

Economic Environment and Business Strategy

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Lecture- 33

Major Business Cycles – I

Hello everyone, welcome back to our continuing series on business cycles, part of the course on the economic environment and business strategy. In this session, we turn to one of the most significant macroeconomic events in modern history: the Great Depression of 1929. Nearly a century has passed, yet its relevance continues to shape our understanding of economic crises, policy responses, and the evolving relationship between the state and markets. The Great Depression was more than a financial collapse. It was a global economic breakdown that profoundly reshaped economic thinking and public policy. For businesses, it brought extreme uncertainty, mass unemployment, deflation, and a collapse in demand, forcing a fundamental rethinking of strategy, investment decisions, and the role of government in economic management.

In this session, we will begin by examining the magnitude of the depression, highlighting the sharp contraction in output, employment, and prices. Next, we will trace a series of events that led to the crisis, from speculative asset bubbles and banking failures to monetary tightening in the United States. Finally, we will explore the policy responses and the major intellectual debates that followed, ranging from early laissez-faire inaction to Roosevelt's New Deal and from Keynesian calls for government demand-side intervention to the monetarist critique of central banking errors during the crisis. By the end of this session, I hope you will gain a deeper understanding of the causes and consequences of one of history's most severe economic downturns and why it continues to serve as a foundational reference point for thinking about macroeconomic policy and business resilience strategy.

Let me begin by providing an overview of major modern recessions, starting with the Great Depression of 1929. As you can see, I have listed the major recessions, beginning with the 1929 Great Depression. The Great Depression lasted nearly 10 years, with peak unemployment reaching 25 percent and GDP declining by 30 percent. Then, in 1973-75, another major recession followed, and then in 1980, 1981-82, and 1990-91, and another one in 2001. And then, the 2008-09 financial crisis, which is another major financial crisis in economic history, happened in 2008-09. So, what I will do here is first let us begin with the 1929 depression.

I will spend most of my time explaining and understanding the 1929 depression, because it is one of the major depressions in human history. Next, I will explain what led to the Great Depression of 1929 and what the policy response was. This will also help you understand other recessions and depressions. To begin with, to give you the magnitude of the problem, the main issue at that time was that the 1929 depression is called the Great Depression of 1929, and, mainly, you know that depression or the business cycle means a kind of disequilibrium in GDP; in this case, aggregate demand was less than aggregate supply. This picture reflects the situation in 1929, characterized by poverty and unemployment. You can see the free coffee and donuts offered to the unemployed.

Everything is reflected in this picture. The 1929 Great Depression was called the mother of all financial crises in human history. It lasted for almost 10 years, from late 1929 to 1939, affecting nearly every country in the world. It was marked by steep declines in industrial production and prices, deflation, mass unemployment, banking panics, and sharp increases in poverty and homelessness. It was also characterized by a stock market crash, bank panics, and economic contraction.

Let me present some key facts about the Great Depression. First, there was a stock market crash; the stock market fell by 85 percent during the initial phases of the depression. The GNP fell by 30 percent, as you know; the GNP refers to the sum of economic activity. As a result of the contraction in economic activity, the GNP decreased by 30 percent. The unemployment rate rose from 3 percent to 25 percent, and net investment was negative.

And the consumer price index, which is the inflation measure, fell nearly 25 percent, indicating deflationary pressure in the economy. So, you can see that a decline in output and unemployment, at the same time, led to inflationary pressure in the economies becoming almost deflationary in nature, which means it is characterized by two features of an economic downturn: low output and employment, accompanied by low inflation. Here is a table of economic statistics from the Great Depression. I have a table that displays the movement and changes in key economic variables over time, from 1929 to 1939. So, this is the period during which the Great Depression lasted until today.

You can see the GNP in billions and investment as a percentage of the GNP; initially, it is 17.8% and 13.5%, but over time, you can see that this has declined. Investment, a key component of aggregate demand, declined during this period. In government expenditure, you can see that there is no significant change, but a slight increase; however, at the same time, GDP has declined.

Then you can see that the unemployment rate was initially only 3.2% and 8.7%, but it has since increased. There was a dramatic rise in the unemployment rate. Regarding the

consumer price index, which uses 1929 as the base year, you can see that consumer prices are below 100, indicating negative inflation, also known as deflation.

The interest rate for the key financial instrument, the commercial paper rate, has declined. There is a slight variation in the highly rated AA debt instrument, but not much decline. However, the stock market index shows an almost crash, and the money supply has declined, along with the full employment surplus as a percentage of GNP, which also shows a decline. So, these are the key facts. Based on this, we can see that it conveys a sense of the magnitude of the Great Depression of 1929. And then I am showing you a figure that displays the real GDP and the potential GDP. This is the real GDP line; you can see that it represents the real GDP over time, also known as the observed GDP.

You can see a decline in GDP from 1929 to 1931, followed by a slight increase from 1941 onward. As you can see, this is the pattern of GDP growth. When we draw a potential GDP trend line, the output trend line represents potential output, or potential GDP, or natural GDP; this is the trend line. If there were no depression or uncertainty in the economy, and it were on a natural path or at its natural level, the output would have grown in this way, which means you can see that this is the natural output. Therefore, the actual output growth was only this much; you can see below that this represents the actual output, or the observed output.

This gap is referred to as the recessionary gap, which represents the negative output gap. This illustrates the magnitude of the depression in output. Moving further, consider another component: when the level of economic activity declines, GDP growth also declines. As we have already seen in the previous slide, there is a large recessionary gap. Then the unemployment rate obviously increases when the output level of economic activity declines, and the demand for inputs also declines.

Then you know that labor is one of the key inputs. What you can see here is that the unemployment rate in the US rose from 3.2 percent in 1929 to 25.2 percent in 1933. This illustrates the magnitude of the unemployment problem in the US.

In Great Britain, the unemployment rate remained above 10 percent for the decade from 1923 to 1935. In other industrial countries, most nationals, including those in Germany and Canada, faced similar unemployment problems in the 1930s. I am also presenting data on key economic variables related to economic performance, including the real interest rate. First, you need to understand why the nominal interest rate has declined. The nominal interest rate equals the real interest rate plus the inflation rate.

First, by examining the rate of inflation during the Great Depression, you can observe negative inflation, which is a deflationary pressure. Therefore, inflation declined because there was no demand, resulting in a shortage of aggregate demand. Consequently, the rate of inflation was negative, which is known as deflation. As a result, investment purchases

are affected by the rate of interest minus the rate of inflation, which is the real rate of interest. That means when you suppose the nominal rate of interest remains almost the same, but because of the inflation, there is negative inflation; as a result, you can see that the real rate of interest has increased. The real rate of interest you can see has increased, which is nothing but the cost of borrowing for the firms that have increased.

That means the cost of inputs and the cost of capital have increased during the crisis. Another major event in 1929 was the stock market crash. The New York Stock Exchange had been booming for the last 4 years before 1929, so there was initially an expansionary phase. At that time, most people were investing in the stock market, and as a result, the value of the stock exchange tripled from \$27 billion to \$87 billion in four years.

You know, at that time, people found that investing in the stock market was one of the best investment opportunities. Even people borrowed money from banks and other lenders, and then they invested this money in the stock market with the expectation of making huge returns. So, even though many people did what they did, whatever income they saved, their money generated some loanable funds and capital, and that amount was pumped into the stock market with the expectation of earning huge returns. That was obvious because, in the first four years preceding the 1929 period, it was an expansionary phase, and the US stock market underwent a historic expansion. However, these were all bubbles because they were not based on the true economic foundation of the economy, as well as the firms, and there was a market crash.

You can see that this was a period of stock market expansion, but by '29, the data show a decline in the stock market. It reached its low point in December 1932, at 10 percent of the September 1929 peak value. As you can see, there is a steep decline in the stock market index; in other words, this is a stock market crash. Once prices began their inevitable decline in October 1929, stock prices fell by 33 percent between September and November. The result was a profound psychological shock, as people had all been led to believe they could make huge profits by investing in the stock market. Consequently, there was a loss of confidence in the economy among both consumers and businesses. This was called on October 24. This day was also known as Black Thursday because people tried to sell their stocks, but there were not enough buyers, which caused the market's size to shrink. A record 16 million shares were exchanged for smaller and smaller values as the day progressed. In just 10 short weeks, you can see the magnitude of the crisis and the tragedy. The value of the entire market was halved.

In parallel, there was a series of bank failures. One was mainly seen in the agricultural sector. There was a default on farm mortgages because, at that time in the 1920s, a lot of mechanization in the U.S. agricultural sector, as well as globally, had been taking place, and as a result, many farmers, because of the mechanization, bought many new machines, including tractors and other equipment, to increase productivity.

For agricultural activities, they borrowed a substantial amount of funds from the banks; however, adverse weather conditions and agricultural failure occurred during this period in 1928-29. As a result, many farmers defaulted on their mortgage loans, leading to loan losses on the bank's balance sheets in agricultural regions. This prompted substantial withdrawals from banks, building to a full flood of panic in November and December of 1930, with the stock market falling sharply. You know that when the banks face a liquidity crisis because of defaults on firm mortgages, the agricultural banks in the US face a lot of liquidity crises, and as a result, when people notice this, when the depositors notice that the banks' financial health is not so sound, not so great, and people begin to withdraw their deposits, it further adds fuel to the problem. Then, the effects of the stock market crash, which occurred simultaneously, rippled throughout the economy.

As a result, you know that when the stock market crashed, the net worth of many firms declined, and to revive, they needed more capital. There was also an increase in loan defaults by these firms because their overall cash flow had declined, resulting in defaults on the loans. Many firms. As a result, nearly 700 banks failed in the waning months of 1929, and over 3,000 more collapsed in 1930. By 1933, more than one-third of US commercial banks had failed.

You can see that the bank failure is one of the key features of any financial crisis or economic crisis. A manifestation of the rise in financial friction is that lenders are charging businesses much higher interest rates to protect themselves from credit losses. And banks realize that the money they lend to future traders as margin would go unpaid. As a result of bank closures, the public also began to lose confidence in banks, so they gradually started withdrawing money from banks and holding it in cash. In other words, there was a continuous flow of deposit withdrawals from the banks, and people were not only withdrawing their money but also not depositing it in the banks at all.

Instead, they prefer to keep whatever surplus they have and any savings in cash. As a result, the banks that survived the crisis were unwilling to lend money. You know why? Because they knew that the ongoing crisis would create a high default risk, which further worsened the situation. Regarding the Great Depression, there are numerous debates about its causes. So, what macroeconomic theories can explain the Great Depression? In short, there is no consensus among economists and historians regarding the exact causes of the Great Depression.

The economic wisdom prevalent in economic thinking until the 1930s was classical economics. So, their belief is that we do not need any kind of government intervention; they just believe in laissez-faire policy. The role of the government is to manage the economy, which includes maintaining law and order; it should not focus solely on economic management, as its main duty is primarily to uphold law and order. Therefore, they lacked a well-developed theory that could explain the persistent and excessive

unemployment, as well as any policy recommendations to address the problem. However, their argument was that in the short run, there would be a mismatch between aggregate demand and aggregate supply, resulting in disequilibrium. Nevertheless, in the long run, there would be no economic crisis; that was the prevailing wisdom until 1929, as evident in the events that followed.

This economic crisis lasted for nearly one decade. Then, the new economic wisdom emerged under the leadership of John Maynard Keynes, who questioned the non-interventionist policy of the classical economists, specifically the laissez-faire economic doctrine. He also challenged the classical short-run argument, which holds that in the short run, aggregate demand may deviate from aggregate supply, but the market mechanism will automatically correct this deviation. However, Keynes, observing that it lasted for nearly 10 years, argued that in the long run we are all dead. So, why do we worry? The point is that it is not only the long run; we also need to worry about the short run.

Keynes argued for strong government intervention to revive the economy from the crisis. Then, another group of economists, especially in the 1960s, provided an explanation for why the 1929 crisis emerged and whether it could have been prevented. They argued that the money supply should have increased during the Great Depression, allowing the recession to be averted from turning into a depression. These are all the arguments made by monetaristic economists using the data. They argued that, based on this data, the economic policy from 1929 to the 1940s was insufficient to address the economic downturn because the money stock fell rapidly due to bank failures. Therefore, the current deposit ratio increased, and the central bank's failure to take adequate expansionary measures showed that the money supply declined in the economy.

There was also concern about the weak fiscal policy, especially during the 1929-30s. Especially in the initial years. Therefore, policymakers attempted to balance the budget by increasing taxes, but this ultimately meant taking the purchasing power of the people away from them. So, as a result, there is a decline in aggregate demand. So, these are all contractionary policies at an inopportune time.

Overall, the Keynesian explanation holds that the essence of their account of the depression is captured in aggregate demand. They argued that the deficiency in aggregate demand was the root cause of the 1929 depression and that government intervention, especially fiscal policy, was required to revive the economy and prevent the recession from turning into a Great Depression. In the initial period of the 1920s, mass production led to a thriving economy. However, the collapse in the 1930s resulted from the drying up of investment opportunities, a decline in consumption expenditure, and poor fiscal policy. Continuing with the Keynesian explanation, they argued that classical economists believe in the market mechanism, particularly in the private sector, and are opposed to

government intervention in the economy. However, Keynes argued that the private economy was inherently unstable, particularly in terms of private demand; private sector investment demand is inherently unstable.

We need an active stabilization policy to maintain a strong economy. The stabilization policy primarily focuses on addressing deficiencies in aggregate demand; it should be implemented by injecting funds, which are then compensated for by an increase in government expenditure, another key component of aggregate demand. So, their suggestion is mainly to prevent not only the Great Depression but also future depressions. The policy response based on the Keynesian revolution led the US government to develop several policy responses; one was to accept the Keynesian policy proposition that an expansionary fiscal policy is required.

That means government expenditure should be increased. So, they came up with the New Deal. This is a series of programs, public works projects, and financial reforms and regulations enacted by President Franklin in the US to respond to the needs for relief, reform, and recovery from the Great Depression. As you can see, aggregate spending policy increased from 3.2 percent of GDP in 1932 to 9.3 percent of GDP in 1936, representing government expenditure.

To revive aggregate demand, government spending increased. Additional capital expenditures were then made, which would raise people's incomes, enhance purchasing power, and subsequently boost aggregate demand. From 1935 to 1943, a second deal was in effect. That was a permanent jobs program that employed 8.5 million people from 1935 to 1943. The idea is that people's purchasing power needs to be increased through government spending programs. World War II also contributed to the end of the Depression because production during the war increased, and the resulting surge in production to meet demand led to increased employment. You know that the Japanese attack on Pearl Harbor in 1941 led to America's entry into World War II. As a result, national factories resumed full production. Between 1940 and 1942, the US entered World War II, and government purchases nearly quadrupled, thereby adding significant economic demand.

This is a brief overview of the data illustrating the various phases through which the economy progressed and the government's policy for reviving the economy to prevent it from falling into depression. In the 1960s, the monetarist revolution, which involved studying monetary transactions and the money supply in the economy for almost a decade, led Friedman to emphasize the role of monetary policy in determining the behavior of output and prices. To him, money is the main factor that explains the variation in output and employment. He argued that the depression was evidence of the importance of monetary policy factors, especially during the 1930s, when this crisis hit the economy. Instead of an expansionary monetary policy, the Fed followed a

contractionary monetary policy that went against basic economic wisdom. There are many research papers on this; I am just showing you some that show how Friedman and Schwarz claim that the fall in the money supply during this period was one of the main reasons. It could have been just an ordinary recession, but because of the contractionary monetary policy, it became a Great Depression.

There are additional research papers on this topic. They show how a contractionary monetary policy played a role. In this session, we discussed key aspects of the Great Depression of the 1930s. We then reviewed the series of events and causes that led to the Great Depression, discussed some policy responses, and finally examined how the Great Depression ultimately came to an end. Thank you for watching this session. We look forward to seeing you at the next one. Thank you.