


# THE GREAT DEPRESSION

Lecture 19  
Econ 4524

- 
- Duration of unemployment and underemployment without precedent
    - 1931-41 unemployment never fell below 14.3%
    - 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%

# 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

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

## □ Example: \$100 tied to Dow

- Buy date 1/1/24
- Sell date 31/12 each year
- All profits & \$100 reinvested at margin

## 2. Credit and deflation

### □ 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/Pro

## 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. Cost & Price/Trans. Cost ↓↓

# Keynsian solution:

## **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?

- Balanced budget mentality – government balance would bolster business confidence
- Government would misallocate resources
- Government borrowing would crowd out private investment
- Government should not be a relief agency