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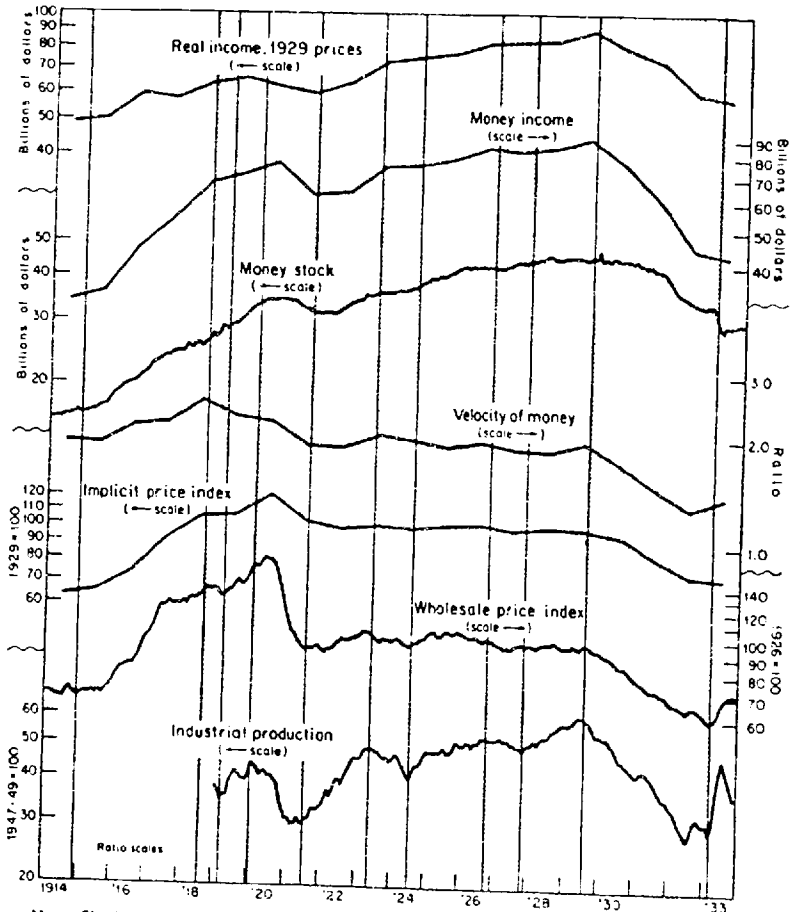
The Great Contraction

1929-1933

CHART 16

Money Stock, Income, Prices, and Velocity, in Reference Cycle Expansions and Contractions, 1914–33



NOTE: Shaded areas represent business contractions; unshaded areas, business expansions.

SOURCE: Industrial production, seasonally adjusted, from *Industrial Production, 1959 Revision*, Board of Governors of the Federal Reserve System, 1960, p. S-151 (manufacturing and mining production only). Other data, same as for Chart 62.

The Great Contraction, 1929–33

THE CONTRACTION from 1929 to 1933 was by far the most severe business-cycle contraction during the near-century of U.S. history we cover and it may well have been the most severe in the whole of U.S. history. Though sharper and more prolonged in the United States than in most other countries, it was worldwide in scope and ranks as the most severe and widely diffused international contraction of modern times. U.S. net national product in current prices fell by more than one-half from 1929 to 1933; net national product in constant prices, by more than one-third; implicit prices, by more than one-quarter; and monthly wholesale prices, by more than one-third.

The antecedents of the contraction have no parallel in the more than fifty years covered by our monthly data. As noted in the preceding chapter, no other contraction before or since has been preceded by such a long period over which the money stock failed to rise. Monetary behavior during the contraction itself is even more striking. From the cyclical peak in August 1929 to the cyclical trough in March 1933, the stock of money fell by over a third. This is more than triple the largest preceding declines recorded in our series, the 9 per cent declines from 1875 to 1879 and from 1920 to 1921. More than one-fifth of the commercial banks in the United States holding nearly one-tenth of the volume of deposits at the beginning of the contraction suspended operations because of financial difficulties. Voluntary liquidations, mergers, and consolidations added to the toll, so that the number of commercial banks fell by well over one-third. The contraction was capped by banking holidays in many states in early 1933 and by a nationwide banking holiday that extended from Monday, March 6, until Monday, March 13, and closed not only all commercial banks but also the Federal Reserve Banks. There was no precedent in U.S. history of a concerted closing of all banks for so extended a period over the entire country.

To find anything in our history remotely comparable to the monetary collapse from 1929 to 1933, one must go back nearly a century to the contraction of 1839 to 1843. That contraction, too, occurred during a period of worldwide crisis, which intensified the domestic monetary uncertainty already unleashed by the political battle over the Second Bank of the United States, the failure to renew its charter, and the speculative

activities of the successor bank under state charter. After the lapsing of the Bank's federal charter, domestic monetary uncertainty was further heightened by the successive measures adopted by the government—distribution of the surplus, the Specie Circular, and establishment of an Independent Treasury in 1840 and its dissolution the next year. In 1839–43, as in 1929–33, a substantial fraction of the banks went out of business —about a quarter in the earlier and over a third in the later contraction —and the stock of money fell by about one-third.[1]

The 1929–33 contraction had far-reaching effects in many directions, not least on monetary institutions and academic and popular thinking about the role of monetary factors in the economy. A number of special monetary institutions were established in the course of the contraction, notably the Reconstruction Finance Corporation and the Federal Home Loan Banks, and the powers of the Federal Reserve System were substantially modified. The contraction was shortly followed by the enactment of federal insurance of bank deposits and by further important modifications in the powers of the Federal Reserve System. It was followed also by a brief period of suspension of gold payments and then by a drastic modification of the gold standard which reduced it to a pale shadow of its former self (see Chapter 8).

The contraction shattered the long-held belief, which had been strengthened during the 1920's, that monetary forces were important elements in the cyclical process and that monetary policy was a potent instrument for promoting economic stability. Opinion shifted almost to the opposite extreme, that "money does not matter"; that it is a passive factor which chiefly reflects the effects of other forces; and that monetary policy is of extremely limited value in promoting stability. The evidence summarized in the rest of this chapter suggests that these judgments are not valid inferences from experience. The monetary collapse was not the inescapable consequence of other forces, but rather a largely independent factor which exerted a powerful influence on the course of events. The failure of the Federal Reserve System to prevent the collapse reflected not the impotence of monetary policy but rather the particular policies followed by the monetary authorities and, in smaller degree, the particular monetary arrangements in existence.

The contraction is in fact a tragic testimonial to the importance of monetary forces. True, as events unfolded, the decline in the stock of money and the near-collapse of the banking system can be regarded as a consequence of nonmonetary forces in the United States, and monetary and nonmonetary forces in the rest of the world. Everything depends on

[1] For an interesting comparison of the two contractions, see George Macesich, "Monetary Disturbances in the United States, 1834–45," unpublished Ph.D. dissertation, University of Chicago, June 1958.

how much is taken as given. For it is true also, as we shall see, that different and feasible actions by the monetary authorities could have prevented the decline in the stock of money—indeed, could have produced almost any desired increase in the money stock. The same actions would also have eased the banking difficulties appreciably. Prevention or moderation of the decline in the stock of money, let alone the substitution of monetary expansion, would have reduced the contraction's severity and almost as certainly its duration. The contraction might still have been relatively severe. But it is hardly conceivable that money income could have declined by over one-half and prices by over one-third in the course of four years if there had been no decline in the stock of money.[2]

1. *The Course of Money, Income, Prices, Velocity, and Interest Rates*

Chart 16, which covers the two decades from 1914 to 1933, shows the magnitude of the contraction in the perspective of a longer period. Money income declined by 15 per cent from 1929 to 1930, 20 per cent the next year, and 27 per cent in the next, and then by a further 5 per cent from 1932 to 1933, even though the cyclical trough is dated in March 1933. The rapid decline in prices made the declines in real income considerably smaller but, even so, real income fell by 11 per cent, 9 per cent, 18 per cent, and 3 per cent in the four successive years. These are extraordinary declines for individual years, let alone for four years in succession. All told, money income fell 53 per cent and real income 36 per cent, or at continuous annual rates of 19 per cent and 11 per cent, respectively, over the four-year period.

Already by 1931, money income was lower than it had been in any year since 1917 and, by 1933, real income was a trifle below the level it had reached in 1916, though in the interim population had grown by 23 per cent. Per capita real income in 1933 was almost the same as in the depression year of 1908, a quarter of a century earlier. Four years of contraction had temporarily erased the gains of two decades, not, of course, by erasing the advances of technology, but by idling men and machines. At the trough of the depression one person was unemployed for every three employed.

In terms of annual averages—to render the figures comparable with the annual income estimates—the money stock fell at a decidedly lower

[2] This view has been argued most cogently by Clark Warburton in a series of important papers, including: "Monetary Expansion and the Inflationary Gap," *American Economic Review*, June 1944, pp. 320, 325–326; "Monetary Theory, Full Production, and the Great Depression," *Econometrica*, Apr. 1945, pp. 124–128; "The Volume of Money and the Price Level Between the World Wars," *Journal of Political Economy*, June 1945, pp. 155–163; "Quantity and Frequency of Use of Money in the United States, 1919–45," *Journal of Political Economy*, Oct. 1946, pp. 442–450.