# REVISITING THE GREAT DEPRESSION1929-33 THROUGH KEYNESIAN AND MONETARISM PERSPECTIVE

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## Abstract

The turning point of economic theory was a great depression. Before the great depression, the classical economic theory was giving more importance. Though there were many sounds were coming from other economist but their voice was not considering. The great depression was a complete failure of classical economics. It also opens the door of different field of economics. It gives birth to the Keynesian School.

The objective of this paper is to analysis the great depression from Keynesian perspective and Monetarism. The other objective of this paper is to analysis the failure of classical economics.

**Keywords:** Great Depression, Effective Demand, Laissez-faire, Margin Buying, Marginal Efficiency of Capital.

## Introduction

When we talk about the phenomenon called depression, the first thing which comes to our mind is the Great Depression. The "Black Thursday" October 24, 1929, led the world economy into the depression for a decade. The peak of depression was in 1933 when the unemployment increased from 3 percent to 25 percent which means one in four workers were unemployed. On the other hand, there was a drastic decline in Gross National Product (GNP) which fell from 315 billion dollars in 1929 to 222 billion dollars in 1933; it means that national income declined by almost 30 percent during this period in the U.S. economy. The magnitude of this depression felt all over the world economy. The European economy too faced the same situation as that of the Amercian economy, high unemployment and a decline in Gross National Product.

The Classical economists were unable to explain this crisis. The Great Depression was the "failure of Classical Economists". And when one school of thought failed then it gave birth to another school. Great Depression gave birth to the "Modern Macroeconomics" as a distinct field of study[1]. And the most important economist to emerge out from the depression was Sir John Maynard Keynes. He said that the great depression was more about contraction in demand. He used the term "animal spirit" to describe the pessimistic or optimistic expectation of the investor. He laid emphasis on the state intervention and increase in government expenditure through fiscal policy in order to increase the demand in the economy.

[1] Ben S. Bernake(2007): Essay On Great Depression; Princeton University Press

## Failure of Classical Economics Theory

It was a complete failure of Classical economic theory. By the "classicalists" Keynes meant "the followers of Ricardo, those who adopted the Ricardian Theory"[2]. They are J.S.Mill, Marshall, and Pigou[3]. Keynes repudiated the orthodox economics thought and policies. Keynesian Economist criticised the classical, so it is important to know first what is the classical economics. Keynes never accepted the classical economics. But Keynesian Economics came to light after the great depression. When he wrote the book "General Theory of Employment, Interest and Money" published in 1936, he developed a new economic theory based on criticism of the classical economic theory. The Keynesian theory brought about revolution into the field of economics.

## Keynesian Framework

John Maynard Keynes was a 19th-century British economist. He is known as the father of Keynesian economics. He first appeared in the printed form as professional economists in 1909. His first professional article "Recent Economics Event in India". But his book "General Theory of Employment, Interest and Money", (1936) was the revolution in the economy.

According to Keynes, the cause of depression and cyclical unemployment in the industrialised capitalist countries was a sharp decline in private investment due to the adverse business expectation about profit making. He used the term "animal spirits" to describe the "human emotion and consumer confidence". He said that

"Most, Probably of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits- a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities."[4]

Keynes is the father of Keynesian economics. He criticised the classical economic. According to him the magnitude of the great depression was more because of the "contraction in demand". He said that it is not the "supplied which creates demands" instead of it is the "demand which creates supply". He rejects the classical postulate that there is always full employment in the economy. According to Keynes, there is always involuntary unemployment in the economy.

Keynesian framework deals with a short run. He said that in the long run "we all are dead."

During the great depression, the U.S. economy was facing the problem of the depression and unemployment which we can see them on the table given below:

| **Year** | Labour Force | Unemployed | Percentage of labour force |
|---|---|---|---|
| 1929 | 49,440,000 | 1,550,000 | 3.14 |
| 1930 | 50,080,000 | 4,340,000 | 8.67 |
| 1931 | 50,680,000 | 8,020,000 | 15.82 |
| 1932 | 51,250,000 | 12,060,000 | 23.53 |

[2] Brian Snowdon and Howard R. Vane (2005): Modern Macroeconomics: Its Origins, Develpoment and Current State; Page No-36
[3] Brian Snowdon and Howard R. Vane (2005): Modern Macroeconomics: Its Origins, Develpoment and Current State; Page No-36
[4] John M. Keynes: The General Theory of Employment, interest and Money; 1936

| | | | |
|---|---|---|---|
| 1933 | 51,840,000 | 12,830,000 | 24.75 |
| 1934 | 52,490,000 | 11,340,000 | 21.60 |
| 1935 | 53,140,000 | 10,610,000 | 19.67 |
| 1936 | 54,320,000 | 7,700,000 | 14.18 |
| 1937 | 55,600,000 | 9,948,000 | 17.05 |
| 1938 | 56,180,00 | 8,120,000 | 14.45 |

Source: U.S. Bureau of the Census, Historical Statistics of the United States

By looking this table, we can say that the unemployment in the United States has increased dramatically over the past years. In 1933 unemployment rate was at its peak, and it reached almost 25 percent of total workforce. To deal with the problem of unemployment, Keynes came up with his own theory which he called the problem of "effective demand".

## Effective Demand

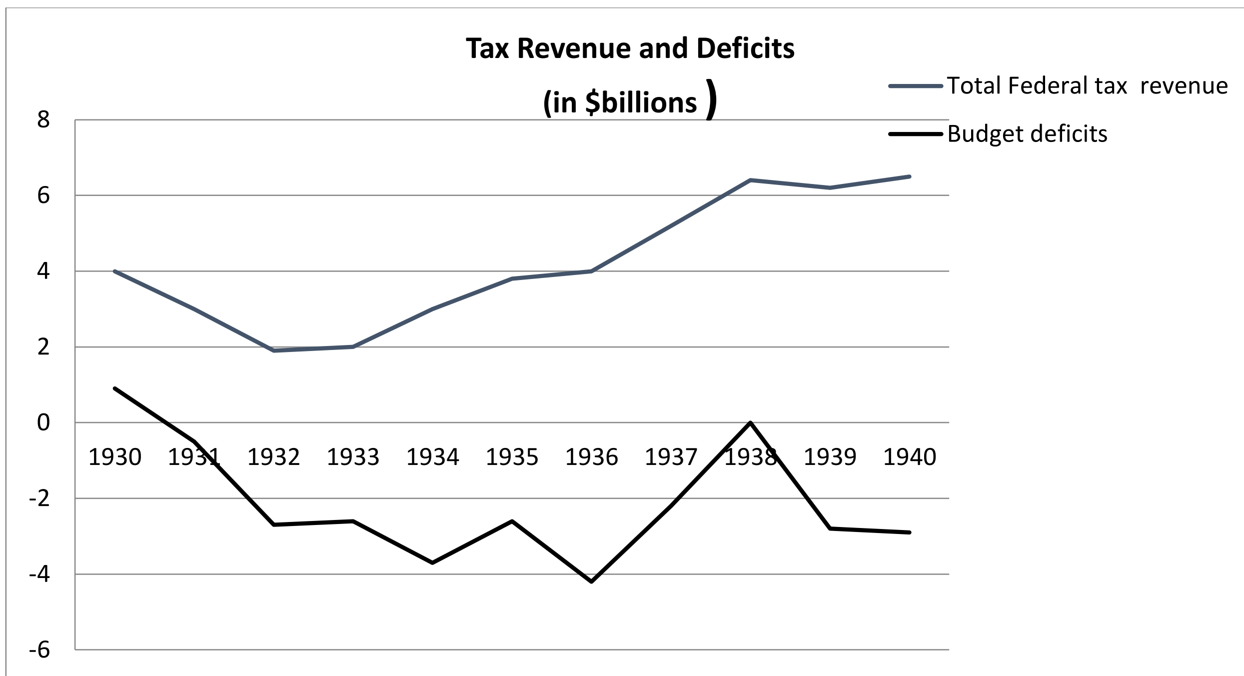
According to Keynes, the great depression was more about contraction in demand. He denied the classical postulate that "supply creates its own demand" and there is no overproduction in the economy as a whole. In other words, the problem of unemployment arises because of a decrease in demand. When there is a decline in demand in the economy, then the problem like depression, unemployment arises which he coined as "effective demand". In the economy, the employment depends on effective demand. Therefore by increasing the effective demand, the level of employment will also increase.

But during 1932 President Hoover introduced new Revenue Act 1932, through which he increased the tax rate. The maximum tax rate increased from 25 percent to 63 percent. The estate tax was doubled, and almost by 15 percent increased the corporate tax. He believed that during the contraction, the government budget should be balanced and this can be done by increasing the tax rate.He thought that by increasing the tax rate, the tax revenue would also increase in the same proportion.

Hoover and Roosevelt argued that to balance the "federal budget", it is necessary to increase the tax. Hoover repeatedly said that "nothing is more necessary at this time than balancing the budget."[5]

Table 1

[5] "message to congress", may 5, 1932, in State Paper and Other Public Writings of Herbert Hoover, ed. William Starr Myers (New york: Doubleday, Doran, 1934).




Source: FY2004 Budget of the U.S. government, Historical Tables.

As the tax rate increased the tax revenue rather than increasing, it started decreasing. During Roosevelt period from 1932 to 1940, the tax revenue increased from 1.9 billion to 6.5 billion, but at the same time, the deficit was 2.9 billion which was larger than FY1932 where the deficit was 2.7 billion.

During the depression, the state should reduce the tax rate so that the expenditure can be increased. But rather than reducing the tax rate, the United States government increased the tax rate which increased unemployment. During 1932 the unemployment reached almost 25 percent of total workforce.

Keynes always emphasised by increasing the public expenditure to solve the problem of unemployment. If the U.S. economy starts increasing its government expenditure then only they would be able to solve the problem of unemployment.

## Liquidity Preference:

Keynes in his book General Theory of Employment, Interest and Money, he used the word "liquidity preference", for the demand for money. He denied the classical view that money is neutral and people do not hoard it. According to Keynes, there are three motives behind the desire to hold the money.:

I. Transaction Motive
II. Precautionary Motive
III. Speculative Motive

## Transaction Motive:

Transaction demand implies demand for money where it acts as a medium of exchange, as per classical viewpoint. Keynes agrees with the classics on this that there is demand for money in day to day life for transaction purpose. There is a need for money for buying goods and services. Keynes underlines the importance of money as"the need of cash for the current transaction of personal and business exchange".The transaction demand for money depends directly on "level of income" and inversely with the "rate of interest." This implies that when the income

increases than the transaction demand for money also increases (direct proportion) and when the interest rate increases, the transaction demand for money decreases.

During the great depression, the transaction demand for money decreased due to the low purchasing power of consumers. When there is a decline in transaction demand for money, it directly affects the business and firm. As the transaction demand for money deal with exchanging the goods and services between firms and people, it is directly related to demand. In other words, we can say that there is a decrease in demand.

The rate of interest determines the transaction demand for money. According to Keynes, "demand for money in the active circulation is also to some extent a function of the rate of interest, since a higher rate of interest may lead to the more economical use of active balance."[6] However, he did not stress the role of interest in this part of his analysis, and many of his popularisers ignored it altogether.[7]Keynes did not give much importance to the rate of interest. But it was not cased with the post-Keynesian economists. William J. Baumol[8] and James Tobin[9] said that the rate of interest plays an important role in transaction demand for money. According to them, the relationship between transaction demand for money and income is not linear and proportional which means that when there is an increase in income, the transaction demand for money also changes but less than the change in income.

## Precautionary Motive:

It is related to "the desire to provide for contingencies recurring sudden expenditures and for unseen opportunities of advantageous purchase." Businessmen and individual both keep a reserve of money for unexpected needs. Individuals hold cash for the uncertainty of future like unemployment, illness and other things like that. In the same way, people in business also keep some cash for their business uncertainty. Therefore, "money held under the precautionary motive is rather like water kept in reserve in a water tank." The demand for precautionary motive depends upon the level of income.

According to Keynes, precautionary demand for money is similar to transaction demand for money. And which is the function of the level of income. But the post-Keynesian economist has a different view on speculative demand for money. According to them like the transaction demand, the speculative demand for money have inversely related to high-interest rate. Both the transaction demand for money and speculative demand for money will be unstable if the economy is not full employment. Both this two can be express in the single equation function.

$LT = f(Y,r)$[10]

## Speculative Motive:

Speculative demand for money has an inverse relationship between the interest rate and the speculative demand for money. According to Keynes, it is related to bonds price. When the interest rate is high, then the bonds price will be low and vice versa. Let's see the function of speculative demand for money and rate of interest:

[6] John M. Keynes in A.D. gayer (ed.), the Lesson of monetary Experience, 1937, P.149

[7] David E.W Ladler

[8] William J. Baumol, Transaction demand for cash An Inventory Theoretic Approach; Quarterly Jout=rnal of economics, November 1952

[9] James Tobin, "The Interest Elasticity of the Transaction Demand for cash"; Review of Economics and Statistics August 1956

[10] Keynes expressed the amount held under these two motives (M1), as a function of level of income (Y), M=L1(Y). By making it a function of interest rate (r), it can be written as (M1)= L1(Y,r).

$M_{SP} = P_g(r)$

Where,

$M_{sp}$ = amount of speculative demand for money

P = Price level

This equation is in nominal term and can be expressed in real term dividing by (P):

$M_{sp}/P = g(r)$

$m_{sp}$= real balanced now

The total demand for money

$m_d = m_t = m_{sp}$

Where,

$m_d$ = total demand for money

$m_t$ = total demand for transaction demand for money

$m_{sp}$ = speculative demand for money

mt = k(Y) (money demanded transaction purpose, which is related to the function of income)

$m_{sp} = g(r)$

now by combining $m_t$=k(Y) and $m_{sp}$=g(r) we will get

$m_d = k(Y) + g(r)$[11]

During the great depression, the speculative demand for money and precautionary demand for money was increasing sharply but not the transaction demand. The speculative demand for money is more related to the interest rate and therefore Keynes talks about the "liquidity trap" situation.

## Liquidity Trap:

According to Keynes, a liquidity trap situation is characterised as an episode when the interest rate is not sensitive towards any move in the money supply. Keynes himself never proclaimed that great depression was a situation of a liquidity trap in the United States.

However, some economists did not agree with Keynes. Hansen (1953, p.132) called assertion by Keynes as "strange and inconsistent".Hansen believed that "the U.S. during the thirties was a good example of a liquidity trap". The U.S. Treasury bonds fell below one percent in May 1931 and for a decade it remained below one percent which formed the premises of liquidity trap as per Hansen's findings.

But if we see Keynes point of view on liquidity trap situation, he said that liquidity trap situation does not mean zero rates of interest in the market. According to him, liquidity trap situation is the point where the monetary policy would be ineffective and this can happen at any point of interest rate not necessarily at zero interest rate.

[11]Vanita Agarwal; Macroeconomics Theory and Policy; Pearson Publisher, 2010

## Keynes' Money-Wage Rigidity:

Keynes completely disagrees with Prof. A.C. Pigou that flexibility of wage rate can be instrumental in solving the problem of unemployment. Keynes have criticised the flexible money wage theory and argued that instead of solving the problem of unemployment, it create involuntary unemployment which is contrary to the classical' view. According to Keynes, when there is involuntary unemployment due to downward of inflexibility money wage, the worker remains unemployed because the supply of labour is greater than the demand for labour. Keynes denied that the full employment situation could not exist in the economy. There will always be unemployment.

The wage rate of labour is decided through contract(s) prior to their deployment to their jobs. They will not agree to cut down their wage rate at any cost. Trade unions are also there to safeguard interests of its members(labour force). Keynes coined a term called "money illusion". Keynes said that "while worker will usually resist a reduction of money wages, it is not their practice to withdraw their labour whenever there is a rise in the price of wage goods"[12]. Keynes said that there is some factor due to which cutting down the wage rate is not possible due to factors like wage fixation through contract, minimum wage law and efficiency wage.

Keynesian believes that money wage rate is not fixed or sticky. According to the Keynesians, as Pigou think that there will fall I money wage rate and unemployment will solve, it is not the case like that. It is a very slow process to bring demand for and supply of labour equilibrium. Because when there is a decline in the wage rate, it creates involuntary unemployment. Keynes accepted the classical theory of labour, "which says that labour demand according to firm demand labour up to the point at which real wage rate is equal to the marginal product of labour." In other words, when the wage rate is high, less amount of labour will be employed and when the wage rate low high amount of labour will be employed.

## Keynes Theory of Investment

Keynes did not agree with classical postulate which says that saving is equal to investment. And if there is high saving than by lowering the interest rate, the investment will increase. And there is no saving in the economy. According to Keynes if a person having saving then he has two option. Either he will save and earn a rate of interest, or he will invest. The decision on investment depends on the expected rate of return. If the expected rate of return on investment is high as compare to the rate of interest than there will be an investment. In other words, the decision on investment depended upon the rate of "expectation". If the rate of expectation is high as compare to the market rate of interest, then there will be an investment. Keynes talk about investment in his General Theory. He coined the term "Marginal efficiency of capital" (MEC).[13]

## Marginal Efficiency of Capital:

The marginal efficiency of capital is nothing but the rate of expectation. It shows the rate of profit expected from an extra unit of a capital asset. There are three factors which are taken into account while making any investment decision which is (a) the cost of the capital asset, (b) the expected rate of return and (c) the market rate of interest and Keynes sum up these factors into a single terminology which he called marginal efficiency of capital. In the words of Kurihara, "it is the ratio between the prospective yield of additional capital goods and their supply price"[14] which means that higher the rate of expectation the higher will be the rate of return.

[12] John M. Keynes; The General Theory of Employment, Interset and Money; Cambridge University Press, 1936

[13] Brian Snowdon and Howard R. Vane(2005): Modern Macroeconomics: Its Origins, Development and Current State;

[14] Kenneth K. Kurihara: Post-Keynesian economics; Routledger; 2005

## Monetarist School of Thought:

We have already talked about the great depression from the viewpoint of Keynesian economics. According to Keynes, the cause and magnitude of the great depression were more because of there was a contraction in demand.

In 1963, Milton Friedman and Anna Schwartz wrote a book named"A Monetary History of United States 1867-1960", and laid out a different explanation of the great depression. According to them, the cause of great depression was because of fall in the money supply. Milton Friedman and Anna Schwartz write in their book: "From the cyclical peak in August 1929 to a cyclical trough in March 1933, the stock of money fell by over a third."[15]And which the Milton Friedman called this period "Great Contraction".And falling in the price and wages because there is not enough money to share. Money supply plays an important role in the economic fluctuation. The monetarist emphasises more on the money. Because according to them the fluctuation in the price and economic activity are an entire monetary phenomenon.

In a simple way how the monetarist talk about the role of money is that, when the price went down, people wanted to hold their money rather than spending. Holding money means they consumed less. And when they consumed less it directly affects demand. And in the fragile scale of demand and supply fluctuate up and down like a rollercoaster.

The Keynesian economic, put more light on the role of fiscal policy to remedy of insufficient demand and unemployment, but the monetarist establishes the quantity theory of money in explaining the economic fluctuation.

Milton Friedman reintroduces the quantity theory of money. The traditional quantity theory of money talk about the doctrine concerned with the relationship between money supply and general price level. Friedman represents the quantity theory of money as the theory of demand for money rather than the theory of general price level or money income.

Monetarist economist gives more importance to the money in the economic activity. In the General Theory of Employment, Interest and Money, the role of money by John Keynes was not so important when the economy was underemployment. Even in the liquidity trap and investment trap situation money does not matter inasmuch, as monetary policy will be ineffective. And give more importance to government expenditure through fiscal policy.

But Milton Friedman and Anna Schwartz in their book "A Monetary History of United States 1867-1960", had laid different explanation. According to them, it was because of the poor monetary policy by the United States central bank, the Federal Reserve was the primary cause of great depression, which they call "Great Contraction". The Federal Reserve was created in 1913 by the Congress. The primary motive of the Federal Reserve was the prevention of the "banking panic", but rather than solving the problem it became the problem and causes of banks failed during the great depression. Because the Fed increases the interest rate rather than they should cut down the interest rate. According to Monetarist, the Fed should increase the money supply when there was a contraction in the money into an economy. It started when the stock market crash and the big banking were running out of cash.

## Stock Market Crash 1929:

The nominal sector also contributed to the great depression. Or else we say that the great depression was from the nominal sector to real sector. It started when the stock market crash in 1929. And when the stock market crash it led the United States economy into the panic situation. The people were not having faith in the market anymore.

[15] Milton Friedman and Anna Schwartz: A Monetary history of United States; Princeton university Press; 1963

It all started in October when the bull market becomes the bear market. The New York Stock Market crash conventionally occurred on 24 of the October and 29 of October 1929. The two dates also called “Black Thursday and Black Tuesday”.

From 1926 to 1929 the Dow Jones Industrial Average (DJIA) index almost double from 158.54 in 1926 to 308.85 in 1929.[16]The First sign of weakness came when the “Conglomerate built up by clearance hence collapse” on September 20 in England. Due to this, there was a decline of 2.14 percent in the New York Stock Market.

But the actual problem started in the month of October. From the 14th of October the stock market started declining. On 16th of October, it fell to 3.20 percent on 18th of October 2.51 percent and 19th it was 2.83 percent. But the real picture came on 24 of October when the New York Stock Market crash dramatically. It opens at 305.85 percent, and within a few hours, it reached to 272.32 percent. Due to this panic Banker of the New York called a meeting to look at this issue in J.P. Morgan office. And to come down the panic and to gain the faith of retail investor the senior Morgan Banker, Thomas W. Lamont, told the press “due to a technical condition of the market, there had been a little distress selling on the Stock Exchange.”[17] Because of that, there was relief in the stock exchange in the market. And Dow Jones stock market was able to close at 299.47 percent. In percentage form, it was only 1.78 percent. And which gives relief to the investor.

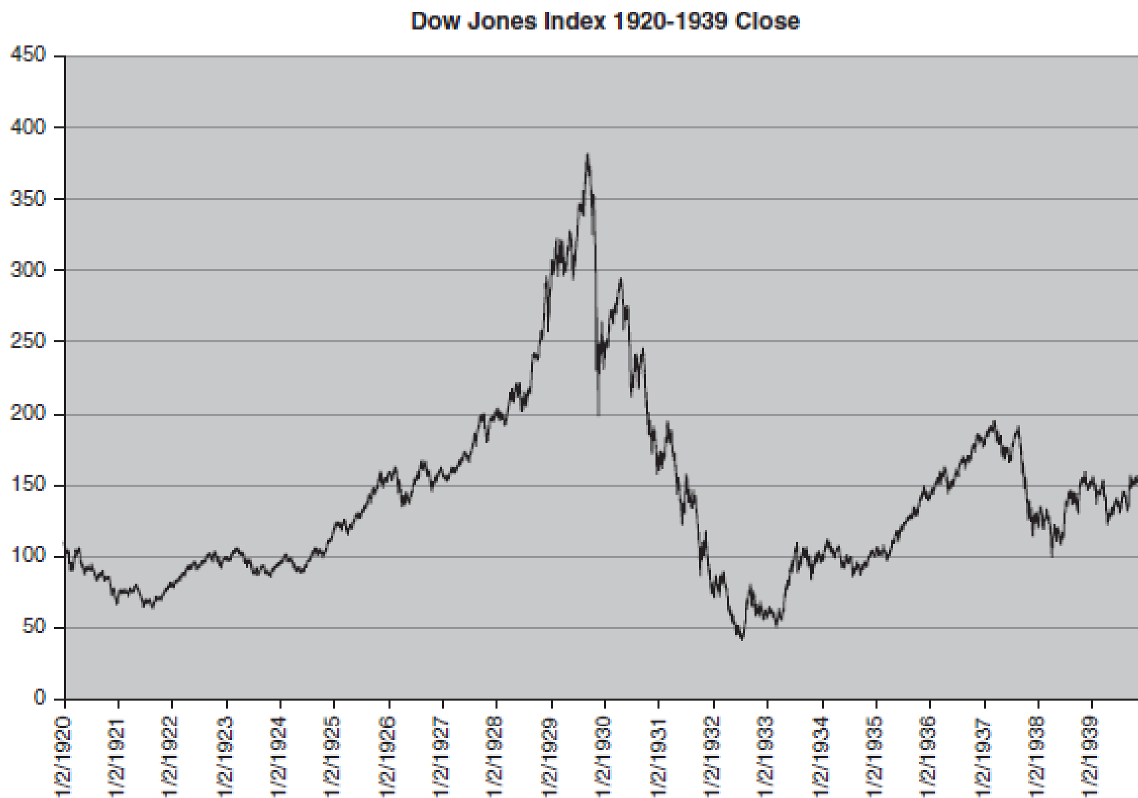
On the other side, the standard and poor index which composite of 90 common stock, it also shows the similar picture related Dow Jones index. On October 4 the index was 228 point. But on the 10th of October, it went to 245 points. But after this point, the decline started. On 24th of October, “nearly 13 million of share were traded. On October 29, when the index fell to 162, nearly 16½ million shares were traded, the compared to daily average during September of little more than 4 million shares.”[18]

[16] Global Financial Data: website

[17] Allen, Only Yesterday, 330; Galbraith, Great Crash, 123

[18] Milton Friedman and Anna Schawartz : A Monetray History of United States 1856-1960; Priceston University Press 1966

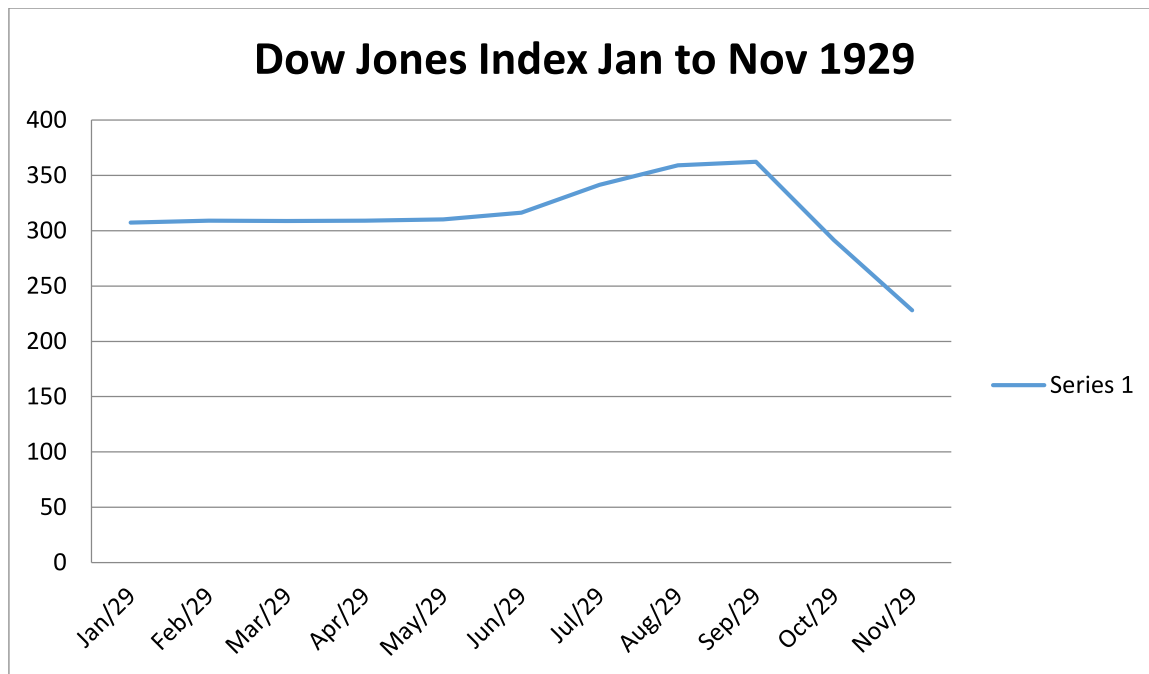
Table 2




Source: Global Financial Data

From the given figure we can see that the Dow Jones index was almost reached to 370 points before the stock market crash, from 100 points. But during the great depression, it fell to below 50 points. Which shows that how the retail investor and other investors lose their money and not ready to invest in the market.

Table 3




Source: National Bureau of Economic Research

At the beginning of the year 1929. The Dow Jones index was 307.25. In February, the index was 309. There was a small hike in the index. Same in April, the index was 309.20. The change in the Dow Jones index or market started in June. In June, the index went to 316.45 from 310.25 previous months. And in July, it went to 341.45. Comparatively the index was steady high in July after which is spiked in the surge. And in August it the Dow Jones Index was in the peak and touched the 359.15 points. But in the month of October, it fell to 291.50 and in November 228.20 points.

In October, the New York Times writes "At the climax of such a movement, the speculation imagination runs as wild as it does on the crest of an exciting rise. Whereas it pictured impossible achievement in prosperity and dividends last August and last February, it now looks for equally impossible disaster."[19]

## Cause of Stock market crash

### (a) Margin Buying:

When there is margin buying of stock means that people are buying in credit. During that, the great depression time the margin buying ratio was three to one. Which means that by investing 1$ people can buy up to 3$. So they can buy more stock with less amount of money. And when there is margin buying of the stock it over-valued the price of the stock. People think that the stock market is going up and price of the stock is also going up. They invest in the market to gain the short-term profit. And which makes the over-valued of the stock. Margin buying is like "scapegoat" for the cause of the stock market crash.

[19] Panicky Liquidation on Stock Exchange partly Checked, New York Times; October 25, 1929, 45

### (b) Federal Reserve Policy:

Adolph Miller, the President of The Federal Reserve, had tightened the monetary policy. Because he thinks that there is speculation in the stock market, and because of which the price of the stock is much high and even the margin boring was high which led the stock price high. The Federal Reserve tightened the monetary policy because to lower down the stock price. Because there was speculation in the stock market and which is not good of an economic. By changing the monetary policy the interest rate changes. Which affect the broker to give more liquidity to the people. They were having less liquidity as compared to previously and when they have less liquidity the margin on the stock also decreases. And because of this, the retail investor did not have enough liquidity to trade in the market.

## Banking Crisis:

Banks play an important role in the economic development. Capital is required for the development of economic. And for that capital, there should be an adequate amount of capital formation. Through banking system, the central bank or the state can increase or decrease the money supply through monetary policy. And when there is a banking crisis in the economy it leads to the panic in the economic. Because during the banking crisis banks loss not only the depositor money but their own money which they earn by providing the loan. It means that there double the loss of the currency in the economy.

During 1930, there is debate over the banking crisis. And there are many different interpretations on that, but we can see over three broader approaches. (1) The quality of the banking asset which was declining during the great depression, (2) When the crisis started there was a panic in the economy which affects the confidence in the banking system and (3) declining in the income of the primary sector, i.e. the agriculture income was declining over the period.

Milton Friedman and Anna Schwartz in their book A Monetary History of United States. One of the main reason was that the “loan and investment” in late 1920. The kind of loan and investment which they section was not such a good decision. The bankers were over-optimistic while selecting the creditors. They were more selective in given the loan rather than asset quality.

## Banking Crisis 1930:

Ater the stock market crash it affects the banking system. There was a monetary contraction in the U.S. economy. The panic in the banking system was not only because of the Stock Market crash but because of the section loan which they give during 1920. Poor loan in the rural areas was the failure of many banks in the rural areas and agriculture banks. And which Milton Friedman and Anna Schwartz believe that that was an indication of the panic of the banking system in 1930. Before that many were believing that rural areas banks were not the problem of banking panic of 1930. And rural areas banks were not so important if they went into the crisis also. But Milton Friedman and Anna Schwartz change the perception. According to them, rural areas banks play an important role in the banking system. Even the agriculture banks were as important as other banks. In their book, they wrote, “In November 1930… A crop of bank failures, particularly in Missouri, Indiana, Illinois, Iowas, Arkansas, and North Carolina, led to widespread attempts to convert demand and time deposits into the currency… A contagion of fear spread among depositors starting from agriculture areas, which had experienced the heaviest impact of bank failures in the twenties. But such contagion knows no geographical limits.”[20]The faith of the people in the banking sector was no longer as they were before. Even the confidence of the banking sector was weakened

[20] Milton Friedman and Anna Schawartz : A Monetray History of United States 1856-1960; Priceston University Press 1966

further when there was "failure of 256 banks with $180 millions of deposits in November 1930 was followed by the failure of 352 with over $370 million of deposits in December."[21]

One of the biggest failure of the bank in the U.S. economy during the great depression was on December 11, when the Bank of United States fail which was having $200 million of deposits. The Bank of United States was the oldest and largest regarding deposit bank in the United States.

Milton Friedman and Anna Schwartz argued that the main reason for the failure of the bank during 1930was the insolvency of the bank and confidence of the people in the banking sector. Because when the agriculture sector bank was not performing well, and the rural areas bank started becoming the defaulter, it spread the panic in the people mind that bank is no safer to keep their money in the bank. The situation becomes worst when the Bank of United States become a failure.

The stock market crash in 1929 from there then there is continuous fall in the stock. The Standard and Poor's index went to almost 50 (index points). And when the stock market crash the people were not having faith in the market and which affect the corporate bonds also. The Yield on corporate bonds was increasing. The Yield of corporate bonds was increasing sharply because people were not having faith in the market and on the other hands the banks were selling the corporates bonds and converting into liquidity. To meet liquidity demand, the bank was selling the lower-grade bond. And due to which Yield also affect the government bonds. As bonds price increase the yield on bonds decreases. Let's first understand the bonds yield with given an example.

Suppose A buy the bonds of coupon rate of 10% and the value of bonds is $1000. So the interest is going to earn from the bonds is $100. So the annual yield of a bond is $100. Now there is an increase in the supply of bond the value of the bond will be same, but there will be no buyer to buy the bond and because of which seller will decrease the price. So now A will sell them at $900 to B. The coupon rate will be the same. The only difference will be that he buy the bond at $900, but he will get the return on the actual value of $1000. So now according to his investment, he will be getting $100 only but the rate changes the current rate according to his investment is 11.1%.

When the bank starts selling there, corporates bond the yield was increasing. And the yield on government bonds fall. When there is a panic in the economy, the demand for government increases. During great depression when the corporate bond was falling the demand of government bonds increase but the yield on government bond decreases. There is an inverse relationship between the interest and bonds price. And the problem of bond yield arises because there was an increase in the interest rate.

The reason behind this was the tight money supply. When the money market is tight, it directly affects the source of money. Because to get the money from the source of money is no easier. And this problem was started because the Federal Reserve was not increasing the money into the economy. They were a contraction in the money supply.

According to Milton Friedman and Anna Schwartz, the banking crisis of 1930 was due to increase in the interest rate and which affect the bond market. Because when there was fall in the bonds price, it makes banks fearful of holding the bonds. But the banking crisis of 1930 was the starting point of the banking crisis.

## Second Banking Crisis:

The stock market crash of 1929 and the banking crisis of 1930 it creates panic in the economy. The banking sector was facing the problem of liquidity. They did not have enough liquidity to meet the demand. And when they try

[21] Milton Friedman and Anna Schawartz : A Monetray History of United States 1856-1960; Priceston University Press 1966

to sell the corporate bonds the yield on the corporates bonds then there was no buyer to buy the bonds. And which affect the government bonds also.

When there is a decline in deposits by the depositor, it creates the problem for the bank. Because the bank cannot spend all the cash on providing the loan they need to keep cash by themselves to meet the demand for cash. In the above chart, we can see that deposits were rising in the suspended bank. During March and June in 1931.

The problem of the United States banks started when there was a failure of foreign "when Austria's largest private banks become a failure in May 1931. It was followed by the closing of banks in Germany on July 14 and 15, as well in other countries, and the freezing of British short-term assets in Germany. A one-year intergovernmental debt moratorium and a "standstill agreement" among commercial banks."[22] There was panic in the banking system in foreign countries. So the foreign bank tries to withdraw their money and assets from the United States. But President Hoover takes a stand with the banks that not to repayment the International credit. Which was a short-term relief for the bankers.

By this situation not so simple as they looked. Because on the one hand the U.S. commercial banks have a large foreign amount which is now frozen and on the other hand people were converting their deposits into currency. On the side was that there was gold accumulation was there. During this period the Federal Reserve should increase the money supply and make the open market purchase to meet the demand for cash. But the Federal Reserved movement was only seasonally.

According to Milton Friedman and Anna, the second banking crisis affects on more in the stock of money. "the commercial bank deposits fell by $2.7 billion or nearly 7% percent, more than the eighteen-month from the cyclical peak in August 1929 to February 1931."[23]

According to the monetarist, the great depression was all because there was a contraction in money supply. But they ignore the other side of a situation like a fall in the agriculture income. When the income falls, it led to the slow down the repayment and chances of becoming the default increases. Because, if we see the Department of Agriculture report of United States then they say that when the farm income fall, it led to farm credit tighter than before. The interest rate also increases, and there was an increase in another factor also like service charge were increased, and the loan limits were decreased as compared to early. All this factor which affect the rural areas bank.

The failure of the banking system was not only because of the external factor but also because of the internal factor. The economy was not stable as they are before which also affect the banking sector to went into crisis.

## Conclusion.

Great Depression was the complete failure of the classical economic theory. They were not been able to explain the depression. This was the first time when the Keynesian economic theory was implemented. But one thing was common between the Keynesian framework and the government policies was that both were doing the same thing. The President Roosevelt government policies and Keynes policies were both foci on the increasing the government expenditure through fiscal stimulus. Keynes policy of New Deal which also talks about the same thing.

According to Keynes, the great depression was more because of the demand deficit. And to overcome the depression the government should focus on the boosting the demand. He also emphasises the role of government

[22] Milton Friedman and Anna Schwartz : A Monetary History of United States 1856-1960; Princeton University Press 1966

[23] Milton Friedman and Anna Schawartz : A Monetray History of United States 1856-1960; Priceston University Press 1966

in the market. Because without the involvement of state the market cannot correct themselves. And which was true. And all his argument was true.

From the Monetarism perspective, the great depression was more about the contraction in money supply. According to the Milton Friedman and Anna argue that when the banks started defaulting it creates panic in the economy. Bank run situation happen. Milton Friedman criticized the Federal Reserve for not increasing the money supply. According to them if the Federal Reserve would work like Lender of Last Resort than the problem of the money supply could be solved and a situation like depression would not happen. Therefore they argued that the main culprit of the great depression was the Federal Reserve.

Both the arguments and their explanation were true from their perspective. Because we have seen that during the depression there was a contraction in demand and contraction in money supply. But when we talk according to the macro level the role of the state is very important. How they form the policies and how they regulate the state is important. Because the market is not sufficient enough to correct them, so the role of the state becomes more important.

But by analyzing both the argument and data, we can say that the great depression was more because of the failure of aggregate demand. During the depression, if the Federal Reserve increased the money supply also then there would be no investment in the economy. Because when the economy is recession the capitalist was not ready to invest in the market. They believe that the market condition is not good and their investment would not give a return. To boost the investment it only the state which can do. And when the government increase the expenditure it generates the employment in the economy which creates demand in the economy.

One of the main objective of government during the depression is to "stimulate investment and discourage saving." Because there will increase the consumption and investment. There is a linkage between saving and investment. It is not possible to ignore one or to focus only one. They should focus simultaneously.

Understanding the Keynes and his central ideas are important for today also. Because now also when an economy faces the problem of recession or depression then they look for the Keynesian economic to solve the problem. Therefore modern economist gives importance to both "fiscal and monetary policies." to influence the investment and growth in Gross National Product (GNP). By applying both the policies, the economy will recover faster than those countries who focus only on one policy.

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