History 271
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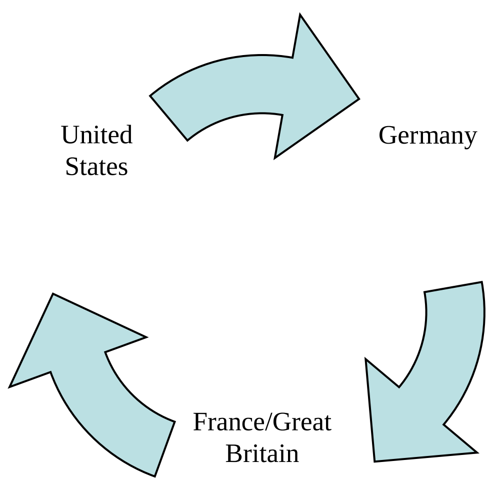
Causes of the Great Depression

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 needed to sustain the European economies.

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



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.

What's more, if the U.S. intent was to lend money so that the economies of Europe would rebuild and 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.

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 <u>forgive</u> French and British war debts

  (After all, the French argue, the European allies paid for victory with the blood of their soldiers; the US contribution to victory should be financial.)

- France and Britain should drastically <u>reduce</u> 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 <u>reconstruction</u>, not debt repayment. The European nations should use loans from the U.S. to improve infrastructure, factory construction, etc.

But political reality makes this impossible.

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

Similarly, 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.)

Obsessed with reducing its debt, the German government literally begins printing currency so it can pay down that debt.

1922-1923 → Germany experiences hyperinflation

TWO Causes

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 → 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, the prices of these goods ***increase***

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

Hyperinflation makes it easier to pay debt to France and Britain (the marks the Germans pay them are worthless)

BUT hyperinflation hurts the German people – destroys people's savings for retirement and hurts those on a fixed income.

People are anxious to avoid losing their savings, so they buy 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 in gold and then send the gold to the U.S. As a result, their money (investment capital) doesn't help the German economy recover.

To combat destabilizing inflation, the German bank declares it will stop printing more money.

People decide their money will now retain its value, so they're more willing to hold onto it – the German economy stabilizes.

In 1924, the Dawes Plan defers the Germans' reparations obligation: short term payments decrease; payments stretched out over a longer period. This makes it easier for Germany to pay.

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. Beyond that, they get a higher return by investing their capital in the stock market.

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

People are anxious to take advantage and banks are eager to lend money.

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, they issue "margin calls." Investors unable to pay back the loans sell their stocks. When everyone begins selling their stocks, the market plummets.

1929 → U.S. Stock Market Crashes. This has a ***global*** effect:

- U.S. Capital for foreign loans dries up, destabilizing the circular flow of money.

- Unable to count on U.S. loans, Germany faces difficulty making its reparation payments.

- Unable to count on German reparation payments, France and Britain threaten to default on their debt payments 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. Many worry what will happen when the year is up.

Frightened investors withdraw gold from Central European banks, sending much of it to the U.S. There are now fewer dollars AND less gold in Europe.

> 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. is for these nations to sell stuff to the U.S. The U.S. pays for foreign products in dollars and those dollars go to paying off debt to U.S. bankers.
>
> We call the "stuff" these nations sell to the U.S. "foreign imports."

II. 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. Sales continue to slump. Layoffs continue.

- Because American consumers buy <u>fewer</u> imported products from Europe (due to the tariff, which has made those goods more expensive), the Europeans have <u>fewer</u> 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 **<u>global effect</u>** 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 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.

III. U.S. Tax Policies

- During the 1920s, taxes <u>decrease</u> 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 – <u>automobiles</u> and <u>housing</u> 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.

IV. Mistakes by the Federal Reserve

The “Fed” has two significant powers:

1) control the money supply (increase or decrease the # of dollars in circulation) This also means the Fed has influence on prices → 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). The Fed can adjust the requirements for fractional reserves → require banks to keep more cash on hand to cover deposits. This means the banks have less money to lend, loans are harder to come by, fewer people borrow.

2) control of interest rates (how much you need to pay the bank in addition to the principal 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 raising requirements for fractional reserves) 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…

V. 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 when it should have lowered them. 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.