The Causes of the Great Depression

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The Big Question is what caused the Great Depression?

- What weaknesses in the 1920s contributed to the Great Depression?
- What occurred between 1929 and 1933 that contributed to the Great Crash?
- What was the relative role of international and domestic forces?

The Great Depression lasted from 1929 to 1940.

The Great Crash occurred between 1929 and 1933. During those years GNP fell by 46 percent, prices by 24 percent, and unemployment rose from 3.2 percent of the labor force to 24.9 percent of the labor force.

What happened? What caused the Great Depression?

One possible cause of the Great Depression is weakenesses in the economy of the 1920s. There are several possible culprits here:

- Low farm incomes
- Collapsing markets for new house construction
- A bubble in the stock market

All three of these factors has some validity, but none are, by themselves (or even in conjunction) large enough to explain the collapse of the economy.

The United States has a “fractional reserve” system of banking.

Fractional reserve systems are extremely susceptible to crisis of confidence.

Here is how the system works.

Start with Individual A making a $100 deposit. The bank follows the policy of making $80 in loans for every $100 in deposits it receives, maintaining reserves of $20.

You believe you have $100 in the bank.

The bank makes an $80 loan to individual B, which he deposits in his bank. He thinks he has $80. The next bank makes a loan of $64 on the basis of individual B’s deposits.

As in the following table:

Deposits	Reserves	Loans
100	20	80
80	16	64
64	12.8	51.2
51.2	10.24	40.96
.	.	.
.	.	.
Sum		
500	100	400

The result of the initial deposit of $100, is to increase the money supply by an additional $400.

The "money multiplier" is the ratio of the initial deposit to the change in the total money supply, mathematically it is equal to 1/ reserve ratio, where the reserve ratio is the amount of a deposit that the bank keeps on hand.

Money Multiplier = 1/ RR

The key thing about the money multiplier in a fractional reserve system is that it works in both directions. If an individual withdraws $100 from his bank account and puts it in his mattress, the money supply ultimately must decrease by $500.

The difficulty for banks occurs when the public loses confidence in the banking system

In our example, on any day the banks only have $100 of money in their vaults, but they have accepted $500 in deposits. The remainder of the deposits are in "assets" in the form of loans to their customers. These assets, however, cannot be easily liquidated.

Liquidating the assets, of course, means reducing the amount of loans available, which makes any business contraction even worse.

What happened between 1929 and 1933 was a series of Banking Panics: 1930, 1931, and 1933.

In these panics the public lost confidence in the banking system and attempted to get their cash out of the banks, forcing the banks to close their doors, and shutting down the banking system.

A second view of the cause of the Great Depression is that it was financial panic, and the disruption that ensued, that caused the decline in economic activity.

Recent work on the Great Depression has suggested that the source of the financial disruptions came from the international community, rather than inside of the United States.

These explanations lay the blame for the depression on the "gold standard" and financial arrangements made between countries at the end of World War I.