

## The Great Depression: Slow Recovery & Policy Mistakes

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**Abstract:** The Great Crash of the United States stock market that took place on October 29, 1929 marked the beginning of the ever longest recession that the US economy endured during the subsequent decade. The US economy experienced a drastic fall in the US real output and soaring rates of unemployment that led policymakers to initiate a multitude of policy measures to overcome this depression and to start the economic recovery, yet this recovery was a very slow and disrupted process that marked the entire decade as the Great Depression. This paper attempts to highlight these policy measures that led to this slow recovery though were intended to speed up the recovery and to retain the prewar rates of economic growth.

**Keywords:** The Great Depression, Economy, Recovery, Policy

### 1. Introduction

What is known in the literature as the “Black Tuesday” marked the onset of the Great Depression in the United States. On October 29, 1929, the stock market that was witnessing a steadily growing rate for a decade collapsed over a night dropping the US economy into the longest and the strongest economic depression ever since.

The created consumer uncertainty regarding their future earning led them to cut on their purchases of durable goods. Thus, while the consumption of perishable goods witnessed a slight increase after the Great Crash in the stock market, consumption of durable goods was significantly reduced by the end of 1929, the thing that had huge repercussions on US aggregate real output during the 1930s (Temin, 1989).

Both of the terms: the Great Crash, which refers to the 1929 collapse in the US stock market, and the Great Depression which denotes the drastic decline in US real output during the 1930s, were used interchangeably by the public to refer to the same economic distress that the US economy was undergoing. However, economists do not view them as the same events to the point that some attempted to estimate the causal relationship among them (Romer, 1990).

Though the US economy went through a process of recovery during the 1930s, yet it was a disrupted and a sluggish recovery that marked the entire decade as the Great Depression. In this paper, I will attempt to review the policy measures that led to this slow recovery though were intended to speed up the recovery and to retain the prewar rates of economic growth.

## **2. Expansion of Federal Government**

The aftermath of the Great Depression witnessed an expansion in the role of the federal government in the economic activity. The slow recovery led the public to call for more government intervention to heal the economy despite the fact that businesses resented the government control of their investment initiatives. The responsibilities that the federal government took over after the Great Crash like social security payments, and unemployment compensation payments for the involuntarily unemployed in addition to the increased role of trade unions that led to the establishment of minimum wage and minimum price set by the Wagner act, all necessitated the enlarged role of the government. In terms of public employment, public employees were increased from 553,000 employees in 1929 to 1,042,420 in 1941. Moreover, the federal budget was also inflated. In 1929 federal receipts represented only 3.8 % of the US GNP, and federal spending was measured as 3.04 % of the US GNP, and the government ran a budget surplus. Meanwhile, in 1939, federal receipts were increased to 5.5 of the US GNP, and the federal expenditure was almost tripled to achieve 9.77 of the GNP (Smiley, 2008).

## **3. Gold Standard**

Though the Great Depression was a worldwide phenomenon where it hit many industrialized economies in Europe, Asia, and South America, the recovery process in the countries whose economy were contracting took shorter time if compared to the time that the economic recovery took in the United States. Many of the recession-inflicted economies recovered within the course of two years, while the process took more than a decade in the US. These economies did not run the same financial crises that the US economy ran, nor did they have the same banking system of the US, in addition to the fact that they relaxed the Gold Standards a few years before the Great Depression (Temin, 1976). In 1914, most of the industrialized economies were adopting the Gold Standard with fixed exchange rates of their domestic currency against gold and against foreign currencies. In the aftermath of WWI, many European countries, relaxed the Gold Standard, adopted floating exchange rates and printed money to finance military spending. As the US sustained the Gold Standard and did not alter the value of the US dollar, gold reserves started flowing into the US economy. Overseas holders of gold reserves started shipping their reserves to the US where gold sustained its value. In the aftermath of WWI, many European countries attempted to retain the Gold Standard alongside prewar rates of currency exchange. Since too much money was printed in the European countries that led to inflationary impact, and as the US reserves of gold were almost doubled where the US held 40% of the world's gold reserves in the 1920s, restoring the Gold Standards in these countries was impossible without a devaluation of their currencies or without the implementation of a set of deflationary policies. Consequently, in order to stem its outflow of gold, the US increased its discount rate in an attempt to raise the real interest rate. Yet, the US received more shipments of gold in 1928.

## **4. The Onset of the Great Depression**

The established deflationary policies in the European countries that were intended to curtail economic activities and to lower price levels led to the crash of the US stock market as it negatively affected the value of firms' securities. The soaring unemployment that was associated with the reduction in real output led President Herbert C. Hoover to confer with industrials, business owners, investors, and

leaders of labor unions in December 1929 in a call to sustain wage rates and distribute more dividends to boost aggregate demand. Thus, urging them to redirect the burden of the economic contraction to fall on profits rather than on dividends. This initiative led to a massive bank runs and failures due to the sharp decline in the value of the firms' securities that was negatively reflected on banks portfolios. In 1931, and upon the drop of the Gold Standard by the United Kingdom, the Federal Reserves initiated another rise in the federal fund rate to affect gold outflow. International investors in the countries that were still holding the Gold Standard expected the US to devalue its currency or to drop the Gold Standard following the UK initiative, so the value of their holdings of US dollar dominated securities will be reduced. Following their expectations, investors in the overseas started selling their US dollars reserves to purchase gold. Accordingly, the increase in the real interest rate built upon the already existing bank failure as the US was committed to the Gold Standards, making American assets more expensive to be sold in the stock market. Bank failures were going on until the US Fed signaled a relief when it conducted an open market purchase of securities in 1931. Consequently, the first round of economic recovery started in 1933, but it was interrupted in 1934 and 1935. Another round of recovery that was initiated by the late 1935 was also interrupted in 1937. The US economy was not yet recovered when it was dragged into WWII in 1941.

## 5. Fiscal Policy

Enthusiasm about the potency of the monetary policy in moderating fluctuation of business cycle was mingled in the aftermath of the Great Depression. Keynes's analysis provided fiscal policy as an alternative to the impotence of monetary policy in heeling depression. Lack of investment opportunities and inadequate aggregate demand could be met by government expenditure that can compensate for the reduction in investment. So, it was believed by economists for a while that tax reduction could stimulate aggregate demand (Freidman, 1968). Thus, another policy measure that added on the slow recovery though was intended to speed it up is a misconduct of fiscal policy. In another initiative to recover the economy, on December 1929, President Hoover reduced all income tax rates by 1% in response to the continuous budget surpluses. This policy mistake turned the surplus into a deficit as less government revenue was achieved. Consequently, President Hoover called for a large increase in income tax that was approved and passed by the congress in 1932. The tax burden that worsened consumers' budget and reduced their disposable income led to a further contraction as consumer spending on durable and perishable goods was drastically declined.

## 6. Monetary Policy

Government intervention in economic activities was first addressed by John Maynard Keynes in his *General Theory of Employment, Interest, and Money* (1936) in response to the Great Depression when self-regulated market and Laissez-Faire market practices led to market failure and a long-run devastating recession. Later, monetary policy measures were also addressed in *A Program for Monetary Stability* (1960) by Melton Friedman, an advocate of Monetarism.

Policy measures are mandatory to overcome market imperfections. Monetary policy measures can boost the economy and increase economic growth through well-designed interest rate policies. By controlling overnight interest rates, Central Bank can affect private sector investments that are essential to achieve

economic progress. In terms of economic development, reducing financial volatility provides an investment-friendly environment that increases the prospects of public-private partnerships required to finance long-term development projects (Ireland, 2005). Moreover, private sector interest rates and market of financial assets are directly impacted by the central bank policies of interest rate. So interest rate could be used as an effective tool to harness the intensity of business cycles. Through controlling money supply, which is another monetary policy tool, aggregate demand on products, real estates, and financial assets is also controlled, thus inflation rates, volatility, and financial uncertainty could be minimized. Long-run consumption plans, especially in the market of real estates, are immediately impacted by financial instability. The damaging effects of financial volatility on economic growth could be minimized by using expansionary and contractionary policies through the inflationary pressure that the former creates or the recessionary effect the latter entails.

International trade is another sector impacted by money supply policies through exchange rates. Trade gains could be boosted and terms of trade could also be improved when inflation rates are controlled and financial instability is minimized. Another economic aggregate that is affected is unemployment rate. Through minimizing financial volatility, long-run employment contracts are likely to be easier to conduct, thus, foreign direct investment opportunities are more plausible and higher rates of economic growth are expected (Ireland, 2005).

Thus, wisely managed government intervention through monetary policy measures can help improving economic outcomes and achieving economic progress. However, though was intended to speed up the economic recovery, the unfortunate monetary measure that was initiated by the US government during the late 1920s decelerated the recovery rather than accelerated it. In response to the massive wave of bank failures where almost 10,800 banks failed during the period between 1929 and 1933 (Smiley, 2008), deposit-holders started reducing their bank deposits and hold more cash at their disposal than before; besides, surviving banks enlarged their cash reserves and held excess to avoid cash crises. The result was a massive decline of 30.9% of money supply. In response to the worsened economic condition, President Franklin D. Roosevelt declared banking holidays during which all banking transactions were suspended. These banking holidays that closed down the entire activities of the financial institutions finally ended the banks runs and failures and reclaimed the public confidence in the US banking system.

## 7. New Deal

President Roosevelt who was mistakenly advised that destructive market competition that led to overproduction and general glut is the main reason behind the depression, came into office in 1932 with the New Deal that included both the Agriculture Adjustment Act (AAA) and the National Recovery Administration (NRA) that were targeting the glut in the production and were designed to reduce real output, but on the other hand, retaining higher rates of wages and higher levels of prices. Higher rates of wages were realized indeed as firms attempted to comply with the adjustments, as well as a reduction in real output that was also realized, but the burden was passed again to consumers' disposable income rather than rates of profits.

## **8. Labor Union and Social Security Tax**

In another attempt to sustain higher rates of wages, Senator Robert Wagner enacted the National Labor Relations Act in 1935 according to which workers were compelled to join labor unions in order to monopolize labor force and to solidify the working class bargaining power for better work conditions. Consequently, hourly labor cost hiked after the realization of an increase in the hourly wages and the establishment of overtime wage payments. Another reason behind the increase in labor cost was President Roosevelt's social security tax that was imposed on corporates' retained earnings. The tax that was designed to urge corporates to distribute dividends led some of them to raise wage rates and provide workers with bonuses to averse the tax on the undistributed earnings. The resulted increase in labor cost that was not associated with an increase in prices led to a massive wave of layovers and to a soaring unemployment rate.

## **9. Change in Monetary Policy**

As banks held higher rates of reserves after bank runs, policy makers feared inflationary pressure that might be generated by these increased reserves of banks in case they were used to increase lending. To keep inflation in check, the Fed doubled its required reserves by 1937 in order to curtail money supply and the expected soaring inflation rates. As the stock of money was reduced, aggregate demand was enormously reduced due to the increased costs of borrowing.

## **10. Conclusion**

In their analysis of the reasons behind the slow recovery of the repercussions of the Great Depression, economists provide different views. Some economists argue that the New Deal that targeted overproduction was one of the main reasons that hindered the process of economic recovery. Meanwhile, others like Milton Friedman and Anna Schwartz emphasize the role mistaken monetary policy measures. Such a depression is unlikely to be repeated because the Federal Reserve Board will no longer be passive and sit aside when a drastic fall in money supply takes place. The experience in the management of economic crises that was acquired during the 1930s provides policy makers with some insightful ideas on policy measures that will lead them to manage the economy in a manner that averse the repetition of such a massive depression.

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