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ECON 201—Montgomery College

LECTURE 31: THE GREAT DEPRESSION

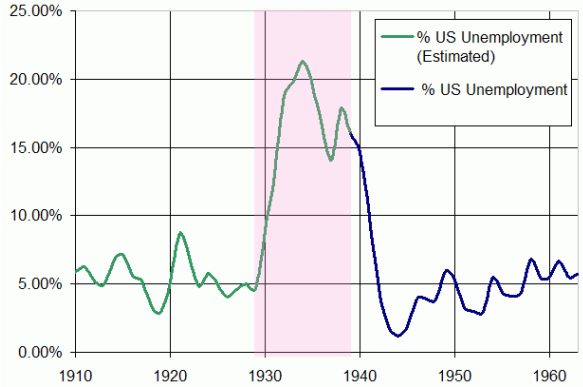
I. Introduction

a. The Great Depression was the longest, deepest economic downturn in U.S. history. The unemployment rate went over 20% and GDP fell as much as 24% in the first few years.[1]

b. There was also massive deflation; prices fell by about one-third in the first few years of the Depression.

c. Nor was it a uniquely American problem; it was worldwide and its devastating effect helped give rise to Adolf Hitler and World War II.

d. It began in 1929 (or 1928 for some countries like Germany and Brazil) and lasted until 1939, though some argue it lasted until the end of WWII.



II. The Cause

a. Economic historians agree the main cause of the Great Depression was a fall in the money supply.[2] It came about due to concerns of inflation during the 1920s and inept Fed policy.

b. The effects of the GD were worldwide because most of the world was on the gold standard. Currencies, and thus economies, were linked through the price of gold. The more gold a country held, the more valuable its currency became.

c. As the U.S. and France attracted investors to park their gold in those countries, done by lowering the money supply to raise interest rates, other countries fought back. Economic activity slowed and prices fell.

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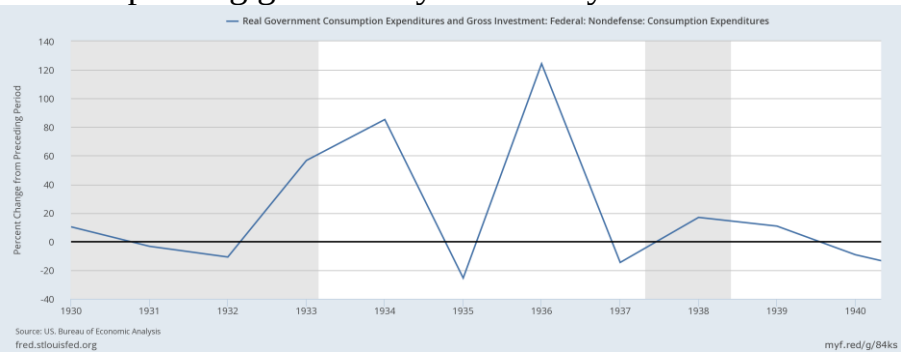
[1] http://www.multpl.com/us-gdp-inflation-adjusted/table

[2] Milton Friedman would win the Nobel Prize in Economics for his work in area. See the landmark book he wrote with Anna Schwartz, *A Monetary History of the United States*.

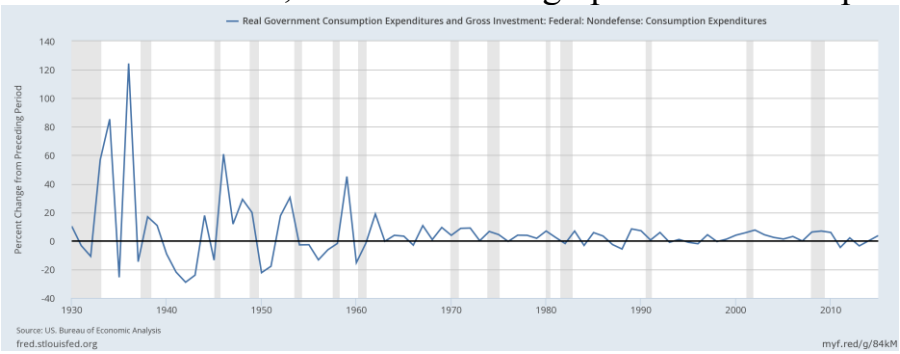
d. Banks began to fail.[3] A lot of them. In 1929, there were 25,000 banks in the U.S. By 1933, there were 15,000.[4] Bank runs were common.
e. Mysteriously, the Fed did not act as lender of last resort; this turned a recession into a depression.
    i. More panic set in as banks failed. (Remember: this destroyed money) And people hoarded money, effectively taking it out of the economy. Deflation deepened. Consumption plummeted.

III. The New Deals

a. Popular history credits the end of the Depression with President Roosevelt's (FDR) New Deal. It included, but wasn't limited to, the creation of Social Security; the establishment of the minimum wage; expanded regulations on agriculture, industry, and finance; and massive increases in government spending.
    i. How big where those increases? Here's a snapshot of the GD era, marking the growth of nondefense government spending from the previous year. FDR took office in 1933. Nondefense spending grew nearly 60% that year.



    ii. For context, here's the same graph from 1930 to present:



b. The New Deal(s) did not end the Depression.

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[3] Banks were failing for a lot of reasons at this time. Part is due to the above effects relating to gold. Part is due to stock market bubbles bursting (though this is a normal economic event). Part of it is due to poor bank diversification. But a big part of it was the banks that failed because of other banks that failed.

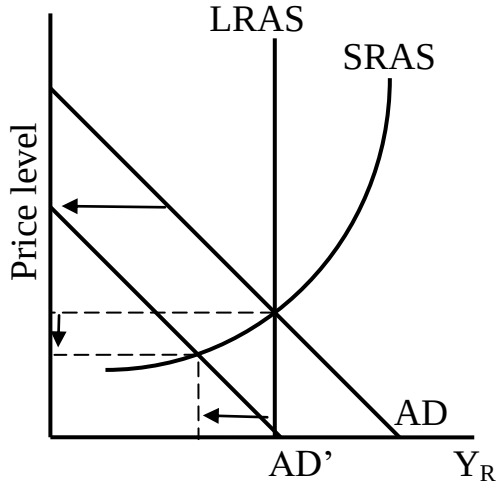
[4] https://fee.org/articles/the-great-depression-according-to-milton-friedman/

i. Many of President Hoover's high wage/high price policies[5] (remember, they were fighting deflation!) were repeated in the First New Deal[6] until they were struck down by the Supreme Court in 1935.

ii. However, the Second New Deal, using wording the Court would find approving, repeated a lot of the same policies.[7]

IV. AD-AS and the Great Depression[8]

a. First, imagine a reduction in the money supply.



i. This creates a recessionary gap. A *recessionary gap* occurs when AD and SRAS intersect at a real GDP below LRAS. It suggests the economy has excess capacity and the current employment level is below full employment. As the name suggests, it represents a recession. Because of how we got this gap (shift AD), there's deflation.

ii. Not to be confused with an inflationary gap. An *inflationary gap* occurs when AD and SRAS intersect at a real GDP above LRAS. It suggests the economy is running "too hot" and that the current employment level is above full employment. This scarcity of workers puts upward pressure on wages across the board, encouraging—as the name suggests—inflation.

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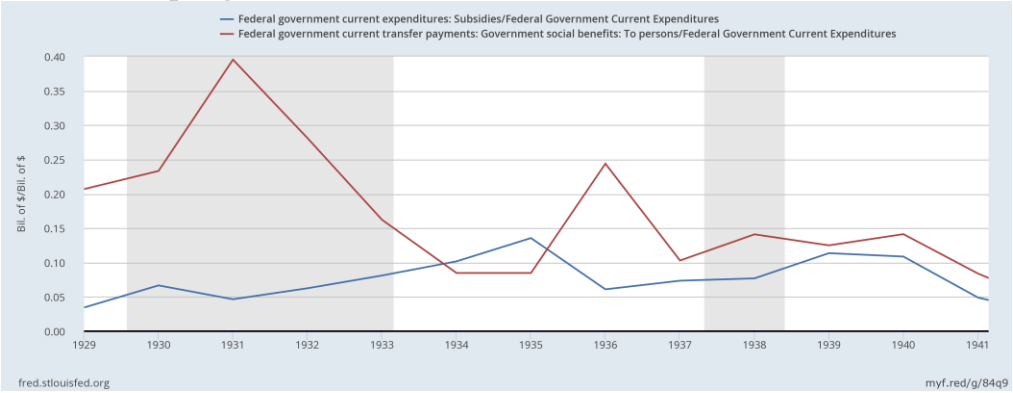
[5] Hoover doubled real government spending during his four years in office. Some of this money was spent to keep food prices high (farmers were paid to not grow crops). He virtually halted all immigration and encouraged businesses to *not* cut salaries. The Davis-Bacon Act (1931), for example, required all government-funded projects to pay the union wage. The Norris-LaGuardia Act (1932) made union-free contracts unenforceable, among other pro-union provisions.

[6] Largely captured by the Agricultural Adjustment Act (AAA) and the National Recovery Administration (NRA) which cartelized industries and reduced competition.

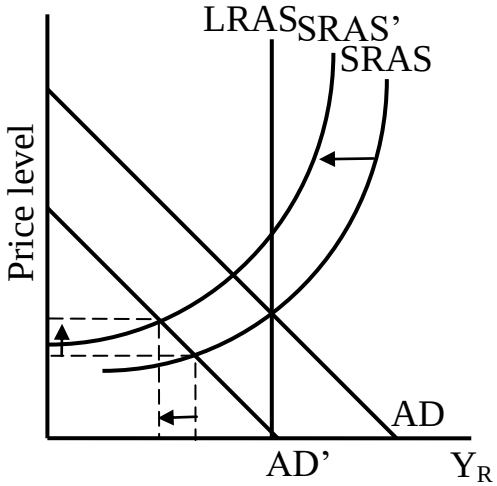
[7] For example, the National Labor Relations Act (1935) allowed union workers to force all other workers for that industry to join the union, effectively creating a monopoly of workers.

[8] Economist Arnold Kling has a nice overview here: https://www.youtube.com/watch?v=4zybZ8cvAIw

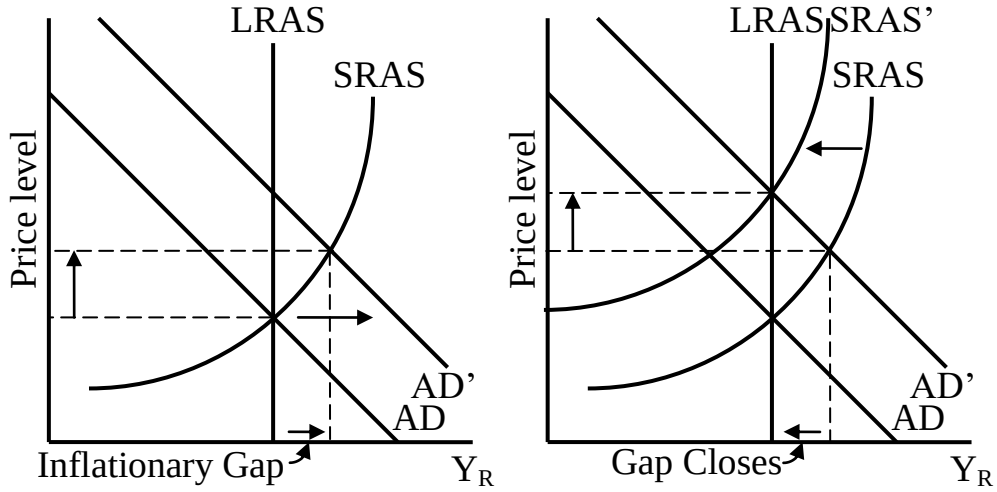
b. We could close the recessionary gap by shifting AD back to the right (perhaps by increasing the money supply or reducing taxes). But that didn't happen.
c. Instead industries were informally cartelized under Hoover and formally cartelized under FDR. FDR's spending increases, though large, had a dual effect. Some of that spending went to things we think of like social programs but other spending were subsidies often used to increase prices (such as paying farmers to not grow crops).
    i. In 1934 and 1935 (year the first New Deal was struck down), the federal government spent more on subsidies than on social programs!



    ii. While this had the desired effect of pushing up prices, it did so in a very counterproductive way: making it harder to produce things. This shifted SRAS to the left.



    iii. Now it's really bad. FDR's policies turned a recession into The Depression. They do a lot to explain why the GD last as long as it did.

V. Now That We Know…

a. Time becomes an important factor in this analysis. Whatever happens, we must make all three curves eventually intersect at one point. The economy trends towards equilibrium
    i. The question you must consistently ask yourself is: in the long-run, what should happen? Should real GDP change or only the price level?
b. If you shift just one curve, the economy shows an imbalance. Rather than three lines intersecting on the same point, three lines will intersect at two different points. Three different scenarios can't be happening at the same time: the price level can only be one result; real GDP can only be one value. The imbalance must correct itself.
c. The correction occurs when another curve shifts so all lines meet at the same point.
d. For example, consider demand-pull inflation:
    i. AD shifts out after the money supply increases.
    ii. This shift puts upward pressure on prices and wages. In the short-run, output increases. This creates an inflationary gap.
    iii. But operating beyond full employment can only happen for so long. Inputs are in high demand; input prices and wages will rise.
    iv. This cutting into profits causes SRAS to shift up to LRAS. The gap closes.
    v. In the long-run, output won't change but we'll get a lot of inflation.