What caused the Great Depression?
Business Cycle

Level of real output

Recession → Trough → Recovery → Peak → Recession → Trough → Recovery

Time

Peak

Growth
Business Cycle

• Depressions (or recessions) occur when there is not enough demand for all the goods and services that an economy produces

• Inventories of surplus goods build up:
  – To compensate, manufacturers:
    • Cut production
    • Lay off workers
    • Buy less raw materials
Business Cycle

• Demand for two kinds of goods – durable goods and capital goods – tends to fluctuate, and these fluctuations drive the cycle
Durable Goods

• Durable goods
  – Consumer goods that last a long time
    • Automobiles, appliances, home furnishings
  – Demand for durables increases when consumers are feeling prosperous; it falls when they are not feeling prosperous
  – Durable goods markets can be saturated (i.e. there will be times when most consumers have purchased the durables that they want and have no desire to buy more)
Capital Goods

• Capital goods
  – Goods that are used to produce other goods
    • Factory buildings, machinery, and equipment
  – Businesses invest in capital goods only when they feel that consumers will buy what is produced; when that prospect seems doubtful, demand for these goods falls
How the Business Cycle Works

• Durable goods eventually wear out and must be replaced
• To supply new goods, manufactures purchase new capital goods, rehire workers, and increase their purchase of raw materials
How the Business Cycle Works

• When demand increases, prices/wages rise
• When demand decreases, prices/wages fall
How the Business Cycle Works

• During **recession** = demand decreases along with employment
• At **trough** = low prices create an incentive for consumers to buy more, leading to recovery
• During **recovery** = demand increases along with employment
• At **peak**, almost every potential worker can find a job
Business Cycle

The diagram illustrates the business cycle, showing the phases of Peak, Recession, Trough, Recovery, and Peak again over time. The trend line represents the long-term growth of the economy.
During most of the 1920s, the business cycle was in peak

- Increase in consumer purchases of homes and durable goods
- Towns and cities grew rapidly
- State and local governments spent money to provide roads, sidewalks, water and sewage services
- Homes were connected to telephone and electricity services
- Consumer and government spending created plentiful, high-paying jobs
In the late 1920s, the economy started to enter a mild recession:
- House and automobile sales decreased
- Governments had completed most of their infrastructure projects
- Total spending in the economy was falling
- Business firms began to cut production
- The stock market crash in October signaled to shareholders that profits would fall
- Wealth decreased and the ability of consumers to meet credit obligations was diminished
Historical Application – 1920s

• Most people thought that the USA was experiencing a recession and that prosperity would return

• But . . .
  – Demand stayed low
  – Layoffs continued and increased in some sectors
  – Many businesses went bankrupt
  – Banks began to fail in the early 1930s; wiping out personal savings and further decreasing demand
  – Government relief funds ran out
  – Foreclosures increased along with homelessness, hunger, and crime
Three Possible Explanations
Keynesian Explanation

• The Great Depression was caused primarily by a fall in total demand.
• The decline in demand was so severe that adequate demand could be restored only by large increases in government spending.
Monetarist Explanation

• The Great Depression may have originated in a fall in total demand, but its length and severity resulted primarily from the unwillingness of the Federal Reserve System to prevent bank failure and maintain a large enough supply of money
International Explanation

• The Americans depression was part of a larger global depression
• The depression was particularly severe in the United States because the Federal Reserve System was obligated to follow the rules of the gold standard
Keynesian Explanation

• John Maynard Keynes

• It is possible for total demand in a modern economy to remain low indefinitely, leading to long periods of high unemployment
Keynesian Explanation

• Workers unemployed $\rightarrow$ consumers spend little $\rightarrow$ businesses reluctant to produce goods that would probably not be purchased $\rightarrow$ businesses cut production $\rightarrow$ more layoffs
Keynesian Explanation

• Way to create demand is to:
  – Radically increase government spending to compensate for decreased consumer and business spending
  – The central banking system (the FED) should create new money for the federal government to borrow and spend
  – The federal government should cut taxes and increase spending, thus creating a deficit
Monetarist Explanation

- Milton Friedman and Anna Schwartz
  - *A Monetary History of the United States* (1963)
- Actions taken by the FED created and perpetuated the depression
  - The FED raised interest rates in 1928 → discouraging business borrowing and spending → decline in production
  - The FED raised interest rates in 1930 and 1931
Monetarist Explanation

• The FED was created in 1913 by Congress for the purpose of preventing bank failure caused by a “run” on the bank

• FED Banks were supposed to supply banks with enough cash to meet the demands of their customers
Monetarist Explanation

• FED Banks in the 1930s refused to support banks that they thought were unlikely to repay them → banks forced into bankruptcy → deposits can no longer be spent → amount of money circulating in society decreases → demand for goods and services decreases
Monetarist Explanation

• Depression lasted for a long time because banks were reluctant to make new loans after 1933 (only very conservative and safe loans)

• Banks believed that the FED would not support them

• FED raised interest rates again in 1936 just as the economy began to improve because they feared inflation
Internationalist Explanation

• Barry Eichengreen and Harold James

• Places the American depression in the context of the worldwide depression that started in 1928-1929
Internationalist Explanation

• Worldwide depression blamed on the return of European nations to the gold standard after WWI
• Gold standard established fixed rates of exchange among nations
  – Each participating nation agreed to exchange a given amount of their currency for an ounce of gold
Internationalist Explanation

• Domestic problem for nations on a gold standard:
  – Banks used gold as reserves to back up their loans → when bank gold reserves were lost to other countries because of the gold standard they had to reduce loans → businesses had to cut back on production because they couldn’t get loans → workers laid off and supply orders reduced
Internationalist Explanation

• Warring nations temporarily adopted a fiat currency during the war
  – When resuming the gold standard after the war they used the same exchange rates as before the war
  – Changes to the world political and economic system put strain on national economies

• Post WWI international gold standard was really a “gold exchange standard”

• World economy was growing, but little new gold was discovered → not enough gold to back the currencies of all the gold-standard nations
Internationalist Explanation

• Banking panic:
  – Credit-Anstaldt (Austria’s largest bank) failed in 1931 → investors demanded deposits be exchanged for gold (bleeding Austrian gold reserves) → Austria stopped honoring gold standard commitments → panic spread → Germany froze gold exchanges → Great Britain left the gold standard → foreign depositors rushed to make withdrawals from U.S. banks
Internationalist Explanation

• The FED never abandoned the gold standard rules as had other countries

• The FED increased interest rates to attract foreign depositors and stop flow of gold
  – Discouraged borrowing $\rightarrow$ business failures
    $\rightarrow$ job losses $\rightarrow$ bank failures
Other Contributing Factors

• Smoot-Hawley Tariff
  – Reduced imports and exports
• Policies of Presidents Hoover and Roosevelt to keep prices and wages from falling had the opposite effect and prevented the economy from adjusting to the rapid international crises
• Excessive personal and business debt caused by overuse of credit
Bibliography