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The Economics of the Great Depression [1]

World War I: 1914-1918

- World War I is a major stimulus to the U.S. economy. The economy booms between 1914 and 1918. The financial havoc reigning in Europe presents U.S. banks with new demands for services. The U.S. economy is the largest in the world in terms of GNP (Gross National Product, the total of all goods and services produced). The financial center of the world shifts from London to Wall Street. After the war, the economy flourishes.

The Roaring '20s

- With their newfound wealth, people buy in record numbers everything from houses to cars to appliances.
- Assembly lines increase production.
- Department stores give credit cards to their wealthier customers. Metal charge-plates are introduced, letting people "charge" their purchases to a credit account. Oil companies offer courtesy cards for charging gas.
- Banks offer loans to stock market speculators on 90 percent*margins* -- that is, people could borrow 90 percent of the value of the stock, in hopes that when the value of the stock rose, it would pay for their investment.
- There are no insider-trading laws to prevent people with special knowledge from manipulating stock prices.
- The stock market undergoes an extraordinary, unprecedented expansion between 1925 and 1929, with stock prices having little relation to the value of companies.
- About 10 percent of U.S. households own stock. (Today, about 50 percent own stock, largely because of 401(k) retirement investment programs.)
- Wealthy Americans look for ways to invest their surplus funds.
- Banks create new financial products for people to invest in. Many of these are risky, but because they are sold by banks or companies affiliated with banks, middle-class investors see them as safe.
- First National City Bank (Citibank) and its stock subsidiary, the National City Company, have 2,000 brokers selling stocks.
- National City Company repackages bad Latin American loans from its affiliated bank and sells them to unknowing investors as new securities. This is one of the deals that initiate the Glass-Steagall Act of 1933.
- Banks speculate on land development, buying real estate in expectation of rising prices.
- By 1929, there are 17,583 state banks and 8,150 national banks.

1929–1930: The Depression begins

- On October 29, 1929, "Black Tuesday," the U.S. stock market crashes. The Dow Jones Industrial Average, a measurement of overall stock prices, drops 25 percent in two days and 30 percent in a week.
- President Herbert Hoover tells Congress the worst effects of the crash are over.
- The Federal Reserve keeps interest rates high and the money supply tight. The economy worsens.
- The Hawley-Smoot Tariff, passed in 1930, steeply raises U.S. tariffs on imports. Foreign governments retaliate, which prevents free trade and lengthens the depression.
- Public confidence in government and business plummets.

1930–1933: The Depression worsens

- Many banks fail, many because they have made loans to stock market speculators that are never repaid.
- Industrial production declines by 47 percent.
- Gross Domestic Product (GDP, the value of all the goods and services produced in the U.S. in a given year) falls by 30 percent.
- Prices begin falling. People expect that goods may be cheaper a year or two later and put off purchases, while the value of investments falls so that people and businesses can't pay back loans. A cycle of *deflation* sets in; prices eventually fall by 33 percent.
- The interest rate on U.S. Treasury bills goes negative because investors are willing to take a loss if they know that their money is safe.
- By 1932, the unemployment rate reaches 25 percent. National income is 50 percent below that of 1929, and the stock market is 75 percent below its value in 1929.
- The Reconstruction Finance Corporation (RFC) Act of 1932 is President Herbert Hoover’s attempt to stimulate the economy. The act provides loans to banks and to railroads, many of which cannot meet their existing debt payments.
- By 1933, the money supply is 40 percent lower than 1929. Lacking money, people turn to barter.
- Bank runs and closings become common. Afraid of losing their investments, people pull their savings out of banks, but many banks cannot call in their loans to pay their depositors. Approximately 4,000 commercial banks and 1,700 savings and loans (S&Ls) fail. Bank failures resulted in losses to depositors of about $1.3 billion.

- Franklin Delano Roosevelt becomes President in March 1933 and immediately declares a bank holiday, closing the nation's banks temporarily to stop runs on banks [2].

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