# The Great Depression - Revisited

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## Abstract

*The present global crisis is showing the sign of slow recovery with more volatility. The present crisis makes few of us to remember the Great Depression. After more than eighty years there is still no general consensus on this question, what caused the Great Depression? For some the cause was primarily Monetary – a drastic decline in quantity of money in the major industrial economy. The Great Depression is well known for its severity. It lasted for a decade from 1929-1939. It began in 1929 with Stock Market crash in United States of America (U.S.A / U.S.) which slowly spread across the globe. It is important at this juncture to know the reasons of Great Depression so that the current Crisis may be handled with more care. This paper made an attempt to explain the exact reasons for the Great Depression of 1929.*


**Keywords**: Great Depression, Stock Market Crash, Black Tuesday, Bank Panic and Monetary Policy

## *Introduction*

The present global crisis is showing the sign of slow recovery with more volatility. The present crisis makes few of us to remember Great Depression. After more than eighty years there is still no general consensus on this question what caused the Great Depression? For some the cause was primarily Monetary – a drastic decline in quantity of money in the major industrial economy.

The Great Depression is well known for its severity. It lasted for a decade from 1929-1939. It began on black Tuesday[1], 29$^{th}$ October, 1929, with a sudden Stock Market crash in United States of America (U.S.A / U.S.). The Market crash in U.S.A. affected the economy as a whole. Many economists believed that the market crash had the effect on the economy; they also believed that the market crash had happened due to artificial speculation and Mismanagement.

There are various reasons for the Great Depression. Let us look at them one by one.

1. **Gold Standard System**

Many economists believed that Gold Standard system is solely responsible for Great Depression. They believe that it is also responsible for market crash.

In 1929, the United Kingdom (U.K.) (presently known as England) withdrawn / abolished gold standard system. They moved from their gold standard system to Fiat Money system. At the same time, there was only one country in the world which followed the Gold Standard system, which is U.S.A. When U.K. moved from Gold Standard System to Fiat Money System they also lowered interest rate. Since U.K. have lowered Interest Rate and moved to Fiat Money system many investors moved their investment to U.S.A which had gold standard system in order to gain more from their investments.

This movement of investments from U.K. affected their economic growth rate, it lowered by 1%. In order to attract Foreign Investment and to accelerate the growth rate, U.K. hiked their bank interest rates from 1.5 % to 6 %. This attracted the investors to move their investments to U.K. which made the U.S. stock market crash. Due to stock market crash investors were afraid to invest in market. They lost the confidence in the market; so, they saved their money in the bank even though the interest rates were very low.

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[1] Due to the crash, the day is famously known as Black Tuesday.

### Is Gold Standard System is only cause of Great Depression?

The answer is NO. Many economists earlier believed that Gold Standard System is the only cause of Great Depression in the U.S. But the fact is United States Federal Bank have failed to control credit and money supply from 1929 to 1933.

Blaming the Gold Standard system for Great Depression lacks sufficient (or) substantial evidences. The Great Depression has substantial monetary manipulations of the Federal Reserve System in 1920's and 1930's.

As Rothbard[2] and many other documented that the money and credit supply was substantially increased between 1924 and 1929 by the Federal Reserve; which then presided over contraction of money supply by one-third between 1929 and 1933. This mischief's are at the hands of government. It is the monetary authority who played a vital role for economic "Great" Depression.

**2. Bank Panic**

Another vital reason for economic "Great" Depression is bank panic. The Austrians and Monetarist agree that the actions taken by the Federal Reserve System in 1928 and 1929 to raise the Discount rate and reduce in the rate of growth in the Money Supply initiated the decline in economic activity and the subsequent market crash. The Austrian would also add this behaviour by the Federal Reserve and the subsequent declines were inevitable result of the system's prior monetary policy of expanding the money supply in the 1920's.

In September 1931, Britain, after a prolonged period of Balance-of-Payment deficit, converted from a system of Fixed Foreign Exchange system to Flexible Foreign Exchange System. The Board of Governors of Federal Reserve System fearing that this action by the British would cause a gold outflow from the United States, which, resulted in raise in discount rate in October 1931 more sharply than ever before to prevent the anticipated gold outflow. This action precipitated in a contraction in both real money supply and nominal money supply and caused a banking panic. This resulted in the suspension of operation of 1, 860 U.S. commercial banks between August 1931 and January 1932. Banks remained in operation greatly reduced loans and sold assets to increase their ability to withstand another banking panic.

### Does increase in Money Supply – A right Move?

In 1920's Fed inflated money supply by about 60 %. If the fed had been little careful in expanding money supply, then it might have prevented artificial stock market boom and subsequent crash. In 1929 Fed hiked the interest rate which is a wrong move. In early 1931 there was another rise in interest rate at the time of contraction phase, another ridiculous move by the Fed.

3. **Hoarding Money**

During and before Depression people hoard money because they aimed for liquidity preference .i.e. People want to have their Asset in the Form of Money. Hoarding is not saving money it's different from saving. When people save money in the bank it will be lent will be used for further investment spending in the economy. Hoarding means "to store secretly for the future use".

Keynes says that "There are many possible explanations why people hoarding money. It may be a consumer loss of confidence in the economy, perhaps, triggered by a visible event like market crash"

In 1929, hoarding money is one of the causes of great depression. Since U.S.A was the only country which followed Gold Standard system the hoarding of money affected the U.S.A. severely. Rothbard asserts that the Federal Reserve purchased $1.1 billion of government securities from February to July 1932 which raised its total holding to $1.8 billion. Total bank reserves only rose by $212 million, but Rothbard argues that this was because the American populace lost faith in the banking system and began hoarding more cash, a factor very much beyond the control of the Central Bank. The potential for a run on the banks caused local bankers to be more conservative in lending out their reserves, and, Rothbard argues, was the cause of the Federal Reserve's inability to inflate.[3]

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[2] Murray Newton Rothbard (Austrian Economists) in his Book: "**America's Great Depression**" (1963).

[3] Rothbard, A History of Money and Banking in the United States, pp.293-294.

### *Is hoarding Money is a Main reason?*

If a country has a gold standard system, then hoarding money can reduce money supply drastically; since gold standard system makes the quantity of money, it is difficult for the governments to control it. Since, it is not easy to determine money supply in the economy; it is not easy to say whether hoarding money is main reason for the Great Depression.

4. **Malinvestments**

The term "Malinvestment" was first used by Austrian Economist. The Austrian Economist termed this concept for using the available money/ resources in wrong area of Investment. An Investment in wrong lines which leads to capital losses. Malinvestment results due the inability of the investors to foresee correctly, at the time of investment. They may have misjudgements' in the future pattern of consumer demand (or) the future availability of more efficient means for satisfying a correctly foreseen consumer demand. Malinvestment is always the result of the inability of human beings to foresee future conditions correctly[4].

Austrian Economists blame that Federal Reserve Board that fed have lowered the interest rate in order to increase the money supply in the economy. The Fed made a wrong move which created malinvestments in the economy that led to the "Great Depression".

Hazlitt another Austrian economist explains that "artificial cheap-money policy pursued both in England and America, leading here to a colossal real-estate and stock-market speculation under the benign encouragement of Messrs. Coolidge and Mellon." This malinvestment, caused by inflationary policies, created distortions in the capital stock that called for correction. Later Hazlitt went on to conclude that malinvestment was the central problem, not only in the Great Depression, but in all business cycles.[5]

### *Does Malinvestment is a good strategy?*

No, it cannot be a good strategy at any place and under any circumstances. If the Fed would have been little cautious and foreseen the things profundity then they would have saved their economy from Great Depression.

5. **Income Inequality**

The large and growing disparity of wealth between the well-to-do and the middle income citizens made the United States economy unstable. In *The Great Depression: An International Disaster of Perverse Economic Policies*, Hall & Ferguson write that:

Wages grew more slowly than output per worker, which suggests that corporate profits were rising. This change shows up as rising dividends, which constituted 4.3 percent of national income in 1920 and rose to 7.2 percent of national income by 1929 (Soule 1947, 284). Since 82 percent of all dividends were paid to the top 5 percent of income earners, this clearly helped contribute to the change in income inequality" (Potter 1974) and:

But critics of that view contend that increase inequality of income and wealth is an unlikely candidate to cause an economic decline on the order of the Great Depression. Their criticism of the underconsumptionist view is that it ignores an obvious adjustment mechanism; if deficient demand for goods and services is caused by unequal distribution of income, then the price level would fall to cause the quantity of goods and services demanded to rise. Underconsumptionists respond that prices could not fall because of various rigidities built into the economic system (see, for example, Strikcer 1983-84).[6]

Paul Alexander Gusmorino III in his book expressed that "A major reason for this large and growing gap between the rich and the working-class people was the increased manufacturing output throughout this period. From 1923-1929 the average output per worker increased 32% in manufacturing. During that same period of time average wages for manufacturing jobs increased only 8%. Thus wages increased at a rate one fourth as fast as productivity increased. As production costs fell quickly, wages rose slowly, and prices remained constant, the bulk benefit of the increased productivity went into corporate profits. In fact, from 1923-1929 corporate profits rose 62% and dividends rose 65%."

[4] Definition and meaning from Ludwig von Mises institute website – www.mises.org
[5] The Free Market, September 1993, Volume 11, Number 9.
[6] http://www.amatecon.com/gd/gdcandc.html

### *Is Income Inequality is a Cause?*

For an economy to function properly demand must be equal to supply. In an economy with such disparity of income it is not assured that demand will be equal to supply. Essentially what happened in 1920's was that "there is oversupply of goods". It is not the surplus products of industrialised society were not wanted, but rather those who needs were not satisfied could not afford more; whereas the wealthy satiated by spending only a small portion of their income. There were very few buyers compared to the sellers. In fact in the stock market there were no buyers to buy the stocks at any prices. The oversupply of goods is one of the reasons which are due to the bad policy and economic indicators.

## *Conclusion*

These are considered as the causes of Great Economic Depression of 1930's. One may not easily able to say what is the foremost or major cause of Great Depression. But, it is clearly notified that how policies plays a vital role even for a strong economy like U.S.A. Any economy in the world should be more careful while it comes to policy framework. If an economy has a bad policy then we can say that they are definitely going to face problems. All the Macroeconomic policies (Fiscal, Monetary & Income) should go simultaneously in order to have a stable economy.

There are lots of issues still unveiled regarding Great Depression. But with the available causes and evidences we can say that U.S.A. failed to use appropriate measure to avoid the Great Depression. They failed to use or frame proper and appropriate macroeconomic policies (i.e. monetary, fiscal and income policies). This is clearly viewed from the bank panic, malinvestment and income inequality. However, it is a clear and good lesson which any nation can/should learn from the Great Depression that appropriate policies should be framed in order to have a stabilised economy.

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