THE GREAT DEPRESSION: A DEFINING MOMENT IN CHILE’S DEVELOPMENT?

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1. INTRODUCTION

GDP, employment, trade and other Chilean economic variables suffered spectacular contractions as a result of the worldwide depression in the early 1930’s. The Great Depression, as it is known, thus became an unforgettable experience for those generations who had to live under those conditions. So much so, that it is now regarded as a plausible landmark in many respects. Among other, it is seen as a fundamental element influencing a great number of significant institutional changes, including policy ones, which took place all over the World in the 1930’s and following decades. In particular, many perceived it as the phenomena responsible for the remarkable worldwide change in the relative scope of state and market activities of those years. In this view, “the defining moment hypothesis” refers to the Great Depression as a natural and practical dividing line between very different periods in the evolution of social organization in the Western world.

Bordo, Goldin and White (1998), referring to the American case, conclude (pp. 18, op. cit.), “without the depression there would not have been a flood of New Deal-style legislation. Some innovations would have occurred following the dictates of economic growth, the two world wars, and the nation’s political economy. But lacking the catalyst that jarred public attitudes and demarked action, the new economic institutions would have been more modest and different in character. The large role of today’s government and its methods of intervention- from the pursuit of a more active monetary policy to the maintenance and extension of a wide range of insurance for labor and business- derive from the crisis years of the 1930’s……60 years later, the basic imprint of the defining moment is still visible.”

In the Chilean case, conventional wisdom also perceives the worldwide depression of the 1930s as an exogenous and significant force shaping institutional change, including those in economic policies. These innovations are then assumed to condition the style and structure of the economy in the following decades. The Great Depression thus became for many a landmark depicting the beginning of fundamental innovations. For Cepal (1969) it constitutes a defining case in their general outlook of the underlying conditions of Latin American development; Pinto (1962) stresses its influence on industrialization and other aspects.

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In the first half of the 1930s Chile was, in fact, also afflicted, among other, by an extremely severe output contraction, maybe the largest in the world in relation to GDP; by very significant actual and expected trade restrictions, and by the collapse of the international payment system\(^1\). These shocks may have altered the weight Chile’s public opinion and political leaders assigned to direct state management of the economy, in detriment of the up to then existing reasonably free market oriented economic system, Cabezón (1971). The dramatic increase of protectionism in trade related countries, which can also be traced back to the Great Depression, may have reinforced relative wealth distribution in favor of those active in import substituting activities. It may therefore have negatively affected the power and influence of Chilean exporters, facilitating the adoption of policies divorced from tradition. In other words, under this hypothesis, the Great Depression plays the role of a enormously powerful and absolutely exogenous phenomena, defining the evolution of the country’s economic institutions.

The Great Depression may have been a dramatic experience and may have become an unforgettable landmark, but a complete picture of the institutional evolution of the country during the first half of the XXth Century, suggests a fundamental question: were these institutional changes provoked only by the Great Depression or was the Depression only one element in a more complex scenario, influencing a policy change?\(^2\)

In Chile significant institutional changes took place already before the Great Depression. On the one hand, a distinctive increase in State intervention could already be detected in the early and middle 1920’s, among other, with the creation of the Central Bank, the adoption of new banking regulations, and the imposition of a mandated benefit type of social security system.\(^3\) On the other hand, natural nitrate, the country’s main export, was in the mid 1920s already well on the downhill trend of its product cycle. Technological advances in traditionally importing countries made it possible to produce “artificial nitrate” at competitive prices, while Chile did not adapt its export tax to nitrate’s dwindling monopoly power in the world markets.

Therefore the understanding of the significant institutional changes which took place in Chile between the two World Wars might benefit from a discussion of “conventional wisdom”, the way in which generally accepted local doctrine views the impact of the Great Depression on the Chilean economy, in a context where a broader set of restrictions is allowed for. The “defining moment hypothesis”

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1 For the data see, Díaz, Lüders and Wagner (2003).
2 In respect to industrialization, which the “old view” sees as an offspring of the Great Depression, (see for example Pinto (1962)), Kirsch (1977) and Muñoz (1968) provide evidence on a much earlier start.
3 By the middle of the 1920’s the country is experiencing profound institutional innovations: (i) a new and centralizing constitution stripping Congress of much of its power is imposed; (ii) the creation of the Central Bank, initially closely tied to gold, takes money emission from Congress; (iii) social security is imposed and (iv) various regulatory agencies are created or given additional powers during the second half of the 1920’s.
might then be better understood as a basic question -defining a research program aiming to understand the development and scope of those institutions and policies which were adopted in the mentioned period and which determined the structure and growth of Chilean society in the following 40 odd years- rather than as of a unique moment in time in which a sharp and sudden switch of economic policies took place.

This is exactly what we have done. In four research projects we are in the process of determining the precise role of the Great Depression as well as of other factors, on fiscal, trade and monetary policy changes around the year 1930.

Ideally the impact of the Great Depression on institutional change in Chile could be obtained from a comparison among actual outcomes and a counterfactual excluding it. Policies and institutions arising on the latter would then be confronted with actual experience. Our inquiry will, in general, be far away from such a demanding procedure. In part it will simply consist in checking for time consistency, that is, in establishing if the policy change really occurred after the outbreak of the Great Depression, or if its roots can meaningfully be traced back to former developments. In another part it will center on developments in previous decades, in search of underlying tendencies. In some cases these may be interpreted as early signals of future restrictions, which might require institutional or policy changes. In such a case the Great Depression might not be the fundamental cause behind the outcome, but may still be a factor explaining its precise timing.

What exactly do we mean by “conventional wisdom” in the case of the defining moment? It is the accepted story of the impact of the Great Depression on the Chilean economy, as told, in different versions but with a common threat, by historians and economists. In the next paragraphs we will develop that story and at the same time summarize the results of our studies about the subject.


A first dimension of “conventional wisdom” is that the rapid decline of the share of Chilean nitrate in the world market is blamed on the closing of overseas markets as a consequence of the Great Depression. The initial impact of the Great Depression in Chile was perceived through the export channel. Nitrate and copper production, which constituted most of the country’s exports, reached in 1932 only 12% and 15%, respectively, of their 1929 record levels. By the end of the decade the latter had more or less recuperated their pre-depression level, while nitrate only reached 40% of the same. What happened in the case of nitrates? According to “conventional wisdom”, the worldwide wave of protectionism, which starting little after the Depression, generated most of the loss of this market, as well as of the related tax base. According to the same view, technological change in the nitrate

4 Based on Lüders and Wagner (2003 a).
business, which made the increase of production of substitutes possible, had taken place independently of the Great Depression and its effect on exports is largely ignored.

To the contrary, our study of the issue shows that Chile’s export tax policy in the previous ten or fifteen years might have played an active role in preparing the scenario for a magnified impact of the crush. In fact, the country continued applying a tax code established in the early 1880s, without taking into account that the monopoly power it then enjoyed had been eroded by technological change. When the Depression broke out, local production of substitutes of the Chilean product allowed many countries to impose prohibitive tariffs on Chilean nitrate, which accelerated considerably the decline of an industry which was, as mentioned above, loosing world market share since the beginning of the century.

3. **Was the Beginning of Protectionism in Chile Directly Related to the Great Depression?**

This brings us to the second dimension of “conventional wisdom”, that is, protectionism. Given the export collapse of the early 1930s, a sharp turn in relative prices of tradable goods was unavoidable. This is the principal argument of “conventional wisdom” for State intervention in this Great Depression induced adjustment process. There is no doubt that relative prices had to adjust to the new trading environment, but this could also have been done by other means than government intervention actually chosen. It is today generally acknowledged by the economic profession of the country that the decentralized muddling through of a market process adjustment would probably have been more efficient. Such a process would have had the additional virtue of simultaneously offering incentives to ration imports and to stimulate exports, once third countries liberalized trade again.

The particular regulatory instruments chosen by the authorities to assign the limited availability of foreign exchange during and several decades after the Depression, turned what should have been a simple rationing process, into a very inefficient and discretionary form of protectionism. Initially import tariffs were raised sharply, but also and simultaneously, authorities began to experience with a broad set of other instruments, among them direct State administration of import quotas and multiple exchange rates. This, we argue, completely changed the existing incentive scenario on which protectionism had been based in Chile up to then. The executive no longer played the role of an agent exclusively interested in maximizing tariff revenues, but instead became now able to maximize a whole set of objectives, including political ones. Among the latter, they could now, for example, fix the prices of goods considered to be politically sensible and tax natural resources, especially in the mining sector. These new instruments eventually acquired a life

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5 Based on Lüders and Wagner (2003 b).
of their own, raising without consistency of any kind, effective protection and de-protection rates to extremely high levels and thereby distorting relative prices completely. As a result, the country was not able to take advantage of the significant exchange opportunities offered by the rest of the world, especially after 1952. This development, we think, was much facilitated by the suspension and later, abandonment, of the Gold Standard, probably the most fundamental institutional change produced by the Great Depression.

4. **Was the Gold Standard abandoned as a result of the Great Depression?**

In Chile the Central Bank began operations in 1925, having been granted the money issue monopoly, subject to the convertibility rules of the Gold Standard. Before that, Parliament had the constitutional right to issue paper money, although a Currency Board type of arrangement co-existed with it, limiting de facto the money expansion possibilities. Once authorities decided to first, suspend conversion in 1931 and then, to abandon it in 1932, money supply increases were freed from any restriction, generating in this way the basic conditions for its loose expansion and the corresponding price level increases. The scenario was prepared for new experiences with high and eventually very high, inflation rates.

To find out if Chile would have had to abandon the Gold Standard due to the relatively sharp expected reduction in its foreign exchange earnings, a consequence of the decline of the nitrate industry, if the Great Depression would not have taken place, we carried-out a counterfactual exercise. Accepting the estimates of GDP growth rates in the USA under the assumption that the Federal Reserve had followed a more expansionary monetary policy and not abandoned the Gold Standard, Mc Callum (1990), we estimated Chilean exports and imports, as well as other items of the Balance of Payments, to conclude that Chile would not have been forced to abandon convertibility. It is possible to infer from it that the Great Depression was responsible for the abandonment of the Gold Standard in Chile and therefore, indirectly, for the significant increase in the rate of inflation which followed. We also feel that exchange rate regulations and its direct administration aiming at a broad set of objectives would have been less probable under those rules and therefore protectionism and price distortions in general would not have taken such an extreme character.  

Up to here we have presented what one may call Chilean “conventional wisdom” about the impact of the Great Depression on fiscal, trade and monetary

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6 Lüders and Wagner (2003 c).

7 Distributional issues, that is specific objectives in relation to relative prices of certain goods, pursued in Chile using differential custom duties and exchange rates among other instruments, interacted with the transmission mechanism from monetary expansions to the price level, increasing price change dispersions; Wagner (1992) measures dispersion, but does not distinguish between inflation and policy induced price changes.
policies of the country, and our evaluation of it. In synthesis, our research so far suggests that in the case of Chile, the Great Depression has many of the characteristics of a “defining moment”. The decline of the nitrate industry, which might have forced the country to abandon the Gold Standard, was not, according to our estimates, strong enough in itself to force a monetary system change. The understanding of the peculiar and aggressive protectionism which characterized the country up to the early 1970’s and its long inflationary experience is made easier once we account for the particular character the Great Depression. The institutions which were shaped during and after de Great Depression, defined the type of development of the country during the next half of a Century.

REFERENCES


