

**Objectives for Chapter 12: The Great Depression (1929 to 1941)
and the Beginning of Keynesian Economics**

At the end of Chapter 12, you will be able to answer the following:

1. Briefly describe, with data, the Great Depression of 1929 to 1941. Draw it on the Aggregate demand – aggregate supply graph.
2. Name the **main causes** of the Great Depression of the 1930s and explain why each contributed to the Depression.
3. What was the recommendation of the Classical Economic Theory as far as solving the problem of the Great Depression? Why?
4. Keynes disagreed with the conclusions of the classical economists. He argued that an economy might not be self-regulating. Explain how this might result and show it on the aggregate demand – aggregate supply graph.
5. Why might wages NOT be flexible downward?
6. Keynes saw the short-run aggregate supply curve as **horizontal**. What would this mean and why might it be so?
7. Name and explain the **main policy responses** once the Great Depression began.
8. What was the *Smoot Hawley Tariff of 1930* and why was it a bad idea?
9. Why did the United States **go off of the Gold Standard** in 1934?

Chapter 12: The Great Depression (1929 to 1941) and the Beginning of Keynesian Economics (latest revision August 2004)

1. The Great Depression

As we saw earlier, a **depression** is a very large recession, a period during which Real Gross Domestic Product is falling. And a **recessionary gap** occurs when the Real Gross Domestic Product is below the Potential Real Gross Domestic Product. Examine the data in Table 1 on Real Gross Domestic Product and on the unemployment rate. From the Real Gross Domestic Product data, you can see that **there was a depression that began in 1929 and lasted until 1933**. By 1933, production had fallen almost 30% from the amount that had existed in 1929. After 1933, the American economy recovered. However, it did not fully recover all of the production that had been lost until 1937. **In 1938, there was yet another recession** before the economy recovered again in 1939. And from the unemployment data, you can see that **there was a very large recessionary gap for the entire decade**. To give these unemployment numbers some perspective, remember that the unemployment rate in the United States has only exceeded 10% for a few months during the past sixty years. Yet the unemployment rate was well over 10% for the entire decade of the 1930s. In 1933, one out of every four workers was unemployed. Even in 1941, almost 10% of workers were still unemployed. Also remember that, in the 1930s, there was no welfare system, there were no unemployment benefits, and there were no Social Security or unemployment benefits. In a family, only one adult typically worked in the labor market. If a worker became unemployed, the family faced a period with no money coming in at all. Many unemployed people were out of work for a very long period of time. The 1930s were an economic disaster that had never been seen before and, fortunately, has never been seen since.

Table 1	<u>Year</u>	<u>Real Gross Domestic Product*</u>	<u>Unemployment Rate</u>
	1929	\$104.4 Billion	3.2%
	1930	95.1	8.9%
	1931	89.5	16.3%
	1932	76.4	24.1%
	1933	74.2	25.2%
	1934	80.8	22.0%
	1935	91.4	20.3%
	1936	100.9	17.0%
	1937	109.1	14.3%
	1938	103.2	19.1%
	1939	111.0	17.2%
	1940	121.0	14.6%
	1941	138.7	9.9%

*1929 prices

Some Suggested Causes of the Great Depression

When we look back at the Great Depression, there are two different, but related, questions we must ask. First, why did the Great Depression occur at all? And second, why did the Great Depression persist for so long?

The most famous cause of the Great Depression was **the stock market crash** of October of 1929. The stock market has crashed many times in its history. In fact, the greatest one-day crash occurred in October of 1987. But these other crashes were quickly reversed. What makes the stock market crash of 1929 unique is that it continued on and on. By 1932, the total value of all of the stocks sold on the New York Stock Exchange was only about 20% of the amount they had been worth in September of 1929. Nearly 80% of the value of all of the shares of stock had simply disappeared. What effect does it have if the value of stocks declines? In fact, there are two major effects. **First, the decline in the value of stocks made many people poorer (the wealth effect).** As we will see in Chapter 14, when people become poorer (that is, when their wealth declines in value), they will spend less on consumer goods. **Second, and perhaps more importantly, the decline in stock prices affected people's expectations, making them much more pessimistic about the future.** When consumers are pessimistic, they are more likely to save their income rather than spend it. And when businesses become pessimistic, they are less likely to buy new capital goods. **Aggregate demand falls as consumption and business investment spending both decrease.** (Consumption fell from \$79 billion in 1929 to \$64.6 billion in 1933. Business investment spending fell from \$16.2 billion in 1929 to only \$0.3 billion in 1933.)

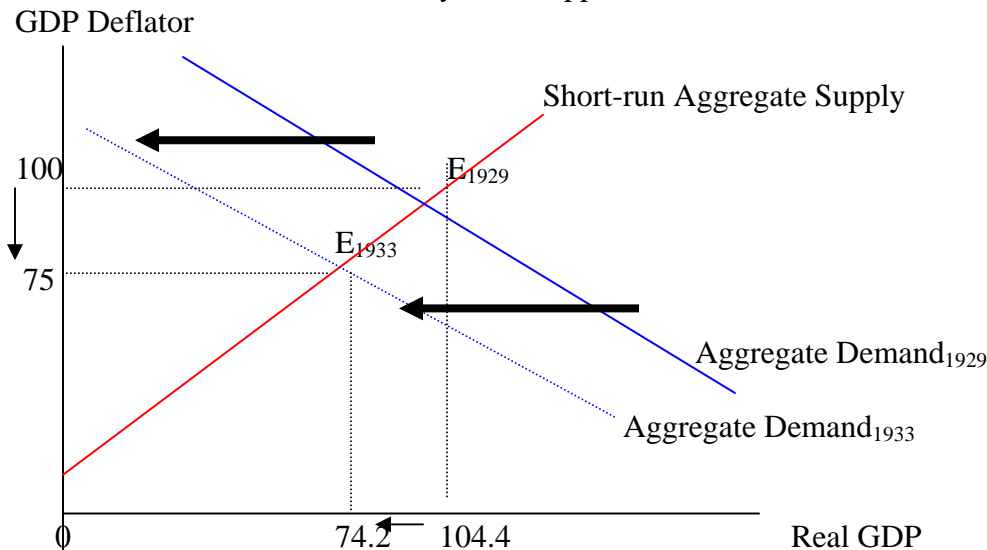
The decline in the stock prices of 1929 also caused a decline in the money supply. We will define "money supply" in Chapter 21. For now, the money supply is simply the number of dollars in existence. Some of this money is held in checking accounts in banks. These banks made loans to people who would use the proceeds to buy stocks. In the 1920s, if one bought stock, one only had to put down 10% of the price in cash (this is called the **"margin"**); the remaining 90% of the price could be borrowed. If the borrower failed to pay the loan, the bank would get the stocks. Suppose that you bought a stock for \$100. You borrowed \$90 from the bank. Then, the price of your stock fell to \$50 on the stock market. It would be smart for you to simply fail to pay your loan. The bank would get your stock – worth \$50 – rather than the \$90 that you would have paid it. The bank would have less available to it. As we will see, if everyone who has an account in a bank wishes to take his or her money out of the bank at the same time, the money is not there. In most situations, this creates no problem at all. But in the 1930s, people would know that the banks were getting into trouble as they came to own stocks that were increasingly worthless. People might then want their money in cash. Those who were not panicking would soon realize that they could lose everything if enough other people withdrew their money from the bank. So they too would get in the line at the bank to withdraw their funds. The result of this panic was a full scale **"run" on the bank.** Since the banks did not have the funds to meet all of these withdrawals, many had to close. If a bank closed, the money in it ceased to exist. It was simply gone. As a result, **the money supply fell.** As shown in Table 2, more than one-fourth of all of the money available in 1929 did not exist in 1933.

Table 2	Year	Money Supply (M-1)
	1929	\$26.4 Billion
	1930	25.4
	1931	23.6
	1932	20.6
	1933	19.4

What happens when the money supply falls? According to the quantity theory of money, what should happen is that the Price Level will decline (deflation). But if the Price Level does not decline, then the Real Gross Domestic Product will decline (recession). **The decline in the money supply was a major cause of the Great Depression.**

Another factor that contributed to the decline of Real Gross Domestic Product involved **high consumer debt**. Installment debt, as we know it, developed and grew greatly in the 1920s. There came a time when consumers found themselves more deeply in debt than they were comfortable with. Not wanting to face the prospects of bankruptcy, consumers reduced their consumer spending and devoted a greater portion of their incomes to paying-off their debts. **The decline in consumer spending contributed to the decline in production.**

The decline in wealth as stock prices fell, the decline in the money supply, and the decline in consumer spending as people reduced their debts all caused **a shift to the left in aggregate demand**. As shown in the graph below, the shift to the left in aggregate demand caused Real Gross Domestic Product to fall --- a recession. And it caused the Price Level to fall. This is exactly what happened in the 1930s.



The Great Depression caused skepticism about the value of a capitalist, market economic system. Companies would not hire workers because they did not believe that they could

sell their products. And companies could not sell their product because the workers were unemployed and had no incomes. To many people, this made no sense.

While we have described some of the main reasons that the Great Depression began in 1929, we still need to explain why it persisted for so long. There are many reasons. But two early policy decisions deserve mention here. First, there was the **Hoover tax increase of 1932**. As Real Gross Domestic Product declined in 1930 and 1931, so did people's incomes. A decline in income reduces the amount of tax people must pay. Tax revenues fell from \$4 billion in 1929 to \$1.9 billion in 1932. With lower tax revenues, the federal government had a budget deficit (government spending was greater than the tax revenues). The position of the federal government changed from a \$0.7 billion surplus in 1929 to a \$2.7 billion deficit in 1932. President Hoover, like all officials of his time, had been raised on the Classical economic view. The Classical view said that budget deficits were bad for the economy and should never exist. In 1932, in an attempt to eliminate the budget deficits, a major tax increase went into effect. What is the effect of raising taxes when the unemployment rate in the country is over 20%? The answer, of course, is that the unemployment rate went even higher the following year.

A second policy deserving of attention was the **Smoot-Hawley tariff of 1930**. Since Americans were not buying enough goods and services, Congress reasoned that it should force Americans to buy all their products from American producers. It did this by imposing a very high tariff (tax) on imported goods. The reasoning was that, if Americans could not afford imported products, they would buy American-made products. This would increase American production and create jobs for Americans. While logical, this reasoning has two important errors. **First, if Americans did not buy foreign products, other countries would not have as much income**. With lower income, people in other countries would buy fewer American-made goods and services. This was exacerbated by the fact that **the other countries retaliated by imposing equally high tariffs against American products**. American exports fell greatly, reducing American production and costing Americans their jobs. **Secondly, many imported products were parts and materials used by American companies in their production**. The tariff raised the prices of these parts and materials, increasing costs of production. Higher costs of production also reduced the production of American companies and cost American workers their jobs. The policy of imposing tariffs came to be called a **“beggar-thy-neighbor”** policy. It came to be widely recognized as a disaster. Since the end of World War II, as we will see, there has been a continuous trend toward eliminating tariffs and expanding world trade.

Test Your Understanding

Go to one of the following sites and read the article on the causes of the Great Depression. Then, write a paragraph explaining how the article differs from the presentation of this chapter.

http://oasis.bellevue.k12.wa.us/sammamish/sstudies.dir/hist_docs.dir/grtdepression.mn.html

<http://www.amatecon.com/gdcandc.html>

http://www.escape.com/~paulg53/politics/great_depression.shtml

The Classical Response to the Great Depression

According to the Classical economic view, the recession of 1929 should have gone away automatically in a relatively short time. Because of this, there were no actions needed from the government. Indeed, until 1933, there were no serious policies undertaken by the government to try to end the recession. And the Federal Reserve System was consistently worried about inflation (as would result from its belief in the quantity theory of money).

Remember that, in the classical view, three changes were to occur to cause the recession to go-away on its own. First, prices were supposed to fall (deflation). Did they? Examine the data in Table 3.

Table 3	Year	Consumer Price Index*	Interest Rate**	Wages***
	1929	100	5.85%	\$0.57
	1930	97	3.59%	0.55
	1931	89	2.64%	0.52
	1932	80	2.73%	0.45
	1933	76	1.73%	0.44
	1934	78	1.02%	0.53
	1935	80	0.75%	0.55
	1936	81	0.75%	0.56
	1937	84	0.94%	0.62
	1938	82	0.81%	0.63
	1939	81	0.59%	0.63
	1940	82	0.56%	0.66
	1941	86	0.53%	0.66

* 1929 = 100 ** The Prime Interest Rate ***Average Hourly Earnings (cents per hour)

Notice that prices did indeed fall from 1929 to 1933 and again from 1937 to 1939. Yet, we know that this price fall did not correct the problem because we know that production also fell greatly in this period. Secondly, interest rates were supposed to fall. The data in Table 3 tells us that nominal interest rates did indeed fall. By 1939, short-term interest rates were barely over $\frac{1}{2}$ of 1%. Yet again, since production fell greatly, we know that the decline in nominal interest rates did not correct the problem. Third, wages were to fall. As you can see, the same result occurred for wages: they fell somewhat but the problem of falling production was not corrected. Something was wrong with the classical view.

Test Your Understanding

1. Use the data in Table 3 to calculate the **real interest rate** in each year. Remember that the real interest rate is the nominal interest rate minus the rate of inflation (or in this case, plus the rate of deflation).
 2. From 1929 to 1933, by what percent did the money supply fall (see Table 2)? By what percent did Real Gross Domestic Product fall (see Table 1)? By what percent did the price level fall (see Table 3)? Using the equation of exchange, what must have happened to **velocity** from 1929 to 1933?
 3. Consider the causes of the Great Depression that were mentioned in the class. Write a one-page essay on the following question. **Could anything like the Great Depression of the 1930s ever happen again?** Why or why not?
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2. The Beginning of Keynesian Economics

John Maynard Keynes (pronounced “Canes”), who lived mainly in the first half of the 20th century, was arguably the most influential economist of the century. His main book was published in 1936 and was influenced by the Great Depression. We will study his views in detail in subsequent chapters, as they were very influential in policy making in the United States after World War II. In this chapter, let us consider his answer to the Classical economic view.

As we have noted, in the classical economic view, a recessionary gap would not persist for very long. Yet, the recessionary gap had begun in late 1929 and was still in existence at the beginning of American involvement World War II in 1941. Obviously, something was wrong. First, the price level was supposed to fall. As the data above show, prices did indeed fall. But **Keynes argued that prices did not fall enough** to solve the problem of the recessionary gap. Some prices did not fall, he argued, because of the power of large corporations with limited competition to control prices.

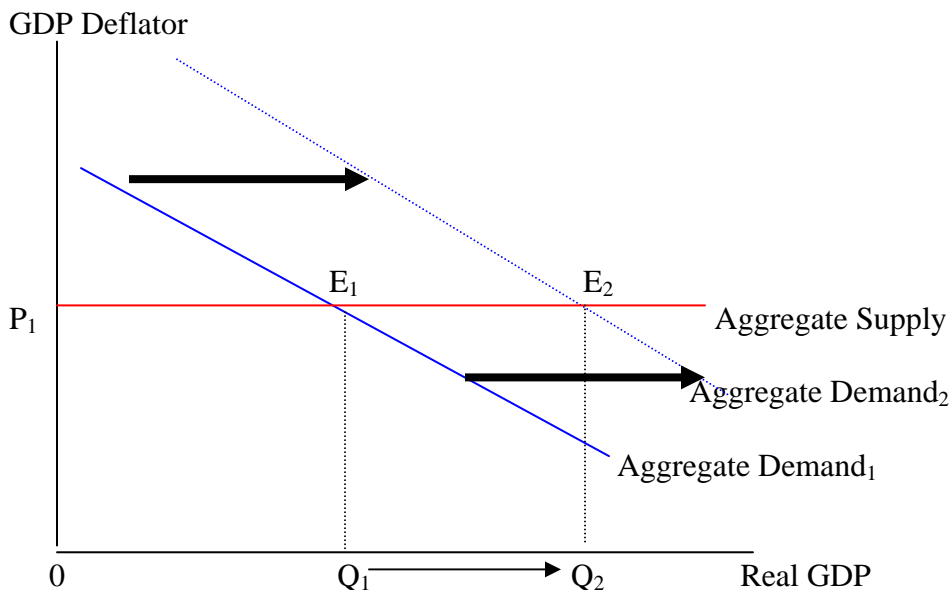
Secondly, wages were to fall. Again, the data show that they did fall. But, Keynes argued that **wages did not fall enough** to generate full employment. He blamed this on the power of big labor unions to prevent wages from falling. However, his explanation is not complete. In the United States today, less than one of ten of those who work for private businesses are unionized. Yet, wages rarely fall for any worker. To explain this, assume that I am your employer. Times are hard, with large numbers of unemployed people. I announce that I am reducing your wages. You really have no choice but to accept. You cannot quit, as I can replace you quickly and you might need a long time to find another job. But there is one thing you can do. You can reduce your work effort. All of us control to some extent how hard we work and how much we produce. If you reduce your work effort, production falls. As your employer, I may lose more than I gain by reducing your wages. In addition, I know that the hard economic times will not last forever. When good times come, you will remember that I took advantage of you. You will then quit. I am probably better off in the long run by not reducing your wages now.

Thirdly, interest rates were to fall. The data show that they did so. But notice that consumer spending and business investment spending actually fell, even though nominal interest rates were extremely low. In a major recession, why would consumers not take advantage of the low interest rates, borrow money, and buy new homes, cars or appliances? The answer is that they are scared. There is a good chance they could lose their jobs. If they do, they will not be able to pay off their loans. They will lose everything. **Fearing that they might lose their jobs in the near future, people choose to save their incomes, rather than spend them.** Why do businesses not take advantage of the low interest rates, borrow money, and build new factories or buy new machinery? The answer is that, in this period of recession, they do not believe they can sell the products they could produce in the new factories or with the new machinery. Many companies have already shut down factories; why would they want to build more? Keynes, in typical British understatement, called these fears **“pessimistic expectations”**.

Keynes conclusion, then, is that, if there is a recessionary gap, prices and wages will not fall enough to end it. Interest rates will fall, but consumers and businesses will not borrow because of pessimistic expectations. The recessionary gap will persist and may

even grow larger (if people's expectations become more and more fearful). The analogy here is to a human body with cancer. If one does nothing, the cancer will grow until it destroys the person. (“Destroying the person” is analogous to destroying the political and economic system. In the 1930s, there were very serious communist and fascist movements in the United States.) The solution to cancer is to see a doctor and receive medical treatment. According to Keynes, the “doctor” in this analogy is the government. **Government action is required because the system will not cure itself.** And, according to Keynes, **the “medicine” is fiscal policy** (changes in government spending or in taxes). We will discuss this “medicine” in the next several chapters.

Keynes vision of aggregate supply was also different from the vision we have used previously. We have shown aggregate supply as upward-sloping. **Keynes saw the aggregate supply as horizontal**, as shown on the next page. ***This means that the economy was so severely depressed that any increase in spending would result only in an increase in production.*** Companies would be so happy to be able to produce and sell more that they would not even consider raising prices. The horizontal aggregate supply shifts all of the focus of policy-making to aggregate demand. Such a horizontal aggregate curve could only exist in a period of extreme recession or depression.



Keynes argued that the economy could suffer for a long period because aggregate demand (total spending) was not sufficient to buy all of the goods and services that could be produced at full employment. **This focus on aggregate demand and the idea of using the government to increase aggregate demand were revolutionary.** Keynes' ideas have had, and continue to have, a major effect on government decision-making. His views are still a major part of the disagreements between political liberals and conservatives.

Test Your Understanding

1. Explain what a “horizontal short-run aggregate supply” means and why it might exist if there is severe unemployment in the economy. Why would aggregate supply not be horizontal if the economy is not experiencing a period of severe unemployment?
2. In 1990, the American economy entered a severe recession. What would Keynes have advised President Bush to do to eliminate the recession soon?

3. Responses to the Great Depression After 1933

The government’s response to the Great Depression, beginning in 1933, marked a major change in the role of the government in the economy. For the first time, the government took what is called an “activist role”, attempting to use its powers to generate better economic times. While we cannot go into great detail here about the reforms, called the **New Deal**, we can highlight several important points. **First, the government at first saw the falling prices and the falling wages as the cause of the problem**, rather than being a result of the problem. As a result, the National Industrial Recovery Act (later declared unconstitutional) was passed to help companies create price floors on their products. The Wagner Act was passed, aiding the ability of workers to form labor unions. With stronger unions, it was believed that wages would not decline. And the Agricultural Adjustment Act was passed, creating the price floors for agricultural products that were analyzed in Chapter 8.

Second, the government created a series of programs designed to put people to work. For example, the Works Progress Administration and the Public Works Administration created employment opportunities building sewers, roads, bridges, water systems, Post Offices, and so forth. Several large dams were built in the Northwest to provide electric power. The Tennessee Valley Authority generated electric power for rural households. The list of such agencies goes on and on.

Third, the government took action to make the banks safer for depositors. The main such action was the creation of the **Federal Deposit Insurance Corporation (FDIC)**. The FDIC insures bank accounts against bank failures. The current limit is \$100,000. This prevents runs on banks, since all money in an account is protected even if the bank fails. Since the creation of FDIC, there has been virtually no risk to having accounts at banks.

Fourth, there was the creation of what has been called the “Welfare State”. The best known of these programs was the creation of **Social Security** in 1935. We will discuss the social security system in detail in Chapter 16. Additional Welfare State programs that were created in this period include **Unemployment Compensation and Aid to Families with Dependent Children (AFDC)**. AFDC was a large part of what most people called “welfare” until it was replaced in 1996. One aspect of the Welfare State that was not created in this period was the provision of medical care for elderly people. Medicare did not come into existence until 1965.

Finally, since the government was now going to actively attempt to influence economic results, there needed to be an ability to control the American money supply. As a result, **the connection to gold was severed in 1934 as the United States went off the Gold Standard.** Since 1934, there has been no connection between the number of dollars in existence and the amount of gold held by the government. Until the 1970s, Americans could not even own gold except for uses such as jewelry and dental fillings.

The American money supply is under the control of the Federal Reserve System (FED), whose powers were strengthened in 1935. We will discuss this agency in detail in Chapter 21.

A complete discussion of the New Deal reforms cannot be undertaken here. But this quick summary of programs does show very clearly that **the role of the government in the economy changed greatly as a result of the Great Depression.**

Test Your Understanding

Examine the data provided in the chapter. To what extent did the actions of the government after 1933 eliminate the Great Depression and bring about prosperity?

4. Chapter Summary and Conclusion

The Great Depression of the 1930s was an economic catastrophe unlike any that had been seen in the United States before. The predictions of the Classical economic view did not hold, calling that view into question. A rival economic view came into existence, associated with the name of John Maynard Keynes. This new view indicated that the predictions of the Classical economic view may not hold in a period of severe depression and that government action through fiscal policy might be necessary to bring about good economic times. To see how revolutionary this was, keep in mind that the Classical economic view had been widely held for well over 100 years and had seemed to work well in the past. The Great Depression ended with the coming of America's involvement in World War II in 1941. (Had there been no war, one can only guess for how long the depression would have gone on. But the end of the Great Depression was not in sight in December of 1941.) That the end of the Great Depression was associated with a large increase in government spending (on World War II) only seemed to confirm the conclusions of Keynes. In the post-World War II period, the role of the government, influenced by the ideas of Keynes, has been forever changed. Today, Presidents are credited when the economy performs well (Bill Clinton) and blamed when there are economic problems (George Bush and Jimmy Carter), even if the problems have nothing to do with any actions taken by the President. Government is expected to bring us prosperity. Until the 1930s, this was not so. We will examine how the government undertakes to do this and whether government policies have been responsible for the fact that no problem even close to as bad as the Great Depression has occurred since.

Practice Quiz for Chapter 12

1. The Great Depression was caused by a/an
 - a. increase in aggregate demand
 - b. decrease in aggregate demand
 - c. increase in aggregate supply
 - d. decrease in aggregate supply

- 2 through 5. Four of the following can be considered **causes** of the Great Depression or reasons why it continued for so long. Name each of these.
 - a. the decrease in stock market prices
 - b. the decrease in the money supply
 - c. the government's budget deficit
 - d. the decrease in interest rates
 - e. the tax increase of 1932
 - f. the decrease in wages
 - g. the Smoot-Hawley tariff of 1930
 - h. the decrease in prices

6. According to **Keynes**, if there is a recessionary gap,
 - a. wages will fall
 - b. prices will fall
 - c. interest rates will fall but people will not borrow due to pessimistic expectations
 - d. the recessionary gap will be eliminated soon
7. According to Keynes, if there is a recessionary gap, the government should
 - a. do nothing
 - b. increase government spending
 - c. increase taxes
 - d. decrease the money supply
8. The agency that protects depositors in banks against bank failure is the
 - a. WPA
 - b. Social Security Administration
 - c. FDIC
 - d. FBI
9. Which of the following was **not** part of the New Deal from 1933 to 1941?
 - a. programs to put people to work, such as WPA and PWA
 - b. creation of the Social Security system
 - c. creation of Medicare
 - d. creation of welfare (AFDC)
10. According to Keynes, the aggregate supply curve is:
 - a. horizontal
 - b. vertical
 - c. upward-sloping
 - d. downward-sloping

Answers: 1. B 2. A 3. B 4. E 5. G 6. C 7. B 8. C 9. C 10. A