Banks and a Depression-Era Interventionist U.S. Government

Research Question:

How did the actions of U.S. private-sector banks in causing the Great Depression result in the increasingly interventionist role of the U.S. government in the economy of the 1930s?

Subject: History of the Americas, HL

Total Word Count: 2,200

Identification and Evaluation of Sources

Drawing inspiration from the cataclysmic Great Depression of the 1930s and the contrast it offers to the American Roaring Twenties, this investigation aims to answer the following research question: **how did the actions of U.S. private-sector banks in causing the Great Depression result in the increasingly interventionist role of the U.S. government in the economy of the 1930s?** The question assumes that U.S. private-sector banks did indeed cause the Great Depression, the U.S. government was not particularly interventionist in the Roaring Twenties, and the government was more interventionist in the 1930s, all of which will be supported in this investigation. Among other sources, the two main sources in this investigation are books: *The Origin of Financial Crises* by Dr. George Cooper published in 2008 and *The Great Crash, 1929* by Dr. John K. Galbraith first published in 1954. These books were chosen for their detailed explanation of the financial system and its underlying paradigms (capitalism v. socialism), offering arguments to attack and defend the rationale behind the economy's foundation. This is useful because according to Cooper, Galbraith, et al. the Great Depression caused a paradigmatic shift in the field of economics, and therefore, in the use of economics as a lens to examine history.

Cooper writes an excellent overview of the money system, central banks, credit creation, etc. all of which had a part in causing the Great Depression, though his purpose is not to explicitly address the Depression. Cooper utilizes his valuable experiences as a strategist and hedge fund manager at major investment banks to provide readers with real-world examples to support/refute arguments. Though he fails to offer many examples relevant to the Great Depression, his ideas can be extrapolated to address the topic; Cooper's policy suggestions are valuable in looking at the U.S. government's role in addressing the Depression though they are limited because they may not have been available at the time due to different perspectives dominating economics. Lastly, the value of Cooper's hindsight bias allows him to take into account the myriad theories that have been propagated since the Depression, though his lack of first-hand experience limits him from truly capturing the atmosphere of the time.

In contrast, the value of Galbraith's book is the eyewitness details, from newspapers, industrialists, politicians, et al., because he worked in President Roosevelt's administration to address the Depression. However, this adds considerable bias to his purpose of educating the general public about the Great Depression's causes and attempted solutions because Galbraith was politically affiliated with President Roosevelt. Nevertheless, his familiarity with the then-governing ideology provides great insight into how resultant government policies were increasingly interventionist. Overall, both sources are excellent complements because Galbraith's specificity helps this investigation by extrapolating Cooper's theory-related arguments to study the Great Depression.

Investigation

The 1929 American stock market crash caused a downwards spiral into financial ruin for many in a prolonged recessionary gap known as the Great Depression. Though many factors caused the Depression, this paper focuses on the role of U.S. private-sector banks and the government's regulatory response to them in the 1930s. Firstly, the business-government partnership of the 1920s encouraged reckless, profitable activity by greedy private-sector banks to further destabilize the American economy, leading to the Great Crash of 1929. However, President Hoover's administration, guided by classical economics and American Individualism, failed to take adequate measures to curb the worsening depression, further exacerbating the crisis. Ultimately, vehement public support led to President Roosevelt's election and his administration's very active role in controlling the economy in an effort to restore pre-depression conditions. Therefore, the controlling nature of the U.S. government in the 1930s economy was a rebuff of the status quo—ushering in progressive reforms aimed at recovery and to change the orthodox economic thinking which led to the private-sector banks' destabilizing activity.

Following the end of WWI, the strength of the American economy was clearly displayed and the capitalists forged a partnership with the government to ensure greater profits. Evidently, the "tranquility and contentment… and the highest record of years of prosperity" had strengthened confidence in the laissez-faire economy (Coolidge). In support, Galbraith writes simply, "...it was a good time to be in business" (2). This 1920s economic thinking led to the government's deep-seated belief in non-regulation. However, this boundless optimism may have been misdirected because it convinced the financial sector in particular to continue their existing, destabilizing activities, further encouraged by the Efficient Market Hypothesis (EMH). Simply, the administration and the financial sector believed, "...an equilibrium-seeking system [the economy] cannot internally generate destabilizing forces able to push it away from equilibrium" causing a lax Federal Reserve and government (Cooper 6). From this, it is clear to see the capitalist's delight in the business-government partnership. To clarify, if everyone believed the economy to be stable and capable of fixing itself, then there would be little need for regulation. In other words, an interventionist government would not be required. Additionally, the partnership resulted in the government funding and creating laws to exclusively help the capitalists. For example, Rothbard succinctly characterizes the partnership by arguing that the financial elites implemented the Federal Reserve, "...a governmentally created and sanctioned cartel device to enable the nation's banks to inflate the money supply [increasing their profits]...without suffering quick retribution" (258). However, Rothbard fails to see that the Federal Reserve was created for the express purpose of regulating the banks, and therefore, the American economy, independent of political pressure from the government. Nevertheless, President Hoover's support of the prevailing economic ideology led to further deregulation of the economy.

The resulting destabilization was brought through various activities, but this paper will focus on the most impactful one—excessive credit creation. Firstly, under a capitalist paradigm credit creation is necessary to fuel the economy and boost corporate profits because of its ability to increase the purchasing power of consumers and businesses, increasing consumption and investment in capital goods (Cooper 118). This leads many to believe that continuous loan issuances to consumers and businesses will facilitate perpetual, sustainable economic growth, but this is not the case. According to economist Minsky's[1] Financial Instability Hypothesis (FIH), "...financial markets can generate their own internal forces" leading to sometimes drastic bubbles/crashes (Cooper 13). This is especially caused by lending to high-risk entities at high interest rates in the hope of making greater profits, i.e. stock brokers borrowing money from commercial banks, and investment banks borrowing money from the Federal Reserve at a discounted rate. In fact, Galbraith writes, "Brokers' loans...increased at a rate of about $400,000,000 a month" which is shocking because stock prices were rapidly, "...catching up with the increase in corporation earnings" (11, 67). This meant that when stock prices slightly decreased, lower investor confidence triggered a selloff. People who cashed-in early were essentially able to receive their principal back, plus profits from selling at a higher price. However, people who sold their stocks at a later date realized lesser gains. Because much of this

[1]Hyman Minsky (1919-1996)- a Harvard alumnus, a professor of economics at Washington University in St. Louis, and a distinguished scholar at the Levy Economics Institute of Bard College whose post-Keynesian theories resurfaced following the Great Recession of 2008

speculation was financed by loans, banks started to call in their loans due to fears of speculators defaulting. Consequently, even more people were forced to sell their shares, ultimately resulting in a vicious cycle of deleveraging until the Crash occurred. Basically, the state of deregulation encouraged by the business-government partnership caused banks to engage in destabilizing activities resulting in the Great Crash.

Unfortunately, the Hoover administration failed to take adequate measures to curb the worsening depression due to the prevailing ideologies of classical economics and American Individualism. The aforementioned EFH persuaded the government to do little because they believed the economy would self-correct. However, it should be noted that the Federal Reserve continued to subsidize loans to, "...inflate reserves...to keep the [stock market] boom going" (Rothbard 272). Theoretically, this expansionary monetary policy should have reversed the economic slowdown initiated by the Crash or at least decreased the rate of contraction. However, the ideology prevented the government from taking other actions with credible precedent such as, "...introducing specific injunctions against the suspension of convertibility" that would have stemmed the capital outflow from major banks in financial distress (Bernanke 259). Instead, voluntarism was a cornerstone of President Hoover's governance, believing it to be better than forceful government interference. To his credit, voluntarism did encourage several large entities to help failing businesses. A noble example is that of the bank, J.P. Morgan. On the day of the Crash, J.P. Morgan pooled together capital from the strongest banks to jointly buy massive amounts of stock from companies on the verge of collapse (The New York Times). Thus, J.P. Morgan postponed the onset of the Depression. Overall, President Hoover's belief in classical economics and American Individualism prevented him from taking strong action to prevent the Great Depression, though the financial status quo attempted a fix.

Following the failure of the aforementioned efforts, President Roosevelt's election led to significant economic recovery and reform efforts which resulted in a very interventionist government. First, a banking holiday was declared so that the government could inspect and certify banks to be stable enough to resume business (Allen 85). However, the main problem to be addressed was the credit contraction because without credit small businesses and consumers were unable to buy goods and services in excess of their purchasing power, enhancing the effect of the depression. Therefore, Allen writes, "...the country went...part way off the gold standard" to enable the government to print money with little limit (85). Though this concept of helicopter money created an, "...inflation monster" that could potentially be uncontrollable according to Cooper, distributing large sums of money theoretically helped the economy (69). It should be noted that never before this time had the U.S. government vastly disregarded the gold standard, showing President Roosevelt's determination to enact any reform needed to reverse the financial status quo's damage to the economy. This blow to the business-government partnership, especially in the financial sector, was just the beginning. The Glass-Steagall Banking Reform Act of 1933 was arguably the most interventionist reform of banking undertaken by President Roosevelt. Essentially, it forbade banks from, "...accept[ing] deposits and issu[ing] securities, and it forbade commercial banks to have securities affiliates" resulting in compartmentalizing the inherent risk cited in the Financial Instability Hypothesis (Allen 95). Furthermore, the Federal Reserve gained new powers to dictate the quantity of loans banks could issue as well as how much reserve capital they needed to hold. This was a rebuff of the status quo because the government could now dictate banking activities instead of maintaining a lax regulatory atmosphere like President Hoover's administration.

In retrospect, the actions of private banks in causing the Great Depression resulted in the U.S. government's increasingly interventionist role in the 1930s economy as a rebuff of the financial status quo created from the business-government partnership of the 1920s. Destabilizing activities stemming from excessive credit creation gave the illusion of expanding the economy, which the predominant ideology at the time accepted. However, after the Crash, the new administration adopted radical economic ideas to end the Depression. Ultimately, the U.S. government was forced to be interventionist to restrain the destabilizing activities of private-sector banks.

Reflection

Historians study the recorded past to make sense of the present, creating shared knowledge to produce a sense of common human heritage. Historians are challenged to find appropriate sources to accurately portray the exact events which occurred. This is no doubt difficult because sources are written by humans and due to everyone's different personal knowledge with various paradigmatic assumptions, the documents inherently reflect the perspective of the author instead of the objective event as historians desire to create shared knowledge. Therefore, value judgments must be used in history to reflect the origin of the documents and their value to historians studying a particular topic. Succinctly, the historian's challenge is to find documents that accurately portray a historical event independent of the author's personal knowledge. This uncertainty contrasts with mathematics because mathematical truths are thought to be certain and transcend time. Mathematicians rely on pure logic to prove theorems and other concepts built off of basic assumptions (axioms). Therefore, the mathematicians need to correctly define the paradigmatic assumptions whereas historians must compile sources from different paradigms to create objective, shared knowledge.

In conducting my research, I found that one source does not have all of the information I needed to answer my research question, primarily due to its failure to contain the exact events that occurred. A primary source written by a government official may give insight into the U.S. government's ideology in regulating the economy around 1929, but it may not give the causes of the crash and the public's attitude. Therefore, I had to collect a variety of sources to gain a comprehensive view of the Great Depression and the U.S. government's role in addressing it. Additionally, I had to take into account the individual's value judgements which are imparted in the document so that as an historian I can create shared knowledge. For example, Dr. John K.

Galbraith clearly advocates for more regulation. Therefore, I had to be cognizant of how his values influence his analysis. In retrospect, I had to collect a variety of sources to ensure that I could take into account the individual values of the sources, while creating shared knowledge.

Works Cited

Allen, Frederick Lewis. *SINCE YESTERDAY: The 1930s in America*. Harper & Row, Publishers, 1972.

“BANKING BUOYS UP STRICKEN STOCKS.” *The New York Times*, 27 Oct. 1929, query.nytimes.com/gst/abstract.html?res=9900E4DE1E30E73ABC4F51DFB6678382639EDE&legacy=true.

Bernanke, Ben. *Essays on the Great Depression*. Princeton: Princeton UP, 2000. Print.

Coolidge, John Calvin. “Sixth Annual Message to the Congress of the United States.” Calvin Coolidge Presidential Foundation. 4 Dec. 1928, Washington, D.C., coolidgefoundation.org/resources/speeches-as-president-1923-1928/.

Cooper, George. *The Origin of Financial Crises*. New York: Vintage, 2008. Print.

DeLong, J. Bradford. *"Liquidation" Cycles: Old-Fashioned Real Business Cycle Theory and the Great Depression*. Working paper no. 3546. Cambridge: National Bureau of Economic Research, 1990. Financial Markets and Monetary Economics. *"Liquidation" Cycles: Old-Fashioned Real Business Cycle Theory and the Great Depression*. National Bureau of Economic Research. Web. 28 Jan. 2017.

Galbraith, John Kenneth. *The Great Crash of 1929*. Boston, MA: Houghton Mifflin, 1954. Print.

Hoover, Herbert C. “American Individualism: The Challenge to Liberty.” *American Individualism: The Challenge to Liberty*, Herbert Hoover Presidential Library Association, 1989.

Rothbard, Murray N. *A History of Money and Banking in the United States: The Colonial Era to World War II*. Auburn, Alabama: Ludwig Von Mises Institute, 2002. Print.