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Getting to the Bottom of the Great Depression

by Kevin E. Pearson

The Great Depression of the thirties tested the foundations of and trust in the capitalist system. In popular thought, the stock market crash of 1929 is viewed as the cause of the depression. Though the chaos in financial markets was a contributing cause, other economic factors affected the length and severity of the Great Depression. One factor noted by Michael A. Bernstein (1987), professor of history at the University of California in San Diego, was a major shift in patterns of consumption during the twenties and thirties and the subsequent problem of shifting investment from mature to growing industries. The specific problems of economic stagnation and high unemployment of the thirties can be traced to this problem. This article describes how the disruption in financial markets hindered the flow of capital into the new growth industries of the thirties, thus prolonging the depression. It then analyzes similarities between the Great Depression and recent economic events.

Changing Consumption Patterns

The twenties were characterized by a rising standard of living, increasing expenditures for new equipment, and a general change in lifestyles. Bernstein (1987) contends that it was this shift in consumption patterns at the time of the crash that caused the Great Depression to be so long and severe. Demand increased for processed food products, tobacco, household appliances, medical care and insurance, recreation, and education. At the same time, traditional consumer spending fell for goods such as housing and standard clothing. Those industries meeting new consumer demands were growing and dynamic; those industries producing traditional consumer goods were declining and mature (Bernstein, 1987, p. 28). These changes in demand changed the kind of output that required
more investment, new technology, and differently trained labor. Since it was the growing industries that needed capital, previous investment patterns were less capable of withstanding a cyclical downturn (Bernstein, 1987, p. 36).

Disruption in Financial Markets

The interruption of the flow of capital after the stock market crash of 1929 was especially devastating to the growing industries of the thirties. In financial markets, bankrupt speculators defaulting on their loans caused bank failures. The initial bank failures resulted in widespread panic to withdraw funds which, in turn, caused additional bank failures. Galbraith notes that even when banks recovered from the great banking crisis they were extremely cautious and fearful of resuming normal amounts of lending (1987, p. 203). It was the newer dynamic industries that needed money for investment to supply the capital and train the labor for new production methods. Unincorporated businesses and small corporations, which made up the growing industries, were affected the most by the reduction in credit (Bernanke, 1983, p. 265).

The crash also affected the confidence of businesses. Following the crash there was a decline in business optimism. Morgan goes as far as to explain the attitude of business as "a functional instability which is . . . strangely similar to the symptoms of manic-depressive psychosis" (1968, p. 8). This decline in optimism made businesses reluctant to invest in new projects until some degree of recovery took place.

The skewed distribution of income was yet another factor that kept investment levels low. The share of disposable income received by the top one percent of the population increased from 13% in 1923 to 19% in 1929 (Holt, 1977, pp. 277-80). Brookes notes that two-thirds of the saving and investing is done by the top five to ten percent of the income distribution (1984, p. 58). Thus, the economy was increasingly dependent on expenditures from the upper income group. Galbraith notes that this group’s inclination to invest was especially sensitive to the events of the stock market (1968, pp. 90-91). When the stock market declined in 1929, so did investment from the upper income group.
Technological Change and Unemployment

In spite of the disruption in financial markets, technological developments continued in the thirties. Kondratieff's theory of the cyclical nature of the economy states that when the economy is in a downturn there are significant changes in technology. According to Kondratieff, the type and amount of technological development depends upon the needs of the people (1984, pp. 66-85). Thus, as the new demands of the "New Era" were carried on into the thirties, technology developed and grew, and new production techniques were implemented. For example, Bernstein finds that the growing food, tobacco, and petroleum industries showed steady rates of technological change (1987, p. 122).

Bernstein contends that the increased use of technology in growing industries and the fact that these industries were not yet mature helps explain the persistent unemployment during the Great Depression. First, technological advances had the adverse effect of causing a lower labor to capital ratio. As a result, growth in dynamic industries did not cause equivalent growth in the demand for labor. Second, as people demanded less from established markets and more from new ones, mature industries shrank while dynamic industries found it difficult to attract sufficient capital. Without this investment, growth industries could not establish the broad-based markets that their full emergence required (Bernstein, 1987, p. 144). Thus, the emerging sectors did not grow fast enough to compensate for the shrinking mature industries. This helped trap the economy at a low level of aggregate demand, causing persistent unemployment.

Consequently, a combination of the three factors of changing consumption patterns, disruption in financial markets, and technological development, combined to magnify the length and severity of the Great Depression.

The Thirties and Seventies: A Comparison

Comparing the Great Depression to the recent past may help us to prepare for the future. It must be kept in mind, however, that since the thirties, changes have occurred and several new controls have been
established. These include a more equitable distribution of income, increased labor concentration in the recession insensitive service sector, increased international cooperation, better control of the money supply by the Federal Reserve, SEC regulation of the stock market, and FDIC insurance on bank accounts (Heller, 1980, p. 7). These developments help to keep financial markets sound, employment steady, and demand healthy.

Bernstein compares the circumstances of the thirties and the seventies and finds that in both cases there was a change in "the composition of national output and thereby of employment and capital goods demand. When short run financial shocks at the beginning of each decade hampered the conversion, the result was a serious and protracted economic crisis" (1987, pp. 215-16). In the seventies, as in the thirties, the economy experienced decreased investment and consumption, high unemployment, and a decline in production. However, the recessions of 1970 and 1975 were far less severe than the Great Depression.

In both the thirties and the seventies, policies designed to help the economy were not as effective as expected. In trying to solve problems of the seventies, the government relied on fiscal expansion. This would be a correct policy if the U.S. were isolated, but increased dependence on international markets meant that there would have to be regulation of capital markets for such a policy to work (Bernstein, 1984, p. 219). In the thirties, the American government did not respond effectively to the economic crisis. It was thought that stimulating demand with New Deal policies would automatically cause recovery. It was not seen that recovery would come about faster from increased investment in growing industries.

The Thirties, the Eighties, and the Future

While the economy experienced a stock market crash in 1987, there are two major differences between it and the crash of 1929. First, rapid price increases and wild speculation were not as predominant in 1987. Of course, there were those people that were "playing the market" in 1987 just as in 1929, but most people in 1987 were willing to hold their stocks for their intrinsic value and to wait until the price of the stock eventually rose again. Second, in 1987 the Federal Reserve was ready to provide the financial system with additional money, and there were planned interest rate reductions in Europe (Sinai, 1988, p. 17). These actions
provided the necessary funds to keep consumption and investment spending healthy so that the U.S. did not experience a marked decline in economic activity. In contrast, the actions of the Federal Reserve in the thirties caused interest rates to rise which discouraged consumption and investment spending.

In the eighties, the United States is more a part of a highly interdependent global economy. As a result, the U.S. economy has become more susceptible to external shocks. In the thirties, the United States was more economically self-sufficient and did not have to worry as much about the rest of the world. Now, however, the stability of the United States may be adversely affected by loan defaults of third world nations. Yet as Greenspan has noted, the major central banks have contingency plans to prevent a collapse before defaults would cause a world-wide recession and damage confidence in the international economic system (1980, p. 13). However, if the central banks' measures are not enough to control a shock to the world economy, the result would be high unemployment, falling productivity and increased pessimism about the future. It is important to realize that even though there is more protection and a larger world economy than existed in the thirties, potential external problems could cause large adverse shocks (Greenspan, 1980, p. 14).

As part of the global economy, the U.S. faces heavy competition from countries that rebuilt their industries after the Second World War. One effect of World War II was that it increased demand enough to allow the dynamic sectors of the U.S. economy to complete their growth. This helped the United States recover from the Great Depression. On the other hand, one could argue that since the war ended, a demilitarized Germany and Japan have had more income available for all types of investment, while the U.S. has invested proportionately less in the continual upkeep and development of capital equipment (Galbraith, 1987, p. 293). This allowed other countries to become more efficient and take some business away from the United States, thus compounding the economic problems the United States faced in the seventies and eighties. In the future, U.S. competitiveness will depend on greater investment and development of new technology.
Conclusion

Demand generated in the "New Era" of the 1920's meant that large scale changes in production were needed. In the early stages of transition, the stock market crash of 1929 drained investment funds, wealth, and confidence. Banks continued to be cautious after they were back on a sound basis and, consequently, dynamic industries grew too slowly to spur enough demand or employment to lead to a full recovery. As a result, the economy remained at a low level. Since then, preventive measures on a national and worldwide scale have been taken to soften the effect of a major shock on the economy. Sinai comments that "there is simply no way that another Great Depression would occur without egregious miscalculations in Washington, Bonn, and Tokyo" (1982, p. 21). With a rapidly changing world economy, however, there is always the possibility of a large economic shock. If this happens, government policy will once again try to help the economy recover. One lesson the government should have learned from the Great Depression is that, ultimately, a successful economy depends upon adequate investment in industries that satisfy the prevalent demands of the consumer.

References


