

## WHAT CAUSED THE GREAT DEPRESSION AND WHY DID RECOVERY TAKE SO LONG?

### Overview

Students read an article describing the causes of the Great Depression and Roosevelt's recovery efforts. Students then imagine that they are advisors to the new President Roosevelt and develop a policy plan they think he should adopt.

### Preparation

**Handout A: Article and Activity** – 1 per student

### Procedure

This lesson could be used in a U.S. History, Government/Civics, or Economics class. Depending on the class, ensure students have enough context and prior knowledge about the Great Depression to understand the details the article offers.

You may want to assign the article as homework and spend class time having students work in small groups (3-4 students per group) to complete the activity.

### Assessment Options:

- Ask students to write two paragraphs:
  - a) Summarize the policy plans you developed for Roosevelt as “advisors”.
  - b) Defend the plan using evidence from the article.

- Ask students to respond in writing to this prompt:

*If “hindsight is 20/20”, what do you think are the most important lessons we can learn from the Great Depression and the policy plans you developed?*

## WHAT CAUSED THE GREAT DEPRESSION AND WHY DID RECOVERY TAKE SO LONG?

**Economists still debate the causes of the Great Depression, especially why recovery took so long. One thing is clear. Few economists and political leaders at the time understood what was happening and what to do about it.**

### Boom and Crash

The decade after World War I was generally a boom time for the United States. Business was good, many Americans enjoyed fair wages, and unemployment was low. Americans could buy houses, automobiles, and electric household appliances by making regular payments.

After World War I, countries in Europe and the United States restored the pre-war **gold standard** to stabilize their economies. Under this standard, all paper money in circulation had to be backed by its value in gold. For example, a \$20 bill was backed by one ounce of gold in 1929.

The gold standard regulated the amount of money governments and consumers could spend, which prevented runaway **inflation** (rapidly rising prices).

Established in 1913, the **U. S. Federal Reserve** is a central bank that sets interest rates that member banks charge when they borrow from each other. These rates influence the amount of interest consumers and businesses have to pay when they borrow money from the banks. The Federal Reserve's low interest rates in the 1920s encouraged consumer and business borrowing.

The Federal Reserve has the power to print money to expand the supply in circulation. But the gold standard limited this power at the time. Paper currency could not exceed the value of the amount of gold held by the United States. Actions by the Federal Reserve relating to interest rates and the money supply are called **monetary policy**.

In the later 1920s, investing in the stock market as a way to increase wealth became very popular. Speculators borrowed heavily from banks to buy stocks in companies. As they poured money into the stock market, stock prices soared. In 1928, the Federal Reserve finally tightened its monetary policy by raising interest rates on borrowing. The Federal Reserve took this action to discourage loans to speculators who were riding a wild Wall Street stock market boom.

The Federal Reserve's higher interest rates succeeded in calming speculation on Wall Street. But, during the summer of 1929, uncertainty about future company earnings led investors to sell stocks. Panic hit Wall Street in October, and the stock market crashed when stock prices plunged sharply and continued to fall.

### From Recession to Depression

From the end of 1929 into 1930, the boom of the 1920s turned into an economic slowdown called a **recession**. The stock market crash seemed to spook many consumers into holding back on their spending and borrowing. This drop in consumer **demand** for goods and services forced businesses to reduce their prices, an economic condition called **deflation**. Lower consumer demand also caused industries to reduce their production **output**, cut wages, and lay off workers.

Jobless workers drastically cut back their spending and often **defaulted** (stopped making payments) on their bank loans. Loan defaults prompted banks to make **credit** harder to get for those who wanted to borrow money.

As the recession worsened, President Herbert Hoover put his faith in the capitalist economy to repair itself. Hoover's secretary of the treasury, Andrew Mellon, declared that the recession should be allowed to follow its natural course.

Hoover's priority was to balance the federal budget by raising taxes and cutting government spending. Matters that involve government taxes and spending are called **fiscal policy**.

In 1930, Hoover signed a tariff act to protect farmers and manufacturers from foreign competition. But the higher tariffs (taxes on imports) provoked a trade war with other countries that harmed U. S. export companies. More unemployment resulted.

In 1931, a financial crisis hit. Panicked depositors demanded to withdraw their money from banks. These "bank runs" put stress on the many banks that did not have the cash to pay their depositors. These banks had to close.

The Federal Reserve was the "lender of last resort" for the nation's banks when they got into trouble. But, sticking by the gold standard, the Federal Reserve refused to inject more money into the banking system even though more cash was needed to stop the bank runs.

Rather than lowering interest rates to stimulate borrowing and spending, the Federal Reserve in 1931 increased interest rates to persuade foreign investors to keep their money in the United States.

Hoover resisted intervening in the banking system. But late in his term he established a federal program to loan money to the banks, which the Federal Reserve had refused to do. This action was too little and too late to save many of the banks.

The recession worsened into a much more severe economic crisis called a **depression**. By early 1933, unemployment reached about 25 percent. Industrial output was down by more than 50 percent. A third of the nation's banks were closed or taken over by other banks. Consumer spending and business investment collapsed.

The period from 1929 to 1933 was the depth of the Great Depression. In 1933, President Franklin D. Roosevelt took office, stabilized the banking system, and abandoned the gold standard. These actions freed the Federal Reserve to expand the money supply, which slowed the downward spiral of price deflation and began a long slow crawl to economic recovery. The Great Depression finally ended in the early 1940s.

### **What Caused the Great Depression?**

Surprisingly, economists are still debating today about what caused the Great Depression. Below are some theories by leading economists:

#### ***Household Debt***

Low interest borrowing rates and installment credit in the 1920s led to higher household debt. The prosperity of this time was largely built upon household debt as spending rose faster than income.

When the recession worsened, many Americans found themselves in a financial trap caused by "debt deflation." This means that the more wages fall, the fewer dollars the person has to make debt payments that always remain constant.

Economist Irving Fisher explained in 1933 that to keep up with their house, auto, and other debt payments, people cut back on their spending. This, he said, was the major reason consumer demand dropped, which caused more price and wage deflation, less investment, falling output by companies, and layoffs. Many eventually stopped making payments on their loans, which helped to cause the banks to fail. Thus, household debt and debt deflation, according to Fisher, pushed a recession into a depression.

### ***Failure of the Federal Reserve***

In 1963, University of Chicago economist Milton Friedman and economic researcher Anna Schwartz found that the money supply in circulation between 1929 and 1933 fell by a third. This was due mainly to hoarding of cash by frightened households and businesses.

Friedman and Schwartz blamed the Federal Reserve for failing to increase the money supply to the banks, causing banks to fail and freezing credit for consumers. The two economists argued this was the chief cause of the drop in consumer demand that crippled the economy.

Friedman and Schwartz said the Federal Reserve made a bad recession into a depression when its leaders called for more money in the economy only when business was good, even when the banks were desperate for more cash. When panicked depositors withdrew their money, the banks failed, lending stopped, and the economy fell into a depression.

### ***The Gold Standard***

For two decades, most economists accepted the Friedman and Schwartz theory that the Federal Reserve's monetary policy caused the Great Depression. But, in 1983, Stanford economist Ben Bernanke proposed that several other causes, especially the gold standard, played a part, too.

Bernanke accepted the analysis of Friedman and Schwartz about the inadequate money supply but blamed the gold standard as the major cause. He noted that countries that abandoned it early, like Britain in 1931, had more freedom to get money circulating in the economy. Those countries that stayed on the gold standard longer, as the U. S. did until 1933, sank deeper into depression.

Bernanke explained that because of the restrictions the gold standard put on the money supply, the Federal Reserve did not act, and banks failed. The resulting interruption of lending depressed demand, which sent into motion the chain of events that led to mass unemployment.

### **Why Did the Recovery Take So Long?**

When he entered office in 1933, President Roosevelt got the banking system working again. But Bernanke argues that the banks tended to be too cautious about lending too long into the recovery. This held down consumer borrowing and spending necessary to get the nation's factories humming again.

FDR had no recovery plan in place for the damage already done to the economy. At first he adopted Hoover's policy of reducing government spending. But spending by consumers and business did not revive and the demand for goods and service remained down.

FDR soon increased government spending with numerous New Deal programs and agencies. These generally improved the economy and reduced unemployment, but very slowly.

Some New Deal programs did not work well. The National Industrial Recovery Act (NIRA) of 1933 attempted to restructure the economy. The NIRA created over 500 industrial groups that set limits on production to raise prices and negotiated higher wages. This program did not speed up the recovery and was declared unconstitutional by the Supreme Court in 1935.

Shortly after the creation of the NIRA, British economist John Maynard Keynes advised Roosevelt in a letter to boost government spending, financed by borrowing rather than taxes, for "a program of public works" to reduce unemployment.

Roosevelt eventually created several public works programs to build roads, dams, and public buildings. These and other New Deal programs helped increase economic output and reduce the unemployment rate from nearly 25 to 17 percent by 1936.

When Roosevelt saw that the recovery was improving, he decided to balance the federal budget by cutting public works spending. But, following Roosevelt's landslide re-election in 1936, business investment stalled, economic output dropped, stock prices fell, farms in the Midwest closed due to droughts and dust storms, and the jobless rate rose again. The 1937-38 economic downturn, is often called the "Roosevelt Recession."

The recession stirred a debate among FDR's advisors. Some argued that FDR should follow the advice of Keynes and borrow to fund large scale public works. Others argued that FDR should continue to reduce spending and balance the budget to reduce the large national debt. FDR finally decided on a moderate increase in spending for public works. The economy gradually improved.

### Theories About the Recovery

#### The Difference Between a Recession and a Depression

A **recession** is a general slowing down of economic activity, such as investment spending by businesses and household income, with a decrease in gross domestic product (GDP). GDP is a measure of the total monetary value of all goods and services a nation produces in any given quarter (three-month period) or year. A recession is accompanied by an increase in unemployment and bankruptcies. Economic journalists typically define a recession as an economic slowdown that lasts more than two quarters.

A **depression** is a longer-lasting and more severe form of a recession. According to *The Economist* magazine, a depression occurs when GDP declines more than 10 percent, or when a recession lasts more than three years. The Great Depression qualifies using both measures.

President Harry Truman had a humorous rule to distinguish recessions and depressions: "It's a recession when your neighbor loses his job; it's a depression when you lose yours."

Some today argue that government interference in the U. S. free market economy held back the recovery. Conservative economists sharply criticize the NIRA as a social reform disaster that purposely cut production and raised wages that discouraged hiring.

The "Roosevelt Recession," conservative economists say, was in large part caused by higher employer labor costs brought on by a new law requiring union collective bargaining for higher wages and Social Security taxes. Employers responded by cutting hiring and investment.

While the economy began to grow again by 1939, the conservative critics argue that the New Deal was hostile to business, which caused a decline in investment in the economy. They point out that economic output and employment remained below 1929 levels. The unemployment rate in 1940 was still at a depression level of about 15 percent.

By contrast, liberal economists today often claim that the reason the recovery struggled so long was that the government did not go far enough. In 1936, John Maynard Keynes wrote an influential book, arguing for a fiscal stimulus policy. This meant the government should borrow and spend when consumers and businesses did not. This was necessary, Keynes wrote, not only to put more people back to work, but to stimulate demand for goods and services.

Keynes proposed that government projects should hire many more of the unemployed. They would then spend and increase demand, which would boost sales, get factories busy, and spur more hiring until the free market economy could function on its own. To get this "multiplier effect" started, Keynes said, the government needed to borrow and spend a lot more.

But Roosevelt never fully adopted Keynes's views. Many liberal economists today say Keynes's fiscal stimulus idea contributed little to speeding up the recovery, but could have done much more if FDR had enthusiastically adopted it.

### **What Finally Ended the Great Depression?**

In 1939, war broke out in Europe. When U. S. neutrality ended, Britain and France purchased massive quantities of war materials. This and war-readiness spending by Congress had a dramatic effect on the U. S. economy as factories reopened and hiring jumped.

Helped by the military draft after the Pearl Harbor attack in 1941, the unemployment rate plunged from 14.6 percent in 1940 to 4.7 percent two years later. By 1945, the U. S. was spending \$90 billion a year on the war. When World War II ended, the U. S. was the economic powerhouse of the world.

### **Writing & Discussion**

1. What do you think was the most important cause of the Great Depression? Why?
2. What do you think is the best explanation for the long slow recovery of the Great Depression? Explain.
3. Based on your study of the causes and long recovery of the Great Depression, what do you think is the most important lesson we should draw from it today? Explain.

### **A C T I V I T Y: A Plan for the Recovery**

When he took office in 1933, President Franklin D. Roosevelt really had no plan for a recovery from the Great Depression.

Your group has been called upon by the new President Roosevelt as advisors. He wants you to develop a set of policies you think he should adopt in the areas listed below.

Work together to develop a plan of policies you think he should adopt in these areas:

1. interest rates on borrowing by individuals and businesses
2. government borrowing and spending
3. taxes
4. wages
5. unemployment

Be prepared to defend your plan by gathering arguments and evidence from the article.