

A Tale of Two Depressions and a Few Crises

Lecture 10

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21 Apr. 2016

- 1 The Great Depression: A Macro Picture
- 2 How Did a Recession Become a Depression?
- 3 The Great Depression Vs The Great Recession
- 4 Banking Crises and Reversals in Financial Reforms (if there is time)

Main Macro Indicators in the Great Depression

The overall picture

Overall trend in the macroeconomy during the Depression:

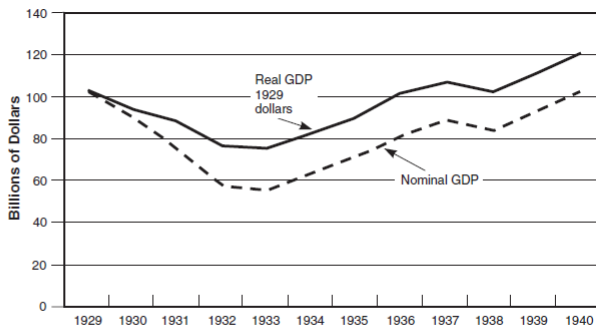
- 1 output fell
- 2 investment collapsed
- 3 unemployment increased
- 4 the stock market crashed
- 5 the government tried to intervene even before the New Deal
- 6 FED's reaction was inadequate

The Great Depression: Macro Indicators

GDP decline

FIGURE 23.1

Gross Domestic Product, 1929–1940



Source: *U.S. Bureau of Economic Analysis*.

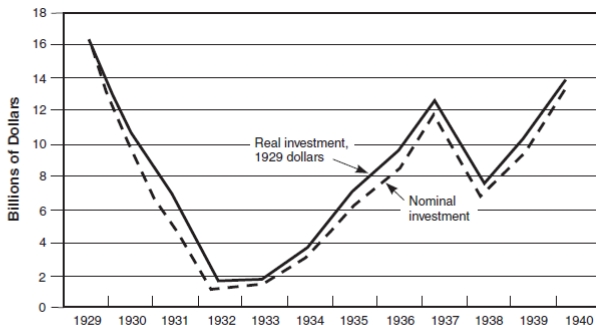
RGDP did not recover for 7 yrs; NGDP did not recover for 11 yrs.
Why is the RGDP higher than the NGDP?

The Great Depression: Macro Indicators

Investment

FIGURE 23.2

Gross Private Domestic
Investment, 1929–1940



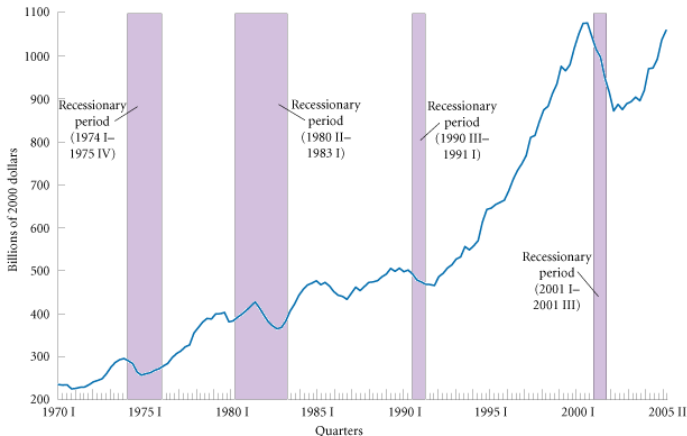
Source: U.S. Bureau of Economic Analysis.

Private investment did not recover until the WWII; wartime crowd-out by the Gmnt.

The Great Depression: Macro Indicators

Investment during other recessions

Plant-and-Equipment Investment



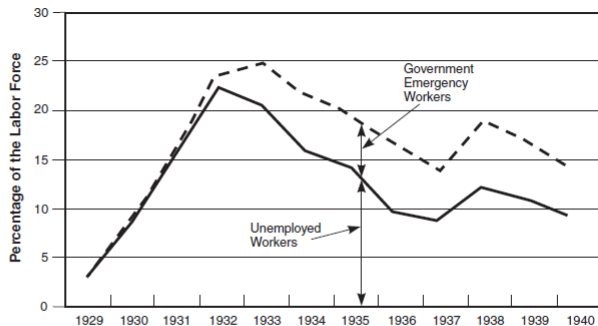
In all recessions, $I \downarrow$. Magnitudes are different.

The Great Depression: Macro Indicators

Unemployment rate (%)

FIGURE 23.3

Percentage of the Labor Force Unemployed, 1920–1940



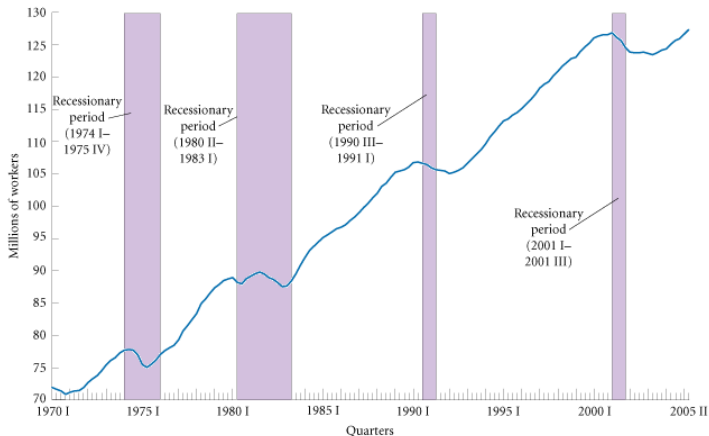
Source: Michael Darby, "Three and a Half Million U.S. Employees Have Been Misled: Or an Explanation of Unemployment, 1934–41," *Journal of Political Economy* 84 (1976): 7, 8.

Unemployment reached unprecedented levels; Gmmt role significant in reducing unemployment; New Deal (1936).

The Great Depression: Macro Indicators

Employment during other recessions

Employment



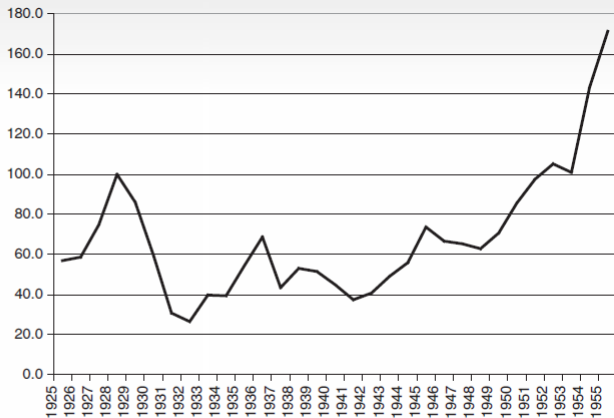
In all recessions, $L \downarrow$. Magnitudes are different.

The Great Depression: Macro Indicators

The Stock Market

FIGURE 23.4

The Cowles Commission/
Standard and Poor Index
of Common Stock Prices,
1925–1955 (1928=100)



Source: Historical Statistics 2006, Series CJ800.

Stock mkt also in deeper depression; did not recover for more than 20 yrs.
Surprise that the depression went for so long? → **Wealth effect**

Factors turning a recession into The Depression

- 1 Building cycles → investment; durables
- 2 Decline in agriculture prices → agriculture production
- 3 Stock market boom and bust → wealth effect
- 4 Response of the FED to the banking crisis → undermining confidence
- 5 Import tariffs → decline in trade worldwide
- 6 Austerity budgets early into the Depression → insufficient fiscal response
- 7 Recession within the Depression → FED got it wrong, again
- 8 Asymmetric information b/w borrowers and lenders during and after the banking crises → amount of loans
- 9 Rising real value of debt because of deflation → demand for loans; hard to service loans
- 10 Sticky wages → unemployment

Factors turning a recession into The Depression

Building cycles

Construction boom started in 1918 → gentle slide from 1925 to 1927 → a marked decline after 1928.

Was that the case with other recessions as well?

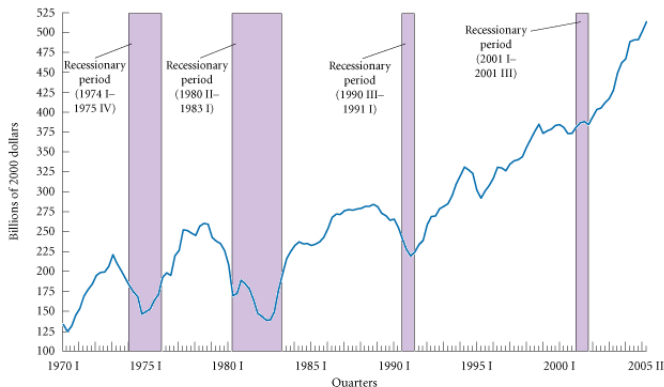
Factors turning a recession into The Depression

Building cycles

Construction boom started in 1918 → gentle slide from 1925 to 1927 → a marked decline after 1928.

Was that the case with other recessions as well?

Housing Investment



Factors turning a recession into The Depression

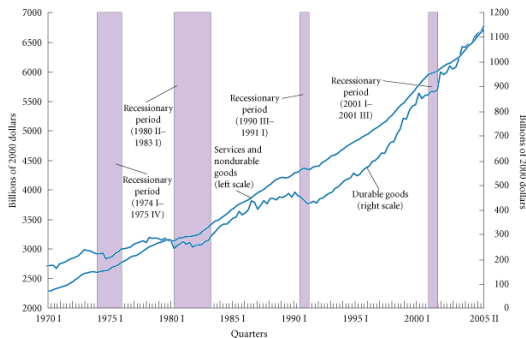
The Wealth Effect coming from the Stock Market

Recall: in the 1920s: a 3-fold increase in the stock mkt → "permanent prosperity"?

By Nov. 1929: stock mkt is 48% down wrt boom prices → durables & housing declined

Is that the case with other recessions?

Consumption



Factors turning a recession into The Depression

The banking crisis and the response of the FED

The spread of the banking crisis:

- ① Summer of 1930: bank runs away from NY and DC
 - ② Dec. 1930: the Bank of the US in NY failed: the largest failure to date
 - ③ **The FED refuses to** act as a lender of last resort. The official position: "failing banks badly managed"
 - ④ March 1931: a second, more intense banking crisis, continues through the summer
 - ⑤ Summer 1931: the banking crisis goes int'l: Kreditanstalt
 - ⑥ July 1931: Germany closes numerous banks
 - ⑦ September 1931: Britain leaves the Gold standard
- 1930-1932: 5000 banks fail; 1933: another 4000 banks fail.

Factors turning a recession into The Depression

The FED policy in the early 1930s

TABLE 23.2 MONEY AND INCOME, 1929–1933

	(1)	(2)	(3)	(4)	(5)
YEAR	MONEY SUPPLY (billions)	GROSS DOMESTIC PRODUCT (billions)	RATIO OF MONEY TO GDP	COMMERCIAL PAPER RATE (percent)	REAL RATE OF INTEREST (percent)
1929	\$46.6	\$103.7	0.45	5.78%	5.88%
1930	45.7	92.3	0.50	3.55	8.15
1931	42.7	76.6	0.56	2.63	15.46
1932	36.1	58.8	0.61	2.72	14.99
1933	32.2	56.4	0.57	1.67	3.03

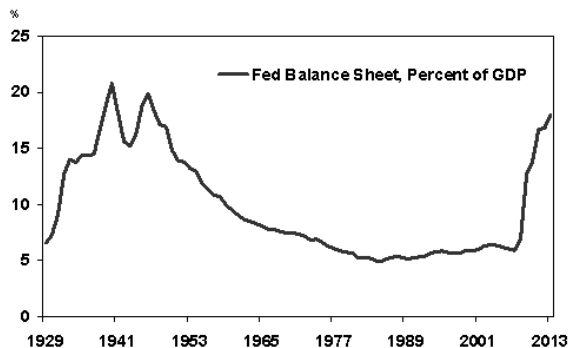
Source: Milton Friedman and Anna J. Schwartz, *Monetary Trends in the United States and the United Kingdom* (Chicago: University of Chicago Press, 1982), 124.

Monetarists: the primary causes of the Great Depression were

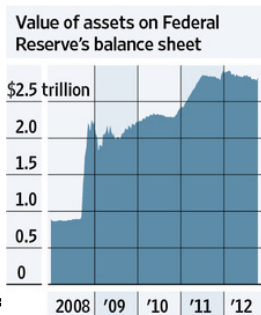
- 1 the decline in the stock of money
- 2 the decisions of banks to hold more reserves

Factors turning a recession into The Depression

The FED policy in the 1930s and today



Source: Morgan Stanley



Source: Federal Reserve

Similarities and differences?

- 1 similar share of GDP
- 2 different reasons: faster decline of GDP then; faster expansion of M_2 now

Factors turning a recession into The Depression

The banking crisis and the late response of the Government

Government response: **Roosevelt in office March 1933:**

- Bank holiday (March, 1933)
- The Banking Act of 1933 (June, 1933)
 - ① Federal Deposit Insurance Corporation (Jan. 1st, 1934)
 - ② Separation of commercial and investment banking

→ The number of bank failures fell from 4,000 in 1933 to 61 in 1934 and remained at double-digit levels through the rest of the 1930s.

Factors turning a recession into The Depression

Fiscal austerity, too little support too late

Balanced budget in 1929 and 1930

Note the G and I :

TABLE 23.3 GOVERNMENTAL EXPENDITURES AND REVENUES, 1927–1940
(BILLIONS OF DOLLARS)

YEAR	FEDERAL		STATE AND LOCAL		PRIVATE INVESTMENT
	EXPENDITURES	REVENUES	EXPENDITURES	REVENUES	
1929	\$2.9	\$3.8	\$ 7.8 ^a	\$ 7.8 ^a	\$14.5
1932	4.8	2.0	8.4	7.9	3.4
1934	6.5	3.1	7.8	8.4	4.1
1936	7.6	4.2	8.5	9.4	7.2
1938	7.2	7.0	10.0	11.1	7.4
1940	9.6	6.9	11.2	11.7	11.0

^aThis is for 1927; data for 1929 is not available.

Source: Historical Statistics 1975, Series F53, Y335, Y336, Y338, Y340, Y652, and Y671.

$G \uparrow < I \downarrow \rightarrow G \uparrow$ was insufficient

Private investment was subdued due to the increased role of the unions and a more anti-business rhetoric of that time.

Factors turning a recession into The Depression

Higher import tariffs

Exports were only 6 percent of GNP in 1930, and imports only 4.9 percent.
→ a general wave of retaliation by raising tariffs worldwide → world trade down → a self-defeating *beggar thy neighbor* policy

After WWII: Recognizing this was a mistake, the US has become a champion of free trade

Today: more gentle *beggar thy neighbor* policies: soft currency wars because of the WTO impact on tariffs

Factors turning a recession into The Depression

The recession within the Depression; sticky wages

Early 1937: industrial production reaches 1929 levels.

At that time, both fiscal and monetary policies turn restrictive, taking the economy into another recession.

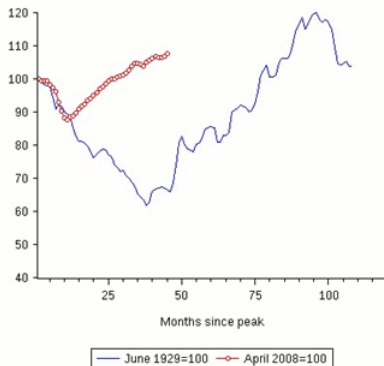
- G: raised taxes
- FED: raised reserve requirements.

Increased role of the unions → sticky wages.

Discussion: How would a sticky wage create unemployment in an environment of declining Labor demand? – use a graph

The Great Depression Vs The Great Recession

World Industrial Production

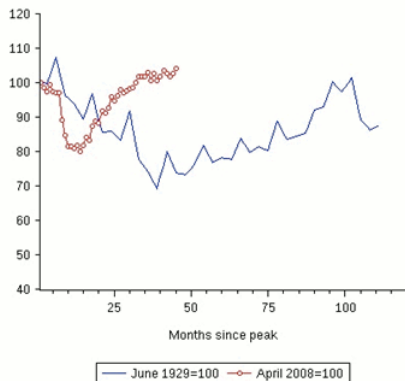


Similarities and differences?

- 1 similar decline in the beginning
- 2 faster recovery now

The Great Depression Vs The Great Recession

World Trade

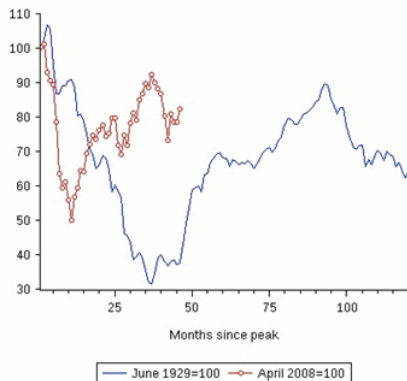


Similarities and differences?

- 1 faster decline in the beginning
- 2 faster recovery now (10yrs VS 2 yrs)

The Great Depression Vs The Great Recession

World Stock Markets



Similarities and differences?

- 1 faster decline in the beginning
- 2 faster recovery now (10yrs VS 3 yrs)

Main points

- 1 Main characteristics of the start of the Great Depression
- 2 Why $NGDP < RGDP$ during the Depression?
- 3 What is the behavior of K , L during the Depression? Is it similar in other recessions?
- 4 Were there expansionary fiscal measures before 1936?
- 5 How did the stock market prolong the Depression? – Wealth effect
- 6 The role of housing and durables in a recession
- 7 What was the FED reaction to bank failures?
- 8 Was the initial fiscal response sufficient?
- 9 What is the role of the sticky wages for unemployment?
- 10 The major causes of the GDP, according to the monetarists?
- 11 Similarities and differences between the M_s expansion (in GDP) then and now
- 12 Financial regulatory responses to the banking crises in the 1930s
- 13 Was the fiscal stimulus sufficient to offset the decline in I ?
- 14 What's a *beggar thy neighbor* policy?
- 15 Why the 1937-38 recession?
- 16 What is the role of labor unions in making w sticky?
- 17 How are the Great Depression and the Great Recession similar and different, especially in terms of policy responses?

- ① *** Eichengreen, B. and K. O'Rourke (2012) A tale of two depressions redux. Retrieved from <http://www.voxeu.org/article/tale-two-depressions-redux> , VoxEU.org, 6 March.
- ② *** Walton, Gary M., and Hugh Rockoff, (2010). *History of the American Economy: Eleventh Edition*. South-Western Cengage Learning, Mason, OH [**Chapter 23: The Great Depression**; Chapter 24: The New Deal]
- ③ Stankov, P. (2012). Banking crises and reversals in financial reforms. *CERGE-EI Working paper No. 474*. Retrieved from <http://www.cerge-ei.cz/pdf/wp/Wp474.pdf>