**Preamble**

To comprehend the Great Depression is the pinnacle of macroeconomics. The depression gave dawn to macroeconomics as an apparent field of study, and to this day the events of the 1930s continue to persuade macroeconomists' beliefs, policy recommendations, and study programs. "Black Thursday", October 24, 1929 heralded the end of the "Roaring Twenties", as the speculative bubble burst and panic set in within the stock market. 13 million shares were traded within the single day, as investors tried desperately to get rid of their shares before they became worthless. On that day alone four billion dollars had been lost on the New York Stock Exchange, and by the end of the year, stock values had dropped by fifteen billion dollars. The shocks to consumer confidence meant that consumption and investment came to a standpoint all over the world. These shocks had already been brewing and most economies had already peaked well before the stock market crash, but the crash was the commencement of the Great Depression.

Throughout the following pages the Great Depression will be explained through the use of a variety of graphs and explanations, these will be given to outline the negative shocks to the economy during the 1930s. It is also important to find out if the Great Depression can happen once more; therefore its imperative to find out if it is relevant to modern policy.

**Balancing the Budget**

Personally, the poor state of economic intelligence during the late 1920s and the 1930s is in my belief one of the greatest contributors to the Great Depression. Take this statement from President Hoover:

“It would steady the country greatly if there could be prompt assurance that there will be no tampering or inflation of the currency; that the budget be unquestionably balanced even if further taxation is necessary.” (Myers & Newton 1936, pp. 339-340)

Mr. Hoover’s (as well as Franklin Roosevelt’s from 1932 onwards) aim of achieving a balanced budget and not tampering with the economy was one of many primary causes for aggregate demand falling during the 1930’s. These Presidents thought that if the budget was steady and balanced, the economy would also be steady and balanced. From 1930s onwards the budget was well out of balance, and the only way to achieve a balanced budget meant increasing taxes and/or reducing government spending. The effect of increasing taxes and/or reducing government spending in a time when consumer confidence was dwindling lead to a fall in aggregate demand (top graph below). This initial fall in aggregate demand lead to a larger than proportional decrease in expenditure (bottom graph, move from A to B), this is known as the negative multiplier:

**Low Consumer Confidence**

According to Keynes trying to achieve a balanced budget was the most inappropriate thing a Government could do in a period of low consumer confidence. In his 1936 publication of *The General Theory of Employment, Interest, and Money,* Keynes gave the following insight:

"If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coalmines which are then filled up to the surface with town rubbish, and leave it to private enterprise on well-tried principles of laissez faire to dig the notes up again . . . there need be no more unemployment . . .. It would indeed be more sensible to build houses and the like; but if there are political and practical difficulties in the way of this, the above would be better than nothing." (John Maynard Keynes, *The General Theory*, p. 129.)

During the Great Depression all the government needed to was fuel the economy with spending, and spending on anything would do. Though the government of the time just did not understand the damaging effect the balanced budget was causing the economy. This triggered Keynes to note, “In the long run, we’re all dead”. Meaning, if the governments of the world did not do anything to induce spending and reduce hoarding of money immediately, the population would not last in the long run.

One of the causes of a severe recession can be explained in the following way: in a normal economy, there is a high level of employment, and everyone is spending their earnings as usual, therefore an individuals marginal propensity to consume is fairly high. This means there is a circular flow of money in the economy, as my spending becomes part of your earnings, and your spending becomes part of my earnings, this is the multiplier effect. But on Thursday of October 24, 1929 (known as Black Thursday) the bottom fell out of the Stock Market and by mid November of 1929 the New York Stock Exchange had fallen 40 percent. This large decrease in the Stock Market lead to an excessive fall in consumer confidence within the American economy, and lead to decreases in consumer confidence all over the world.

**Low Consumer Confidence continued**

Hence worried consumers then tried to endure the economic adversity by saving their money; therefore their marginal propensity to save was very high. But because my spending is part of your earnings, my decision to stockpile money makes things worse for you. And you, responding to your own difficult times, will start stockpiling money too, making things even worse for me. This is the vicious cycle that was at work during the Great Depression, as people accumulate money in difficult times, living becomes more and more arduous.

In this situation, Keynes suggested that government should do what the people were not: start spending. He called this "priming the pump" of the economy (Kangas .S. 1997). The effect of 'priming the pump' can be shown in the below graph, as the initial increase in Government expenditure (top graph) has lead to a larger than proportional increase expenditure (bottom graph point A to B), this is known as the Multiplier Effect:

**Hoarding Funds**

But why did consumers hoard money in the first place. Personally this is the most important question that required to be answered. Finding a solution to this question will be a major stepping-stone into stopping further depressions happening.

It must be noted that the Hoover Government of the time, in its aim to achieve a balanced budget, mistakenly tightened the money supply within the economy. This compelled people to hold on to money, as the supply of money was decreasing. In my belief, the stock market crash is a more visible event that lead to a huge loss in the confidence of consumers from 1929 onwards.

Had the economy been running effectively and efficiently at the time of the stock market crash, its affect may have been partial. Hence, the shock to confidence and the loss of spending by those who were caught in the market might soon have worn off. But business in 1929 was not sound; on the contrary it was exceedingly fragile. Hence it was vulnerable to the kind of blow it received from Wall Street (Galbraith, 1954, p.p 187). The fragile economy and the stock market crash worked hand-in-hand during the 1930s to dwindle consumer confidence, and bring on the hoarding of money.

The Economy from 1929 onwards:

In 1929 the economy was at full employment, which is shown by point A. Then aggregate demand fell; which was due to the low consumer confidence that sprang from the stock market crash, this lead consumers to hoard money hence consumption fell; also government spending was cut as the government of the tried to achieve a balanced budget; and animal spirits lead to decreases in investments. This decrease in aggregate demand is shown from point A (1929) to B (1932). Then if labour were to do as commanded and take a pay cut, the economy would return to full employment at point C (1937 – 8):

**Animal Spirits**

Investment on capital items during the 1930s fell to four billion dollars from a top of forty billion dollars almost overnight. This thirty-six billion dollar reduction left the economy within American (and eventually other economies around the world) in a cycle of negative investment. Though there was still four billion dollars being invested during the Great Depression, this amount is hardly enough to cover the amount of depreciation that was taking place, hence negative investment was occurring.

This negative investment mainly occurred due to pessimistic animal spirits of investors. These pessimistic spirits started on 'Black Thursday', the day the stock market crashed, and continued on through most of the 1930s. Animal spirits have a huge impact on whether investments will occur or not. Moreover, from October 1929, Investors were no longer in the disposition to spend large amounts of money on investments, as their estimated rates of return on the investments became greatly reduced. This decrease in the estimated rates on return on investment can be shown through the investment function of the ISLM model:

Even though the rate of return on these investments is higher than the rates of funds, they still do not take place, as the banks were unable to lean the money for the investments to take place.

Investment has ceased

**Bankrupt Banks**

Demand deposits are represented as liabilities from a banks point-of-view. These are deposits that can be taken out instantly by the consumers, and hence must be immediately honoured by the bank in question. Whilst the bank has these deposits, it uses them to purchase assets, to create profit for the bank, as well as pay the interest back to the consumer. When the bank runs occurred in the 1930s, the banks were required to pay back the deposits to consumers. To be able to do this the banks had to sell their assets (usually long term loans, shares, bonds, etc), though as everyone was selling their assets and no one was buying, the price of these assets was greatly bid down. So the banks were selling their assets at prices less than they were worth, thus the banks could not honour the demand deposits, consequently 10,000 banks failed during the Great Depression, or 40 percent of the banks in 1929 (Kangas .S. 1997).

The bank runs created a shortage of real money balances within the economy, and as investments within the economy are largely due to the funds being lent by the banks, investment during the 1930s came to an absolute halt. The ISLM model below further explains how the shortage of funds leads to decreases in investment, and its affect on the interest rate:

The LM curve shifts upwards as the supply of real money balances has decreased, which leads to an increase in the interest rate in the market for real money balances.

**Great Depression Cured**

World War II cured the Great Depression; Keynesians believe this was so, due to the large amounts of money being spent on defense. This is where the thought that 'wars are good for the economy' comes from. During World War II the Hoover Government unknowingly resorted to Keynesian spending, hence it can be said that wars are of economic benefit. Though it would be much more preferable for social programs to be put into place instead of war.

The success of Keynesian economics since World War II needs to be recognized. In that time there has been nine recessions in total (1945-46, 1949, 1954, 1956, 1960-61, 1970, 1973-75, 1980-83, 1990-92) (Kangas .S. 1997) and not one has turned into a depression, which is significantly due to Keynesian economics.

**Modern Policy Relevancy**

The historical episode of the Great Depression is scarcely relevant to modern policy makers, as current governments do not aim to achieve a balanced budget any longer and great care is taken to control consumer confidence, thus controlling aggregate demand. Modern governments are also more aware of how to manipulate the economy out of bad times through Keynesian economics. Therefore compared to the 1930s the Governments of the today have learnt from previous government's mistakes; they know what decisions will benefit the economy, compared to those that are detrimental. An example of positive governmental action is the first homeowners grant offered by the Howard government. This grant meant that while America was going through a mild recession, Australia was thriving, as the economy was being prime pumped from the money being spent on new housing developments. Thus causing a multiplier effect within our economy.

**Can the Great Depression happen again?**

The thought that the Great Depression won't happen again is that of Keynesian's, as they always believe that the government will always induce a multiplier, either through the monetary policy (through the Reserve Bank) or fiscal policy. Though there are many that are opposed to the Keynesian way of thinking, and these people look to Japan currently to point out the view that an increase in government spending (decreasing the interest rate, increasing the money supply within the economy) does not always induce the multiplier effect. Currently the Japanese interest rate is at 0.04% (Econstats, 03) and their economy does not look like bouncing back out of its recession. Personally as Japan is known to have a high saving rate (Mankiw, 2000, p.p 450), I believe it is a cultural trait that is stopping Keynesian economics from working within the Japanese economy. Due to the low interest rate, the rate of return on savings is inexcusably low, though the Japanese consumer will still save rather than invest, as they are more reluctant to take on risk and more tolerant to harsh economic conditions than consumers from other countries such as Australia, and America. Hence the average Japanese consumer is more likely to sit on their hands and save money, rather than invest large sums of borrowed money.

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