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LESSON

# Whatdunnit? The Great Depression Mystery

## Description

The students read a brief passage posing the basic question about the Great Depression: Why did it happen? A brief simulation activity shows how unemployment in one part of the economy can lead to unemployment in other parts of the economy. With the aid of a visual, the teacher compares the simulation to the business cycle. The teacher then uses another visual to introduce the role of bank failures in intensifying the depression, and the students fill out a worksheet that helps them understand how the decisions of foreign and domestic banks, the Federal Reserve System, and individual depositors brought about the collapse of the American banking system in 1933.

## Mystery

The American economy went from unprecedented prosperity in the 1920s to unprecedented misery in the 1930s. It was an extraordinary reversal. Why did it occur?

## Economic History

The Great Depression of the 1930s began with falling demand for durable and investment goods in mid-1929, followed by a slowdown in business activity. The stock market crash of October 1929 reduced the assets held by many investors and consequently their willingness and ability to buy. Under normal circumstances both the economy and the stock market would probably have recovered quickly. Most politicians and economists, in fact, agreed at the time that "prosperity was just around the corner."

But demand continued to fall, business activity continued to decline and unemployment rates continued to rise until, by March 1933, unemployment stood at 28 percent of the labor force. The primary cause of this continued decline was the dramatic rise in bank failures, which led to a significant reduction in the amount of money that was available to buy goods and services. Between 1929 and 1933 there were more than 9,000 bank failures in the United States. When Franklin Roosevelt took office, 38 states had already declared "bank holidays" — suspending all banking activity to prevent bank failures.

The Federal Reserve System had been established in 1913, in part to prevent bank failures by lending reserves to banks that were experiencing unusually high cash withdrawals. On the eve of the Depression, the first concern of the 12 regional Federal Reserve Banks should have been the overall health of the financial system. But many of the regional presidents, formerly commercial bankers, hesitated to lend to banks in their districts that they considered unsound. Many banks thus were allowed to fail, and the failures caused fear among account holders in sound banks, prompting them to panic and withdraw their funds.

The Federal Reserve System also raised interest rates in late 1931, which discouraged business borrowing and contracted the money supply. Banks keep some of their reserves in the form of bonds. When interest rates rise, the prices of bonds fall; banks then hold assets that have declined in value, yielding less revenue when banks sell them to raise funds to pay depositors.

The problem the Federal Reserve Banks faced in the 1930s is that they were obliged to follow the rules of the gold standard. When gold began to flow out of the United States as a result of financial instability in foreign countries, the reserve banks raised the interest rates that their member banks had to pay to borrow reserves. This encouraged foreign governments and individuals to buy American bonds rather than exchange their dollars for American gold. But it also raised interest rates throughout the American economy, which discouraged spending by American businesses.

## Concepts

- Business cycle
- Demand
- Federal Reserve System
- Income
- Money
- Multiplier

## Objectives

Students will:

1. Analyze the relationship between decreases in consumer spending and unemployment.
2. Describe the multiplier effect that comes into play when workers who lose jobs spend less, reducing total spending and causing other workers to lose jobs.
3. Analyze the gold standard as it contributed to bank failures and a reduction in the money supply.

## Content Standards

*Economics*

- A nation's overall levels of income, employment, and prices are determined by the interaction of spending and produc-

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tion decisions made by all households, firms, government agencies and others in the economy. (NCEE Content Standard 18)

- Federal government budgetary policy and the Federal Reserve System's monetary policy influence overall levels of employment output and prices. (NCEE Content Standard 20)

*History*

- The causes of the Great Depression and how it affected American society. (Era 8, Standard 1, National Standards for History)

## Time Required

45 Minutes

## Materials Required

- A transparency of Visuals 1, 2 and 3
- A copy of Activities 1 and 3 for each student
- An Occupation Card for each student, made from Activity 2

## Procedure

**1.** Tell the students that this lesson will focus on the causes of the Great Depression. Distribute Activity 1. Invite the class to speculate on explanations of the mystery.

**2.** Explain that most economists agree that the Great Depression began with a recession caused by a fall in spending. Randomly distribute Occupation Cards made from Activity 2 to the students. Tell them not to reveal their occupations to others.

**3.** Tell the students that U.S. prosperity in the 1920s had been based to a large extent on the sale of houses and automobiles. Consumers for the first time could buy houses and cars on the installment plan, and they were eager to do so. These purchases created jobs for workers who built homes and cars, the furniture and appliances that went into new homes and the steel and other materials that were used to produce cars. Jobs were also created as business firms built new plants and bought new equipment to produce what consumers wanted. Governments built paved roads for the new automobiles and electric plants and water and sewage facilities to service the new households. The prosperity of workers in all these industries allowed them to spend a lot of money, thus providing income to other workers—income which they in turn spent to buy other goods and services. Economists call the spread of such new spending a *multiplier effect*—one person's spending becomes income to another person, who in turn can spend more and add to the income of others.

**4.** But the multiplier effect can work in reverse. By the late 1920s, U.S. business activity began to slow down as the economy entered what began as a mild recession. Sales of homes and new automobiles began to fall. Business firms slowed their expansion of new plants, causing workers who made a living building plants or producing machinery to lose their jobs.

**5.** Tell the students who received Occupation Cards in the machinery-producing industry to stand up. They are now unemployed because business firms are ordering less machinery.

**6.** Tell the students in car sales to stand up. They are now unemployed because sales of new cars are down. The car dealers who lay them off also cancel their orders to automobile factories. Owners of these factories fire autoworkers. Tell the autoworkers to stand up; they are now unemployed, too. Auto factories in turn cancel their orders for steel and other raw materials used to make cars. Tell the steel workers to stand up—joining the ranks of the unemployed.

**7.** Since sales of new houses have also gone down, tell the housing construction workers to stand up. Furniture sales are also down. Tell the furniture sellers to stand up. Furniture stores reduce orders to furniture factories. Tell the furniture workers to stand up. All these people are out of work.

**8.** Ask the students who are still seated to look around at all the people who are unemployed. The jobs of students who are still seated are now in danger too. People who are unemployed don't buy new clothes. Tell the clothing salespeople to stand up. People who are unemployed don't eat out at restaurants. Tell the restaurant workers to stand up. Unemployed people still eat, but they cut back on food purchases, particularly the purchases of more expensive food items that mean higher profits for grocery stores. Grocery store owners reduce the number of their employees. Tell the grocery store workers to stand up. All these people are out of work.

**9.** Tell the students that if people start buying again, unemployment will fall. Think about automobiles, for example. Automobiles wear out. If people decide to buy new automobiles, car dealers will place new orders. Autoworkers and producers of materials for the auto industry will be reemployed. Tell the autoworkers and steelworkers to sit down. Car dealers will hire new salespeople. Tell the car salespeople to sit down. Furniture wears out, too, and eventually some people decide to buy new furniture. Tell the furniture makers and furniture salespeople to sit down. These people are back on the job.

**10.** As more and more people gain employment again, some feel they can afford new homes. Tell the housing construction workers to sit down. People begin to buy higher-priced food in grocery stores, to eat in restaurants and to buy new clothes. Tell the grocery store workers, restaurant workers and clothing salespeople to sit down. As purchases of various new products rise, business firms expand production and buy new machinery and equipment. Tell the machinery producers to sit down. These people are back on the job. By this time, everyone in the class is sitting.

**11.** Explain that the downturn beginning in July 1929 was typical of a *business cycle*. Display Visual 1. A slowdown in business activity (a recession) begins with a fall in demand for durable goods. Durable goods are goods that are relatively expensive and don't wear out quickly, such as cars or refrigerators. Houses, although classified separately by economists, are the most expensive and the most long-lasting goods. People buy food on a regular basis and usually purchase some clothing every year, but they buy durable goods far more irregularly. Demand for housing peaked in 1926, and by 1929 many used cars were available to compete with new automobiles for buyers. Normally, as durable goods wear out and prices fall due to lower demand, some people begin to buy again and the economy begins to recover. But that didn't happen after the recession that began in 1929; instead, it turned into a severe and long-lasting depression. Why?

**12.** Tell the students that the Stock Market Crash of October 1929 undoubtedly made people feel poorer and contributed to falling demand. However, investors usually see lower stock prices as a buying opportunity, and the market usually recovers at some point. In mid-November, stock prices stopped falling, and they had increased substantially by the end of April 1930. But then prices began to decline again.

**13.** Tell the students that, from 1930 to 1933, banks began to close in record numbers. Display Visual 2. Many of the businesses that had borrowed money during the booming 1920s were unable to repay their loans. Remind the students that when banks fail, depositors lose the money they have in their accounts. Money actually disappears from the economy. Display Visual 3. From 1929 to 1933, the United States money supply was reduced by about one third. When there is less money circulating in the economy, fewer goods and services are purchased and fewer workers are employed.

**14.** Explain that according to the Federal Reserve Act of 1913, the regional Federal Reserve Banks were supposed to lend reserves to banks in trouble; they were to be "lenders of last resort." Too often, however, the regional banks would lend only to those banks that they believed were in no real danger of failing. They stood by passively while many banks collapsed.

**15.** The American banking disaster was only part of a worldwide financial collapse that appeared beyond the power of any national banking system to prevent. Major nations such as England, France and Germany were on the gold standard, either partially or fully. If one of these nations experienced economic problems, the actions it took to get itself out of trouble often passed the problems on to other nations.

**16.** Distribute a copy of Activity 3 to each student. Have the students answer the questions individually or allow them to work in groups.

- **A.** *Business owners were less likely to borrow to expand production; therefore, no new jobs would be created.*
- **B.** *Again, business activity would be discouraged and no new jobs would be created.*
- **C.** *You might want to withdraw your funds from the bank, which would discourage bank lending and increase the chances of bank failure. For high-level students, also explain that banks keep some of their extra money in the form of bonds. If they lose too many reserves, they can sell the bonds for cash to pay their depositors. But when interest rates rise, the prices of bonds go down, so that the banks that sell them get less money to pay out.*
- **D.** *You would probably conclude that your bank was likely to fail, and then you would withdraw your funds.*

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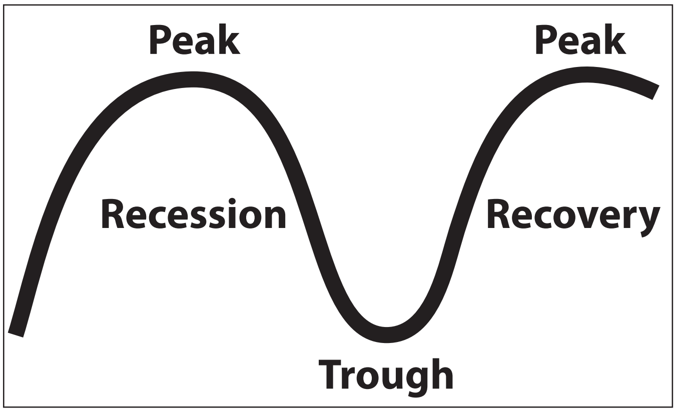
Visual 1. **What is a Business Cycle?**




- Demand for durable goods falls
- Demand for investment goods falls
- Workers who make those goods are laid off
- Because these workers now have less income, they spend less—and demand falls further
- Demand for durable goods revives
- Demand for investment goods revives
- Workers are rehired

## Handout

Visual 2. **Number of U.S. Banks Closing Temporarily or Permanently, 1920–1933**

| Year | Number of Bank Closings |
|---|---|
| 1920 | 168 |
| 1921 | 505 |
| 1922 | 367 |
| 1923 | 646 |
| 1924 | 775 |
| 1925 | 618 |
| 1926 | 976 |
| 1927 | 669 |
| 1928 | 499 |
| 1929 | 659 |
| 1930 | 1,352 |
| 1931 | 2,294 |
| 1932 | 1,456 |
| 1933 | 4,004 |

Source: U.S. Bureau of the Census, *Historical Statistics of the United States* (U.S. Government Printing Office: Washington, D.C., 1960).

Visual 3. **Money in Circulation**

| Year | Money in Circulation* |
|---|---|
| 1929 | $26.2 |
| 1930 | $25.1 |
| 1931 | $23.5 |
| 1932 | $20.2 |
| 1933 | $19.2 |

*Currency plus bank deposits, in billions of dollars.

Source: U.S. Bureau of the Census, *Historical Statistics of the United States* (U.S. Government Printing Office: Washington, D.C., 1960).

# Activity 1

**Whatdunnit: The Great Depression Mystery**

One of the great mysteries of the twentieth century is how the U.S. economy could have gone from a state of unprecedented prosperity in the 1920s to one of unprecedented failure in the 1930s. In the 1920s, jobs were plentiful, the economy was growing and the standard of living was rising. Between 1920 and 1929, home ownership had doubled, and most home-owning families enjoyed amenities, including electric lights and flush toilets, once regarded as luxuries. Sixty percent of all households had automobiles, up from 26 percent in 1920. More teenagers were attending high school; fewer were working full time. Leading political and economic figures of the day said that the United States appeared to have reached "a permanent plateau of peace and prosperity."

But by 1933 at least one fourth of the U.S. labor force was unemployed, and about the same percentage was working shorter hours, which reduced their incomes. Families were losing their homes, and many were going hungry. Adolescents who should have been in high school were riding around the country in freight cars, looking for work. Although 1933 marked the low point of what came to be called the Great Depression, the unemployment rate never dropped below 14 percent until 1941. A decade of hope had been succeeded by a decade of hopelessness.

What happened? The United States possessed the same productive resources in the 1930s as it had in the 1920s. The great factories and productive machinery that had raised living standards in the 1920s were still present in the 1930s. Workers still had the same skills and were willing to work just as hard as before, and farmers were producing more food than ever. How could life have become so miserable for so many Americans in such a short period of time?

A murder mystery is often called a "whodunnit" because we want to know who committed the crime. The mystery of the Great Depression is a "whatdunnit"—what caused the Great Depression and what made it last so long? Many people who are neither historians nor economists care about the answer because they fear that such a depression could happen again in our country and they want to know whether such a recurrence can be prevented.

# Activity 2

**Occupation Cards**

Directions: Make enough cards so that each student gets one, repeating occupations as necessary.

| | |
|---|---|
| You work in a factory that makes machinery | You are an autoworker |
| You sell cars | You are a steelworker |
| You are a construction worker | You sell furniture |
| You work in a furniture factory | You sell clothing |
| You work in a restaurant | You work in a grocery store |

Handout

# Activity 3

**What Would You Have Done?**

**A.** The world financial system that emerged after World War I was based upon the gold standard. The United States and Great Britain guaranteed that they would exchange their currencies for gold at a fixed rate—$20.67 for an ounce of gold, or £4.86. Other major countries agreed to exchange their currencies for gold, dollars or pounds. In 1927, several countries, most notably Germany and Austria, experienced serious bank runs. To stabilize their currencies, they exchanged their dollars and pounds for gold. The United States experienced a serious loss of gold (as did Great Britain). To encourage foreign investors to buy American investments, the Federal Reserve Banks raised interest rates. If you were an American business owner planning to build a new factory or buy new equipment, what would you have done after interest rates were increased?

**B.** The Federal Reserve lowered interest rates after a time, but in 1930 and 1931, when the American economy had already taken a downturn, more bank runs occurred in many countries, and again gold flowed out of the United States. To keep gold in the United States, the Federal Reserve Banks again raised interest rates. What was the result?

**C.** Now imagine that you are an American citizen with a bank account. You read the newspapers. You see that banks are collapsing in other countries and that the rate of bank failures in the United States has risen. What might you do?

**D.** In 1932 Congress creates the Reconstruction Finance Corporation (RFC), which lends money to businesses that are in trouble, including banks. The law requires that the names of banks receiving loans from the RFC must be published. You read in the newspaper that the bank in which your money is deposited is receiving help from the RFC. What are you likely to do?

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17. Discuss the answers with the students. Tell them that throughout the 1930s, savers mistrusted banks because of bank failures that occurred between 1930 and 1933. Many people kept their savings in postal savings banks or even under their mattresses, which meant that their money could not serve as reserves for bank loans. At the same time, banks were reluctant to make loans because they felt they couldn't trust the Federal Reserve System to come to their aid if they lost money due to risky loans. The result was that the money supply was relatively low throughout the Great Depression and business activity was sluggish, creating few jobs.

## Closure

Review the explanations of the causes of the Great Depression. The explanations stress a set of interrelated events: that more goods and services were produced than people were able or willing to buy, that falling demand in some industries caused unemployment, and that decreases in spending by unemployed workers caused further unemployment. However, problems with the money supply drove the economy into its deepest trough in 1933 and had a great deal to do with the persistence of the Depression during the entire decade of the 1930s.

## Assessment

*Multiple-Choice Questions*

1. When demand falls for durable goods such as houses, furniture, appliances and cars, workers who produce those goods tend to lose jobs and income, and a multiplier effect occurs. The meaning of the term *multiplier effect* is that

   **A.** demand for nondurable goods increases and more workers are hired in these industries.
   **B.** laid-off workers spend less, which reduces demand and therefore jobs in other industries.
   **C.** the government multiplies its spending to compensate for the fall in demand in durable-goods industries.
   **D.** the Federal Reserve System increases the money in circulation in order to increase demand.

2. Which of the following two-part conditions tends to cause unemployment?

   **A.** A decrease in consumer and business spending and an increase in the money supply
   **B.** An increase in consumer and business spending and an increase in the money supply
   **C.** An increase in consumer and business spending and a decrease in the money supply
   **D.** A decrease in consumer and business spending and a decrease in the money supply

Answers: 1 (b); 2 (d)

## Essay Questions

1. **Explain how falling demand for goods, especially durable goods, may lead to an economic depression. Also explain how an economy in depression might recover over time.**

*(**Possible answer 1**: People don't buy durable goods on a regular basis. If a lot of people buy fewer durable goods, some workers lose their jobs. Employers reduce their orders for machinery and equipment, which may cause job losses in those industries. Many workers now have less income and buy less, which reduces demand even more. Even workers who have jobs outside of durable-goods production may lose their jobs. This is the multiplier effect. However, after a period of time, demand for durable goods will probably recover. Also, lower prices caused by falling demand might cause some people to buy. As demand recovers, employers will rehire workers, who will then demand more goods and services themselves. This reviving demand will lead to a multiplier effect that increases demand and employment.)*

2. **How did problems with the banking system, the American money supply and the international gold standard make the Great Depression worse?**

*(**Possible answer 2**: When there is less money in the economy, demand cannot increase. In the early 1930s, the American economy showed signs of recovery, but a substantial increase in bank failures in 1930 was succeeded by an even worse increase in 1931. Banks were being forced out of business by loans that could not be paid back and by the withdrawal of funds by depositors who were afraid their banks would collapse. Bank failures declined in 1932, but a new wave of failures began in early 1933. By the time Franklin Roosevelt took office, most states had declared "bank holidays," suspending all banking operations. Each failure reduced the money supply and lowered demand. Many of these failures could have been averted if the Federal Reserve Banks had lent reserves to banks that were in need of help. But many of the Federal Reserve Bank officers did not want to lend to banks that they thought were unsound. The Federal Reserve was also required by the rules of the international gold standard to exchange dollars for gold. In order to keep gold in the country, the regional banks raised interest rates on reserves, which discouraged lending and kept demand low.)*