

What Economists can Learn from Downton Abbey

By Robert Huebscher

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Economists warn that the U.S. economy could be heading toward one of two catastrophes: the two-decade long stagnation that has befallen Japan, or the hyperinflation that struck Zimbabwe and the Weimar Republic. Such cautionary tales alert policymakers to the failed efforts of their predecessors. But the most relevant comparison is rarely cited – to Great Britain in the 1920s, as depicted in the highly popular PBS series *Downton Abbey*.

While *Downton Abbey's* plot focuses on the interpersonal relationships of the fictional Yorkshire country estate where the period drama is set, a subplot illustrates the crisis that Great Britain faced in the interwar period. Season three, which is currently airing, depicts the struggles of the agricultural workers whose labor economically supports the estate.

Great Britain entered the Great Depression in the 1920s, a decade before the rest of the world. The country faced high unemployment and depressed domestic consumption.



Highclere Castle, in Hampshire, England,
where *Downton Abbey* is filmed.

Sterling's status as the reserve currency was the overarching cause of Britain's economic problems. As I will illustrate, the parallels to the U.S. today and the dollar's reserve-currency status are numerous and include high unemployment, slow economic growth and low interest rates.

The comparison between interwar Great Britain and the U.S. today was first explained to me in an [interview](#) with Columbia professor Bruce Greenwald. Greenwald and his co-author Judd Kahn elaborate on the analogy in their book, [Globalization: The Irrational Fear that Someone in China will Take Your Job](#). Michael Pettis, a professor at Peking University, has a new book, [The Great Rebalancing](#), which further explores the role of reserve currencies.

Let's look first at the role reserve-currency status plays in a country's economy. I'll then turn to the comparison to Britain in the 1920s, and then to what this means for the U.S. today.



The exorbitant burden

Pundits and economists obsess over budget deficits, sequestration, the debt ceiling and quantitative easing. But, as Pettis explains, “the source of the global crisis through which we are living can be found in the great trade and capital flow imbalances of the past decade or two.”

The dollar’s status as the reserve currency has driven those imbalances. The dollar is the primary currency held by foreign central banks and institutions to settle international transactions.

Because dollars are so widely held, there is a persistent structural demand for them. This forces the value of the dollar higher relative to other currencies. Indeed, despite several rounds of quantitative easing – which many warned would weaken the dollar – its value relative to a trade-weighted [basket](#) of foreign currencies is the same as it was at the onset of the financial crisis.

This is because America’s trading partners – including China, Europe and Japan – have employed similar policies of quantitative easing, offsetting actions by the Fed that would have otherwise weakened the dollar. Those countries run trade surpluses, and as Greenwald and Kahn explained in their book, it is always the surplus countries that control global trade and currency values. To maintain reserve-currency status, the Fed must act cautiously and responsibly, whereas the surplus countries can devalue more aggressively.

Reserve currency status has been called an “exorbitant privilege” – a term coined in 1965 by Valery Giscard d’Estaing, then France’s minister of finance and economic affairs, according to Pettis. Giscard d’Estaing was referring to America’s ability to finance a high level of internal consumption with a seemingly limitless capacity to issue debt.

But Pettis argues that a more appropriate term would be an “exorbitant burden.” Because our trading partners are accumulating dollars, the U.S. must run a current-account deficit. U.S. demand exceeds production, with imports making up the difference. U.S. manufacturers are penalized by the overvaluation of the dollar, are forced to contract and unemployment rises.

Our large trade deficit flows directly from our reserve-currency status, as does our low savings rate and high levels of private and public debt.

“Consuming beyond your means, it seems, is not much of a blessing,” Pettis wrote. “And why should it be? Allowing excessive foreign purchases of its bonds requires often that the reserve currency choose between rising unemployment and rising debt.”

Like Britain in the 1920s, the U.S. today faces both burdens.

The Great Britain of *Downton Abbey*

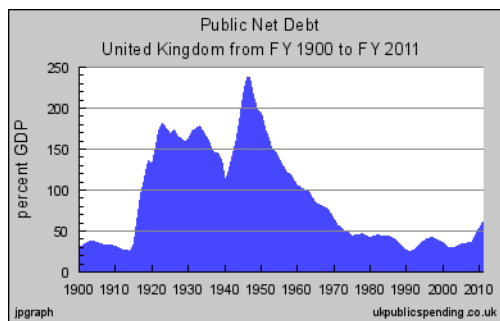
Britain achieved reserve-currency status around 1870 as a result of its leadership in the Industrial Revolution. The nation's economic downfall began after World War I. Let's look at some of the key economic themes of Britain at the time and their parallels to the U.S. today.

Britain's economy collapsed almost immediately after the end of the war. In a counterpart to the U.S. economy during the financial crisis, the British economy contracted from 1919 to 1921, with real GDP decreasing by 9.9%, 7.8% and 10.1% annually in those years.

Britain faced the same dilemma as rest of the world during the Great Depression. Productivity rose in its agricultural sector – *Downton's* farmers – due to the advances of the Industrial Revolution. Fewer workers could produce the same amount of goods. Today, the U.S. economy faces the same situation in its manufacturing sector, which has shrunk to 9% of its economy thanks to post-World War II productivity increases. Higher productivity naturally leads to higher unemployment.

Unemployment was the dominant theme in Britain's economy during the interwar period, as it is in the U.S. today. Britain's unemployment averaged less than 6% for the 40 years prior to World War I. But it jumped from approximately 2% in 1919 to 12% in 1921 and remained high until 1938. Its mean was more than 10%, with a peak of 17% in 1932.

Britain's public debt-to-GDP ratio rose from about 30% at the beginning of the century to more than 150% during the war, and it remained high during the interwar period. Its debt-to-GDP ratio is shown below:



The U.S. debt-to-GDP ratio, now about 100%, has become the primary focus of policymakers.



Britain had low interest rates, as does the U.S. today. Its long-term government bond rate was 4.62% in 1919 and remained below 5% throughout the 1920s. It also had low inflation – its CPI was 3.58% in 1919 and remained at or below 3% throughout the 1920s.

To address its debt burden, British policymakers employed tactics similar to those implemented in the U.S. recently. Britain increased tax rates, first implementing a 50% “excess profit duty” on corporations in 1915, which was increased to 60% in 1916 and 80% in 1918. Though that was abolished in 1920, the British were also being faced with higher income tax rates. The highest marginal rate rose from approximately 8% in 1914 to 50% in 1920. Higher taxes forced many families to sell their estates, as was the case with Highclere, the real-life manor where *Downton* is filmed.

Britain also introduced generous unemployment insurance in 1920. Economists still debate the extent to which that or higher taxes contributed to high unemployment.

Britain also had a parallel to the U.S.-China trade relationship today. France grew exceptionally well in the interwar period by devaluing its currency. France held 60% of sterling reserves and became very vulnerable to British policy.

A few caveats

No analogy is perfect, and one would be mistaken to focus only on the similarities between *Downton’s* Britain and the U.S. today. One key difference was the gold standard. Britain suspended gold convertibility in 1914, at the outset of the war, and reinstated it in 1925. The gold standard kept sterling overvalued, in part because Winston Churchill and the British Parliament pegged it at too high a level in 1925. Sterling was not devalued until 1931, after the start of the Great Depression.

Still, the dominant cause of Britain’s troubles was its reserve-currency status. The gold standard affected only the mechanism by which exchange rates were set. Indeed, in *Indian Currency and Finance*, John Maynard Keynes argued that whether a central bank holds its reserves in gold or in foreign exchange “is a matter of comparative indifference.”

Another difference is that sterling was not the only reserve currency in the interwar period. Recent research by Barry Eichengreen, an economist at the University of California at Berkeley, showed that the dollar achieved partial reserve-currency status during that time, based on the value of dollars held by central banks.

Implications for the U.S. today

If the U.S. wants to avoid the early onset of the Great Depression that Britain faced in the 1920s, should it relinquish its reserve-currency status?



One benefit of reserve-currency status, which Pettis did not discuss, is a higher standard of living. A strong currency can buy cheap imports — which is why U.S. consumers can purchase \$300 flat-screen TVs and why the owners of *Downton* enjoy such a luxurious life style.

For standard-of-living and political reasons, it is virtually certain that the U.S. will not willingly cede its reserve-currency status. That status is a matter of national pride.

A few scenarios, however, could lessen the exorbitant burden it imposes.

One scenario, which is often discussed in the media, is virtually impossible. Neither China nor any other surplus country will sell its U.S. bond holdings. In such a hypothetical scenario, U.S. interest rates would rise and cripple the US economy. As both Pettis and Greenwald explain, this would be self-defeating for the Chinese by decreasing the value of their remaining U.S. bond holdings. It would also bring about offsetting measures by the other surplus countries.

Keynes understood the devastation that the reserve currency was causing in Britain and attempted to address it by creating a universal currency, the “bancor.” American opposition to the concept doomed it to failure, according to Pettis.

But the concept has lived on, and Pettis and Greenwald both support the idea of special drawing rights (SDRs) as a supranational currency. SDRs have also been advocated by Nobel Prize-winning economist Joseph Stiglitz.

A universal currency would allow an institution, such as the International Monetary Fund, to control exchange rates and capital flows, preventing excessive trade surpluses and deficits and halting the imbalances that destabilize the global economy today.

Pettis considers a move to SDRs unlikely. “If the SDR is truly to replace the dollar as the dominant reserve currency, it will not happen simply because there is a more robust institutional framework around the existence of the SDR. It will happen only because the world, or more likely the United States, creates the rules that prevent countries from accumulating U.S. dollars.”

Regardless, Greenwald foresees a rebalancing in global trade. Unlike most other developed nations, the U.S. economy has largely completed its transition from a manufacturing- to a service-oriented economy. Jobs in the service sector are more likely to remain in the U.S. than those in the manufacturing sector. Over the coming decades, according to Greenwald, sectors such as healthcare and education will experience high



growth, at least partially offsetting the job losses caused by the dollar's reserve status and its overvaluation.

Britain ultimately lost its reserve status because the U.S supplanted its dominance. The American economy outgrew that of Britain, providing open capital markets and fiscal and monetary policies that instilled investor confidence.

Downton Abbey is likely to air for several more seasons, so we don't know yet the toll the British economy will take on its inhabitants. But history tells us that reserve-currency status can endure for hundreds of years. The Roman Empire ran a persistent trade deficit with India for centuries, and Spain ran deficits throughout the 16th and 17th centuries. Whatever scenario plays out, don't expect it to emerge in our lifetimes.

I highly recommend both Pettis' and Greenwald's books. Together, they provide a thorough explanation of the forces of global trade, which will be the dominant theme determining the long-term direction of the world's economies.

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