Causes of the Great Depression, Part II

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. By sending gold abroad, investors may have been making a wise decision about how to insure their own personal financial stability, but taking such a large amount of capital out of Europe was disastrous for the economies of the European nations.

This makes it even harder for European nations to pay their debts, particularly their debts to the U.S.

The only way 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....

Unwise Tariff Policies

After the stock market crash, people fear a business slump. By 1930, many companies are beginning to lay off workers. 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 slips in the U.S., many demand a higher tariff to
protect American 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. U.S. customers may not buy Swiss watches, but the Swiss won't buy U.S. automobiles. A net loss for the U.S.

- Europeans also retaliate by raising the prices on raw materials that the U.S. must import in order to make manufactured goods - rubber, tungsten (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 affects other nations.

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 - cut back, spend less. This SEEMED to make sense, but, as the economist John Keynes argued at the time, government 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.

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

- During the 1920s, taxes **decrease** substantially, especially on the wealthy.

  - The theory is 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."

  - *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 make enough money 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.

• Unwilling to expand production when demand is 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. 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 rise; access to credit is easier and allows the middle class to buy products "over time" on the installment plan.

• 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.

• 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, less needed 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 lay offs... and the cycle continues.

Mistakes by the Federal Reserve

The "Fed" has two significant powers:
1) control the money supply (increase or decrease 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) control of interest rates (how much you need to pay the bank in addition to the principle of your loan.)
   -- 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 they can't afford.

When speculation on the stock market seemed to be getting out of control, the Fed reasoned it would be best to contract the money supply (by issuing fewer dollars) AND raise interest rates. This would discourage people from borrowing money to buy stocks; 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 further contracted the economy, making a bad situation even worse.

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.

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

Instead, given the higher interest rates, even those who had money to spend saved it. Why? Because when interest rates rise, the amount of interest you earn on your savings account rises too. Raising interest rates incentivizes people to keep their money in the bank (where it earns a high rate of interest) rather than spending it.
The Fed's colossal mistake was largely due to...

**Lack of Economic Knowledge**

- Few political leaders understood the wide ranging ramifications of the economic policies they pursued. For example, the Smoot-Hawley tariff was meant to **solve** problems, but ended up **creating** even bigger 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.

- The Federal Reserve raised interest rates too late and so when people needed lower rates so they could borrow money to pay debts (and workers) once the stock market 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.