



Case study: Demand-side policies in the Great Depression and the Global Financial Crisis of 2008

Introduction

This case study has been written by teachers for teachers to support the delivery of a new topic within the specification. It provides ideas and suggestions for teaching approaches and is not intended to provide exhaustive coverage of this topic. It is not intended to be prescriptive or indicative of content and questions in the specification and assessments. The specification must be referred to as the authoritative source of information.

This case study focuses on demand-side policies in the Great Depression and the Global Financial Crisis. It provides research ideas and practice questions for students for use within class or as homework activities.



This resource sheet is designed to support the AS and A level Economics A specification Topic 2.6.2: *Demand-side policies*.

- h) Awareness of demand-side policies in the great Depression and the Global Financial Crisis of 2008
- different interpretations
 - policy responses in the US and UK.

The Great Depression

In 1929, after a decade of rapid growth and a huge rise in share prices, the US stock exchange crashed. The extent to which the stock market crash caused the Great Depression is debated among economic historians. Widespread share ownership among many middle-income consumers meant consumption plummeted and there was a large-scale loss of confidence, leading to a fall in investment and closure of businesses. Banks had to reduce lending as debts were not being repaid and as individuals withdrew their savings.

The falling demand in the US set off a downward spiral in international demand. The common view among economists is that the simultaneous tightening of monetary and fiscal policy in the late 1920s and early 1930s, combined with the increase in protectionism, turned a tough financial crisis into a deep depression.

US policy responses

Protectionism

In 1930, US president Herbert Hoover attempted to protect US industries by increasing tariffs. This led to a trade war and world trade contracted, setting off a cycle of ever-falling production. This made the depression more severe but is not considered to be one of the main factors.

Fiscal policy and monetary policy

At this time, the US, in accordance with the thinking of the day, believed in balanced budgets. They thought an unbalanced budget would slow business recovery: a fiscal deficit would lead either to rising taxes (in which case consumers would have less to spend), government borrowing (which would lead to the public sector crowding out private investment) or an increase in the money supply (this was not possible since the US dollar was backed by gold, meaning the US had adopted the Gold Standard, which limited the ability of central banks to expand the money supply for fear of devaluing their currencies).

In 1930, Hoover ran a budget surplus. By 1931–32 fiscal policy was weakly expansionary, but negligible given the scale in collapse of gross domestic product (GDP). The stance taken prolonged the depression.



There is some debate as to the extent to which monetary policy was tight in the US during the early 1930s. However, raising interest rates in September 1931 to preserve the value of the dollar (linked to the Gold Standard) further restricted credit for businesses and reduced aggregate demand. Money supply also fell because the banking panics caused people to hold more cash in relation to their bank deposits. Some studies suggest that money supply fell by 31 per cent between 1929–33 due to a combination of these factors.

The combination of protectionism, a lack of fiscal stimulus and restricted money supply all reduced aggregate demand, making the depression particularly severe in the early 1930s.

The New Deal

In 1933, under the new president Franklin D. Roosevelt, the New Deal programme was launched which represented a fairly significant fiscal stimulus to the economy. (Roosevelt raised spending to 10.7 per cent of output in 1934.) However, there is some debate as to what extent this was effective in bringing the US into recovery or whether it was the huge spending associated with the Second World War which provided the real boost.

Leaving the Gold Standard

Once Roosevelt came to power, the Gold Standard constraint was removed and the money supply increased. Many economists believe the growth in the money supply was a significant factor in aiding recovery until 1937–38.

The extent to which the recovery between 1933–37 can be credited to the New Deal programme or the expansion in the money supply is still debated. However, the combination of the two clearly explains the positive economic growth in this period, when annual real GDP growth averaged at over 9 per cent.

However, because of concern that the national debt was too high, by 1937 government spending was cut and taxes were raised. The Federal Reserve also increased the reserve requirement, causing money supply to fall. This contributed to a recession in the US in 1937–38.

UK policy measures

Fiscal policy

Classical doctrine said that the budget should be balanced at all costs. The UK Treasury followed this doctrine until the 1940s. As unemployment was rising during the Great Depression, spending on unemployment was rising while tax revenue was falling. The 1931 budget cut public sector wages and unemployment benefit by 10 per cent and raised income tax from 22½ to 25 per cent. This had highly deflationary consequences.

Monetary policy

In 1931 the UK left the Gold Standard. This meant that the value of the pound immediately fell by 25 per cent and money supply was relaxed, with interest rates reduced from 6 to 2 per cent. This all helped to spark economic recovery.



The Global Financial Crisis of 2008

Fiscal policy

The response to the Global Financial Crisis of 2008 was different. The Classical view that unemployment would be cured by the labour market self-adjusting to a balanced real wage had been challenged by John Maynard Keynes. Keynesians argue that governments need to spend more in the economy to stimulate recovery, and most countries had stimulus packages in place within five months of the collapse of Lehman Brothers in September 2008.

- **In the US**, President Barack Obama in 2009 signed the American Recovery and Reinvestment Act, a stimulus plan worth almost 6 per cent of that year's GDP.

Although elements of the stimulus will stretch to 2019, more than 90 per cent of the budgetary impact was realised by the end of 2011. The stimulus was mixed between tax cuts for businesses and spending on health, education, social security and infrastructure.

- **In the UK**, a number of fiscal measures were introduced which amounted to 2.2 per cent of 2009 GDP. These included a reduction in VAT, support for the construction sector, spending on infrastructure for schools, hospitals and green energy, and training help for the unemployed.

However, by 2010 the UK had moved towards measures aimed at reducing the budget deficit, in contrast to the US where this was considered less a priority.

Monetary policy

In the UK, the Bank of England's Monetary Policy Committee (MPC) cut the base interest rate in stages from 5.75 per cent in 2007 to eventually 0.5 per cent in March 2009. **In the US**, the Federal Reserve cut the interest rate in stages from 5.25 per cent in 2007 to 0–0.25 per cent in 2008. Both countries cut interest rates to stimulate aggregate demand. Once the interest rates set by the MPC and the Federal Reserve had reached record lows, there was no scope for further reductions. To further stimulate the economy, a different monetary tool was needed.

Since the Global Financial Crisis, both the Bank of England and the Federal Reserve have used the policy of quantitative easing (QE) to try to revive consumer spending and economic growth.

In the UK, by 2014 the Bank of England had spent £375 billion on its QE programme.

In the US, at the end of October 2014 the Federal Reserve announced the end of its QE programme, which had spent \$4.5 trillion US dollars.

The objective of QE was to help businesses have access to finance at a time when the supply of credit in markets had been scarce. The effect of QE was to lower long-term borrowing costs for firms and individuals, which should then have stimulated spending.

Has it worked?

In the UK, the Bank of England has suggested that the first round of QE of £200 billion between March–November 2009 helped increase the UK's annual economic output by between 1½–2 per cent. However, critics argue that lending to businesses and households remained sluggish since institutions just hoarded the extra 'cash'.

In the US, Ben Bernanke said the first two rounds of QE had raised economic activity by almost 3 per cent and increased private sector jobs by 2 million (compared with projected figures without QE).



However, it is difficult to judge the effectiveness since no one knows how bad the economy would have been without QE. It is also difficult to know to what extent other policies might have been more effective at stimulating growth. There are many critics of QE, as well as proponents of it, and different groups have benefitted at the cost of others. For example, those with 'tracker' mortgages have benefitted from very low interest payments while savers – and in particular pensioners with savings – have suffered.

Overall

It is difficult to compare the effectiveness of the different policy responses. Both the UK and US economies improved.

The UK experienced a much harsher recession than the US, with the peak to trough representing 6 per cent of GDP, whereas for the US it was 4.2 per cent.

Recovery growth rates were similar up to 2011 but then diverged. The US continued to have modest growth but the UK stalled. The UK's GDP in the third quarter of 2014 was 3.4 per cent above its pre-recession level, whereas the US GDP in the same quarter was 7.7 per cent larger (source: House of Commons library 2014: 'US Economy: Developments since 2008/2009').



Research ideas

1. The debate about the effectiveness of quantitative easing during the Global Financial Crisis is ongoing. **Research the arguments for and against** quantitative easing, in the context of the evidence researched in the UK and US.

The BBC News article from 30 October 2014 'Has quantitative easing worked in the US?' by Andrew Walker (www.bbc.co.uk/news/business-29778331) highlights some key arguments for and against.

The *Guardian* Economics blog entry from 29 October 2014 'Quantitative easing: Giving cash to the public would have been more effective' is also a good article to use to research the arguments for and against.

Prepare a handout summarising the key points for and against quantitative easing.

2. 'Lessons of the 1930s: There could be trouble ahead' (*The Economist*, www.economist.com/node/21541388) looks at the economic policies used in the 1930s' Great Depression years and compares those with the approach used during the Global Financial Crisis and immediately afterwards. **Read this article and identify the similarities and differences in policy approach.**

Find other articles on this theme and produce a poster to display for the classroom. Use plenty of Great Depression photos to cheer everyone up!

3. It is worth looking at a few video clips (eg history BBC clips, GCSE Bitesize) on the 1930s Great Depression, since it helps to get a feel for the scale of the crisis at the time and can highlight some of the key points.

Short-answer questions

1. UK unemployment rates (taken from Labour Force Survey):

Year	Unemployment rate
2008	5.7%
2009	7.7%
2010	7.8%
2011	8.1%

- a) Define the term 'unemployment'.
- b) Which of the following can be inferred from the data?
 - A Interest rates must have risen over this period.
 - B It is likely that real GDP was falling over at least some of the period shown.
 - C A rise in unemployment means there are more people choosing not to work.
 - D The economy is moving closer towards its PPF.
- c) Explain **one** policy measure which a government could take to reduce unemployment.



2. Between October 2008 and March 2009 the Monetary Policy Committee of the Bank of England cut its interest rate (base rate) from 5 to 0.5 per cent, despite inflation being above its target of 2 per cent in 2008.
 - a) It can be inferred from this that:
 - A The MPC expected the rate of inflation to fall significantly.
 - B Aggregate demand was high in 2008 because the rate of inflation was high.
 - C The Bank of England no longer had an inflation target.
 - D The effect of reducing interest rates would be to reduce aggregate demand.
 - b) Explain how a fall in interest rates will cause the value of the pound to depreciate.
 - c) Explain how a fall in interest rates will affect the components of aggregate demand.
3. During the Great Depression of the 1930s the US increased its spending massively on investment projects, such as vast new infrastructure projects (eg the Hoover Dam on the Colorado River).
 - a) Explain how this policy would increase aggregate demand.
 - b) Using an AD/AS diagram, show the likely effect of this policy on real GDP.
4. In 'normal' times, a fall in interest rates by central banks would spur economic growth. However, by early 2009 most central banks had reduced their base interest rate to almost zero without any real impact on increasing borrowing and reducing savings.
 - a) Give **one** reason why this was the case during the financial crisis.
 - b) The UK and US used quantitative easing as part of its monetary policy.
 - i. Explain what quantitative easing means.
 - ii. Explain how quantitative easing should boost aggregate demand.
5. Explain how the UK's temporary cut in VAT from 17.5 to 15 per cent in December 2008 might have helped to combat the recession during the financial crisis.

Essay questions

1. During the Global Financial Crisis, fiscal stimulus was used in many economies to aid economic recovery.

Evaluate the extent to which a fiscal stimulus package should be used to promote economic recovery in times of recession.
2. Evaluate the likely impact of measures a government could take to stimulate growth in times of recession.



Marking guidance

Essay questions

Essay 1

- Expect students to go through how a fiscal stimulus affects aggregate demand, ie budget deficit increases so net injection into circular flow. Differentiate between automatic fiscal policy and discretionary fiscal policy.
- Clear understanding of role of multiplier – what affects value of multiplier and why, if interest rates are low, multiplier would be higher. Therefore particularly effective at boosting aggregate demand if monetary policy is also set appropriately.
- Recognition that a fiscal stimulus package can prevent a downward spiral in aggregate demand.
- A fiscal stimulus, combined with a high-value multiplier, may generate high growth quickly which means that, via automatic fiscal policy, budget deficits will start to fall.
- If growth occurs and long-term unemployment is minimised, this reduces the hysteresis effect. Without a fiscal stimulus, there may be more people who remain unemployed long term. This would mean more people will have 'outdated' skills and would lead to higher structural unemployment, leading to a rise in the natural rate of unemployment. This would increase the budget deficit in the long run.
- However, a fiscal stimulus will be most effective when the value of the multiplier is high (hence a role for low interest rates in monetary policy), since less injection will be needed initially to achieve a given rise in real GDP. The budget deficit would not have to significantly rise. Also, the government needs to fine tune their response to ensure real GDP does not overshoot its target and lead to a positive output gap which could be inflationary.
- A fiscal stimulus may also be necessary if interest rates are virtually zero but not doing enough to kick start aggregate demand – when in a liquidity trap.
- If a fiscal stimulus ends up crowding out the private sector (either resource or financial crowding out) then the stimulus has been too high. But if unemployment remains high and interest rates are not pushed up, then the stimulus package would be viewed positively. If interest rates are pushed up, then the fiscal stimulus will reduce private sector investment which counteracts the injection provided by the public sector, and then just leaves the problem of how to finance the budget deficit!
- A fiscal stimulus which attempts to channel a rise in government spending on investment and infrastructure will be particularly effective, since not only will aggregate demand increase but supply-side growth will also occur. This means that inflationary pressures will ease and tax revenues will increase.

Essay 2

- Students are likely to discuss the need for policies to increase aggregate demand in times of recession. This can be done by fiscal and/or monetary policy. A discussion on the effectiveness of fiscal policy will raise some of the points covered above for Essay 1.
- Expansionary monetary policy – reducing interest rates and increasing the money supply. Students are likely to explain the transmission mechanism, ie how lower interest rates increase aggregate demand (including impact on value of a currency on the foreign exchange markets, hence boosting exports). Financial crisis highlighted how, despite the base interest rate falling very low, aggregate demand was not sufficiently stimulated, hence use of quantitative easing to prevent deflation. Students should discuss how quantitative easing works.



Students may highlight some of the disadvantages of quantitative easing, eg just how effective it was during the financial crisis at boosting aggregate demand and how it may also have hit some groups adversely.

- Some reference to how adherence to 'balanced budgets' by many countries in the 1930s made the depression worse. However, some recognition of view of Classical economists that, if the government does not intervene, the labour market may eventually self-adjust, so real wages return to their equilibrium level – there would be no involuntary unemployment if the labour market clears. Recognition also of Keynesian view that wages are sticky downwards so government intervention to stimulate aggregate demand is important.