History 271
Devine

Causes of the Great Depression

CENTRAL QUESTION:

What are some of the major causes of the Great Depression and how do these causes interact with each other to make the economic situation even worse?

I. The International Economic Situation

The U.S. emerges from World War I as the "Engine of Prosperity" - it is the leading **creditor nation** and is the source of capital (money) needed to sustain the European economies. [A creditor nation is a nation that lends more money to other nations than it borrows from other nations.]

Germany must pay “reparations” (in cash and in material goods) to France and Britain as part of the terms of the Treaty of Versailles that ended WWI.

Lacking the cash to pay reparations, the Germans borrow money to do so from the US.

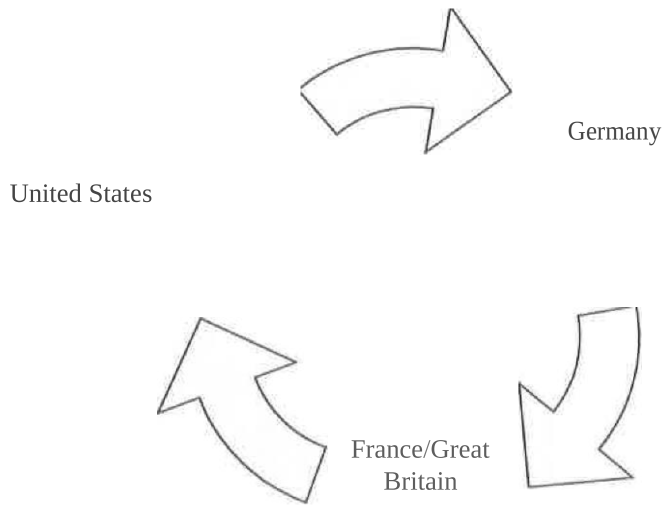
France and Britain must pay back loans taken from the US during WWI.

Given these circumstances a circular flow of capital creates an unstable international economy:

- Germany pays reparations to France and Great Britain
- France and Great Britain pay war debts to the U.S.

• U.S. loans money to Germany to pay reparations

This visual diagram sums up the flow of money:



So long as the U.S. continues to lend money abroad, the system survives.

If an interruption occurs at any point in the cycle, the entire system collapses, making it an inherently unstable system. Given that the US, by lending money to Germany, is the “spring” from which the “water” (money) flows, anything that happens in the US that prevents money from going to Germany has implications for the entire economic system.

What's more, if the U.S. intent was to lend money so that the economies of Europe would rebuild after the devastation of World War I and, in time, once again become markets for U.S. goods, this goal is not achieved.

Germany, France, and Britain are using the bulk of the funds to service their debt, rather than to rebuild infrastructure and encourage economic growth. Their economies remain weak, and their demand for US goods decreases. This in turn has negative consequences for the American economy.

Some observers - Thomas Lamont of J.P. Morgan and Company, for example - realized the inherent instability of the system was dangerous AND that it was not achieving its goal of economic reconstruction.

They suggest an alternative:

- U.S. should forgive French and British war debts

  (The French were already arguing that since the European allies paid for victory with the blood of their soldiers, the US contribution to victory should be financial – forgiving the Allied war debts.)

- France and Britain should drastically reduce German reparation payments

  (Relieved of the burden of reparations, the Germans could rebuild their own economy, and in time they would be able to buy French and British goods and everyone would win.)

- Europe should focus on reconstruction, not debt repayment. The European nations should use loans from the U.S. to improve infrastructure, factory construction, etc.

But political reality makes enacting this proposal impossible.

The French hate the Germans and want vengeance. Any French politician who suggests cancelling the German obligation to pay reparations will be voted out of office.

The British also want reparations from Germany so they can pay the costs of taking care of their World War I veterans. “Taking” money from combat veterans was not politically feasible.

Similarly, the American public insists foreign loans MUST be repaid and does not like the idea of being financially connected to European powers. (That's how the nation got into World War I in the first place.)

GERMAN “HYPERINFLATION”

Obsessed with reducing its debt, in 1922-23 the German government literally begins printing currency so it can pay down that debt as quickly as possible. This immediate creates a spike in prices (hyperinflation).

There are TWO causes of hyperinflation:

1 The government is ***printing*** too much money.

- The more Marks (German currency) the government prints, the less they are worth.

- The less money is worth, the fewer goods it can buy. (This is another way of saying that prices go up.)

2. People ***expect*** inflation to get worse (they expect their money to decrease in worth, this is the “anticipation of inflation”)

- Since they expect the value of the money they're holding to ***decrease,*** they try to spend it as fast as they can before its value goes down further.

- When money floods into the economy in pursuit of goods (that is demand increases), the prices of these goods ***increase*** (because the supply of the goods has decreased)

(More money chases the same amount of goods, driving up the price of goods - this is inflation.)

The irony here is that by trying to get rid of their money quickly (because its value is decreasing each day they hold onto it), consumers end up driving prices up – and therefore making inflation even worse!

Hyperinflation makes it easier for Germany to pay off its debt to France and Britain (the marks the Germans pay them are worthless).

Of course, the French and Brits are understandably furious. They are paid in worthless German currency, but must pay back the US with their own non-inflated currency.

BUT hyperinflation also hurts the German people - destroys people's savings for retirement and hurts those on a fixed income. The 10,000 marks you had in the bank for your retirement now buys the morning paper. Money becomes worthless.

In fact, a story circulated at the time that the price of bread had risen so high that a house wife had to bring an entire wheelbarrow full of money to the bakery just to pay for a loaf of bread. She went into the bakery to order the bread, leaving the wheelbarrow full of money outside. When she went back out to get the money, it was all there. But her wheelbarrow had been stolen.

People are anxious to avoid losing their savings, so they exchange currency for gold. At least gold will retain its value.

But the hoarding of gold contracts the economy. Instead of using available funds to invest in factories (that employ workers), the wealthy put their money toward buying more gold and then send the gold to the U.S. (where they believed it would be safe and not confiscated by their own governments).

As a result, their money (investment capital) doesn't help the German economy recover. It sits in US banks.

To combat the economic chaos that hyperinflation has caused, the German national bank finally declares it will stop printing more money.

After some lag time, people decide their money will now retain its value, so they're more willing to hold onto it - the German economy stabilizes.

The hyperinflation of these years makes it clear, however, that the German reparation situation must be addressed.

In 1924, the Dawes Plan (developed by the US banker Charles G. Dawes who modestly named it after himself) changed the payment schedule for the Germans' reparations obligation. In accordance with Dawes's plan, the amount required in monthly payments decreased because payments were stretched out over a longer period of time. (The last payment, for example, would be made in 1981!) This made it easier for Germany to pay (without encountering the political opposition that "debt forgiveness" would have generated.)

This ***temporarily*** stabilizes the economic situation, but by 1928 U.S. investors no longer put their money into loans for Germany. They fear the Germans may have over-borrowed. Even though Germany continues to pay interest on time, many lenders wonder if the nation will go bankrupt before it even begins to pay off all the principal.

Beyond that, these lenders realize they'll get a higher return by investing their capital in the US stock market. Why settle for 6% interest payments when you can make 12% on the stock market?

The Stock Market – Boom and Bust

Money flooding into the stock market causes the market to spike.

People are anxious to take advantage of increasing yields on their investments in stock, and banks are eager to lend money to people who want to buy more stock.

When buyers do not have sufficient collateral to secure their loans, banks begin to lend "on margin" - the collateral to back a loan for stock purchases is the *anticipated* profit that the stock to be purchased will generate. In other words, the loan is backed with "hope."

When the banks get skittish about the stock market's potential to crash, they issue "margin calls." Investors unable to pay the "margin" (not the whole loan, just a small part of it) sell their stocks to acquire the cash to pay the margin. When everyone begins selling their stocks to gain access to cash, the market plummets (goes down quickly).

1929 → U.S. Stock Market Crashes.

The market crash does not "cause" the Depression. Rather, it is one of many factors that contributes to the economic slump.
The question for us is: *How* did the stock market crash in the US contribute to the global economic turmoil?

Most importantly, the crash has a ***global*** effect:

- When investors lose all their money after the crash, U.S. Capital for foreign loans dries up, destabilizing the circular flow of money.

- Unable to count on loans from US investors, Germany faces difficulty making its reparation payments.

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- Unable to count on German reparation payments, France and Britain threaten to default on their debt payments to the U.S.

- Banks no longer receiving payments have less money to lend and then must reduce the number of loans they make which further hurts the economy. Access to credit begins to dry up in the US.

As the flow of money from the US into Germany slows to a trickle, many Europeans correctly fear that a major economic collapse is coming.

After the Second National Bank of Austria closes its doors, unable to cover its deposits, investors begin to panic and start to withdraw gold from Central European banks, sending much of it to the U.S. There are now fewer dollars AND less gold in Europe.

One could argue that by sending gold abroad, investors may have been making a wise decision about how to insure their own personal financial stability. That said, withdrawing such a large amount of capital out of Europe was disastrous for the economies of the European nations.

Why? Because that capital (the value of the gold) could no longer go to paying workers, financing business expansions, public services, etc.

Instead, it just sat in American banks.

This economic instability contributes to growing political instability in Germany, which the National Socialists [Nazis] exploit. They do well in local elections.

Even more important, lack of capital in Europe makes it that much harder for European nations to pay their debts, particularly their debts to the U.S.

President Hoover finally suggests a **one-year moratorium** on reparations and debt payments (1931); but this ends up being too little too late. After all, the stock market had crashed nearly two years earlier!

Many Europeans worry about what will happen when the year is up. Even though they no longer have to pay reparations to France and Britain, the Germans still do not use the money coming from the US to reconstruct their economy. Instead, the Germans hold on to it knowing they will need to resume paying debts the very next year. As a result, the moratorium is ineffective.

The only way for Europeans to get dollars to repay debts to the U.S. at this point is for these nations to sell stuff to the U.S (i.e. exports). The U.S. pays for foreign products in dollars and those dollars go to paying off debt to U.S. bankers.

The "stuff" these nations sell to the U.S. to gain access to dollars are called "foreign imports."

This brings up another cause for why the Depression occurred and why it ended up lasting so long…

II. Unwise Tariff Policies

After the stock market crash in 1929, employers fear a business slump. By 1930, many companies are beginning to lay off workers. No longer gaining capital from investors purchasing shares of their stock, these companies cannot afford to pay their workers, let alone expand production.

Consumers won't buy as much if they fear losing their jobs, so even people lucky enough to keep their jobs are saving money and not making purchases.

As the economy contracts in the U.S., many Americans demand a higher tariff to protect US businesses from cheaper foreign imports.

Congress passes the ***Smoot-Hawley tariff*** which significantly raises the tax on nearly all imported goods. This produces numerous harmful unintended consequences:

- Because of the tariff, not only do prices of imports rise, often prices of domestic goods rise in the U.S. as well. People can't afford to buy higher priced goods made in the U.S., so the tariff fails to protect domestic businesses. In fact, most people cannot afford to buy either foreign or domestic goods. Sales continue to slump. Layoffs continue.

- Because American consumers buy fewer imported products from Europe (due to the tariff, which has made those goods more expensive), the Europeans have fewer dollars to pay off their debts to the U.S.

- Europeans retaliate by slapping tariffs on U.S. products. Retaliatory tariffs hurt U.S. more than Smoot-Hawley helps U.S. businesses.

  High tariffs may discourage U.S. customers from buying Swiss watches, but the Swiss won't buy U.S. automobiles once the Swiss government imposes a retaliatory tariff on American goods. This is a net loss for the U.S. because not only do the car companies suffer, all the companies that supply products to make cars suffer (windshields, wiring, tires, paint, steel, etc.)

- Europeans also retaliate by raising the prices on raw materials that the U.S. must import in order to make manufactured goods.

For example, the prices of rubber and tungsten increase (both needed in making cars).

As a result, U.S. products cost more and U.S. customers can't afford to buy them. Demand for products slackens. Production slows. Workers are laid off. Fewer people have money to buy U.S. goods... and the cycle spirals downward.

- Because high tariffs keep the Europeans from selling their goods in the U.S., they lose access to dollars. As a result, they have *even* more difficulty in paying their debts to U.S. lenders.

  Also, as a result of being shut out of the U.S. market, the European factories produce less, forcing businesses to fire workers (who in turn can't buy as much), and the European economies spiral downward as well.

Note the **global effect** of **national** policies. What each nation does negatively affects *other* nations. High tariffs are key in de-stabilizing and contracting the global economy.

ALTERNATIVES TO RAISING THE TARIFF….

Instead of raising the tariff, a better solution might have been for the government to increase spending (even if this meant the government going into debt - spending more than it took in).

By putting more money into people's hands, especially people who might invest in hiring workers, building factories, or expanding businesses, the Depression might not have been as severe or as long.

Government, however, acted as an individual would act in hard times…

It cut spending and raised taxes (including tariffs) to insure the budget is balanced.

This SEEMED to make sense, but, as the economist John Maynard Keynes argued at the time, when the economy is sinking, governments had to act differently than individuals.

Keynes claimed that when the private sector no longer had the capital (money) to keep the economy humming along, then government had to infuse cash to make up for the loss of cash coming from the private sector – even if this meant spending more than was coming in (or, in other words, “running a deficit”).

The high tariffs of the 1930s, that were supposed to “help” the economy recover, in fact made things worse. Arguably, raising the tariff had helped the economy in the past (as in the late 19th century when tariffs protected new American industries until they were ready to compete with the Europeans).

But in the 1930s, circumstances were different. The problem was that people had no money to spend and those who did were afraid to spend it. “Foreign competition” had not caused this problem and therefore policies enacted to prevent foreign competition weren’t going to solve it.

Unwise tariff policies in the 1930s were not the only thing that produced unintended consequences. The tax policies of the 1920s came back to haunt the economy in the 1930s as well. And so we must investigate why lowering taxes in the 1920s helped create economic turmoil in the 1930s…

III. U.S. Tax Policies during the 1920s also contribute (indirectly) to the Depression

During the 1920s, taxes <u>decrease</u> substantially, especially on the wealthy.

The theory was that, with more money in their pockets, the wealthy will invest it in expanding American businesses, allowing companies to hire more workers. Prosperity will "trickle down" from the rich to the average American.

- *To an extent,* this works. But there are limits to how much can be produced and consumed when the vast majority of Americans do not earn high enough wages to buy all that is produced in American factories. It is also hard to sell American goods abroad since during the 1920s, the Europeans (our primary market for exports) don't have the money to pay for our goods and retaliatory tariffs imposed on imports from America make U.S. products more expensive.

- Believing it was unwise to expand production when demand for their products was limited - both at home and in Europe - many American businessmen put the money from their tax break into speculating on Wall Street rather than into investments like building more factories or opening new stores or constructing new homes or, perhaps most importantly, raising their workers' wages. This results in the speculative frenzy that leads to the stock market crash of 1929.

Prosperity during the 1920s is real, but also is fragile.

Wages and standard of living do rise; access to credit is easier and allows the middle class to buy products "over time" on the installment plan. But the working class largely lives paycheck to paycheck – a rise in prices or the loss of a job, for these Americans, could be devastating.

By looking at three big industries – TECHNOLOGY, AUTOMOBILES, and HOUSING – we can see how the initial prosperity of the 1920s leveled off and, by the end of the decade, seemed ready to crash. The government tried to stimulate the economy by passing further tax cuts, but this didn't solve the problem. In fact, doing so may have made things worse.

Radios were the breakthrough technology of the decade. At first, only hobbyists bought them, but soon there was enough programming available that everyone wanted a radio. It helped that technological advances brought down the price.

So, by the mid-1920s, companies like RCA (Radio Corporation of America) were doing very well. BUT what would happen once everyone had a radio? RCA would probably stop expanding (and using its tax rebates to fund expansion).

Similarly, people were eager to buy automobiles once they became affordable in the 1920s. But, again, what happens after the initial spike in sales – when everyone has a car and doesn't yet need a new one? The major car companies, by the end of the decade, were cautious about expanding any further.

Most importantly, the housing market, which started the decade doing exceptionally well, also begins to level off by the mid-1920s.

Housing is a key sector of the economy since so many other companies are dependent on the construction of new homes – pipes, furniture, kitchen appliances, wiring, windows, doors, toilet, fixtures, etc. etc. When construction levels off, so do the profits of all these other companies. (The same is true in the auto industry.)

In sum, by the end of the decade, major sectors of the economy - automobiles and housing in particular - stop expanding. Demand slackens. Since so many other businesses depend on these two sectors, economic instability appears to be on the horizon.

People ignore the signs of economic weakness, though, because the stock market is booming. The stock market is booming because many wealthy Americans – now paying lower taxes and therefore having more ready cash – are speculating on stock rather than expanding their businesses. Average Americans, again, are only living paycheck to paycheck.

Thus the prosperity is real, but fragile.

At the first sign of economic turmoil (the stock market crash of 1929), consumers fear for the future and stop buying.

This sets off a downward spiral in the economy → fewer people buying, fewer goods need to be produced, fewer workers needed, fear of losing one's job keeps even those who still have jobs from buying, still less is needed to be produced, further layoffs... and the cycle continues.

The tax cuts of the 1920s, then, may have had their intended effect at first, but by the end of the decade, the money given back to the wealthy in the form of lower taxes is not “trickling down” to the workers. It’s flooding into the Stock Market.

Average Americans’ wages are stagnant. Middle class Americans maintain a higher standard of living, but, increasingly, they do so by relying on “credit.”

Had the money from tax breaks gone to fund higher wages, perhaps the prosperity of the nation would have been more solid.

Finally, we need to take account of the role of “monetary policy” in causing (and worsening) the Great Depression….

IV. Mistakes by the Federal Reserve

The Federal Reserve has <u>two significant powers</u>, which, together constitute “monetary policy” (policy involving the production and regulation of “money”)

1) controlling the money supply (increasing or decreasing the number of dollars in circulation) This also means the Fed has influence on prices: if there are more dollars in the economy, prices go down (and people may buy more); fewer dollars in the economy and prices go up (and people may buy less).

2) determining interest rates (how much you need to pay the bank in addition to the principal of your loan or how much the bank pays you when you deposit your

money in a savings account.)

High interest rates make people less likely to borrow money and therefore less likely to buy things they can't afford.

Low interest rates make people more likely to borrow money and therefore more likely to buy things (like stock!) that they can't afford.

When speculation on the stock market seemed to be getting out of control, the Federal Reserve reasoned it would be best to contract the money supply (by issuing fewer dollars) AND to <u>raise</u> interest rates. This would discourage people from borrowing money to buy stocks. If the demand for stocks went down, it stood to reason that the price of stocks would stabilize. Also, by contracting the money supply, prices of everything, including stocks, should drop. Fewer dollars = lower prices.

The problem was, 1) the Fed acted too slowly and 2) it took time for the Fed's policies to take effect.

By the time the raise in interest rates took effect, the stock market had crashed and the economy was quickly contracting. The raise in interest rates and contraction of money supply <u>further</u> contracted the economy which, after the crash, was already shrinking quickly anyway. The Federal Reserve, in short, had made a bad situation even worse.

When interest rates went up, even people who had money chose to save it. 1) because they wanted to have "something for a rainy day" and 2) because with higher interest rates, they were getting more return by simply keeping their money in the bank.

In other words, by raising interest rates, the Federal Reserve motivated those who had money in their pockets to save it rather than spend it. Why? Because when interest rates rise, the amount of interest you earn on your savings account rises too. Raising interest rates encourage people to keep their money in the bank (where it earns a high rate of interest) rather than spending it.

Once the Depression had hit, the economy needed the Federal Reserve to LOWER interest rates so people could borrow money (and spend money) more easily. Only spending would revive the economy.

With high interest rates, people were less likely to borrow. If they didn't borrow, they couldn't spend.

Also, businesses that needed to borrow to pay workers couldn't afford to borrow at higher interest rates, especially when demand for their products was declining (along with their profits). And so they continued to lay off workers, with the accompanying negative consequences for the economy.

Even worse, banks didn't have as much money to lend -- they, too, had lost millions in assets because they had invested their assets in the stock market. When the market crashed, their assets vanished. On top of that, they now had to pay higher interest to their depositors.

Not only could they not lend money to Americans who needed it, they could no longer lend money to European nations – who needed money to keep their own economies afloat and who owed money to American bankers.

As you can see, all of these factors are related and inter-dependent.

One would think if more people kept their money in the bank, wouldn't the bank have more to lend? Under normal circumstances, yes. But by 1929-1930, there were far fewer people than normal who had ANY savings, so banks in fact had fewer assets (deposits).

The Fed's colossal mistake was largely due to...

V. Lack of Economic Knowledge

Few political leaders understood the wide ranging ramifications of the economic policies they pursued. (By this point, you may feel the same way!)

For example, raising the tariff was meant to solve problems, but ended up creating even bigger problems. Cutting taxes on the wealthy was meant to stimulate economic growth, but falling demand due to low wages convinced the wealthy they were better off putting their money into the stock market than expanding their businesses and hiring more workers or raising wages. As a result, a policy meant to encourage growth ended up fueling speculation and instability.

In another example of how limited economic knowledge caused problems, National governments looked out only for their own interests, disregarding (or failing to recognize) the fact that their policies had a global impact and were generating unintended consequences. In trying to solve immediate problems, or trying to do what seemed politically "popular," many governments failed to grasp the "big picture."

Finally, the Federal Reserve raised interest rates too late. When people needed lower rates so they could borrow money to pay debts (and workers) once the stock market had crashed, rates were actually headed up. No one knew precisely how quickly (or slowly) Fed policies would affect the economy, so the timing of the policies was not guided by accurate information.

All of the economic chaos coming to a head at the beginning of the 1930s also caused political instability. In the US, President Hoover, heralded as a genius and a champion administrator in 1928, was now denounced for "doing nothing" to save the nation from financial ruin. In the upcoming presidential election of 1932, it appeared he had little to no chance of winning re-election.

More importantly, economic instability in Germany helped pave the way for the political collapse of the government and the rise of the National Socialist Party (Nazis) under Adolph Hitler.