The prevention of the stock market crash economics essay

ASSIGN BUSTER

The Great Depression was an economic slump in North America, Europe, and other industrialized areas of the world that began in 1929 and lasted until 1939. It was the longest and most severe depression the world had ever seen. What happened and how did the stock market crash occur? Could it have been avoided? Simply put, yes! There were numerous issues and oversights that were made during that time by all Americans. Obviously, it did not occur overnight. Where had the consumers, government, and/or businesses gone wrong? There is no doubt that we, as Americans, have become smarter in terms of our economic knowledge, but are we doomed to go through another Great Depression in the future? What have we done, or what can we do to avoid this from happening again?

To understand the Great Depression we first must look back at the economy prior to that time. “ For most Americans the stock market crash of 1929 has become the symbol marking the beginning of the Great Depression. The economic boom of the 1920s was reflected in a stock market which rose from 60 in 1920 to its peak of 381 on September 3, 1929” (Tothero & Crowley, 2008). After World War I, the soldiers returned home. They had money in their pockets and many new products to spend their money on. Prior to the war, many products on the market were considered a luxury, but with the onset of mass production, many of those items that were considered a luxury were now common. With the soldiers returning from the war, everyone having money in their pockets, and having products and services readily available, this put the world in a euphoric state, with the idea that everything was ideal. The “ Roaring Twenties,” as they were referred to, was a time of great economic prosperity. This was mostly due to

the wide array of consumer goods that were available. “ New technologies, soaring business profits, and higher wages allowed more and more Americans to purchase a wide range of consumer goods. Prosperity also provided Americans with more leisure time…” (“ The Great Depression (1920-1940),” 2009). Americans were purchasing more consumer products on credit such as automobiles. As the economy blossomed, suburbs were created, U. S. cities had drastically changed, radios began broadcasting news and music, and the aviation and motion picture industry had grown, as well. Times were good for the American people during the Roaring Twenties. “ The decade saw North America becoming the richest region on the earth, with industry aligned to mass production, and a society with a culture of consumerism” (“ Roaring Twenties – Economy of the 1920s,” 2005). With so much growth in the economy at that time, the government did not feel that they were in jeopardy of a crash so they did not intervene.

Since the war was over and all the men were home, there were goods and services being pumped into the economy and everyone had money to spend. People were borrowing and spending money without a care, and thought nothing could go wrong. By the time the government figured out there was a problem with the economy, it was already too late. “ Prior to the Great Depression, governments traditionally took little or no action in time of business downturn, relying instead on impersonal market forces to achieve the necessary economic correction. From one extreme to the other – boom to bust. The magical prosperity vanished almost overnight as people lost confidence following the stock market crash” (Nelson, ed., 2000). This could have possibly avoided the crash had the government had the foresight to be

more strict with the financial institutions and their lending habits. Individuals should have been wiser with their spending. They should have saved money rather than buying things they did not necessarily need.

During the early 1920s, federal spending grew three times larger than tax collections and when the government cut back spending to balance the budget, a severe recession was the result of those actions. The value of farmland fell 30-40 percent, and the middle class comprised about 15 to 20 percent of all Americans, while the richest one person owned 40 percent of the nation’s wealth. Between 1920 and 1929, individual worker productivity rose 43 percent and the number of people reporting half-million dollar incomes grew from 156 to 1, 489 between this time period; a phenomenal rise compared to other decades, but still less than the one percent of all income-earners. In the early 1930s, more than half of all Americans were living below the minimum subsistence level and the annual per-capita income was $750; and $273 for farm people. Construction was down by $2 billion and then a recession began, approximately two months before the stock market crash. During this timeframe, production declined 20 percent, wholesale prices were at 7. 5 percent and personal income was at 5 percent. Then, on October 24, the stock market crashed. Investors called October 29th Black Tuesday for the loss of $16 billion, which was a lot of money in those days. Also during this time, the gross domestic product (GDP) fell 9. 4 percent from the year before and the unemployment rate rose from 3. 2 to 8. 7 percent. During this time there was absolute panic, no major legislations were passed addressing the depression, a second banking scare occurred in

the spring, the GDP fell another 8. 5 percent, and unemployment rose to 15. 9 percent.

The decline in the GDP, while dramatic, was not as spectacular as the explosion in the unemployment rate. Mainly because the unemployment rate represents what was not produced that could have been produced. Consumer purchasing somewhat fell, government purchases did not fall at all compared to 1929, but there was a dramatic collapse of investment purchases. Why did investment purchases collapse so dramatically? Because interest rates affect investments. The problem in the early 1930s was that the rate of inflation was negative, meaning there was deflation instead of inflation. This meant that borrowers were not paying back as much money as they borrowed. The table below shows the nominal interest rate was declining during this period, but because the rate of inflation was negative, the real interest rate was much higher than the nominal interest rate.

YEAR

PRICE

INDEX

RATE OF

INFLATION

%

NOMINAL

INTEREST

RATE

%

REAL

INTEREST

RATE

%

1929

13. 12

5. 85

1930

12. 60

-3. 96

3. 59

7. 87

1931

11. 34

-10. 00

2. 64

14. 04

1932

10. 05

-11. 38

2. 73

15. 92

1933

9. 78

-2. 96

1. 73

4. 54

In the years leading up to the stock market crash, the stock market had gained much popularity as a way of making money. Because stock prices had been on the rise, they gained the reputation of being a safe way to invest. Beginning in 1926 and ending with the crash in 1929, the market moved up nearly 400%. Many investors believed stocks were their ticket to riches (Valentine, 2009). Investors were talking up the idea of how much money could be made by investing in stock. With all the talk of the " get rich quick" scheme and the relaxed credit terms from banks, the buying frenzy began.

Simply put, people were naive, greedy, and wanted a way to get rich quickly. American businesses and the people placed too much faith on what they did not fully understand, and they did not think of the long-term repercussions that could occur in the event of an economic crisis, such as a recession, or in this case, with the Great Depression. Problem one: People were too loose with their money. Rather than to save for their families, they placed their money in the stock market in hopes of receiving a nice return. People were purchasing stock on margin. What does this mean? They were only required to pay 10% down and borrow the other 90%. " For example, if $10 worth of stock was purchased, the investor put in $1, while the mortgage broker put in the other $9. It was a good deal as long as stocks were gaining value. However, if the stock lost value, the stockbroker would issue a margin call requiring the investor to pay back the loan. In the example above, not only did the investor lose the $1 he invested, he also had to pay back the $9 he'd borrowed" (Valentine, 2009). As you can see from the example, stocks could go awry at any given time injuring the broker, but more specifically injuring

the investor. People were disillusioned that stocks would always rise and never fall. Today, not all stocks and investors are eligible for a margin account. This is a great benefit in determining what stocks investors are safer using, such as a margin account, and may not be so prone to losing the funds that are invested. Do you recall the definition of a margin call? Money placed for the original purchase of a stock needed to be paid back by someone; the investor. The economy rapidly deteriorated as people sold their stocks to hold on to their hard earned money, and brokers wanted their borrowed money back. Resolution: In general, there is no resolution on how people should spent their money. We cannot tell another individual what they can or cannot buy. Some people save, while others do not. An option that is current in present times, but could have been an acceptable solution prior to the crash, could have been to have financial regulators increase their financial ratio requirements for banks so less money would have been borrowed. Banks would have had less of a money supply by doing as such. Perhaps by increasing the banks financial ratio requirements, Americans generally could have spent less and purchased less in stocks.

“ The stock market crash devastated the American economy because not only had individual investors put their money into stocks, so did businesses. When the stock market crashed, businesses lost their money. Consumers lost their money too, because many banks had invested their money without their permission or knowledge” (Valentine, 2009). Problem 2: There were no programs that would protect the consumers from having their money be used, without their permission, by banks to pay back debts for the stocks. As you can imagine, American consumers and businesses were losing money,

which caused people to panic and pull their life savings from the banks to hold on to what they had left in order to feed their families. Resolution: Unfortunately, without the regulations in place, there were no regulatory rules on what could or could not be done by the banks. The financial institutions were stealing money from the American people without permission. Until the proper regulations were put into place, there was nothing that could have been done at that time. Resolution: Eventually, " the Securities and Exchange Commission (SEC) was created…to regulate stocks, bonds, and other commissions. The Federal Deposit Insurance Corporation (FDIC) was also created to insure consumers' deposits in FDIC-enrolled financial institutions. In addition, the Federal Crop Insurance Corporation (FCIC) was created to insure crops planted by farmers" (Valentine, 2009).

Soon after Herbert Hoover became president, the stock market began to take a turn for the worst. "…In 1929, some of the larger investors realized the stock prices were artificially high as a result of the mass investments from speculative investors. So, those ' savvy' investors started trading their stocks and consequently, stock prices began to fall. Then, brokers issued margin

calls leading to further stock market drops" (Valentine, 2009). Problem three: The way the stock market was handling the tracking of the volume of buying and selling of stocks. As stocks were traded and falling in price, investors started selling their shares over the course of several days, being Black Thursday through Black Tuesday, which caused the stock market to crash because millions of shares were being sold too rapidly. The technology then was not what it is today. This should have been taken into consideration

when dealing with something of this magnitude. At one point the ticker tapes were nearly 90 minutes behind the market causing the market to drop by 33 points or 9% by the end of the day. Also, by Tuesday, the ticker tapes fell nearly 3 hours behind causing another 12 % drop in the market. Due to the issues with tracking most of the time investors were trading blind (" Stock Market Crash of 1929", 2007). Knowing what we know today, regulations should have been put into place to help keep things under control. For example, today if the DOW drops by 10% before 2 p. m., trading will be halted for one hour. If the DOW drops by 20% before 2 p. m., trading will be halted for two hours. If the DOW drops 30% before 2 p. m., trading will be halted for one day and if another event such as September 11, 2001 occurs, they will either close early or not open at all to prevent panic (Little, 2009).

Besides the issues of tracking, another subject to address is the relaxed credit terms. When stock prices began to drop, the market started changing. In turn, investors were requiring the loans to be paid in full. If the individual had their money in the bank, there was a good chance the bank had invested their money without their permission causing yet another loss of funds on top of the money they had already lost themselves in the stock market. Although President Hoover believed that the government should not intervene with the economy, he said families could turn the economy around if they continued to work hard and rely on themselves (Valentine, 2009). Of course, we all know hindsight is 20/20, but by creating the SEC, FDIC, and FCIC I believe that it helps the economy have a little assurance that the government is trying to help anyway that they can to prevent the stock market from crashing again.

In conclusion, it takes more than the government, investments, and American people to change economic activity. It takes everyone in the U. S. to contribute, in one way or another, to the overall health of the economy. In regards to government involvement, money supplies and/or government spending can be increased or decreased, and/or taxes can be lowered or raised in order to assist in the health of an economy. Businesses can invest in new equipment or buildings, and/or construct new homes. We, as consumers, should find a happy medium, if applicable, to our spending habits. For instance, do not borrow more than you can pay back or afford. On the same note, do not spend more of your income on unwanted items and only spend on what is absolutely needed, such as food, clothing, bills, and leisurely activities. Unlike many Americans prior to the stock market crash, do the needed research prior to blindly committing and purchasing any good or service that is not 100% understood. It is best to financially access your individual needs based on your income. Take into consideration the chances of a potential layoff or the future health of a loved when considering a major purchase of something. It is best to plan for the future and to invest in something that is thoroughly researched and understood prior to placing your life, and that of your family, at stake. With all the more economic knowledge we know today, can we avoid another Great Depression? Only time will tell if lessons have been learned, but knowledge is the first step in understanding how to avoid disasters such as those that had occurred 80 years ago.