Causes of the great depression

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Economic fluctuations are inevitable in any nations that have any kinds of market, industries and more. However, there are always some unknown factors that deteriorate the fluctuations. During the 20 th century, there were various economic fluctuations including the Great Depression which was triggered by some unknown factors at the time. This depression was considered one of the worst depressions ever faced by many nations during the time. Unemployment rate peaked at 24. 9% that many people lost their jobs and decided to give up on their lives.[1]Even inflation rates sharply fluctuated which made investors to hesitate that whether they should invest or not. The Great Depression affected many nations around the world, including the U. S, and put these nations into disastrous situations. In this paper, there are two sections. First, I will talk about how the Great Depression started and came to hit the U. S. Also, I will be discussing about some effects the depression brought to the U. S. Lastly, I will talk about how the U. S economy was recovered and the process behind it.

Falling Economy

It is hard to point out where it exactly started from, but most countries started to face the depression at the same time.[2]Before we discuss about the Great Depression, let’s look at the industrial production of several countries. Before the depression started, many nations reached their peaks of production. During the time, the five major industrialized countries, the United States, Canada, Germany, Japan, and the United Kingdom, were highly innovative, competitive, and large-investing nations. Among 22

industrialized nations, the United States was not hit by the Great Depression until first twelve countries were tied to the depression.[3]

Most nations that are part of the League of Nations were affected by the depression in similar ways, but the U. S did not responded in the same way. Among these variations, how the United States faced immediate severity of the Great Depression in ways that sharp decline in American output is more important.[4]The first year for most countries was just a common bad year that they faced the average decline in production only over 9 percent, which was not considered that severe. Compared to these countries, the U. S faced a huge decline in industrial production, 21 percent in the first year. This fact makes the Great Depression was considered great in the U. S earlier than other nations.[5]

In more depth about the decline in output, the initial fall in production was more focused on consumer goods, while investment goods remained relatively the same unlike other countries.[6]However, as this depression continued a few years, most countries were experiencing a greater depression than before. Among these countries, however, the United States was an apparent loser that from the peak to fall in industrial production of 62 percent, which is a significant number. There was no country that experienced the same magnitude of the decline.[7]

Now, let’s talk about the causes of the “ American” depression. Simply, between 1929 and 1933, there were chains of shocks caused the United States’ aggregate demand to decline repeatedly, which caused the economy down.[8]Specifically, the U. S. economy was apparently experiencing

downturn in the summer of 1929. However, in the beginning, this downturn was at slow pace. Not surprisingly, the source of this downturn was tightening of Federal Reserve policy, which Fed started open market sales of securities in January 1928.[9]Unfortunately, Fed failed to decrease in the money supply because banks sought this as opportunities that they significantly increased their borrowing at the discount window.[10]Both nominal and real interest rates dramatically increased due to the interplay of the open market sales and the increased demand for money and brokers' loans caused by the stock market boom.[11]

Whenever there is rise in interest rates, it is assumable that the country will face some kind of negative situations because this rise would make people to save more than investment, which creates imbalance between savings and investments. And this monetary policy that causes this significant rise in interest rates was mostly due to the stock market according to Hamilton.[12]And the situation deteriorated in October 1929 as the stock market crashed. The Federal Reserve Bank of New York bought significant amounts of government bonds, thus increasing the stock of high-powered money, which made both nominal and real interest rates fall sharply, but was not good enough to hold the depression back. And even bank panics followed up and the real interest rates became consistently high.[13]

Another feature of the depression is the collapse in domestic consumption spending which followed the stock market crash. As mentioned earlier, consumer spending played a significant role in the decline of output.[14]The main source of this drop in consumption was the crash market itself. The stock market crash and frequent fluctuations in stock prices created large

amount of uncertainties about future income. The fluctuations of stock prices did not always made consumers and investors pessimistic about future, but just uncertain.[15]Also, this uncertainty was fostered by forecasts made by analysts of the time that they expressed tremendous uncertainty about their assumptions of the future.[16]And yes, it did immediately cut consumers' and investors' spending on irreversible goods and they simply waited for future information. Fortunately, sellers of essential goods, grocery stores for example experienced rise in their profits, since everyone was restraining themselves from wasting their income. Also, the effect of uncertainty also decreased consumer spending by decreasing wealth and by shifting households' balance sheets toward illiquidity.[17]

Lastly, let's talk about last feature that deteriorated the depression. Doubtlessly, last source of the continuous decline in production was a series of banking panics.[18]Several panics occurred in sequences that one wave of panics followed by another and so on. In the process, more than 9000 banks were inevitably forced to suspend their operations and depositors and stockholders lost roughly $2. 5 billion.[19]In detail, these banking failures came in many ways. First, the money supply was directly impacted by the bank failures. The ratio of deposits to currency fell significantly because the safety of banks misgave depositors which made them not to save their money to banks.[20]This lack of deposits to the banks sharply reduced the money multiplier and the situation got worse as the Fed has done nothing to increase the stock of high-powered money, which could reduce the effects of this shock in money supply. Also, the financial panics interrupted the intermediation role of banks. As the bank failures prevented these banks to

help out small businesses that cannot issue stocks or bonds, it became more expensive for other banks to loan to customers from the failed banks, because it required large amounts of transaction costs, which worsened the depression.[21]

Recovery from the Great Depression

There were many factors that deteriorated the depression and it seems unrecoverable. Then what possibly can restore the economy of the United States? There could been many solutions, but one solution at the time was stimulus to aggregate demand, large portion of it was in the form of monetary expansion.[22]Before the monetary expansion, there have been many fiscal policies involved to fix the situation, but they were mostly ineffective. The fact that aggregate demand stimulus really brought the recovery was largely caused by demand-induced changes in the money multiplier, which make people to spend their money instead of just keeping it under their bed.[23]

Then how did this monetary expansion really took place? The main source of this increase in the money supply of the United States was a large amount of gold inflow began in 1933.[24]The rapid rate of the growth was a " consequence of gold inflow produced by the revaluation of gold plus the flight of capital to the United States. It was in no way a consequence of the contemporaneous business expansion."[25]This increase in gold inflow and revaluation made people to spend more dollars on gold in exchange of risk of holding dollars.

Another source of the immense movement of funds to the United States was the fast deterioration in the international political situation.[26]European citizens largely transferred their funds to the United States due to the increasing threat of a European war which created misgiving of seizure or destruction of wealth by the enemy.[27]Many economists concluded that " Munich and the outbreak of war in Europe were the main factors determining the U. S. money stock, as Hitler and the gold miners had been."[28]It is ironic that other countries' economic collapses helped the U. S. to restore its economy.

To make the argument that monetary expansion was the source of the recovery more plausible, let's look at the transmission mechanism. It is widely accepted that the increase in money supply will decrease the interest rates. First, nominal interest rates fall as the money stock increases. With fixed or rising expected inflation, the fall in nominal interest rates implies a fall in real interest rates. This drop in rates will foster people to buy more of equipment and durable consumer goods because cost of borrowing decreased as interest rates dropped.[29]

During the depression, rise in wages and prices were not fully offset by the rapid monetary expansion. If money supply did not grow as fast as the rise in wages and prices, real balances would not have improved and there would have been no force on nominal interest rates, which possibly could restrain the restoration. But in fact the money supply did grow at very rapid rate that the prices and wages did not completely amend to the very rapid rates of money growth. This made the real balances to increase while the nominal interest rates fall during the recovery process. Even with these very low

nominal interest rates, the economy was not fully recovered yet, but there was no other way to continue the monetary expansion. So, the main way to continue the monetary expansion was to encourage the economy by generating potentials of inflation and thus triggering a reduction in real interest rates. However, consumers and investors believed in the stickiness of price which made them to think that prices would rise ultimately and therefore expected inflation over the not too distant horizon.[30]

In order for monetary expansions to stimulate the economy, not only the real interest rates had to decrease, but there had to be positive respond in investment and other types of interest-sensitive spending.[31]In fact, the economy responded as expected that there have been sharp increase in fixed investment and the consumption of durable goods. Over the next few years, the spending grew very rapidly as the real interest rates stayed negative. Although the economy still experienced fluctuations that real interest rates turned significantly positive which disrupted the growth of the economy by restraining the consumption and investment. However, overall the economy was finding its way back to the peak again at very fast rate that spending remained consistently high enough to stimulate the growth.

Conclusion

The Great Depression occurred in 1929 around the world indeed led the time into a chaos. Although the Great Depression occurred simultaneously in the industrialized countries, the U. S. depression was quite unique in several ways. Compare to other nations, the U. S. experienced much more severe declines. No country experienced similar magnitude of depression as the U.

S. did. Also, the United States' depression was started by a decline in consumption in durable goods due, increase bank failures, and sharp rise in interest rates. Since the Great Depression was a worldwide problem so it can be considered international shocks, but it also can be considered as national aggregate demand shocks, only in American perspective, because it had many uniquely American roots. There were many shocks that were internationally dealt, but it was ultimately the U. S. shocks and the U. S. policy choices that determined the path of the America.[32]

Throughout the depression, the U. S. government tried many things to solve the situation. Yes, in fact the monetary expansion was the important key to the restoration of the United States' economy from the depression. On the other hand, fiscal policy did not really help anything during the process and remained ineffective until 1942. Since, many international elements also contributed to the U. S. depression, there had to be some international elements to get through the situation. In fact, World War II helped the U. S. economy from further deterioration by many Europeans transfer their funds to the U. S. in order to avoid the risk of losing them by the war. Also, the large amount of gold inflow helped the U. S. expansionary monetary developments to be successful in decreasing both nominal and real interest rates, which stimulated the economy and people to spend their money on consumption of durable goods and investments. Also, the very low interest rates helped this positive atmosphere to continue furthermore and in fact the U. S. economy successfully recovered from the depression.[33]

Although the Great Depression was successfully overcome, it is still doubtful that other depressions can be handled in the same way. Future research and

more data is needed to confirm and confidently conclude that the actions took during the Great Depression was the “ most” efficient and effective options.

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