Unit 17

THE GREAT DEPRESSION, GOLDEN AGE AND GLOBAL FINANCIAL CRISIS

OUTLINE

A. Introduction
B. Economic epochs
C. The Great Depression
D. The Golden Age
E. Stagflation and the financial crisis
F. Lessons learned

A. Introduction

The Context for This Unit

Good policies and institutions can promote economic growth and stabilize the economy during a recession. (Units 13-15)

Major recessions and slowdowns in growth are due to policy and institutional failures.

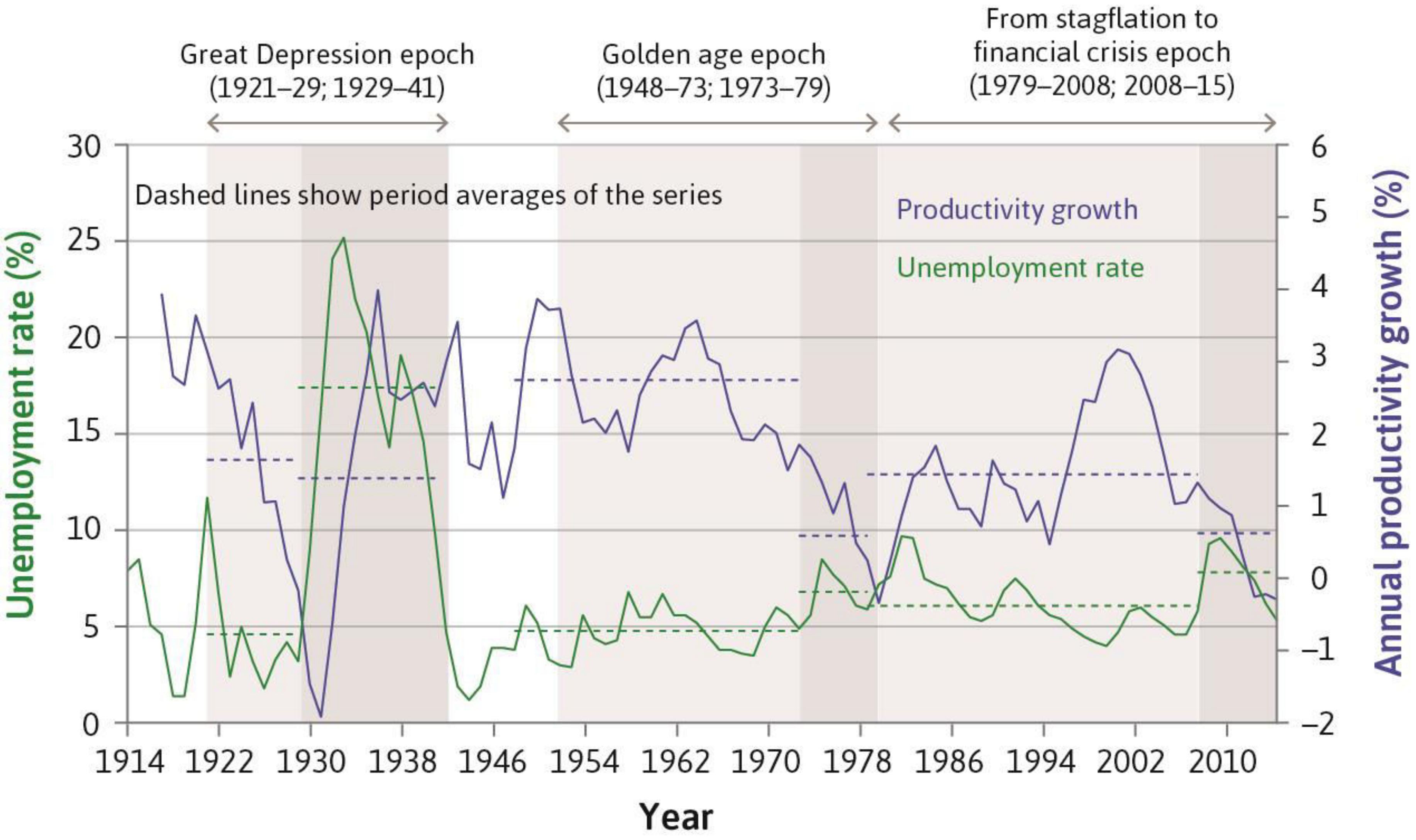
- What caused the economic failures of the last century?
- What policy-making lessons can we learn from the past?

This Unit

- Three economic epochs of the last century: the Great Depression, the Golden Age, and the Financial Crisis
- Economic successes and causes of eventual failure
- Lessons that policymakers learned from each epoch

B. Economic epochs

The three economic epochs



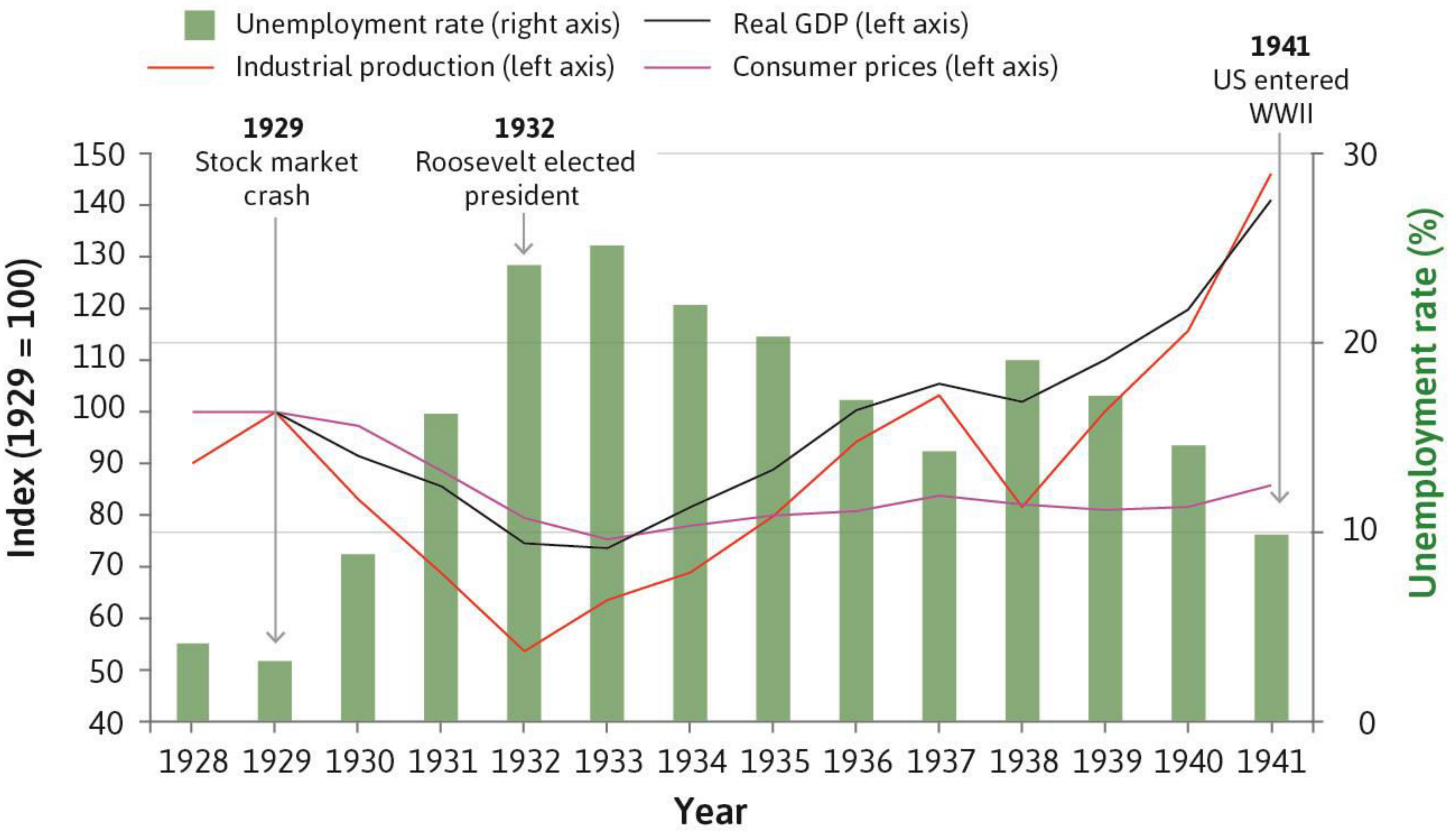
International comparisons

GREAT DEPRESSION	• US : Large, sustained downturn in GDP starting from 1929 • UK : Avoided a banking crisis, experienced a modest fall in GDP
GOLDEN AGE	• US : Technology leader • Outside US : Diffusion of technology creates catch-up growth, improving productivity
FINANCIAL CRISIS	• US : Housing bubble creates banking crisis • Germany, Nordic countries, Japan, Canada, Australia : Did not experience bubble, largely avoided financial crisis
INTERNATIONAL OPENNESS (ALL THREE PERIODS)	More important in most countries than in the US

The three epochs of modern capitalism were worldwide phenomena, but some countries experienced them differently compared to the US

C. The Great Depression

The Great Depression



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Causes

The Great Depression = The period during the 1930s in which there was a sharp fall in output and employment in many countries.

Caused by 3 simultaneous **positive feedback** mechanisms in the US:

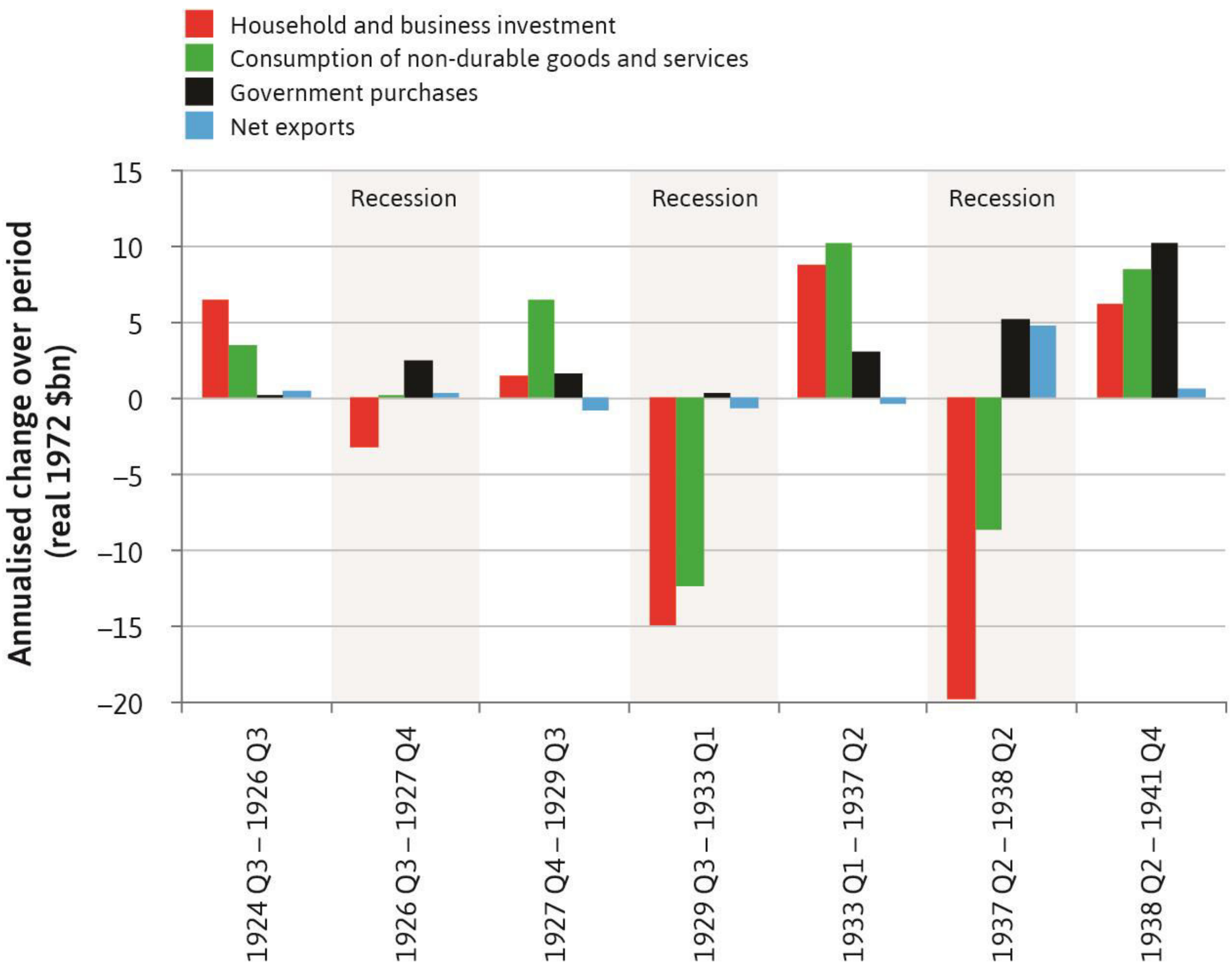
- Pessimism about the future – households reacted to the 1929 stock market crash by saving more, further decreasing consumption
- Banking system failure – many banks failed because loans could not be repaid; surviving banks raised interest rates
- Deflation – Prices fell due to falling demand

The problem of deflation

Deflation affects aggregate demand through several routes:

1. the real value of debt increased; debt levels were relatively high.
2. many debtors become insolvent, which also hurt creditors.
3. farmers reacted by producing more to maintain their income, but this reduced prices further.
4. households also postponed the purchase of durables, which further reduced aggregate demand.

Aggregate demand in the Great Depression

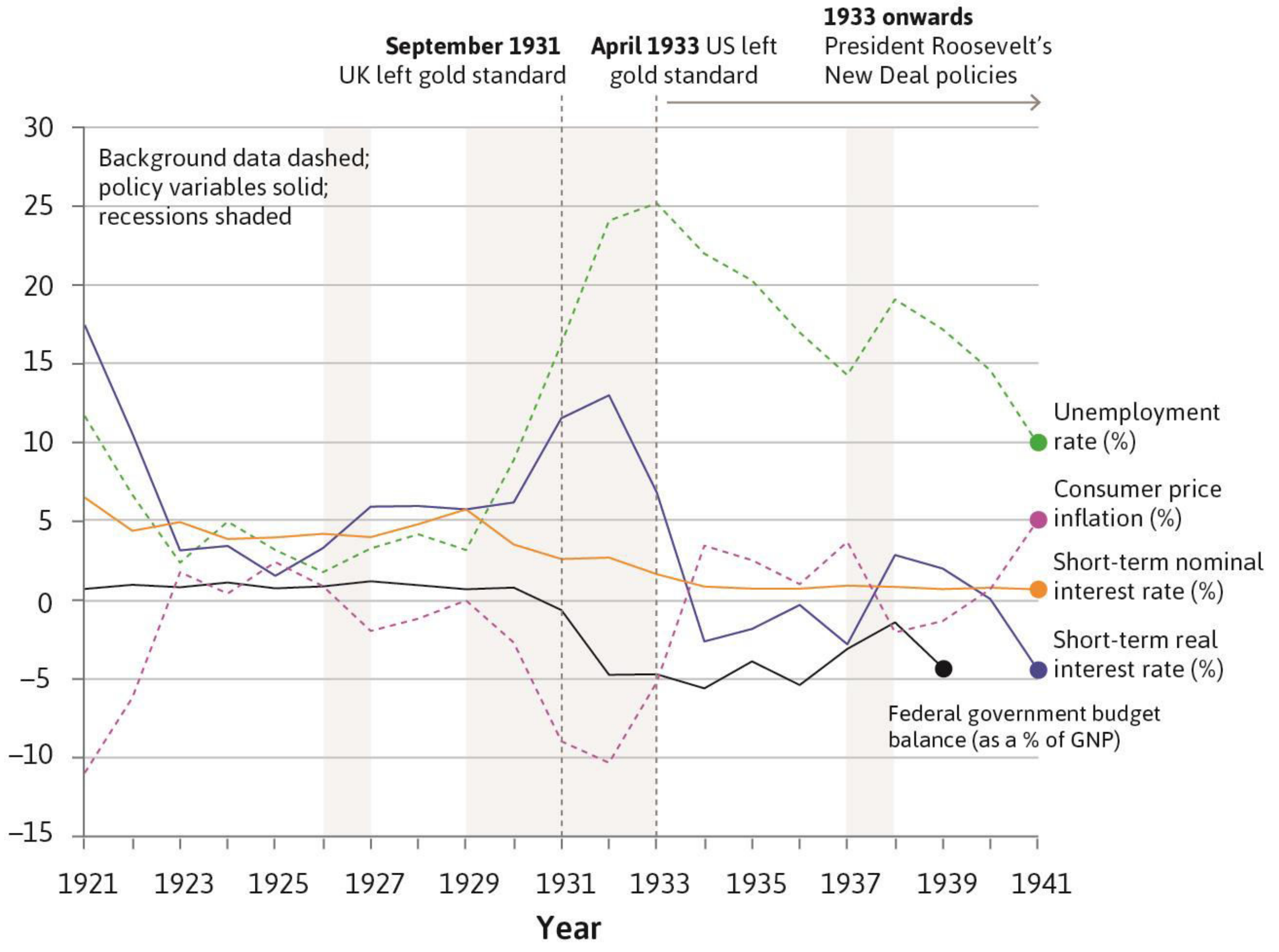


The downswing was driven by big falls in household and business investment, and in consumption of nondurables = shocks to AD.

Initial policy issues

Government policy both amplified and prolonged the shock:

- Fiscal policy – austerity to maintain balanced budget
- Contractionary monetary policy – real interest rate increased



The role of the Gold Standard

Gold Standard = The system of fixed exchange rates by which the value of a currency was defined in terms of gold, for which the currency could be exchanged.

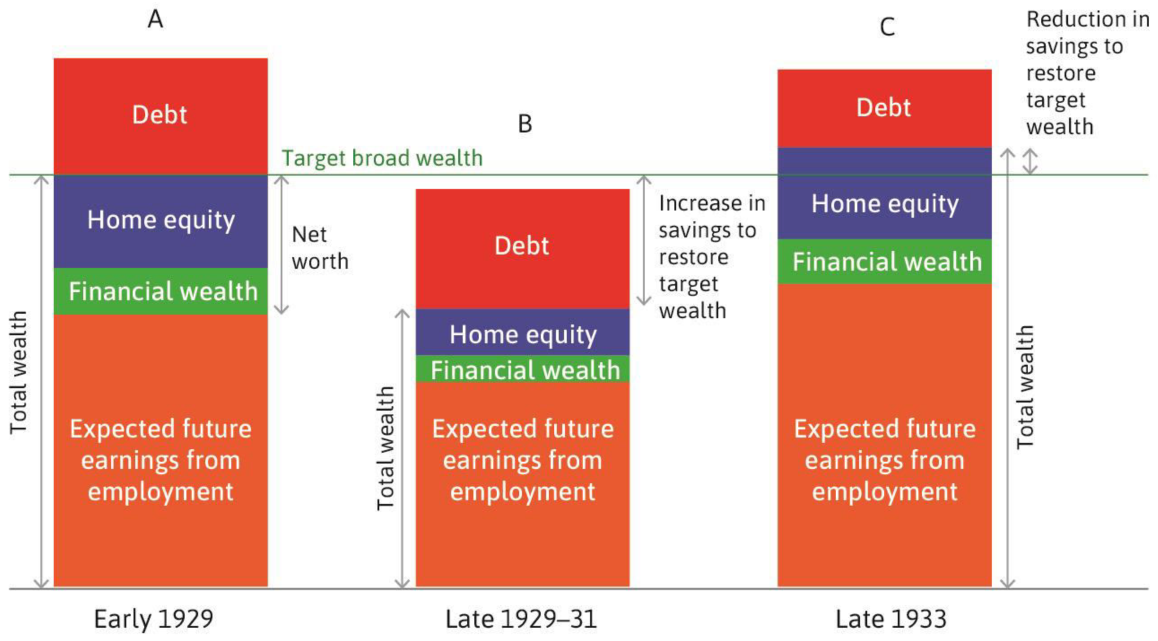
To prevent gold outflows, the government kept interest rates high.

This closed off the possibility of using monetary policy to counteract the recession.

Policy changes

Roosevelt's 1933 reforms changed expectations, which started economy recovery.

- The **New Deal** – government spending on public works and relief programmes to increase aggregate demand; resulted in a budget deficit
- US left the gold standard
- Nominal interest rate close to zero
- Banking system reforms to avoid bank runs

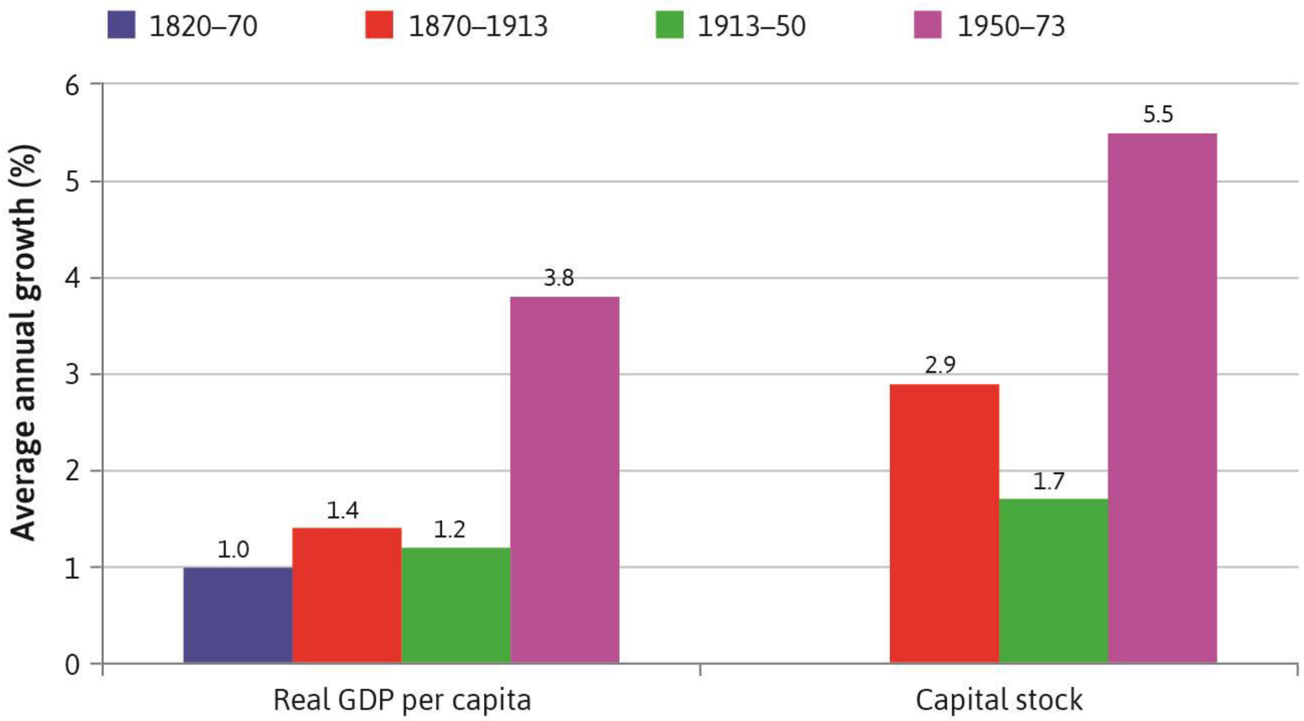


D. The Golden Age

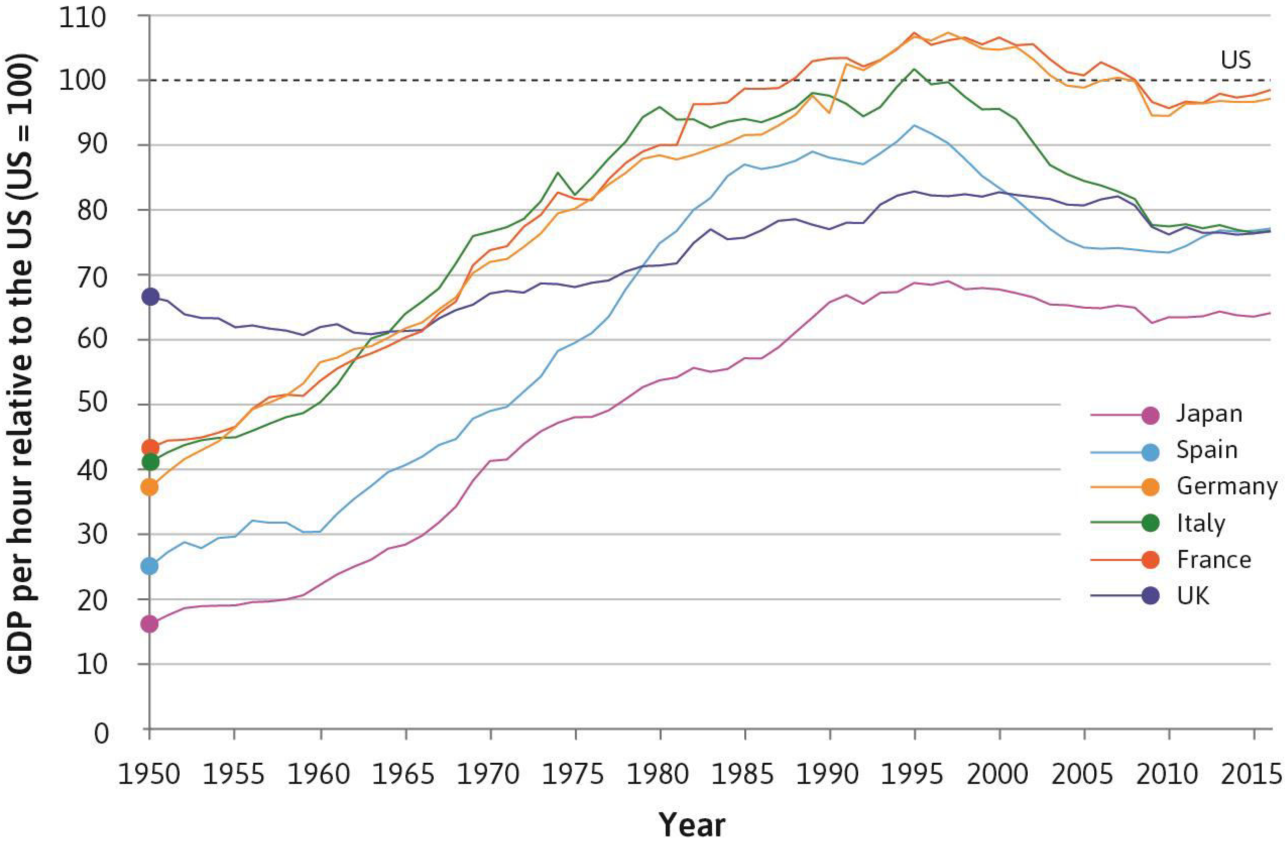
The Golden Age

Golden Age = The period of high productivity growth, high employment, and stable inflation extending from the end of the Second World War to the early 1970s.

Living standards were doubling every 20 years.



Catch-up growth



Economic growth was even faster in many other (initially poorer) economies.

Causes

1. Changes in economic policymaking and regulation
   - governments provided reassurance that policy would be used to support aggregate demand if necessary
   - The size of governments increased continuously
   - **Bretton Woods System** as a more flexible alternative to Gold Standard
2. The **postwar accord** between employers and workers
   - Sharing the gains of technological progress provided incentives for firms to innovate

Workers and Employers

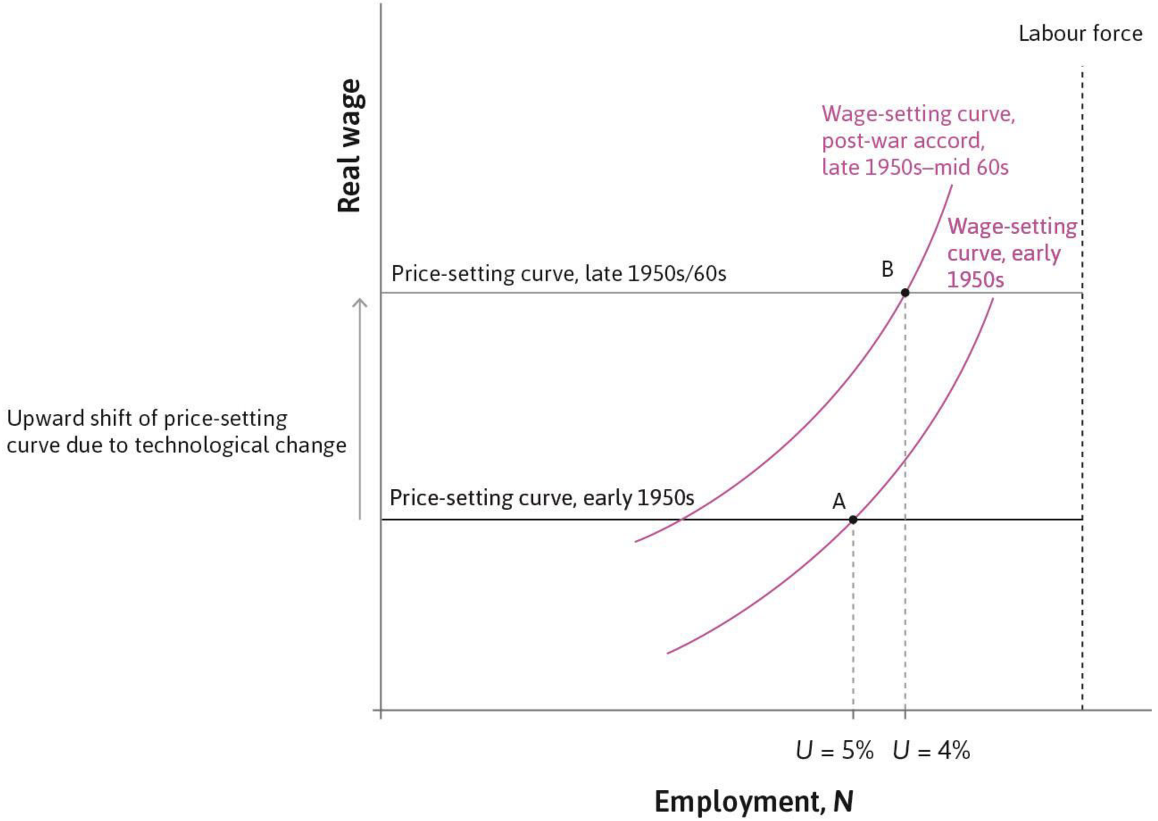
A ‘**virtuous circle**’ of low unemployment, high profits and high investment:

- High after-tax profits in many advanced economies
- Expectations of high profits led to high levels of investment
- High investment and technological progress created more jobs, keeping unemployment low
- Trade unions gave workers high bargaining power, which allowed wages to increase (fair-shares bargaining)
- The union voice effect encouraged cooperation between workers and firms in the face of technology adoption

Using the labour market model

Technological progress shifted the price-setting curve up

wage-setting curve shifted up due to increased worker bargaining power, but only modestly (informal agreement between employees and employers to share the gains to technological progress)



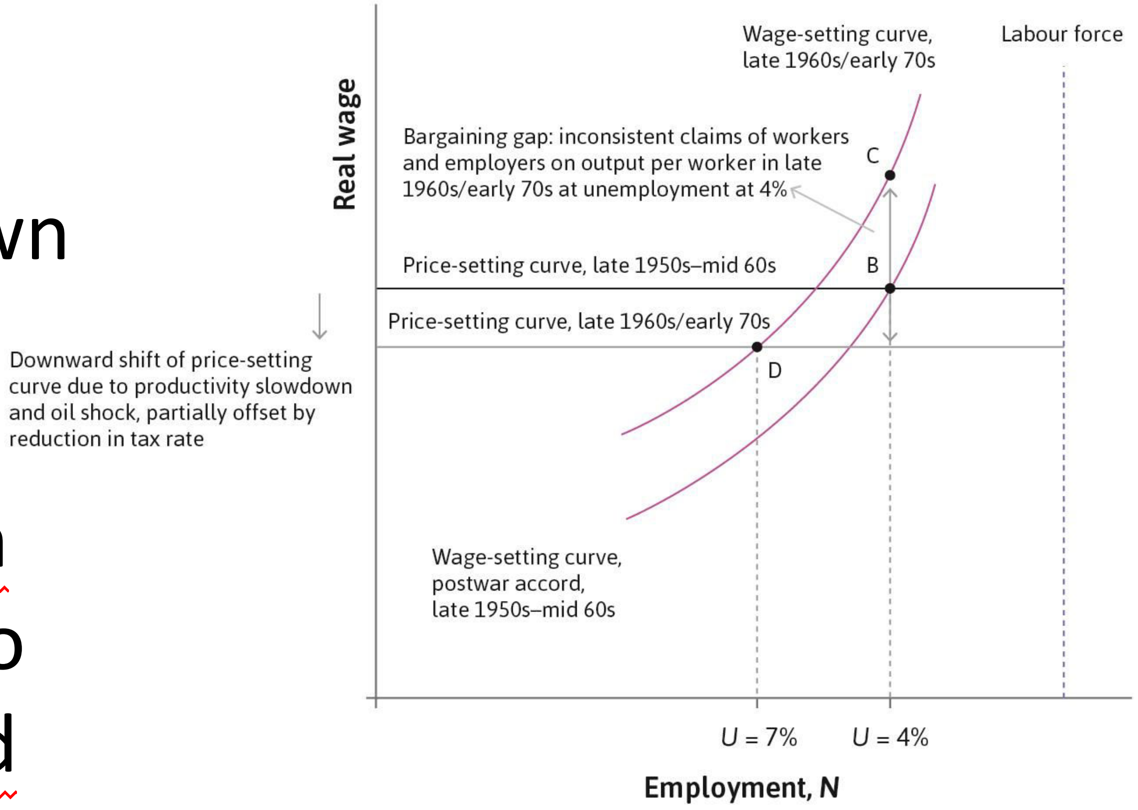
Postwar accord across countries

- wage restraint was achieved by a single centralized union, or coordinated among unions (e.g. West Germany)
- government set wages directly in state-owned firms, creating wage guidance (e.g. France)
- strong but fragmented unions resulted in weak coordination and opposition to technological progress, and the country's performance in the golden age was worse than elsewhere (e.g. Britain).

Collapse of the postwar accord

Price-setting curve eventually shifted down:

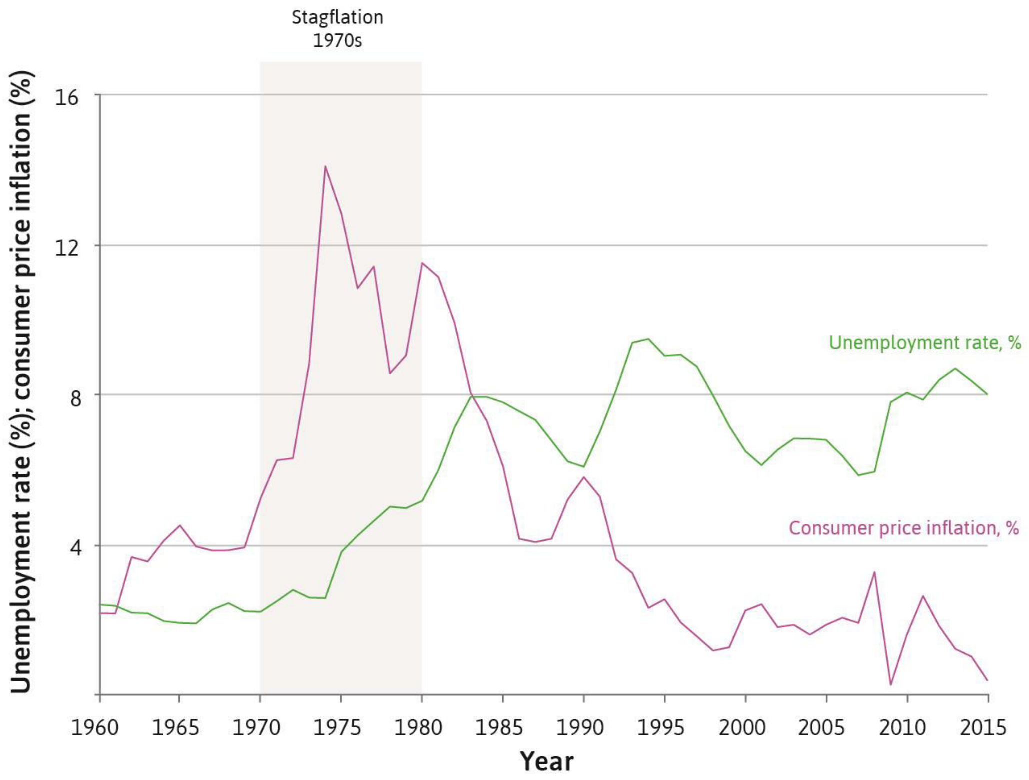
- Workers demanded higher wages
- Economy-wide productivity slowdown
- Oil price shocks in the 1970s



Workers' strong bargaining position shifted the cost of oil price shocks to employers → Lower investment and productivity growth

→ rising inflation and high unemployment

Stagflation



Stagflation = Persistent high inflation combined with high unemployment in a country's economy.

This was the result of an upward shift of the Phillips curve.

Supply-side crisis

The Great Depression was caused by problems of aggregate demand. It was a **demand-side crisis**.

The end of the golden age was a **supply-side crisis**: problems on the supply side of the economy depressed the rates of profit, investment, and productivity growth.

Demand-side policies that would have been part of the solution during the Great Depression had now become part of the problem.

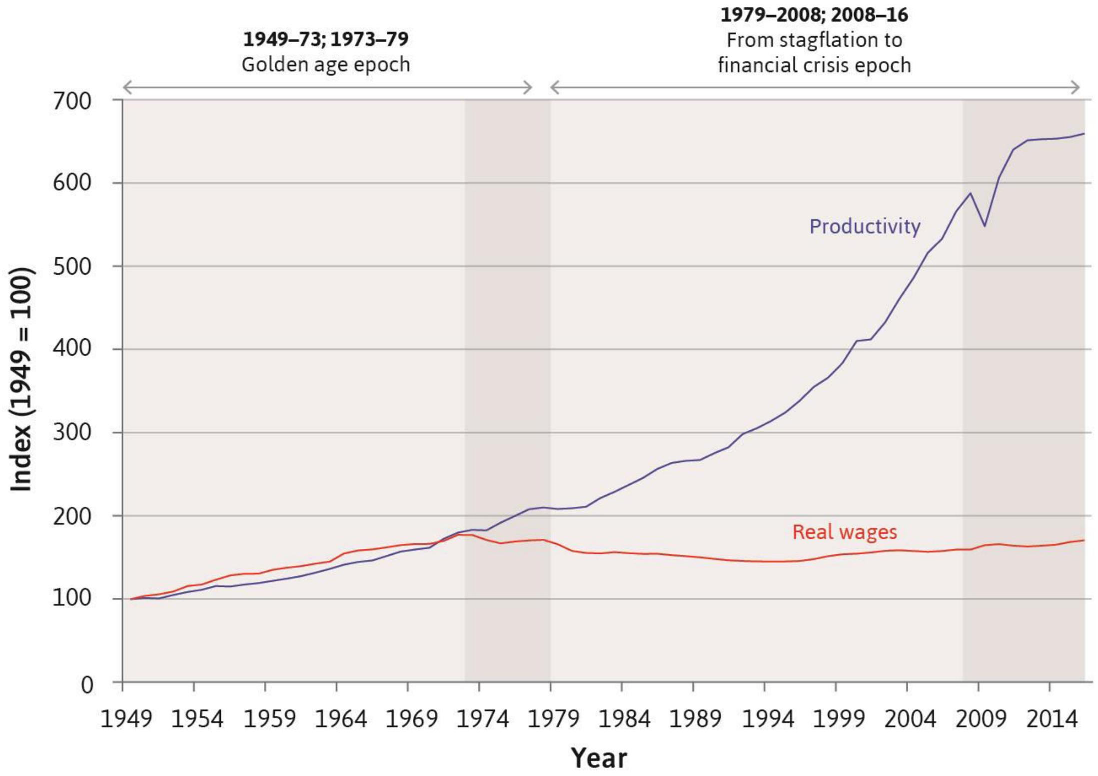
D. Stagflation and the financial crisis

Supply-side reforms

Policies centred on shifting the balance of power between employers and workers:

- Restrictive monetary and fiscal policy – governments tolerated high unemployment rates to lower inflation and reduce workers' bargaining power
- Shifting the wage-setting curve down via cuts in unemployment benefits and legislation that reduced trade union power

Result: The Great Moderation



Productivity growth no longer shared with workers

Low and stable inflation, falling unemployment

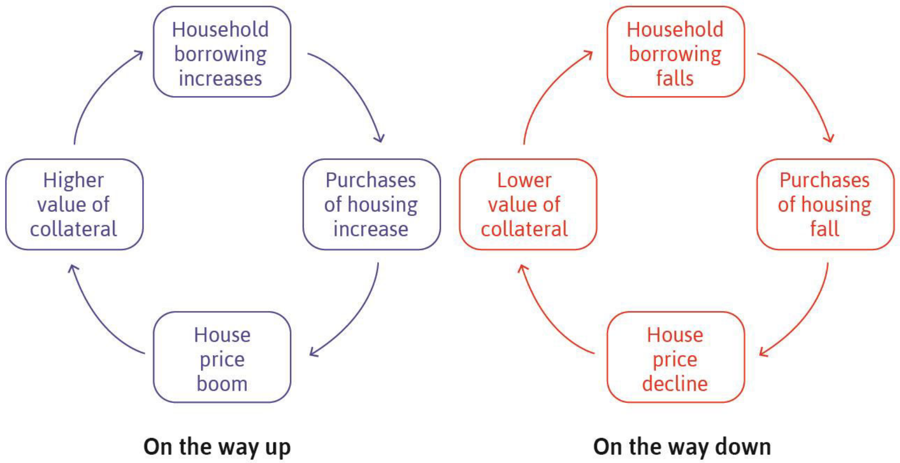
Investment did not match the growth in profits

Problems with the Great Moderation

- Rising debt
- Increasing house prices
- Rising inequality due to end of fair-shares bargaining

Higher debt was the result of rising inequality and **financial deregulation** that allowed households to improve their consumption via borrowing.

Housing boom and the financial accelerator



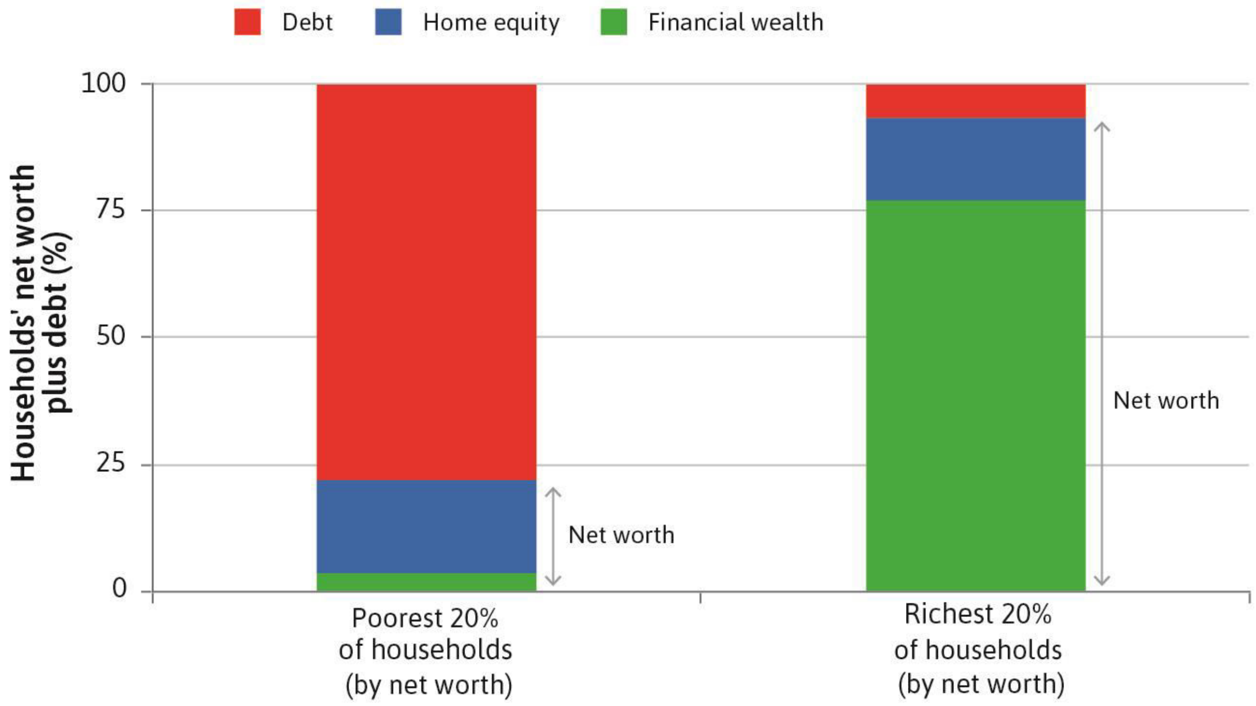
Buying a house via mortgage is a secured (collateralised) loan.

Carlstrom and Fuerst (1997) Bernanke, Ge

Financial accelerator: when house prices go up, so does the value of collateral, and households can borrow more.

This pushes up house prices further and sustains the bubble.

Subprime borrowers



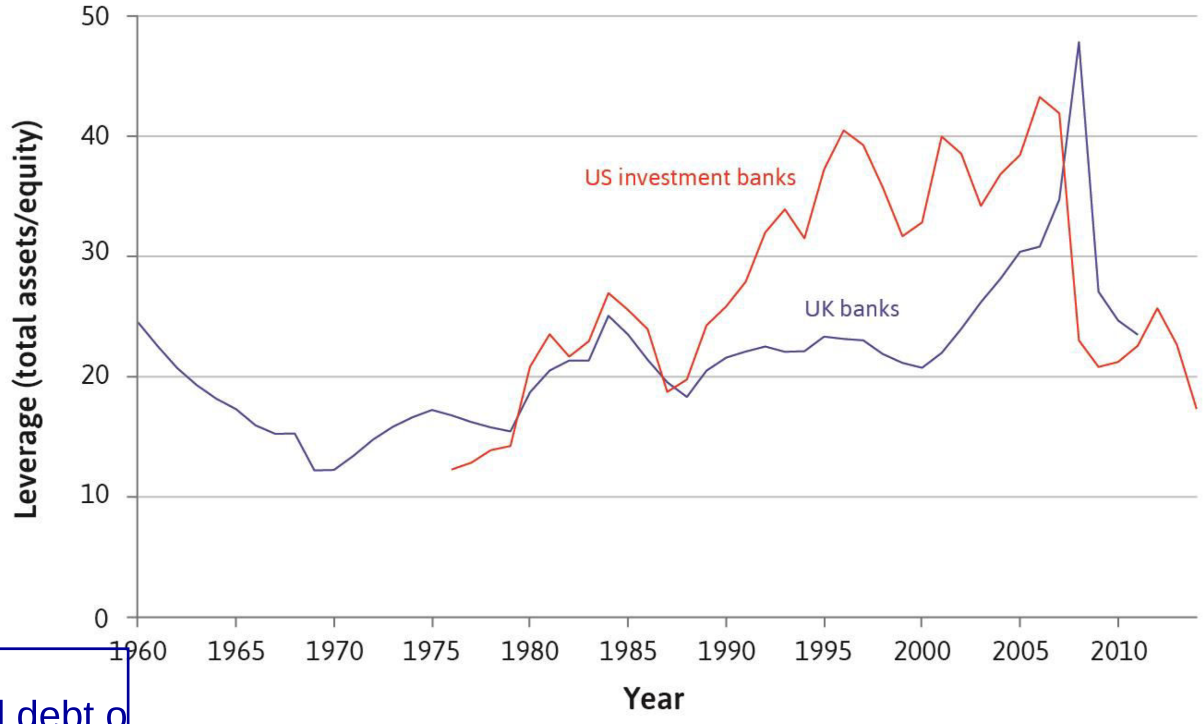
Poor households are normally only able to borrow when they have housing collateral. When house prices are expected to rise, the riskiness of home loans falls. Lenders ask for lower deposits, or even no deposit at all.

Financial deregulation

The combination of the great moderation, rising house prices, and the development of new, apparently less risky financial assets (**CDOs** and **MBSs**) made it profitable for banks to become highly leveraged.

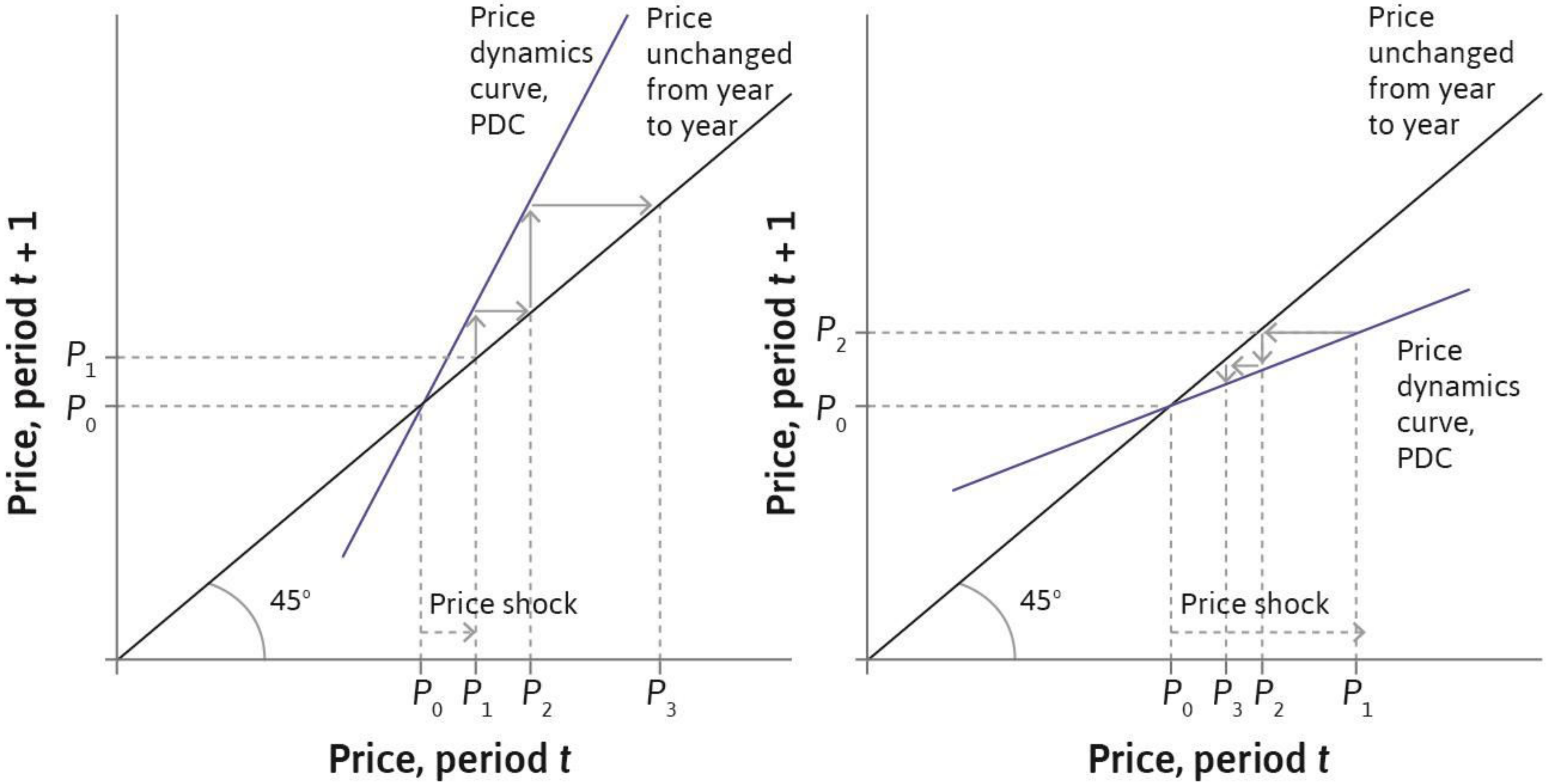
Mortgage-Backed S

collateralized debt o



Credit ratings agencies gave high ratings to many assets created from **subprime mortgages**.

Positive and negative feedback

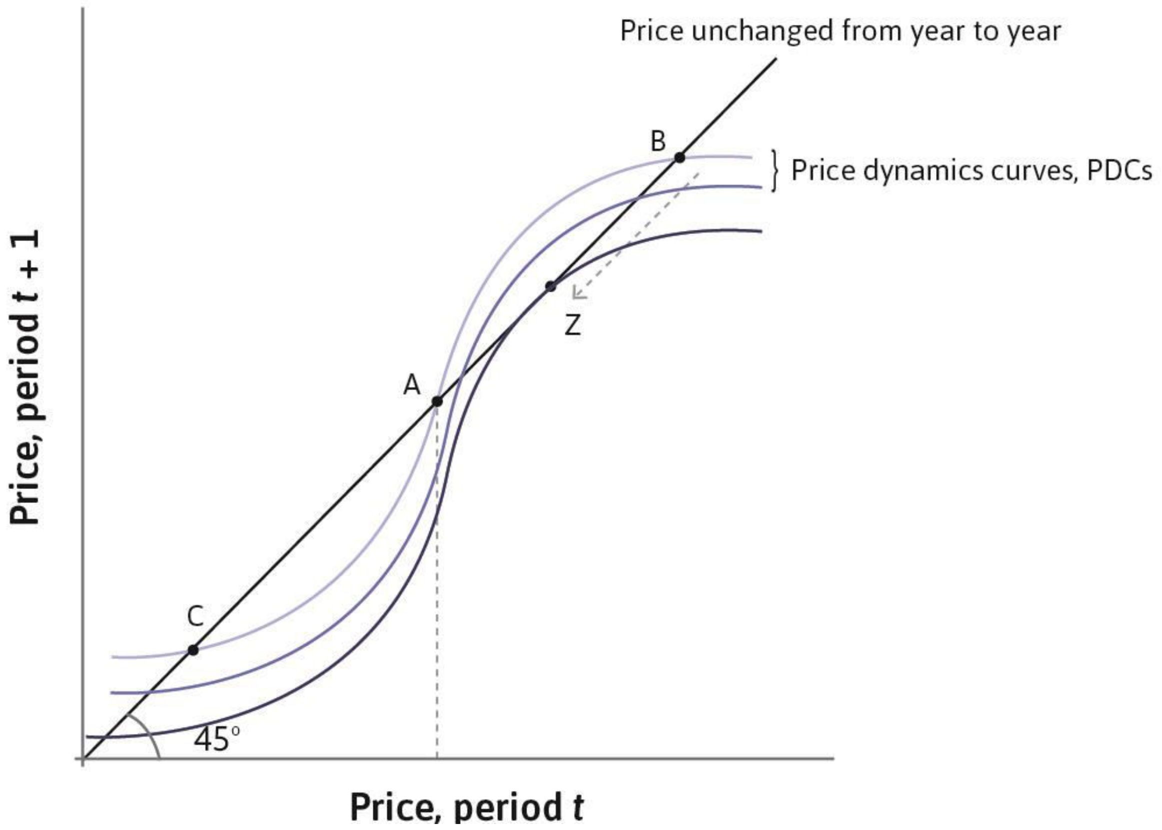


A positive feedback process leads to a destabilizing path.

A negative feedback process leads to a stable equilibrium.

Modelling housing bubbles

The housing market can have several equilibria, some stable and some unstable.



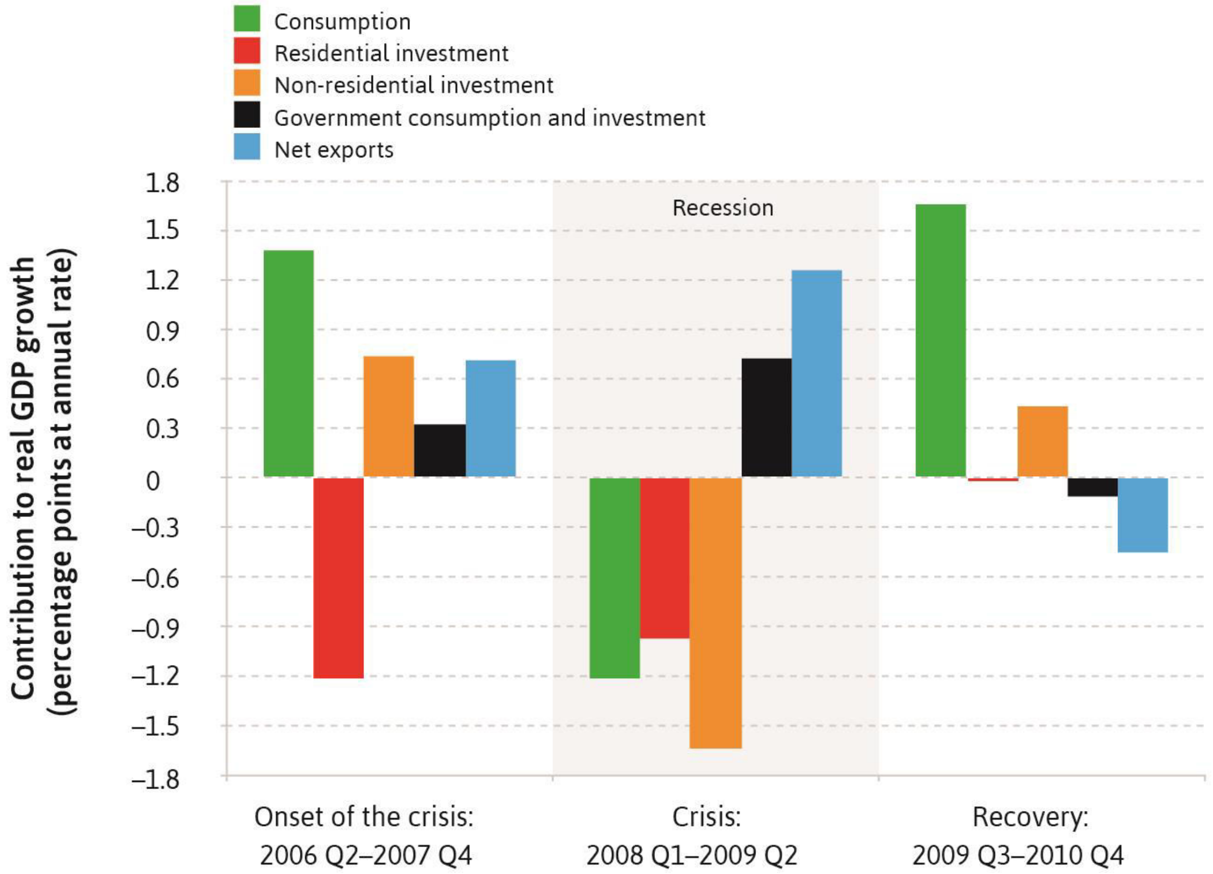
A is a **tipping point**: a small change in prices will lead to a housing bubble/crash.

Shifts in expectations shift the S-shaped curve, changing the equilibria.

The financial crisis

The Great Moderation was ended by the global financial crisis, triggered by falling US house prices from 2007 onwards.

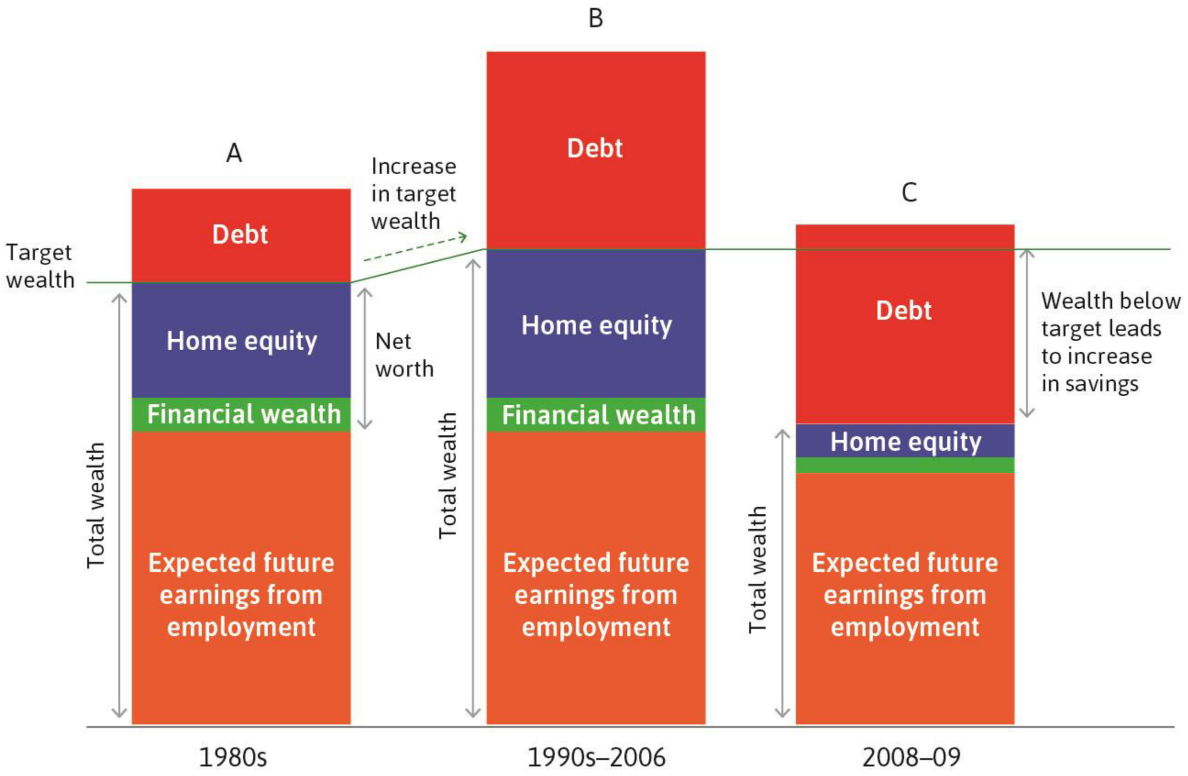
Despite the **bank bailouts** and stabilisation policies, there followed a sustained global fall in aggregate output (**the Great Recession**).



The financial crisis

The initial fall in housing prices started a positive feedback process:

- Non-residential investment and consumption fell (wealth targeting), especially among poorer households with subprime mortgages
- Spillover effects to the financial sector via subprime mortgages
- Investment also fell, which increased unemployment



The role of banks in the crisis

- Many banks were highly leveraged and at risk of **insolvency**.
  - Financial assets were hard to value, so it was difficult to judge which banks were in trouble
- **Liquidity problems**: the high risk of default made banks unwilling to lend or only at a high interest rate (the '**credit crunch**')
- **Fire sales** reinforced the fall in asset prices and hastens the insolvency of banks (positive feedback process)

Governments had to rescue the banks

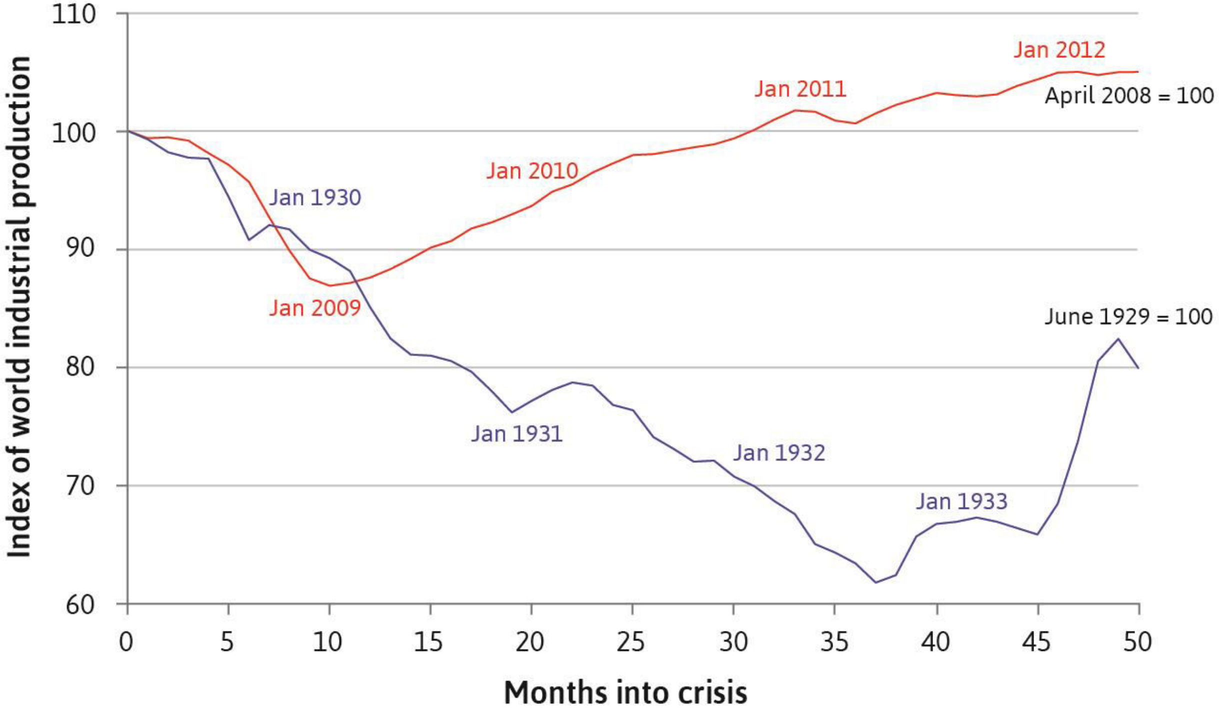
Recall: principal-agent problem encourages excessive risk-taking

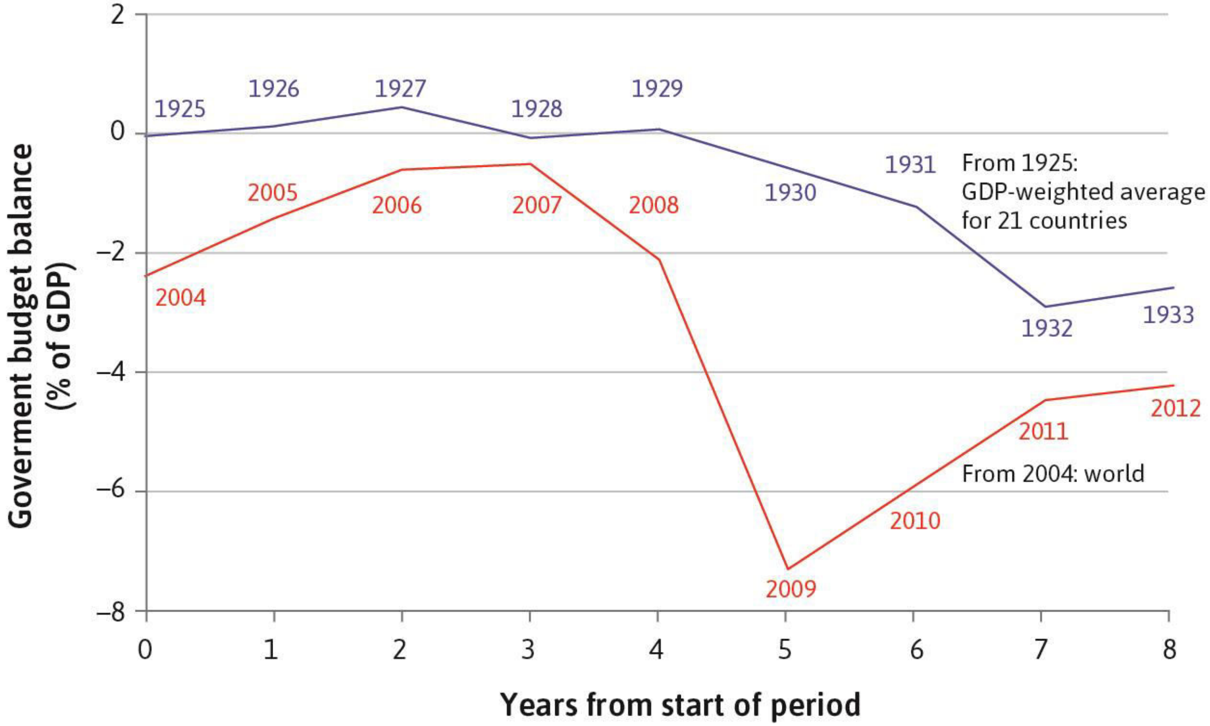
F. Lessons learned

Lessons learned from the last century

EPOCH	DATES	PRIOR CONVENTIONAL WISDOM	THE LESSON	WHAT ECONOMISTS LEARNED	PRIMARY AUTHOR
1920s AND GREAT DEPRESSION	1921-1941	Markets are self-correcting, efficient, and ensure the full use of resources.	Collapse of aggregate demand, high and persistent unemployment.	• Instability is an intrinsic feature of the aggregate economy • Aggregate demand can be stabilised by government policy • Demand matters	Keynes
GOLDEN AGE OF CAPITALISM AND ITS DEMISE	1948-1979	Government policy can implement an employment target by picking a point on the Philips curve.	Late 60s decline in profits, investment and productivity growth. Stable Phillips curve trade-off disappears.	• With given institutions, the need to maintain profits, investment and productivity growth can limit the ability of a government to implement sustainable low unemployment • Supply matters • Institutions matter	Friedman
FROM STAGNATION TO THE FINANCIAL CRISIS	1979-2013	Instability has been purged from capitalist dynamics; minimally regulated financial markets work well.	Financial and housing market crash of 2008.	• Debt-fuelled financial and housing bubbles will destabilise an economy in the absence of appropriate regulations • Institutions matter • Money matters	Minsky

Lessons learned?





Summary

Great depression = **demand-side** crisis

Golden age = **supply-side** crisis

Financial crisis = banking crisis

- Economists have learned from the successes and the failures of the three epochs.
- Successful policies in each epoch did not prevent positive feedback processes that contributed to subsequent crises
- No school of thought has policy advice that would have been good in every epoch

In the next unit

- Another trend over time: Globalization
- Why nations choose to specialize in production of certain goods/services, and how mutual gains are possible with specialization and trade
- The positive/negative effects of globalization: Evaluating government policies and international agreements