent output movements. This points up the difficulty of distinguishing the credit and stock-market boom interpretations of the slump.³²

3. A Composite Indicator

If we are prepared to be more courageous, we can combine these three dimensions of the credit boom phenomenon into a composite indicator similar to that utilized by Borio and Lowe (2002). The simplest approach is to weight the three components equally.³³ The result is shown in Figure 7, with the composite indicator averaged across countries. The idea is to capture not just the availability of credit to the private sector but also its transmission to asset prices and economic activity. The motivation is that the same increase in domestic credit may have different effects depending on the structure of the economy that amplifies or muffles its impact.

³²While the stock market boom as a factor in the depression is a staple of history textbooks, it has not been much emphasized in the scholarly literature. In part, scholarly skepticism reflects problems with the thesis in the case of the United States, the country where the rise in stock prices was evidently most pronounced. The economic downturn in the U.S. preceded the stock market crash; while the business cycle peak was reached in August 1929, the Wall Street crash is conventionally dated as occurring in October. (The market reached its peak on September 3rd, 1929, but the big price drops associated in the popular mind with the Great Crash were Black Thursday, October 24, and Black Tuesday, October 29, well after industrial production peaked.) Moreover, the Great Depression in the United States was clearly compounded by the blunders of U.S. policy makers starting in 1930 – Hoover’s tax increases and the failure of the Federal Reserve to stem the banking panics that ultimately forced a substantial fraction of all American banks to close their doors – as much as to any adverse consequences flowing from the run-up of the stock market. We will have more to say about this below.

³³This is not exactly the procedure utilized by Borio and Lowe, who search for the best combination of weights that minimize the signal-to-noise ratio of subsequent banking crises correctly and incorrectly predicted. Below we experiment with some sensitivity analysis along these lines.

Such a composite indicator thus seeks to capture both the impulse and its amplification by measuring not only the growth of credit but also its impact on asset prices and aggregate demand. Whether the composite indicator has more explanatory power than simpler, more familiar alternatives is an empirical question. To be clear, we are not necessarily advocating the utility of this measure, but we are interested in exploring its explanatory power and implications.

Figure 7 highlights the credit boom of the immediate post-World War I period, when interest rates were pegged at low levels but domestic demand was freed of wartime controls, allowing the volume of credit to be essentially demand determined and setting off a wave of merger-and-acquisitions activity and a surge of plant and equipment investment. This boom was then reined in by interest rate hikes starting in 1920 (see Lewis 1949). Lax credit conditions reemerged in the second half of the 1920s (as emphasized by Kindleberger 1973), peaking in 1928. Interestingly, the late-1920s boom does not appear particularly pronounced relative to that at the beginning of the decade. The credit boom then gives way to a credit bust, which bottoms out in 1932.

Figure 8 shows the composite indicator by country. Consistent with the interpretation of the immediate postwar credit boom in terms of the difficulty of curtailing wartime budget deficits and decontrolling interest rates, there is less evidence of the immediate postwar credit boom outside the main theaters of the war.³⁴ Turning to the second half of the 1920s, we see evidence of France's credit-induced recession in 1926, the year of the Poincaré stabilization. We observe the relatively early end of the credit boom in Germany, reflecting the Reichsbank's effort to discourage foreign borrowing in 1926 (by, among other things, allowing the Reichsmark to

³⁴In Argentina and Australia, for example.

fluctuate more freely within the gold points, thereby introducing a foreign-investment-repelling element of exchange risk into the market) and then to put a damper on stock market speculation in the first half of 1927 (McNeill 1986, Voth 2002).³⁵ Evidently, the pegged exchange rates of the interwar gold standard, while transmitting credit conditions across countries, also left room for distinctive national experiences.³⁶

Figure 9 shows that the height of the credit boom, measured by the percentage deviation of the composite indicator from trend in 1928, varied across countries, and that its height at that date significantly predicts the severity of the subsequent downturn, here measured through 1932. We see, *qua* Robbins (1934), that the credit boom of the late 1920s was led by the North Americans – consistent with the U.S.-centered nature of the dominant interpretation of the financial boom and bust – with France and Italy not far behind. The Fed cut interest rates in 1927, partly in response to the motor-vehicle induced slowdown in the U.S. economy, as Henry Ford shut down his assembly lines to retool for the Model A (Kindleberger 1973), partly to address the problems of Western farmers suffering the effects of chronically depressed agricultural prices (Noyes 1938), and partly to relieve the pressure on sterling and other weak

³⁵Robbins (1934, pp.49-50) argues that the German credit boom persisted into 1928, as capital flows from the United States “overbore” the Reichsbank’s efforts to institute tighter conditions. Our composite indicators suggest that the boom ended earlier in Germany than the U.S., although one can quibble about the dating.

³⁶Schacht’s emphasis on the need to introduce an element of exchange risk into the market in order to discourage what we would now refer to as the carry trade suggests that the pegged exchange rates of the interwar gold standard were a factor in the development of the credit boom. It will remind readers of contemporary arguments (*viz.* Goldstein 1998) that pegged rates can be an important source of investor moral hazard. We pursue these ideas in Section 5 below.

European currencies (Clarke 1967).³⁷

A more limited credit boom is also said to have developed in the United States in 1925 (Kindleberger 1973), although this is hardly evident in our calculations (see Figure 8). The emphasis placed by these earlier authors on credit conditions in this period derives from the upsurge in residential construction (mainly in Florida, but to a more limited extent in other parts of the country).³⁸ This earlier credit boom may have similarly had roots in interest rate cuts taken by the Fed in 1924-5 to help Britain back onto the gold standard.³⁹ Whatever the motivations for the policy, there is little reason to doubt that monetary ease lay behind the property boom. In the words Vanderblue (1927a, p.116), “[t]he relatively low yield on high-grade investments made it possible to tempt investors into purchasing real estate bonds...secured by new structures located in the boom territory.”

But the 1925 boom was relatively minor and short-lived compared to what came after;

³⁷Other authors thus offer a more eclectic interpretation of the Fed’s motives than Robbins (1934), who focuses on the weakness of the British balance of payments and the Fed’s concern for the stability of the interwar gold standard. Note that the NBER placed the business cycle peak in October 1926, and industrial production hit its low in the final quarter of the subsequent year. The Fed’s interest rate cut was in the summer of 1927.

³⁸The Florida land boom is a story in itself (we will have more to say about it below). Among other things it featured the involvement of no less than Charles Ponzi. Ponzi issued certificates of indebtedness promising a 200 per cent dividend in two months’ time. He used the capital thereby raised to purchase land for subdivision, planning 23 lots to the acre. Ponzi’s advertising described the land in question as being “near Jacksonville,” where in fact it was 65 miles west of the city and covered with a thick growth of palmetto and other weeds. When he was unable to quickly sell the lots, Ponzi predictably found himself unable to meet his financial obligations, and was subsequently indicted for violating Florida statutes regarding trusts and found guilty by jury. For details, see Vanderblue (1927a,b).

³⁹Of course, other factors also contributed to the bias toward monetary ease, including the fact that the economy experienced a slowdown in 1923-4 and that the latter was an election year. On international motivations for 1924-5 interest rate policies, see Wicker (1966), Chapter 7.

this comes out clearly from our Figure 8, if not from narrative accounts of the period. By 1927 investment in real structures had declined by six per cent from its 1925 peak. This, clearly, poses difficulties for the credit-boom interpretation of the post-1928 slump. Even if credit fueled the residential real estate boom in the United States, the timing of the latter is wrong for explaining the onset of the Great Depression, unless one is prepared to argue that the fall in investment in structures worked through to the rest of the economy with an unusually long lag.⁴⁰

As investment in structures declined, the Fed cut rates. U.S. bank reserves grew faster in the second half of 1927 than in any other semester of the 1920s.⁴¹ This supports the notion that the ready availability of credit to the American economy was a factor shaping the expansion of the later 1920s. Moreover, that expansion was heavily driven by spending on consumer durables purchased on the installment plan (Olney 1990), using credit provided mainly by nonbank lenders (finance companies, which had developed previously to finance purchases of income-earning durable goods like sewing machines and pianos but acquired new importance on the American scene when in the 1920s the major automobile producers established divisions and subsidiaries designed to finance purchases of their own durable goods), and by speculative purchases of financial assets, purchased using bank credit funneled to investors through their brokers (White 1990b).⁴² The consequences showed up not just in the stock market, but in the burgeoning automobile industry, the leading sector of the 1920s, and in the commercial property

⁴⁰This was of course Temin's (1976) objection to the older literature associated with authors like Robert A. Gordon emphasizing the rise and fall of fixed investment as a prime mover in the Depression.

⁴¹Rothbard (1975), Table 8.

⁴²We elaborate the role of these factors in the sectoral studies of Section 5, below.

market, which boomed in virtually every American city. It is no coincidence, for example, that the late 1920s was the occasion for the appearance of the modern high-rise, when the skylines of many American cities were defined. While the Florida real estate boom attracted more attention, given the sensational nature of some of the frauds and the colorful character of the individuals involved, the urban building boom that followed later in the decade is temporally more consistent with the evolution of the composite indicator.⁴³

In France, another country where there is evidence of a credit boom, capital inflows lubricated the operation of French capital markets starting in 1927, as the flight capital of the prior period was repatriated following the Poincaré stabilization. In the second half of 1926, this capital influx drove up the value of the franc. By the end of the year, the Bank of France and the politicians grew worried that further real appreciation would create hardships for French industry, and they pegged the currency (a policy given legal status in 1928 when gold convertibility was officially reestablished at the new, lower value of the franc). Nominal interest rates came down, and with the price level now stable (tied as it was to prices in the rest of the world), lower yields encouraged a movement into riskier investments (Eichengreen and Wyplosz 1988). Thus, one of the mechanisms that might have damped the subsequent investment boom, namely a real

⁴³From 1920 to 1929, real private nonresidential construction spending in the United States rose by a cumulative 56 per cent. The peak years were 1926-29: annual nonresidential real estate spending exceeded \$5 billion in each of these years (up from \$3 billion in the immediately preceding period); construction activity was most intense in the central business districts of cities like New York, Boston and Detroit. The value of commercial contracts awarded peaked in 1927-28, coincident with the peak in the composite credit boom indicator. Given the need for time to build, the process exhibited persistent: large commercial real estate projects like the Empire State Building were only finalized in 1929. (The Empire State Building actually broke ground only in March 1930; by 1931 it was being referred to as the “Empty State Building.”) See Hoyt (1933) and Wendt (1953).

appreciation, was effectively disabled.

Less has been written about the credit boom in Italy.⁴⁴ Prior to the reintroduction of the gold standard at the end of 1927, the big universal banks could already count on discount window access at the Bank of Italy. Thereafter, capital inflows resulting from the placement of a succession of foreign loans underwrote the continued expansion of credit. In addition, the central bank continued to follow an accommodating policy in view of its concerns with the financial condition of the three largest banks, something it could afford to do to the extent that it possessed reserves in excess of those required to back currency in circulation (Fратиanni and Spinelli 1997, p.151).

The credit boom was less pronounced – though echoes were still audible – in Argentina, Australia, Belgium, Canada, Germany, and Norway.⁴⁵ It was all but absent in the United Kingdom, where starting in 1927 the Bank of England was forced to maintain restrictive credit conditions to support an increasingly overvalued currency, and in Denmark, another country that brought its currency back to par, which traded heavily with Britain, and which was tightly integrated into the London market.⁴⁶

Boom turned to bust in 1929. The Fed, concerned that the high level of the stock market was diverting resources from more productive uses and heightening financial fragility, began

⁴⁴The classic reference is Toniolo (1980).

⁴⁵We will have more to say about some of these countries, Australia in particular, below.

⁴⁶See Johansen (1987). Denmark is not conventionally regarded as a country with chronic financial problems in the second half of the 1920s, although the analysis here suggests that it may have had more in common with Britain than commonly believed. Consistent with this interpretation, Denmark was quick to follow the UK off the gold standard in 1931 and then joined the sterling area.

raising its discount rate in 1928; higher U.S. rates in turn curtailed capital flows to Europe and Latin America, forcing central banks there to tighten to prevent their currencies from weakening.⁴⁷

Overall, this analysis points to the existence of a short but sharp credit boom in the second half of the 1920s, peaking in 1928 and most prominent in the United States. Countries with close economic ties to the U.S., such as Canada, had the greatest tendency to share in these conditions (Green and Sparks 1988). In contrast, countries with chronic exchange rate problems, notably Britain, did not share the same conditions because they did not share the same policies, their central banks being forced to put a damper on money and credit growth in order to defend weak currencies. A few countries where economic conditions were special – France because of the relatively late date of its postwar stabilization, Spain by virtue of never joining the interwar gold standard – display different time profiles, which is itself evidence of the tendency for an international financial system organized around the pegged exchange rates of the gold exchange standard to transmit these lax credit conditions to the rest of the world.

Figure 9 also shows the bivariate regression line summarizing the relationship between the height of the credit boom circa 1928 and the magnitude of the subsequent output collapse, accompanied by regression coefficients and t-statistics. The relationship is significantly positive. It retains its significance when we control for other national characteristics that also shape countries' susceptibility of recessionary forces – for example, their openness, their trade

⁴⁷The large flow of capital and gold to France in this period affected the rest of the world in the same manner, as observed in histories of the period (e.g. Johnson 1998).

in the 1920s and not going back onto the gold standard until 1930, it did not have far to fall when the Depression struck. Italy is also below the line. The Bank of Italy extended large amounts of secret last-resort lending to the three large ailing universal banks under cover of disguised exchange controls, supporting both the financial system and the economy.

These observations – and specifically the low value of the R-squared – give us an opportunity to clarify what we are and are not prepared to claim for this analysis.⁵⁰ We do not wish to be misunderstood as arguing that the height scaled by the credit boom circa 1928 provides a complete explanation for the Great Depression, or that it provides a superior explanation to popular alternatives like post-1929 policy mistakes or the constraints of the international monetary system. Readers familiar with our own previous work on the role of the gold standard and bank failures (respectively) in propagating the Depression will have anticipated this point. Here the point is evident in the fact that the credit boom indicator explains less than a third of the cross-country variation in the post-1929 slump in economic activity. In

principal export market, the U.S., was delayed until 1933.

⁵⁰Note also that the R-squared of the regression (of the fall in output between 1929 and either 1931 or 1932 on the one hand and the deviation from trend of the boom indicator in 1928) is higher when we use the deviation of share prices from trend than when we use the composite. One way of understanding this is that the impact of the stock market was felt partly insofar as its also affected the other components of the composite indicator. Although these linkages existed, they worked in opposite directions and were subject to variable lags. Table 2 above documented the positive association of equity valuations with investment. At the same time, however, the fluctuation of share prices affected the excess supply of money and credit in the other direction. The deviation of the domestic credit/GDP ratio from trend is designed to capture the availability of credit for speculative uses. A higher level of q which stimulated investment would have also raised the denominator of this ratio, other things equal. With the other two components of the composite indicator moving in opposite directions in response to the rise of share prices, but subject to complex and variable lags, it is not entirely surprising that these other two components added more noise than information content useful for forecasting output.

addition, there is the fact, already emphasized, that the components of the composite indicator are not really distinguishable from proxies that might be used to test the effects of alternatives like the monetary, stock market bubble, and over-investment interpretations of the slump.

Thus, if we are going to convince the reader that the credit boom interpretation is a useful supplement to these better known interpretations of the onset of the Great Depression, this simple quantitative analysis will need to be supplemented with qualitative evidence pointing in the same direction. We turn to this qualitative evidence in the next section.

We conducted a variety of sensitivity analyses to give these measures a run for their money. For example, we considered only the fall in output through 1930 or 1931. Shortening the period over which the dependent variable is measured from 1929-32 to 1929-31 has essentially no effect; the t-statistic on the composite indicator changes from 2.36 to 2.49, and the R-squared of the regression is now 0.31 instead of 0.28. When we shorten the period covered by the dependent variable to 1929-30, however, the t-statistic on the composite indicator drops to 1.64 (just on the margin of significance at the 90 per cent level of confidence), and the R-squared falls to 0.16. There is a sense in which supporters of the credit-boom interpretation can take heart even from this negative result. Those who would emphasize the preeminence of policy mistakes (failure to act as a lender of last resort resulting in widespread bank failures, for example) would presumably argue that even if the credit boom indicator had explanatory power for the initial phase of the downturn, it can explain little of the subsequent cross-country variation in its depth and duration, which is primarily attributable to these other factors. In fact, we do not find that the shorter the period, the greater the explanatory power of the credit-boom thesis; the actual story is more complex.

We also experimented with a variety of alternative weighting schemes for the components of the composite indicator. One possibility is to weight the three ratios by their respective signal-to-noise ratios – that is, by the ratio of the share of subsequent crises successfully predicted by data through 1928 to the share of false positives, where the signaling threshold is set to maximize this ratio.⁵¹ We are suspicious of this procedure insofar as it uses information on post-1928 developments (on whether a country had a banking or currency crisis), which are plausibly correlated with the magnitude of the fall in output to derive the weights used to construct the composite used for forecasting the fall in output. For what it is worth, this variant of the composite actually performs less well; the t-statistics on the composite and the R-squared of the regression are lower than when we use unweighted averages of the three components, regardless of the period covered by the dependent variable.

We then looked to see whether there was any evidence of nonlinear effects of the credit boom indicators. Borio and Lowe (2002) suggest that credit booms are likely to have larger effects when the various indicators exceed typical levels by a relatively large margin (a “critical threshold”), and when several components exceed those typical levels simultaneously (when a high level of the composite indicator reflects substantial contributions from several components and not just one). A first test simply added squared values of the composite indicator as a second

⁵¹Borio and Lowe (2002) do something along these lines. When this is done separately for currency and banking crises, it yields slightly different composite indicators for the two cases, although the prevalence of twin crises in the 1930s dictates that the differences in the two variants are small. In practice, this means picking weights of 0.26, 0.40 and 0.34 on the M2/GDP, investment/GDP and equity price/CPI ratios for currency crises, and of 0.38, 0.32, and 0.30, respectively, for banking crises. Banking and currency crisis dates are taken from Bordo, Eichengreen, Klingebiel and Martinez-Peria (2001). Conveniently, this is the same source as used by Borio and Lowe for the recent period.

independent variable; these never entered with coefficients significantly different from zero or significantly enhanced the overall explanatory power of the regressions. We obtained more interesting results when we added to the regression equation displayed in Figure 9 interaction terms involving the individual components, setting the value of those components to zero when they were below trend. Thus, the interaction terms capture additional effects in above-trend “credit boom periods” only. When we added two-way interactions of credit with equity prices and credit with fixed investment, the coefficient on the composite remained essentially unchanged (the slope coefficient fell slightly to 1.13, and the t-statistic fell marginally to 2.33). In addition, the two-way interaction of credit and the stock market entered with a coefficient that was significantly greater than zero at the 95 per cent confidence level, while the coefficient on the two-way interaction of credit and investment entered with a coefficient that was significantly less than zero at the 95 per cent level. This suggests that the credit expansion in the 1920s had the largest impact on the slump of the 1930s in countries where it was mainly associated with a stock market boom, while it had the smallest adverse effect where it was mainly associated with fixed investment. Neither of these additional interaction effects was large enough to reverse the dominance of the composite indicator in any of our sample countries. But the additional effects do suggest that whether the credit expansion of the later ‘twenties was mainly associated with an equity run-up or a fixed-investment surge did significantly shape its implications for the severity of the subsequent downturn.

We then added the two other two interaction terms (the two way interaction of the stock market and investment, and the interaction of all three components of the composite index), but neither of the additional coefficients differed significantly from zero. The other effects were

essentially changed.⁵²

Some readers will worry about the combination of more and less developed countries in our sample and question whether the experience of the less developed countries speaks to the issues at hand. Eyeballing Figure 9 is sufficient to confirm that leaving out Argentina and the low-income European countries (Spain, Italy) does not weaken the relationship between the height of the credit boom circa 1928 and the magnitude of the output fall thereafter; if anything the opposite is true. If we use weighted least squares (weighting the observations by per capita income), to more systematically reduce the weight on low income countries, the results are in fact strengthened; the fit of the equation is significantly improved. The same conclusion follows if we instead leave out the non-European and North American countries (Australia and Japan).

4. Sectoral Evidence

Another way of adding substance to the credit boom interpretation is by looking more closely at the behavior of credit-sensitive sectors.

A. The Construction Sector

As Figures 10 and 11 show, investment in structures, especially private residential fixed investment, rose in the 1920s, not just in the United States but also in Canada, Finland, Sweden, the Netherlands, and the UK. While indoor plumbing, electrification, and the diffusion of the automobile all fueled the demand for new housing, the most important factor in the housing

⁵²The significance levels declined, which is understandable given very limited degrees of freedom. The composite indicator was now significant at the 90 per cent confidence level, while the two-way interaction of credit and the stock market was significant at the 95 per cent level, and the two-way interaction of credit and investment just missed significance at the 90 per cent level.

boom was the end of World War I. The war destroyed thousands of structures and affected demographic conditions in ways that stoked the demand for housing (it led to unusually high family formation in the 1920s, for example). In turn, the cessation of the war stabilized the investment environment (or at least set the stage for doing so).

But there were significant differences across countries in the size and timing of their construction booms that cannot be explained by simply the cessation of hostilities or the damage caused by the war. Australia, Canada, and the United States all experienced residential housing booms of varying degrees of intensity but had suffered no direct damage from the war. This points to the importance of credit market developments and in turn to differences in the structure and operation of the financial sector. Countries differed in terms of the institutions that were primarily used to finance mortgages (savings and loan associations and building societies in the U.S. and UK; savings banks in Australia; private mortgage banks in Belgium, the Netherlands, and Canada; the Credit Foncier in France; and cooperative mortgage societies in Scandinavia). They also differed in the development of secondary markets, as shown in Table 3. One conjecture based on Table 3 is that banks more aggressively financed investment in residential housing in countries where the financial system was more intensely competitive. In the U.S., where banks and Savings & Loans were already failing at significant rates in the 1920s, financial institutions competed aggressively for high-yielding construction loans. In Australia, in contrast, where there had been prior consolidation of the financial industry, there was less of a tendency for banks to gamble for survival, and the magnitude of the construction boom was less. Indeed, Merrett (1991) criticizes the banks for the conservatism of their investment behavior in the 1920s.

These differences in behavior in the upswing had important implications for the subsequent depression. The slump was severe in Australia and Canada, but in neither case was it compounded by a U.S. style banking crisis. The relative health of the Australian banking system enabled it to escape the 1930s with only three bank suspensions despite a sharp decline in output. And, in Canada, the country's 11 commercial banks remained in operation throughout the period. This greater resilience of the banking sector in the slump is partly a reflection of more conservative behavior during the upswing.⁵³

In addition, there may have been a role for accumulated experience in these differences. As noted above, Australia had experienced an earlier housing boom in the 1880s, fueled by rapid increases in mortgage lending by savings banks. Bank credit as a share of GDP doubled between 1880 and 1890. The majority of the increase went into residential construction, the 1880s being a period of rapid urbanization and population growth. In the early 1890s, when this boom turned to bust, 13 of the country's 23 banks failed or were forced to suspend operations. The U.S. also had credit booms in the 19th century, but none as dramatic as this earlier Australian episode. None of these 19th century cycles had resulted in the failure of more than half of the country's financial institutions.

This earlier experience is said to have rendered Australian savings banks more cautious during the next credit boom, that of the 1920s. As Schedvin (1970, p.80) puts it, "Even after nearly 40 years the effect of the events of '93 coloured in no small way the banks' reaction to the depression." In contrast to the 1890s, even as credit expanded rapidly at the end of the 1920s

⁵³And partly of different macroeconomic policies after 1929, Australia being early to abandon the gold standard, the U.S. being relatively late.

(Figure 10), savings banks raised their capital ratios, limited their exposure to property, kept the maturity of loans relatively short, and held a relatively high share of government securities (Kent and D'Arcy, 2002). Meanwhile, in the U.S., S&Ls and other intermediaries fueled an orgy of construction that left the landscape littered with vacant apartment buildings, and with subdivisions that were prematurely divided and remained undeveloped for years (Field 1992). Mortgage debt more than tripled from \$8 billion in 1919 to \$27 billion in 1929. Realtors and developers often sat on the boards of S&Ls, influencing the operation and real estate lending of these intermediaries. This conflict of interest may have led lenders to make loans of lower quality and higher risk. Moreover, new and complementary sources of credit further fueled the boom. In 1913, regulators removed restrictions on national banks which had previously prevented the latter from holding real estate mortgages. And the growth of auto ownership (made easier in part through installment plans offered by auto finance companies, described below) accelerated the pace and extent of land subdivision and encouraged speculation on city edges and recently converted farmland.

To be sure, credit was not the only conditioning factor. Governments also put in place (positive and negative) incentives for residential housing construction by the private sector. Most European countries imposed price caps on rental housing at the beginning of the war and kept them in place for some years following the conclusion of hostilities. The speed with which those controls were removed thus played a role in shaping the construction boom. In countries where the removal of rent control was delayed, the incentive for the private sector to undertake new construction projects was correspondingly less. Countries such as Belgium, Denmark, Norway, and France that were slow to remove rent restrictions in the 1920s or only did so

partially (Table 3) experienced delayed growth or only modest growth in residential housing. In contrast, Finland, Sweden, and the Netherlands abolished rent control altogether in the 1920s, the UK began to phase out its laws in 1923, and Canada and the United States never adopted comprehensive rent control at the national level. In these countries, prices were freer to respond to the increase in demand for housing. The construction industry in turn responded to the market signals, undertaking building activity that was fueled by ample credit from building societies, mortgage banks, and insurance companies.

In addition, in many countries construction costs had risen faster than rents both during and after the war, stifling the incentives for new housing projects. Even after the initial postwar deflation, wage rates in the British building trades (circa 1923) remained 90 per cent above 1914 levels for craftsmen and fully 115 per cent for unskilled workers. Given the lag between price and wage adjustment in the 1920s, how and when countries stabilized their currencies appears to have mattered for the course of their subsequent housing booms. In particular, countries that deflated in the effort to restore prewar parities often saddled construction with higher labor costs that damped the response of the industry.

These considerations go some way toward explaining the precocious timing of the U.S. construction boom. The country had no wartime depreciation to be reversed and no postwar depreciation to be halted; continual maintenance of the gold standard encouraged long-term financial commitments. It largely completed the necessary deflation in the initial postwar years, avoiding extended disjunctures between prices and labor costs. Its competitive banking system provided ample financing to the construction sector. While the story of the 1925 Florida land boom would not be complete without references to the actions of Charles Ponzi et al, the broader

monetary and financial conditions that are the focus here seem to take us a considerable way toward explaining the timing.

B. Consumer Durables

Consumer durables further illustrate how the structure of the financial sector shaped the credit boom of the 1920s. As in the 1990s, the rise in expenditure was not limited to investment; the period also featured rapid increases in consumer spending. To be sure, rising household incomes supported the growth of consumption, but financial institutions aggressively competing to supply households with credit allowed consumer spending to rise even faster than personal income. The most prominent case is the United States, where consumer debt as a percentage of personal income doubled from 4 ½ per cent in 1918-20 to more than 9 per cent in 1929 (Olney 1991). Not surprisingly, analysts of the U.S. economy have placed considerable weight on the deterioration of household balance sheets a factor as depressing consumer spending in the subsequent slump (Mishkin 1978).

Unfortunately, systematic information on consumer debt and installment credit in this period is not available for countries other than the United States. That such information was only gathered in the U.S. is consistent with the view that consumer credit was most prevalent there. The only other country that appears to have come close is Canada, where proximity to the U.S. market heightened the power of example and made it relatively easy for U.S. financial firms to set up operations north of the border. By 1928 there were as many as 1,300 finance companies operating in Canada (which is only slightly smaller than the comparable number for the United States – see below).

Scattered evidence suggests that the rate of growth of the number of installment contracts

in the 1920s was also rapid in a number of our other sample countries. But in other countries the process started from a lower base. Hence, consumer credit and household debt played a less important role in the macroeconomic upswing and eventual collapse in these other countries.⁵⁴ Recall that the credit boom as measured in Section 2 above was most pronounced in the U.S. and Canada. That financial institutions providing consumer credit had penetrated these economies extensively suggests that they played a role in amplifying the credit boom in both North American countries.

None of these practices was entirely new. In both the United States and Britain they were already widely commented upon in the first half of the 19th century.⁵⁵ Singer had sold sewing machines on credit in both the U.S. and Britain from the 1850s. Pianos, household furniture and even books were financed using installment credit in subsequent decades.

But it was the advent of assembly-line methods for the production of automobiles and the development a mass market in motor vehicles that resulted in the rapid growth of installment credit. The General Motors Corporation established the General Motors Acceptance Corporation (GMAC) in 1919 to finance sales of its cars. GMAC having demonstrated the advantages of this mechanism, other producers followed suit, along with a large number of independent (non-producer affiliated) finance companies. By 1925 there were more than 1,500 finance companies

⁵⁴This observation is not original with us. Crick (1929, p.103) argues that installment credit did more to amplify the business cycle upswing in the U.S. because it started from a higher base and its use was more evenly spread over the population. In the UK, in contrast, “the net result is a comparatively small expansion in the total volume of installment buying on the upward phase of the business cycle.”

⁵⁵The first instance of an installment credit plan in the United States of which we are aware was that introduced in 1807 by Cowperthwaite & Sons of New York, a furniture store. Scott (2003) argues that the phenomenon emerged in Britain in the second quarter of the century.

operating in the United States.⁵⁶ By 1927 nearly two-thirds of new cars in the U.S. were purchased on installment terms.⁵⁷ Olney (1991) shows that installment credit was of comparable importance for purchases of a variety of household appliances.

While the growth of installment purchase was global, commentators were unanimous in arguing that the phenomenon was most advanced in the United States. An indication of this fact is the role of U.S. financial institutions in the development of analogous mechanisms in other countries. Almost immediately following its establishment, GMAC branched into Canada, where General Motors and other U.S. producers dominated the motor vehicle market.⁵⁸ GMAC was active in the UK in the 1920s, prompting the development of indigenous competitors such as the United Motor Finance Corporation Ltd.⁵⁹ GMAC similarly established branches in Antwerp, Berlin, and Copenhagen (Crick, 1929, p.22). Inspired by this example, the Italian Automobile Club attempted to establish a finance company to promote sales of cars.

Other American companies also participated in the development abroad of institutions of

⁵⁶The National Association of Finance Companies was then formed with the object of standardizing the installment business. The NAFC laid down rules for, inter alia, deposits and maturities, and in 1925 the American Rediscount Corporation was established to act as a kind of proprietary reserve bank for finance companies. The history of the ARC is yet to be written.

⁵⁷Bowden and Turner (1993), p.252.

⁵⁸The first Canadian sales finance company, the Continental Guaranty Corporation Canada, was formed in 1916, coincident with the growth of motor vehicle purchases (Neufeld 1972). A specialized company, the Fidelity Contract Corporation, had been established in 1904 to discount piano paper, and it had been joined by several competitors by 1916.

⁵⁹UMFC went public in 1928. In the UK the practice was known as hire purchase rather than installment purchase. Reflecting differences in legal convention, in the U.S. case ownership of the goods passed to the consumer, the seller or finance company merely retaining a lien. Under hire purchase, in contrast, the consumer leased the good (whose title thus resided with the financier) with an option to buy.

consumer credit, reflecting the relatively advanced state of installment lending in the U.S. and the country's role as a capital exporter. An important step in the diffusion of installment credit in the UK came in 1919 when Continental Guaranty of America created a British subsidiary, United Dominions Trust, to handle credit sales for motor cars. In the 1920s, the Commercial Investment Trust Company, the second largest American finance company, purchased subsidiaries in Germany, France and Scandinavia while operating its own offices in Argentina, Brazil and Cuba. Installment credit spread to the Netherlands partly through the creation of the N.V. Hollandsche Disconteerings-Bank in 1925, formed with American capital participation. Other capital and commodity exporters emulated the practice. Thus, once installment finance companies sprang up in Switzerland in the 1920s, they quickly opened offices in Germany to finance purchases of Swiss products.

Installment business similarly gained importance in Australia in the 1920s, especially in financing purchases of imported goods, including motor vehicles. By 1928 at least 70 companies were engaged in the business in the state of Victoria alone. Specialized finance companies issued cash orders to be paid off in installments that were accepted at leading shops in payment for virtually anything except food. (They were even used to pay for dental care on the installment plan.) But the Australian authorities, their views still colored by the crisis of the 1890s (see Subsection 4A above), began to worry about the over-extension of credit as early as the summer of 1927. In response they applied direct pressure to curtail the extension of installment credit for the purchase of imported cars. In parallel with the conservative approach of Australian banks to financing construction activity, this constrained the role of credit in fueling the upswing, and in turn limited the extent of financial distress in the subsequent slump.

Elsewhere, the growth of installment credit was rapid. Scott (2003) shows that number of hire-purchase agreements outstanding in Britain nearly tripled from 6 million in 1924 to 16 million between in 1928. Crick (1929, p.6) estimates that 80 per cent of pianos and gramophones, 50 to 60 per cent of motor cars, 70 per cent of sewing machines and 50 per cent of furniture sold in the UK in the 1920s were subject to installment agreements.⁶⁰ He notes that down-payment terms were lower than in the United States and that the terms on which installment credit was extended grew increasingly liberal over the period, consistent with other observations about financial behavior the late stages of a credit boom.

However, all this growth began from a much lower base than in the United States. Even at the end of the 1920s, installment credit was still too small to significantly affect the macroeconomic aggregates. Figures in Scott (2003) suggest that installment credit financed only about 2 per cent of British retail sales in this period. Comparable ratios for other European countries were almost surely lower. In the U.S., in contrast, nearly 9 per cent of consumer spending in the 1920s was on durable goods.⁶¹ Of all spending on durables, 60 per cent was on big-ticket items (major durable goods), and some 70 per cent of that in turn was financed with consumer credit. In addition, a substantial fraction of minor durable goods were purchased under the installment plan.⁶² We see here the higher base from which installment credit in the United

⁶⁰The Board of Trade estimated that by the late 1930s, hire purchase agreements were used in more than 70 per cent of sales for cars and bicycles, working class furniture, and electrical household equipment (Hoovers, audio equipment), while trade estimates suggest that it accounted for at least this proportion of pianos and sewing machines.

⁶¹Olney (1991), p.27.

⁶²Olney (1991, Table 4.4) suggests that the share may have been only slightly lower than that for automobiles.

States expanded in the 1920s and thus the more significant macroeconomic consequences of its growth.

As in construction, part of the explanation for these exceptional features of U.S. experience may have been the intensely competitive nature of the financial sector, including ease of entry. By the late 1920s, 1,500 finance companies competed with commercial banks for a toehold in the market. To be sure, other factors played a role as well; for example, relatively high household incomes and an egalitarian distribution of income meant that there was a large pool of households in a position to purchase big-ticket items like automobiles, vacuum cleaners, audio equipment, and kitchen appliances. European motor-car producers continued to concentrate on high-end vehicles, partly reflecting their slowness in adopting mass-production methods, but partly because they perceived more limited working-class demand.⁶³ Scott suggests that the household equipment component of consumer spending was less important in the UK than the U.S. because British husbands somehow failed to appreciate their wives' need for a Hoover! More plausibly the explanation lies in lower living standards and greater income inequality.

Thus, the structure and response of the financial sector seems to have played an important role in transmitting the credit boom of the 1920s, although financial structure was not the only factor shaping the differential response of different countries.

C. High Tech

The end of World War I and the restoration of price stability restored investor as well as consumer confidence. This in turn laid the groundwork for a rise in purchases of producer

⁶³Bowden and Turner (1993) find that income distribution was very important for explaining the diffusion of motor vehicle ownership in the UK – that a more uneven income distribution than in the U.S. led to significantly slower diffusion.

durable equipment. Purchases of machinery and equipment rose most rapidly in Australia, Canada, the U.S. and the UK, as shown in Figure 12. The most prominent aspect of this trend was investor enthusiasm for the commercial potential and profitability of newly developed, technologically sophisticated products and processes (including but not limited to consumer durables). The most visible case in point was radio, as noted in Section 1 above. Radio was the 1920s analog to the Internet, right down to the use of the medium to trumpet the promise of investment in that same medium. RCA was market leader into which investors scrambled in anticipation of capital gains (the price of RCA stock rose from 1 ½ in 1921 to a high of 549 in 1929 – some 73 times earnings – despite the fact that the company paid no dividends anytime in the period).

But while radio was the most dramatic case in point, technological dynamism was not limited to this one sector. The 1920s was also the age of automobiles and mass production – the years following Henry Ford’s development of the assembly line and the decade of the Model T.⁶⁴ It featured technological breakthroughs in the use of electrical machinery and the production of synthetic chemicals. Along with RCA, the high-tech stars of the period included Westinghouse, General Electric, AT&T, and Montgomery Ward (the Walmart of the time, whose attractions to investors resided in the innovative nature of its retail network). Field (2003) suggests that the technological advances associated with the activities of these companies, had as a corollary, a significant acceleration in the rate of total factor productivity growth, which stoked the

⁶⁴Ford switched over to the Model A in 1927, as noted above, not without consequences for the course of the boom.

enthusiasm of investors.⁶⁵

Firms captured this investor enthusiasm in the form of rising stock prices. Our index of “high tech” stocks in sectors such as communications, electrical equipment and appliances, inorganic chemicals and transportation (i.e. Dupont, Maytag, General Electric, Westinghouse, Chrysler and GM) rose by over 200% between 1926-29..⁶⁶ (See Figures 13 and 14.) What these technological advances did not uniformly translate into, however, was profitability, at least in the short run. With benefit of hindsight, we now know that the enthusiasm of investors for the commercial potential of these new technologies, above all radio, was premature, although not wholly unwarranted. Networks require an installed base in order to be commercially viable, and radio in particular required a significant installed base before the industry became profitable. The number of U.S. households with radio sets rose rapidly but in 1928 was still less than a third of 1939 levels. A profitable market for advertising presupposed the existence of broadcast networks which only began to develop with the establishment of the National Broadcast Company in 1926 (initially as a network of 19 stations). For all these reasons, commercial viability took time. That investors overestimated the speed with which profitability would ensue may not have been entirely unrelated to prevailing credit conditions: the low level of interest rates prevailing in the United States and the ample availability of brokers loans, reflecting the liquidity of the financial system, may have encouraged investors to reach for more speculative

⁶⁵Although, just as in the case of the second half of the 1990s, there remains dispute over the precise magnitude of the acceleration and the sectors in which it was centered.

⁶⁶The quarterly market capitalization index is based on 10 industries, using SIC-level data from CRISP. The market capitalization figures for the 10 industries are summed and then indexed (1929:01 = 100).

investments.

Perez (2002) generalizes the point, arguing that the emergence of new network technologies regularly causes stock markets to overreact. Securities markets typically respond to the emergence of a new network technology with a boom and bust cycle which must be completed before glimmers of profitability and commercial viability finally become visible. She tells this same story of the canal boom of the 1820s, the railroad boom of the 1840s, electrification in the 1890s, the age of radio, automobiles and mass production in the 1920s, and the information and communications boom of the 1990s. Each of these innovations involved the deployment of a network technology, necessarily implying a lag of uncertain length between initial installation and eventual profitability. In each case, market participants overestimated the speed of deployment and adaptation, causing securities markets to overshoot.

Importantly from the present point of view, Perez emphasizes the role of the financial system, and of accommodating credit conditions in particular, in fueling speculative activity.⁶⁷ In each case, she argues, the availability of credit was enhanced by financial innovation, which provided channels for liquidity to flow to technologically dynamic sectors. In the 1920s the innovations in question included the new techniques for marketing securities to individual investors and the spread of the investment trust. In Perez's view, the infusion of liquidity into the markets leads to easy capital gains, which in turn encourage "ethical softening" in the frenzy phase, followed by the inevitable fall.⁶⁸ The long-run productive potential of the economy is

⁶⁷This, of course, is a familiar argument, also highlighted by, *inter alia*, Schumpeter (1939).

⁶⁸Again, the argument has important precedents, such as Minsky (1986) and Kindleberger (1978).

enhanced by the investment consequences of all this speculative activity, but an extended period of capital losses and consolidation still must intervene before a positive impact on profitability is felt.

Can the behavior of the high-tech sectors in the 1920s help us to distinguish between the credit-boom and bubble interpretations? That the run-up in the stock market was most pronounced among high-tech firms and particularly evident in the United States, the seed bed of the new industries, might seem like *prima facie* evidence for the bubble interpretation; as Perez argues, bubbles seem to be associated with the early emergence of network technologies of great promise but uncertain short-run profitability. However, accommodating credit conditions play an important role in the response of the securities markets, even in Perez's own story. It is not technology but the interaction of technology with financial conditions that matters for her story. The technological impulse propelling the stock market may have been exogenous from the present point of view, but had credit market conditions been tighter, due to some combination of a more restrictive monetary policy and a less dynamic financial structure, the response of securities prices would have been less.

Thus, while this sectoral case study does not permit us to distinguish between the credit-boom and bubble interpretations, it reinforces the emphasis we place elsewhere in this paper on the role of financial structure and of the interaction of finance with innovation.

5. Credit Booms and the Gold Standard

How a pronounced credit boom could develop under the gold standard is not obvious. In principle, the gold standard did not provide an elastic currency at the global level, which should

have worked to limit the amplitude of the credit boom.⁶⁹ For the world as a whole, supplies of money and credit should have been tied down by supplies of monetary gold that were inelastic in the short run.⁷⁰ Hence, when a credit boom got underway, it was not accommodated by increased supplies of money and credit. Higher interest rates would tend to dampen investment and choke off borrowing by stock-market speculators. The implication was that credit booms should have been less pronounced under the gold standard. This was the contemporary conclusion of Mises and Hayek, described in Section 1 above.

Today, in contrast, “the external constraint on credit imposed by the gold standard has gone.” “Central banks now virtually ignore the pace of credit expansion so long as inflation is under control. As a result, the ‘elasticity’ of private credit creation has increased significantly” (*The Economist* 2002, p.23).

How to characterize the 1920s from this point of view is not clear. There was a sharp rise in the importance of foreign exchange reserves relative to gold, compared to the prewar era, imparting more elasticity to global supplies of money and credit. During the boom period (1924-28) the share of foreign exchange in the total reserves (gold plus foreign exchange) of the 24 central banks considered by Nurkse (1944) rose from 27 to 42 per cent (before falling back

⁶⁹To be sure, the inelasticity of the currency under the gold standard created other problems, such as pronounced fluctuations in money and credit over the cycle that could cause financial stringency and distress in the banking system, including, in the worst case, financial crises. It is revealing that the Federal Reserve System was established precisely in order to provide “an elastic currency.”

⁷⁰Mining and prospecting activity and the incentive to melt down jewelry for coinage in periods of deflation lent some elasticity to global gold supplies, as emphasized by contemporary observers, but the magnitude of this response was limited at business cycle frequencies; see Rockoff (1984).

slightly to 37 per cent in 1929). It then collapsed to 19 per cent in 1931 and 8 per cent in 1932. This lent a procyclical elasticity to money and credit under the hybrid interwar gold-exchange standard. It is one reason why the elasticity of credit creation could have been higher than suggested by textbook models of the gold standard system.

Of course, this critique of the interwar gold standard may equally constitute a critique of the prewar gold standard. Central banks also held foreign exchange reserves before 1913. But the practice was not as widespread as in the 1920s. And we are aware of no other period in which the share of foreign exchange reserves fell as sharply as in 1929-32, effectively destroying a third of the global monetary base.

Before 1914, central banks holding excess gold reserves were also able to manipulate the money multiplier by, *inter alia*, altering their discount rates. Bloomfield (1959) emphasized the tendency for the rates of discount of the major central banks to move together over the cycle, as if some such reaction was occurring on a global scale. Authors like Cairncross (1953) and Ford (1962) suggest that changes in money and credit conditions occurring in response to investment fluctuations were an important source of global business cycle fluctuations under the pre-1914 gold standard. Portraits of the consequences by authors like Kindleberger (1978) do not suggest that credit booms were less pronounced in the gold-standard years than under subsequent monetary regimes.

The preceding discussion focuses on the gold standard as a global monetary regime, an appropriate view if the credit boom of the 1920s is seen as a global phenomenon. Alternatively, we can consider the gold standard's operation at the country level and ask whether it would have worked to restrain or encourage a credit boom in a particular country.

We are not aware of much satisfactory theoretical analysis of the connections between the exchange rate regime and endogenous credit dynamics. The Asian crisis and other recent episodes in which pegged rates have collapsed have encouraged the view that pegged rates encourage credit booms. Under pegged rates, animal spirits that drive up the stock market and investment, in turn raising interest rates, will encourage capital inflows from abroad, augmenting supplies of money and credit. When the exchange rate is pegged, there is little perceived exchange risk to deter interest arbitrage and no tendency for the currency to appreciate and tamp down the investment boom.⁷¹ Even if the supply of credit is fixed at the global level, it is elastic from the point of view of the individual country. Thus, credit booms concentrated in individual countries (or groups of countries) may be even more pronounced under fixed than flexible exchange rates. This view is informed by the experience of Scandinavian countries in the late 1980s and by the experience of Asian countries in the 1990s, when large capital inflows sustained pronounced credit booms, setting the stage for an even more painful subsequent fall (McKinnon and Pill 1997, Goldstein 1998).

This view assumes that the boom does not originate in increases in domestic credit but rather from other sources like irrational investor exuberance and that it is then accommodated by capital inflows. If, on the other hand, the source of the boom is excessive domestic credit creation, then this will lead to balance of payments deficits and capital outflows that, if left uncorrected, may jeopardize the pegged exchange rate. In this situation, the pegged rate is a restraint rather than a contributor to the credit boom. From this point of view, whether pegged

⁷¹Recall our discussion of the French credit boom of the late 1920s, which is couched in exactly these terms.

rates in general and the gold standard in particular are part of the problem or part of this solution will depend on the source of the boom – whether it is domestic credit as opposed to investment or asset-price inflation – and whether it is a global or country-specific phenomenon. The answer will also depend on how monetary policy is conducted, since even pegged rates provide some room for discretion under certain circumstances.

Ultimately, then, whether credit booms were more or less pronounced under the gold standard is an empirical question. We can analyze it by constructing analogous indicators of credit booms using annual data for the period from 1880 up through 1997 and then calculating whether the volatility of our measure is greater in times and places when the gold standard was absent than when it was present. We have the necessary data for all or most of this period for nine countries: Australia, Canada, Denmark, France, Germany, Italy, Sweden, the United Kingdom and the United States.⁷² We detrended separately for the pre-1914, interwar, Bretton Woods and post-Bretton Woods periods. We then computed the standard deviation of the detrended composite, looking only at boom periods (observations for years when the composite was above trend). Finally, we compared years when countries were on the gold standard with years when they were not, and years when exchange rates were pegged to when they were floating (on the grounds that the same arguments regarding the external constraint that apply to the gold standard also apply, in principle, to other fixed-rate regimes).

From the results (Table 4), it would appear that the amplitude of credit booms as measured by the standard deviation was greater in periods when exchange rates were pegged than

⁷²We are missing data for the early part of the pre-1914 period for Canada, Denmark, Italy and Sweden (due to gaps in the stock market series).

when they were floating. The difference is significant at the 95 per cent level.⁷³ In contrast, when we compare when countries were on the gold standard than when they were not, we find no differences in volatility under the two regimes.⁷⁴ These comparisons thus lend little support to the notion that credit booms were less of a problem under the gold standard. On the other hand, they are consistent with the view that *pegged rates* – which limit inflationary pressures but allow the demand for money to be endogenously determined, and which encourage policy makers to focus on the stability of prices and exchange rates but not the evolution of credit conditions – are conducive to credit booms, in individual countries or groups of countries at least, if not necessarily in the world as a whole.

It could be that the interwar gold standard was special – that the credit boom of the 1920s was an anomaly and that similar phenomena were absent, or at least more muted, prior to 1914. This, after all, was the Mises/Hayek view. Hence, the final row of Table 4, instead of comparing gold-standard and non-gold-standard observations, compares pre-1914 gold-standard observations with non-gold-standard observations (that is, it eliminates the interwar gold standard years). As before, we restrict the analysis to credit-boom episodes – that is, to periods when the credit boom indicator is above trend. This change in periodization transforms the

⁷³This is also true when we use signal/noise ratios constructed on the basis of banking crises or currency crises.

⁷⁴A variety of sensitivity analyses confirmed these results. Thus, we used different detrending schemes (for example, fitting log-linear rather than linear trends to the stock market series); the results were in all cases virtually identical. We weighted the components of the composite using signal/noise ratios, as explained above. We used different weights for the four subperiods (1880-1913, 1919-1938, 1945-1971, and 1973-97); again, none of our results was affected. We computed the standard deviation of the entire series (rather than simply for those portions where the composite indicator was above trend), in which case we were able to detect no significant differences between the gold standard years and other periods.

picture. The amplitude of credit-boom episodes appears to have been less before 1914 than in the non-gold-standard years (starting in the 1930s).⁷⁵ Any evidence that credit booms were more pronounced under the gold standard than other monetary regimes, in other words, is attributable to the 1920s experience that is the subject of this paper.⁷⁶

Our overall conclusion is that the gold standard was neither the cause nor the solution to the credit-boom problem; the effects depended importantly on how that gold standard was structured and managed. Similarly, this analysis does not support the notion that pegged exchange rates are either a fundamental cause or a solution to the credit-boom problem. Our own view is that an exchange rate rule, which focuses monetary policy makers' attention on a particular asset price rather than on the broader constellation of asset and commodity market conditions, is not the optimal basis on which to formulate monetary policy. But the evidence of this section suggests that, more than the putative monetary regime, what matters is how monetary conditions are managed in practice.

⁷⁵Note that any bias in the volatility of estimates of pre-1914 national income would work against this conclusion (authors like Romer arguing that conventional estimates of pre-1914 GNP may be excessively volatile), which only reinforces our finding.

⁷⁶Recall also that we find that the credit boom of the 1920s was heavily concentrated in a handful of countries and that equity prices rather than the supply of domestic credit was the most important contributing factor. Our preceding discussion suggests that these are precisely the circumstances under which a pegged exchange rate would amplify such booms: as equity prices rose, stimulating investment and increasing the demand for credit, capital would flow in to arbitrage interest differentials, rendering credit more elastic and deactivating one mechanism (scarcity of funds and higher interest rates) that would work to limit the boom. The question, of course, is whether there was any difference in the factors initiating credit booms before and after 1914. The popular view of pre-1914 expansions and recessions is that they were mainly driven by investment and asset price booms and collapses, not by monetary policy (Summers 2000). Thus, it is not clear that this provides an explanation for the apparent contrast between the pre-1914 period and the 1920s evident in the data.

6. Conclusion

The 1990s was a decade of ample liquidity and low and stable interest rates in many countries. Accommodating credit fueled increases in property prices and facilitated increasing consumer indebtedness, notably in the United States, while financing high investment rates. It encouraged rapid increases in securities prices. These developments heightened the vulnerability of financial systems and economies to a sudden reversal of sentiment, although the consequences to date have taken the form less of a bang than a fizzle. To be sure, credit market conditions do not provide the entire explanation for these developments. Investment and equity valuations were also stimulated by accelerating productivity growth, although the magnitude of this new-economy phenomenon remains a matter of dispute. But it is hard to dispute that credit market conditions at a minimum played a supporting role.

Among the consequences of these developments has been renewed interest in the work of Mises, Hayek, Robbins and Rothbard, who emphasized the role of credit dynamics in post-World War I cyclical developments. For a combination of domestic and international reasons, the Fed maintained a relatively accommodating stance for much of the 1920s. With inflation stabilization, other countries found themselves on the receiving end of capital inflows. Financial innovation magnified the impact of these accommodating credit conditions, and central banks did little to preempt their effects. The consequences, as in the 1990s, included property booms, increasing consumer debt, surging investment, and rising securities prices (particularly those of high-tech firms). They included growing worries about the stability of financial institutions and markets. They culminated in the wholesale collapse of financial markets and institutions and the gravest macroeconomic crisis the modern world has ever seen.

This characterization of the Great Depression as a credit boom gone wrong has much to recommend it, if not as a complete and rounded portrait of interwar macroeconomic developments, then at least as a cautionary tale for contemporary policy makers. We wish not to be misunderstood: as repeatedly emphasized above, we are not arguing that the credit-boom interpretation is a superior alternative to analyses of the Depression emphasizing the roles of the gold standard, the stock market boom, and monetary blunders. But a horse-race is not the best context in which to assess theories of the Great Depression. The Depression was a complex and multifaceted event. The perspective provided by the credit-boom view is a useful supplement to these more conventional interpretations.

In particular, focusing on the credit boom of the 1920s directs attention to the role of the interwar gold standard in setting the stage for the slump of the 1930s. Our analysis suggests that equally pronounced credit booms were not a facet of the classical gold standard. Notwithstanding the colorful accounts of Kindleberger et al., the amplitude of credit fluctuations appears to have been less under the pre-1914 gold standard than under the more flexible exchange rate regimes that followed. Evidently, however, the interwar gold standard was different. Our conjecture is that the strongly procyclical behavior of the foreign exchange component of global international reserves and the failure of domestic monetary authorities to quickly install stable policy rules to guide the more discretionary approach to monetary management that replaced the more rigid rules-based gold standard of the earlier era are important for explaining the fragilities that set the stage for the Great Depression. Previous work has tended to emphasize the role of the interwar gold standard in the post-1929 collapse of foreign-exchange reserves and money supplies and in the international transmission of

destabilizing impulses. That one of the present authors is associated with this literature should remind the reader that we are by no means questioning the explanatory power of this view.⁷⁷ But the credit boom view suggests that the structure and operation of the interwar gold standard also played a role in the expansion phase, when the endogenous response of the foreign exchange component of global reserves allowed credit to expand more rapidly than would have been possible under traditional gold standard arrangements. This is an important extension of the conventional gold-standard-and-Great-Depression story.

In addition, focusing on the role of credit conditions in the expansion of the 1920s and slump of the 1930s directs attention to two factors that warrant more attention than they have received in the recent literature on the Great Depression: the structure of domestic financial systems, and the interplay of finance and innovation. Financial structure and regulation have featured in the comparative literature on the causes of banking crises in the 1930s (Grossman 1994), but other channels through which they could have shaped and accentuated the boom of the 1920s and the subsequent reaction may have not received their due. The interplay of finance and innovation in stimulating the expansion and setting the stage for the crash has been the subject of even less attention, with recent authors tending to focus exclusively on one or the other of these two factors. It was of course precisely the experience of the 1920s and 1930s that provided the backdrop for Schumpeter's great work, *Business Cycles*, where he characterized capitalism, and in particular its cyclical aspect, as "innovation financed by credit." The experience of the 1990s reminds us that the development and effects of credit conditions may play out in quite different ways depending on the nature of the technological environment. It reminds us that the

⁷⁷See Eichengreen (1992).

interaction of credit with innovation warrants additional attention.

The implications for policy are less clear. One possible implication is that policy makers should act preemptively to prevent the development of unsustainable credit booms that might have seriously negative macroeconomic and financial consequences when they turn to bust. The strong version is that central banks should concern themselves not just with commodity price inflation but also with asset price inflation, especially in periods of technological dynamism when asset market inflation has a particular tendency to overshoot. They should tighten when they see credit expanding rapidly and asset-market conditions responding enthusiastically, and do so even if commodity-price inflation remains subdued.

But most policy makers and analysts are reluctant to draw this conclusion. Central banks have no reliable way of determining when asset prices lose touch with fundamentals. This was as much a problem in the 1920s as the 1990s. It is only with benefit of hindsight that textbook writers refer confidently to a bubble, and even now, not all observers agree. In any case, monetary policy is a blunt instrument to deploy in response to increases in asset price valuations. The collateral damage to the real economy can be severe, as Hjalmar Schacht learned in 1927 and George Harrison learned in 1929.

A more appropriate conclusion, in our view, is that although financial market conditions are important, they are first and foremost the responsibility of financial market regulators. In the interwar period, regulators should have concerned themselves with conflicts of interest between the underwriting and advising activities of the investment banks before as well as after the fact. They should have engaged in closer supervision of financial institutions if they saw signs that loan quality was deteriorating. They should have contemplated increases in capital and liquidity

requirements to prevent the credit boom from developing in ways that heightened the vulnerability of the economy and the financial system to a subsequent downturn. This seems to us the right lesson for policy to draw also from the experience of the 1990s. The problem, of course, is that such lessons are always more evident after the fact.

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Table 1
Ratio of Private Credit to GDP

	1913	1929
Belgium	2.34	2.51
Denmark	3.41	3.72
France	2.79	2.57
Germany	2.59	1.64
Japan	1.88	3.39
Norway	2.19	3.08
Switzerland	4.30	4.49
United Kingdom	2.65	4.60
United States	2.43	4.08

Notes: Computations based on data from Raymond Goldsmith, *Comparative National Balance Sheets, A Study of Twenty Countries, 1688 - 1978*, University of Chicago Press, 1985. The years provided by Goldsmith very slightly for some countries: US (1912); Norway (1930); Japan (1930); and UK (1927). Total private credit is the sum of the following national balance sheet items: mortgages, consumer credit, loans by banks and other financial institutions, corporate stocks and bonds, trade credit, and other private credit. The figures exclude government debt.

Table 2
Tobin's q and Investment
(Double log regression, with investment ratio as the dependant variable)

	Pooled		Country & time				Random effects	
			Country fixed effects		fixed effects			
q	0.18 (2.64)	-	0.15 (2.25)	-	0.20 (2.45)	-	0.18 (2.64)	-
q ₋₁	-0.01 (0.06)	0.15 (4.34)	0.08 (1.12)	0.20 (4.98)	0.03 (0.43)	0.21 (4.72)	-0.01 (0.06)	0.15 (4.34)
(I/Y) ₋₁	0.72 (21.25)	0.71 (21.00)	0.55 (13.42)	0.54 (13.18)	0.58 (13.04)	0.56 (12.68)	0.72 (21.25)	0.71 (21.00)
(GDP growth) ₋₁	0.01 (2.70)	0.01 (3.08)	0.01 (2.58)	0.01 (2.96)	0.01 (0.24)	0.01 (0.75)	0.01 (2.70)	0.01 (3.08)
Constant	-1.33 (7.09)	-1.25 (6.78)	-1.88 (8.79)	-1.79 (8.57)	-1.71 (7.32)	-1.55 (6.42)	-1.33 (7.09)	-1.25 (6.78)
Number of obs.	298	298	298	298	298	298	298	298
R ²	0.67	0.49	0.66	0.66	0.73	0.72	0.72	0.71

Note: t-statistics in parentheses.

Source: See text.

Table 3
Residential Real Estate Market

	Average mortgage (as % of home value)	Return to gold standard	End of rent control
BE	60%	1925	1928 phase out begins; re-enacted 1934
UK	75%	1925	1923 phase out begins
DE	60%	1927	1929(except Copenhagen, 1935)
FI	50%	1926	1923
FR	60%	1928	1929 laws partially phase out
NE	65%	1925	1927
NO	60%	1928	1931
SW	55%	1924	1922
US	60%	na	none, only regional in nature
AU	na	1925	none
CA	55%	1926	none

	Second mortgage market	Usual length of mortgage	Primary source for borrowed funds
BE	no	5-20 years	Antwerp Mortgage Bank; Land Credit Bank of Belgium
UK		20 years	building societies, insurance co.'s
DE	yes		credit associations; mortgage associations
FI	yes		savings banks, insurance co.'s
FR	no	9-30 years	Credit Foncier de France
NE	not active		mortgage banks
NO	yes		insurance companies & savings banks
SW	yes	5 or 10 years/renewable	mortgage banks; Urban Mortgage Bank of the Kingdom of Sweden
US	yes	11 years	S&Ls
AU	no		Savings banks, building societies
CA	yes		Loan&Trust Co.'s, insurance co.'s

Table 4
Volatility of Credit Booms: The Gold Standard, Pegged Rates and Other Exchange Rate Regimes
(credit-boom observations only)

Comparison	Pegs (including Gold)		Flexible		p
	obs	SD	obs	SD	
Pegs v. others (equal weights)	216	7.46888	155	6.472419	0.0294
Gold Standard v. others (equal weights)	130	7.262342	241	6.949759	0.2786
Pre-1914 Gold Standard v. non-gold (equal weights)	88	5.373846	241	6.949759	0.0030

Source: See text.

Figure 1
 Stock Prices: Radio versus the Internet

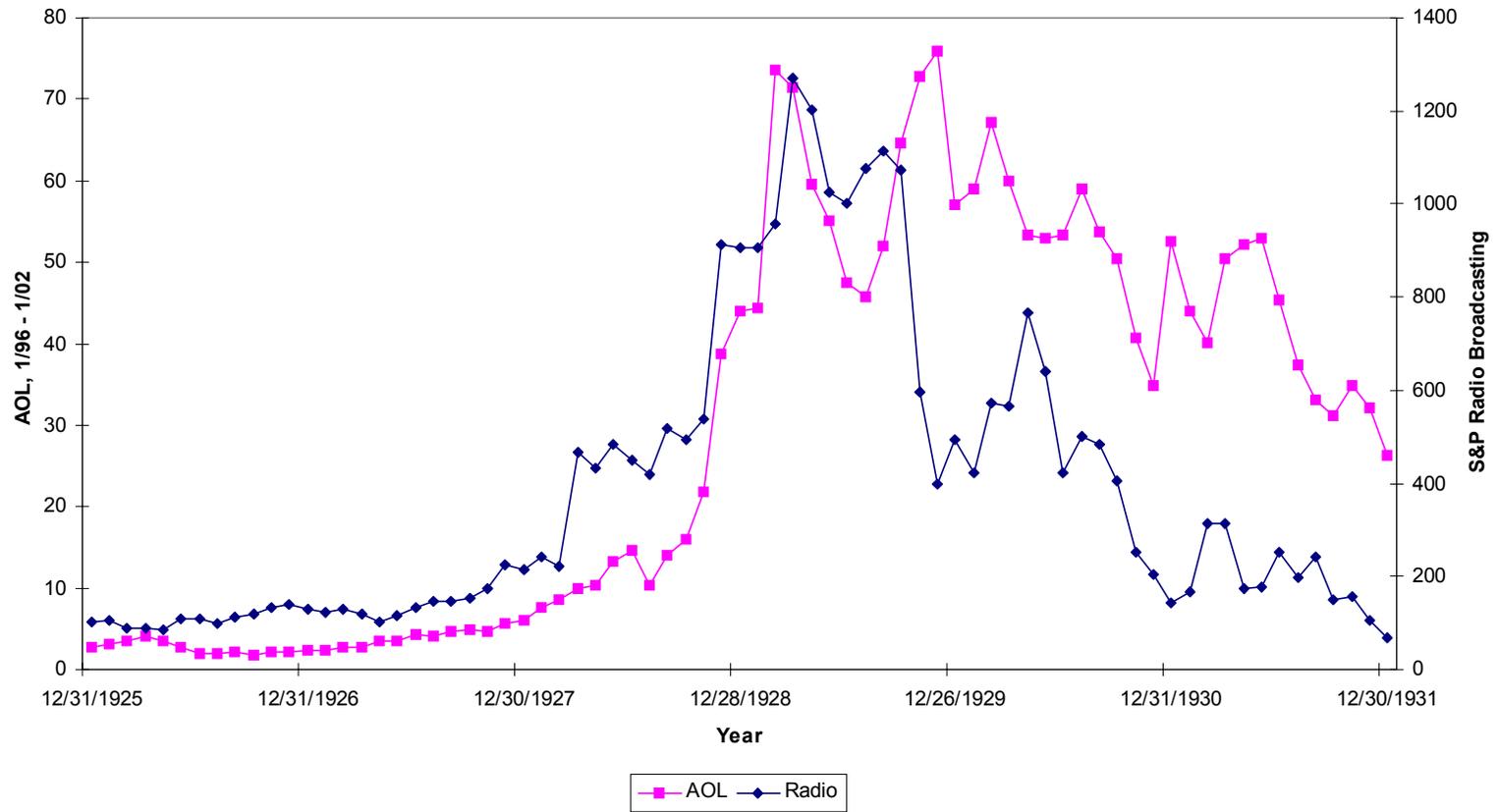


Figure 2
Divergence in US Dividends & Stock Prices

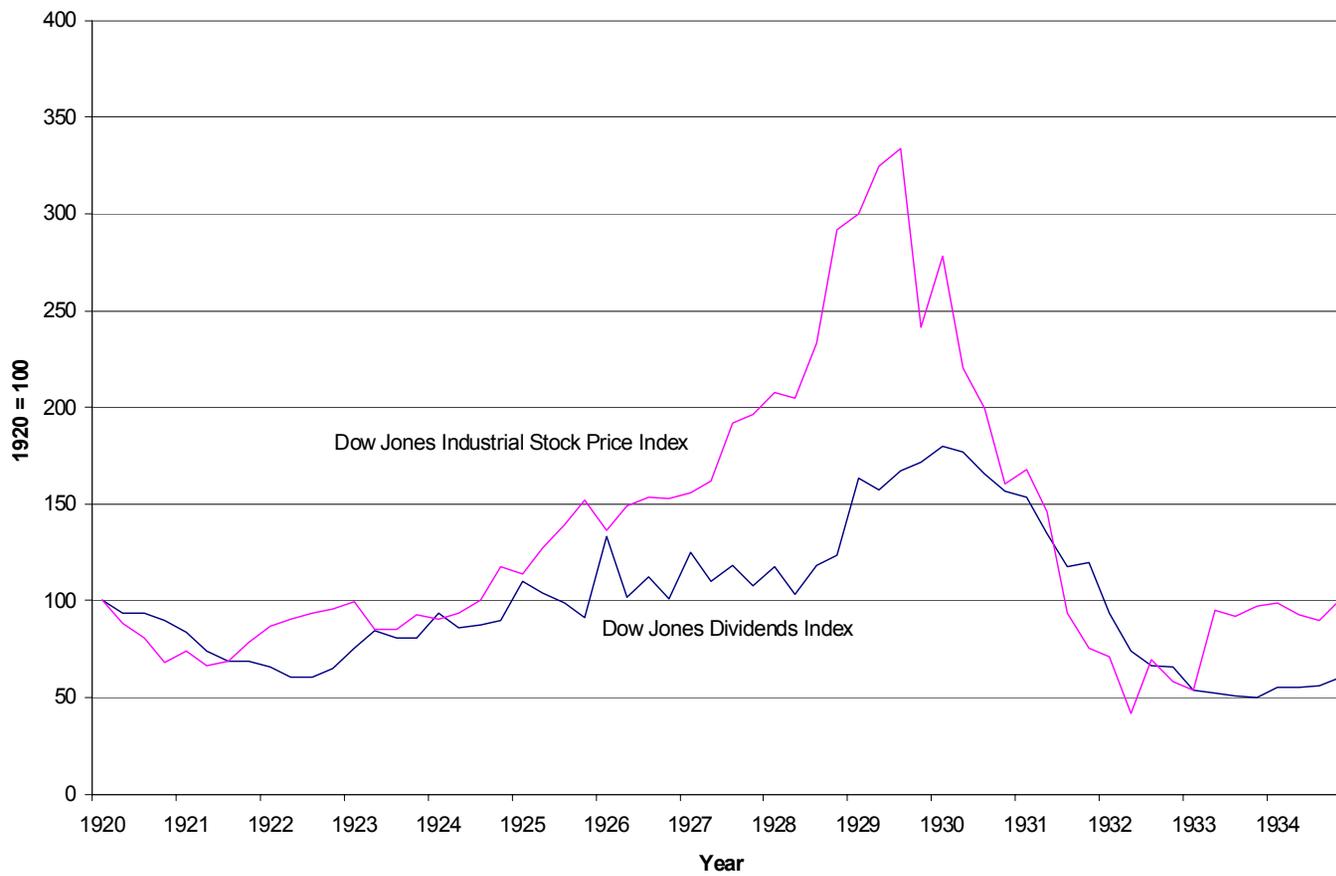


Figure 3
Money to GDP (%) and Trend

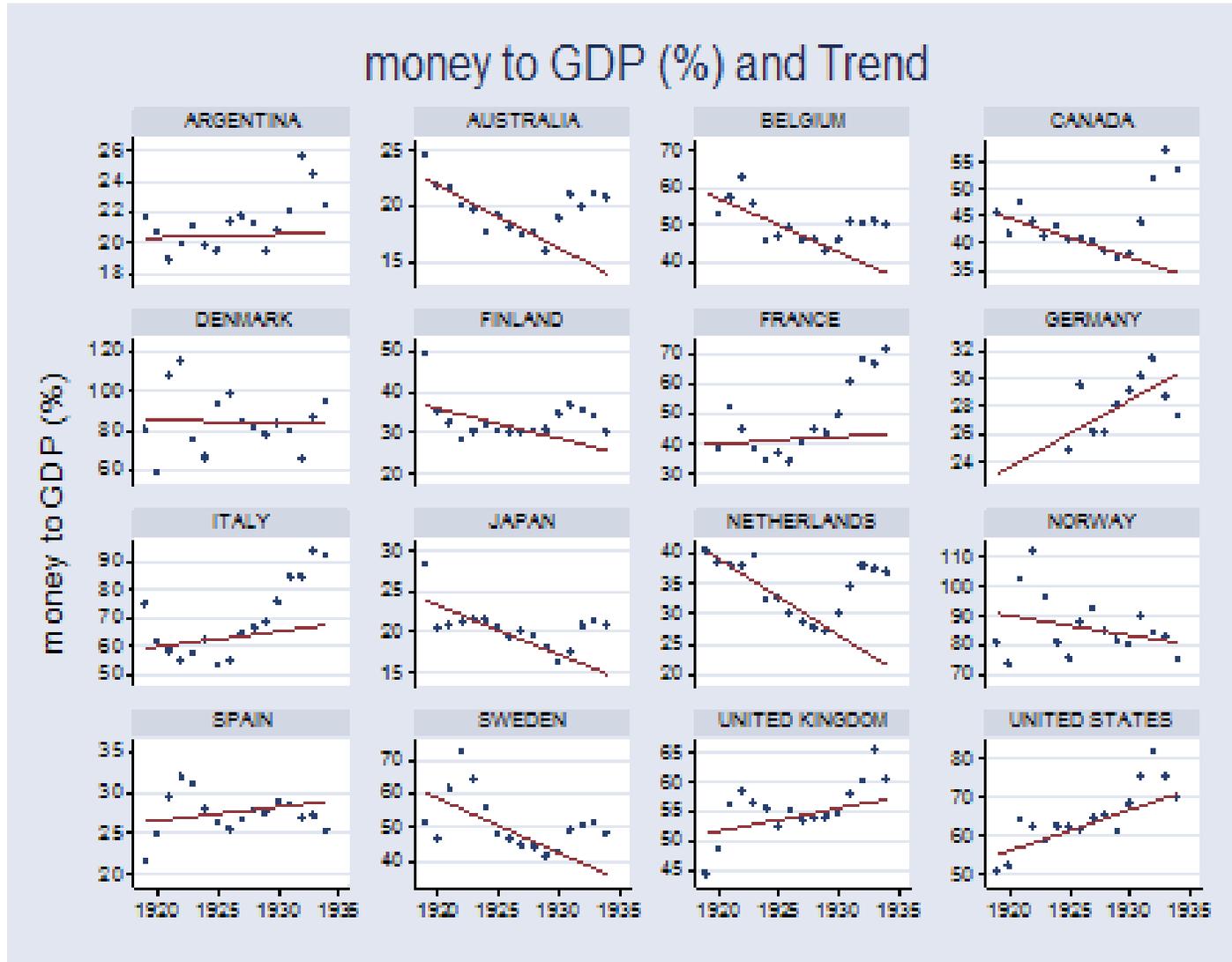


Figure 4
Stock Index Adjusted by CPI and Trend

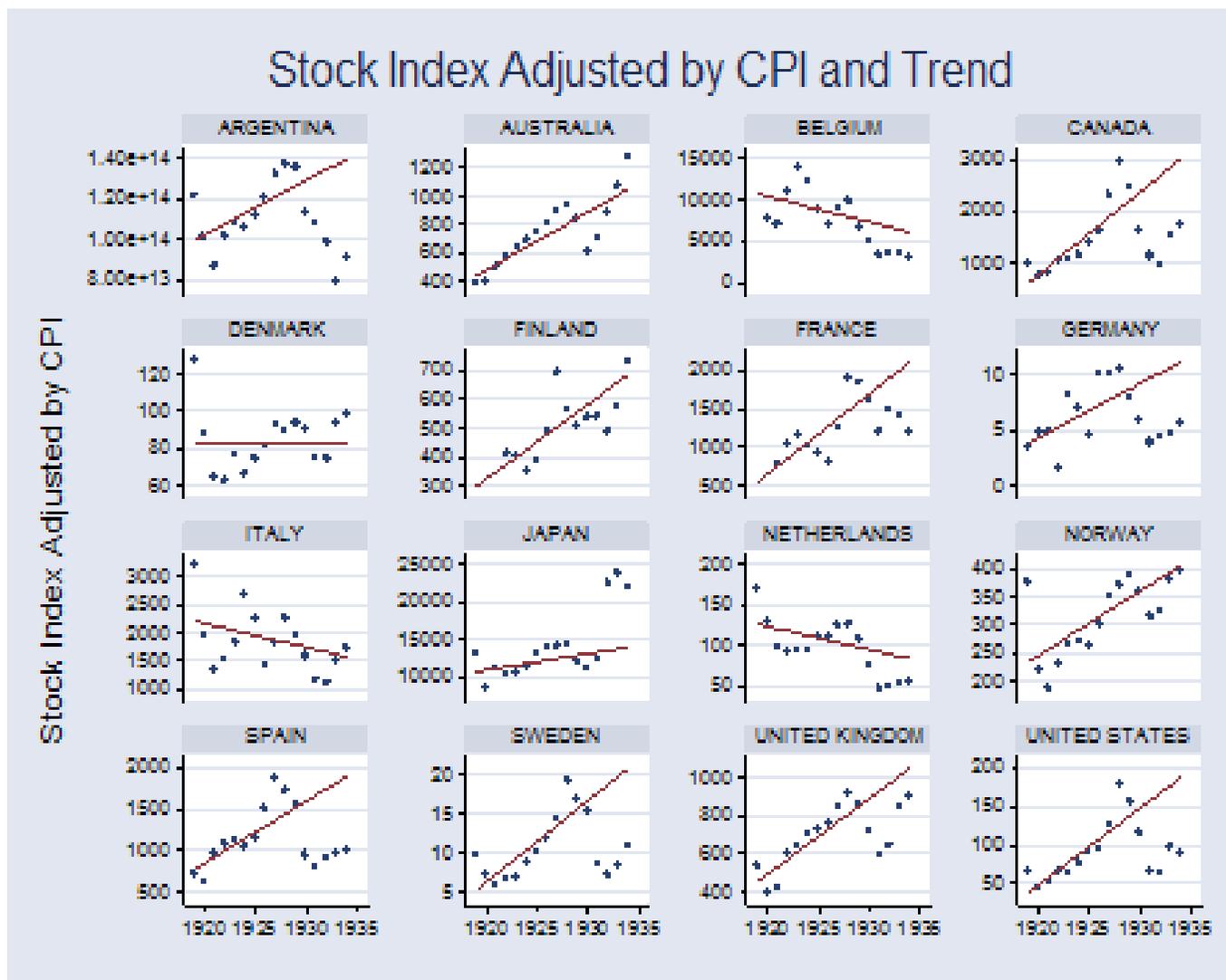


Figure 5
Investment/GDP and Trend

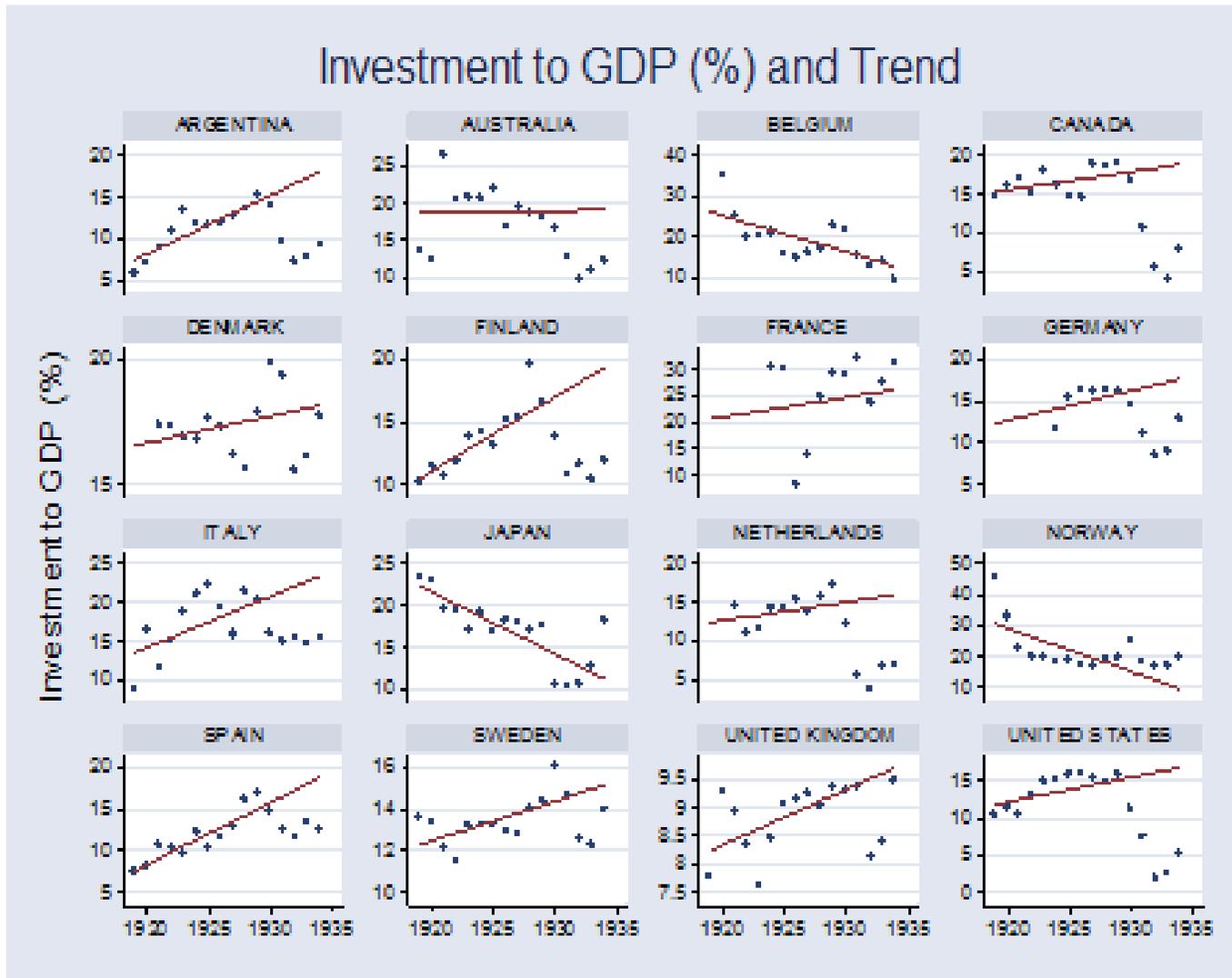


Figure 6
Credit Boom Components and Subsequent Output Fall

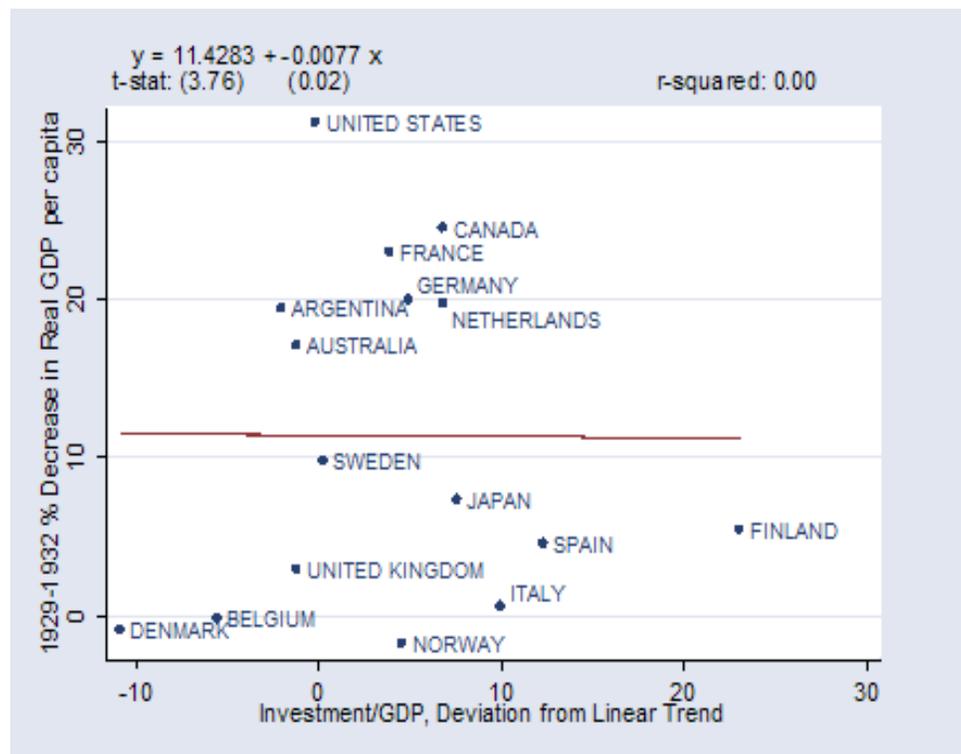
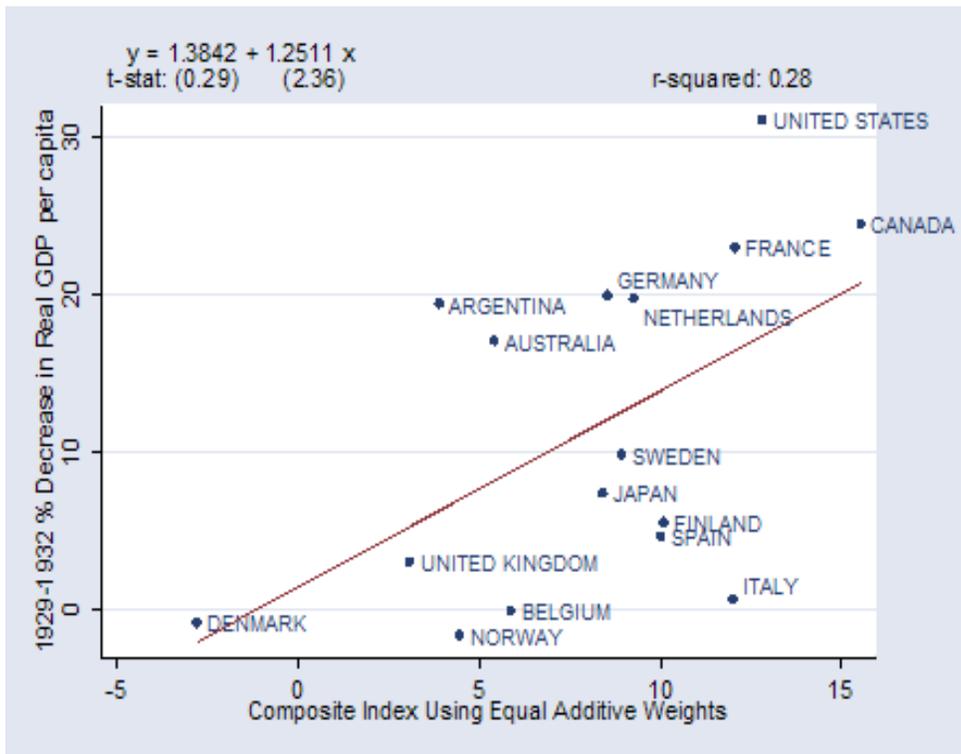


Figure 6 Continued

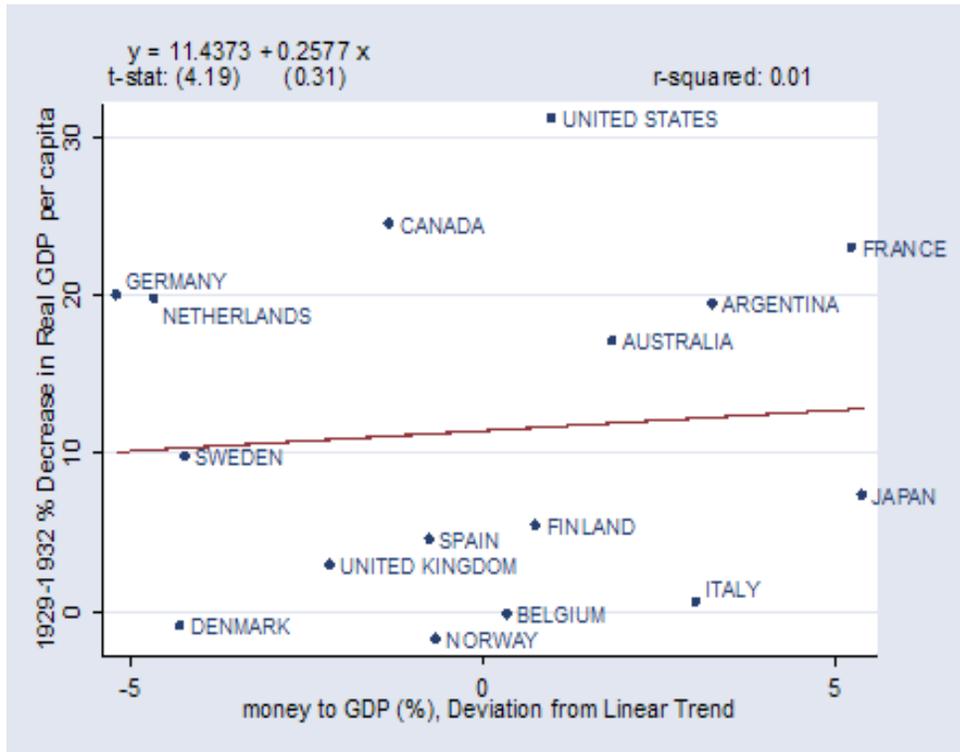


Figure 7
Average Composite Indicator Using Equal Weights



Figure 8
Composite Indicator Using Equal Weights

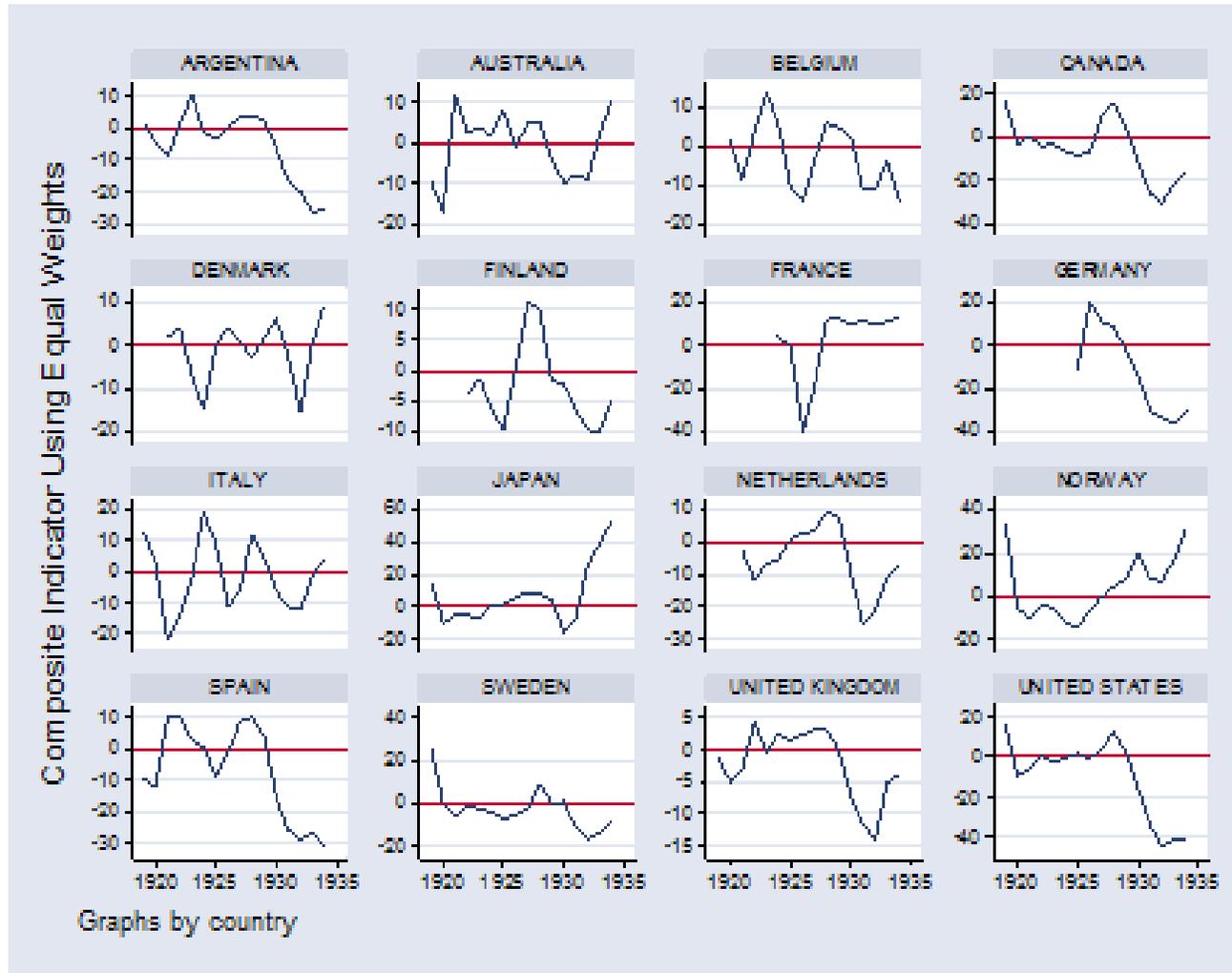


Figure 9
Credit Boom and Economic Slump

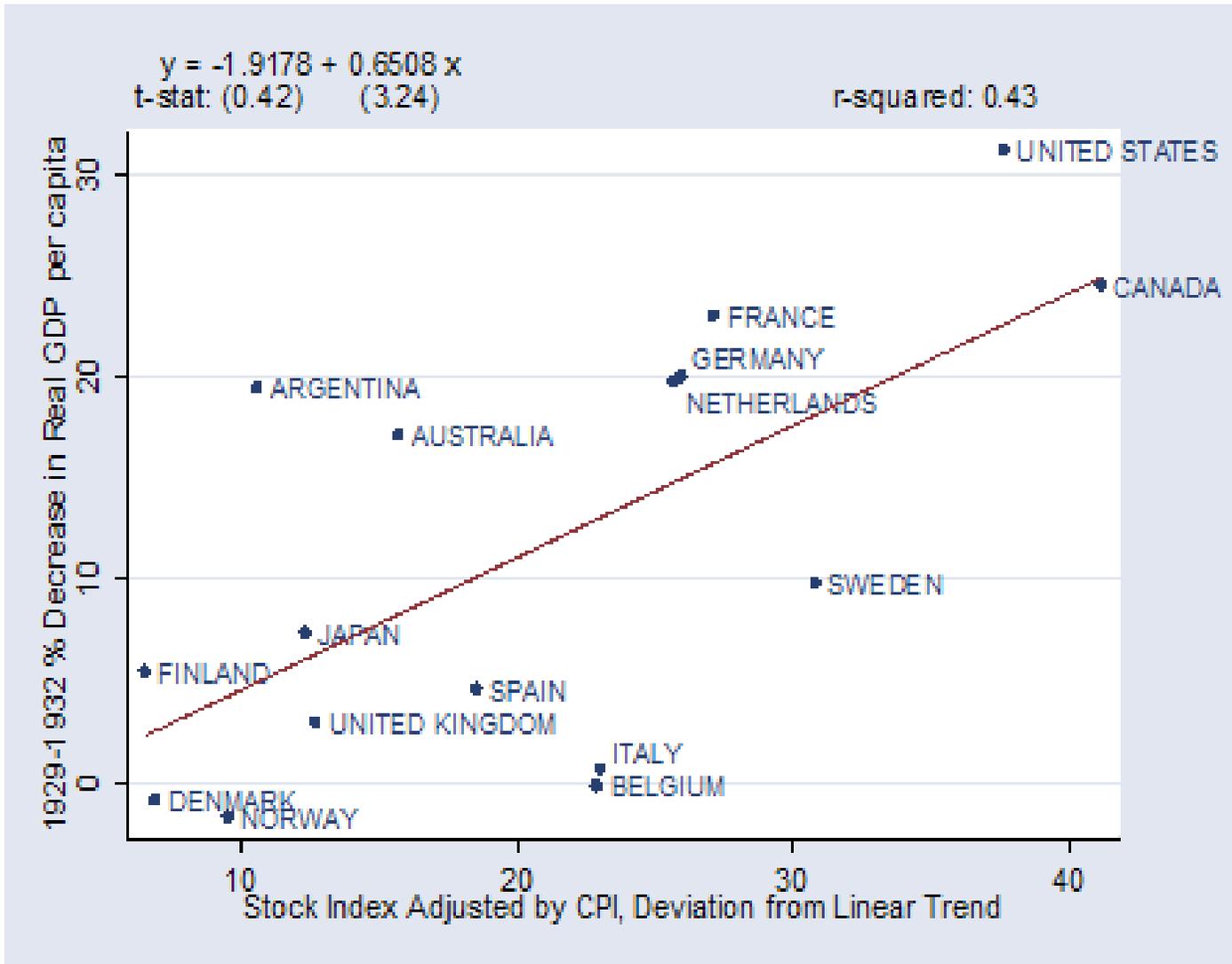


Figure 10
Newly Constructed Dwellings

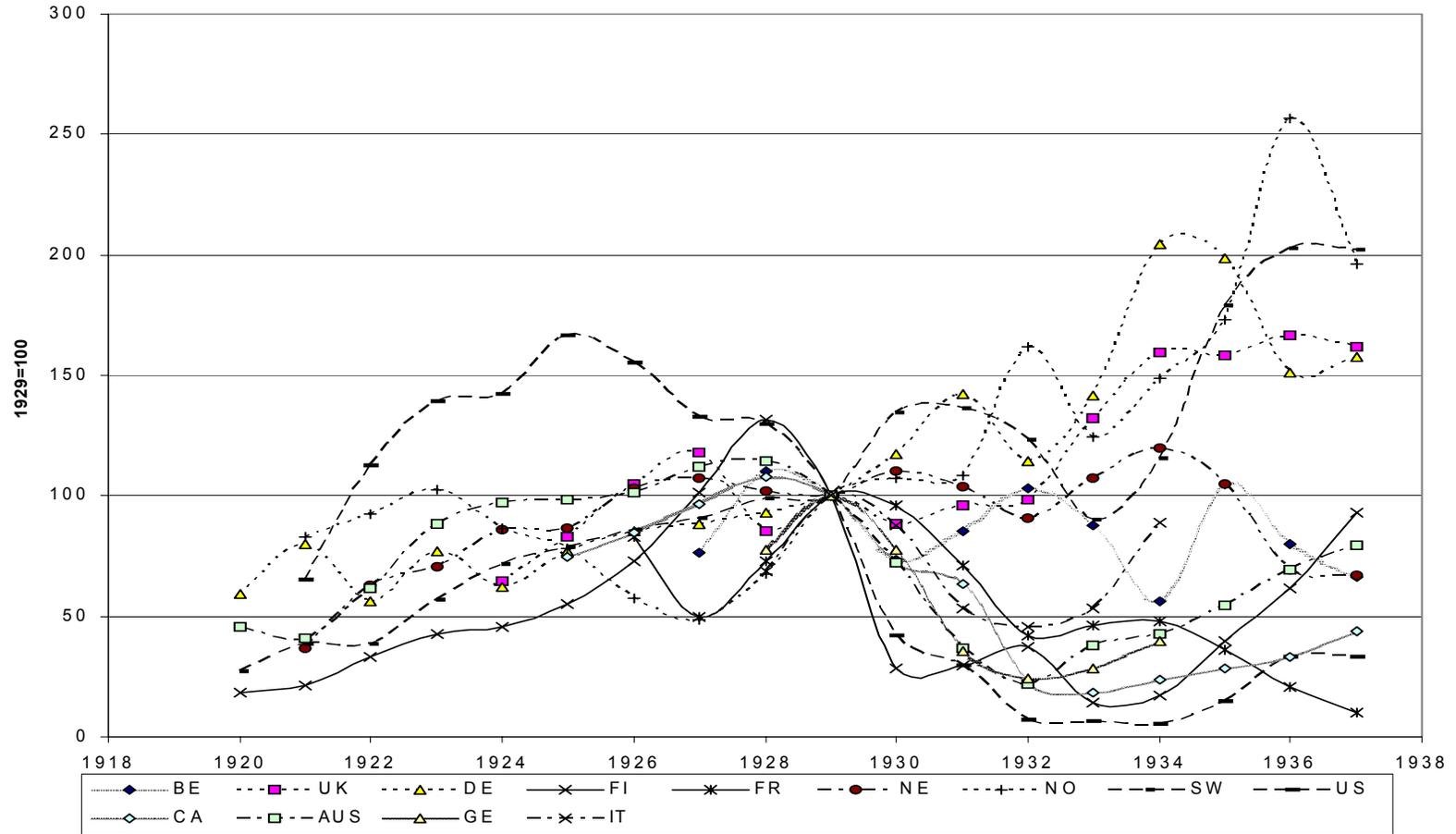


Figure 11
Private Capital Formation, Structures

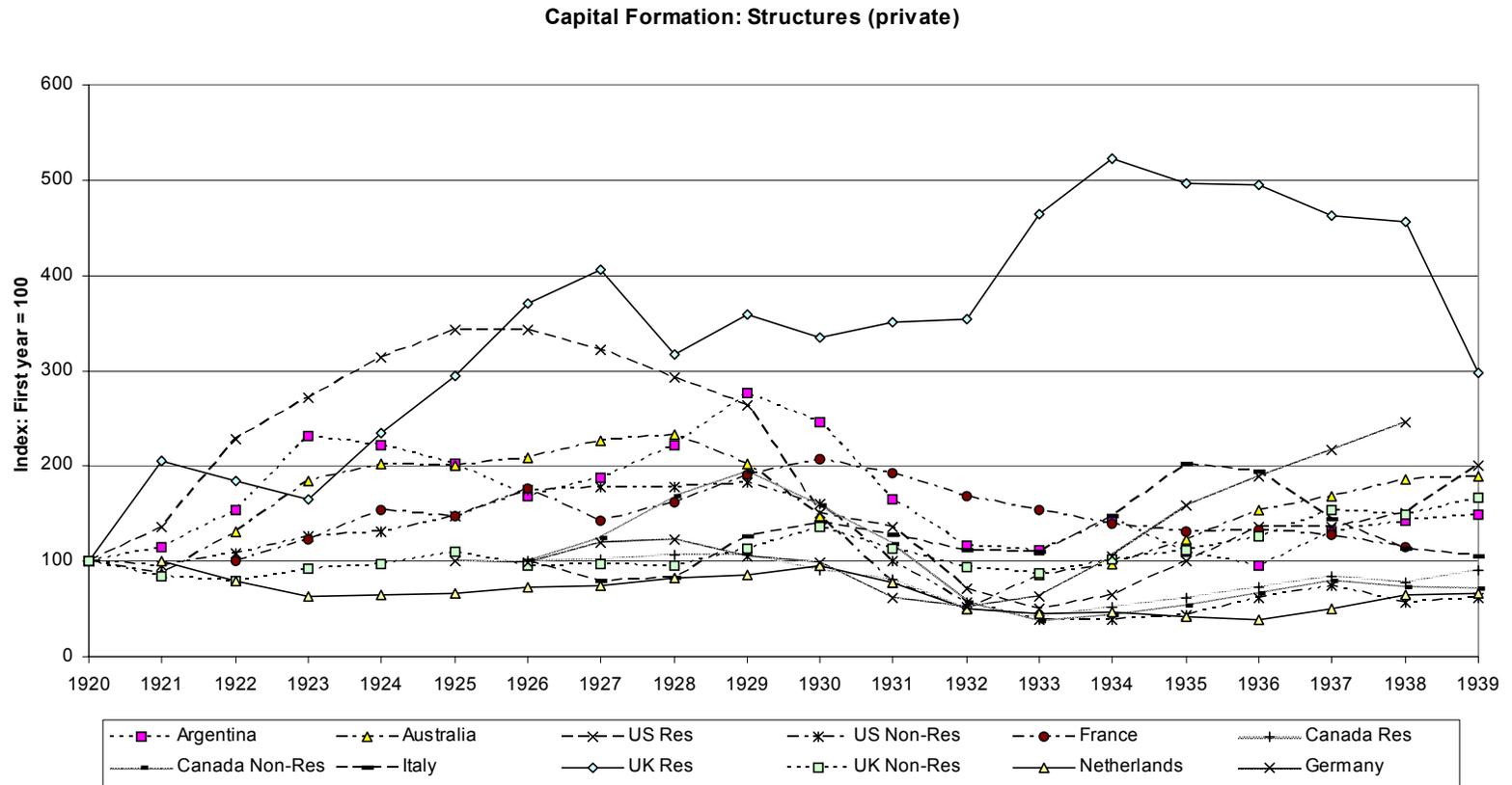


Figure 12
Gross Capital Formation, Machinery and Equipment

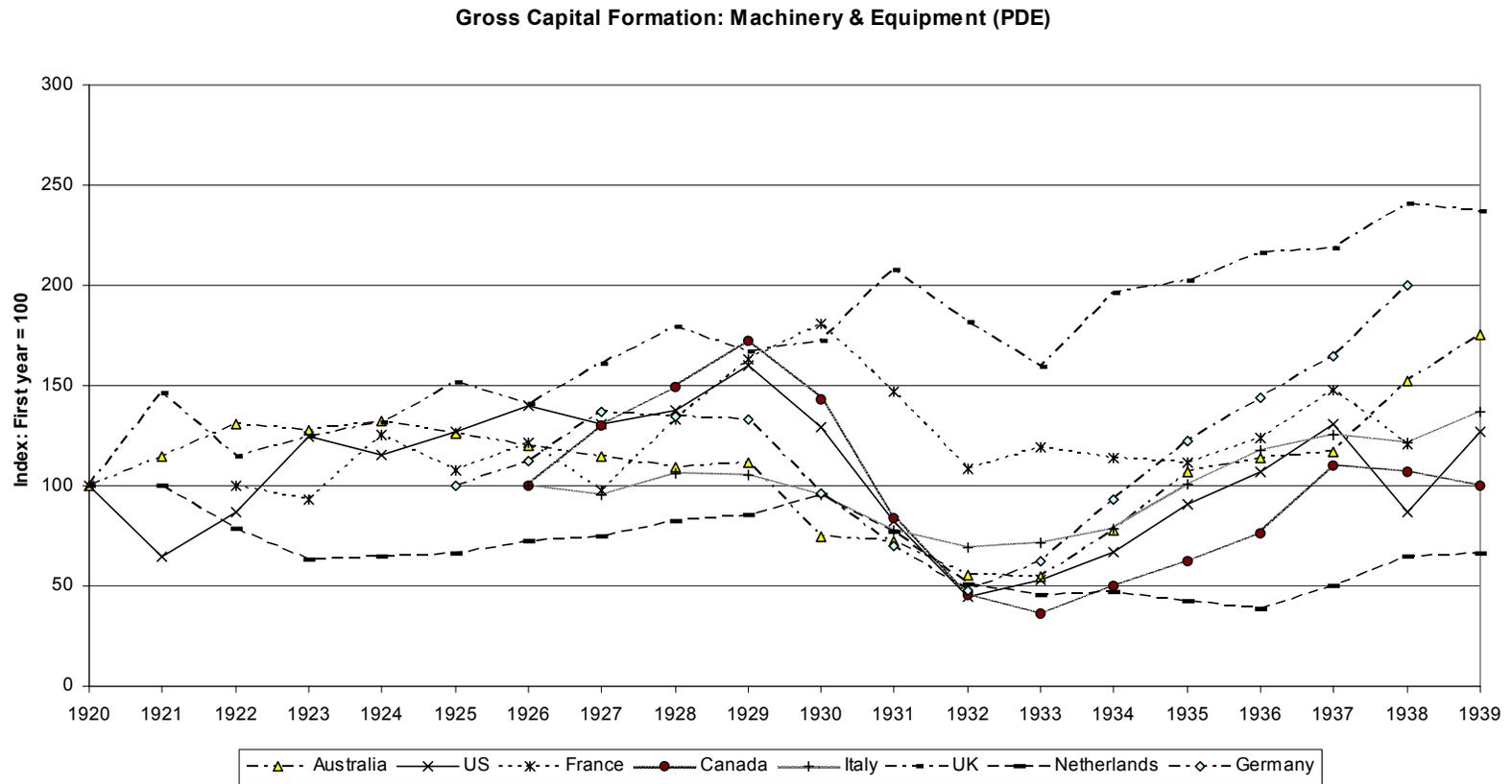


Figure 13
Market Capitalization for Aggregate Technology Index



Based on data for 10 Technology Industries

Figure 14
Market Capitalization for Various Technology Industries of the 1920s

