Problem Set 16

Love, Hate, and The Great Depression

Overview

What caused the Great Depression? What eventually pulled us out of it? Yes, many a relationship ahs broken up over this question. In this problem set you will IS-LM curves to analyze two competing views about the Great Depression. If you are successful in your analysis, you might be able to restore a friendship ruined by this issue.

Our two friends are Peter Temin and Milton Friedman, both famous economists. Peter argues that weaknesses in spending, having nothing to do with monetary forces, caused the great depression. For example, he believes consumer and investment spending were very weak because pessimism was sweeping through the economy. i.e. There was too much national savings. He also believes that a tightening of fiscal policy (increasing tax rates and try to hold government spending down) in the early years caused this weak demand. Again, he does not believe that monetary forces played a significant role.

Peter Temin also believes that a rebound in spending, not caused by monetary forces, explains the recovery. In particular, he believes that increased government spending (the New Deal and later the defense build-up) along with recovering business and consumer confidence boosted spending. In short, Peter believes that national savings decreased thereby boosting the economy out of the recession. He believes that this was largely independent of monetary policy.

Milton, strongly disagrees. He believes that monetary forces caused the Great Depression. He also believes that monetary forces are largely responsible for its recovery.

Instructions: Answer these on a separate sheet(s) of paper.

1. For the love of economics, restore this friendship! Start by showing Peter Temin’s claim regarding the cause of the Great Depression using IS-LM analysis. Clearly label your points. You should have at least two points: pre-depression (ex. 1929) and Depression (ex. 1933).
Make this neat! What testable predictions does Peter’s theory about the causes of the Great Depression make?

2. Now it’s Milton’s turn. Show Milton Friedman’s claim regarding the cause of the Great Depression using IS-LM analysis. Clearly label your points. You should have at least two points: pre-depression (ex. 1929) and Depression (ex. 1933). Make this neat! This should be a separate graph. What testable predictions does Milton’s theory about the causes of the Great Depression make?

3. Based on the empirical evidence, who is correct? Hint: It should depend on how you measure something.

4. On to the recovery. Show Peter Temin’s claim regarding the cure for the Great Depression using IS-LM analysis. Clearly label your points. You should have at least two points: depression (ex. 1933) and Recovery (ex. 1935 … unless you manage to get data for later years). Make this neat! This should be a separate graph.

5. Next, show Milton Friedman’s claim regarding the cure for the Great Depression using IS-LM analysis. Clearly label your points. You should have at least two points: depression (ex. 1933) and Recovery (ex. 1935 … unless you manage to get data for later years). Make this neat! This should be a separate graph.

6. Based on the empirical evidence, who is correct? Hint: It should depend on how you measure something.

7. Learn from Peter and Milton. Make sure this issue never comes between you and a loved one. Know how to handle and analyze this issue.

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1 Ideally, you would be looking at the years 1933 – about 1941. However, our “Meet the Great Depression” handout does not go this far.