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The Great Depression: Financial Crisis and Reform

by Kimberly S. Amdahl

The United States went through a period of severe economic decline during the 1930s, a period commonly called the Great Depression. The exact cause for this Depression, especially after a period of prosperity such as the 1920s, is warmly debated among economists. Such a severe economic collapse had never occurred before. There are many possible explanations.

Causes

Arthur Burns’s theory (1972) is that no new investment outlets were opened during the early 1930s. During the 1920s, a huge buildup in capital expenditures occurred. Too much was being spent on investment and too little on consumption. At the beginning of the 1930s, investments by foreigners fell because of the financial crisis overseas. Falling foreign demand and a limited domestic demand meant that the pace of investment spending achieved during the 1920s could not be maintained in the 1930s. As spending declined, national income, productivity, and employment also declined.

A.J. Field’s theory (1984) involves the stock market and the crash of 1929. During the long boom of the 1920s, investors got greedy; they kept producing and invested more money without paying attention to the mild downturns in the economy. This caused a considerable post-1925 increase in the value and volume on the New York Stock Exchange which led to a substantial increase in the transactional demand for money. Not even the experts realized how much this demand for money had increased. Had the Federal Reserve Board been aware of this increased demand for money, it would not have persisted in its anti-speculative policies of 1928-29, such as the imposition of a tight monetary policy. The high interest rates resulting from these policies caused the downturn in real economic activity that eventually tumbled into the Great Depression.

A significant deceleration of the money supply also occurred during late 1929 and the early 1930s. Currency and bank deposits decreased from $45,736 billion in late June 1929, to $30,021 billion in late June 1933
According to Anna Schwartz, this decline in the money supply reinforced the effects of the stock market crash and the banking crises during the early 1930s (Brummer, 1981, p. 321). With all of these events combined, it is no surprise that the Depression lasted as long as it did and was as severe as it was. All of these factors contributed to the devastating effects of the Great Depression.

Banking Collapse

As S. Fraser notes (1984), the economic crisis inevitably called into question the prevailing relationship among government, the economy, and society. In order to preserve our capitalist system and its financial institutions, government took over. Because people did not trust the economy or the financial institutions, government soon became involved in almost every aspect of the economy.

The most immediate need in the country was to reform the banking system and make it secure. Banks were closing all across the country as people, terrified of losing their deposits, withdrew huge amounts of money.

Even though there had been bank failures since 1930, at the beginning of December 1932, collapse did not seem likely. Indeed, the banking situation seemed to be improving. Bank failures in 1932 numbered only 1,453 compared to 2,293 in 1931. Bond prices were improving and short-term interest rates were falling. Bank reserves had improved due to large gold imports, Fed purchases of securities, and some net return of currency from the public to the banks. Loans from the Reconstruction Finance Corporation (RFC) helped reorganize closed banks. The RFC also relieved borrowers from other financial institutions of the pressure to sell bonds, enabling them to pay off some of their bank loans.

The commercial banking system as a whole, however, was very weak. Many banks had serious capital problems from the decline in the value of bank assets. Even though the prices of higher grade bonds had increased somewhat, the bond accounts of most banks continued to be severely depressed. By 1933, most banks were unsound, having both solvency and liquidity problems.

In late December 1932, the rate of bank failures began to rise. Gold imports stopped in mid-January 1933 and a low rate of gold exports began. Many states started declaring bank holidays to try to prevent massive outflows of funds. The banks that did stay open had substantial amounts of funds withdrawn.

President Herbert Hoover would not take any action without President-
elect Franklin Roosevelt’s permission, and permission was not forthcoming. As a result, no action was taken until Roosevelt was inaugurated on Friday, March 3, 1933. That day President Roosevelt declared a national bank holiday effective Monday, March 6 through Thursday, March 9. For these four days, all banking transactions were prohibited.

The banking crisis was significant because of the magnitude and central role commercial banks played in the financial system. The percentages of banks that failed in the four years from 1930 to 1933 were 5.6 percent, 10.5 percent, 7.8 percent, and 12.9 percent (Bernanke, 1983, p. 259). Due to bank failures and mergers, the number of banks operating in 1933 was just over half the number of banks operating in 1929. In addition, the banks that did survive the crisis experienced heavy losses.

Emergency Legislation

The Emergency Banking Act was signed into law on March 9, 1933. This act allowed the President to suspend all banking functions so that the nation’s currency could be regulated and controlled in order to protect the banks and the public from the potentially catastrophic effects of unwarranted withdrawals by panic-stricken depositors. The Emergency Banking Act extended the bank holiday indefinitely and would allow only “sound” banks to reopen. There were three major provisions in the act. First, it gave the President the power and authority to close the banks. Secondly, the Secretary of the Treasury was given the authority to regulate the business of banks during the emergency period declared by the President. Finally, the Comptroller of the Currency was given the authority to appoint conservators whenever necessary in order to conserve the assets of a national bank for the benefit of its depositors and creditors and to effect reorganizations of such banks as the conditions and circumstances warranted.

Most of the banks that opened after the bank holiday on June 30, 1933 were liquidated or placed in receivership. Deposits did not flow back in great quantities until 1934. The Reconstruction Finance Corporation (RFC), the largest government agency used to help the financial system, continued to pump large amounts of money into the banks. Fear of runs caused banks to shift away from making loans to making safe and liquid investments such as buying government securities. This lender reluctance, combined with debtor insolvency, interfered with credit flows for several years after 1933.

The RFC was converted into the government’s largest general-purpose
institution. It helped three different classes of banks: closed banks, restricted banks, and unrestricted banks that needed to improve their solvency, liquidity, or both. By March 4, 1933 the RFC had already lent around $80 million to liquidators of closed banks. Between March 4, 1933 and October 1937, total loan disbursements were over $875 million (Chandler, 1971, p. 264). These loans made funds available to depositors quickly, which enabled liquidators to realize more on bank assets by disposing of the assets in an orderly manner. This lessened the downward pressure on the market prices of bank assets.

The RFC made a smaller volume of loans to banks after March 1933. This served to help their recovery in a different way. The RFC supplied funds and increased bank solvency by subscribing to preferred stock or other equity claims against the banks. This was closely related to the creation of a system that would insure bank deposits.

The Banking Act of 1933 established the Federal Deposit Insurance Corporation (FDIC). Its primary purpose was to provide a supplementary stabilizing device for the banks to prevent the reoccurrence of bank runs by insuring the deposits of over 60 million Americans. Two plans for insurance were developed. One was a temporary plan that went into effect on January 1, 1934. The other plan was a permanent plan to follow the temporary plan after the bugs had been worked out. All licensed member banks were required to join the FDIC. Non-member banks could join if they met certain requirements. Most elected to join since people had more faith in banks that were insured. As a result, the banks that were insured received a higher return of currency than banks which were not insured.

Government Involvement

The New Deal’s rehabilitation of the financial system from 1933 to 1935 started the economy on its slow recovery from the Great Depression. When the banking recovery started in 1933, it was a vigorous one. But as T. Mayer (1978) points out, because of the low level to which the economy had sunk, it still left the economy depressed for many years. The overall program, in the short and long run, preserved the basic institutions of a free-enterprise, capitalistic system by using extensive government support.

Unfortunately, the banking problems of 1930-33 also disrupted the credit allocation process by creating large, unplanned changes in the channels of credit flow (Bernanke, 1983, p. 264). Both large withdrawals of deposits and fear of bank runs led banks to increase the liquidity of their assets. These factors, along with actual bank closings, forced the banking system
to decrease its role in the intermediation of credit. Some of the slack was taken up by other creditors, such as savings and loans, but they didn’t have the experience or knowledge of the customers that the banks possessed. As the banking crisis worsened, so did the shrinkage of credit. During October 1931, the worst month for bank failures before the bank holiday, the net credit reduction was a record 31 percent of personal income (Bernanke, 1983, 264).

The contraction of bank credit in the United States was twice that of other major countries, even ones that had proportionate declines in output. The high rates of default and bankruptcy in the banking sector affected every class of borrower. Bernanke (1983) identifies those hardest hit by the credit reductions as households, farmers, unincorporated businesses, and small corporations. These were the borrowers who relied most on bank credit.

Two economists, Hardy and Viner, conducted their own credit survey in the Seventh Federal Reserve District from 1934-35. Based on coverage of 2,600 individual cases, they found a genuine unsatisfied demand for credit by solvent borrowers. Most of these borrowers could have made economically sound use of working capital. Hardy and Viner concluded that the total amount of this unsatisfied demand for credit was a significant factor in retarding business recovery (Bernanke, 1983, p. 273). Credit difficulties for many small businesses continued for at least two years after the bank holiday.

A financial deadlock between debtors and lenders appeared to exist. Debtors could only meet their obligations fully when something close to full employment had been achieved. Full employment could not be achieved until financial institutions lent money to businesses so they could start producing again. However, financial institutions were too scared to risk making loans to businesses.

In order to ease out of this financial deadlock, government readjusted some privately held debt. Payment dates were postponed, interest charges were reduced, and principal values were scaled down. Chandler (1971) notes that the federal government also supplied huge amounts of capital to aid the process of financial rehabilitation by lending and purchasing equity claims.

Conclusions

Many people, including economists, think that government should not play an important role in the economy. Yet, while the return of the finan-
cial system to normal conditions after March 1933 was not rapid, it would have been more difficult (if not impossible) without government intervention and assistance. As Stuart Chase notes, if government had not taken action, there would have been "prices cascading; banks and insurance companies falling all over; wages back to a dollar; the stock market trying to find the middle of the earth" (1934, p. 6). Roosevelt and his advisors opened the banks, started check money circulating again, and started the business world moving. This business reform stimulated economic recovery.

Government policies were designed only to lend a helping hand until the financial institutions could take over again. As wages increased and wealth was redistributed to people who otherwise would have been unemployed, relief decreased. The government sought to keep the economy moving as a free-enterprise one, not to repress it and take over control. Indeed, if the government had done more, the private sector could have recovered sooner. However, businesses did not see it that way. They feared government would take over for good and this fear retarded business recovery.

Because of the emergence of government intervention, this period is regarded as the turning point in the history of the American economy. The RFC, the Emergency Banking Act, and the FDIC were all the government's way of dealing with the Great Depression. The impact of these policies may not have been great, but they did help. Some of these policies, such as the FDIC, are still in effect. People may disagree about government involvement in the economy; however, the financial crisis of the Great Depression showed that government intervention is sometimes necessary.

References


