Understanding the fiscal/monetary policy mess of the 1930s
Glendale Academy
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1. Causes of the Great Depression
    - stock market crash
    - bank failures
    - many policy mistakes
2. Lessons learned
    - how to survive an economic crisis

Introduce myself

Defn of recession, depression

- recession: two consecutive quarters of negative economic growth
- depression: eight consecutive quarters, or -10% growth

Causes of Great Depression

- Stock market crash kicked it off.
    - Ask what your reaction would be if you lost a fortune on the stock market (Ans: postpone retirement, cut spending. Give story of Sheldon, who mortgaged his house.)
        - This is what economists call the "wealth effect"
        - Important aside: Only invest money you can afford to lose
- decreased confidence in economy
- led to bank runs and bank failures.
    - How? Ans: decreased value of stocks meant that bank portfolios deteriorated, leading to bank failures.
    - Note that Hoover made it worse by encouraging companies to increase wages without cutting dividends. This meant profits fell, which made the banks' portfolios even worse.

Then a chain of at least four policy mistakes turned it into a depression.

- Fed increased interest rates to prevent outflows of Gold into other countries.
    - Why would higher interest rates make things worse? (Ans: less investment, more bank failures, business failures)
    - 10k of 24k banks failed btwn 1929 and 1933.
        - What would you do if you saw a bunch of banks fail? (Ans: take money out)
        - How would you end a flurry of bank failures? (Ans: Ended when FDR imposed a banking holiday)
        - How would this end the bank runs?
    - But by then, many people already took their money out of the banks, and money supply had fallen by 30%
    - In 1935/6, the Fed doubled reserve requirements. This means that banks had to hold twice as much cash in their vaults (or at the Fed) as they used to.
        - What would this do? (Ans: Less money to lend, so less lending. Companies can't invest, so they cut back. More companies fail, more banks fail, more money taken out of economy, economic growth shrinks further.)

- 1930 tax receipts fell, so government deficit started. President Hoover responded by increasing taxes substantially. Top rate became 63% on incomes >$1m.
    - What would you expect the result to be? (Ans: decreased disposable income, decreased consumption, further contraction in economic activity)
    - Five years into it, tax receipts had fallen further. In 1935/6 US had a 5.5% deficit. So FDR slashed spending and increased taxes further to close off that deficit, thereby inadvertently killing off another 10% of the economy.

- Let's look at international side of the economy
    - Currency devaluation is one way to stimulate economic growth. Explain why.
        - But if France devalues, what do you think the UK would do? The USA? (Ans: devalue even further. Result is "Beggar-thy-neighbor" currency devaluations, a race to the bottom, and complete financial turmoil.)
    - Tariffs and trade barriers.   Smoot-Hawley Tariff Act increased tariffs on imports. E.g. Cdn hard winter wheat rose 40%. Overall, tariffs rose from 40% to 53% across all dutiable imports.
        - What would this do to price levels? to production? (Ans: Imports become more expensive. That Cdn wheat now too costly to buy. Price levels increase. But this increases demand for locally-produced wheat, which will lead to increased production of local wheat. Economic stimulus.)
        - So you can see why Hoover did this
        - How will other countries respond? (Ans: imposing tariffs themselves. Net result is a DECREASE in global production, which is bad for everyone.)
    - Result: disaster gets worse, but now it's globally worse

- Counter-productive gov't intervention (anti-competition): New Deal was great, but had some serious flaws because of the administration's view that excessive competition led to over-production, which caused the recession. So it was aimed at reducing production and increasing wages:
    - criminalized farmers who sold chickens too cheaply
    - slaughter 6m baby pigs
    - paid cotton farmers to plow under 25% of their crops
    - Labor cost increases:
        - Nat'l Industrial Recovery Act allowed companies to collude if they allowed unions to form.
        - Cartelization of industries as the government mandated investment, prices, production, etc., within each industry, seeking to reduce production and increase prices.
        - Nat'l Labor Relations Act in 1935 gave even more power to unions, leading to higher wages and higher unemployment. Studies show wages were 25% higher than they should have been.
        - New Social Security taxes in 1936 was a tax increase, at exactly the wrong time.

Why all these policy mistakes?

Let's look at the historical debate, which was raging at that time, between two different views about the role of government in the economy: Treasury view (TV) versus Keynesian view (KV):

- TV: Fiscal policy has no effect on overall economy, even during recessions. Therefore, should balance budget no matter what.
  - "Crowding out": Fiscal policy moves resources from one use to another, without any impact on overall economic activity.
    - Gov't spends $1m to build a bridge. Where does it get that money from? (Ans: either raise taxes, or borrows)
    - What happens to spending if financed by raising taxes? (Ans: drops by amount of tax increase)
    - What happens if financed by government borrowing? (Ans: To entice people to lend, must offer a more attractive (higher) interest rate. This increases overall interest rates, and decreases borrowing and investment by companies, probably by the same amount that the government borrowed.)
    - In either case, just moved resources from one productive activity to another. No lasting impact on the economy.
  - Look closer... what happens to the labor force and corporate profits?
    - How will it entice that laborer to move from building a house to building a bridge? (Ans: Offer a higher wage). What does the increased wage rate mean to the economy? (Ans: Lower profits, which eventually leads companies to lay people off, which reduces overall economic activity.)
    - Also, note that there are fewer houses being built... home-building was "crowded out" by bridge-building
  - Bottom line of TV: Government spending, and more generally government intervention, is fruitless at best and destructive at worst. Leave the economy alone.
  - This is an extension of Say's Law, which dominated economic thought at that time: Free market would naturally establish full employment equilibrium w/o need for gov't intervention. Stated differently, prices and wages are flexible and will adapt to create equilibrium between supply and demand.
    - If recession occurs, then wages drop until everyone finds a job; productivity is maintained.
  - When does the TV fail? Ask class when the above logic fails.
    - When is there no crowding out? (Answer: When there are idle resources. I.e., when unemployment exists, or when resources are under-utilized, or when there's a recession. Then that house-builder is sitting around looking for work, and the gov't can increase overall economic activity)
    - When else might Say's Law (and therefore the TV) fail? (Ans: If workers are unwilling to drop wages during a recession. This is clearly true today, as wages are known to be "downward sticky" for a whole host of reasons.)
    - Ask class why. (Ans: Pride [I know someone unemployed who refused to take that job at Home Depot]. Greed. Unemployment insurance. Unions.)
    - note that wages increased in 1930/31, partly due to stickiness and partly due to Hoover's economic policies. Smoot-Hawley Act gave protection from imports, but only for companies that didn't drop wage rates.. Result was layoffs and unemployment. The TV says that wages should have decreased during a recession.

- KV: Gov't plays an important role in managing the business cycle
  - Showed theoretically in General Theory how fiscal stimulus can increase economic activity during a recession. Suppose that a recession exists, and is caused by insufficient demand

        - You've already discovered why. If recession, and there exists excess capacity in the economy, the gov't can fill that capacity by either putting more money in the hands of the people (cutting taxes) or creating new production themselves (increasing spending...building bridges).
        - What about the financing of these public works? In a recession, there's enough spare capacity that gov't doesn't have to increase interest rates to borrow.
    - World transitioned to KV in 1930s. Let's look at why.
        - When did the Great Depression end? (Ans: about 1939)
        - What else happened in 1939? (Ans: WWII began, US spent huge amounts on the war, ran big deficits)
        - This stimulus, though for tragic reasons, pulled the US out of the GD and proved the KV to be correct.
    - KV says that gov't action can change employment through public works or tax cuts, and through changes in interest rates and money supply (monetary policy)

- So let's summarize:
    - At beginning of GD, the TV was accepted wisdom...there was zero anti-cyclical fiscal policy. This led to a series of serious policy errors -- contractionary fiscal policy, contractionary monetary policy, trade barriers and tariffs, etc.)
    - By end of GD, the KV had taken over, and governments worldwide recognized their ability to manage the economic cycle.

- Quick aside on the dominance of the KV in the last century:
    - KV dominated economic thought for decades, from late 1930s to 1980s.
        - In 1980s, the TV resurgence due to distrust in gov't and belief in free markets.
        - Swung back again recently, with tensions btwn KV and TV again post-2008 crisis.
    - Strong opponent (Murray Rothband): "The General Theory was one of the most dazzlingly successful books of all time. In a few short years, his "revolutionary" theory had conquered the economics profession and soon had transformed public policy, while old-fashioned economics was swept, unhonored and unsung, into the dustbin of history." [Until 2000s.]
    - The KV transformed role of government in the economy

- Comment on Keynes's ego: In letter to George Bernard Shaw - "I believe myself to be writing a book on economic theory which will largely revolutionize...the way the world thinks about economic problems...I don't merely hope what I say, in my own mind I'm quite sure."

Lessons learned and not learned

Compare Great Depression (GD) to Great Recession (GR)

- in 12months following 2008 peak, IP fell by as much as 12m into GD. Equity prices and global trade fell more. But no depression followed.
    - Over longer run, stock mkt fell 90% in GD, versus only 50% during GR.
    - Thousands of bank failures (30% to 40%) in GD versus <1% in GR.
    - IP fell 40% peak to trough in GD, but only 13% in GR
    - Unemployment 25% in GD versus 10% in GR
- Why no depression? (Ans: Governments learned from the mistakes of the 1930s, and didn't repeat them)
    - Fiscal policy hugely expansionary:
        - Hoover's stimulus package post 1929 was only 1/6 the size of Obama's, relative to size of economy
        - 2009 recovery package was $787b…as Keynesian as it gets.
    - Monetary policy even more expansionary: Fed's injected trillions of dollars, growing at $80b per month
- (another explanation: have safety nets today, like SocSec and Unemployment Ins and FDIC. All mean that during recession, the unemployed still have ability to spend money.)

Some lessons not learned

- US imposing tariffs on China
- Swiss Natl Bank fed up with appreciation against Euro
- Strong push, both in Europe and USA, for fiscal austerity
- Comments on Europe:
    - Treasury view resurrected in Germany, only 20 months into crisis. All about austerity. Therefore, Europe still struggling. Comparison of GD to GR
    - Europe made same mistake as GD (fiscal tightening), explaining why they took so long to recover

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Summary

Those who can't remember the past are condemned to repeat it. (George Santayana, philosopher in 1800s, paraphrasing Edmund Burke in 1700s)

✓ The GD was bad. It was much worse than it needed to be because of at least five policy errors. The TV and the KV were at war with each other. By the end of the 1930s the KV had displaced the TV as the dominant school of economic thought (with the help of WWII), and the GD ended.

✓ The US economy is strong, healthy and growing again despite a 2008 that threatened to suck us into another GD. The primary reason is that we'd learned from history.

✓ ..and that's why we study history.