The Great Depression, golden age, and global financial crisis

BCPM0058: ECONOMICS

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Lecture 17

Context

- 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?

Policy: Aggregate Demand Shock

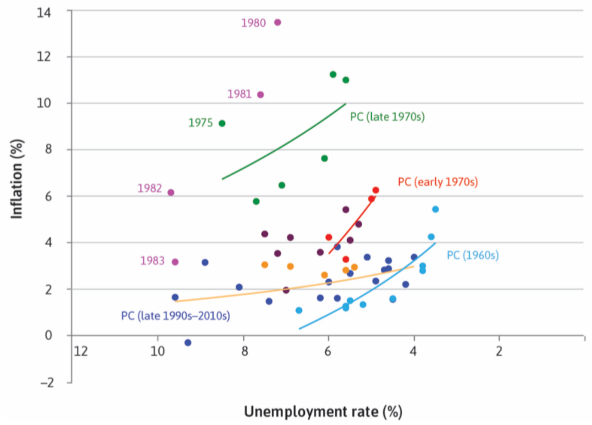
AD Shock Two sources for aggregate demand shock: *change* in households' *consumption* or firms' *investment* demand

Stabilisation Government has two broad policies that it can use to *counter-act* a *aggregate demand shock* and stabilise the economy

Policy	Instrument	*Expansionary*	*Contractionary*
Fiscal	Government spending	*rises*	*falls*
	Tax	*falls*	*rises*
Monetary	Interest rate	*falls*	*rises*

Phillips Curve

- Oil price shocks increase *inflationary expectations* and *inflation-stabilising unemployment rate* moving the Philips curve up



Philips Curve

Philips curve unemployment inflation trade-off in the short run

Higher employment may results in inflation in the short run: increase workers' bargaining position *leads to* higher wages *leads to* higher cost of production leads to inflation

The economy can either

- move along Philips curve as unemployment & inflation change
- or the Philips curve can shift due to the following reasons:

  If people *expect inflation to be higher* in the future, the Philips curve would shift up

  Unemployment rate which keeps inflation constant is called the *inflation-stabilising unemployment rate*. If it increases, the Philips curve would shift left.

Periods in the US Economy

Names	Dates	US economy features
1920s	1921–29	Low unemployment, high productivity growth, rising inequality
Great Depression	1929-41	High unemployment, deflation, low investment, falling inequality
Golden age	1948–1973	Low unemployment, high productivity growth & investment, falling inequality
Stagflation	1973–1979	High unemployment and inflation, low productivity growth, lower profits
Great moderation	1979–2008	low unemployment & inflation, investment slowing down, sharply rising inequality, rising debt
Financial crisis	2008–2015	High unemployment, low inflation, rising inequality

Economic Epochs: Stylised facts

Productivity — *three low points*

hits a low point in 1931, 1979 and 2013

Unemployment — *High, low, cyclical and high again*

high during the Great Depression, low till the 1979 and then cyclical with business cycles.

Re-emerges again in 2008 with the Financial crisis

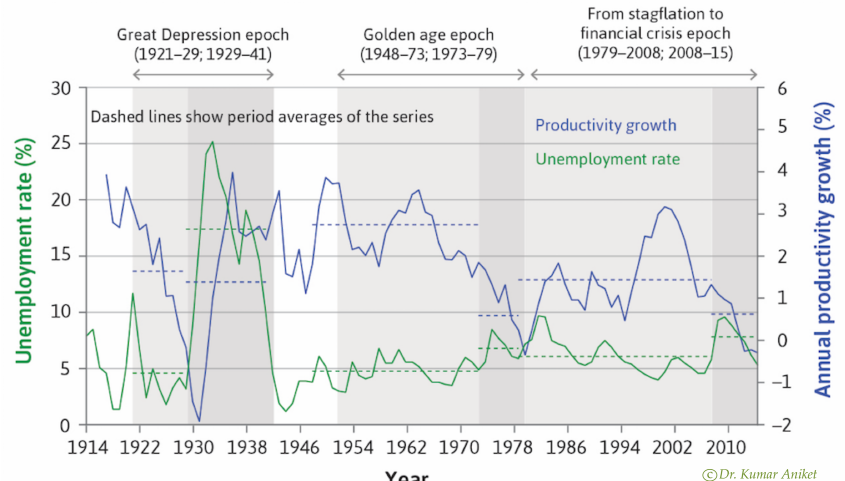
Inequality — *U-shaped*

Richest 1% had 20% of income share in 1920s.

It declined till 1979 and then started rising to the levels of 1920s

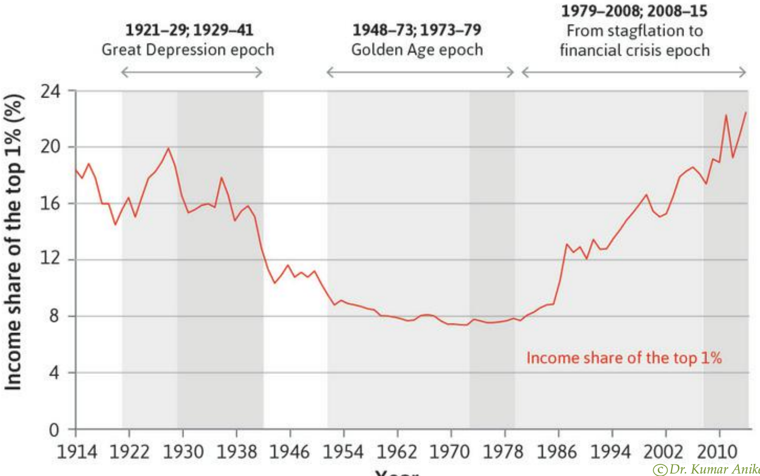
3 epochs: Unemployment and productivity

US: Unemployment and productivity



3 EPOCHS: INEQUALITY

US: Inequality



Different experiences of the three epochs

Name of Period	Differences between US and other rich countries	
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

1920s and the Great Depression

- *Dates*: 1921–1941
- *Conventional wisdom before this epoch*

  Markets are self-correcting, efficient, and ensure the full use of resources.
- *Economic outcomes in the epoch*

  Collapse of aggregate demand, high and persistent unemployment.
- *Lessons learnt from the epoch*

  Instability is an intrinsic feature of the aggregate economy and aggregate demand can be stabilised by government policy.
  - *Best framework to understand the epoch*

    Keynes

The Great Depression: Causes

Great Depression — the period during 1930s in which there was a sharp decline in output and employment in many countries

Caused by 3 simultaneous positive feedback mechanisms in the US

Pessimism about 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

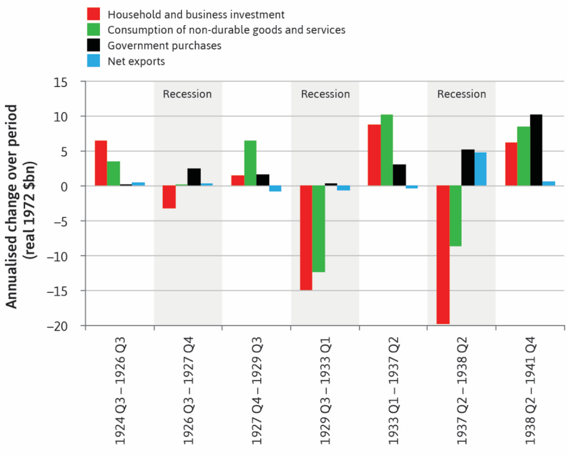
The problem of deflation

Deflation affects aggregate demand through several routes:

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

The Great Depression

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

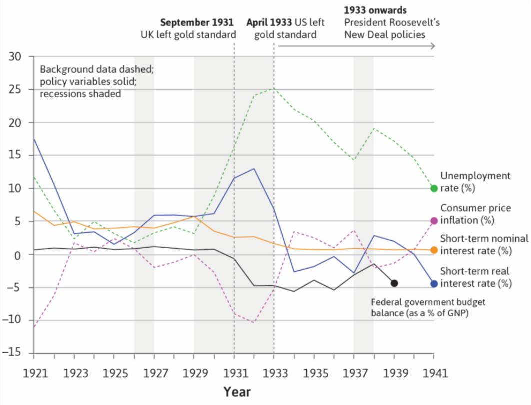


Initial policy issues

Government policy both amplified and prolonged the shock:

Contractionary fiscal policy *austerity* to maintain balanced budget

Contractionary monetary policy *real interest rate increased*

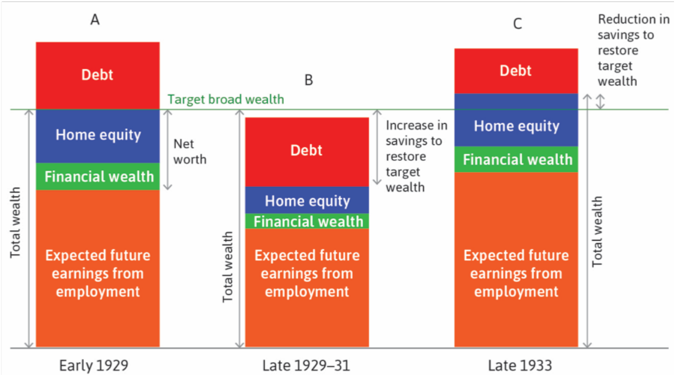


Policy Reform

Roosevelt's reforms	Roosevelt's reforms in 1933 changed expectations, which started economy recovery
The New Deal	*government spending* on public works and relief programmes to increase aggregate demand and counter-act shock
Fiscal Policy	New Deal *resulted in a budget deficit*
Monetary Policy	Nominal interest rate close to zero
Banking System	reforms initiated to avoid bank runs

Policy Reform

- Households cut consumption to restore target wealth during depression (1929-31) and
- increased consumption from 1933



Golden age of capitalism and its demise

- *Dates:* 1945–1979
- *Conventional wisdom before this epoch*

  Government policy can implement an employment target by picking a point on the Phillips curve.
- *Economic outcomes in the epoch*

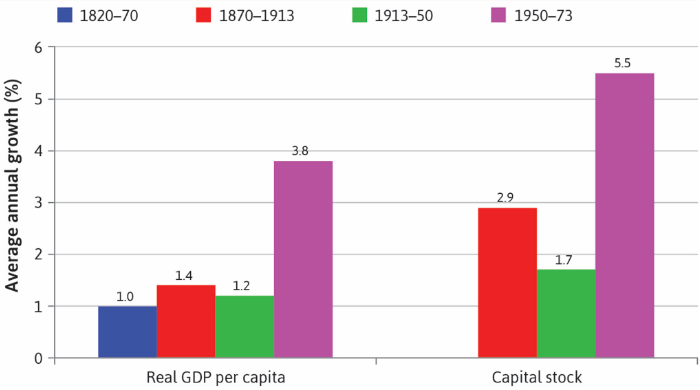
  Late-60s decline in profits, investment, and productivity growth. Stable Phillips curve trade-off disappears.
- *Lessons learnt from the epoch*

  The need to maintain profits, investment, and productivity growth. The ability of a government to implement sustainable low unemployment using aggregate demand policies limited.
- *Best framework to understand the epoch*

  Friedman

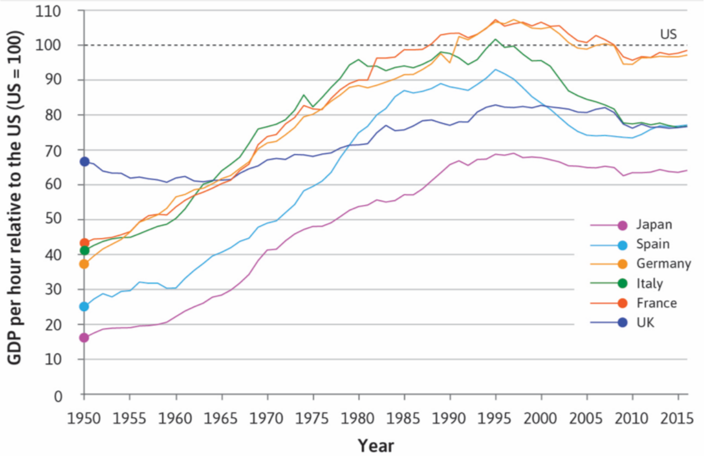
The Golden Age: 1945-1979

- 1945-1979 period with high productivity growth, high employment and stable inflation
- Living standards were doubling every 20 years.



CATCH-UP GROWTH

- Poor economies grew faster than richer economics to catch up.



Golden Age: Causes

Goods market

- Government's reassurance that a policy for supporting aggregate demand would be used when necessary
- Size of governments increased continuously

Money market

- *Bretton Woods System* was established

  Bretton Woods: a post-war monetary system that maintained a system of fixed but adjustable exchange rates

Labour market

- *Postwar agreement between employers and workers:* sharing the gains of technological progress between workers and employers provided incentives for firms to innovate

Workers and Employers

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

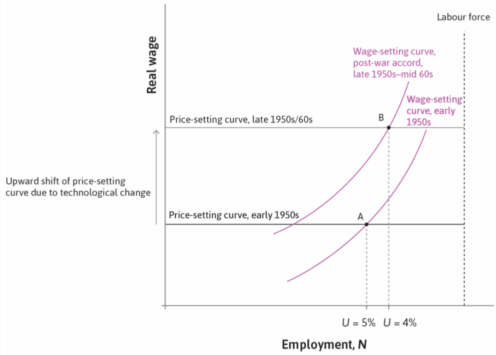
- High after-tax profits in many advanced economies
- Expectations of high profits led to high levels of investment
- High investment and technological progress created more jobs, keeping unemployment low

Fair-shares bargaining: Trade unions gave workers high bargaining power, which allowed *wages to increase*

Technology adoption: 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 (informal agreement between employees and employers to share the gains to technological progress)



Postwar accord across countries

Wage restraint

- achieved by a single centralized union, or coordinated among unions (e.g. West Germany)

Government's centralised wage policy

- 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

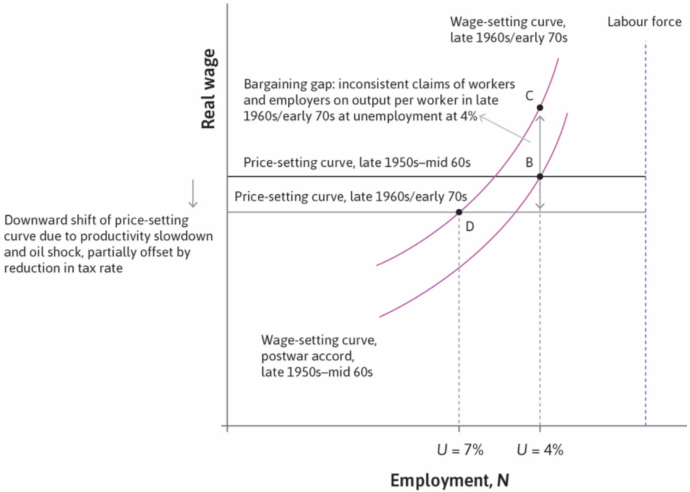
- Oil price shocks in the 1970s
- Economy-wide productivity slowdown
- Workers demanded higher wages

Workers' increasingly strong bargaining position implied that

- Employers bore the costs of the oil price shocks
- Lower investment and productivity growth
- Rising inflation and high unemployment

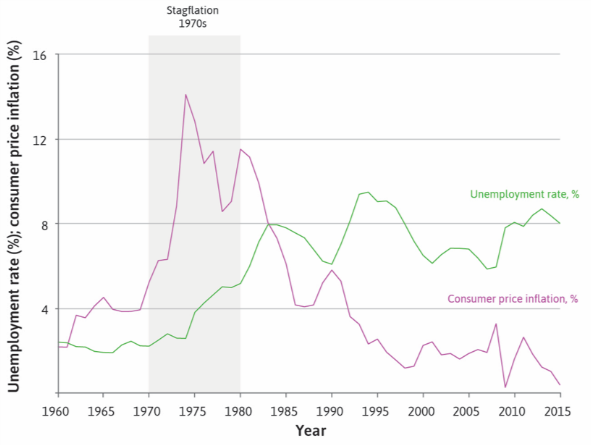
Collapse of the postwar accord

$B \longrightarrow C \longrightarrow D$



STAGFLATION

Stagflation Persistent *high inflation* combined with *high unemployment*.
Result of an *upward shift of Phillips curve.*



Types of Crises

Great Depression	*Golden Age*	*Stagflation*
caused by shocks and amplification mechanism of the aggregate demand	active management of demand side by the government, while problems were creeping up on the supply side	caused by shocks and amplification mechanism on both the demand and supply side

Stagflation

- Problems on the supply side of the economy depressed the rates of profit, investment, and productivity growth.

The Great Moderation

- *Dates:* 1979–2008
- *Conventional wisdom before this epoch*

  Instability has been purged from capitalist dynamics; minimally regulated financial markets work well.
- *Economic outcomes in the epoch*

  Financial and housing market crash of 2008.

Supply-side reforms

Stagflation leads to 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

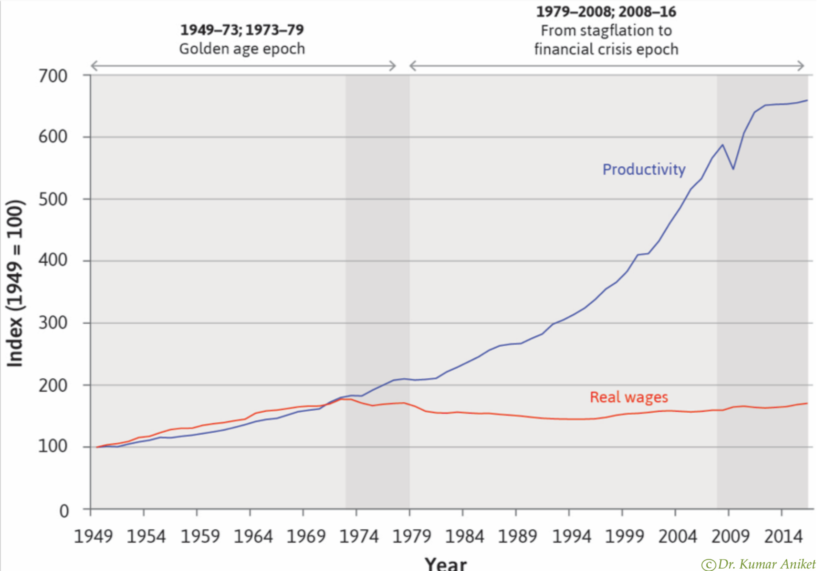
Shifting the wage-setting curve down

- through cuts in unemployment benefits and legislation that *reduced trade union power*

Results in "*The Great Moderation*"

- Productivity growth no longer shared with workers
- Low and stable inflation, falling unemployment
- Investment did not match the growth in profits

Great Moderation



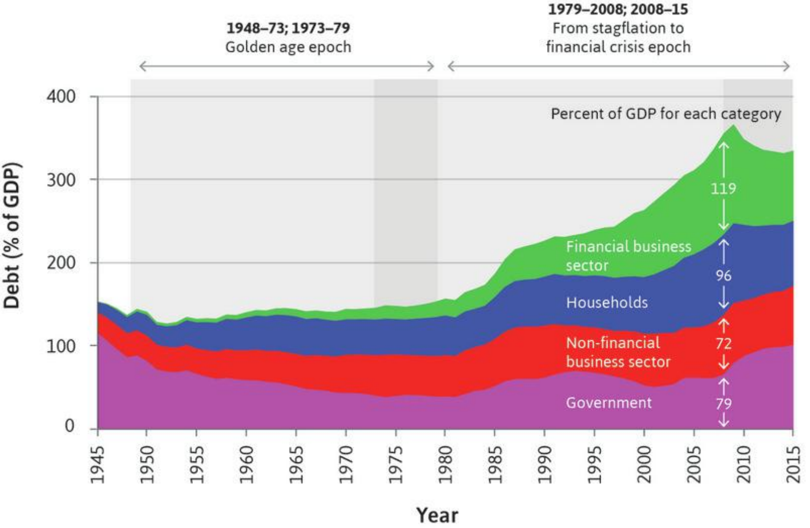
Problems with the Great Moderation

Rising inequality — *Financial deregulation*

results in higher debts as households improve their consumption via borrowing

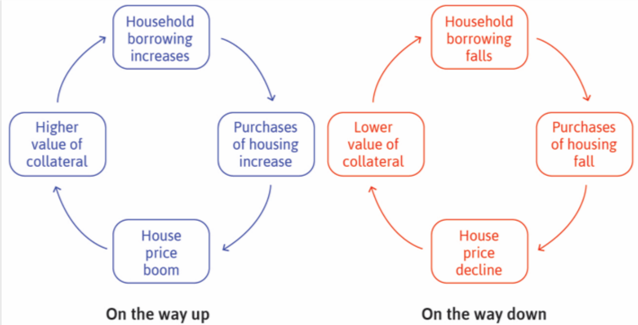
- Rising *debt*
- Increasing house prices
- Rising inequality due to end of fair-shares bargaining

Great Moderation



Housing boom and the financial accelerator

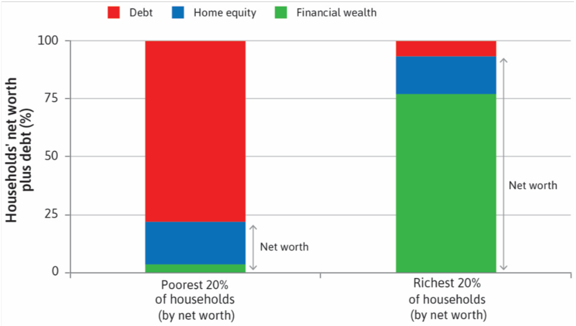
- *Buying a house:* mortgage requires a secured (collateralised) loan
- *Financial accelerator:* when house prices go up, so does the value of collateral, and households can borrow more.
- This pushes up house prices further and *sustains the bubble.*



SUBPRIME BORROWERS

Sub-prime borrowers: borrowers with no collateralisable wealth

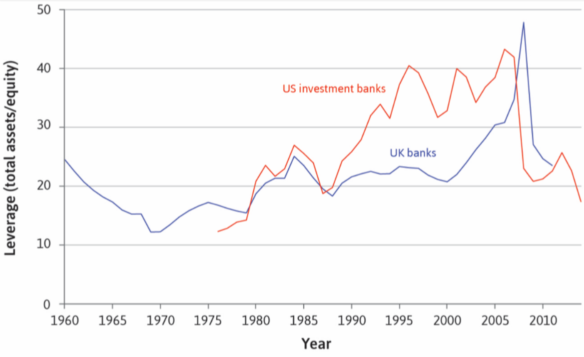
- Poor households usually require collateral to borrow.
- Home loans' risk falls when house prices are expected to rise
- Lenders ask for lower deposits, or even no deposit at all.



Financial deregulation

Banks lend more and more

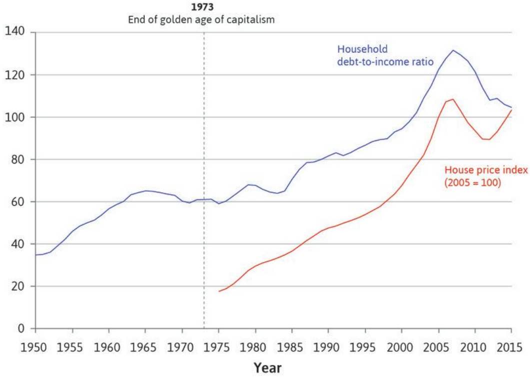
Great moderation, *rising house prices*, and the development of fancy *new financial assets* (CDOs and MBSs) made it profitable for banks to *significantly increase lending* recklessly.



Housing Market

Households borrow more and more

High *debt-to-income ratio* lead to the house prices becoming unsustainable and collapsing in 2008 *(Financial Accelerator)*



The financial crisis

- Great Moderation ended by the global financial crisis, triggered by fall in US house prices

The financial crisis

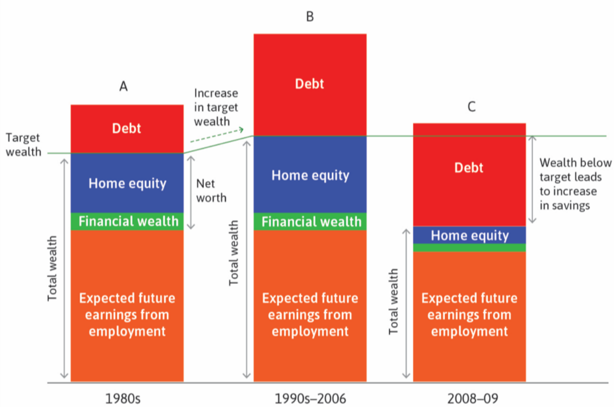
Great Moderation ended by the global financial crisis, triggered by *fall in US house prices* and started a range of feedback processes

- *Consumption fell* especially among poorer households with subprime mortgages (due wealth targeting)
- *Spillover effects* to the financial sector through the subprime mortgages because borrowers were caught in negative home equity and could not repay the loans
- *Investment fell*, which *increased unemployment*

In spite of *bank bailouts* and *stabilisation policies*, there followed a *sustained global fall in aggregate output*

Financial Crisis

1990-2006	rising house prices increased consumption through debt
2006-2009	Household net worth shrank with rising unemployment
	Household cut consumption as wealth below target



From stagnation to the financial crisis

- *Dates:* 1979–2016
- *Conventional wisdom before this epoch*

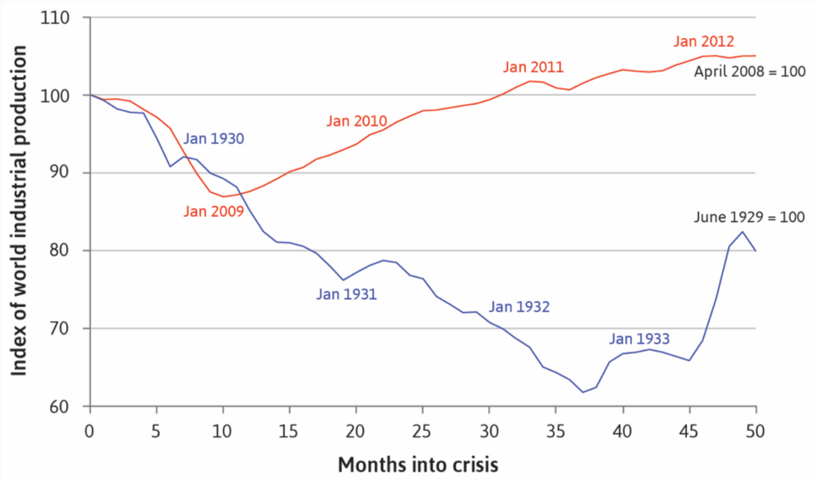
  Instability has been purged from capitalist dynamics; minimally regulated financial markets work well.
- *Economic outcomes in the epoch*

  Financial and housing market crash of 2008.
- *Lessons learnt from the epoch*

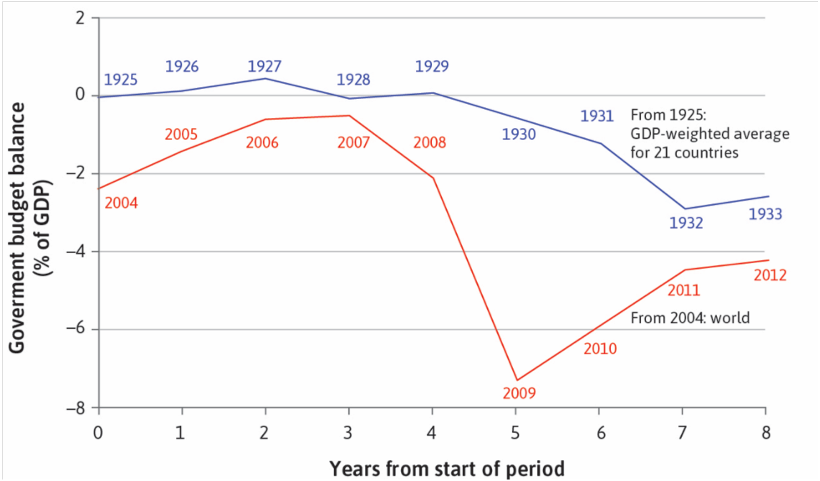
  Debt-fuelled financial and housing bubbles can co-exist with low and stable inflation, and will destabilise an economy in the absence of appropriate regulations.
- *Best framework to understand the epoch*

  Minsky

Lessons Learnt



Lessons Learnt



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

Summary

- Epochs
  - Great Depression
  - Golden Age and Stagflation
  - Great moderation and Financial 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