The Great Economic Depression and the Fiscal Policy

ISSN 1857-9973 **338.124.4:336.02(100)**

Vasilka Gaber-Naumoska[1], Stevan Gaber[2], Aleksandar Naumoski[3]

[1]Public Revenue Office, Bul. Kuzman Josifovski-Pitu No.1, Skopje 1000, Republic of Macedonia, e-mail: vasilka.gaber-naumoska@ujp.gov.mk;

[2]Goce Delcev University, Faculty of Economics, Krste Misirkov St., 10-A, Stip, Republic of Macedonia, e-mail: stevan.gaber@ugd.edu.mk

[3] Ss. Cyril and Methodius University in Skopje, Faculty of Economics, Bul. Goce Delcev 9V, Skopje 1000, Republic of Macedonia, e-mail: aleksandar@eccf.ukim.edu.mk

Abstract

The Great Depression is known as one of the biggest crises in economic history which caused serious economic consequences expressed through increased unemployment, high rates of deflation, bank panic, banking crisis and bankruptcies of many companies and households. The fascination of many economists from this crisis was the main cause of the preparation of this work that aims to capture the overall crisis and to see different views of numerous economists about the reasons that led to the appearance of the same, but also the solutions to overcome it. The paper reviews the different posts of economists, beginning with those who felt that the crisis was caused by monetary factors (tight monetary policy, the gold standard, vulnerable banking system), other authors who considered that the reasons lie in the real sector, and third in the insufficient aggregate demand. Furthermore, the paper examines the Keynesian theory and her attempt to explain and overcome the crises and their views on the increased activity of the state in periods of low economic growth and high unemployment. Keynes succeeded by his revolutionary work to refute all previous views that the market alone manages to declare balance in the economy and that the role of the state should be minimized. Keynes's focus was on capital investments, i.e. the execution of public works which will generate new jobs that can influence to boost consumption. That kind of capital investment in terms of depression should be the main substitute for private investment. The last section elaborates the fiscal measures incorporated in the so-called New Deal of President Roosevelt which were represented through substantial increase in public spending, but such an inevitable march was preceded by the abolition of numerous tax exemptions.

Keywords
Depression, monetary shocks, aggregate demand, money supply, fiscal measures, banking crises, unemployment.

1. Introduction

The Great Depression was an incredibly dramatic episode of American history- era of decline in stock prices in the stock market, bank panics and banking crises, high unemployment, variable financial markets, currency crises, dangerous inflation or a word complete collapse of every aspect of the economy [1]. Namely, it is known for long queues for bread men wearing long coats and hats, small businesses selling apples on every corner of the streets guided by the motto: "Buy an apple a day and send the Depression away" and numerous shoemakers who with his aides and astutely kindly offered their services. While relatively few Americans have lost their money directly to the fall of shares in October 1929, the pain of general collapse of the economy was felt by almost everyone [2]. In order to discover the causes of depression appeared numerous debates among economists and historians that are relevant to this day. The Great Depression is relevant and challenging for the economy for two main reasons: it was a very big event and had an impact on most countries in the world. This event not only opened a new field of research for macroeconomists, but also the experience of 1930 continued to impact macroeconomic beliefs, policy recommendations and agendas for research. Abstaining from the practice, searching to explain the global collapse of 1930 remains a fascinating intellectual challenge. However, the experience of 1930 it helped build consensus that the government bears an important responsibility in trying to stabilize the economy and financial system, as well as providing social assistance to people affected by economic downturns. Numerous important state agencies and programs ranging from social insurance (to help the elderly and disabled), then the Federal Corporation for Insurance of deposits (to eliminate bank panics) to the Commission for Securities (to regulate financial activities) were created in the 1930s, as a legacy of depression.

2. Depression as a challenge to economic doctrine

Namely, after the end of the decade of prosperity in 1920, aggregate economic activity reached a peak in August 1929, two months before the fall of the stock market. Between the bottom of the business cycle in 1929 and the peak of the cycle in 1933, known as most contractive phase of depression, real GDP decreased almost for 30%. During the same period, the unemployment rate increased from 3% to approximately 25% and many of those who have been fortunate to stay on the job. To see how a serious and severe recession, a comparison with the two most severe recessions of 1973-1975 and 1981-1982. Compared with the fall of 30% of GDP and an unemployment rate of 25% in the depression in 1973-'75 GDP decreased by 3.4% and the unemployment rate noticeable increase of 4% to 9%, while the GDP from 1981-'82 decreased by 2.8% and the rate of unemployment rose from 7% to 11%.

Other features of depression from 1929-'33 include strong deflation -the price dropped by approximately 10% per year during the early 1930-like the stock market decline, widespread bank failures (collapse of major US bank of America in December 1930, the Austrian bank in May 1931 which led to the European crisis) and bankruptcies of many corporations and households. Namely, no sector remained spared, some were very hard hit. In the financial sector, stock prices continued to collapse after the stock market crash of October 29, 1929 (a day known as Black Tuesday). Namely during the most contractive period (1929-'33) the yield of broad share index of the largest companies (Standard & Poor's 500) decreased by 86%. Depositors began intensively to withdraw deposits from banks (bank run), and borrowers who were unable to repay their debts to banks went bankrupt. As a consequence, many banks were forced to leave the business or merge with other banks. Serious bank panics were not inherent only to the US, but also Austria, Belgium, Germany, Hungary, Latvia, Poland and other European countries [3]. The total collapse of the system of financial intermediation is marked with the fact that since the beginning of 1930 until the "bank holiday" in 1933 in the banking system there were 9090 suspensions of commercial banks.

In agriculture, farmers went bankrupt through low prices of various types of agricultural crops, and the prolonged drought in the western United States turned many families of farmers in to homeless and migrants. Investments in business and real estate have fallen to very low levels, and "trade war" in which countries competed in setting up barriers to imports (customs) virtually stopped the international trade. Although many people consider depression as a single episode, however it is composed of two business cycles. Contractile phase of the first business cycle lasted 43 months, from August 1929 until March 1933god, and is the largest economic downturn in US history. After Roosevelt became president in March 1933 and implemented a package of policy measures, known as the "New Deal" strong expansion began and lasted 50 months from March 1933 until May so 1937. In 1937 the real GDP approached the level of 1929, although the unemployment rate remained still high 14% that the number of people capable of work (actively seeking work) has increased since 1929 and because productivity growth enabled employment to grow more slowly than output.

The second cycle of the Great Depression began, in May 1937 with contractile phase that lasted more than a year. Despite the new expansion that began in June 1938, the unemployment rate was still more than 17% in 1939. Great Depression ended with the Second World War. Namely, increased production of weapons, aircraft, ships, the real GDP increased significantly between 1939-1944, unemployment dropped sharply in average approximately 2%, reaching its lowest level of 1.2% in 1944 which means that the United States emerged completely from depression.

The reasons for the occurrence of depression varied over the years. Namely, viewed historically, many of the debates about the causes of depression have focused on the role of monetary factors, including monetary policy and other factors affecting the money supply in the country, such as conditions in the banking system. Arguments have changed over time. During the Depression, and decades after that, many economists objected that monetary factors were not relevant to the cause of depression. For example, many observers noted that nominal interest rates were close to zero during the depression, concluding that too expansionary monetary policy caused no good benefits for the economy. During the first decade after the depression, many economists will incline towards explanation of the real side of the economy than monetary factors. Some criticism that over-investment and building dynamic during 1920 (the emergence of radio, refrigerators, cars that were bought with loans from banks) led to a decline in shares when they perceived that the yield of these investments is lower than expected [4].

Another popular theory is that the chronic problem of "low consumption" - the inability of households to buy enough goods and services to harness the productive capacity of the economy, causing the fall. However, in 1963, Milton Friedman and Anna J. Schwartz transformed the debate about the Great Depression, through the publication of their book -A Monetary History of the United States, 1867-1960 in order to understand how monetary forces affect the US economy over this period. In the process of carrying out this common goal, Friedman and Schwartz offer significant evidence and arguments on the role of monetary factors. Contrary to previous views that money and monetary policy had a minor role during the Depression, Friedman and Schwartz argued that "contraction is actually tragic testimony to the importance of monetary forces" (Friedman and Schwartz, 1963, page 300) [5]. According to them they mentioned four major errors of the monetary authorities of the United States as follows:

- restrictive monetary policy that started from spring 1928 and continued until the stock market crash in October 1929 (Hamilton, 1987, or Bernanke, 2003a);
- Gold Standard or the regime of fixed exchange rate (the value of each currency was tied to gold);
- Weak banking system 1920;

- The fact that nominal interest rates reached the level to 0 means that the policy of the Fed were too expansive and inefficient [6];

However, the final lectures of the former policy are:
- The role of the central bank as lender of last resort is essential to stabilize the financial system in the short term;
- Deflation is extremely expensive;
- The gold standard is dangerous;

3. Keynes and his theory of economic imbalances

The model of Keynes was primarily created during the Great Depression, when economists tried to explain the worldwide decline in the economy and create policies that will help the economy to return to normal. Early Keynesians emphasized that fiscal policy - the state decision for public revenues and public expenditures - can significantly affect output and employment levels [7]. Overall, in macroeconomics there are two main theories of business cycles (recession, expansion) as follows: Classicists and Keynesians.

According to Classicists, prices and wages are assumed to be adjusted rapidly from which markets are always in a general equilibrium. They believe that business cycles represent the best response to the disruption in the economy, such as productive shocks, where there is little justification for state intervention to mitigate business cycles. Unlike them, the Keynesians are less optimistic about the ability of the free market (free-market economies) to respond quickly and effectively to shocks. One of the central ideas of Keynes is that prices and wages are rigid and do not adapt quickly to the level of "clean markets" or balancing of the three main markets in the economy: the market of goods and services (shown by the IS curve), money market (shown by the LM curve) and the labor market (as shown by the curve FE). The rigidity of wages and prices shows that the economy may be far from the level of general equilibrium for a certain period of time. Therefore, a deep recession is not optimal response to free markets to external shocks, but despite this, it is a state of imbalance in which high unemployment shows that the labor supply exceeds labor demand. Keynesians believe that the state should intervene to eliminate - or at least minimize - periods of low output and high unemployment.
During the Great Depression, the Fed does not take any step to maintain the stability of the money supply and price stability, on the contrary, the former monetary authorities acted most catastrophic - with the view that the Great Depression can be avoided and that the best solution is to be left to market forces alone to balance the market. This liquidation theory was common in that period until the emergence of the Keynesian Revolution, and was supported and promoted by economists like Hayek, Schumpeter and Robbins. In fact, they thought the Fed should increase liquidity in the banking system by means of increase of reserves in 1929-33, although nominal money supply fell by 1/3. Open market operations are isolated and do not always have expansive influence. (Temin, 1974) [8].

Part of the former authorities are favorites for weaker deflatory policy, however, were dominated by those who thought that the economy needs to pass the time of "liquidation" in order to lay the foundation for renewed expansion (Eichengreen, 1991). These policies eventually relegated devastating. Abstaining from antideflatory measures, the Federal Government authorities closely followed the advice of so-called "academic scribblers". They really were "slaves to some (not yet) nonexistent economists" (Keynes, 1936). It can be concluded that the existence of liquidation theory played a key role in motivating the decisions of state policy not to fight depression, i.e. undertake measures to increase aggregate demand and consumption. Starting from the summer of 1929 until the inauguration of Roosevelt, macroeconomic indicators signaled urgently implementation of expansionary measures. But what actually happened? Did the former economic policy of Hoover undertake expansionary measures? - No. Despite the sharp decline in real GDP per worker by 40% in 1929 and rise in unemployment, which absorbed more than 1/4 of the labor force, however, the state has not supported the aggregate demand.

The only expansionary fiscal measure was "Veterans ‘Bonus" implemented despite the veto of President Hoover (Chandler, 1970). Fed did not apply the instrument of open market operations to stop the decrease of the nominal money supply. Instead, the only significant use of the instrument of open market operations was in one way: to raise interest rates and discourage outflows of gold after Britain left the gold standard in 1931 (Temin, 1974). The inaction of the Fed did not arise because of the need to defend the gold standards. United States in 1931 had about half the world's reserves of gold and was far from the state when expansionary monetary policy can foster successful speculative attack on the gold standard (Eichengreen, 1991). Fed realized what was doing: allowing the private sector to deal with depression as comes to hand. The task of the private sector was considered as "liquidation" of the US economy. Also, it was feared that the expansionary monetary policy will impede the necessary process of re-adjustment of the private sector. Thinking about the ruin of the economy in his country and his political career in retrospect, Herbert Hoover wrote bitterly for the staff in his administration who advised him to passivity (inaction) during the economic downturn in depression, "Leave her alone liquidation (Live- it-alone liquidationists) headed by Secretary of the Treasury Melon. He considered that the government must keep hands off and let the liquidation occurs itself. Mr. Mellon had only one formula: "Liquidate the labor, liquidate the shocks, liquidate the farmers, liquidate the real estate ..." He thought that panic is not at all a bad thing. He said: "It would clean the rottenness out of the system. Reduce the high cost of living and high living. People will work with more effort, will live more moral lives. Values will be adjusted and determined people will undertake ruins from less competent people "(Hoover, 1952, Volume 3, page 30). The Hoover administration and the lack of willingness of the Fed to implement fiscal and monetary policies to boost aggregate demand during the depression was supported by the most eminent economists in that period.

From Harvard, Seymour Harris argued that just because the banking system was close to collapse there is no reason that the Fed should buy bonds for cash: "Open market operations are not the most effective method for resolving bank failures, as the filling of small holes in the ground with water is not supposed to flood the earth with water "(Harris, 1934; p.104). According to Schumpeter, economy can function efficiently only if left alone. Lionel Robbins (1934) also considered that the world needs more deflation and monetary policy measures will only deepen the depression. Schumpeter and Robins believed that appropriate policy response is not to take measures to increase aggregate demand and thereby stop the process of liquidation and reallocation: the process should be carried out finally or delay simply increases social costs.

This doctrine - that on the long-term Great Depression will turn out to be "good medicine" for the economy, and that proponents of stimulus policies are short-sighted enemies of public wealth fare- drew pain and resistance in others. Milton Friedman (1974) noted that in Chicago (Knight, Simons and Viner) such dangerous thoughts are not taught, but he understood why Harvard - where such nonsense was learned- because you can bring such students who are rebels, who reject the views of their professor’s macroeconomists and become Keynesians.

John M. Keynes (1931) tried to discredit "the view of liquidity" with the rhetoric of stupidity. He called it the "imbecility" their claim that "wonderful surge of productive energy" during the boom of 1924-29 made the depression inevitable. He also wrote for his fellow Hayek, Robbins and Schumpeter and their followers they were "harsh and rigid people who perceived the Great Depression inevitable and desirable reward of so many" expansion "as they say ... that will be a victory of injustice if so much prosperity not subsequently balanced by universal bankruptcy. We have need, they said, as politely called "prolonged liquidation" to bring things in normal. The liquidation, who spoke of, though not yet over. But with time will be. "(Keynes, 1972; vol. XIII, pt. 1, p. 329). Despite opposition, the view of liquidity was conducted in the period of 1929-33 and in most 1933-39god. Interestingly, governments such as France and the United States, which had massive gold reserves and Britain after leaving the gold standard - tended not to make expansive economic policy, because it will reduce investor confidence and slow the process of liquidation, relocation and private investments (Temin, 1990; Eichengreen, 1991; Hall, ed., 1989). After the Great Depression and World War II victory of the Keynesian revolution was complete. Nothing remained of the proponents of liquidity - it was not easy to study their doctrines. After the war macroeconomics takes a new course and expand economic knowledge by applying the model of Léon Walras (made the first attempt at making models that will cover several aspects of the real economy), a supporter of neoclassical school or model of general equilibrium involving more markets even those of Keynes and monetarists for business cycles (Patikin, 1982).

The Great Depression will stay remembered for the revolutionary work of Keynes' "General theory of employment, interest and money "(1936), whose inspiration was exactly 1929-33 economic crisis, and which failed to ignite the biggest debates whose embers felt today. He was able to refute the economic theory of "Economy freed from state control" arguing that economic depression should either increase the level of private investment or create public substitutes as a temporary replacement of the necessary private investment. Keynes was opposed to the claims that under mild stagnation, monetary policy in the form of facilitating loans and reduced interest rates may contribute to stimulating investment. The occurrence of serious, large-scale crisis had increased the need for deliberate public deficits or in the form of public undertakings or through subsidies for the poor and unemployed.

The classicists believed that under capitalism there is no involuntary unemployment, the offer is automatically met with demand, and the market itself has sufficient self-regulation which leaves no room for state interference in the economy. However, these tenets apparently offered no remedy for the Great Depression, which problematized their validity and practical use. Keynes, held that companies will hire workers if they believe they can produce and sell more on the market, or fired if they cut production. With the dismissal of workers reduces power consumption, and therefore demand is reduced to a lower level, and output. So the economy is suffering from high unemployment, low demand and deflation, with adverse consequences on living standards and prosperity. In such a situation, Keynes believed that the state should intervene and a package of measures to influence the increase in demand. One of the most popular measures Keynes proposed by, despite tighter controls on financial markets, realization of capital investments (public works) such as building roads, schools and other facilities where you can hire unemployed persons and in such a way mitigate the shock of the economic crisis. Following this recommendation of Keynes, at that time were built some of the most known and impressive facilities in the US, such as the Golden Gate Bridge, the embankments of the river Mississippi, many highways and other capital investments [9].

4. The “New Agreement” and fiscal measures

The possibility that stimulus to aggregate demand in the form of changes in public spending were a source of recovery from depression were analyzed especially in the 1940s and 1950s. Initial research by Smithies (1946) found that "fiscal policy has not proved effective and actually only effective concerns to the recovery". Hansen (1941) has argued that fiscal policy had not been used extensively in the 1930s. Brown (1956) applies conventional Keynesian multiplier model and the concept of discretionary government spending policies to support the position of Hansen. His often quoted conclusion that "fiscal policy, then, seems to be backfiring device (tool) for reconstruction in the thirties - not because it was not working, but because not used."

The primary failure of fiscal policy to have an expansive effect due to the sharp increase in the tax structures that are attributed to all levels of government. The total state (public) consumption of goods and services increased virtually every year during the 30's. Increasing from 13.6 billion dollars in 1929 to 22.8 billion in 1939. In particular, various initiatives were started by President Roosevelt under his "New Deal" in 1933 to create jobs and to stimulate aggregate demand.

Key initiatives include the following measures: creation of the Civilian Conservative Corps to provide work for men aged 18-35 through camps run by the Military Department; programs of the Department of Agriculture and the Department of Interior to preserve national cultures and forests; creating Administration for federal emergency assistance (FERA) which provides subsidies for the states; creating administration for public works with a budget of 3.3 billion dollars (approximately 6% of GDP) to provide finance to local municipalities for public projects. Another new agency, administration of civil work (CWA) was created in 1934, which goal was to incorporate state officials and employ people directly in the agency. CWA employees were used to repair the city halls, public docks and roads, all on the payroll of the federal government. Finally, the Law on budget for emergency aid to provide the President 5 billion for additional projects including railways, maintenance, irrigation, electrification, housing, sanitation, flood control and virtually every conceivable public good. Roosevelt applied the law to establish the Administration work in progress (WPA) who took it from FERA. WPA spend money directly from the state budget and hire workers to build hospitals, schools, airports and playgrounds. The program drew criticism for spending public money to pay for inactive people to carry unproductive work (Rauchway, 2008) [10].

Tax revenues, however, were moving in line with rising costs in the 1930s. Law Revenue from 1932 raised the interest rates virtually over the border, but especially the poor and middle-lucrative or groups of more vulnerable social groups. The changes brought by this law were: tax exemptions for personal income declined; normal taxes and additional tax rates were significantly elevated, the tax credit on earned income equal to 25% of low income taxes was abolished; Corporate tax rates were increased sharply and tax breaks were drastically reduced; Property tax rates are elevated, tax exemptions and reduced tax gift was set; broad new list of excise taxes was introduced and greatly increased tax rates of old taxes; "Processing taxes" were introduced in the late 30-ies and taxes for Social Security were introduced in 1937.

5. Conclusion

What was the reason for ending the Great Depression? The traditional view is that public spending associated with World War II bring the economy to its potential output. Vernon (1994) emphasized the importance of the war and proved that fiscal policy relying on the Second World War was really the most important factor for renewal during 1941 and 1942. Half of rebuilding in output from the lowest point in 1933 appeared during 1941 and 1942. This stance was prompted by Delong and Summers (1988) who claimed that the decrease of 5/6 from the output compared with the trend that has emerged during the depression was made before 1942. They faced the "difficulty to attribute any achievement before 1942." By the same token, Romer (1992) argues that the renovation was substantially completed before 1942, shows that fiscal policies "contributed almost nothing to the recovery before 1942."

Another view is that conventional stimulus to aggregate demand had no importance in the recovery from the Great Depression. Bernanke and Parkinson (1989) analyzed the apparent trend of return of employment in 1930 and the strength of the recovery. They claimed that "New Deal (New deal) is better characterized as clearing the path to recovery ... naturally than it is the engine of self-recovery" They indicate that the reverse trend in interwar economy is evidence of a strong self-corrective force.

Finally, recent document of Eggertsson (2008) uses a model for stochastic general equilibrium which claims that the recovery of the US economy since the Great Depression was led (driven) by changes in expectations brought by the political actions of President Roosevelt. The increase in federal expenditures and the increase in the federal (rather than state) deficit in the 1930s played a role in the changing expectations from deflatory to inflationary. This, in turn, reduced the real interest rate and stimulated aggregate demand.

Great Depression will still remain as one of the most complex, most difficult and most intriguing economic events of American history, which created the revolutionary theories and numerous changes and build wisdom and awareness of the invaluable importance of the implementation of prudent and effective monetary and fiscal policies as a precondition for sustainable economic growth and stable financial system with sound financial institutions.

References

1. Cecchetti G. S. Understanding the Great Depression: Lessons for current policy, NBER, working paper 6015, April 1997;
2. Lange B. The Stock Market Crash of 1929: The End of Prosperity, Infobase Publishing, 2007;
3. Burg F. D. The Great Depression, Facts On File, 2005;
4. Bernanke B. Essays on the Great Depression, Princeton University Press, 2000;
5. Friedman M. and Schwartz J. A. A Monetary History of the United States, 1867-1960, Princeton University Press, 1963, p.300;
6. Bernanke B. Remarks by Governer Ben S. Bernanke: Money, Gold and the Great Depression, At the H. Parker Willis Lecture in Economic Policy, Washington and Lee University, Lexington, Virginia, 2004;
7. Abel B. A., Bernanke S. B., Croushore D. Macroeconomics, Chapter 11, Keynesianism, PH Professional Business, 2008, p.390;
8. Temin P. The Anglo-American Business Cycle 1820-60, The Economic History Review, 1974;
9. De Long J. B. "Liquidation" Cycles: Old-Fashioned Real Business Cycle Theory and the Great Depression, NBER Working Paper No. 3546, Issued in December 1990;
10. Rauchway E. The Great Depression and the New Deal: A Very Short Introduction, Oxford University Press, 2008;