LECTURE 2
Overview of the Great Depression

January 24, 2013
I. EVOLUTION OF THE MACROECONOMIC ENVIRONMENT
The U.S. was a major industrial power by the late 1800s.
Nominal Rigidity

- Developed over the 1800s.
- Was substantial by early 1900s.
- May have gotten greater in the 1920s.
Rise of Macro Policy

- Federal Reserve founded in 1913
- Income tax introduced in 1913
- Government spending increased substantially around World War I.
Government Spending as a Percent of GDP

Spending rose as a share of GDP in WW I and after.
II. The 1920s
What were some features of the economy in the 1920s?
Issue: Was GDP growth above the growth rate of potential output?
Real GDP Growth and Inflation
1919-1929
Issue: What effect might increasing inequality have on short-run fluctuations?
Issue: What do we mean by a bubble?
III. THE GREAT DEPRESSION
Depression was worldwide, but likely began in the U.S.
Table 1

Distribution of the Percentage Change in Industrial Production

<table>
<thead>
<tr>
<th>Percentage Change</th>
<th>Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1 to 10%</td>
<td>Denmark, South Africa, New Zealand</td>
</tr>
<tr>
<td>0.0 to 5%</td>
<td>Chile, France, Greece, Norway, Sweden</td>
</tr>
<tr>
<td>−0.1 to −5%</td>
<td>Estonia, Romania</td>
</tr>
<tr>
<td>−5.1 to −10%</td>
<td>Finland, Hungary, Italy, Japan, Netherlands, UK</td>
</tr>
<tr>
<td>−10.1 to −15%</td>
<td>Belgium, Czechoslovakia, Germany</td>
</tr>
<tr>
<td>−15.1 to −20%</td>
<td>Austria, Canada, Poland</td>
</tr>
<tr>
<td>−20.1 to −25%</td>
<td>USA</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Percentage Change</th>
<th>Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>−0.1 to −10%</td>
<td>Greece, Japan, New Zealand</td>
</tr>
<tr>
<td>−10.1 to −20%</td>
<td>Denmark, Romania, Sweden</td>
</tr>
<tr>
<td>−20.1 to −30%</td>
<td>Chile, Estonia, Finland, Hungary, Norway</td>
</tr>
<tr>
<td>−30.1 to −40%</td>
<td>Belgium, France, Italy</td>
</tr>
<tr>
<td>−40.1 to −50%</td>
<td>Austria, Netherlands</td>
</tr>
<tr>
<td>−50.1 to −60%</td>
<td>Canada, Czechoslovakia, Germany</td>
</tr>
<tr>
<td>−60.1 to −70%</td>
<td>Poland, USA</td>
</tr>
</tbody>
</table>

Depression was faster, larger, and longer in the U.S.
Why do we think Depression began in the U.S.?

• Circumstantial evidence – timing, severity, etc.

• Can identify shocks in the U.S. and transmission mechanism to the rest of the world.
The fundamental cause of the Great Depression was a collapse in aggregate demand caused by:

- Stock market crash.
- Banking panics and a decline in the money supply.
- Misguided macroeconomic policy.
- International factors.
Issue: What role did the Great Crash play in the onset of the Depression?
Industrial Production, 1929-1933

August 1929

October 1929
Bank Suspensions
Money Supply and Banking Crises 1929-1935

Vertical lines show the dates of waves of panics identified by Friedman and Schwartz.
Issue: What was the impact of the banking panics and the collapse of the money supply?
Issue: What role did actual and expected deflation play?
### Table 1
Interwar Tax Legislation

<table>
<thead>
<tr>
<th>Act (Date Enacted)</th>
<th>Revenue Estimate</th>
<th>Change in Top Marginal Rate (Percentage Points)</th>
<th>Nature of Tax Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue Act of 1932 (6/6/32)</td>
<td>+$1,121 million +1.91% of GDP</td>
<td>+38</td>
<td>Raised normal and surtax rates; surtax rates doubled at most income levels; raised corporate income tax and excise taxes</td>
</tr>
</tbody>
</table>

**Issue:** Can fiscal contractions ever be expansionary?
Fig. 2. The Behavior of Output and Prices During 1928–32: The Gold Countries and Spain Compared with the United States

Issue: What role did the gold standard play in spreading the Depression throughout the world?
Unemployment Rate, 1920-2010
IV. THE RECOVERY FROM THE GREAT DEPRESSION
Industrial Production, 1929-1941

August 1929
March 1933
Issue: Can monetary expansion still be helpful at the zero lower bound on nominal interest rates?
Money Supply, 1929-1941
Government Spending as a Percent of GDP

US Government Spending As Percent Of GDP
US from FY 1895 to FY 1940

Issue: Does fiscal stimulus work?
Issue: What caused the recession of 1937-38?
V. WORLD WAR II
Issue: Can wars provide evidence on the impact of government spending?
Issue: What are the impacts of high government debt?

U.S. Debt-to-GDP Ratio

Percent

0.0  10.0  20.0  30.0  40.0  50.0  60.0  70.0  80.0  90.0  100.0  110.0  120.0