**The Great Depression: An Overview**

*by David C. Wheelock*

Why should students learn about the Great Depression? Our grandparents and great-grandparents lived through these tough times, but you may think that you should focus on more recent episodes in American life. In this essay, I hope to convince you that the Great Depression is worthy of your interest and deserves attention in economics, social studies and history courses.

One reason to study the Great Depression is that it was by far the worst economic catastrophe of the 20th century and, perhaps, the worst in our nation’s history. Between 1929 and 1933, the quantity of goods and services produced in the United States fell by one-third, the unemployment rate soared to 25 percent of the labor force, the stock market lost 80 percent of its value and some 7,000 banks failed.

At the store, the price of chicken fell from 38 cents a pound to 12 cents, the price of eggs dropped from 50 cents a dozen to just over 13 cents, and the price of gasoline fell from 10 cents a gallon to less than a nickel. Still, many families went hungry, and few could afford to own a car.

Another reason to study the Great Depression is that the sheer magnitude of the economic collapse— and the fact that it involved every aspect of our economy and every region of our country—makes this event a great vehicle for teaching important economic concepts. You can learn about inflation and deflation, Gross Domestic Product (GDP), and unemployment by comparing the Depression with more recent experiences. Further, the Great Depression shows the important roles that money, banks and the stock market play in our economy.

A third reason to study the Great Depression is that it dramatically changed the role of government, especially the federal government, in our nation’s economy. Before the Great Depression, federal government spending accounted for less than 3 percent of GDP. By 1939, federal outlays exceeded 10 percent of GDP.1 (At present, federal spending accounts for about 20 percent of GDP.) The Great Depression also brought us the Federal Deposit Insurance Corp. (FDIC), regulation of securities markets, the birth of the Social Security System and the first national minimum wage.

**What Caused the Great Depression?**

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 was even greater than the collapse of world output of goods and services. Still, like the stock market crash, protectionist trade policies alone did not cause the Great Depression.

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. None of these explanations has held up very well over time. 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 stock. Economists Milton Friedman and Anna Schwartz make a strong case that a falling money stock caused the sharp decline in output and prices in the economy.2

As the money stock 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 stock contracted further, and output, prices and employment continued to decline.3

**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 stock, 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 stock. Bank deposits are created when banks make loans, and deposits contract when customers repay loans. The amount of loans that banks can make, and hence the quantity of deposits that are created, is determined partly by regulations on the amount of reserves that banks must hold against their 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 stock. A decrease in reserves, on the other hand, would tend to contract the money stock. For example, large withdrawals of cash or gold from banks could reduce bank reserves to the point that banks would have to contract their outstanding loans, which would further reduce deposits and shrink the money stock.

The money stock 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.4

Starting in 1930, a series of banking panics rocked the U.S. financial system. As depositors pulled funds out of banks, banks lost reserves and had to contract their loans and deposits, which reduced the nation’s money stock. 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 and increased borrowing costs 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 increased the real burden of debt and left many firms and households with too little income to repay their loans. 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.