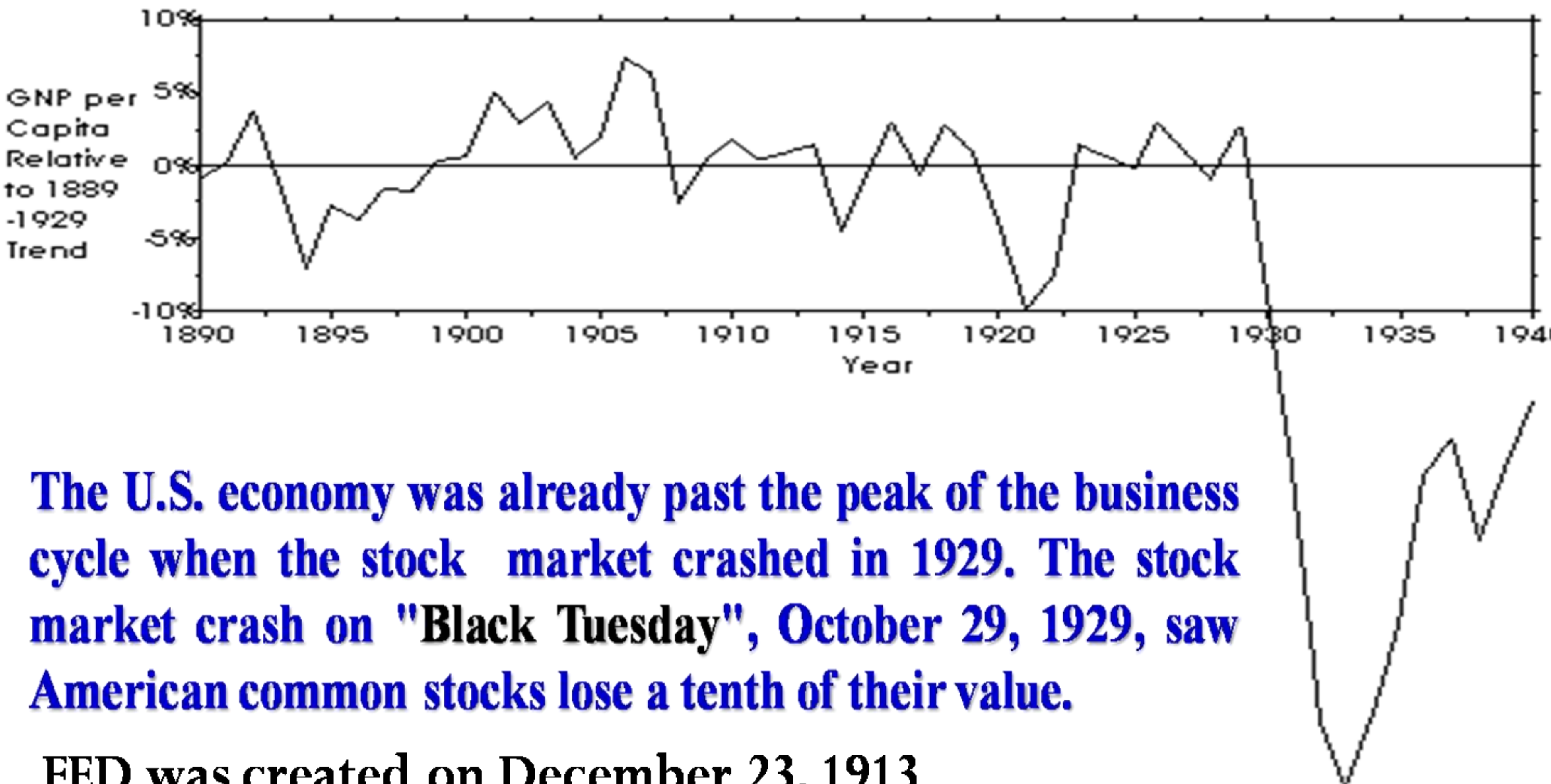
The Macroeconomic History of the Twentieth Century

The Great Depression!

The United States Business Cycle, 1890-1940



The U.S. economy was already past the peak of the business cycle when the stock market crashed in 1929. The stock market crash on "Black Tuesday", October 29, 1929, saw American common stocks lose a tenth of their value.

FED was created on December 23, 1913

Brief History of Modern Macroeconomics

1930s: the capitalist world reeled under the *Great Depression* and doubts were raised about its market mechanism.

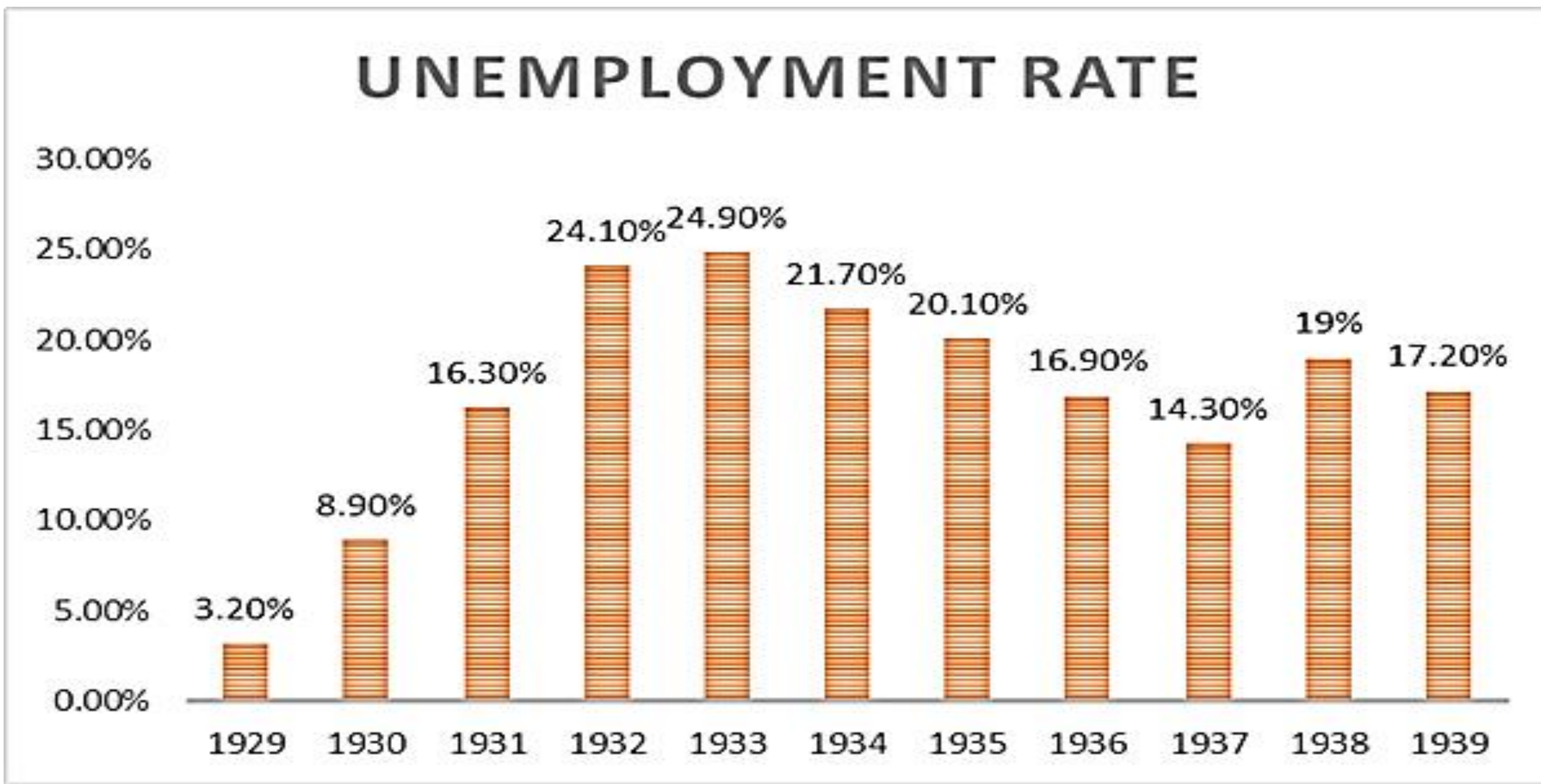
- The 1920's saw a stock market boom in the U.S — businessmen and economists believed that the newly-born Federal Reserve would stabilize the economy. The U.S Federal Reserve's attempts in 1928 and 1929 to raise interest rates to discourage stock speculation brought on an initial recession.

- Caught by surprise, firms cut back further purchase of producer durable goods; firms cut back production; out-of-work consumers and those who feared they might soon be out of work cut back purchases of consumer durables, and firms making consumer durables faced falling demand.

Workers were idle because firms would not hire them to work their machines; firms would not hire workers to work machines because they saw no market for goods; and there was no market for goods because workers had no incomes to spend.

The Great Depression was the deepest and longest-lasting economic downturn in the history of the Western industrialized world.

Around 15 million Americans were unemployed and nearly half of the country's banks had failed.



The US Unemployment Rate During Great Depression

Year	Unemployment Rate (%)
1929	3.2
1930	8.7
1931	15.9
1932	23.6
1933	24.9
1934	21.7
1935	20.1
1936	16.9
1937	14.3

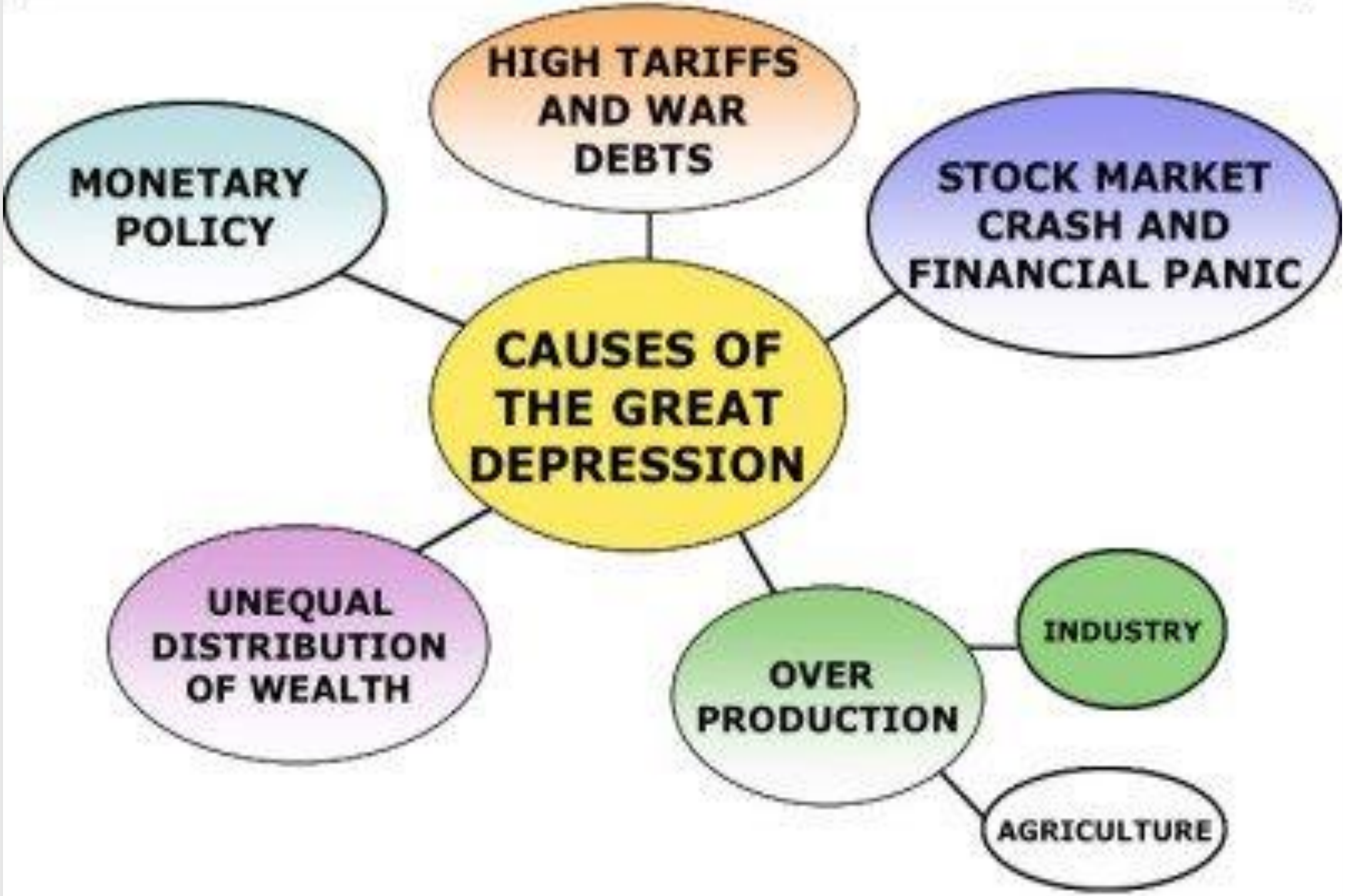
High unemployment $\Rightarrow$ Low employment $\Rightarrow$ Low income $\Rightarrow$ Low demand $\Rightarrow$ Low output

The presidential campaign of 1932 was chiefly a debate over the causes and possible remedies of the Great Depression.

The Republican Herbert Hoover planned to depend largely on natural processes of recovery, while the Democrat Franklin D. Roosevelt was prepared to use the federal government's authority for bold experimental remedies.

Franklin Roosevelt was elected president on the platform of a "New Deal" for the American people.

Historians disagree as to the causes of the Great Depression. Most scholars would include:



Classical Economics

Before the 1930s, economists believed that the economy was self-equilibrating:

– a shortfall in demand for goods (*recession*) would result in falling prices and interest rates, and a recovery in demand.

– a shortfall in the demand for workers (*unemployment*) would result in falling wages, and a recovery in employment.

Says Law — ***Supply creates its own demand.***

Persistence of 1930s depression cast doubt on "Classical" economics.

Keynesian Economics: ***Output is demand determined.***

Main Twofold Arguments of Keynes (1936)

It is possible for high unemployment and underutilized capacity to persist in market economies.

Government policies (*fiscal* and *monetary*) can affect output and thereby reduce unemployment and shorten economic downturns.

Govt. exp. & Tax

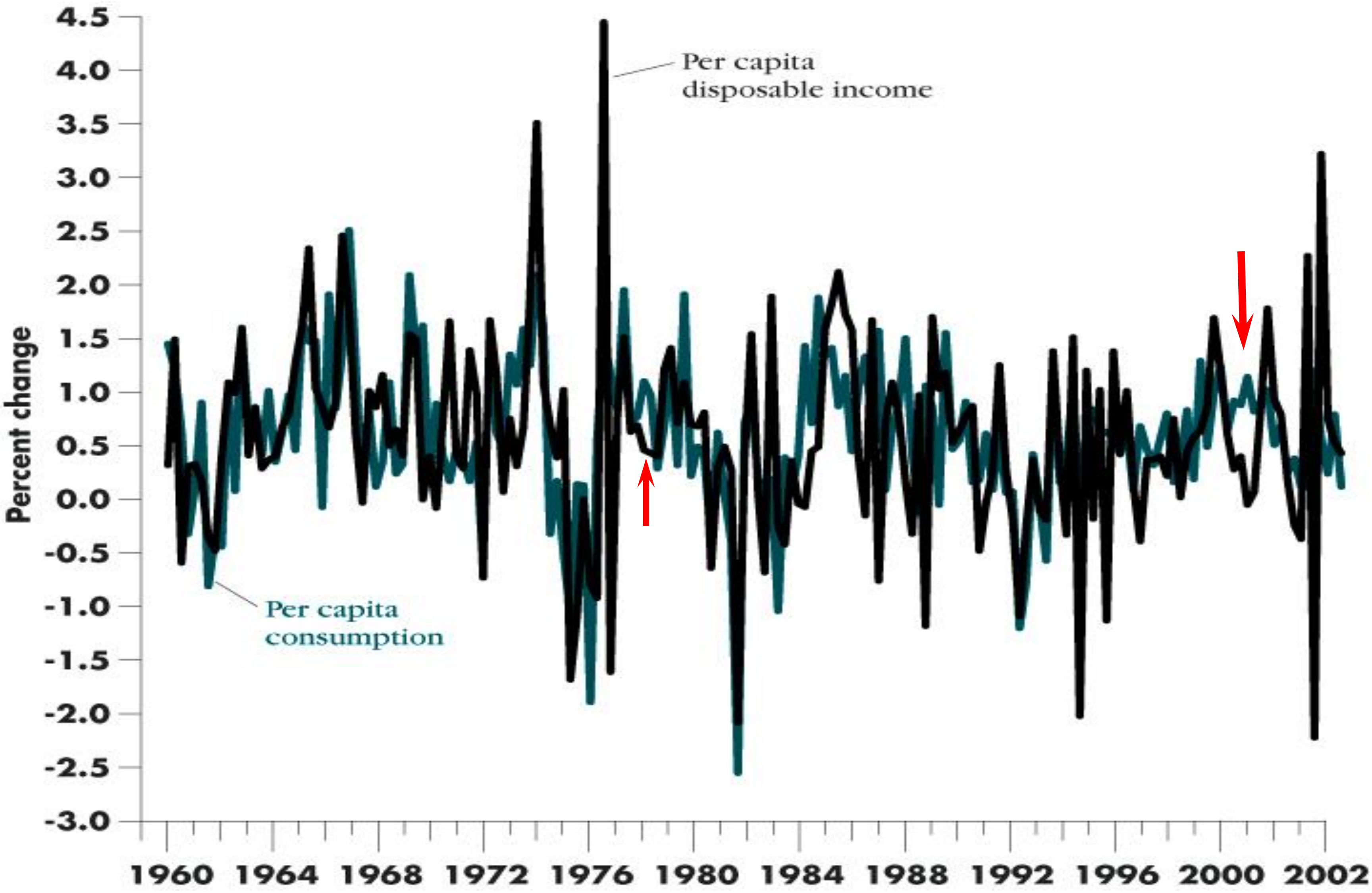
Money supply &
Interest rate

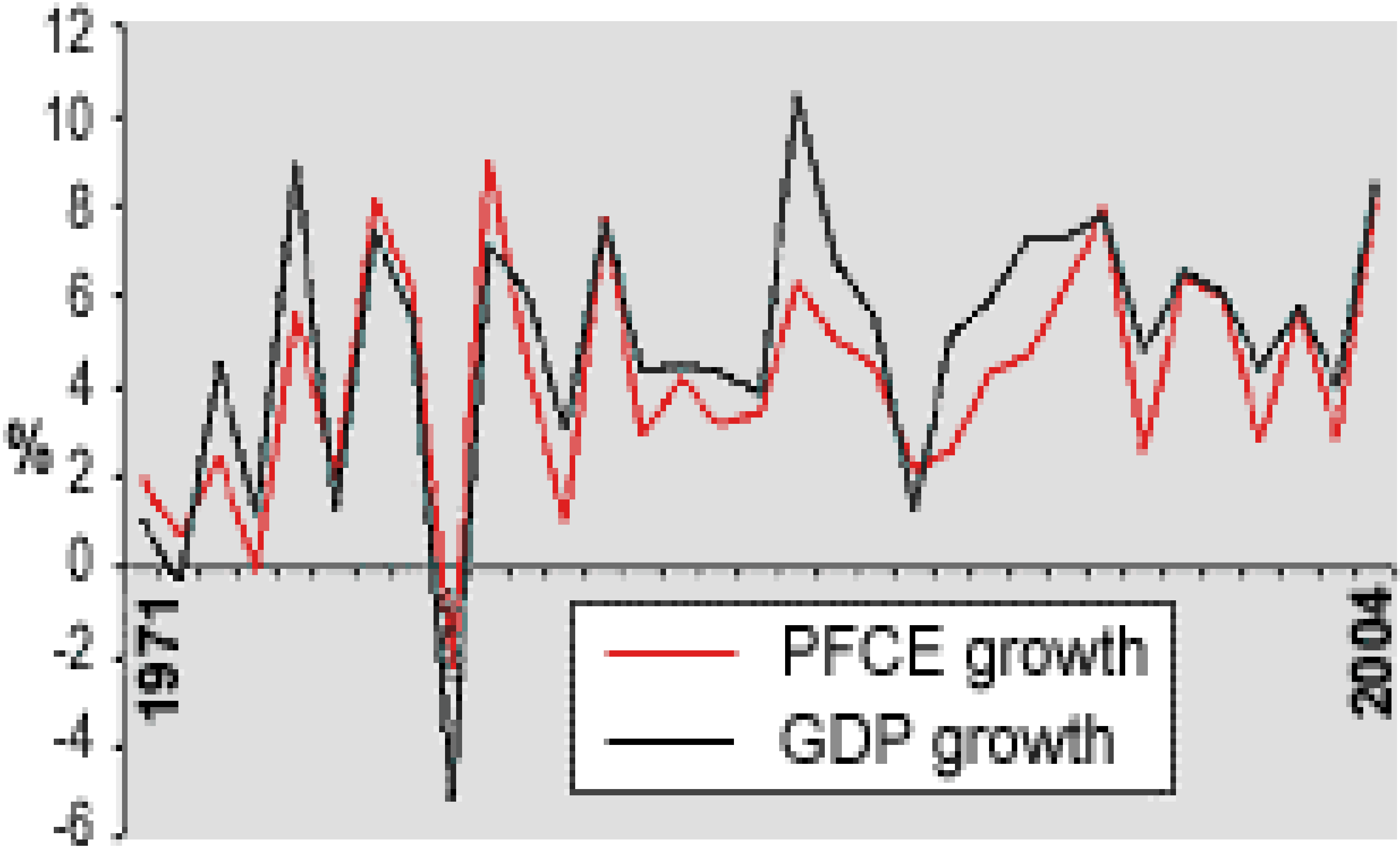
Post World War II, for the first time in history, the U.S Congress affirmed the government's role in promoting output growth, fostering employment and maintaining price stability.

Theories of Consumption

Behavioural Function

Per Capita Consumption and Disposable Income in the US (1959-2002)





SOURCE: Center for Monitoring Indian Economy, and CSO

Consumption is the sole end and purpose of all production.

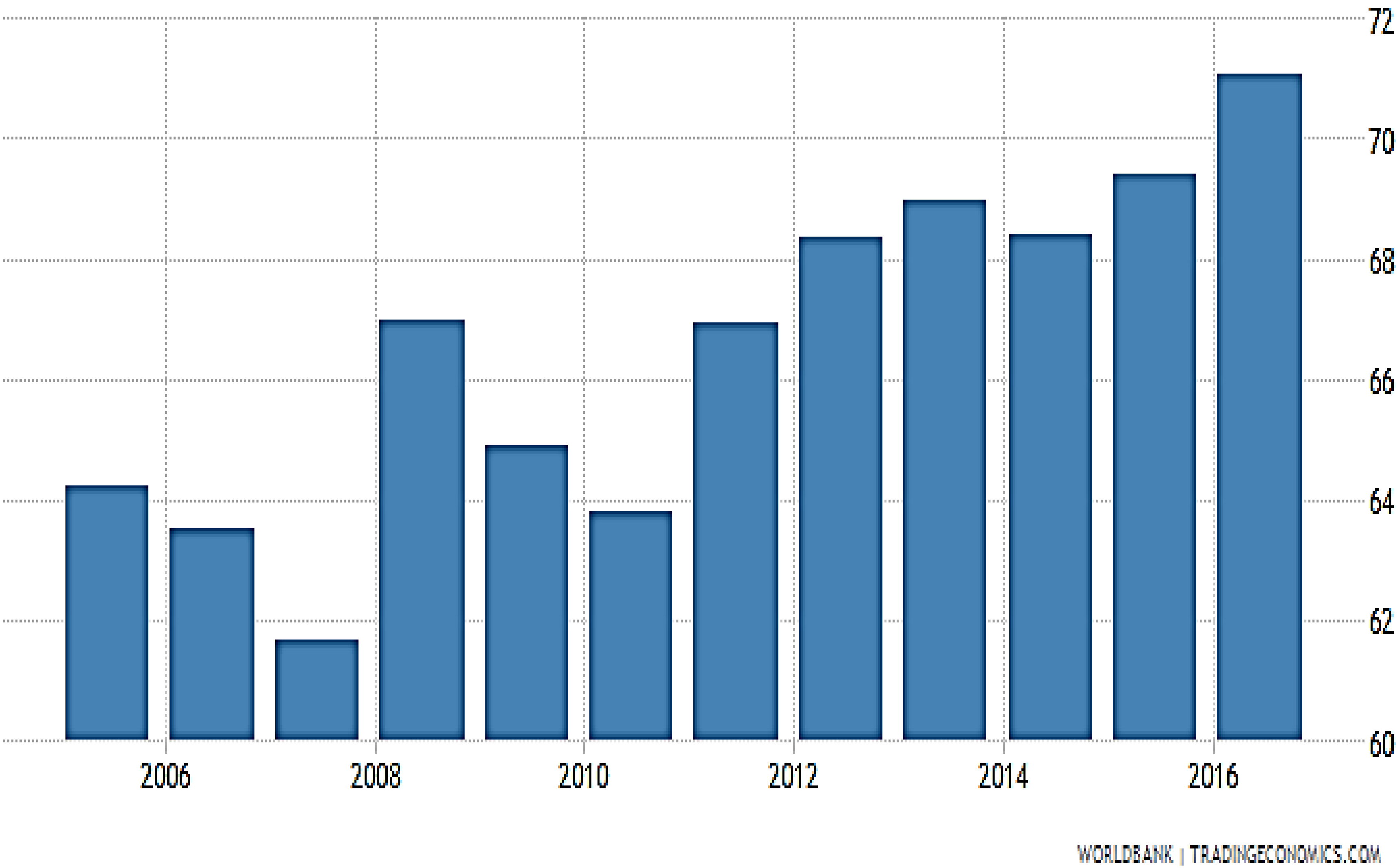
— Adam Smith

Consumption contributes more to China's GDP growth, January 30, 2008, REUTERS India.

The contribution of PFCE to GDP growth increased from 50.4% in 2002-03 to 60.9% in 2003-04 in India. [Source: GOI, Economic Survey 2004-05].

The Final consumption expenditure (% of GDP) in India was last reported at 69.69 in 2011, according to the World Bank report published in 2012.

Final consumption expenditure (% of GDP) in India was **71.08 %** in 2016, according to the World Bank.



Consumption Function

(Behavioral Function)

Consumption constitutes a very high proportion of aggregate demand in the economy. And consumption demand in an economy is generally quite *stable* — fluctuations in consumption are proportionately *smaller* than the fluctuations in GDP.

MPC $\left[\frac{dC}{dY} \text{ or } \frac{\Delta C}{\Delta Y}\right]$: Increase in consumption due to per unit increase in income.

Keynesian model suggests a high value of MPC.

Keynes had put high importance on the consumption demand of an economy.

APC $\left[\frac{C}{Y}\right]$: Consumption per unit of income.

Absolute Income Hypothesis (AIH)

"The fundamental psychological law … is that men are disposed, as a rule and on the average, to increase their consumption as their income increases, but not by as much as the increase in their income" — *John Maynard Keynes* (1936, p. 96).

The Keynesian Theory

Consumption is a *linear* function of disposable income.

$$C = a + bY_D \quad a > 0 \text{ and } 0 < b < 1$$

where C is consumption, Y_D is disposable income, $\boldsymbol{b}$ is the *marginal propensity to consume*.

$$\frac{C}{Y_D} = \frac{a}{Y_D} + b \quad \Rightarrow \text{APC} - \text{MPC} > 0$$