Chapter 1

Aggregation effects in the Great Depression : firms and institutions as victims and offenders

"*To understand the Great Depression is the Holy Grail of macroeconomics.*"

(Ben Bernanke, 1995)

"*Si elle [la Grande Dépression] demeure une 'énigme', ce n'est pas le défaut d'analyse qui est en cause, mais au contraire le foisonnement d'explications concurrentes.*"

(Asselain, 1995)

1.1 Chronology of the crisis

- established by Jean-Charles Asselain (Histoire économique du 20e siècle, 1995)

1.1.1 Outbreak of the crisis

- US growth of the 1920th driven by two unstable components of global demand : investment and durable consumer goods.
- Durable consumer goods = fragile pillar of growth : increasingly unequal distribution of added-value → insufficiency of wage incomes → temporary maintain of workers' demand thanks to consumer credit.
- Saturation of the auto-mobile market in April 1929 → initiating event of the crisis.
- Blocking of the standard instrument of interest rate decrease (Fed's refusal to feed stock market bubble).
- Interest rate increase → US foreign investments flows back → financial weakening of debtor countries.

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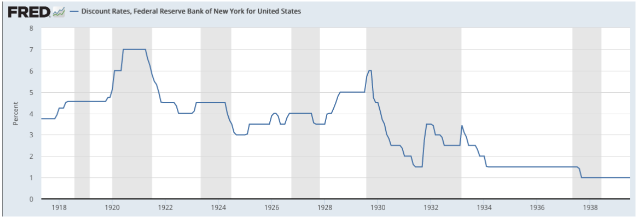

FIGURE: Federal Reserve Discount Rates, 1918 - 1940

- Increasing disconnection between real economy and stock markets → 1929 Wall Street Crash.
- Liquidity crisis : falling stock market prices → financial losses of banks → depositors' distrust, bank run risk → need for liquidity reconstitution → decreasing bank lending to domestic and foreign debtors : credit crunch.

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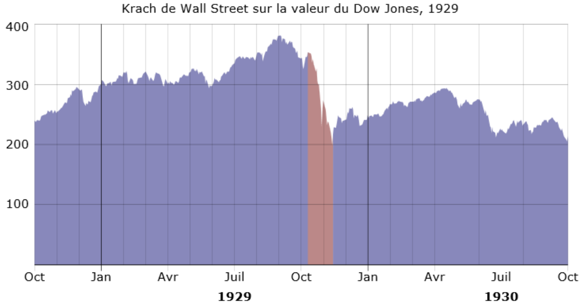

FIGURE: The Wall Street Crash on the Dow Jones Industrial Average, 1929

- Consequences of the credit crunch : a) further decline of demand for investment and durable consumer goods, b) repatriation of American capital → financial weakening of countries depending on US capital.

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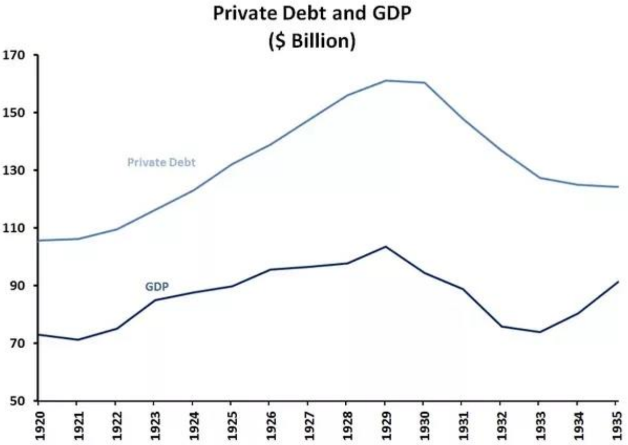

FIGURE: Private Debt and GDP (Source : US Department of Commerce)

1.1 Chronology of the crisis

1.1.1 Outbreak of the crisis

- Psychological consequences : fall in households' and business confidence → intended debt relief → further decline of demand for investment and durable consumer goods

1.1.2 Spreading and deepening of the crisis

- Main spreading/deepening mechanism : simultaneous fall of US capital outflows and of US goods' and raw material imports.
- Autumn 1929 : drop in US industrial production → drop in US imports of raw materials.
- Wall Street Boom → capital attracted by high earning opportunities → consequences : a) capital leave other stock markets → decreasing imports of countries depending on US capital → fall in US exports ; b) Raise of interest rates on other stock markets to prevent capital outflows → depressive effect on investment.
- Adjustment of supply to demand → sharp decrease in US production, increasing unemployment → protectionism.

1.1 Chronology of the crisis

1.1.2 Spreading and deepening of the crisis

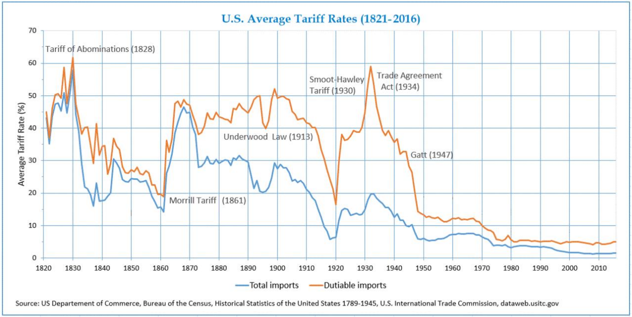

FIGURE: US Average Tariff Rates, 1821 - 2016

- Autumn 1929 : drop in US industrial production → drop in US imports of raw materials.

1.1 Chronology of the crisis

1.1.2 Spreading and deepening of the crisis

- Perverse effects of Smoot-Hawley Act : a) trade partners have no more means of import financing ; b) retaliatory protectionist measures → fall in US exports ; c) implication of third countries : falling German exports to USA, capital outflow from Germany to USA → exhaustion of foreign exchange reserves → falling German raw material imports from Australia → Australia affected by the crisis, falling Australian foreign exchange reserves → decrease in Australian imports from UK → further weakening of the British economy.

1.1 Chronology of the crisis

1.1.2 Spreading and deepening of the crisis

- *Conclusion : a) general scheme : decreases in imports produce decreases in exports ; b) protectionism is a major spreading mechanism of the Great depression ; c) protectionism is an aggravating factor of the crisis*.
- Inappropriate economic policies : a) deflationary fiscal policies. Objective : balanced government budget (GDP decrease → falling tax revenues → falling government expenditures → decrease of public demand → further GDP decrease) ; b) interventionism in favour of wage and price deflation : reduction of unemployment allowance, price control ; c) (involuntary) restrictive monetary policy.
- World economy in deflation trap : a) consumers postpone major purchases → low global demand ; b) asphyxiation of debtors → bankruptcies of firms, households, banks → further decrease of global demand → further price deflation (vicious circle of price deflation)

1.1 Chronology of the crisis

1.1.2 Spreading and deepening of the crisis

- Cascade of financial crises : Austria, Germany (setting-up of foreign exchange control), UK (pound sterling devaluation + abandon of fixed parity to gold) → British example followed by Japan, Scandinavia, Commonwealth countries ; maintain of fixed gold parity by France, Italy, Belgium, Netherlands, Switzerland (heavily handicapped by appreciation of their currencies : decrease of exports → decrease of imports).

1.2 The role of aggregation effects

1.2.1 Firms' decisions

- Firms' objective of profit maximization → 1920th : wage increases < added-value increases → danger of under-consumption, maintain of sufficient workers' consumption thanks to consumer credit → high indebtedness of low-income households → increasingly fragile global demand = permanent threat to firms' future profits.
- Firms confronted with decreasing demand lay off "excess" workers ; problem : undelayed and massive dismissals = major vector of income deflation → further decrease of global demand → increasing losses/decreasing profits.
- Firms confronted with sales problems lower selling prices, but : ineffective strategy if applied by all firms → deflation of price level → harmful deflation effects : debtor asphyxiation, expenditures' postponement.

1.2 The role of aggregation effects

1.2.2 Banks' decisions

- Investment banks : rational to buy over-valued shares as long as the upward trend is supposed to continue.
  - "Better to be wrong with the market than to have reason alone." (Stock market proverb)
  - "Successful investing is anticipating the anticipation of others." (John Maynard Keynes)
- → reinforcement of the stock market bubble → aggravation of the future stock market / liquidity crisis.
- Banks' liquidity shortage due to falling stock prices → individually rational reaction : less credits (reconstitute of liquidity) → credit crunch → GDP contraction → firms' bankruptcies and falling stock prices → aggravation of liquidity shortage and credit events.

1.2 The role of aggregation effects

1.2.3 Institutional mismanagement

- Protectionism can only function if it is unilateral ; in reality : retaliatory measures of the trade partners → multilateral protectionism = negative sum game.
- Even unilateral protectionism can be harmful : decreasing imports → trade partners lack of foreign exchange reserves → trade partners cut imports from the protectionist country.

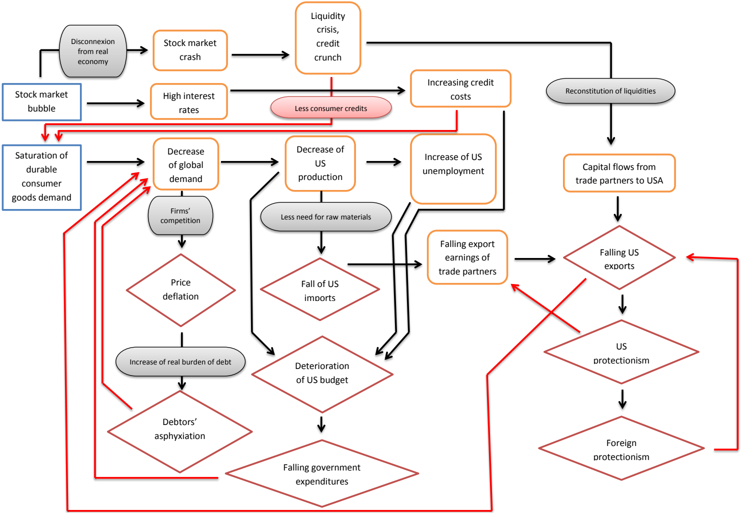

FIGURE: The Great Depression : chain of events

Bibliography

- Asselain, J.-C. 1995, *Histoire économique du vingtième siècle, 1, La montée de l'Etat, 1914–1939*, p. 165–202, Dalloz.