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LECTURE 33: THE GREAT DEPRESSION

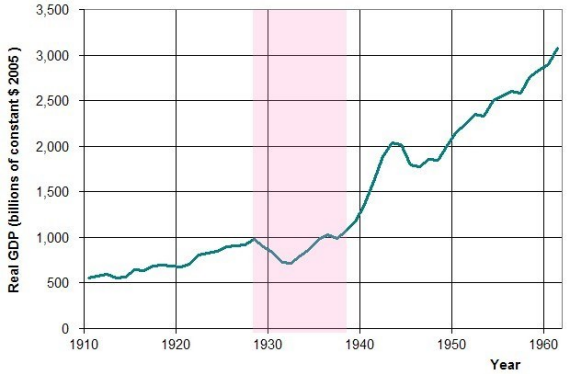
"To understand the Great Depression is the Holy Grail of macroeconomics."
—Ben S. Bernanke, 1994

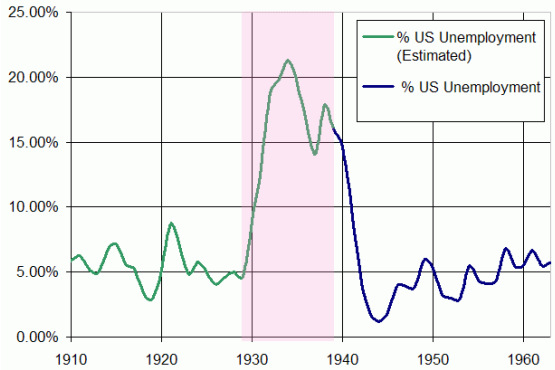
I. Introduction

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 a worldwide crisis, beginning 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. Background

a. Understanding the causes of the Great Depression requires understanding why it was a global event, and that requires understanding the gold standard, which was an important way economies at the time were linked together.

b. Before World War I, most countries were on the gold standard. Paper currency was backed by gold and people could exchange gold for currency and vice versa. During the War, countries switched to a pure fiat system to fund the war effort (so they were no longer constrained by their gold supply), and slowly readopted the gold standard during the 1920s.

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

c. At the same time, bank panics were not unusual. These were the days before deposit insurance: when even mere rumors of insolvent banks surfaced, bank runs, and subsequent failures, would follow.
    i. Banks failed throughout the 1920s, although these failures are relatively small scale and spread out.
    ii. There was a major recession in 1920-21, however this did not lead to massive bank failure because banks were less exposed to debt. Corporate and household debt levels were much lower in 1920 compared to later, in 1929.
d. Economic historians agree the initial cause of the Great Depression was a fall in the money supply.[2] The Depression would then be aggravated by the collapse of the banking system, then later by wage shocks. In our AD-AS diagram, these three events manifest as three different shifts: a leftward shift in AD, a leftward shift in LRAS, and a leftward shift in SRAS. Note all of these shifts decrease real GDP.

II. Prices and the Gold Market
a. The market for gold linked economies together because (almost) all economies were on the gold standard. But a gold standard make the gold market strange because the price of gold is set by law.
    i. For example, in 1920s America an ounce of gold was worth $20.67. You could go to a bank and get one ounce of gold at that price. You bought gold from the government.
b. If the demand for gold increases, how do you reflect a change in the price of gold? After all, a dollar is *defined as* a certain amount of gold. The answer is to change the price of *all other goods*, or to change the price level.
    i. Imagine you have an ounce of gold and that gold has become more valuable because lots of people want it.
    ii. In normal circumstances, the price of gold would go up and if you sold the gold, you would get more money than usual, and could use that money to buy lots of stuff.
    iii. But gold prices *can't* increase because money is *defined* as a certain amount of gold. So how can we get to being able to have more stuff, like we should? By cutting the prices of everything else. And as we'll see, that exactly what happened.

[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*.

III. AD Shifts Left

a. In the 1920s, central banks in the U.S. and France started buying gold. *Lots of it*. About <u>half</u> of the world's gold would be held by these two central banks.
    i. Why did France do this? There were few francs in circulation—people bought gold with foreign currencies and sold the gold to the central bank to get francs. It was the only way to get cash. Also, the French Monetary Law of 1928 required the French central bank to have a high minimum of gold reserves relative to the francs in circulation (at least 35 percent), which it often bought with foreign currencies. By 1930, France's "cover ratio" was over 50 percent.
    ii. Why did the U.S. do this? Concerns about stock market speculation encouraged the Federal Reserve to increase interest rates (so people wouldn't borrow money to put into the stock market). As interest rates rose, people sold gold to the Fed to get dollars, which they put in banks to earn these high interest rates.
b. Critically, neither central bank increased the money supply to balance out all this gold. The money supply fell. (AD shifts left.)
c. As the price level falls, investors (correctly) predict businesses will have a difficult time. The stock market crashes, the public gets scared. (AD shifts left more.)
d. As deflation deepened, banks started to fail because lenders, especially farmers, defaulted. People panicked and pulled money out; bank runs were common, meaning even more banks failed. Bank failures meant less money in the system (remember, banks create money through loans), and they scared people into keeping money at home, where it was functionally removed from circulation. (AD shifts left <u>*even more*</u>.)
e. This is a classic deflationary spiral—lower prices establishes expectations of lower prices in the future. Expected lower prices reduce the demand for investment, thus shifting AD left and causing even lower prices.

IV. LRAS Shifts Left

a. Remember, prices eventually would fall by one-third. That's huge, especially for banks who rely on people being able to pay back their loans. With so many defaults, 40 percent of U.S. banks failed by 1933. Bank runs, and subsequent failures, were common throughout the world.
b. The financial system broke down, and this had a real impact, one that's not simply about changing prices. Remember, banks connect savers

with borrowers—they perform a valuable function by reducing transaction costs. When so many banks failed, the fundamentals of the economy changed, and LRAS shifted left. This was no ordinary recession. This was a depression.

c. The Great Depression illustrates the importance of maintaining the financial sector during economic downturns. It's why during the Great Recession, Bernanke (who was Fed chair at the time) bailed out banks. If the Fed had done something similar in the early 1930s, the Great Depression might well have been avoided altogether.

V. SRAS Shifts Left

a. The key problem of the Great Depression was the gold standard and the tight money policy that it came with. It's hard to increase the money supply when you're limited by how much gold you have.
    i. Bernanke and James (1990) showed that the faster a country left the gold standard, the faster it recovered. For example, Spain, which never got back on the gold standard after leaving it during World War I, largely avoided the Depression.

b. The U.S. left the gold standard in June of 1933.[3] Not long after, the Great Depression began a recovery, but the New Deal %$&# it up.

c. The New Deal had both good and bad parts to it. We'll touch on the good parts (employing unemployed people, for example) when we do fiscal policy. But the bad parts help explain the length of the Great Depression.

d. At the core of the bad parts were forcing wages higher. Higher wages seem like a good idea in general, but higher wages increase the cost of employment. Over the course of just two months in 1933, nominal wages rose by 22 percent.

e. This shifted SRAS left and is a *terrible idea* during a depression. Higher wages were accomplished through a few ways:
    i. The federal minimum wage was established.
    ii. Unions were strengthened, giving workers more bargaining power.[4]
    iii. Shorter work hours, induced by the National Recovery Act, increased the effective hourly wage.

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[3] This might be confusing for anyone who thinks the U.S. left the gold standard in 1971. Both dates are correct. In 1933, FDR functionally ended the gold standard for the general public because citizens would no longer be allowed to exchange dollars for gold. The 1971 law signed by Nixon extended that prohibition to foreign governments and central banks.

[4] 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.

VI. The End

a. Exactly when the Depression ended is a matter of debate but most economists put it around the start of World War II.
b. While war isn't inherently good for economic growth, the government spending and the greater economic stability that resulted from the War allowed us to leave the uncertain and volatile times of the 1930s.
c. There was a massive increase in government spending, an increase in regime stability because wars create clear goals, and a repelling of many the anti-production policies.
d. All of this helped with the recovery to such a degree that after World War II ended, people feared the economy would return to the Depression. Spoiler alert: it didn't.