

The Great Depression

Duration of unemployment and underemployment without precedent

- 1. 1931-41 unemployment never fell below 14.3%.**
- 2. Since 1941 it has never risen above 10%**

**1929 – Ok year, record high GDP, late year downturn
unemployment 3%**

**1930 – Bad year, at the time generally believed to be an
'ordinary' bad year- unemployment 9%**

1931- bad to still worse – unemployment 16%

1932 – still worse again unemployment 24%

1933 – hit the bottom with unemployment at 25%

1934-36 – nascent recovery but unemployment 20%

1937-38 – recession within a depression

1937-38 another recession, very bad compared to most

Some indicators/consequences by 1933

- 1. Real output down by 30% from 1929 level (money income down 50%)**
- 2. Gross private domestic investment down 89%**
- 3. Unemployment up to 25% in 1932-33**
- 4. Black Unemployment 75% in some cities**
- 5. Net income of farmers down 30% (from already low levels) highest failure rates ever**
- 6. No new home construction – no mortgages available**
- 7. Increasing hunger, homelessness**
- 8. Business failure rate up 50%**
- 9. Banking failures widespread: one in five banks failed**

- 10. State and local governments bankrupt**
- 11. Depression is worldwide – only the Soviet Union and Japan avoid it**
- 12. 67% decline in total world trade**

Did the “roaring twenties” contain the seeds of the depression? Real GDP at 1.6% a year

Possible culprits

- 1. “Bad” Distribution of Income**

1919: Labor Income 72%; Property Income 28%

1929: Labor Income 72%; Property Income 28%

- 2. “Bad” Banking**

Many banks failed but system fundamentally sound

- 3. “Bad” agricultural system**

Overall new but regional “weeding” out due to ex-post overly optimistic expectations

- 4. “Bad” stock market**

Some merit; margin requirements 10%; considerable speculation; but financial crash did not have to result in “Great” depression.

Causes of the Great Depression

Domestic Fiscal Causes – Initial collapse of stock market set in motion a multiplier effect

$$Y = C + I + G + (X - M)$$

$$C = a + b(Y) + dW$$

$$G = G$$

$$I = h + gY - ki$$

Where **Y** = income; **C**= consumption; **I** = private investment; **G**= government spending; **X**= exports; **M**=imports; **W**=wealth; **h** = expectations “animal instincts” according to Keynes; and **i** = interest rate.

Autonomous drops in a, G, I, X, M result in a drop in income

1. Consumption drop due to the stock market crash

Sept. 3, 1929 Dow = 381

Nov. 13, 1929 Dow = 198

Effect

I Consumption $C = C(Y, W)$
Wealth effect of crash

II Confidence
Effect on investment
Postpone purchase of durables

Why was this stock market crash different from others?

Magnitude

Larger % of population in the market

Cumulative effect

Leverage

10% margin

More wealth tied to market

Impact of loss

Example: \$100 tied to Dow

Buy date 1/1/24

Sell date 31/12 each year

All profits & \$100 reinvested at margin

Margin Rate	Sell 3/9/29	Sell 1/1/30
10%	117,257	-76,765
22%	76,305	-11,887
50%	905	305

2. Credit and deflation: mass consumption of the 1920s was financed on credit. Deflation made it costly to pay back these debts. People cut back on consumption to pay debts. Result: multiplier effect.

3. The Decline of World Trade – exports fell

I Intl. Commodities Prices ↓

Bumper harvests of the 1920s

Effect on Commodities exporters

Price/Prod. Cost & Price/Trans. Cost ↓↓

II European Markets

1925 gold-standard resumed

German War reparations

UK, Ger. depended on low i in USA for finance

USA raised i to reduce speculation

III Barriers to Trade

Smoot Hawley Act 1930

Retaliation by rest of the world

Keynsian solution: to a decline in autonomous expenditure is

- 1. decrease taxes – never tried during the 1930s; large tax increases in 1932 and 1937**
- 2. increase government spending - never tried during the 1930s.**

Why fiscal policy was never tried?

- 1. Balanced budget mentality – government balance would bolster business confidence**
- 2. government would misallocate resources**
- 3. government borrowing would crowd out private investment**
- 4. government should not be a relief agency.**