The Effects on the Aggregate Demand and Aggregate Supply during the Great Economic Depression

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Abstract

The Great Depression of 1929 created significant consequences for the US economy and world economy that are detected through serious changes in output and prices. It contributed to put greater emphasis on aggregate demand and aggregate supply. Many economists agreed that in addition to monetary factors major impact on the crisis had also non-monetary factors. Numerous studies have indicated that even the gold standard played an important role in reducing output and the price level. This paper attempts to highlight key segments, such as the wrong monetary policy, the gold standard, neglected banking problems, political pressure aimed at relaxing the monetary policy as areas that have made mistakes when looking a way out of the crisis. The critics of such thesis believed that the tighter monetary policy was not strong enough to cause so far-reaching consequences and expressed serious doubts that the reduced money supply is the real cause of the collapse of the national product and price levels. According to some authors the use of the gold standard allowed a significant decline in the supply of money in order to survive as the monetary standard of the time despite his suspension during the war period because violated international trade and capital flows. Customs war in the 1930s is considered to be a serious cause for deepening the economic crisis which returned protectionism in economic policies on the world scene. Besides the analysis of aggregate demand considerable attention is paid to the aggregate supply expressed through the effects of financial crises and the rigidity of nominal wages. The paper also reviews the channels of debt deflation and stability of the banking capital.

Keywords
Aggregate demand, aggregate supply, gold standard, debt deflation, nominal wages, economic crises.

1. Introduction

During the depression, changes in output and the price level had a strong positive correlation in almost every country, suggesting an important role of shocks on the side of aggregate demand. Although there is no doubt that in that period many factors had an impact on aggregate demand, however this section will pay attention to the crucial role of monetary shocks. For many years, the main debate about the causes of the Great Depression is about relevance to be attributed to monetary factors. It was easy to see that the money supply, output and prices reduced dramatically in the phase of contraction and increased in the phase of expansion (economic recovery). Difficulty existed in establishing causal links between these variables. In their classic study of monetary history of the United States, Friedman and Schwartz (1963) presented the monetary explanation of these remarks, insisting that the main lines of causality from monetary contraction - the result of poor policy and the continuing crisis in the banking sector - until falling prices and output. Braving the Friedman and Schwartz, Temin (1976) argued that a significant part of the monetary contraction is actually a reflection of the passive response of money on output and that the main source of depression lies in the real side of the economy (e.g., the famous drop in consumption in 1930). However, there is a reasonable condition that is accepted by many economists that monetary and non-monetary factors had all influence in a separate phase of the Great Depression in the United States. Since early 1980-ies, it is introduced a new investigative body for depression by focusing on the operations of the international gold standard during the interwar period. The survey of the gold standard made it possible to assert with confidence that monetary factors significantly played an important causal role in reducing world prices and output in their eventual recovery. Two well-documented research support this conclusion:

- Research and analysis on the operations of the interwar gold standard showed that much of global monetary contraction in early 1930, was not a passive response to declining output, instead it was unintentional result of interaction of bad Designed institutions, shortsighted policy and unfavorable economic and political preconditions. Hence, the connection between money and reduction of the prices by reducing output, which was observed in almost every country, the most viable interpreted as reflecting primarily the impact of money on the real economy, not vice versa.
- For reasons that were largely historical, political, philosophical rather than purely economic, some governments have responded to the crisis in early 1930 with a rapid departure from the gold standard, unlike other countries despite deteriorating conditions still remained the gold standard. Those countries that left the gold standard were able to increase the money supply and mitigate deflationary effect on the level of prices, which is to take monetary measures. Countries that remained on the gold standard faced further deflation in the country. Namely, the facts show that countries that abandoned the gold standard more quickly rescued from the Great Depression than countries remained tied to gold. The strong dependence of the rate of rebuilding the country with the choice of a fixed exchange rate is powerful evidence of the relevance of monetary factors [1].

2. Aggregate demand and the source of monetary contraction

According to Friedman and Schwartz (1963) there are four measures (errors) of monetary authorities that contributed to the monetary contraction and reduction of output and prices as follows [2]:

First, the error of a Fed tightening of monetary policy that began in 1928 and continued until the fall of stock exchange in 1929. This measure of the Fed was not justified by the macroeconomic environment. The economy had entered a recession, consumer prices were falling sharply, and there was little danger of inflation. Why then the Fed raised interest rates in 1928? The main reason was the concern of the Fed about rumors that emerged on Wall Strees. The government had made a sharp distinction between "productive" (good) and "speculative" (bad) uses of credit, and they were concerned that lending to brokers and investors are fueling speculative wave of financial market. When Fed attempts to persuade the banks not to approve loans for speculative purposes had shown unsuccessful, they acted directly with the rise in interest rate. The fall of the stock market played a significant role during the Depression. The tightening of monetary policy led to the start of the recession in August 1929, according to official data from the NBER (National Bureau od Economic Research). In other words, the stock market crash, rather than be the cause of depression, as popular legend has it, was largely the result of a slowing economy and inadequate monetary policy that preceded headed by Adolf Müller who believed that speculation is the cause of the rise in prices and it is very harmful to the economy. For these reasons, together with President-elect Herbert Hoover decided to prevent the further rise in prices. In fact, today there is a consensus among economists and historians that there is no single reason that caused the stock market crash of October 29 1929, but it was a combination of events, both natural and induced events in accordance with the government policies, the improvement in production, increasing purchasing credit, all these contributed to the sudden drop in the stock market [3].

Second, the system of the gold standard. Namely, during the gold standard each currency was tied to gold, which means that the exchange rate between two currencies within the gold standard was fixed. Like any system of fixed exchange rates, the gold standard was the target of speculative attacks if investors doubted the ability of the state to maintain law specified parity. In September 1931, the generated financial mess in Europe has created concern about British investment in the continent, which was opportunity for the speculators to attack the pound, reducing the reserves of the former Bank of England. Facing the increased demand for gold from speculators and the great disbelieve in the pound, the Bank of England drastically reduced gold reserves. Unable to continue to maintain the official value of the pound, Britain was forced to abandon the gold standard, allowing the pound to fluctuate freely and under the influence of market forces. With the collapse of the pound, speculators have turned to the US dollar, which was the next target of speculators. Central banks and investors convert large amount of money for gold in September and October 1931, reducing the reserves of gold. These speculative attack created panic in the banking system. Fearing a major devaluation of the dollar, many foreign and domestic investors and depositors withdrew their money from banks in order to convert them into gold or other assets. The deteriorating economic situation has increased distrust of depositors in the financial system and financial institutions. During this period, there was no deposit insurance, so the collapse of a bank could cause depositors to lose all or most of their money. Thus, depositaries who doubted the failure of a bank ran to withdraw funds. During 1920, thousands of banks were faced with collectively withdrawing deposits and subsequent failure. But how did the Fed reacted at that time and how he managed monetary policy? The long practice of central banks requires the Fed to respond to speculative attacks on the dollar and the domestic bank panics.

However, the Fed decided to ignore the plight of the banking system and to focus only on stopping the loss of gold reserves in order to protect the dollar. To stabilize the dollar, the Fed again raised interest rates sharply, believing that speculators will not want to liquidate their dollars if it can earn higher interest for them in banks. Fed's strategy was successful, with subsided attacks against the dollar and the obligation of the US to defend the gold standard was promptly carried out, at least for a moment. However, the Fed again chose to tighten monetary policy despite the fact that macroeconomic conditions - including the accelerated decline in production, prices and money supply - seemed in need of expansive monetary policy.

Third, the monetary actions from 1932. From the spring of that year, depression had advanced well and the Congress began to exert considerable pressure on the Fed to loosen monetary policy. Fed Board showed reluctance to agree with the Congress, but after facing big pressure at the end conducted operation in the open market between April and June 1932 deciding to increase the money supply and bank liquidity. These policy actions have reduced the interest rate on government bonds and corporate debt, and seemed to slow the decline in prices and economic activity. However, the competent Fed remained uncertain about the expansionary monetary policy. Some considered depression as necessary purification of over-spending and investment that occurred during 1920, and all actions of slowing economic collapse through an expansive monetary policy could only delay the inevitable adjustment. Other, according to the low nominal interest rates concluded that monetary policy has already been relaxed and that there is nothing more to take. Namely, these politicians were not sufficiently aware that although nominal interest rates were very low, the current deflation has meant that the real cost of borrowing was very high because each taken credit should be returned with dollars that have greater value (Meltzer, 2003) [4]. So, monetary policy was not expansive even slightly, despite low nominal interest rates. In any case, the authorities of the Fed were convinced that the policy advocated by the Congress was not adequate, and when the Congress delayed for 1932, Fed changed the course of its policy, causing even more dramatic decline in the economy in the second half of the year.

Fourth, as mentioned before by Friedman and Schwartz, the last error of the monetary authorities was the neglection of the ongoing problems in the banking sector. The banking sector in early 1930 was subjected to great pressure because of fears depositaries for the health of banks and withdrawals of deposits become common activity. Wave of banking panics spread across the country, often with an impact on all banks in a big city or even in one region of the country. Between December 1930 and March 1933 when President Roosevelt declared "bank holiday" that shut down the entire US banking system, about half of US banks closed or merged with other banks. The banks that survived the market, have reduced their banking considerably instead replace banks that failed. The banking crises had very damaging consequences for the wider economy. Friedman and Schwartz pointed to the effects of bank failures over the money supply. Because deposits are a form of money, the closure of many banks significantly reduced the money supply. People fearing for their funds holding more cash with them or kept the money under the pillow or in cans of coffee, which in turn contributed to the continuing deflationary pressure. The virtual closure of the US banking system is also considered an important source of monetary contraction or deprivation of loans and other funds provided by banks which affect the investment and economic growth (Bernanke 1983).

Friedman and Schwartz discussed the other episodes and policy actions, as well as the tightening of monetary policy in 1937-38god which contributed to a new depression in those years. According to the above-described four episodes, monetary policy led by the Fed for various reasons was needlessly restrictive, before the depression and during its most dramatic phase. Based on the collected evidence, Friedman and Schwartz concluded that it found a "smoke gun" evidence that most of the seriousness and depth of the Great Depression can be attributed to monetary factors [5].

Decades after their case for monetary history was published, although it was very influential, still managed to inflame the debate about the importance of monetary factors in depression. Opponents made several objections to the thesis of Friedman and Schwartz, who is necessery to be recalled.

First, critics had doubts if the tightening of monetary policy during 1928 and 1929 due to poor advice was large enough to cause such dramatic consequences. According to them, in addition to monetary factors should be taken into consideration and non-monetary factors as causes of the economic crisis.

Second, whether the sharp decline in the money supply during the 1930s was the primary cause or effect as a result of falling output and prices. According to Friedman and Schwartz reducing the supply of money is the cause of depression from 1929. To assume that depression is due primarily to non-monetary factors such as excessive spending and too much investment from 1920. As incomes and wages are reduced, people need less money to carry out everyday transactions. The critics of Fed actions will be justified if allow the money supply to be reduced because it will adjust the amount of money that people want to have with him. In this case the reduction in the money supply will be an answer, not a cause, of the reduction in output and prices in the United States. However, the debate that emerged in 1980 drew attention to another segment depression that is necessary for a full understanding of depression as the operations of the international gold standard and the international monetary system.

2.1. Gold standard and deflation

The main reason for the Great Depression in the United States was the reduction of consumption (sometimes referred to as aggregate demand) which led to a decrease in production, as manufacturers and retailers saw an unexpected increase in inventory. The sources for the contraction of spending in the United States vary according to the course of the Depression, but all they accumulated in monumental decline in aggregate demand. The decline of US economic activity was transfered around the world mainly through the gold standard. However a number of factors influenced the economic downturn around the world who have been mentioned before partially - stock market crash of 1929 (Mishkin 1978 and Romer 1990), non-monetary effects of bank panics (Bernanke 1983), a dramatic rise in global tariffs (Meltzer 1976 and Crucini and Kahn 1996), the impact of the gold standard (Eichengreen and Temin 1992a, 1989) and the autonomous decline in consumption (Temin 1976).

In fact, recent research on the causes of the Great Depression shifted much of the blame on the gold standard. Some economists believe that the Fed has allowed or caused a huge drop in the money supply, partly to preserve the gold standard. During the gold standard, each country determined the value of its currency in terms of gold and took on monetary measures to defend the fixed price [6]. The setting value of each currency in terms of gold defines a system of fixed exchange rates in which the relative value of the US dollar and the British pound are fixed to rate determined by the relative gold containing each currency. To maintain the gold standard, central banks had to make commitments that will replace their gold for paper currencies according to the statutory rate. Gold Standard seemed to have been greatly successful from 1870 until the First World War in 1914. During the so-called "classic" period of the gold standard, international trade and capital flows have expanded significantly, and central banks had relatively less trouble keeping their currencies at the legal level. The gold standard was suspended during World War I, however, due to disruptions in trade and international capital flows and because countries were in need of greater financial flexibility to fund their military endeavors (USA remained technically on the gold standard during the war, but with many restrictions). After 1918, when the war ended, countries around the world have made huge efforts to restore the gold standard, believing that it will be the key element for a return to normal functioning of the international economic system. Britain was among the first countries to return on the golden standad in 1925, and during 1929 many countries in the world have returned to the gold standard.

While there is debate about the role of the gold standard in limiting monetary policy, there is no question that in fact was a key factor for the transmission of the economic crisis on other countries. During the gold standard, imbalance in trade flows or flows of funds contributed to a rise in international flows of gold. For example, in mid-1920, the intense demand for US assets such as stocks and bonds brought large inflows of gold in the United States. Also, the decision of France after the First World War to return to the gold standard with devaluated French franc led to a trade surplus and significant inflows of gold. Britain decided to return to the gold standard after WW II on the before war parity. Inflation during the war, however, implied that the pound was overrated, and this overvaluation led to trade deficits and significant outflows of gold after 1925. To prevent the outflow of gold, the Bank of England raised interest rates significantly. High interest rates have reduced spending in Great Britain which led to high unemployment during the second half of the 1920s. When the US economy began to create contractile monetary policy, the tendency of gold to abandon other countries and transmitted in the United States began intensively. This occurred because the deflation in the United States made American products partly desirable from abroad, while low domestic revenue reduced US demand for foreign goods and services. In order to oppose a subsequent tendency towards American trade surplus and foreign outflows of gold, central banks around the world had increased interest rates. The maintaining of the international gold standard had a need for a massive monetary contraction around the world in order to be equated with the one that arose in the United States. The central bank with limited gold reserves has no option but to raise their interest rates when interest rates are high worldwide. If it fails to do so, then they will quickly lose gold reserves as financial investors transfer their funds in countries where their income is higher. Hence, when the Fed raised interest rates to combat speculation in the stock market, it inadvertently forced tightening of monetary policy in many other countries. This tug abroad have weakened the global economy, with feedback effects on the US economy and financial system. The fact that the contraction of the money supply inevitably have been accompanied by a decrease in output and prices suggests that the money was more cause than effect of economic collapse in those countries. The willingness and ability of countries to retain the gold standard despite the bad conditions in the 1930s differ from country to country.

Some countries did not joined the gold standard anyway. This includes Spain (which was embroiled in domestic political upheaval, possibly leading to civil war) and China (which employed silver monetary standard rather then a gold standard). A number of countries have adapted the gold standard in the early 1920s but abandened it in 1931. In this category countries belongs the UK, Japan and several Scandinavian countries. Some countries, like Italy and the United States remained until 1932 1933god. A few countries known by the name "gold bloc" led by France and including Poland, Belgium and Switzerland remained to the gold till 1935 or 1936. If the reduction of the money supply caused by the gold standard was the primary cause of economic depression, the countries which first left the gold standard had to be able to avoid the worst of the depression and start earliest healing process. The evidence strongly supports this observation. For example, Great Britain and Scandinavia, which left the gold standard in 1931, recovered much faster than France and Belgium, which remained hardly on the gold. Countries like China, which used the silver standard rather a gold, completely avoided depression.

This data for direct connection to the time of departure from the gold standard with a time of recovery of the economy of these countries is intriguing result which provides further evidence of the importance of monetary factors during the Depression. Also motive for faster abandonment of the gold standard were the numerous financial crises and panics that have emerged in countries around the world [7]. In May 1931 payment difficulties that have emerged in the Creditanstalt, the biggest Austrian bank triggered a series of financial crises that affected much of the countries in Europe and were a key factor for Britain to leave the golden standard. Among the countries with hardest hit by bank failures and variable financial markets were Austria, Germany and Hungary. These widespread banking crises may have been a result of poor regulation and other local factors, or simply infection from one to another. The gold standard forcing countries to fall into deflation like the US, have undermined the banking collateral and make them more vulnerable to the withdrawal of bank deposits. Deflation is a major cause of bank panics and induction of the depression. It must not be neglected secondary effect from the price of the financial sector, the famous "debt deflation" (debt-deflation). By increasing the real value of nominal debts and promoting insolvency of borrowers, deflation creates an environment of financial disaster by distorting the image of debtors and hindering the ability to take a new loan. Again, this is evidence that the fall in prices has real effects. By rejecting the constraints of the gold standard and stabilization of the banking system, money supply and the price level began to rise, leaving depression far behind.

2.2. The role of customs in the Great Depression

There is supported view that the customs war in the 1930s bears significant responsibility for the great collapse of economic activity. In 1930 the adoption of the Smoot-Hawley tariff the rise of protectionism in trade policies in the world created other complications. This imposed duties meant increased farmers' incomes by reducing foreign competition of agricultural products. However, other countries have followed the same path as revenge and tryed to correct the trade imbalance. Scientists now believe that these policies could somehow have reduced trade and aggregate demand, but they were not a significant cause for the Great Depression in the big industrial producers. Policies of protectionism contributed to the extreme decline of world commodity prices, which caused serious problems in the balance of payments for primary-production countries such as Africa, Asia and Latin America which led to restrictive policies.

3. Aggregate supply: the nominal rigidity of prices and wages

Despite the consensus that the cause of the Great Depression has long included the role of monetary shocks, recent studies realizing the comparative perspective, greatly contributed to supporting the empirical case for the money as the major driving force. The effects of monetary contraction on the real economy were persistent and significant. The explanation of this persistent (persistent) non-neutrality is particularly challenging to the modern macroeconomists because current theories about the non-neutrality (such as menu costs or confusion about the relative and absolute prices) generally predict that the effects of monetary shocks are transitory.

On the aggregate supply, there is still a puzzle: Why the adjustment process of nominal shocks lasted so long in the interwar economies? The answer to this question will be analyzed through an explanation of two important aspects that show how monetary shocks have long-term effects: induced financial crises and rigid nominal wages.

3.1. Deflation and financial system

If anyone thought the important package of agreements in the economy that are set in nominal amounts, and who are likely not to be insured or indexed against unexpected price movement immediately remind us on financial contracts, such as debt instruments. According to the Bernanke's paper from 1983, he noted that nonindexed financial agreements can provide a mechanism through which the decline in the amount of money and the level of prices may have real effects on the economy in 1930. According to him two related channels are discussed, namely: one operated through "debt deflation" and the other through capital and banking stability.

The idea of debt deflation was coined by Irving Fisher (1933) [8]. Fisher predicted dynamic process in which the decrease in prices of assets and goods, creates pressure on nominal debtors, that due to the poor condition are forced to sale off assets, which in turn leads to a further reduction in prices and financial difficulties. His ideas were not very influential in academic circles, due to counter argument that the debt deflation represents no more than a redistribution from one group (debtors) to another (creditors). However, debt deflation recently experienced a resurgence thanks to the vast literature on asymmetric information and the agency costs of capital markets. According to many principal-agency models, reducing the net value of the borrower increases the agency costs of providing loans and net financing costs of the proposed project by the borrower (agent). Intuitively, if the borrower can contribute little financially to the project and therefore must initially rely on external financing, the motives of the borrower to undertake actions that are not of interest of the loan (principal) may be relatively large. The consequences are: large losses (eg inefficient high-ventures or small effort) and the need to provide expensive information and monitoring. If the net value of the borrower falls below the minimum limit (threshold of opportunity to take credit) he or she can not take credit again. In terms of agency perspective, the debt deflation that unexpectedly redistribute wealth from debtors is not a neutral macroeconomic event. In fact, given that potential borrowers have unique and cheaper access to specific investment projects or consumer opportunities, loss of net wealth of the borrower can effectively shorten the options of the economy. So, for example, a firm with financial difficulty may not be able to provide the working capital needed to expand production or to fund a project that will be sustainable for the better financial conditions. Similarly, households whose current nominal revenues have fallen relative to their debts may be prohibited to buy a new home, even though the purchase is justified in terms of the permanent household income. By causing financial difficulties on borrowing firms and households, debt deflation can have real effects on the economy (the first channel).

If the incurred debt deflation is severe enough, it can also be a threat to the health of banks and other financial intermediaries (second channel). Banks typically have nominal assets and nominal liabilities, in which a certain amount is protected from sudden deflation. However, as the difficulty of borrowers increases, nominal claims of banks are replaced by requirements for real assets (eg collateral) which involves deflation on the banks too. The growth of the potential losses on loans as a result of debt deflation, causes disruption of banking capital and banking efficiency in several ways, as follows: First, especially in a system without deposit insurance, panic withdrawal of deposits drastically reduces the banks' assets for credit, i.e. their creditworthiness; Second, the threat of withdrawal of deposits also causes banks to increase liquidity and security of their assets, reducing the lending activity further more. Finally, the closure of banks and branches can destroy local information capital and reduce the provision of financial services.

As with the previous debate on the role of monetary shocks, ranging from the US case to an international comparative perspective, we can see strong evidence of the potential role of banking crises in depression.

In fact, the strong presumption is that the effects of debt deflation were much more widespread than banking crises that were relatively more localized in space and time.

3.2. Deflation and nominal wages

Traditionally explanation of monetary non-neutrality by 1930 is that nominal wages and prices are adjusted very slowly in terms of monetary shocks. In fact, price index, as consumer price index and the index of wholesale prices showed relatively smaller nominal inertia during the Great Depression. The conection between the adjustment of nominal wages and aggregate supply is as follows: If nominal wages adjust imperfect, then the reduction in the price level raises real wages, which employers respond by firing workers. Similarly, in a country experiencing monetary reflation, real wages are falling, letting reemployment.

During the Great Depression of 1930 and 1931, nominal wages have fallen far shortly then the prices which led to an increase in the indicator of nominal wages / prices. As a result of the significant growth in real wages followed a sharp decline in employment and output. Namely, in 1932 has been noticed a difference in the movement of real wages between countries inside and outside the gold standard. In countries that left the gold standard prices rose much faster than nominal wages, whiche led towards reduction in the real wages.

In contrast, the real wages in the countries that remained tied to the gold standard have increased or stabilized, and employment remained stagnant. The countries in which nominal wages have adjusted relatively slowly to the changes of the price level experienced the sharpest cuts in production.

Namely, there are two general explanations why then economies failed to adapt to large nominal shocks of the early 1930s:

- non-indexed debt agreements through which deflation caused redistribution and financial crises;
- The slow adjustment of nominal wages (and other elements of the structure of costs).

From an economic perspective, there is an important difference between these two sources of non-neutrality, and that is - following the unexpected deflation - there are motives of certain groups to change the conditions in contracts for nominal wages (and prices) but not on nominal debt contracts. Namely, if nominal wages are "very high" in terms of the balance of the labor market, the employer and the employee (who otherwise would be unemployed) should be willing to accept lower wages, or take other measures to achieve efficient employment (Barro, 1977) [9]. In contrast, there is no assumption that the distributional effects of the unprecedented deflation that operates through debt contracts will be returned by some type of indexing or amending the terms of a contract, because large net lenders realize large gains from deflation and have no reason to give up those gains.

Methodological, the main contribution of recent research on depression is to expand the sample to which the analysis will include more countries other than the US. Comparative studies of a number of countries have helped greatly to explain the forces that brought the world into the Great Depression in the 1930 th year. In particular, the evidence of monetary contraction as an important cause of depression, as well as monetary reflation as a leading component of recovery, strengthened considerably in the past.

On the offer side we have learned and will continue to learn about the interwar period. One key result is that the redistribution of wealth can have aggregate effects, if in the form to cause financial systemic disorders. Empirical evidence is also found for the uncomplite adjustment of the nominal wage as a factor leading to the monetary non-neutrality. Understanding of this recent phenomenon will probably need a broader perspective that implies not only political, but and economic factors.

4. Conclusion

The intention with this paper was to analyze some of the major effects on the aggregate demand and aggregate supply during the period of Great economic depression in the USA and to emphasis the importance of devastating power of deflation. The most economic experts are agreed that there are a lot of factors that caused the major downturn in the national product and price level. Starting from inadequate monetary policy and ending with some political factors like the stagnation in political response expressed through some insufficient fiscal measures. Therefore the paper intends to emphasis those aspects of the monetary policy that triggered that bad economic situation and other supplementary factors which were elaborated previously.

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