The Causes of The Great Depression
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In the 1930s, the economies of the capitalist world collapsed. It was a world-wide collapse. Economic production plummeted, tens of millions of people were thrown out of work, tens of thousands of companies went bankrupt, international trade shriveled, and democracies came under threat. This paper briefly establishes some facts about the severity of the Great Depression, then examines its causes. It looks at some of the ways that government policy responses to the collapse actually magnified its effects and it concludes with a final word.

The Great Depression

The Great Depression began in 1928 in Europe. It quickly spread to the U.S. where it assumed its most virulent form. In 1929 in the U.S., two million workers were unemployed. By 1932, that number had surpassed 13 million, a more than 600% increase. It represented more than 25% of the entire nation’s workforce. In some cities, more than 50% of all men were without jobs. In a time when most families were supported by a single bread-winner, the human toll was devastating.

Other indicators of economic well-being tell a similar story. Industrial production fell by 50%. More than 5,000 banks failed, wiping out more than 9 million bank accounts. By 1933, more than 1,000 homes and farms were foreclosed every day. It is no exaggeration to state that the effects were calamitous. And it was truly a world-wide collapse as shown in the following table.

![Figure 5. Indices of industrial production, 1929-1937 (1929 = 100)](image)

*Source: League of Nations, *World production and prices, 1925-38*, p. 44*

From Eichengreen, “The Origins and Nature of the Great Slump Revisited,” p. 233
Global production fell by more than one third. In Germany, industrial production was down by 42% while unemployment rose by 230%. For Germany, it was the third economic calamity in a decade (the first was World War I; the second was the Great Inflation of Weimar Germany in the early Twenties). The Depression gave direct impetus to the rise of Adolph Hitler, who promised to restore German jobs, production, and prosperity. And Germany was not alone. The political stability of the entire capitalist world was at risk.

**Initial Causes of the Great Depression**

The causes of the Great Depression have been debated since it first occurred. Suggested causes range from increasing productivity, over-extension of credit, and wage stagnation. Five causes command general agreement among economists and historians. They are:

1) Declining global farm incomes;
2) Deflationary effects of the gold standard;
3) Restrictive monetary policy leading to a collapse in the U.S. stock market;
4) The contagion of that collapse to the system of international payments; and,
5) Extreme levels of income inequality, leading to insufficiency of demand.

The first cause of the Great Depression was declining agricultural prices. During World War I, the U.S. had dramatically increased the land under cultivation in order to feed both itself and its Western allies. It also substantially increased the use of mechanization in planting and harvesting—engine-powered tractors, combines, and reapers. These two factors resulted in a very large increase in the amount of food and other farm products that were produced.

Soon after World War I, European countries returned to producing their own farm products. At the same time, new regions of the world which had not historically been farm exporters came on-line with industrial-scale production of their own. These included Australia, New Zealand, Canada, Argentina, and Ukraine. The result of all of this production was a global glut, or over-production, of farm goods relative to demand. As a consequence, global prices of agricultural commodities fell precipitously. The Table on the following page illustrates the extent of the price collapse in the U.S. Other countries suffered similar collapses.

But prices for farm goods are incomes to everyone involved in farm production. So, as agricultural prices fell, farm incomes fell. In the U.S., more than 30% of the population still lived on farms, so the impact was substantial. In a perverse feedback loop, many farmers put still more acreage under tillage. Their hope was to raise their individual incomes, but when everybody did this, it only made the glut worse, accelerating the collapse.\(^1\) Some farmers, understanding this dynamic, actually began destroying crops. But it was too little, too late. A vicious global downward spiral of prices and incomes was under way.

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\(^1\) The great British economist John Maynard Keynes would later describe this as the “fallacy of composition.” What is good for an individual backfires when everybody does it. It came into play when nations raised tariffs to try to keep out other nations’ goods. It works in isolation, but if all nations do it the result is lower production for all.
This left farm consumers unable to purchase the goods that were being produced by the increasingly productive industrial economy. This, in turn, led to shut-downs and layoffs in the industrial sector of the global economy, leaving its workers also impoverished and unable to sustain overall demand. Thus began a second vicious downward spiral of declining incomes, declining purchases, declining industrial production, declining employment, and, finally, more declining incomes. By the time it was over, the economy of the U.S. had shrunk by half. The global economy had shrunk by one third.

A second cause of the Great Depression was the deflationary effects of the gold standard. During the nineteenth century the world’s economy used the gold standard as the basis of international trade. This standard was enforced by Britain, which was the leader in global commerce. There were two key mechanisms that made the gold standard work: one that operated internationally, settling trade balances between countries; and the other that operated domestically, making the necessary adjustments within a country.

When one country, A, bought goods from another country, B, it paid for those goods in its own currency. But that currency was then returned by country B to the central bank of country A, where it was exchanged for gold at a fixed and pre-determined rate of exchange. So, if a country consistently bought more from other countries than it sold to them (a trade deficit) it would experience an out-flow of gold from its national vaults. If, on the other hand, a country consistently sold more abroad than it bought (a trade surplus), it would enjoy an in-flow of gold. The domestic adjustment mechanism was intimately related to this process.

Domestically, the nation’s money supply was set in fixed proportion to the amount of gold it held. So, when a nation ran a persistent trade deficit, the out-flow of gold would cause its money supply to contract. With less money to lubricate transactions, the domestic economy would either have to shrink, or wages would have to fall. Falling wages would improve its relative international competitiveness, thus restoring trade balance. Conversely, nations running persistent trade surpluses accumulated gold and so saw their money supplies and
wages increase. This resulted in a decline in their international competitiveness, and a restoration of trade balance. This system broke down during the 1920s.

During World War I, the U.S. economy had boomed. As with agriculture, its industries supplied not only its own needs, but those of its allies as well. At the end of the War, the U.S. had the only economy in the industrial world that was still intact. Other countries had to come to the U.S. for the machinery, steel, supplies, and equipment they needed to rebuild their economies. And U.S. industries were by far the highest volume, lowest cost producers in the world. As a result, the U.S. ran very large and persistent trade surpluses with other countries of the world. In the process, it accumulated enormous quantities of gold.

The other country that accumulated gold during the 1920s was France, though for a different reason than the U.S. France pegged its currency to gold, but at an artificially low rate. This had the effect of making French goods appear cheap to foreign buyers and foreign goods expensive to French buyers. As a result, France ran persistent trade surpluses, selling more abroad than it bought. Gold flowed into France from other countries. In the late 1920s, the U.S. and France together held more than half of the entire world’s supply of monetary gold.

This concentration of gold in the U.S. and France left other countries with insufficient “liquidity” for their economies to operate normally. Their economies contracted. But both France and the U.S. carried out domestic measures (called “sterilization”) to prevent their increases in gold from inflating their domestic money supplies. So, the automatic adjustment mechanism that was supposed to restore international equilibrium was prevented from working. Instead, the U.S. and France effectively imposed economic contraction on all other countries of the world. Ultimately that hurt their own economies, as their export markets shrunk.

A third cause of the Great Depression was the contractionary monetary policy pursued by the U.S. Federal Reserve Board, beginning in 1925. During the 1920s, Americans came to believe that money invested in new technologies produced superior financial returns compared to investments in older technologies. Companies making automobiles, radios, durable consumer appliances, and other “high tech” products produced outsized growth in the price of their stock. This helped feed a boom in the stock market.

Between 1924 and 1929 the Dow Jones Industrial Average index of the stock market more than quadrupled. Much of this growth, however, had been fueled by purchases made “on margin,” or with debt. A buyer could borrow as much as 90% of the price of a stock, speculating that its price would rise. If the price rose only 10%, the buyer doubled his invested money. But by 1928, the Federal Reserve Board had come to believe that the stock market’s gains had outpaced underlying productivity and, as such, was posing a risk to the larger economy.

In an attempt to rein in some of the stock market’s growth (and especially speculative investing), the Federal Reserve began tightening monetary policy (policies affecting the money supply and interest rates). It began in 1925 by shrinking the money supply (see the chart, below). The effect was to leave less money available to facilitate agricultural, commercial, and industrial transactions. As a result, economic activity slowed dramatically, reaching its cyclical peak in August 1929, two months before the peak in the stock market.
In 1928, the Federal Reserve resumed its campaign to rein in the stock market. It raised the rates it charged commercial banks to borrow money and required banks and brokers to raise the rates they charged customers for margin loans. The combination of all of these contractionary monetary forces (together with a turning down of the “real” economy in August 1929) led to a collapse in the stock market. On October 24, 1929 (“Black Thursday”) the stock market lost 11 percent of its value. The following Tuesday, October 29th (“Black Tuesday”) it lost an additional 12 percent. A massive, unstoppable collapse was under way. The chart below illustrates how steep were both the ascent and collapse.
The stock market collapse worked through two channels to help cause the Depression. The first channel was the “wealth effect.” Tens of billions of dollars of wealth was destroyed as stock prices plummeted. Much of this affected individual investors whose life savings were wiped out. Some of it affected the capital of corporations whose stocks’ prices had fallen. Their ability to fund operations (materials, payrolls, etc.) was dramatically reduced. As a result of this “wealth effect,” purchases by consumers fell while companies cut back production.

The second channel was psychological. Throughout the 1920s, economic expansion had been robust and prospects were assumed to be good into the future. So, when the collapse occurred, it spooked millions of people, many of whom didn’t even have money in the stock market. They put off purchases, especially of “big ticket” items such as refrigerators or washing machines, causing an almost immediate contraction in the economy. The combination of these effects from monetary contraction was a rapid and dramatic shrinkage in the economy.

The fourth cause of the Great Depression lay in the international system of payments. One of the provisions of the Treaty of Versailles which settled World War I was that Germany was obligated to pay reparations to England and France. It fell behind in these payments almost immediately, precipitating the Great Inflation of the early 1920s. England and France, of course, owed payments for their War debts to the United States. Without reparations payments from Germany they could not make these payments.

In 1924, the Dawes plan, arranged by the U.S., offered at least a temporary solution to this problem. It provided loans from U.S. banks to the German government. The German government then recycled these funds into reparations payments to England and France. England and France then used the reparation payments from Germany to help cover their war debt repayments to the U.S. This scheme is illustrated in the chart below. The Dawes Plan was updated in 1928 by the Young Plan, which reduced German reparation payments, but retained the fundamental circular flow of funds.

Illustration: Robert Freeman
In 1928, the U.S. Federal Reserve began raising interest rates in order to cool down an overheated stock market, as noted above. (Higher interest rates make stocks purchased on credit more expensive, reducing demand for them.) One of the unintended consequences of this move was that it drew loanable funds back from Europe to the U.S., where they could now earn more money. This interrupted the flow of loans to Europe, the same flow described above. But Europe, and especially Germany, were now critically dependent on this flow. As a result of the interruption, European economies began to slow dramatically in 1928.

The first effect was to reduce industrial employment in Europe. A secondary effect was to reduce demand in Europe for exports from the U.S. During the 1920s, exports to Europe had become a significant portion of U.S. economic production. So, with export demand reduced, factory owners in the U.S. began laying off workers, amplifying the downward spirals of declining incomes outlined above.

In other words, two international institutions—the gold standard and the system of payments for debts and reparations—created a tight coupling among Western nations which all but guaranteed that “contagion” in one country’s economy would be quickly transmitted to other countries. This “contagion” included not only the impact of gold, debts, and reparations, but all of the pathologies affecting the global economy—agricultural, industrial, commercial, and financial—as discussed above.

All of these forces coalesced to the same effect: to reduce the purchasing power of the world’s consumers. This occurred at precisely the time that industry was building larger and larger factories and producing more and more goods (See the final cause, below). The result was an increasing gap between what was being produced (supply) and what could be bought (demand). As inventories of unsold goods piled up, business owners responded in the only rational way they could: they began cutting back production and laying off workers. This, of course, only aggravated the shortfall in purchasing power, amplifying the already-accelerating downward spirals described above.

The final cause of the Great Depression lay in the high levels of inequality that came to characterize the capitalist system, especially the United States. During World War I, U.S. industry expanded dramatically, to supply not only the U.S. economy, but materiale for War allies as well. As it did so, it incorporated the latest labor-saving technologies. This expansion continued into the 1920s. The consequence was that after the War, productivity (what could be produced with a man-hour of labor) was much higher than what it was before the War. But the flip side of higher productivity was that the same output could be produced with less labor input. That is what actually occurred.

Between 1919 and 1929, total manufacturing output in the U.S. economy increased by 64% while the number of workers employed in manufacturing remained almost constant. With the labor force expanding from natural population growth, the result was downward pressure on wages. Between 1923 and 1929 weekly earnings in manufacturing actually declined, falling about 20%. This decline occurred despite dramatically improved output. Wages fell 8% in steel

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2 This section owes a considerable intellectual debt to Professor Jon Whisman of American University. The data cited are from his paper, “Labor Busted, Rising Inequality, and the Financial Crisis of 1929.”
production. This had the effect of shifting the composition of national income away from labor and toward profits. Again, the data tell the story.

The share of national income captured by the top 1% of income earners rose from 19.1% in 1919 to 24.6% in 1929. The richest 7% of income earners increased their share of national income from 36.2% in 1919 to 44.8% in 1929. This means that the share of national income available to the remaining 93% of the population fell from 63.8% to 55.2% over the same period. Wealth became similarly more concentrated. The share held by the top 1% went from 36.7% in 1919 to 44.2% in 1929. By 1929, the top 1% of income earners held an astounding 80% of the nation’s total personal savings. It was a literal case that the rich were getting richer and everyone else was getting at least relatively poorer. The extent of the inequality is shown in the following chart.

![Top 10% Pre-tax Income Share in the US, 1917-2011](chart.png)

Source: Piketty and Saez, 2003 updated to 2011. Series based on pre-tax cash market income including realized capital gains and excluding government transfers.

From Saez, “Income Inequality: Evidence and Policy Implications,” p. 5

With a declining relative share of the nation’s income and wealth, workers resorted to reducing their savings in an attempt to sustain their standards of living. They also dramatically increased their borrowing. Personal savings declined 42%, from 6.4% of income to 3.8% during the Twenties. At the same time, debt as a percent of income doubled, growing from 4.7% to 9.3%. Much of this debt went to purchase the new consumer durables that so entranced the nation and that signaled social status: automobiles, washing machines, refrigerators, vacuum cleaners, radios, and phonographs. By the end of the decade, more than 90% of such consumer durables were being financed on credit. Much of the money lent to consumers in this way was being recycled from the large sums being amassed by the very rich.

The picture painted here is of an unsustainable expansion. With so much of the nation’s income and wealth going to such a small part of the population, and with output expanding rapidly, there was not enough purchasing power in the hands of average consumers to clear the market off all the goods being produced. The recourse to reduced savings and expanded debt
worked for a while to mask the shortfall in incomes, but could not be sustained. The business cycle reached a peak in August 1929 when the real economy began to turn down. When the stock market crashed two months later, it was the “perfect storm.” Massive amounts of wealth were destroyed in the collapse, accelerating the contraction in business activity, and, then, an amplification of that contraction kicked in when overextended consumers—many of which were rapidly becoming laid-off workers—began cutting back on major purchases.

**Making Matters Worse**

The above discussion considers the causes of the Great Depression prior to its incidence. Once it was under way, in late 1929, a series of policy blunders, especially in the U.S., served to aggravate the collapse, sending the global economy into depths it had literally never experienced before. This section mentions two of these “aggravating forces” but without going into the same depth as was applied to the causes above.

The first of the blunders was raising tariffs to keep out other countries’ goods. This began in the U.S. with the Smoot-Hawley tariffs, enacted in June 1930 and affecting more than 20,000 imported goods. As with farmers putting more acreage under cultivation to boost their own income, this works only so long as other countries don’t retaliate. But if other countries retaliate, raising tariffs of their own in order to keep out U.S. goods, everybody is left worse off. This is what actually happened. The following “spider diagram” shows the progressing implosion.

![Figure 10. The contracting spiral of world trade, January 1929–March 1933: Total imports of 75 countries (monthly values in terms of old U.S. gold dollars [millions]).](image)

Canada, the U.S.’s largest trading partner, imposed retaliatory tariffs almost immediately. Britain and France shifted trade policy to favor imperial partners. U.S. imports from Europe fell by two-thirds, from $1.3 billion in 1929 to $.4 billion in 1933. U.S. exports to Europe fell by a similar amount, from $2.3 billion in 1929 to $.8 billion in 1933. Both economies were worse off. As the above chart indicates, from 1929 to 1933, global trade fell by two-thirds. It was a catastrophe for the entire world.

A second blunder was to allow almost half of the nation’s banks to go under. As financial panic gripped the U.S., millions of people began withdrawing their savings from local banks. Under a “fractional reserve system” such as is used in the U.S., banks kept only a small percentage of total deposits on hand at a given time. If a bank needed more money, it could borrow from other banks. But when a large share of depositors tried to withdraw their money at the same time, the banks couldn’t meet the need. Nor could they borrow from other banks, which were experiencing similar runs. The banks were forced to close. This is what actually occurred.

Between 1930 and 1932, bank failures averaged 1,700 per year. In 1933, More than 4,000 failed. The above chart shows the enormous extent of the failure. These failures wiped out billions of dollars of depositors’ savings. They also resulted in a severe reduction in funds available for loans and an equally severe contraction in the nation’s money supply. The combination of these factors produced extreme downward pressure on both consumption and production.

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3 U.S. State Department, “Protection in the Interwar Period.”
4 Walter, John R. “Depression-Era Bank Failures: The Great Contagion or the Great Shakeout?”
Discussion and Conclusion

These causes are presented in an international/domestic framework. They can also be summarized in another framework, one that focuses on institutional, policy, and structural factors. For example, the gold standard and the international system of payments were “institutional factors” causing the Great Depression. These were institutions put in place to manage the increasingly complex international economy of the post-War period. They proved flawed, and were eventually replaced by institutions that provided greater global stability.

Contraction of the nation’s money supply, beginning in 1925, falls into the category of “policy factors,” choices made within the given institutional framework of the time. The Federal Reserve’s moves to increase interest rates in 1928 was a policy choice. The Smoot-Hawley tariffs fall squarely into this category as well. Decisions to let banks fail are an ambiguous cause, partly residing in policy, and partly in institutions, since it was the nature of the banking system that there was little recourse if a national run on the banks occurred.

The fact of increasing inequality in both income and wealth can be attributed to “structural factors” inherent in the capitalist system. This can be explained using two different analytical perspectives. A Marxist analysis notes that industrial systems produce exceptional increases in output. But those increases owe to the productivity of industrial capital (machines), which is owned by capitalists. Their fruits do not accrue to workers, who have only their labor to sell. And the returns to labor (wages) decrease in capitalist production as labor is replaced by capital in the production process. As such, the system produces both greater inequality in incomes and wealth, and more goods than can be purchased with the limited incomes of workers. The consequence is inevitable collapse. This is exactly what occurred in the 1920s.

More recent research uses a different analytical lens to explain the same structural basis of the collapse. Private capital can choose to invest in only those projects that produce the highest returns. The overall economy, on the other hand (and even more so, government), is laden with investments that produce lower, or even negative returns. As a result, with private capital growing faster than the overall economy, a capitalist system, unless managed with progressive taxes, inevitably produces structural inequality of the kind seen in the 1920s. A glance back at the chart on page 8, above, shows that the inequality that helped produce the Great Depression returned in the first decade of the Twenty First Century to produce the Great Recession—the greatest global economic collapse since the 1930s. In Piketty’s framework, the role of inequality is the same in both cases and owes to the same cause.

As the above discussion indicates, the causes of the Depression were varied, complex, dynamic, and interactive. There were international and domestic factors. Alternatively, there were institutional, policy, and structural factors that affected the entire world’s economy. What is unique to the Depression is the way all of these factors played upon one another, amplifying each other, to produce the “perfect storm” of collapse. It wasn’t until World War II, when governments assumed major roles in the creation of aggregate demand, that democratic capitalist economies really recovered from the collapse.

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5 See, for example, Thomas Piketty, Capital in the Twenty-First Century
Sources:


