



Case study: The Great Depression

This case study has been written for teachers to support the delivery of a new topic within the specification. Different case studies – written by different teachers – have been provided as an example of a range of resources you can use.

This case study provides ideas and suggestions for teaching approaches and is not intended to provide exhaustive coverage of this topic. It is not intended to be prescriptive or indicative of content and questions in the specification and assessments. The specification must be referred to as the authoritative source of information.

This case study focuses on the Great Depression. It provides research ideas and practice questions for students for use within class or as homework activities.



Students need not be aware of the causes of the Great Depression, but this resource begins with a short section on this for teachers. Inquisitive students are bound to ask why the Depression happened. This could be used as extension material, background reading, extra reading, or as part of an extension lesson on the Depression.

Remember that students will not need a large amount of subject knowledge on the Great Depression. The requirement is that students are able to apply their knowledge of demand-side policies to a case study of the Great Depression. Students' rote learning the material below is not advised but familiarisation with the topic will support students with applying key concepts to this context.

This resource sheet is designed to support the AS and A level Economics A specification Topic 2.6.2 Demand Side Policies: h) Awareness of demand side policies in the Great Depression: different interpretations and policy responses in the US and UK.

Causes of the Depression

In 1929, supply of industrial goods outweighed demand. Businesses ran down their stocks rather than raising production. This slowdown in production then led, via the multiplier effect, to a fall in economic growth. In addition, there is evidence that in the US, profits rose far more rapidly than wages. Therefore, growth relied upon investment by businesses, rather than consumer spending. So declining investment couldn't be supported by higher consumer spending levels. Interest rates were also relatively high in 1929 at a time when economic activity was slowing.

The reason why supply of industrial goods outweighed demand is that the late 1920s was a time of great uncertainty. The global economic order was changing, as Britain was declining and countries like Japan were emerging. Many countries raised tariffs during the 1920s: US tariffs quadrupled over the decade, culminating in the famous Smoot-Hawley tariffs in 1930. Some countries had floating exchange rates, although others followed Britain onto the Gold Standard after 1925. This uncertainty eventually had a negative impact on investment, a decline that was accelerated by the Wall Street Crash of 1929. The crash also led to a drop in consumer confidence and decline in spending on houses and consumer durables.



From Recession to Depression

The factors above explain the leftward shift in the aggregate demand curve in the UK and the US in the early 1930s. However, there is disagreement among economists as to what turned the recession into a Depression. The Keynesian argument is that continued uncertainty led to a fall in investment demand and a fall in autonomous expenditure (expenditure unrelated to the level of real GDP). The Monetarist explanation, as argued by Friedman and Schwartz, is that the slump into a Depression was largely caused by a significant fall in the money supply.

The money supply fell in the early 1930s because of a fall in bank deposits, rather than a fall in notes and coins in circulation. The crash and recession led to significant defaults on loans. Banks had lent recklessly during the 1920s. The uncertainty led to many deposit holders withdrawing money from their bank accounts, which meant that banks lost reserves and were unable to provide depositors with cash when they wanted to withdraw money. Bank failures resulted, leading to depositors taking money out of other banks – a domino effect ensued.

The leftward shift in the money supply led to a rise in the price of money, the interest rate. Deflation in the early 1930s meant that real interest rates – roughly, the nominal interest rate minus the inflation rate – rose. This helped to keep investment and consumer spending low.

Galbraith argues in *The Great Crash 1929* that five other fundamentals were responsible for the severity of the recession in the early 1930s:

- 1) The unequal distribution of income. This meant that the boom of the 1920s and subsequent bust was driven largely by fluctuations in investment. Investment is more volatile than other components of aggregate demand, such as consumption, particularly of low paid workers.
- 2) Poor corporate governance. Many financial companies had significant shareholdings in US utilities, such as the railways, which were used to finance the debt of these companies. During the crash, the profits from the utilities were used to pay their debts rather than generate funds for investment.
- 3) Reckless lending by the banks, along with what, even by today's standards, would be deemed a 'bad' banking system (the FDIC didn't come along till later – see below).
- 4) The US trade surplus in the 1920s meant that other countries either began to give the US gold, or take out loans issued by the US. Britain was in deficit because of export markets lost during the First World War and rising imports needed for post war rebuilding. During the Depression, countries couldn't afford to pay the money back, nor could they export to the US exports to cover the debt, thanks to the Smoot Hawley tariffs. Many debtors defaulted on US debt. Britain couldn't devalue the pound as it was on the Gold Standard. So deflationary policies were imposed to reduce wages and restore competitiveness.
- 5) The initial response of economic policy – see below.

This topic also gives students an opportunity to practise applying Keynesian and Classical AD and AS analysis to the policy responses to the Depression.



Policy responses during the Great Depression – Fiscal Policy

Classical (Orthodox) policy response

In the 1920s and 1930s, governments adhered to classical economic policies. This means balancing the budget, despite the recession. This was the *macroeconomic objective*. The Depression led to an automatic rise in welfare benefits as unemployment was rising, and a reduction in tax revenue, since incomes were falling.

Keynesian Policy response

Some economists in the UK, including Keynes, argued for expansionary fiscal policy in order to bring the economy out of the Depression. They argued that the government should increase its spending on public works – public sector projects, like road building – which could be financed either by borrowing (running a budget deficit), raising the money supply, or raising taxes. Remember that $AD=C+I+G+(X-M)$. During a recession, C and I are falling, while X will fall during a global slump. Therefore, the only way for real GDP to grow is if the government takes up the slack.

The debate

In the late 1920s and early 1930s, both the British and US governments cut the level of expenditure and reduced tax, rather than adopting Keynesian demand management policies. The reasons were that the rise in government spending had to be financed somehow:

1. Higher borrowing would lead to the government having to raise interest rates to encourage people to buy government bonds. This would drive up interest rates generally in the economy, leading to a collapse in borrowing by firms and households. This is called *crowding out*.
2. Paying for the deficit by raising the money supply would lead to inflation, which would further reduce the price competitiveness of UK goods and worsen the current account balance. Remember that classical economists believe that the AS curve is vertical. Attempts to increase aggregate demand would simply lead to inflation, as LRAS is vertical in the long run at the full employment level of output.
3. Higher taxes would simply lead to a fall in consumer spending by households and investment spending by businesses.

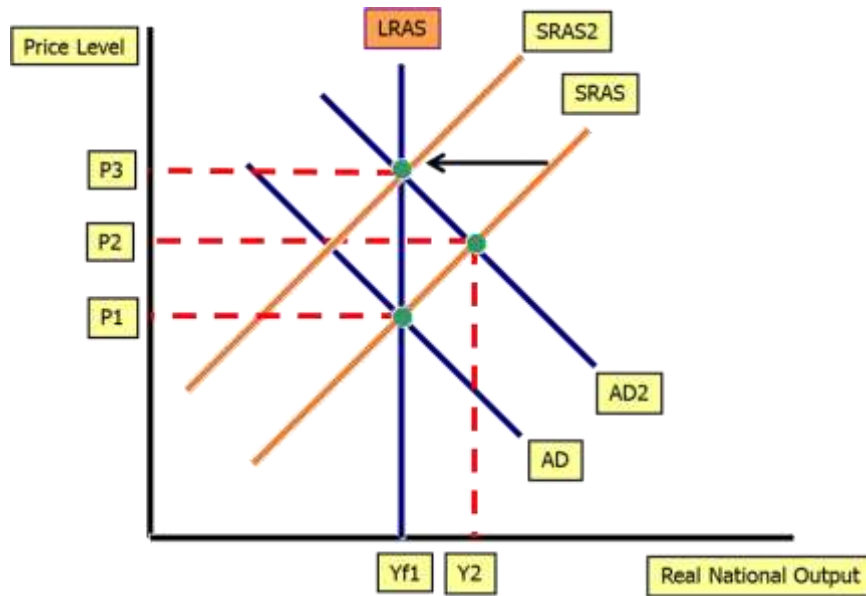
In contrast, Keynesians believe that the economy can be in macroeconomic equilibrium below the full employment level of output, when the economy is working well below full capacity, i.e. a negative output gap. This meant that a public works programme would increase aggregate demand, leading to a rise in real output and employment. Crowding out would be less of an issue, since the money supply will not be fixed. Higher incomes will bring in tax revenue, helping to balance the budget.

Between 1933 and 1938, the New Deal programme in America involved a public works programme designed to stimulate output and employment. Despite being against budget deficits, the US government found itself running them to pay for the programmes. New Deal also involved schemes to raise agricultural output to boost farmers' income, trade liberalisation and measures to increase home ownership. From 1934, Britain also boosted total government spending, though there is debate over to what extent fiscal policy was expansionary over this period.

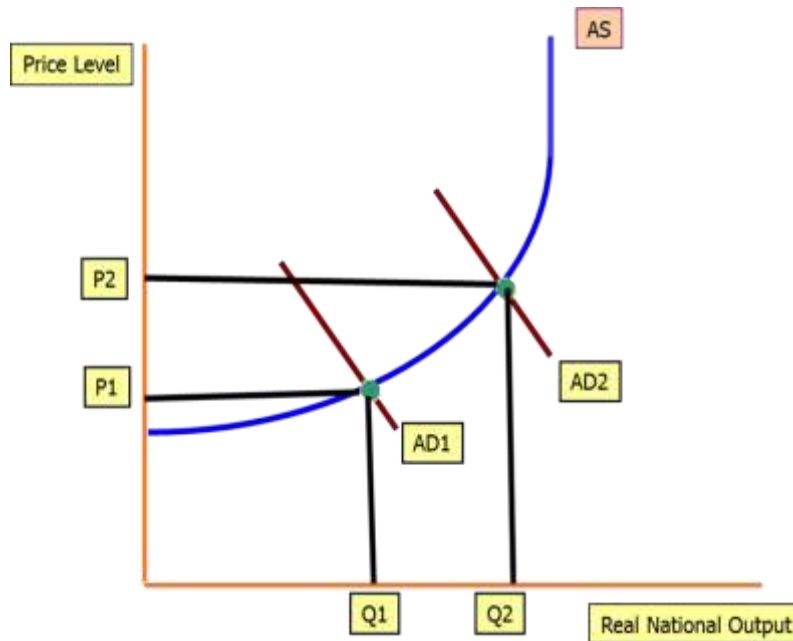


(Neo) Classical Diagram

This attempt to stimulate aggregate demand will be ineffective, since wages and prices will be bid up, leading to an inward shift in SRAS.



'Keynesian' Diagram





Policy responses during the Great Depression – Monetary Policy

Britain remained on the Gold Standard until 1931 and the US until 1932. Under this system, each currency was fixed in terms of a certain amount of gold. Winston Churchill had put Britain back on the Gold Standard in 1925 in order to stabilise inflation and, in theory, restore current account equilibrium. However, Britain was already running a deficit before the Depression, thanks to a fall in export demand following the First World War and a rise in import demand to pay for post War reconstruction. The Great Depression made things worse. The inability to devalue sterling led to a further worsening of the current account balance. In addition, inflation did not need stabilising in 1930-32: rather, there was *deflation*.

Deflation led to a rise in real interest rates (nominal interest rates minus inflation). However, the authorities were reluctant to cut nominal interest rates in the early 1930s, because of fear of inflation, due to previous historical experience. This rise in real interest rates helped to weaken aggregate demand further and helped to turn the recession into a Depression.

Extension

Even if the authorities had cut interest rates, Keynesian economists would argue that this would result in a liquidity trap: a situation where interest rates are cut so low that the public believe that they can go no lower. They therefore expect interest rates to rise soon and bond prices to fall and consequently hold onto cash rather than spend it.

So, the Classical response was to remain on the Gold Standard, thereby eliminating the options to raise the money supply, devalue the currency or reduce interest rates

In 1930, the US government created the Federal Deposit Insurance Corporation. This insures bank deposits so that households and firms do not lose their money if their bank fails: the FDIC pays them instead. (Britain did not introduce such a scheme until 1979). This is argued by Galbraith, a Keynesian, to have revolutionised the banking structure, addressing one of the areas of weakness that he argued caused the Depression. The Classical argument against this is that it leads to a *moral hazard* problem: if the authorities are going to bail out the banks anyway, this encourages both reckless lending by banks and reckless borrowing by households and businesses, increasing the likelihood of subsequent financial crises.

Britain came off the Gold Standard in 1931; the US followed in 1932. This allowed the Bank of England to cut interest rates from 6% in the beginning of 1932 to 2% by the end of June. The US also reduced interest rates and substantially increased the money supply in the mid-1930s. These policies allowed aggregate demand to recover.



Lesson and resource ideas

The well-known 'Fear the Boom and Bust' Keynes vs. Hayek rap anthem may serve as a light-hearted starter... <https://www.youtube.com/watch?v=d0nERTFo-Sk>

Good short summary of the article above, perhaps slightly more digestible, at:

<http://econ.economicshelp.org/2008/10/causes-of-great-depression.html>

Students could do research and do mini-presentations, perhaps in pairs or threes, on key topic areas. The key topics could be divided as follows:

- 1) Why did governments seek to balance budgets 1929-32? (Classical fiscal)
- 2) The role of the Gold Standard (Classical monetary)
- 3) The role of the FDIC and the moral hazard problem, see <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11148323/Why-bank-deposit-insurance-leads-to-more-financial-crises.html>
- 4) What did the UK and US do to government spending and interest rates after 1932? ('Keynesian' policy - public works, expansionary monetary policy)
- 5) For gifted and talented students, the Liquidity Trap

Text resources include:

- ✓ Sloman, J (2015), 9th edition *Economics* (2015) pp 470-2; for G&T, perhaps use of pp 472-476
- ✓ Galbraith (1954), *The Great Crash 1929* Ch 10, pp 186-210, but especially pp 191-202

The above material can be adapted for classroom use, e.g. divide the material into UK/US case studies, or presented as a teacher led power point, incorporating the AD/AS diagrams above.

Students could build up a data bank on The Great Depression. The Bank of England's website has data on interest rates: <http://www.ukpublicspending.co.uk/index.php?year=1935> for public spending data for any given year. The ONS website provides data on UK inflation during the period.

Assessment for learning

Mini whiteboard/Play your cards right activities. Teacher states policies, such as Smoot Hawley Tariff Act; rise in interest rates in 1931. Students have to draw/select the correct diagram. Alternatively, teacher shows a diagram and students have to provide examples of which policies would have led to the shift in the diagram.

Structured questions on the Great Depression

These questions are designed for practice and are not exam-style questions.

- 1) (Background – only if you choose to teach the causes, or set as reading):
Analyse three reasons why the recession in the UK and US turned into a Depression in the early 1930s. (9)
- 2) Define the following terms:
 - a) A balanced budget (2)
 - b) Expansionary fiscal policy (2)
 - c) Moral hazard (2)
 - d) Crowding out (G&T) (2)
 - e) Liquidity Trap (G&T) (2)



- 3) Using Keynesian aggregate demand and aggregate supply analysis, evaluate the effect of reducing the budget deficit in the UK in the early 1930s on macroeconomic equilibrium. (8)
- 4) Using Classical aggregate demand and aggregate supply analysis, evaluate the effect of a cut in interest rates, such as that in Britain in 1932, on macroeconomic equilibrium. (8)
- 5) Discuss the assertion that macroeconomic policy in the UK and the US between 1929 and 1931 prolonged the length of the Great Depression. (10)

Suggested mark scheme for structured questions on the Great Depression

- 1) Three of the following five points: (1) for identifying each factor and (2) for explaining
 - I. Business cycle driven largely by fluctuations in investment, which is more volatile than other components of aggregate demand
 - II. Poor corporate governance: profits from the utilities used to pay debts of the financial companies that owned them, rather than using the funds to finance investment.
 - III. Reckless lending by banks to individuals and companies who could not afford to pay them money back
 - IV. Deflationary policies to reduce wages and restore competitiveness, given inability to devalue.
 - V. Tight monetary and fiscal policy once recession began: refusal to raise government spending, cut taxes, or cut interest rates, preventing aggregate demand from shifting to the right.
- 2
 - a. Government spending is equal to government revenue (2)
 - b. Any two of rise in government spending/reduction in tax rates/(rise in) budget deficit (2)
 - c. The idea that behaviour changes because of an insurance policy, or because of the knowledge that an individual or business won't bear the consequences of its actions. (2). Any application to banking, e.g. banks will continue to lend knowing that they will be bailed out (2)
 - d. Crowding out: any good definition of either resource or financial crowding out, e.g. any two of: a budget deficit has to be financed by borrowing money (1), which may lead to a shortage of loanable funds (1), driving up market interest rates (1) and reducing aggregate demand (1) (2)
 - e. Liquidity Trap: when very low interest rates fail to stimulate consumer spending (2); or a rise in the money supply doesn't reduce interest rates, so consumer spending doesn't increase; or, where individuals expect interest rates to rise, bond prices to fall, so they hold money rather than buy bonds (2)



- 3) 4 marks for any of: reduction in budget deficit could involve lower G and/ or higher T (2); net leakage out of circular flow, (2), leading to multiplied fall in national income and fall in price level (2).

Reserve 2 marks for clearly labelled Keynesian AD/AS diagram showing shift left in AD leading to fall in equilibrium price level and fall in level of real output.

Reserve 2 marks for evaluation: it depends on elasticity of Keynesian AS curve (2), magnitude of the cut in the deficit (2), impact of other components of AD (2), impact of other policies (2)

- 4) 4 marks for any of: cut in interest rates reduces opportunity cost of spending or similar (2), reduces cost of borrowing (2) leading to rise in C and I (2)

Reserve 2 marks for clearly labelled Classical AD/SRAS diagram showing shift right in AD leading to rise in equilibrium price level and rise in level of real output.

Reserve 2 marks for evaluation: Classical LRAS is vertical, so no change in level of real output in the long run (2), magnitude of the cut in interest rates (2), impact of other components of AD (2), impact of other policies (2)

- 5) 6 for KAA (2 x 3 marks or 3 x 2 marks), 4 for Evaluation (2 x 2 marks or 3 + 1 mark)

KAA could include:

- Gold standard prevented devaluation and therefore export-led growth
- Gold standard prevented reduction in interest rates/rise in money supply
- Austerity led to reduction in AD and therefore helped to turn recession into Depression
- Protectionist policies prevented export led growth

Evaluation points could include:

- Classical perspective: expansionary fiscal policy would have been ineffective in the long run because of financial or resource crowding out (this could count as two points)
- Expansionary monetary policy would have been ineffective because of the liquidity trap
- Austrian perspective that interest rates should remain high in order to allow indebted institutions to fail
- The recession turned into Depression because of structural factors, e.g. inequality, bad banking system: it would have occurred anyway, regardless of policy
- Some policies were effective in this period: FDIC created in 1930 in US, Britain came off Gold Standard in 1931