THE GREAT DEPRESSION OF THE 1930S: WHAT WENT WRONG?

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> *"...when we went down to check on the bank, there were hundreds of people out front yelling and crying and fighting and beating on the locked doors and windows. They had fires built in the street to keep warm and there were people milling around all over the downtown. Anybody that thinks what we are going through now is a depression don't have a clue of what a real depression is,"*[2]

It was a Thursday, when people of the United States of America realized that their savings in their trusted banks were at risk. The market was dipping lower and lower by the day; unemployment levels increasing, prices falling. The economy on the whole was crashing. It was the era of the Great Depression in the United States. It started in 1929 and continued till the advent of Second World War in 1945. In fact, the stock market regained its 1929 height only in 1954.

The author presents a literature review on the cause of the Great Depression of the 1930s. She focuses only on the economy of the United States. Initially discussing what is meant by the economic theory of depression, the paper thereafter details the start of the Great Depression. Lastly, the paper examines in great detail the views of various scholars on the factors behind the onset of the Great Depression.

THE GREAT DEPRESSION

The National Bureau of Economic Research defines depression as a "particularly severe period of economic weakness"[3] It is a prolonged recession, i.e. generally if a recession continues for more than six months, it is termed depression.[4]

In the 1920s, American economy was enjoying a boom, with Jazz culture, smoking, drinking, new inventions, automobiles, and women in short skirts etc. Businesses were making huge profits and were flourishing under the Presidential administration of Harding and Coolridge. But happy days don't last

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[2] Jeremy Kutner, Those who lived through the Great Depression tell their stories (The Christian Science Monitor, 12 May, 2009) <http://www.csmonitor.com/Business/2009/0512/those-who-lived-through-the-great-depression-tell-their-stories> accessed 4 March 2014

[3] 'Defining An Economic Depression' (Economic greenfield, 30 November 2011) http://www.economicgreenfield.com/2011/11/30/defining-an-economic-depression/> accessed 5 March 5, 2014

[4] 'Definition of Depression' < http://economictimes.indiatimes.com/definition/depression> accessed 6 March 2014

long. There were a series of Black days for the United States of America in October 1929, when the Wall Street crashed, causing losses to several thousands of Americans. It started on 24 October 1929, the Black Thursday, when the stock fell by 11 percent. The following Black Monday, the market slid down by 13% and 12% on the Black Tuesday when about sixteen million shares were traded.[5] But the worst was yet to come. In next three years, the market dipped by about 89%.[6] The American economy plunged into the biggest financial crisis they had yet seen. It was the worst depression in the history, thereby rightly called the Great Depression. There was deflation of prices, chronic unemployment was rampant, and output decline was horrendous.[7] The Great Depression, though originated in United States, was not confined to its boundaries. Countries all over the world were affected, including all major countries of Europe, Australia, Canada, Thailand and even India. Such world-wide demolition of economies was never seen before. People lost their jobs, their homes, their money; many starved.[8] Poverty struck hard. People didn't have enough to feed their children and even have a roof over their head. Great Depression was an era of chaos and trouble in the history of United States.[9]

DISSENT BETWEEN ECONOMISTS

A survey of 178 economists was undertaken by Robert Whaples, which was published in the year 1995.[10] Their views were noted on forty propositions, one of which was the cause behind the Great Depression of 1929. For this, seven different answers were procured from these economists.[11] The causes behind the Great Depression are hotly debated among the economists, and different economists give different theories for the same. Views range from the depression resulting because of climatic factors, to death of Benjamin Strong. The approaches of some eminent economists are discussed below.

Richard Salsman and Lee. Ohanian:

Renowned American economist, Richard Salsman directs the cause of Great Depression to the economic expansion and contraction as a result of contrasting governance tactics of different Presidents of the

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[5] Niall Ferguson, *The Ascent of Money: A financial history of the world* (Penguin Books, 2008)
[6] ibid.
[7] ibid.
[8] ibid.
[9] Neenah Ellis, 'Survivors of the Great Depression tell their stories' (NPR, 27 November 2008) <http://www.npr.org/templates/story/story.php?storyId=97468008> accessed 5 March 2014
[10] Robert Whaples, 'Where Is There Consensus Among American Economic Historians? The Results of a Survey on Forty Propositions' (March 1995) 55(1) The Journal of Economic History < http://www.jstor.org/stable/2123771> accessed 3 March 2014
[11] ibid

United States.[12] Warren G. Harding was the President of United States from 1921-1923 and Calvin Coolridge from 1923-1929.[13] Under their governance, there was an increase in the real per capita personal income by 38%, life expectancy by 10%, real wages, and a spectacular increase in the stock prices by 385%.[14] Thus, in general, the US economy in 1920s was a happy and blooming one.[15] In a blatant contrast, during 1929-1945, under the administration of President Hoover and President Roosevelt, the economy tumbled, causing one of the biggest economic falls in the history of US. Stock price fell by 88% in 1932.[16] Thousands of banks went bankrupt. Unemployment rate sky rocketed.[17] The economy plunged into a depression. Salsman refers to President Hoover as a "typical Progressive whose beliefs were infused with the corrupt philosophical notions of Marx, Hegel, Kant, and Dewey."[18] Hoover's first assault on capitalism was in 1929, when he persuaded the businessmen not to lower the wage rates, even when their profits were declining, so as to not infringe on consumer's "purchasing power".[19] This, however, resulted in a rapid increase in unemployment. After this came the Smoot-Hawley Tariff Act, 1930 which increased the tariff rates on imported goods by four times.[20] Further harm was done by Glass-Stegall Act, 1932, separating investment and commercial banking, and Norris LaGuardia Act, 1932, which intensified the standing of labor unions.[21] Farmers and businessmen alike were swamped by the corrupt policies of President Hoover. The lowest point of the Great Depression was in 1933, when President Roosevelt entered the office.[22] His policies further damaged the already suffering economy, when he did away with the gold standard system, curbed production, increased tax rates, and spent furiously on public works projects.[23] Thus, Salsman blames the rule of Presidents for the Great Depression. A similar theory was developed by Lee E. Ohanian, who criticized the policies of President Hoover. He theorized that Hoover's industrial labor program, wherein he presented his plan to deal with an upcoming recession with businessmen and asked them not to lower the wage rates.[24] This coupled with weak labor unions, led to contraction in the economy.[25]

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[12] Larry J. Sechrest, 'Missing the Mark: Salsman's Review of the Great Depression' (2008) 9(2) The Journal of Ayn Rand Studies <http://www.jstor.org/stable/41560363> accessed 3 March 2014
[13] ibid.
[14] ibid.
[15] ibid.
[16] ibid.
[17] ibid.
[18] ibid.
[19] ibid.
[20] ibid.
[21] ibid.
[22] ibid.
[23] ibid.
[24] Lee E. Ohanian, 'What - or Who - Started the Great Depression?' UCLA and Federal Reserve Bank of Minneapolis <http://www.econ.ucla.edu/people/papers/Ohanian/Ohanian499.pdf> accessed 2 March 2014
[25] ibid

Irving Fisher:

According to Irving Fisher, a leading American economist of 19th century[26] over- indebtness and subsequent deflation were the primary triggers for the Great Depression. "Attempts to liquidate debt in the context of over-indebtedness slow down the velocity of circulation and increase the incidence of bankruptcy, thereby reducing the level of aggregate demand and price."[27]As banks try to pay off the debts, the money supply falls, causing deflation in the economy. According to Fisher, the economy was in equilibrium, even if an unstable one, but was suffering from heavy debts. A minor shock, by fall of stock prices was enough to startle the people and cause the "first wave of liquidation of debts."[28] This scenario was aggravated by a deflation, setting into motion an "almost universal bankruptcy". In United States, as there was an economic boom in the 1920s, there were "technological innovations" and increase in profits, inducing businessmen to borrow money from financial institutions.[29] This caused the indebtness in the 1930s, and the subsequent deflation initiated the Great Depression.

John Maynard Keynes:

John Maynard Keynes, in his revolutionary book *The General Theory of Employment, Interest and Money*, released in 1936, put forth his theory behind the Great Depression. He found a crack in the classical macroeconomics theory.[30] The classicists theorized the Say's law, i.e., supply creates its own demand. This however, was disproved after the Great Depression, when there was mass unemployment and according to Say's law, in situation of mass unemployment, new jobs would be created to employ people. This did not happen in case of the Great Depression. Keynes' ideas transformed the general thinking of economists. Keynes blamed the Great Depression on the central bank for keeping the interest rates too high. Keynes reasoned that after the World War I, population growth slowed down. As a result of this, capital exceeded the population, and the marginal efficiency of capital and the profit began to tumble.[31] Now, equilibrium occurs when the marginal efficiency of capital equals the interest rate. As the former had plunged after the First World War, full employment equilibrium could have been maintained

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[26] Giovanni Pavanelli, 'The Great Depression In Irving Fisher's Thought' (2001) University of Toronto < http://web.econ.unito.it/prato/papers/qd57.pdf> accessed 5 March 2014

[27]Michael Assous, 'Irving Fisher's Debt Deflation Analysis: From The Purchasing Power Of Money (1911) To The Debt-Deflation Theory Of The Great Depression (1933)' < http://www.univ-paris1.fr/fileadmin/UFR02/RI/papiers_caire/Micha%C3%ABl_Assous_-_Irving_Fisher_s_Debt_Deflation_Analysis_.pdf> accessed 5 March 2014

[28] ibid.

[29] Giovanni Pavanelli, 'The Great Depression In Irving Fisher's Thought' (2001) University of Toronto < http://web.econ.unito.it/prato/papers/qd57.pdf> accessed 5 March 2014

[30] ibid.

[31] ibid.

by lowering the interest rates too.[32] But as the central bank did not take this course of action, the economy remained at equilibrium with high rates of unemployment.[33] Keynes also wrote that an increase in the interest rates makes it costly to borrow money, and thus the businesses invest less. Less investment means less savings as per the Investment- Savings identity, and less savings for people implies that people have lower incomes as savings is what is left of income after the consumption expenditure.[34] This fall in the investments and savings, led to a reduction in the aggregate demand, and a slowdown in the economic activity.

Alvin Hansen:

Alvin Hansen, often called the "*American Keynes"* proposed a theory marking a relationship between population decline and the onset of the Great Depression.[35] He says that "the widening of capital is a function of an increase in final output, which in turn is due partly to an increase in population and partly to an increase in per capita productivity, arising from causes other than a larger use of capital per unit of output." The rate of population determines the nature of output. For example, a rapidly growing population group would demand more residential buildings. Thus, any shift in the population trend will alter the "composition of final flow of goods." An increase or decrease in the population growth can adversely affect the capital formation, and it was this decline in population after the First World War that eventually led to the Great Depression.

Friedman and Schwartz:

In 1963, Friedman and Schwartz released a book *Monetary History of the United States* proposing a theory for the causation of the Great Depression which starkly contrasted with that of John Keynes. They talk about monetary shocks, which they define as "any movement in money that is unusual given the economic circumstances."[36] Friedman and Schwartz write that there were both endogenous (as a result of decrease in discount rates) and exogenous (banking panics) money shocks.[37] Scholars have interpreted these money shocks, i.e. decrease in the money supply through the simple IS-LM model, wherein LM curve shifts leftwards and results in a fall in the interest rates.[38]They blame the central bank of the United

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[32] ibid.
[33] 'The Ideas of John Maynard Keynes'
[34] 'A Summary/Explanation of John Maynard Keynes' General Theory' <
http://www.aaronsw.com/weblog/generaltheory> accessed 4 March 2014
[35] Alvin Hansen on Economic Progress and Declining Population Growth (2004) 30(2) Population and Development Review <http://www.jstor.org/stable/3401389> accessed March 6 2014
[36] Milton Friedman and Anna Schwartz, *A Monetary History of the United States* (Princeton University Press, 1963)
[37] ibid.
[38] Christina D. Romer and David H. Romer, 'The Missing Transmission Mechanism In The Monetary Explanation Of The Great Depression' (2013) University of California <

States, the Federal Reserve, or the Fed for standing as a spectator to the bank failures happening all around the country.[39] These bank failures, or bank runs, i.e. when people run to liquidate their money from banks[40], result in low money balance with the banks, as banks do not keep all the money of the people in liquid cash.[41] Thus, the banks are not able to satisfy all the people who come to liquidate their deposits.[42] Friedman and Schwartz argued that the Fed should not have been a bystander to this havoc caused and could have taken steps to freeze the 'bank run' in its initial stages.[43] It could have bought the banks' bonds, thus eliminating the money shortage problem of the banks.[44] However, the Federal Reserve did no such thing. Friedman and Schwartz suggest that such behavior of Fed may be because of the ongoing politics between the state Federal Reserve Board and the regional Feds; or because the Fed did not understand the full consequences of the bank failures; or the Fed prioritized their own interest before the interest of the general public.[45]

Gerald Epstein and Thomas Ferguson:

Gerald Epstein and Thomas Ferguson, in 1984 also blamed the Federal Reserve for the Great Depression, claiming that the Federal Reserve failed to act for the benefit of people and instead worked only towards prosperity of the banking industry.[46] The monetary expansion policy of the Federal Reserve which was introduced in January 1932 was reversed in July 1932, which is what "set the stage for complete financial collapse of the United States in early 1933."[47] According to Epstein and Ferguson, the expansionary monetary policy led to a fall in the interest rates.[48] This can be explained by a simple chain flow: an expansion in the monetary policy caused an Excess Supply of Money, which in turn causes an Excess Demand for Bonds as people would like to convert their money into bonds.[49] As a result, there will be a rise in the price of bonds, and a subsequent fall in the interest rates, as interest rate is inversely related to

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http://emlab.berkeley.edu/~dromer/papers/Romer%20and%20Romer%20Working%20Paper%20Draft.pdf > accessed 2 March 2014

39 ibid.

40 Ivan Pongracic, 'The Great Depression According to Milton Friedman' (The Freeman, 1 September 2007) http://www.fee.org/the_freeman/detail/the-great-depression-according-to-milton-friedman#axzz2v74Hi9hv accessed 5 March 2014

41 ibid.

42 ibid.

43 ibid.

44 ibid.

45 ibid.

46 Gerald Epstein and Thomas Ferguson, 'Monetary Policy, Loan Liquidation, and Industrial Conflict: The Federal Reserve and the Open Market Operations of 1932 (1984) 44(4) The Journal of Economic History http://www.jstor.org/stable/2122114 accessed 5 March 2014

47 ibid.

48 ibid.

49 ibid.

the price of bonds.[50] This fall in interest rate adversely affected the banks of United States.[51] Epstein and Ferguson argue that the gap between the introduction and reversal of this policy, i.e. the gap between January 1932 and July 1932 was unreasonable, and the Federal Reserve should have realized earlier the impact this policy would have on the banks.[52]

Joseph Stiglitz and others:

Joseph Stiglitz, receiver of Nobel Memorial Prize in Economic Sciences, and Bruce Greenwald refer to the Great Depression as the "Long Slump" blames it on a downfall of aggregate demand as a result of increased productivity. The prices fell, making farmers go bankrupt, and rush to banks. The banking industry thereafter also fell.[53]

Another school of thought argues that the protectionist policies adopted by different countries resulted in the Great Depression.[54] The countries that abandoned the gold standard policy suffered relatively mild recessions than the countries that continued with the gold standard policy.[55] The former could have a free monetary policy wherein they could also cut down on the interest rates, as they had advantage from the inflows of gold.[56] On the other hand, the countries which did not abandon the gold standard policy had use restrictive trade policies.[57] They suffered from gold losses and had to use protectionist measures to control it.[58] United States was one of the countries who did not abandon the gold standard and had to move towards restrictive trade policies.[59] In this interest, the Smoot- Hawley Tariff Act was passed which increased the import duties. This caused resentment in the countries that traded with the United States, and exports to US declined considerably thereafter.[60]

A school of thought on the causes behind the Great Depression propagated that the death of Benjamin Strong resulted in such a severe depression.[61] This view is supported by Friedman and Schwartz and

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[50] ibid.
[51] ibid.
[52] ibid.
[53] Robert Teitelman, 'Stiglitz explains the Great Depression' (The Deal, 20 December 2011) <http://www.thedeal.com/thedealeconomy/stiglitz-explains-the-great-depression.php> accessed 6 March 2014
[54] Barry Eichengreen and Douglas A. Irwin, 'The Slide to Protectionism in the Great Depression: Who Succumbed and Why? <http://www.dartmouth.edu/~dirwin/Eichengreen-IrwinJEH.pdf> accessed 4 March 2014
[55] ibid.
[56] ibid.
[57] ibid.
[58] ibid.
[59] ibid.
[60] ibid
[61] David C Wheelock, 'Monetary Policy in the Great Depression: What the Fed Did, and Why' <http://research.stlouisfed.org/publications/review/92/03/Depression_Mar_Apr1992.pdf> accessed 3 March 2014

Irving Fisher.[62] Benjamin Strong was the governor of Federal Reserve Bank of New York until he died in 1928.[63] It is claimed that Strong had developed policies to make the price level stable, preventing fluctuations in the same.[64] He was a "strong and forceful leader."[65] Had Strong been alive during the depression period, he would not have stood as a bystander and see the banks fall and Friedman and Schwartz blame the Fed did.[66]

CONCLUSION

Acknowledging and researching on the causes behind an event, especially one as important and grave as the Great Depression is very significant in order to avoid any future similar event. Despite multitude of scholars having researched on what prompted the Great Depression, there has been no unanimous conclusion. However, what is clear from all the discussion is that the Great Depression or the Long Slump of the 1930s could have been prevented by the government and the bankers of the United States, had they foresaw the consequences that the mild recession in 1920s brought. The Great Depression continued up to the advent of the Second World War, at the end of which, the United States regained its prior prosperity.

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[62] ibid.
[63] ibid.
[64] ibid.
[65] ibid.
[66] ibid.