

Chapter 30

The Causes of the Great Depression

What caused the most severe economic crisis in American history?

30.1 Introduction

The door to the hotel room burst open. Groucho Marx, a wealthy, famous actor, and quite likely the funniest man in America, was breathless. He had just received a hot stock tip: shares of Union Carbide were a sure bet to go up in price.

From the doorway, Groucho shouted the news to his sleepy-eyed brother Harpo. They had to act fast, he said, before others heard the same tip. Harpo, still in his bathrobe, asked his brother to wait while he got dressed. “Are you crazy?” Groucho growled. “If we wait until you get your clothes on, the stock may jump 10 points.” That day, Harpo Marx bought stock in his bathrobe.

The Marx brothers were not alone in their enthusiasm for buying stocks. In the late 1920s, many people were investing. As more and more people put money in the stock market, prices of shares kept rising. By the fall of 1929, Groucho was rich but nervous. Just how long would the good times last?

Unfortunately, Groucho’s world, and that of every other American, was about to change significantly. On Tuesday, October 29, 1929, a day still remembered as **Black Tuesday**, stock prices plunged. Stocks lost their value because, all at once, many people wanted to sell their shares but very few people wanted to buy. Groucho saw his fortune evaporate that day. So did many other Americans. Suddenly the good times were over.

The 1920s were not supposed to end this way. Just the year before, President Herbert Hoover had boasted that the nation was “nearer to the final triumph over poverty than ever before in the history of any land.” That triumph never happened. Instead, the nation slid into the longest economic slump Americans had ever experienced—the Great Depression.

The stock market crash was a key cause of the Great Depression, but it was not the only cause. Other factors contributed, too. In this chapter, you will learn how conditions of the 1920s and choices made after the stock market crash combined to bring about the worst economic crisis in American history.

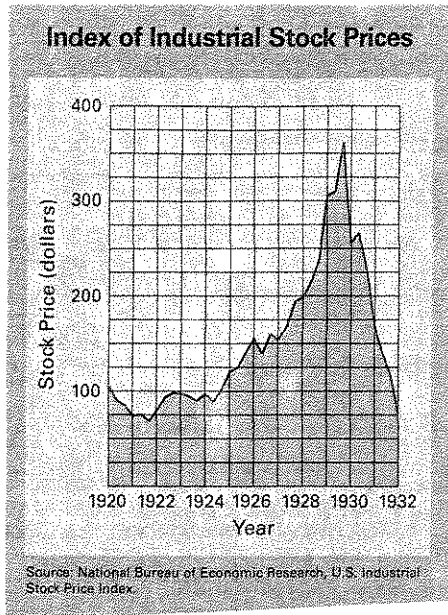


Crowds gathered outside the New York Stock Exchange as the market plummeted on Black Tuesday. Many investors lost everything they owned in the crash. Ticker-tape printouts showed the prices at which stocks were being bought and sold. Record numbers of shares were traded as investors tried desperately to sell their stocks before their shares became worthless.

4 A man selling his car after the stock market crash

30.2 A Shaky Stock Market Triggers a Banking Crisis

The purpose of the stock market is to provide businesses with the capital they need to grow. Business owners sell portions, or shares, of their companies to investors. By buying shares, investors supply money for businesses to expand. When all is well, the stock market is a useful tool in a capitalist economy. But all was not well in the 1920s.



Frightening headlines on the stock market crash fueled public anxiety and helped contribute to the financial collapse that followed. As the graph shows, the index of industrial stocks plunged between its peak in 1929 and 1932, losing nearly two thirds of its value. A stock index measures the performance of stock prices over time.

A Speculative Boom Leads to a Spectacular Crash The stock market boom began innocently enough. Businesses thrived in the 1920s. Manufacturers were making products that consumers were eager to buy. As Americans saw business profits growing, many thought they could make a lot of money by buying shares in successful companies. The promise of financial gain drew new investors to the stock market. The result was a **bull market**, or a steady rise in stock prices over a long period of time.

But investing is not a rational science. In the late 1920s, a lot of people were swept up in the wave of speculative enthusiasm for the stock market. Like Groucho Marx, these investors believed that if prices were high today, they would go even higher tomorrow. So they bought the maximum number of shares they could afford and began counting their paper profits as the price of most stocks went up. It seemed to many Americans that there was no limit to how high the bull market could go. Investor optimism was so intense that not only did people put their savings in the stock market, but a growing number actually borrowed money to invest in stocks.

Borrowing money was easy to do in the 1920s. A buyer might pay as little as 10 percent of a stock's price and borrow the other 90 percent from a **broker**, a person who sells stock. The result was that someone with just \$1,000 could borrow \$9,000 and buy \$10,000 worth of shares. This is called **buying on margin**. When the market was rising, brokers were happy to lend money to almost anyone.

Easy borrowing encouraged speculation, or the making of risky investments in the hope of earning large profits. Stock speculators do not necessarily buy stock to own a part of a company they believe will do well. They buy stock to make as much money as they can as quickly as possible. In a speculative market, a company's stock price does not go up because the company is growing. Prices rise because speculators want to buy a stock today and sell it for a quick profit tomorrow. As speculation drives up the price of a company's stock, the total value of the stock may become worth far more than the company itself.

Rising stock prices created a high-flying bull market without a solid foundation. When the market turned down, this borrowed-money house of cards collapsed. As prices dropped, creditors who had loaned money for buying stock on margin demanded that those loans be repaid. Unfortunately, because of falling prices, most investors could not make enough selling their stocks to repay their loans. Many had to sell their homes, cars, and furniture to pay their debts. Even businesses were affected. Many companies that had invested their profits in the stock market lost everything and had to close their doors.

Stock market prices peaked on September 3, 1929. After that, prices began dropping, sometimes in small increments, sometimes in tumbles like the huge

drop on Black Tuesday in October. By then it was clear to many investors that a **bear market**, in which prices decrease steadily, had begun. Fearful of losing everything, investors rushed to sell their stocks, pushing prices down still further. By the end of the year, investors had lost more than \$30 billion—an amount that exceeded the money spent by the United States to fight World War I.

A Banking Crisis Wipes Out People's Savings

The stock market crash also hurt banks, triggering a crisis that unfolded over the next three years. To understand how stock losses affected banks, think about how banks operate. When people are prospering, they deposit money they do not need for day-to-day expenses in banks. The money they deposit does not just sit in the bank vault. Banks lend it out to businesses or other borrowers to earn **interest**. Interest is the charge made by a bank for the use of their money. Bank loans help people start businesses, buy homes, and plant crops.

In the 1920s, banks caught the same stock market fever that gripped the nation as a whole. Usually bankers lend money to businesses or farmers. But in the 1920s, they increasingly loaned money to stockbrokers, who in turn loaned that borrowed money to individual investors. When the stock market took a nosedive in October 1929, many investors could not repay the money borrowed from their brokers. In turn, brokers who had borrowed money from banks could not repay their loans. With bad loans piling up, banks stopped looking like a safe place to keep one's money.

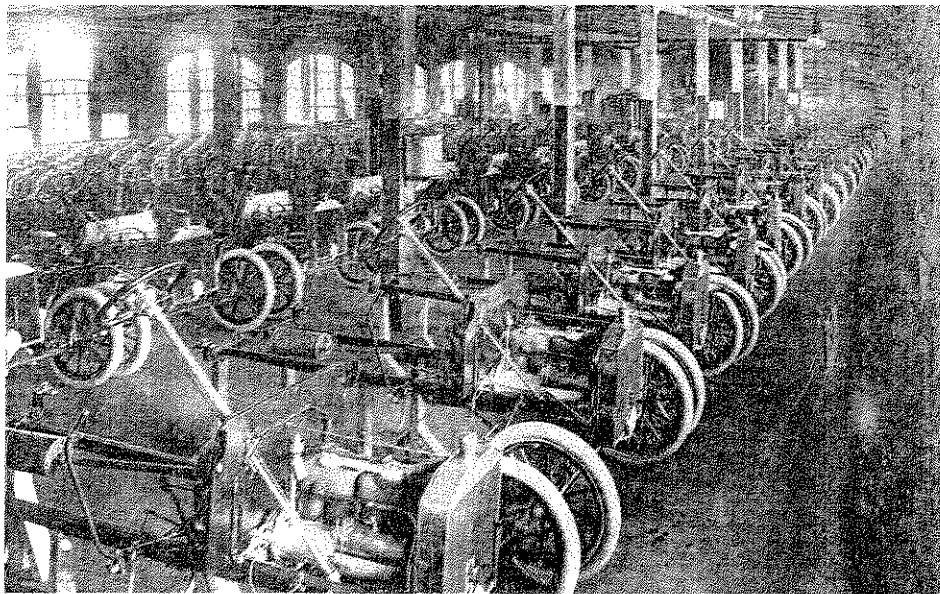
People who had trusted their money to banks had good reason to worry. Even before the Depression, it was not unheard of for banks to go out of business, wiping out the savings of their depositors. During the "good times" between 1923 and 1929, banks folded at the rate of about two per day. Most of these failures were small rural banks. The stock market crash made this bad situation much worse.

As the economy continued to falter in 1930 and 1931, large numbers of depositors lost confidence in their local banks. The result was a rash of **bank runs**. In a typical bank run, panicked depositors lined up around the block to try to withdraw their money. Those first in line got their money out. But once the bank ran out of cash, it closed its doors. An appalling 3,800 banks failed in 1931 and 1932. By 1933, one fifth of the banks that were in business in the United States in 1930 had gone out of business, and millions of people had seen their savings vanish.



As news of bank failures spread, worried depositors rushed to local banks like this one in hopes of getting their money out before it was too late. Bank runs only made matters worse by forcing healthy banks to close once they ran out of funds to meet their depositors' demands. Bank failures were part of the general economic collapse brought about by the stock market crash, falling farm prices, and the decline of industry.

The Model T, produced by Ford Motor Company, was the most popular car of the 1920s. By 1925, a new Model T was rolling off the assembly line every 10 seconds. By the end of the 1920s, however, Americans could not afford to buy all the cars and other products that were being produced.



30.3 Too Much for Sale, Too Little to Spend

Industry had thrived in the 1920s because manufacturers were able to make a lot of merchandise very quickly. The ability to mass-produce a wide range of consumer goods started the stock boom. However, for mass production to succeed, people had to buy the goods being churned out of factories. By the late 1920s, demand for consumer goods could not keep up with production. People simply could not afford to buy all that was being produced. The resulting glut of goods in the market, combined with the stock market crash and the bank crisis, caused the economy to collapse.

Overproduction Puts Too Many Goods in Stores By 1920, most American factories were using the assembly-line method of mass production. As a result, they were able to make more goods more quickly than ever before. Between 1923 and 1929, the output per worker-hour in manufacturing increased an astounding 32 percent. Farm output, too, increased throughout the 1920s. New machines and new farming techniques expanded farm production even while demand for farm products was falling.

In general, companies welcome increased production because it means increased income. A company that makes appliances, for example, wants to produce as many refrigerators as possible because the more refrigerators it makes, the more it can sell. The more refrigerators the company sells, the more money it earns. If making refrigerators costs less than it did before, so much the better.

Trouble arises when there are not enough consumers to buy all those products rolling off the assembly lines and arriving from the farms. Economists call such a predicament *overproduction*. The term refers to a situation in which more products are being created than people can afford to buy. As the 1920s came to an end, overproduction overwhelmed the American economy.

A Widening Wealth Gap Leads to Rising Debt Greater productivity led to greater profits for businesses. Some of the profits went to workers, whose wages rose steadily in the 1920s. But workers' wages did not go up nearly enough for them to consume as much as manufacturers were producing.

Most business profits went to a relatively small number of people. A wide gap separated the rich from the working class. On one side of the gap, the wealthiest 5 percent of American families received about a third of all the money earned in the country. That was more than the 60 percent of all families at the bottom on the income scale earned. Moreover, an estimated 40 percent of all Americans lived in poverty.

For a time, Americans made up for the unequal distribution of wealth by using credit to buy the radios, cars, and household appliances that flooded the market. The growing advertising industry also helped persuade people that thrift was an old-fashioned value. The more modern approach was to borrow money to buy the latest products right away. Between 1921 and 1929, personal debt more than doubled, from \$3.1 billion to \$6.9 billion.

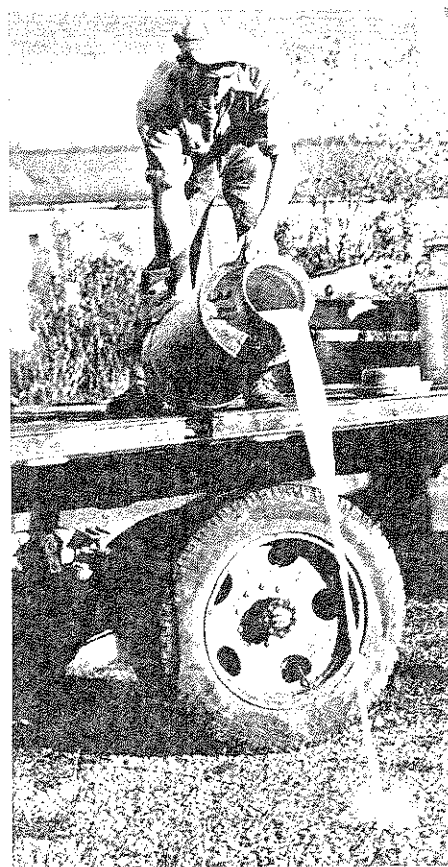
Underconsumption Causes Farm Failures, Bankruptcies, and Layoffs By 1929, the buying spree was coming to an end. Many Americans found themselves deep in debt and were unwilling or unable to borrow more. Even the wealthy, who could afford to buy whatever they wanted, were buying less because they had all the goods they needed. One historian remarked that by 1929, everyone who could buy a car or radio probably already had one. The economy was showing signs of *underconsumption*. This means that people were not buying as much as the economy was producing. It is the flip side of overproduction.

Farmers were the first to experience the pain of underconsumption. Their financial difficulties began after World War I, a full decade before industry began to suffer. During the war, farmers had prospered by supplying food for American soldiers and the people of war-torn Europe. When the war ended, those markets disappeared. Consumption of farm products decreased, causing prices to drop.

Underconsumption affected farms in another way. It caused them to go further into debt. Farm incomes were falling. But farmers still wanted to buy goods made by industry, such as cars, tractors, and appliances. Like everyone else, farmers borrowed money and paid for their goods in installments. As agricultural prices continued to decline, more and more farmers had difficulty making their payments. Some farmers lost everything they owned when banks seized their farms as payment for their debts. As a result, for the first time in the nation's history, the number of farms and farmers began to decline.

By the late 1920s, the problem of underconsumption had spread to industry. Responding to the glut of products on the market, many manufacturers cut back production. In the auto and steel industries, for example, production declined by as much as 38 percent by the end of 1930. Some companies lost so much business that they were forced to declare bankruptcy and close down altogether.

Whether businesses decreased production or went bankrupt, the result was the same for workers: unemployment. As industry declined, companies laid off many workers. Those who lost their jobs also lost the ability to buy the products that industry produced. A vicious downward spiral—consisting of layoffs, reduced consumption, and then more layoffs—was set in motion. Between 1929 and 1933, the unemployment rate rose from 3 percent of the American workforce to 25 percent. Millions of Americans found themselves out of work and, as the Depression wore on, out of hope.



The pain of shrinking markets hurt agriculture years before it affected industry. Excess farm goods could not sit in warehouses until buyers were able to purchase them. Many farmers discarded farm products such as milk because they were unable to sell them.

30.4 Government Actions Make a Bad Situation Worse

By early 1931, the economy was a shambles. Stock prices had plunged. Bank closings were widespread. Manufacturers could not sell their products. And farmers were entering their second decade of financial distress. The federal government, under the leadership of President Herbert Hoover, took steps to improve the situation. Unfortunately, instead of minimizing the damage, many of the government's actions made things worse.

A Tight Money Supply Hobbles the Economy Many economists blame the **Federal Reserve System**, known as "the Fed," for further weakening the economy in 1930 and 1931. The Fed manages the nation's money supply. It decides how much money will be available to circulate among investors, producers, and consumers. One way it adjusts the money supply is by setting the **discount rate**. This is the rate of interest at which banks that belong to the system can borrow money from Federal Reserve banks. Member banks use the discount rate to determine the interest rates they will charge borrowers.

Before the stock market crash, the Fed had kept interest rates low. Low interest rates made borrowing easier. Easy borrowing kept money circulating. In fact, low interest rates had supported the excessive borrowing of the 1920s.

Following the crash, Federal Reserve officials kept rates low for a time. Then, in 1931, it began raising the discount rate. The immediate effect of this action was to decrease the amount of money moving through the economy. The timing of this action could not have been worse. Many people had already stopped spending, and producers had slowed production. Higher interest rates further damaged the economy by depriving businesses of the capital they needed to survive. As the amount of money dwindled, the economy slowed down, like an animal going into hibernation.

If Federal Reserve officials had concentrated on expanding the money supply after the crash, things might have gotten better. More money in circulation would have stimulated the economy to grow by making loans less expensive. Companies would have found it easier to borrow the money they needed to stay in business. This would have reduced their need to lay off so many workers. Consumers would have had more money in their pockets to spend. This would have kept factories humming. Instead, the Fed allowed the money supply to drop by a third between 1929 and 1933. This decline helped turn a nasty recession into an economic calamity.

Tariffs Cause Trade Troubles Economists also blame Congress for making decisions that further hurt the economy. To understand why, one needs to look beyond the United States. Financial problems overseas, especially in Europe, also contributed to the onset of the Great Depression.

World War I had left much of Europe in economic shambles. The Allies were having trouble paying back money borrowed from U.S. banks to finance the war. Germany was in even worse shape. The Germans were able to make their reparation payments to the Allies only by borrowing the money needed from the United States. In order to earn the dollars required to pay off these debts, these nations desperately needed to sell large amounts of goods in the

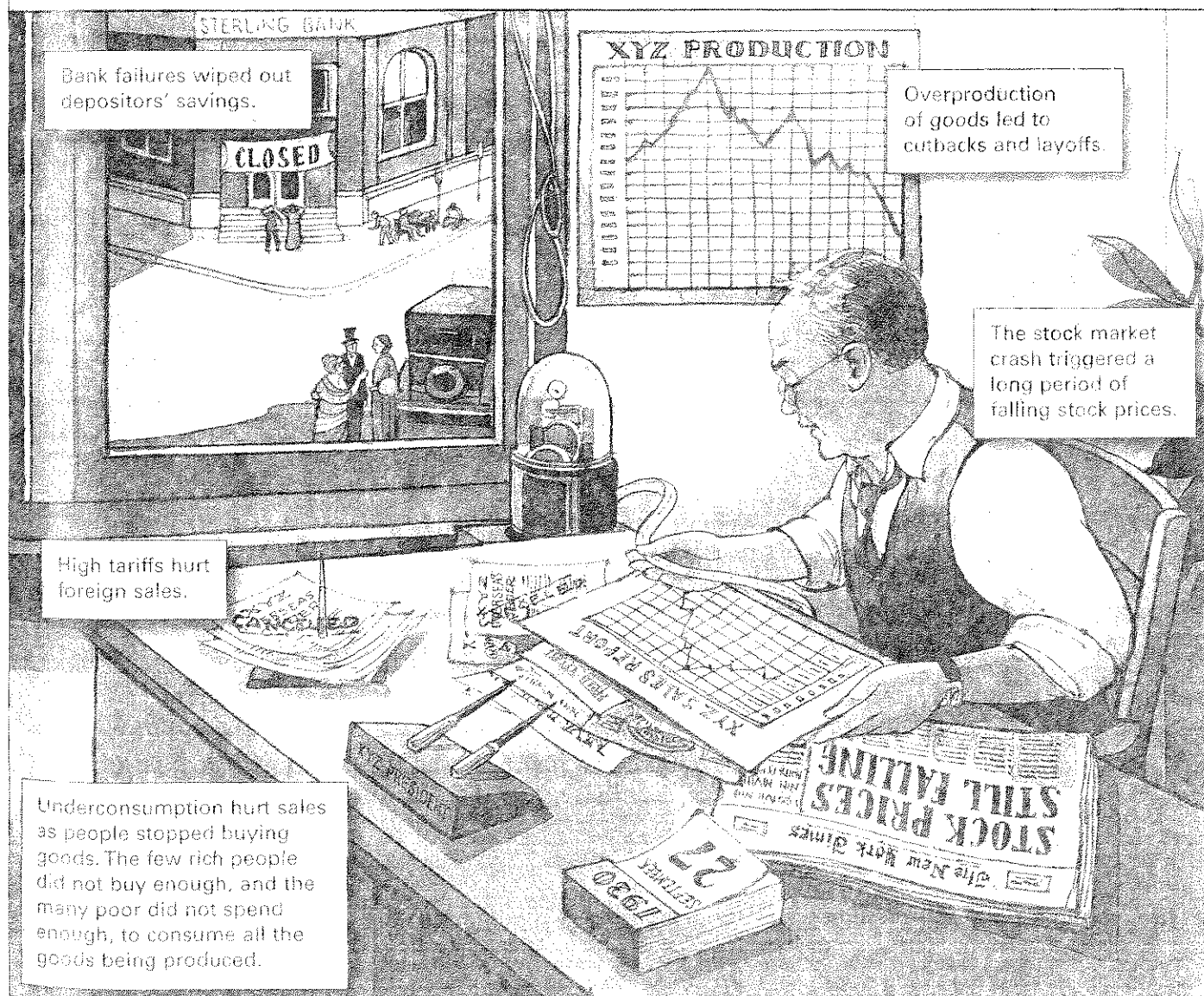
United States. After the war, however, Congress enacted tariffs on many imported goods that made such sales difficult.

In 1930, Congress made a bad situation worse by passing the *Hawley-Smoot Tariff Act*. Congress meant for this law to protect American businesses from foreign competition by raising tariffs still higher. Instead, it triggered a trade war as European countries raised their tariffs on goods imported from the United States. As a result, U.S. farmers and businesses were not able to cope with overproduction by selling their excess goods to other countries.

The record-high tariffs on both sides of the Atlantic stifled international trade. This, in turn, caused a slump in the world economy. Gradually, the Great Depression spread around the globe.

What Caused the Great Depression?

Like most important events in history, the economic calamity that began with the stock market crash had many causes.





Today tulips are a widely grown flower beloved by both gardeners and florists. At the height of “tulipmania,” as the tulip bubble of the 1630s is known, a single bulb was worth a fortune. Like other speculative bubbles, this one eventually burst.



Current Connections

30.5 Speculative Bubbles: Past, Present, and Future

The Great Depression was the worst economic slump in American history. But it was not the only one. The country had experienced depressions before, often when the economy became “overheated” and then collapsed. Historians and economists warn that this “boom-and-bust” cycle could happen again. As in 1929, the trigger for the next economic crisis could be the “popping” of a **speculative bubble**. A speculative bubble is an unrealistic or unfounded rise in economic values.

Bubbles can develop around a particular product—like baseball cards, for example. Or they can affect a whole sector of the economy, such as real estate. In this chapter, you read about the rampant speculation in stocks that helped provoke the stock market crash of 1929. The rise of stock values at the time was a speculative bubble, and Black Tuesday was an example of the popping of a bubble.

Speculative bubbles have occurred many times throughout history. In the 1600s, for example, many investors in Holland got carried away by a rising market in tulip bulbs. It seems strange now, but for a time, tulip bulbs—the bulbs that produce tulip flowers—became as valuable as gold. As “tulipmania” gripped Holland, people sold their homes, businesses, and family jewels to invest in tulips. One bill of sale shows that someone traded a single bulb for 12 sheep, 8 hogs, 4 oxen, 1,000 pounds of cheese, 6 loads of grain, 4 barrels of beer, 2 hogshead of wine, 2 barrels of butter, a marriage bed, and a wagon large enough to haul it all away. When the market came to its senses, the bubble popped and many investors lost vast fortunes.

A similar bubble occurred in the United States in the late 1990s. This was known as the dot-com bubble. During this period, investors poured money into the stocks of brand-new Internet companies—known as dot-coms—hoping to take advantage of the commercial possibilities of the World Wide Web. Many

Dot-Com Stock Prices, 1998

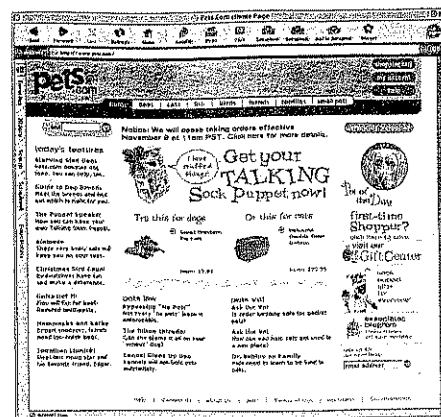
E-company	Price per Share, Sept. 1998	Price per Share, Dec. 1998
eBay	\$18	\$241
Amazon	\$80	\$240

At the height of the dot-com boom, the values of companies, like eBay and Amazon, that used the Internet to sell goods or services skyrocketed. Some investors quit their day jobs to devote all of their time to trading stocks. Many of the companies these day-traders hoped would make them rich did not survive the dot-com bust.

of these new companies had very little actual worth. They didn't make any products or own any assets to speak of. What they offered was a service, or in some cases, just an idea. Investors were entranced. They poured billions of dollars into dot-com stocks. Some investors made out well. But when the bubble burst in 2000, many others lost all their money.

A more recent bubble involved real estate. In some parts of the country, home prices doubled between 2000 and 2005. By then, analysts were warning that housing prices couldn't keep rising forever. The real estate bubble had to burst. In 2006, prices dropped sharply. "It's just like someone flipped a switch," reported a real estate auctioneer as the bubble appeared to burst.

Could the bursting of a speculative bubble today trigger another major depression? No one knows for sure. But the fact is, investors, and people in general, are drawn to making a profit in the capitalist economy. There are likely to be speculative bubbles again, in stocks, real estate, art, or something else yet unknown. And if the history of bubbles is any clue, the market will eventually take a tumble, sending a ripple effect throughout the economy. Some investors will make out just fine, but many will not. The lessons of history are not always easily learned.



Pets.com was founded in 1998 to sell pet supplies over the Internet. Ads featuring a cute sock-puppet dog helped make pet owners aware of the new way to shop. But not enough of them ordered pet supplies online to keep the company going. Pets.com folded in 2000.

Summary

The Great Depression was triggered by the stock market crash of 1929, but many other causes contributed to what became the worst economic crisis in U.S. history.

The stock market crash The stock market crash cost investors millions of dollars and contributed to bank failures and industry bankruptcies.

The financial crisis Banks made risky loans and investments in the 1920s. Some banks had to shut down when the economy collapsed, and many depositors lost their savings.

An unequal distribution of wealth The concentration of money in the hands of a few left most wage earners unable to buy all of the goods businesses were producing.

Underconsumption For a time, many consumers used credit, rather than cash, to buy such goods as cars and radios. When their level of debt grew too high, people stopped buying new products. The result was underconsumption of factory goods.

Overproduction American businesses produced more goods than people wanted or could afford. Eventually, factories had to close and workers lost their jobs.

Tight money supply After the stock market crash, Federal Reserve officials allowed the money supply to shrink. As the amount of money in circulation fell, economic activity decreased. This made it more difficult for businesses to produce and consumers to spend.

Rising interest rates After the stock market crash, Federal Reserve officials raised interest rates, making loans more expensive and limiting the amount of money in circulation. This made it more difficult for businesses to produce and consumers to spend.

Decline of international trade High import tariffs and collapsing European economies restricted international trade and deepened the Depression.