Depression – What Was Then Is Not Even Close To What Is Now

Introduction

The Great Depression of the 1930s was the economic event of the 20th century. The history of the depression is fascinating because it is a reference point for economic misery and fear. When people make financial planning decisions and politicians set policy the depression experience is, or maybe should be, in the back of everyone's mind as a worst case scenario.

The depression is also interesting because, in hindsight, the downturn could have been much shallower had policy makers not made certain mistakes. Some of these mistakes have been very well researched by economists over the years and are highlighted here. There are also lessons to be had from the depression on human behavior and society in general. Lessons such as how blind and greedy we become when swept away by delusions of grandeur, only to flagellate ourselves when our dreams don't work out. And how our initial reaction to fear is to create barriers between others and ourselves resulting in added misery for everyone.

If this was an article about how we recovered from the Great Depression there would also be inspiring stories of leadership and daring generosity among all kinds of people. How facing extreme difficulties put people in touch with a wealth that was beyond their empty bank accounts. In this article though we'll focus on the economics of the downside.

What Happened?

The Great Depression began in 1929 when the entire world suffered an enormous drop in output and an unprecedented rise in unemployment. *World* economic output continued to decline until 1932 when it clinked bottom at 50% of its 1929 level. Unemployment soared, in the United States it peaked at 24.9% in 1933. It remained above 20% for two more years, reluctantly declining to 14.3% by 1937. It then leapt back to 19% before its long-term decline. Since most households had only one income earner the equivalent modern unemployment rates would likely be much higher. Real economic output (real GDP) fell by 29% from 1929 to 1933 and the US stock market lost 89.5% of its value.

Another unusual aspect of the Great Depression was deflation. Prices fell 25%, 30%, 30%, and 40% in the UK, Germany, the US, and France respectively from 1929 to 1933. These were the four largest economies in the world at that time.

To put the severity of the depression in modern perspective, consider the following. Real US GDP went down 4.4% in the five years that it declined since 1959, *all added together*! Unemployment has never exceeded 9.7% and we have not had one year of deflation. Maybe you're thinking, "what's wrong with a little price deflation?" Depending on how much and how unexpected, deflation can be a devastating economic event. Imagine wages falling by 30% and the value of debts simultaneously increasing by that much.

In the great depression it would have been nice if the suffering had been so evenly distributed. Instead the deflation caused bankruptcies, which in turn led to, more bankruptcies! Millions of people and companies were wiped out completely. The lack of adequate social programs left people of all social strata depending on relatives and friends for charity. Spending became paralyzed with fear as the downturn was so unexpected, so severe, and the bad news just kept coming for years.

Many did not realize how severe the downturn was until 1932 or 1933 when the economy had technically hit bottom and even begun to chug forward. People's resources were depleted by then and so were many of their friends'. So the human misery caused by the Depression really started in the mid-1930s.

The political backlash to the miserable economic situation is often blamed for toppling democracies, bringing fascist governments to power in Germany, Italy, and Japan, and ultimately provoking the Second World War. "Hitler's rise to power can be directly linked to the profound economic crisis in Germany at that time". The German economic crisis was compounded by the huge war reparations imposed upon the Germans following World War I (an interesting comment on the efficacy of economic sanctions!).

What Caused the Great Depression?

There are several explanations for what happened but the most obvious conclusion is that it was the confluence of several shortsighted and commiserating factors. Three main themes emerge: historical factors, central bank policies, and political decision making. For the purposes of this discussion the focus will be on the United States.

The US in the 1920's: Buying into the Boom

The 1929 stock market crash marked the beginning of the Depression. Prior to the crash the stock market had been an important source of funding for industry; thus the crash itself was a contributing factor to the downturn as well as a harbinger of things to come. Since stock prices are based on estimates of future earnings potential, the stock market performance of the 1920's tells a story of runaway optimism for the future. When it peaked a few weeks before the crash, The Dow Jones had risen 597% over the previous 8 years. It was soon to become a symbol of runaway pessimism.

The freeing of capital from government use to commercial use following World War I caused commodity prices to inflate. In 1920, Ben Strong of the US Federal Reserve Bank of New York raised interest rates sharply to prevent inflation. This caused a recession and the stock market to fall. Once hard assets like commodities and real estate were no longer rising in price, money began to pour into stocks and bonds. The Dow started climbing from its low at 63.90 in 1921 and rose 150% over the four years to 1925.

According to Ron Chernow, in "The House of Morgan", It was in 1925 that Ben Strong made a secret commitment to Montague Norman, Governor of the Bank of England, to help England reinstate the Gold Standard. This action would later be shown to have undermined the British economy but the Pound had been the main medium of international exchange at that time and it was felt to be in everyone's interest to have it be exchangeable for gold. With moral support from the US Treasury, Strong chose to help strengthen the value of the Pound by depressing US interest rates. This depressed the value of the US Dollar and caused the already robust economy to boom.

It was suddenly cheaper to borrow money to invest in the stock market (called margin investing). Since the Dow had risen steadily since 1921, "small investors leapt giddily into the stock market in large numbers". The margin requirement at that time was only 10%, meaning you could buy $10,000 worth of stock with only $1,000 down, borrowing the rest. With artificially low interest rates and a booming economy people and companies were more apt than ever to invest in grandiose business expansions and over-priced stocks. Mergers and acquisitions soared.

In 1927, Britain ran into trouble with its gold standard again and Ben Strong lowered US interest rates in sympathy for a second time. This ignited the boom into the speculative frenzy that brought the market to its peak on September 3, 1929. It was like pouring gasoline onto a fire - the flames rose up, no lasting fuel was added, but the economy sure *looked* great.

Ben Strong died in October 1928. George Harrison, his successor immediately lobbied for higher interest rates to cool the speculative fervor. Rates were finally raised 1% in August of 1929, but by then it was way too late. The Dow peaked at 381.17.

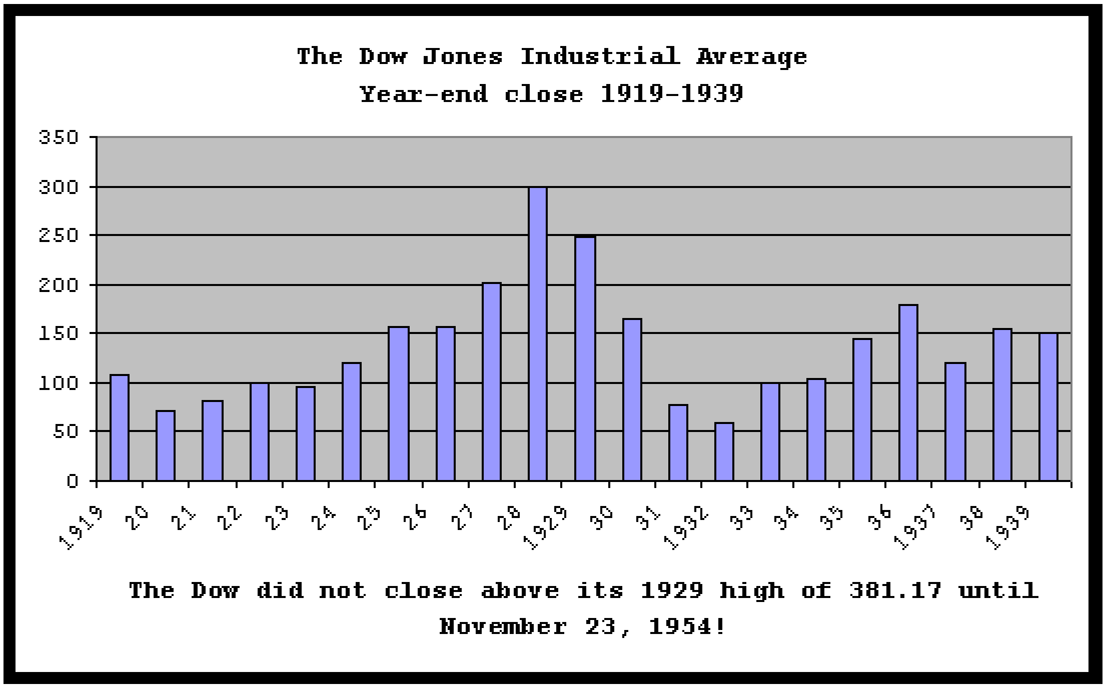
The market and the economy had buoyed itself from one source of hope to the next for a whole decade. First it was the end of war-related inflation and booming exports for war reparations, next artificially low interest rates in 1925 and 1927 and booming exports due to a reduced value of the Dollar vs. the Pound. There were major tax reductions instituted by the Republicans under Hoover and finally in June of 1929 an international accord was struck with the Germans (albeit short-lived) over the financing of war reparations, a major issue of the decade.

By Monday, October 28, 1929 the Dow had fallen 20% to 300. It fell 40 more points that day and another 30 on Tuesday (Tragic Tuesday) to reach a temporary bottom at 230.07. It was down 40% from the peak 56 days earlier.

George Harrison bravely stepped in to provide tremendous amounts of credit to the banking system. This action prevented immediate bank failures and bankruptcies and a total collapse. The market recovered a good bit of ground but began to fall again before year-end. By mid-1930 this liberal credit policy was to be reversed affecting the money supply crisis discussed below.

In early 1930, there were 60 bank failures per month in the US but when the Fed tightened its purse strings, things got much worse. 254 banks failed in November and 344 in December of 1930. Among these was the Bank of the United States, with 450,000 depositors it was the fourth largest bank in New York. Although it was a private bank, "The biggest bank failure in American history, the Bank of the United States bankruptcy fed a psychology of fear that gripped depositors across the country."

In spite of further tax cuts, public works programs and optimistic speeches, spending and thus economic activity just kept going down. The stock market would make temporary recoveries, sucking buyers in, only to free fall again. The Dow finally hit bottom at the level of 41.22 on July 8, 1932, 10.5% of its peak three years prior.



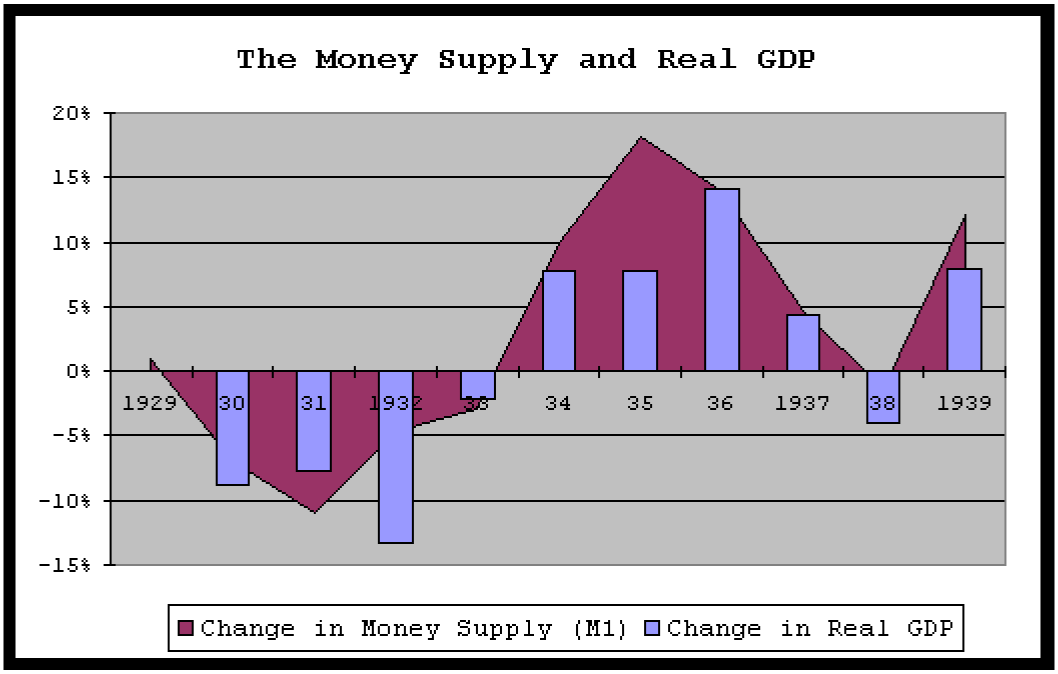
Interestingly, various bankers, government officials, and academics chose this three-year period to expound righteous advocacy of personal, corporate, and governmental frugality and restraint. "Leadership" that was so lacking when it could have helped in the frenetic 1920s. John Maynard Keynes, the famous British economist whose economic stabilization theories would greatly influence the recovery in years to come, however, warned such austerity would only deepen the depression. As we will see, truly it did.

Central Banking Delusion: A Sharp Reduction in the Money Supply

Milton Friedman and Anna Schwartz argued in their book "A Monetary History of the United States, 1867-1960," that the highly conservative monetary policy followed by the Fed beginning in 1930, completely failed to counteract the tidal wave of bank failures in the early 30's.

Simply put, when a bank fails a large amount of money disappears from the economy, which has a depressing effect on prices and a stagnating effect on business activity. Depositors were not insured at that point, many losing all their savings. Business customers also lost their money and could not finance their activities; thus everyone linked to the bank or its customers was economically paralyzed in one way or another, including other banks!

It is generally agreed today that the "money supply", which refers to the total amount of money circulating in the economy, should grow at the same rate that the economy grows. Any faster is inflationary and any slower is deflationary. When a bank fails the Fed has the option to either bailout that bank by lending it money or to lend more money to other banks to fill in the shrinkage in the money supply. Otherwise the amount of money in circulation shrinks and the economy limps along like a person parched for water.



The Fed had allowed the money supply to grow at the annual rate of 2.7% from 1921 through 1929, slightly slower than the economy grew over that period, thus the economically booming 1920's was a period of price stability and even modest deflation. Between 1930 and 1933 the Fed refused to replenish the banking system sufficiently, even though the money supply was shrinking due to hoards of bankruptcies and bank failures. "Many at the Fed saw the austerity as a bitter but necessary medicine". The money supply fell 27% from 1929 to 1933 and real economic output fell 29% accordingly. Thus early bank failures led to further bank failures and bankruptcies and so on. Had the Fed been more accommodating, much of the domino effect would not have occurred.

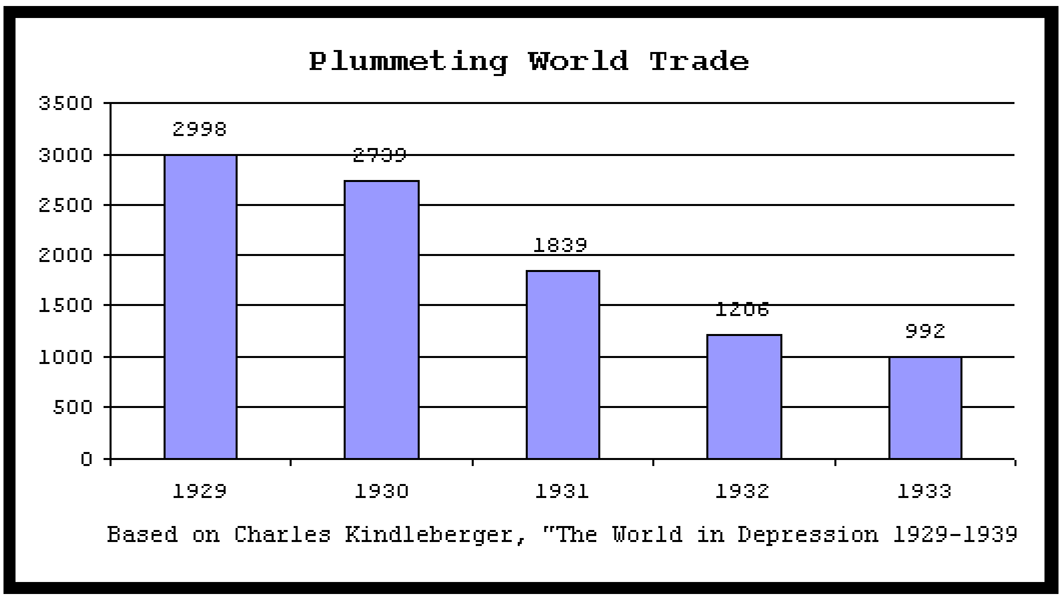
Political Faux pas

There were two important political contributions to the severity and length of the great depression. The first was the cataclysmic collapse of world trade.

The Demise of Trade

The leading industrialized nations responded to the crisis by imposing trade barriers on imports with the hopes of increasing demand for domestically produced goods and to raise revenue from tariffs. "Concerns about low agricultural prices, an influx of imports, rising unemployment, and declining tax revenue generated public sentiment for trade restraints." The Smoot-Hawley Tariff Act of June 17, 1930 responded by raising tariffs by up to 50% on a wide range of goods. Unfortunately, the resulting fall in imports created unemployment abroad that quickly invoked protectionism in response, creating unemployment back in the US!

Many fruitful trading relationships fell apart and the depressed domestic economies could not make up for them. In "The World in Depression 1929-1939" Charles Kinderberger shows that by March 1933 international trade plummeted to 33% of its 1929 level. Since there were even more communications, logistic, and financial barriers to be overcome back then than there are today, it is likely that the goods traded internationally were of great economic value and advantage to the economies that were receiving them. The loss of such trade was devastating and had ripple effects not unlike bank failures.



Ironically, even though tariff rates rose by up to 50%, imports declined so sharply that tariff revenues fell 46% from $602 million in 1929 to $328 million in 1932. This not to mention the loss of tax revenue from the domestic unemployment the tariffs caused indirectly.

Taxing Timing

Under the political thinking of the day (and since nothing else was working) the federal government decided it was morally prudent to pursue a balanced budget. As tax revenue was plummeting along with economic activity in the period from 1929 to 1932 it was only natural to raise taxes to cover the mushrooming deficit.

In 1932, Republican president, Herbert Hoover, with the support of the newly elected Democratic majority in the House of Representatives, passed the largest peacetime tax increase in the history of the United States. Marginal income tax rates were raised from

1.5% to 4% at the low end and from 25% to 63% at the top of the scale. A huge tax increase by any measure.

Some people say the timing for this couldn't have been worse because tax increases are generally associated with decreases in aggregate demand for goods and services and the incentive to earn. But the low tax rates prior to 1932 had not prevented the drop in demand to date. At that point the situation was becoming so severe that anybody that still had a job had every incentive to earn, if only to keep it. The main obstacle to demand then was probably fear of spending! If you earned money, you saved as much as you possibly could and with bank failures everywhere, you probably hid your savings under the mattress. So maybe it was just as well to pay more out in taxes because then the government could spend it for you and stimulate the economy that way. But the tax increase did take money out of people's hands that could have been spent more "efficiently" if not equitably, so it is considered to be a factor, which prolonged the downturn. Under the circumstances the government should have simply borrowed and engaged in generous deficit spending.

Conclusion

So the three main factors contributing to the severity of the Great Depression were:

1. The over-stimulated economic euphoria of the 1920s.
2. The draconian monetary policy pursued by the Federal Reserve Bank from 1930-1933.
3. The sudden rise of global protectionism leading to the collapse of world trade.
   The dramatic rise of income taxes in 1932 may have also prolonged the downturn.

There were many other factors which made the human experience much worse than it had to be such as the lack of adequate social safety nets like Unemployment Insurance, Social Security, Medicare, and Welfare programs. These programs were mostly implemented in response to the Great Depression and have well served the function of automatic economic stabilizers since. It is morbidly amusing to witness policy debate over such programs by politicians these days who have forgotten the depression. When times are good, those in need are seen as anomalous social groups and social programs become ill funded and pejorative. Perhaps it takes a Great Depression once in a while to remind us that we are all cut from the same cloth. It is just a matter of time.

"real" means adjusted for changes in the price level caused by inflation or deflation in this case

as measured by the Dow Jones Industrial Average

This quote and other background was taken from "Macroeconomics in the Global Economy", by Sachs and Larrain.

The full title of this wonderful book is "The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance" by Ron Chernow.

From "the House of Morgan"

Chernow

Chernow

This quote and other background provided by "economics: Private and Public Choice", by Gwartney and Stroup

This type of economic policy is called protectionism" with the idea of protecting domestic industries/jobs from foreign competition.

This information and other background provided by "economics: Private and Public Choice", by Gwartney and Stroup.

What the unemployment figures don't show is also how "under-employed" many people who were not on the list were likely to be.