

What Caused the Great Depression?

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Economists and historians have struggled for almost 80 years to account for the American Great Depression, which began in 1929 and lasted until the early years of World War II. The depth of this depression was unprecedented; in March, 1933, more than one quarter of willing workers in the United States were unemployed, and another quarter could find only part-time work. Although conditions improved after this low point, high rates of unemployment continued to haunt the economy for many years.

Business Cycles and the Great Depression

Depressions (or recessions) occur when there is not enough demand for all the goods and services that an economy produces. Inventories of unsold goods build up, and manufacturers cut production by laying off workers and buying less of the raw materials that they use to make their products. Service providers, from doctors to hair stylists, have fewer clients, and their incomes fall.

Most economists believe that such falling demand is a normal part of what is commonly called a “business cycle.” Demand for two kinds of goods—durable goods and capital goods—tends to fluctuate, and these fluctuations drive the cycle.

Durable goods are consumer goods that last a long time, such as automobiles, appliances, and home furnishings. Demand for such goods increases when consumers are feeling prosperous; it falls when they are not feeling prosperous. Many economists also believe that durable goods markets can be “saturated”—that there are, in other words, times when most consumers have pur-

chased the durables that they want and have no desire to buy more. At such times, demand obviously will fall.

Capital goods are goods such as factory buildings, machinery, and equipment. These are goods that are used to produce other goods. Business firms invest in such goods only when they feel that consumers will buy what is produced by the new capital goods. When that prospect seems doubtful, demand for these goods falls.

At some point in the course of a business cycle, most economists believe, demand will reverse. Durable goods eventually wear out and must be replaced. To supply new goods for consumers seeking replacements, manufacturers purchase new equipment, rehire workers, and increase their purchase of raw materials. As demand increases, employment increases. In times of peak demand in a given sector of the economy, almost every potential worker who wants a job can find one.

There is also a price dimension to the business cycle. When demand is increasing, prices tend to rise; but when demand is falling, prices normally go down, too. At the low point of the business cycle (the

“trough”), low prices create an incentive for consumers to buy more, leading the economy into recovery.

Events during the mid-1920s illustrate the high point (“peak”) of a business cycle. In these years, there was a great increase in the number of Americans who bought houses, home furnishings, appliances, and automobiles. Towns and cities were growing rapidly, and state and local governments spent money to provide roads, sidewalks, and water and sewage services. The homes of town dwellers were connected to electricity and telephone services. Spending by consumers, business firms, and state and local governments created plentiful, high-paying jobs.

In the late 1920s, demand was beginning to soften for houses and automobiles. Cities and states had completed most of the efforts they had undertaken to provide services for their citizens. In the summer of 1929, total spending in the American economy was falling, and business firms began to cut production. October’s stock market crash—signaling to shareholders that business profits would fall—probably made the recession worse. There was a loss of wealth and, as a result, people spent less, but the crash did not cause the recession.

At first, most observers thought that the recession would be temporary. Stock prices began to rise again, and the unemployed, aided by local and private charities, were assured that “Prosperity is just around the corner”—that is, the down-



At left: A crowd of depositors gather in the rain outside the Bank of United States after its failure in 1931.

(World-Telegram staff photo/Library of Congress, Prints & Photographs Division, LC-USZ62-117261)

ward trend of the business cycle would hit bottom and the economy would start to recover. But this did not happen. Total demand stayed low. Business firms continued to lay off employees, and many firms went bankrupt. Then, in 1930, banks began to fail in large numbers, wiping out the savings of potential buyers and further lowering demand. State and local relief funds were soon exhausted, and many laid-off workers and their families, who had only recently led comfortable lives, now faced hunger and even homelessness. As the economy worsened, President Franklin Roosevelt initiated a series of relief measures, but recovery under Roosevelt's New Deal was only partial. Throughout the 1930s business activity remained low and unemployment rates remained high.

Explanations for the Great Depression

Today there are three major schools of thought on the causes of the Great

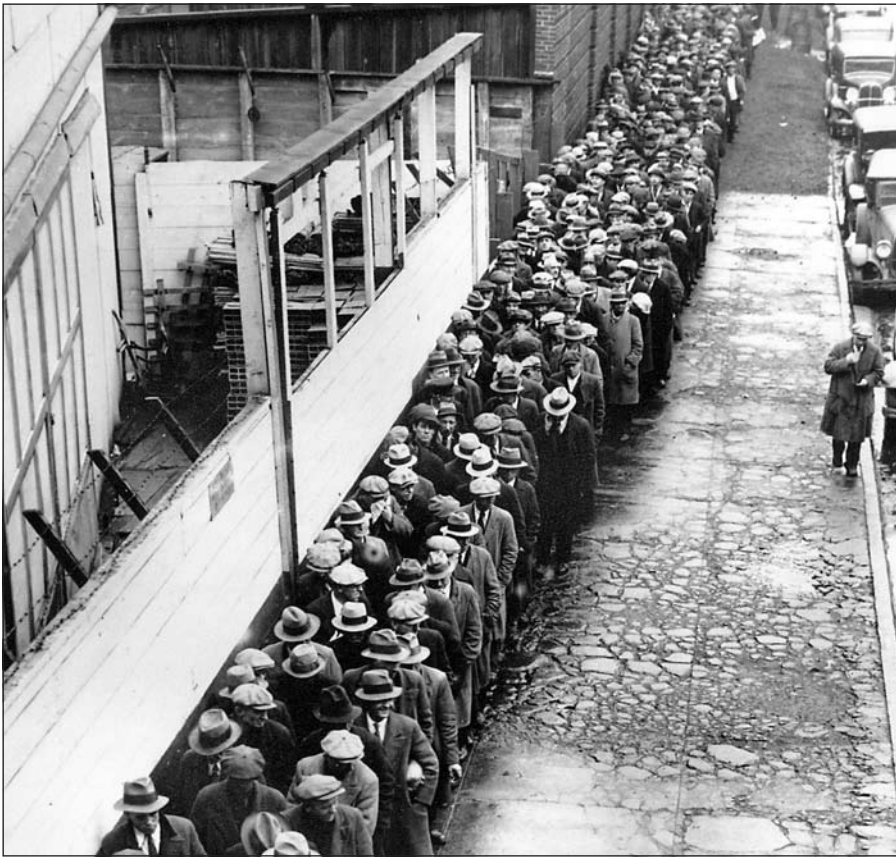
Depression and the long failure of the American economy to return to full employment.

- **The Keynesian Explanation.** The Great Depression was caused primarily by a fall in total demand. The decline in demand was so severe that adequate demand could be restored only by large increases in government spending.
- **The Monetarist Explanation.** The Great Depression may have originated in a fall in total demand, but its length and severity resulted primarily from the unwillingness of the Federal Reserve System to prevent bank failures and to maintain a large enough money supply.
- **The International Explanation.** The American depression was part of a larger global depression.

The depression was particularly severe in the United States because the Federal Reserve System was obligated to follow the rules of the gold standard.

The Keynesian Explanation

The Keynesian explanation is based on the theories of John Maynard Keynes, a British economist who, in 1936, published *The General Theory of Employment, Interest, and Money*. Keynes held that it was possible for total demand in a modern economy to remain low indefinitely, leading to long periods of high unemployment. When workers were unemployed, they spent very little; and when business firms saw large numbers of unemployed workers, they were reluctant to produce goods that probably would not be purchased. Businesses, therefore, cut production, and more workers lost their jobs. According to Keynes, the only way to create enough demand to employ the work force fully was for the



A line of jobless and homeless men wait outside to get free dinner at New York's municipal lodging house in the winter of 1932. (AP Photo)

national government to increase spending radically to compensate for the decreased spending of consumers and business firms. Furthermore, the central banking system (in the United States, the Federal Reserve System) should create new money for the national government to borrow and spend. Rather than raising taxes, the government should take steps to create a deficit by cutting taxes, increasing spending, or some combination. The Hoover administration did just the reverse. In 1932, the federal government raised taxes drastically to reduce the budget deficit resulting from the depression.

Previously, mainstream economists (generally referred to now as “classical” economists) had held that, if demand for products fell, the demand of business firms for money to finance new production would also fall. When demand for loans fell, interest rates would go down. According to the accepted economic theory, lower interest rates would encourage business firms to borrow more

and increase production, which, in turn, would employ more workers. An increase in the number of employed workers would mean more consumer spending, which would make increased government spending unnecessary.

The length of the Great Depression in the United States seemed to confirm Keynesian theory. Unemployment remained high throughout the 1930s; the unemployment rate was 14.6 percent in 1940. Under Roosevelt, government spending did increase, but by far too little to achieve full employment. Only when the American government began to increase spending in preparation for World War II did unemployment begin to fall to normal levels. In light of these developments, the Keynesian explanation of the Great Depression was increasingly accepted by economists, historians, and politicians.

The Monetarist View

In 1963, a new book challenged the Keynesian viewpoint. In *A Monetary*

History of the United States, Milton Friedman and Anna Schwartz contended that actions taken by the Federal Reserve System both caused and perpetuated the depression. The Federal Reserve System raised interest rates in early 1928, which discouraged business borrowing and spending and brought about the decline in production that began that summer. Interest rates were raised again in 1930 and 1931.

Furthermore, when banks began to fail in large numbers at the end of 1930, the Federal Reserve System did little to assist them. The Federal Reserve System had been established by Congress in 1913 for the express purpose of preventing bank failure caused by a “run” on the bank. A run occurred when many customers withdrew all their deposits in the form of cash, forcing the bank to close when all its cash was depleted. In such cases, Federal Reserve Banks were to supply banks with enough cash to meet the demands of their customers, thus preventing bank failure. But, according to Friedman and Schwartz, the Federal Reserve Banks in the 1930s refused to support banks that they thought were unlikely to repay them, forcing many basically sound banks into bankruptcy. When a bank fails, its deposits can no longer be spent; as a result, the amount of money circulating in society goes down, depressing demand for goods and services.

The Great Depression lasted for a long time, according to the monetarists (Friedman and his followers), because bankers were reluctant to make new loans after 1933. Bankers made only the safest and most conservative loans in these years because they believed that the Federal Reserve would not support them if they got into trouble. Furthermore, as the economy began to improve in 1936, the Federal Reserve System actually raised interest rates on loans, fearing inflation.

The International View

Both the Keynesian and the monetarist explanations identify the causes of the Great Depression within the framework

of the American economy. However, most nations of Europe and several Latin American and Asian countries also experienced depressions of varying severity throughout the later 1920s and the 1930s. Many of these nations, most notably Germany, began to slide into recession in 1928 and 1929, while the United States economy was still booming.

In 1992, Barry Eichengreen and Harold James published *Golden Fetters: The Gold Standard and the Great Depression, 1919-1932*. The authors placed the blame for the worldwide depression on the return of European nations to the gold standard after World War I. The gold standard, which had been adopted by most developed nations during the latter half of the nineteenth century, was a series of monetary rules that established fixed rates of exchange among nations. Each participating nation agreed to exchange a given amount of its currency for an ounce of gold. For example, the United States guaranteed to exchange \$20.67 for an ounce of gold; Great Britain exchanged £4.86 for each ounce of gold. This meant that if a British businessman wanted to buy something from the United States that had a \$100 price tag (for example, 50 pipe wrenches), he could buy gold worth 100 American dollars and exchange that gold for the wrenches. Or, more simply, he could just buy 100 American dollars at a price of 0.2058 pounds for each dollar. Since each nation that followed the rules of the gold standard was willing to exchange gold for a certain amount of currency, each nation's currency had a fixed price in terms of other currencies.

There was a domestic problem, however, for nations on the gold standard. Banks used gold as reserves to back up the loans they made. When a nation's banks lost a lot of reserves to other countries because of the operations of the gold standard, those banks had to reduce the number of loans they made. Since most of these loans were made to business firms, businesses then had to cut back on production, laying off workers and reducing supply orders. Thus a nation

that lost a large amount of gold reserves faced lower business activity and higher unemployment.

The post-World War I gold standard was, in reality, a gold exchange standard. Not much new gold was being discovered, and yet the world economy was growing. There really wasn't enough gold to back the currencies of all the gold-standard nations. Therefore, the governments of Great Britain and the United States guaranteed to accept the currencies of other nations under all conditions—they would never suspend redemption of dollars and pounds for gold. The foreign exchange reserves of many nations, therefore, consisted of gold and also of British pounds and American dollars.

Because a gold standard restrains the amount of new money that can be created and lent, and since great amounts of money were needed by the combatants in World War I, those nations temporarily went off the gold standard. By the mid-1920s, each nation had resumed exchanging its currency for gold at the same exchange rates that had existed before the war. This was a hardship for many nations, since economic relationships had changed. Some nations could not produce as much as they had produced before the war and found it difficult to produce enough exports to earn gold to back their currencies. Hardest hit were Germany, which had to pay reparations to the nations that had won the war, and the new nations formed after the breakup of the Austro-Hungarian Empire.

Problems with the gold standard first appeared in Austria, in May 1931, with the failure of that nation's largest bank, the Credit-Anstalt. Rumors that the bank was in trouble caused both foreign and domestic customers to demand their deposits in the form of Austrian currency, which they then exchanged for the gold reserves of the Austrian government. Gold, pounds, and dollars flowed out of the country for more than a month. Austrian banks did not have a basis for making new loans or renewing old ones, and this situation led to business failures and increasing unemployment. Finally the Austrian government stopped hon-

oring its commitments under the gold standard. Deposits owned by foreign customers were frozen, and Austrian citizens were strongly discouraged from removing their funds from the bank.

Panic spread then, and depositors began runs on banks in other countries. Other central European nations soon followed Austria's example. Germany froze gold exchanges, and in September, Great Britain officially left the gold standard. Foreign depositors quickly began making withdrawals from United States banks, fearing that the United States, too, would "close the gold window."

Most of the actions of the American Federal Reserve System from 1931 to 1933 can be traced to its adherence to the rules of the gold standard. Instead of abandoning those rules, as had most other countries, the Federal Reserve raised interest rates to attract foreign depositors. The increased rates did, in fact, temporarily stop the gold flow out of the country, but of course they also discouraged borrowing, leading to more business failures and more job losses. Banks failed, too, when they could not collect on loans they had made. Only after the newly elected Franklin Roosevelt abandoned the gold standard did recovery begin.

Monetarists have argued that the Federal Reserve System should not have raised interest rates to stop the outflow of gold. But other economists point out that only Congress and the president had the authority to abandon the gold standard. Only after Roosevelt substantially altered the rules of the gold standard did economic recovery begin. The Emergency Banking Act of 1933 gave the president power over foreign exchange. Roosevelt quickly prohibited Americans from owning gold, and he devalued the dollar; in effect, the United States was no longer committed to following the rules of the gold standard.

Conclusion

Apart from the events and policies cited in the three interpretations discussed above, a number of other factors contributed to the causes and continuation of the

Great Depression. The Smoot-Hawley Tariff, for example, reduced imports, but also exports. Both President Hoover and President Roosevelt instituted policies to keep prices and wages from falling, not realizing that such policies had the effect of preventing the economy from adjusting to change. Economic research continues to add to our body of knowledge about the Great Depression, even as many questions remain. An excellent source for the new research and opinion on this topic is Gene Smiley's *Rethinking the Great Depression*, published in 2002.*

We believe that teachers will find that presenting the approaches described in this article is a useful way of encouraging students to review and analyze the causes and progression of the Great Depression. Teachers might combine the elements of each approach in a single broad-based presentation introducing the Great Depression to their classes, or else outline the different approaches and

ask students what each approach seems to explain best or explain least about the Depression. Students can consider: would the Depression have been just another low point in a business cycle, or at least have been less prolonged and devastating, if the government had increased its spending? Or if the Federal Reserve had prevented bank failures and maintained a larger money supply? Or if there had been no gold standard? By examining the known historical facts and developing their own interpretations, students can further their understanding both of the history of the Great Depression and of some basic principles of economics. 📖

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There are two inserts in the center of this issue. The first insert consists of twelve pages and includes two lesson plans, the first of which accompanies the preceding article, and is titled "Whatdunnit? The Great Depression Mystery." The second lesson plan, "The U.S. Constitution: Rules of the Game," complements the opening article of this issue.

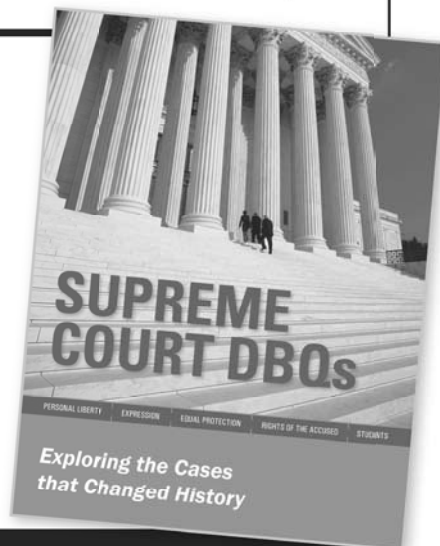
The second insert, placed by the American Bar Association, announces the upcoming Law Day (May 1, 2007), and provides a Law Day fact sheet, answers to questions, and classroom ideas for readers of *Social Education*.

Both inserts are also pull-outs.

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