WHAT CAUSED THE GREAT DEPRESSION?

An Honors Thesis (ID 499)

by

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Any study of a phenomenon as complicated as the Great Depression of the 1930's could be approached in a variety of ways. Hundreds of studies have been conducted on why the depression started and how economic recovery was induced. Also, the social impact of the depression on millions of people has been analyzed countless times. Sometimes a tragedy can have good effects in the sense that it helps people to learn and become aware. And in the aftermath of a tragedy, almost always, a "cause" or a "combination of causes" surfaces to let us know if, in any way, we failed in preventing the tragedy. This preventive medicine approach can be useful, and it is in this context that a study of the causes of the depression in the United States seems sensible. The United States cannot afford to struggle through another decade of economic chaos. With many of our allies feeling threatened, and with many of our adversaries threatening, America must have a strong economy in order to assure the proper allocation of resources. Therefore, to not let a depression occur again is vital, and the best way to prevent this tragedy is to study what caused the Great Depression of the 1930's in the United States.

This report is about the causes of the depression, but if all the causes were simply listed, a conclusion about the most formidable causes would be extremely difficult to derive. Therefore, research on this paper consisted of
obtaining several leading economists' views and looking for common, significant causes that came to surface in various appraisals. Then, after viewing filmstrips and reading each author's standpoint on the causes of the depression, the views were blended together to find the most significant cause or, as this paper presents, combination of causes for the depression.

Also, sometimes after an event has happened as lasting and severe as the depression, it takes many years to completely analyze the situation. Therefore, almost the entire report has sources documented from contemporary economists. As in all reports, some sources give more helpful insights than others. In this thesis, it was found that the works of Milton and Rose Friedman, Dr. Arthur Laffer, and Alan Reynolds best supplemented the research. Therefore, this thesis will include a brief discussion of the onset and results of the depression, then it will turn to the causes of the depression as stated by several different economists and authors, and finally, through the works of Friedman, Reynolds, and Laffer, the causes will be blended together to reach a main theory as to the causes of the depression of the 1930's— that being the failure of the federal government to analyze the effects of a restrictive tariff, and the failure of the Federal Reserve System to analyze the effects of not participating in open market operations to raise the money supply.

As already mentioned, the depression that started in 1929 was a nightmare for the United States. The total
output of the country fell by one-third, and unemployment of America's labor force reached an all time high of twenty-five percent. But also, the depression was just as tragic for the rest of the world. Along with the unemployment, low output, and general despair, the world watched as the depression helped ease Adolf Hitler into power in Germany. And in China, the world depression helped bring about economic conditions which led to the overthrow of Chiang Kai-Shek, leaving the communists to take control.

With this collapse came one general belief as to just why the economic system in the United States was in such disarray, that being that the private enterprise system had failed, and that "capitalism was an unstable system destined to suffer even more serious crises." We know now that the capitalist system was not at fault, but it would be many years before this attitude would change. But what did go wrong?

The next part of this paper examines how several authors analyze this question. It is important to note that while the majority of these authors do not actually make an outright statement as to "the" cause of the depression, they all contributed to the research in a very important way in the fact that they all offered significant views as to what contributed to the severity of the depression. And when any economist does list a cause, it should be thought of in the context of the causes that the others list because many of their ideas overlap, and, as the main theme of this paper presents, one feels that there was a combination of causes after reading these views.
In his book, *The Great Boom and Panic*, Patterson starts out his *Causes* chapter by stating, "The causes of the panic, and of the depression that it heralded, were complex and deep rooted." He mentioned that even now different economists have different views as to what led to the depression. However, Patterson's main emphasis on how the depression was enhanced lies in the interworkings of the economic boom of 1926-1929 and the ensuing stock market crash of October 1929. Many authors mentioned in this book felt that the nature of the boom itself led to the crash which in turn fueled the fires for the depression. Among those mentioned were E.H.H. Simmons who said, "'The primary cause . . . was undoubtedly the high level of prices . . . ." To expand on this Roepke stated, "'... from 1925 to 1929 the productive powers of the world had grown to an extraordinary extent. That this growth was not organic, but was accomplished amidst . . . political tensions, was one of the main causes of the collapse . . . ." This feeling that the growth of production rate was not a result of proper synergism, but was the result of political tensions for self-betterment definitely shows why many people held private enterprise accountable for the depression. In this context H.V. Hodson said that the boom started in America, spread to other countries, and when the collapse occurred, that it again, started in the United States. This held Americans responsible, Hodson felt.

In the book *The Origins and Nature of the Great Slump, 1929-1932*, Fearon states that economic growth was rising quickly from 1925 to 1929. In "mid 1929 there were no
visible signs of strain on the US economy." Fearon offers that then in mid 1929, consumers began to seriously curtail their spending and that only "tenative explanations" can be given as to why. Fearon mentions that there was a reduction in the money supply in 1928 that "preceded the cyclical downturn," and he states one more origin of the depression in the context of the previously mentioned stock market crash. Speculation was high because of "a combination of optimism, cheap credit and plentiful savings," so "stock prices reached their peak in September 1929, before commencing a steady decline, which gathered momentum and terminated in panic." This crash had several causes, but most economists concur that the stock market crash did not cause the depression, rather it was a result of "trends already in existence." With respect to the severity of the depression, Fearon states one main reason as low demand.

Given the levels of unemployment, the absence of welfare benefits for those out of work, which would have sustained income, short-time working, the imposition, from 1931 of wage cuts and the impoverished state of the rural community, it is easy to see that demand was low. There was excess capacity in housing, as people were unable to pay their mortgages or rents, and many could not afford or were unwilling, to go into debt, to buy consumer goods. Entrepreneurs were gloomy.

Fearon also mentions the Smoot-Hawley tariff which was enacted into law in 1930. This tariff will be studied later as Laffer, Reynolds, and Friedman are integrated into the paper. Fearon uses this high tariff concept as his main cause of the depression by concluding, "the origins of the great slump . . . are to be found in the United States, which . . ."
placed an impossible strain . . . upon the world economy" by the legislation of acts such as the Smoot-Hawley tariff. This type of protection greatly restricted the inflow and outflow of goods and services produced by the United States thereby inducing the slump in the many countries where a recession had already started.\textsuperscript{12}

So far Patterson has explained why the boom of 1925-1929 helped induce the depression by stating that inorganic growth led to the stock market crash, and Fearon has gone as far as to offer an origin for the world depression— the United States. In his book \textit{The World in Depression: 1929-1939}, Kindleberger goes even further to mention several explanations or causes. Among these were the "British inability and United States unwillingness to assume responsibility for stabilizing" the world economic condition in three areas:

1. "maintaining a relatively open market for distress goods;"
2. "providing counter-cyclical long-term lending;" and
3. "discounting in crisis."\textsuperscript{13} Among his many other reasons were the lack of asymmetry, the lack of British and American leadership, the lack of cooperation, and the effects of the many changes of leadership in different countries.\textsuperscript{14} Obviously each of these causes mentioned by Kindleberger played a role in the depression and are no doubt very legitimate. But the purpose here is to boil down these causes to one cause or a relatively few combination of causes. However, each economists' viewpoint offers a variable that comes into play when making the final decision, so it is important to examine many alternatives and opinions.
In his book *The Great Crash*, Galbraith makes the degree of difficulty with determining the real factors of the Great Depression apparent. As already observed, different economists have different opinions, some stating one cause, and at the other end of the spectrum the economist that lists several contributing factors. Indeed, Galbraith mentions, "it is easier to account for the boom and crash in the market than to explain their bearing on the depression which followed." He goes on to say frankly, "The causes of the depression are still far from certain." Even though he does not list a specific cause, Galbraith goes through a valuable explanation of contributing factors to the "ensuing disaster."

It is a fact that in 1929 the condition of the United States' economy was "fundamentally sound." However many things in the economy were inefficient, and Galbraith terms these problems as "weaknesses." First was the poor distribution of income in the economy. In 1929, people that had a lot of money had a disproportionate amount. One estimate was "5 per cent of the population with the highest incomes in that year received approximately one third of all personal income." This meant "that the economy was vulnerably dependent on a high level of investment or a high level of luxury consumer spending or both." With this impact on the economy, when the bad news about the stock market in 1929 was heard, it can be assumed that the effect on the economy was large.

The second contributing factor was the bad corporate structure. Galbraith felt that "the most important corporate
weakness was inherent in the vast new structure of holding companies and investment trusts." Through their actions, "income was earmarked for debt repayment . . . new investment became impossible . . . and a corporate system . . . designed to continue and accentuate a deflationary spiral" emerged.21

Third was the bad banking structure. The banks then were largely independent, and when any bank suffered a failure, other depositors were tempted to draw their money out. "Thus one failure led to other failures, and these spread with a domino effect."22 Obviously, such a banking system was not helpful in steering the country clear of the slump. This concept is very important and will be researched in more depth later.

The fourth cause was the dubious state of the foreign balance. Countries could not cover their adverse trade balance with the United States with increased payments of gold . . . President Hoover and the Congress moved promptly by sharply increasing the tariff . . . there was a precipitate fall in American exports . . . it contributed to the general distress and was especially hard on farmers.23

Finally Galbraith felt that the poor state of economic intelligence helped contribute to the crash and slump. Concepts such as the fear of inflation, the balanced budget, and "going off the gold standard" stirred up many controversies that sometimes led to "events" that "played a very bad trick on people."24 Galbraith felt that these attitudes and policies in the 1930's contributed to the depression in many complex, interacting ways.

Up to now, several leading economists have stated what
they felt caused or contributed to the depression. Their views were all closely related and as hoped for, several causes have surfaced with some consistency, such as the mention of Smoot-Hawley and the bad banking structure. In the research, Laffer and Reynolds concur with the Smoot-Hawley cause and Friedman with the bad banking structure—namely the Federal Reserve System. These will be examined soon. First, research from other authors and magazines offered more insights as the fiftieth anniversary of the depression prompted many reminiscences.

There are numerous ways to distribute responsibility when things go badly. President Hoover, for example, received much of the blame from the editors of The New Republic. Hoover had inherited Coolidge's bull market, but Hoover felt this trend could be dangerous. Money was too cheap, he argued, and he encouraged Andrew Mellon, his secretary of the Treasury, to warn people. Hoover also encouraged a raising of taxes, which included the Smoot-Hawley tariff, which worked against everything Andrew Mellon had tried to accomplish while in office.25

Other publications gave the connotation that the stock market crash was to be held accountable for the depression. In an article in Readers' Digest, emphasis is put upon the fact that when the stock market crashed, many people realized "a sudden terrible end."26 It was noted that in the months following the crash, production fell and unemployment rose.27 Again the crash is given credit for the depression in statements such as, "when the bubble burst ... the world plunged
into a decade-long recession;"\(^{28}\) and, "Fifty years ago this month, the bottom fell out of the stock market, shoving the U.S. down the road to an economic collapse,"\(^{29}\) and, "The crash . . . occurred on October 29, 1929 . . . the resulting depression lasted almost until the beginning of World War II."\(^{30}\) While the seriousness of the stock market crash should not be underestimated, research shows that it was not the main cause of the depression.

Samuelson backs this up by stating:

"Naive people think that celebrating the memory of the stock market crash is much the same thing as celebrating the memory of the Great Depression. Experts know better. The Depression could well have occurred with no dramatic fireworks in Wall Street. Indeed it was not until late in 1930 that America's slowdown went from being a fairly run-of-the-mill recession to its becoming a malignant slump.\(^{31}\)"

With the elimination of the stock market crash as a cause, the causes begin to narrow down. The Smoot-Hawley tariff which "Many scholars have long agreed . . . had disastrous effects,"\(^{32}\) and the bad banking structure are still the most prominent. Therefore, the influence of taxes in general will be discussed now, followed by an examination of the effects of the Smoot-Hawley tariff. Finally, the role the Federal Reserve System played will be examined—both in the area of its relationship to Smoot-Hawley and in the area of the failing banks. The three authors about to be discussed contributed to the most convincing stage of research.

On October 19, 1981, Dr. Arthur Laffer gave a lecture on the campus of Ball State University, Muncie, Indiana. In this speech he uses the theory of taxation as a cause for the
depression, with emphasis on the redistributionist versus the
growthist model. Redistributionists believe that the function
of the state is to redistribute from those that have a lot,
to those that have very little. Growthists, on the other
hand, firmly believe that the function of the state is to
change monetary policy and tax laws so to make a "structure of
incentives." Laffer, supporting the growthist viewpoint,
gave examples where tax cuts stimulated the economy. In 1961,
President John F. Kennedy's tax cuts helped the nation's
economy immensely. In the early twenties taxes were cut from
78 per cent to 25 percent for the highest brackets and from 6
per cent to 1.5 percent for the lowest brackets. Dr. Laffer
argued that this increased incentives and reminded us that
the following years are referred to as the "Roaring Twenties." When taxes were raised under Hoover, a trend that included
Smoot-Hawley, incentives that had been so well structured
by the earlier tax cuts were destroyed, and again, Dr.
Laffer reminded us that the following years are referred to
as the "Great Depression." "The United States had tariffs ... raised higher in
the twentieth century, especially by the Smoot-Hawley tariff
of 1930, which some scholars regard as partly responsible for
the severity of the depression." Milton Friedman again
refers us to the importance and possible consequences of a
high tariff. But why was Smoot-Hawley considered to be so
detrimental?
The reason for this is that Smoot-Hawley imposed taxes
in an area of great importance to any economy- international
Foreign countries were flattened by higher U.S. tariffs. The impoverishment of foreign producers reduced their purchases of, say, U.S. cotton, thus bankrupting both farmers and the farmers' banks. An effective limit on imports also reduces exports. Without the dollars obtained by selling here, foreign countries could not afford to buy our goods (or to repay their debts). Americans also had little use for foreign currency, since foreign goods were subject to prohibitive tariffs, so the dollar was artificially costly in terms of other currencies. That too depressed our exports, which turned out to be particularly devastating to farmers — the group that was supposed to benefit from the tariffs.

Reynold's explanation helps to make clear the bad effects of the tariff. Also, other countries at this time started to ship gold to the United States as a result of the Smoot-Hawley tariff, and Milton Friedman explains how the Federal Reserve System should have reacted to this. Friedman's explanation of the depression rests mainly with the Federal Reserve, so a short history of this institution will be given followed by Friedman's criticism of the system.

The Federal Reserve Act of 1913 was the result of a recession and a panic that occurred in 1907 and 1908. The Federal Reserve System started operations in 1914, and it gained respect and prominence after World War I. The Federal Reserve System was rather successful in the Twenties, partly due to the actions of Benjamin Strong, then head of the Federal Reserve Bank of New York. He died unfortunately, and the Federal Reserve Bank in Washington, D.C., the headquarters, which was "weak and divided" decided that it would assume the leadership role formerly held by Strong and his
New York branch. This caused much dissention.\textsuperscript{38}

Bank closings at that time were feared, and when the Bank of United States closed in December 1930, it was the biggest commercial bank in the country to close up to that time, and as a result people rushed to banks everywhere to get their deposited money. A rescue plan to save the Bank of United States (and to stave off the panic) was devised, but it failed partly because of adverse feelings toward the bank because of the advantage of its name and because of the "anti-Semitism" among the people who could have saved the largely Jewish owned and operated bank. The Fed was included in the merging plan to save the Bank of United States, but it could have "provided a far better solution by engaging in ... open market purchases ... ."\textsuperscript{39} Friedman then gives the cause for the subsequent closing of the thousands of banks across the country by saying that these open market operations

\ldots would have provided the banks with the additional cash to meet the demands of their depositors ... . Unfortunately, the Fed's actions were resistant and small. In the main, it stood idly by and let the crisis take the course.\textsuperscript{40}

Once in 1932, Congress ordered the Federal Reserve to step up its purchases of government bonds, and soon the good effects were being felt by the economy. Congress, however, adjourned so the Federal Reserve promptly stopped its open market operations.\textsuperscript{41} Also, the stock of gold in the United States rose from August 1929 to August 1931, partly due to the Smoot-Hawley tariff. "Had the Federal Reserve System followed the rules of the gold standard, it should have
reacted to the inflow of gold by increasing the quantity of money." Instead the money supply fell. Had the Federal Reserve System raised the supply of money, both the failing banks would have been saved and businesses would have been able to obtain the capital they needed to grow.

CONCLUSION:

It is not feasible to try to derive one cause for the Great Depression. There are just too many variables. However, I feel it can be said, and backed up by appropriate research, that the cause of the depression in the United States was inherent in the policy thinking of the Thirties; namely in the areas of restrictive tariffs and the money supply. The Congress of the United States did not act in the best interest of America or capitalism by enacting the Smoot-Hawley tariff. The Federal Reserve System did not act in a responsible way (a way it was originally intended to function) by not participating in open market operations to raise the money supply. A complex interaction of the Smoot-Hawley tariff and the Federal Reserve System's decisions led to the nation's most severe depression. Hopefully, the government of the United States has learned from the past, and it will never again pass into law such a prohibitive tariff. And hopefully, the Federal Reserve System can learn from its past and never permit such a catastrophe to happen again. The United States can ill afford another blow from
within as crippling as the one in the 1930's. I feel that now we are more educated and experienced, and we are too aware to let such mishaps occur again. If the policies of the Thirties were our downfall, maybe we can look at the policies of today such as the tax cuts and the deregulations, as policies of hope and promise that will enable our economy to remain strong and stable well into the twenty-first century.
NOTES


2 Ibid.


5 Ibid., p. 231.

6 Ibid., pp. 237-238.


8 Ibid., p. 32.

9 Ibid., p. 33.

10 Ibid., p. 34.

11 Ibid., pp. 35-36.

12 Ibid., pp. 35-36.


14 Ibid., pp. 292-301.


16 Ibid.

17 Ibid., p. 182.

18 Ibid.

19 Ibid.

20 Ibid., pp. 182-183.

21 Ibid., pp. 183-184.

22 Ibid., p. 184.

23 Ibid., p. 187.

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26 Gordon Thomas and Max Morgan Witts, "The Day the Bubble Burst," Reader's Digest, October 1979, p. 236.

27 Ibid., p. 287.


32 Alan Reynolds, "What do We Know About the Great Crash?" National Review, 9 Nov. 1979, p. 1418.


34 Ibid.

35 Ibid.

36 Friedman, p. 32.

37 Reynolds, p. 1419.

38 Friedman, pp. 64-70.

39 Ibid., pp. 72-74.

40 Ibid., p. 75.

41 Ibid.

42 Ibid., p. 80.
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