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The Stock Market Crash and the Great Depression

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Abstract: At the beginning of the 20th century, the United States experienced the Great Depression. In this paper, we will analyze the stock market crash to deduce the cause of the Great Depression. Through the analysis of Gini coefficient and Dow Jones Index, this paper argues that the error of fiscal policy, the widening gap between the rich and the poor, and the ineffective government management of the financial market are the main causes of the Great Depression in the United States
Keywords: The Great Depression; The Stock Market Crash; Industrial Revolution

1. Introduction

On October 24, 1929, the United States encountered its "Black Thursday" (White 1990), which triggered a chain effect that the U.S. stock market collapsed rapidly and the market value of hundreds of billions disappeared almost overnight. The disappeared wealth came not only from capitalists, but also from the life-long savings saved by ordinary people. With the avalanche falling of the stock market, thousands of families were driven out of their homes because they could not pay the monthly mortgage payment. Instead, they had to build temporary shelters using old boards and discarded newspapers. Some even slept on the streets and wandered around. Engelman and Gorman's calculation results demonstrated that the American Gini coefficient jumped from 0.48 in 1919 to 0.589 in 1930, and correspondingly, the poverty rate in the United States climbed from 51.6% to 65.8% (James, 2010). The short-term prosperity brought by the industrial revolution turned meaningless at this moment. The change of Gini coefficient indicated that their rich and prosperous life came to the end, and many people could not accept this cruel destiny. Political, economic and social dynamics all contribute to the occurrence of the Great Depression in America, but the most significant ones are malfunction of the incumbent government, the misbehaviors in the financial sectors, and the illusion of permanent prosperity among the populace.

2. Malfunction of the incumbent government

From the macro policy analysis, the relevant policies did not seem to play a good-regulatory role in the economy. Firstly, in 1930, the U.S government initiated The Smoot Hawley Tariff Act, which resulted in additional tax of nearly 900 imported products, and such goods witnessed its average tax rate reaching up to more than 50% (Irwin, 1998). In the post-legislation period, other countries followed the step of American government by imposing a higher tax rate for American products. Accordingly, the total trade volume of the United States was dropping extremely fast and the pulling effect of economic growth continued to weaken. Secondly, the U.S government sought balance for income and expenditure excessively, and the total government consumption expenditure and the amount of investment boost from $18.04 billion in 1929 to $20.68 billion two years later to cope with the economic recession (Kimberly, 2020). However, with the increasing of fiscal expenditure, the government's financial deficit was raising. In order to balance the budget, the government passed The Revenue Act Of 1932 to increase different tax rates, including corporate income tax and individual income tax, which was also the largest tax increase plan in America during the Great Depression (The Revenue Act, 1932). According to the Scholar of Economic Forecasting Department Wu Qiong, "in 1932 and 1933, the government expenditure decreased to $20.02 billion and $19.38 billion respectively"(2020, p.50). It could be seen that the US government's tax increase did not promote economic growth, but also had a negative impact. This also led to the relatively limited help of fiscal policy to the U.S.

economy out of the depression. Thirdly, monetary policy mistakes had led to a significant shortage of market liquidity. The economist Thomas Wilson (1942, as cited in Ferderer, 1994) analyzed that " the succession of sensational (banking crisis) has a disastrous effect on confidence, which raised the risk premium on long-term securities on the one hand, and made businessmen reluctant to borrow on the other." The banking crisis had brought great uncertainty to the market. The market panic rose sharply and depositors worried that their deposits would disappear and rushed to the bank to withdraw money, which triggered a run on banks.The shortage of liquidity not only caused a large number of bank crashes, but also aggravated the degree of deflation. Therefore, the above three policies did not strengthen the rescue role of policies and measures in the event of crisis. On the contrary, it made the fiscal policy more negative, reduced fiscal expenditure and increased taxes which declined the consumption demand (Goodman, 1956).

3. The misbehaviors in the financial sectors

It was true that macro policies did not contribute to the stable development of the economy, but the collapse of the stock market was also one of the important factors leading to the great depression. The stock market had been ascending rapidly since the year of 1924. The Dow Jones Industrial Average Index increased from 97.34 points in the first month of 1924 to 198.27 points in December 1927 (James, 2010). During the aforementioned period, the stock market appealed to people from all stratum, and reselling stocks became the most popular speculative trade in America. Surprisingly, there were no loan financing restrictions in the stock market at that time. Obviously, all investors began to borrow to purchase in stocks. They could get a lot of money by paying a small part of the margin, even some people got their margin from loans. Therefore, many speculators poured into the American stock market, the stock bubble had increased and the market had lost stability. According to three famous economists, John R. Graham, Sonali Hazarika and Krishnamoorthy Narasimhan, "low leverage recovered their 'value' firms sooner than their highly levered counterparts, who lost nearly half of their value" (2021,p.842). The economic prosperity and development led to the increase of residents' salary level, and everyone wanted to take a share, so a large number of low-grading companies entered the market, which buried hidden dangers for the subsequent credit crisis. Meanwhile, the prevalence of margin had stimulated the further rise of the stock market and raised people's expectation of a continuous increasing in stocks. The funds raised by enterprises were not used for productive activities, but were speculative activities in stocks. At the same time, the speedy growth of credit demand eventually changed consumer loans and consumer loans to speculative loans. Hence, high leverage effects promoted the stock market to go crazy. When the stock market disaster came, even if there was capital to protect the market, it still could not resist the huge losses caused by the leverage effect, which was the reason why the U.S. stock market fell so far and did not recover until 1940.

4. The illusion of permanent prosperity among the populace

At the beginning of the 20th century, the American Industrial Revolution promoted economic prosperity and development. The industrial revolution had provided society with a huge amount of wealth and scientific and technological innovation. After the first World War, the United States benefited the most from it and ushered in a prosperous Jazz Age. Just like the famous American novelist F. Scott Fitzgerald wrote in The Great Gatsby, "it's a replica of the Normandy city hall…And shirts with more than ten layers of bricks" (1925, p.18). This description vividly reproduced the overflow of material desire and the life scene of consumption and entertainment in American society at the beginning of the 20th century. The prevalence of consumerism culture had a profound impact on the social economy, seeking and enjoying happiness urged people to indulge in the empty world of material desires. This led to people's lack of awareness of danger in times of peace, and the public were all immersed in the illusion of false prosperity. "Money first" culture was doomed not to have a positive influence on economic growth. The variation of Gini coefficient in America revealed that most of the social recourses were inclined to minorities. The income discrepancy caused the American public to not have enough fortune to cope with the economic crisis, but the American upper class and capitalists continued to squeeze the working class.

5. Conclusion

In conclusion, this essay discusses the process of the collapse of the stock market and the following economic activities in the United States. The monetary policy, tax policy, tariff policy and the high leverage effect of the stock market led to the great depression, and the results of these events caused a serious burden on the lives of the American public and exacerbated income inequality.

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