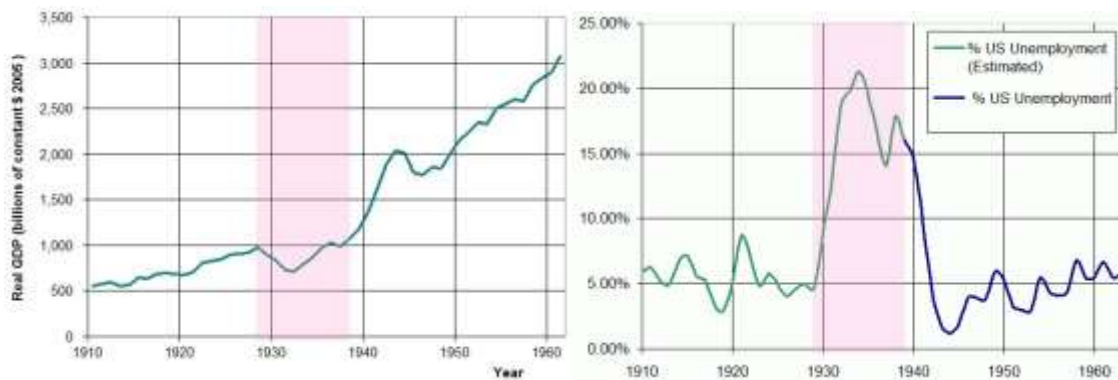


LECTURE 33: THE GREAT DEPRESSION

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 Fed drastically reduced the money supply. Interest rates increased, economic activity slowed, and prices fell, averaging a 10 percent decline between 1930 and 1933.
- c. 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 and

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*.

³ Banks were failing for a lot of reasons at this time. 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.

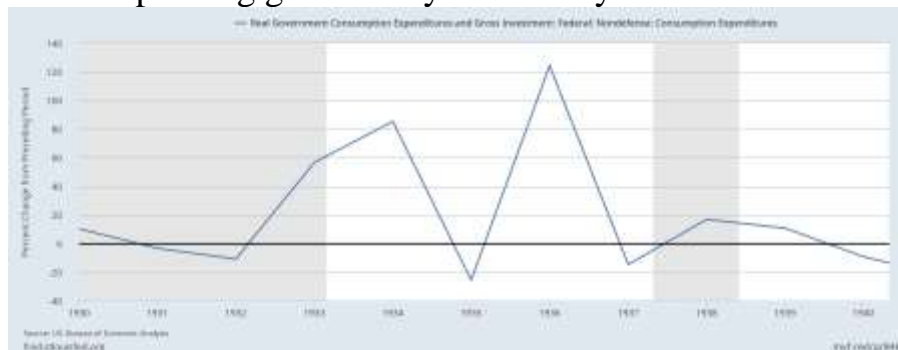
⁴ <https://fee.org/articles/the-great-depression-according-to-milton-friedman/>

the money supply fell even more as people pulled their savings out of banks and kept it out of circulation.

- i. Wait, isn't deflation good for lenders and bad for borrowers? Sure but when deflation's so large that borrowers can't repay loans, it's bad for everyone! As industrialist Jean Paul Getty once said, "If you owe the bank \$100 that's your problem. If you owe the bank \$100 million, that's the bank's problem."
- d. 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 were 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.



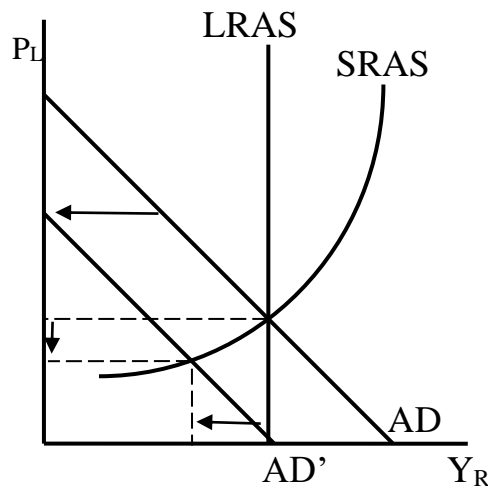
- ii. For context, here's the same graph from 1930 to present:



- b. The New Deal(s) did not end the Depression.
 - i. Many of President Hoover's high wage/high price policies⁵ (remember, they were fighting deflation!) were repeated in the First New Deal⁶ 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 Depression⁸

- 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

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.

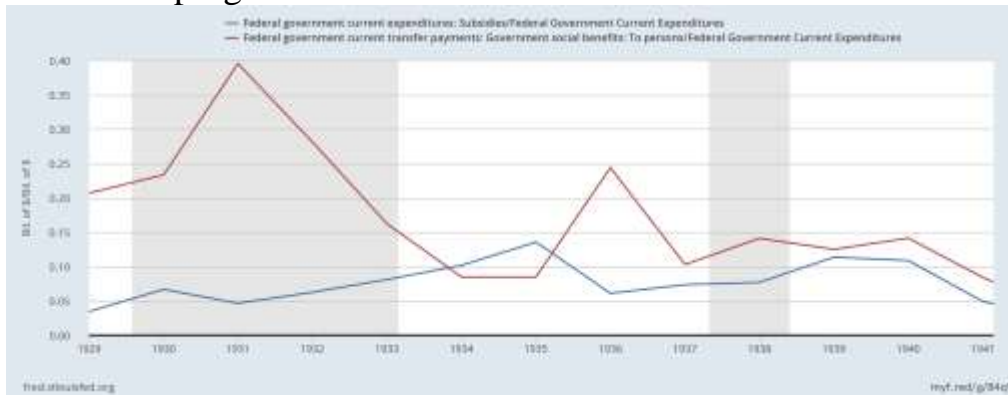
⁶ Largely captured by the Agricultural Adjustment Act (AAA) and the National Recovery Administration (NRA) which cartelized industries and reduced competition.

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.

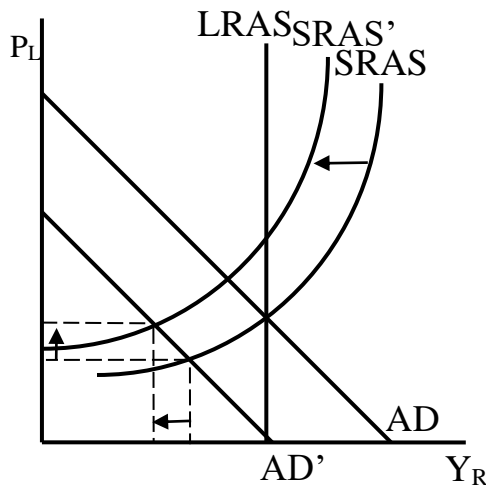
⁸ Economist Arnold Kling has a nice overview here: <https://www.youtube.com/watch?v=4zybZ8cvAIw>

scarcity of workers puts upward pressure on wages across the board, encouraging—as the name suggests—inflation.

- 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. This analysis does a lot to explain why the GD last as long as it did.