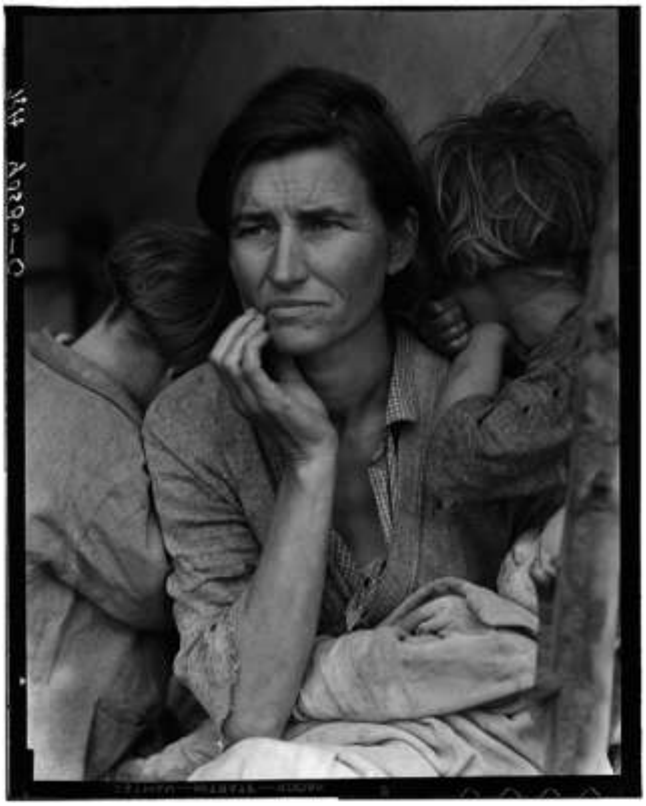
CENTRAL UNIVERSITY COLLEGE

ELEMENTS OF BANKING

THE GREAT DEPRESSION



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BRIEF HISTORY OF THE GREAT DEPRESSION

The Great Depression was a severe worldwide economic depression in the decade preceding World War II. The timing of the Great Depression varied across nations, but in most countries it started in about 1929 and lasted until the late 1930s or early 1940s. It was the longest, most widespread, and deepest depression of the 20th century, and is used in the 21st century as an example of how far the world's economy can decline. The depression originated in the U.S., starting with the stock market crash of October 29, 1929 (known as Black Tuesday), but quickly spread to almost every country in the world.

Cities all around the world were hit hard, especially those dependent on heavy industry. Construction was virtually halted in many countries. Farming and rural areas suffered as crop prices fell by approximately 60%.

Countries started to recover by the mid-1930s, but in many countries the negative effects of the Great Depression lasted until the start of World War II.

Economic historians most often attribute the start of the Great Depression to the sudden and total collapse of US stock market prices on October 29, 1929, known as Black Tuesday. However, some dispute this conclusion, and see the stock crash as a symptom, rather than a cause of the Great Depression. Even after the Wall Street Crash of 1929, optimism persisted for some time; John D. Rockefeller said that "These are days when many are discouraged. In the 93 years of my life, depressions have come and gone. Prosperity has always returned and will again."

By mid-1930, interest rates had dropped to low levels, but expected deflation and the reluctance of people to add new debt by borrowing, meant that consumer spending and investment were depressed.

Prices in general began to decline, although wages held steady in 1930; but then a deflationary spiral started in 1931. Conditions were worse in farming areas, where commodity prices plunged, and in mining and logging areas, where unemployment was high and there were few other jobs.

CAUSES / EFFECTS OF THE GREAT DEPRESSION ON FINANCIAL INSTITUTIONS.

1. Stock Market Crash of 1929: The crash of the stock market in 1929 was one of the major causes that led to the Great Depression. The stock market crash occurred as a result of the tight U.S monetary policy aimed at limiting stock market speculation. Two months after the original crash in October, stockholders had lost more than $40 billion dollars. Even though the stock market began to regain some of its losses, by the end of 1930, it just was not enough and America truly entered what is called the Great Depression. The effects on financial institutions (Banks) was that they invested heavily in the stock market during that period and that as a result cost them their investments.

2. Banking Panics and Bank Failures: A banking panic arises when many depositors lose confidence in the banks and simultaneously demand their deposits be paid to them in cash. Banks, which typically hold only a fraction of deposits as cash reserves, must liquidate loans in order to raise the required cash. The panics took a severe toll on the American banking system. By 1933, one-fifth of the banks in existence at the start of 1930 had failed. The effects of the panics also allowed for the bank

failures. Throughout the 1930s over 9,000 banks failed. Bank deposits were uninsured and thus as banks failed people simply lost their savings. Surviving banks which were unsure of the economic situation and concerned for their own survival, stopped being as willing to create new loans. This exacerbated the situation leading to less and less expenditures. The effects on financial institutions were that banks faced the problem of liquidity as depositors demand that they deposits be paid to them in cash. This exacerbated bank crisis and as a result the banks failed.

3. Drought Conditions: While not a direct cause of the Great Depression, the drought that occurred in the Mississippi Valley in 1930 was of such proportions that many could not even pay their taxes or other debts and had to sell their farms for no profit to themselves. The area was nicknamed "the dust bowl". The drought adversely affected agriculture. Agriculture is more or less an engine of growth for every economy and that no economy can survive without depending on agriculture. The question about how financial institutions suffered during the time of the drought was that ‘’how do banks (financial institutions) make money?’’. One of the ways by which banks make money is by lending money at higher rates to borrowers than they pay to savers’’. Critical players who depend on agriculture are farmers, marketers, industrialists and so on. These people would have made more money if the climate situations were to be favourable and hence saving the excess of their proceeds and therefore banks would end up benefiting from that.

4. Reduction in Purchasing across the Board: With the stock market crash and the fears of further economic woes, individuals from all classes stopped purchasing items. This then led to a reduction in the number of items produced and thus a reduction in the workforce. As people lost their jobs, they were unable to keep up with paying for items they had bought through instalment plans and their items were repossessed. More and more inventory began to accumulate. The unemployment rate rose above 25% which meant, of course, even less spending to help alleviate the economic situation.

5. International lending and trade

Foreign lending to Germany and Latin America had expanded greatly in the mid-1920s. U.S. lending abroad then fell in 1928 and 1929 as a result of high interest rates and the booming stock market in the United States. This reduction in foreign lending may have led to further credit contractions and declines in output in borrower countries. In Germany, which experienced extremely rapid inflation (“hyperinflation”) in the early 1920s, monetary authorities may have hesitated to undertake expansionary policy to counteract the economic slowdown because they worried it might re-ignite inflation. The effects of reduced foreign lending may explain why the economies of Germany, Argentina, and Brazil turned down before the Great Depression began in the United States.

CURES/SOLUTIONS TO THE GREAT DEPRESSION

During President Roosevelt’s era, he came out with many programmes (New Deal) to help mitigate the harshness of the depression. This exercise of the creation of new programmes was termed as the new deal.

Money and banking

Roosevelt’s first priority was to deal with the crisis of the bank failure. Two days after his inauguration, the president declared a nationwide banking holiday, and then called a special session of congress. With sizeable democratic majorities in both houses, the new congress was ready to rubbers-stamp bills drafted by white house advisors, and they gave the president himself extraordinary blank-check powers, in some cases delegating to him legislative authority. Only eight hours into the emergency session, the congress passed the ***Emergency Banking Relief Act***, which gave the president absolute control over the national finances and foreign exchange of the United States. Combined with the Federal Reserve’s commitment to supply unlimited amounts of currency to reopened banks, the new law created de facto 100 percent deposit insurance.

Job creation

At the time of Roosevelt's first inauguration, nearly 25% of the nation's labour force was unemployed, the highest percentage in the nation's history, and there was no social safety net in place to provide them any relief. Job creation cried out for immediate relief and recovery, and President Roosevelt had no reservations about using federal dollars to address the problem.

Nine days later, the Congress created *the* ***Civilian Conservation Corps (CCC)***, perhaps the most popular of all the New Deal Programs. The CCC provided unskilled manual labour jobs for about 3 million unmarried young men, many of whom might otherwise have drifted into criminal activity. Organized into outdoor government camps, the CCC worked in conservation and development of land resources owned by federal, state, and local governments. They planted 3 billion trees to replace the forests that had been devastated by unregulated industrialization. They fought fires, worked in flood control, drained swamplands, and built public access and service roads in rural areas.

Relief for the adult workers of America was provided by the creation of the ***Federal Emergency Relief Administration (FERA)*** on May 12. This agency granted about $3 billion tax dollars to the states, to be doled out as unemployment payments or as wages for work on state projects. FERA, intended as immediate relief, closed at the end of 1935 after providing work for over 20 million people on public projects.

The same congress that had created the NRA had had in contracts to private construction firms that did the actual work. The PWA accomplished the electrification of rural also created *the* ***Public Works Administration (PWA).*** The primary purpose of the PWA was long-range recovery. By the time it was shut down in 1943, $6 billion taxpayer dollars had been spent on 34,000 projects. Most of it was spent America, the building of canals, tunnels, bridges, highways, streets, sewage systems, and housing areas, as well as hospitals, schools, universities, and courthouses.

In May 1935Congress created the ***Works Progress Administration (WPA)***. It was the largest New Deal agency, designed to employ millions on useful projects, including the construction of public buildings, bridges, and roads. Almost every community in the United States had a park, bridge or school constructed by the agency, which especially benefited rural and Western populations. It fed children and redistributed food, clothing and housing. Over a period of 8 years, some 9 million Americans were employed.

Between 1935 and 1943, the WPA provided almost 8 million jobs, at a cost of over $14 billion. Full employment was never its intended goal. Rather, it tried to provide one paid job for all families where the breadwinner suffered long-term unemployment.

Social security

Real reform was enacted by passage of the ***Social Security Act of 1935***, which provided a social safety net beneath FDR's New Deal economy. The new law provided for federal-state unemployment insurance and a retirement pension for old-age workers, ranging from $10 to $85 a month, and paid for by a payroll tax of both employers and employees. Provision was also provided for the blind, the physically handicapped, fatherless children, and other dependents.

World War II

During the war more than 12 million Americans were sent into the military, and a similar number toiled in defence-related jobs. Those war jobs seemingly took care of the 17 million unemployed in 1939. Most historians have therefore cited the massive spending during wartime as the event that ended the Great Depression. The expense of funding World War II hiked the national debt from $49 billion in 1941 to almost $260 billion in 1945. The end of the World War II marked the end of the Great Depression.

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