What Caused the Great Depression?

Federal Reserve Bank of St. Louis, www.stlouisfed.org/education

Economists continue to study the Great Depression because they still disagree on what caused it. Many theories have been advanced over the years, but there remains no single, universally agreed-upon explanation as to why the Depression happened or why the economy eventually recovered.

The 1929 stock market crash often comes to mind first when people think about the Great Depression. The crash destroyed considerable wealth. Perhaps even more important, the crash sparked doubts about the health of the economy, which led consumers and firms to pull back on their spending, especially on big-ticket items like cars and appliances. However, as big as it was, the stock market crash alone did not cause the Great Depression.

Some economists point a finger at protectionist trade policies and the collapse of international trade. The Smoot-Hawley tariff of 1930 dramatically increased the cost of imported goods and led to retaliatory actions by the United States' major trading partners. The Great Depression was a worldwide phenomenon, and the collapse of international trade helped spread this global phenomenon.

Other experts offer different explanations for the Great Depression. Some historians have called the Depression an inevitable failure of capitalism. Others blame the Depression on the "excesses" of the 1920s: excessive production of commodities, excessive building, excessive financial speculation or an excessively skewed distribution of income and wealth. . . .

One explanation that has stood the test of time focuses on the collapse of the U.S. banking system and resulting contraction of the nation's money supply. Economists Milton Friedman and Anna Schwartz make a strong case that when there was less money available (i.e., because banks did not loan it or people hoarded it) it caused a sharp decline in prices. As the money supply fell, spending on goods and services declined, which in turn caused firms to cut prices and output and to lay off workers. The resulting decline in incomes made it harder for borrowers to repay loans. Defaults and bankruptcies soared, creating a vicious spiral in which more banks failed, the money supply contracted further, and output, prices and employment continued to decline.

Money, Banking and Deflation

Money makes the economy function. Money evolved thousands of years ago because barter—the direct trading of goods or services for other goods or services—simply didn't work. A modern economy could not function without money, and economies tend to break down when the quantity or value of money changes suddenly or dramatically. Print too much money, and its value declines—that is, prices rise (inflation). Shrink the money supply, on the other hand, and the value of money rises—that is, prices fall (deflation).

In modern economies, bank deposits—not coins or currency—comprise the lion's share of the money supply. The amount of loans that a bank can make reflects the amount of money (deposits from customers) in the bank and is determined partly by regulations on the amount of money in reserve that a bank must hold against its deposits and partly by the business judgment of bankers.

In the United States, bank reserves consist of the cash that banks hold in their vaults and the deposits they keep at Federal Reserve banks. Reserves earn little or no interest, so banks don't like to hold too much of them. On the other hand, if banks hold too few reserves, they risk getting caught short in the event of unexpected deposit withdrawals.

In the 1930s, the United States was on the gold standard, meaning that the U.S. government would exchange dollars for gold at a fixed price. Commercial banks, as well as Federal Reserve banks, held a portion of their reserves in the form of gold coin and bullion, as required by law.

An increase in gold reserves, which might come from domestic mining or inflows of gold from abroad, would enable banks to increase their lending and, as a result, would tend to inflate the money supply. A decrease in reserves, on the other hand, would tend to contract the money supply. For example, large withdrawals of cash or gold from banks could reduce bank reserves to the point that banks had to make fewer loans, which shrinks the money supply available for businesses and consumers. The money supply fell during the Great Depression primarily because of banking panics. Banking systems rely on the confidence of depositors that they will be able to access their funds in banks whenever they need them. If that confidence is shaken—perhaps by the failure of an important bank or large commercial firm—people will rush to withdraw their deposits to avoid losing their funds if their own bank fails.

Because banks hold only a fraction of the value of their customers' deposits in the form of reserves, a sudden, unexpected attempt to convert deposits into cash can leave banks short of reserves. Ordinarily, banks can borrow extra reserves from other banks or from the Federal Reserve. However, borrowing from other banks becomes extremely expensive or even impossible when depositors make demands on all banks. During the Great Depression, many banks could not or would not borrow from the Federal Reserve because they either lacked acceptable collateral or did not belong to the Federal Reserve System. Starting in 1930, a series of banking panics rocked the U.S. financial system. As depositors pulled funds out of banks, banks lost reserves, which reduced the nation's money supply. The monetary contraction, as well as the financial chaos associated with the failure of large numbers of banks, caused the economy to collapse.

Less money reduced spending on goods and services, which caused firms to cut back on production, cut prices and lay off workers. Falling prices and incomes, in turn, led to even more economic distress. Deflation reduced the income of businesses and households and made it harder for them to repay their debt. Bankruptcies and defaults increased, which caused thousands of banks to fail. In each year from 1930 to 1933, more than 1,000 U.S. banks closed.

Banking panics are pretty much a thing of the past, thanks to federal deposit insurance. Widespread failures of banks and savings institutions during the 1980s did not cause depositors to panic, which limited withdrawals from the banking system and prevented serious reverberations throughout the economy.

Adapted from: David C. Wheelock is an assistant vice president and economist at the Federal Reserve Bank of St. Louis.