The Great Depression (5/3/2011) Econ 310-008

Definitions

- ***buying on margin*** – purchase of an asset by paying the margin and borrowing the balance from a bank
- ***margin call*** – lender's demand on an investor using margin to deposit additional money or securities so that the margin account is brought up to the minimum margin
- ***tariff*** – tax imposed on a product when it is imported into a country
- ***retaliatory tariff*** – tariff imposed by a foreign country to punish the government for its high tariffs
- ***jawboning*** – attempt to persuade others to act in a certain way by using the pressure of a high office

Principles

- Keynes advocated a counter cyclical public spending policy.
- Irving Fisher believed the Great Depression was caused by margin calls leading to a debt-deflation spiral.
- Friedman and Schwartz believed the depression was caused by contractionary monetary policy by the Federal Reserve, as shown in their book *A Monetary History of the United States 1867-1960*.
- In 1928 the Fed began contracting due to the stock bubble.
- Late in the Depression the Fed believed it had a loose policy, but did not take into account bank failures which made the money supply still contractionary.
- Ludwig von Mises and F.A. Hayek believed the Great Depression was an Austrian Business Cycle.
- Barry Eichengreen theorized in *Golden Fetters* that it was caused by the international gold standard.
- Tariffs hurt consumers and help producers, but producers are helped far less than consumers are hurt.
- President Herbert Hoover was a big believer in wage & price floors.
- FDR created programs designed to keep prices and wages high.
- In 1942 FDR set income tax rates above $25,000 at 100% by executive order.
- In the 1920's M^s expanded by 40%, but the price level was stable because M^d also increased.
- Milton Friedman pointed out that when you see unemployment high for a decade, it is not a rise in cyclical unemployment, but rather a rise in the natural rate of unemployment.
- The real endof the Great Depression is after WWII when unemployment lowered for voluntary work.
- The Great Depression was the first recession with interventionism; all other presidents didn't intervene.
- No bank failures in Canada during Great Depression.
- 1839-1843 was a deflation like 1929-1933, but it occured with price flexibility and full employment.

Aggregate theories

- Keynesian – J.M. Keynes
- Debt Deflation – Irving Fisher
- Monetarist – Milton Friedman
- ABCT – F.A. Hayek & L.v. Mises
- Golden Fetters – B. Eichengreen

Other theories

- tariffs
- wage & price floors
- income tax
- make-work projects
- consumer loans
- gold standard
- regime uncertainty

1929-1933

- unemployment rose 3% to 25%
- money supply deflated
  - M1 fell 25%
  - M2 fell 35%
- 9,000 banks failed
- international trade
  - imports declined 66%
  - exports declined 61%
- real wages *increased*
  - P dropped faster than W

Keynesian

- blamed aggregate demand failure
- advocated government spending
  - massive public works projects
- wrote pamphlets, books, and op-eds
  - "A Means to Prosperity" (1933)
  - General Theory of Employment, Interest and Money (1936)
  - "An Open Letter to President Roosevelt" (1933)

Debt-Deflation

- margin calls
  - margin requirements were 10%
  - margin calls when stocks declined
  - selling made stocks decline more
- banks
  - didn't re-lend called in loans
  - borrowers default, banks insolvent
  - bank runs, bank panics, bank failures
- spirals in margin calls & bank failures
  - massive deflation

Monetarist

- money supply
  - M1 declined by 25% 1929-1933
  - M2 declined by 35% 1929-1933
- Federal Reserve
  - looked at interest rates, not M1
  - tight policy 1928 (stock market)
  - believed loose later, really tight
    - due to bank failures
  - doubled reserve requirements 1936
    - led to double dip recession

Austrian Business Cycle Theory

- boom
  - artificially low interest rates
  - 1920's expansion
  - stock bubble
- bust
  - 1929 stock market crash
  - malinvestments revealed
  - Great Depression

Golden Fetters

- gold exchange standard
  - restrictions on printing money
    - 15% minimum gold backing
- must import gold to print money
  - only trade surplus countries
    - United States – contracted
    - France – feared hyperinflation
- LM contracted worldwide
  - deflation
  - output declined

Wage & Price Floors

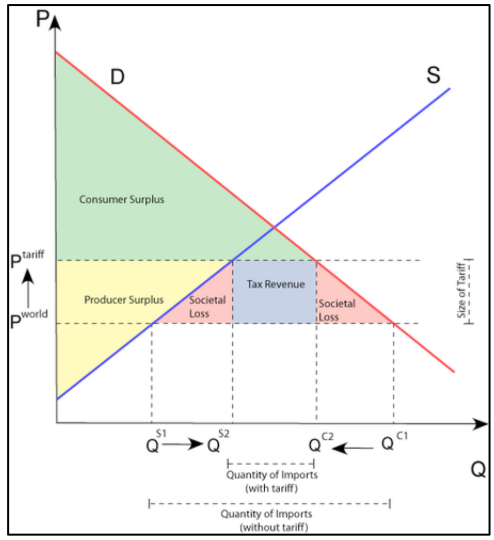
- Herbert Hoover
  - head of U.S. Food Administration
    - rationed food for nation (World War I)
  - Secretary of Commerce
    - massive business regulation
  - President
    - jawboned business leaders
    - kept wages & prices high
- Franklin D. Roosevelt
  - National Industrial Recovery Act
    - work hours: max hours
    - wages & salaries: min wage
    - prices: price floors
  - Agricultural Adjustment Act
    - farm subsidies
    - raise food prices

Make-Work Projects

- Civilian Conservation Corps
  - trees, parks, roads
- Works Progress Administration
  - bridges, dams, schools
  - arts, drama, media, literacy
- projects often unnecessary
  - Broken Window Fallacy
- no incentive for productivity

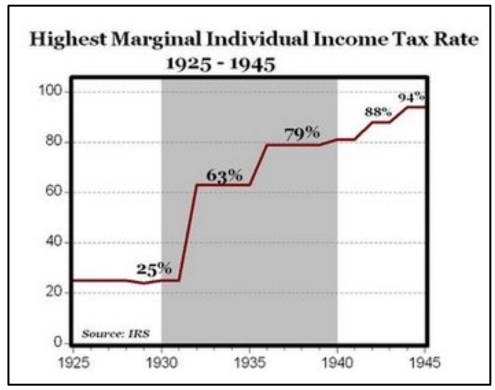
Smoot-Hawley Tariff Act

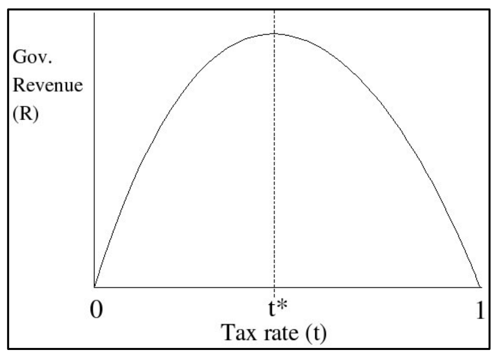
- passed in 1930
- signed by President Herbert Hoover
- 1,028 economists asked for veto
- 23 countries threatened retaliation
- Smoot and Hawley not re-elected
- raised tariffs on 20,000 goods
- tariff rate varied (depends on good)
- imports declined 66% 1929-1933
- exports declined 61% 1929-1933
- caused 1929 stock market crash



Income Tax

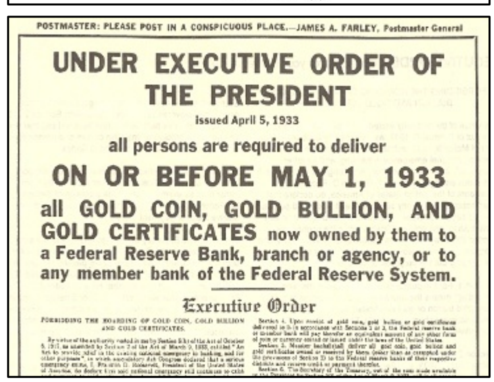
- Andrew Mellon
  - o Secretary of Treasury 1921-1932
    - Harding, Coolidge, Hoover
  - o cut income tax 77% to 25%
  - o economy boomed in 1920's
- Franklin D. Roosevelt
  - o raised income tax
    - 25% to: 63%, 79%, 88%, 94%
  - o 100% tax by executive order
    - (see Laffer Curve)
  - o Great Depression





Miscellaneous

- consumer loans
  - o banks called in loans quicker
    - only 1 missed payment
  - o consumer spending declined
- gold standard (note backing)
  - o internationally: 15% gold
  - o Federal Reserve: 40% gold
- regime uncertainty
  - o taxes, regulation, etc. vary
  - o don't invest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Issued April 5, 1933

all persons are required to deliver

ON OR BEFORE MAY 1, 1933

all GOLD COIN, GOLD BULLION, AND GOLD CERTIFICATES now owned by them to a Federal Reserve Bank, branch or agency, or to any member bank of the Federal Reserve System.

Executive Order

FORBIDDING THE HOARDING OF GOLD COIN, GOLD BULLION AND GOLD CERTIFICATES.

Severity vs. Duration

- AD (severity)
  - o bank panics
  - o 1/3 fall in M2
- SRAS (duration)
  - o government cartels
  - o wages & prices rigid
- LRAS
  - o tariffs
  - o international trade