Julian Erbil
113b Paper
3/12/2017

Ambiguity and the Depression

Did the stock market affect the Great Depression, or did the Great Depression affect stock market? One definitely affected the negative propulsion of the other, but does the common student of history see the simple complexity behind the stock market being the culprit, or are they able to read between the lines of American stock history? The history of assets as securities began March 8th, 1817, with the creation of the New York Stock Exchange. “The market” has been, and will hopefully continue to be a representation of the connection between the real economy and the financial economy. Whether or not that connection was a weak one during the 1920s through early 50s is what should be questioned. What happened to make the stock market such a centrality inside one of the largest events in American financial and economic history? Market logistics differ from what would be seen as viable economic reactions, and need to be understood independently. There are several economic, psychological, and financial interactions collaborating to cause this infamous selloff, of which a few will be exemplified. These interactions are intriguing, yet connected, and help to explain away the ambiguous fallacy that the stock market is what single handedly caused the Great Depression.

Why would the market prices of securities not be exactly correlated to company share value? Is the Efficient Market Hypothesis not correct? Several historical events have shown this hypothesis to be false in the short term. For the past two generations, the age of the Internet has shown a de-linkage between the market value of a security, and the true book value of the underlying asset. Psychologically, this can be hard to grasp, and it definitely was for those in the mid-1900s. Although that is a question for another paper, one major answer to the abstract relationship of the market to the real economy has an application to this contracting period of time. The fact that institutional investors have always controlled the direction of the market compared to retail investors is undeniably a crucial factor in explaining drops in security prices and therefore a population's wealth. They have more capital, more technology, more resources with which to raise capital, government backing at times, better rates, and a better chance of being right in the market. Sure, a spike in retail demand can cause changes in prices, shown in reverse in the panic selloff of 1929, where retail only joined the selloff physically at the NYSE in that October. "The stock market crash of 1929 was due to a market that was overbought, overvalued and excessively bullish, rising even as economic conditions were not supporting the advance."[1] These economic conditions and what led to this overvalued market will be discussed later. To clarify, there were several individual market corrections within the entirety of the Great Depression. The point though is to show how there were prevailing circumstances that led to these crashes, as opposed to the belief that the crashes caused the negative circumstances. One of which is this concept of big institutional buyers and sellers are often able to act before personal investors. This is a psychological understanding that was not as common prior to the 1929 crash. Most of the Panics that preceded the Great Depression were usually a day to a few days to a year in extent. At this point not many were expecting this long and harsh of a crash. "In 1925, the total value of the NYSE was $27 billion. By September 1929, that figure skyrocketed to $87 billion… John J. Raskob advised Americans to invest just $15 dollars a month in the market… Stock fever was sweeping the nation."[2] As a result of the bull market that was the Roaring Twenties, families were placing a large portion of savings in the market, hoping in a sort of blind fashion for a continuance in this uptrend. Many did not stop and think about the significance of the abstract periods of growth that the market experiences. Is $27 billion to $87 billion in around

1 "What caused the stock market crash and preceded The Great Depression?," *Investopedia*, April 21, 2015, March 5, 2017, http://www.investopedia.com/ask/answers/042115/what-caused-stock-market-crash-1929-preceded-great-depression.asp

2 "The Market Crashes." *Ushistory.org*. Independence Hall Association, 2008-2016. Web. 05 Mar. 2017. http://www.ushistory.org/us/48a.asp

4 years a sign of real productivity, economical, output, and business growth? That's over a 300% increase in value while GDP growth was nowhere near that increase. The market intrinsically cannot be blamed for the overinflated spike in valuation.

Public confirmation bias can psychologically be self-justifying and self-reinforcing. If the majority seems to be making positive returns on the market, why can't the next individual? As an investor, one does not want to miss out on potential extra capital gains, even if their investment meets their goal. This was the first time where there was a continuous, drawn out trend of drops in real prices leading to more drops in prices for a brutal 4-year collapse. The public psyche was not prepared for this by the shorter-term Panics in the past. The average American believed in the same growth they were experiencing in the 20s, and it takes a great contrarian mind to predict a reversal in a trend. While public expectation can partially be blamed for the Great Depression then, so can institutional overconfidence. Institutional overconfidence can inspire public overconfidence, but when the institutional sellers move in, as in the big banks and funds, it often proves to be a catastrophe for the middle and working classes who at the time could not move their savings fast enough. Overconfidence, then, is linked more often than not with overbought securities, which links to unease, and unease can lead to market turmoil, which, again, is not an intrinsic fault.

Retail investors, commonly defined as those who purchase securities for their own personal behalf, rather than on behalf of investors, are arguably hurt the worst in these selloffs, because they don't have banks or government to bail them out of their positions. There is no insurance on speculation, only gain or loss. They also don't have the same capital endowments fund managers do. Their investments can be composed of their savings, and their savings composed of their investments. The following is a micro example, but it has macro insinuations. “Bob Aden's father in Nebraska was one of thousands of owners of General Motors stock. He had borrowed money against the family car to buy a few shares. The stock went up for a while and then dropped well below what he paid for it. Bob says, ‘There were slim pickings around the dinner table.’”[3] This is one example of millions of lives changed by a drop that did not recover for almost 25 years. “The ultimate bottom was made on July 8, 1932 at 41.22. From peak to trough, this was a loss of 89%... Not until Nov. 23, 1954, did the Dow reach its previous peak of 381.17.”[4] Large masses of wealth were lost in a very short amount of time, which leads to discussions about liquidity that will be pursued later in this argument. Although retail investors have some say in the market, their power is often a negligible complement to the true power of market movers, shown merely by how quickly big firms can push the market in different directions. An argument could be made that because there will always be a bigger investor affecting the private investor’s ability to wisely place his money, and thus the market has a fault in that regard. However, by that trend of logic, one could also argue that any investor who makes a wrong decision by buying or selling a security is never at fault, which is obviously not the case. Private and institutional wealth managers have to be consistently cautious, even for unexpected events.

The Panic of 1983 is a fantastic financial example of how the economic factors are not always linked with the market, and thus by reverse logic, economic reactions should not always point to the market to blame, though it is definitely easy. Yes, the United States experienced a

3 Ganzel, Bill. "The Impact of the Stock Market's Crash on Rural America." *The Impact of the Stock Market's Crash on Rural America*. Living History Farm, 2003, Web. 05 Mar. 2017. http://www.livinghistoryfarm.org/farminginthe30s/money_01.html

4 “What caused the stock market crash and preceded The Great Depression?,” *Investopedia*, April 21, 2015, March 5, 2017, http://www.investopedia.com/ask/answers/042115/what-caused-stock-market-crash-1929-preceded-great-depression.asp

period of depression. However, was it due to the stock market? Not according to several historical records. It was due initially to the bankruptcy of a major railroad, and the consequences thereafter. The market declined because there was a true reason to sell, not because of equity overvaluation, but because of speculation gone badly, the value of the dollar declining and the resulting selloff of securities and conversion to gold and silver. The panic to convert assets to gold allowed for a total market depreciation. "The failure of major industries was followed by a crisis in the US Government. The U.S. Treasury's gold reserves fell to below $65 million which sparked a financial panic as investors panicked selling off assets and converting them to gold."[5] In this case, the market decline was due to significant, but real extraneous circumstances, not aggregate finance reasons. Though it did spark a harsh rise in unemployment due to devaluation of the dollar, and dropping prices, the stock market was not in its own function an initiator, but a victim of the economy's shortfall. One reason that the link could not have been too great between the market and the production economy was the fact that the economy could be saved by financing it. "Morgan was so powerful that it was necessary for him to intervene to help rescue the federal government from financial crises in 1895 and 1907… after the Panic of 1893 had caused a depletion of the US Treasury's gold reserves, Morgan visited Democratic president Grover Cleveland in the White House and promised help…"[6] He pulled together leading financiers, who settled their positions to help prop up the reserves of the government. The common man could not have bailed out the government in the same way JP Morgan did in 1893. In the 19th century, big banks truly had developed a financial importance that the population's stock of money could not match. Needless to say, this also most likely

5 Alchin, Linda. "Panic of 1893," *American-Historama*, 2017, March 5, 2017, http://www.american-historama.org/1881-1913-maturation-era/panic-of-1893.htm

6 Lind, Michael. *Land of Promise*. (New York: Harper Collins, 2012), 222.

played a part in the income disparity that did not assist in the aftermath of the market drop in either crash.

When the Panic of 1893 and the Great Depression are compared, the severities of both are similar in the depth of their impact. The Treasury's reserves fell by almost half, and in the Great Depression, money income fell 53%.[7] Different aspects were severely damaged in the general economical system. The question is, did the market itself cause either? From the history behind the Panic of 1893, it surely did not play an instigating role. How about the Depression? Some sources do cite the 1929 October crash as the beginning of the Great Depression. Nominally, that may be correct, but it indubitably does not infer that it was the major causal factor only because it was the first reaction from a monetary side. No, in essence it is more of a signal to the economy of circumstances to come. The 1920s played a huge role in the Great Depression's introductory conditions. Liquidity and credit are two of the most relevant concerns that grew inversely during the Roaring Twenties, and though the market was a great medium for this disconnect, it is justified enough to be a causal factor.

As history would suggest, many saw the stock market as a place to keep funds, as opposed to a place to intelligently and actively grow capital. This type of view leads to what could be perceived, as Milton Friedman suggests in *A Monetary History of the United States*, as increased illiquidity in the sense that the investment is done without due diligence. Increased monetary credit alongside an environment in which prices and the stock of money declines makes for an interesting historical period. As confidence in the market increased among investors, more purchases on credit were made in the 1920s prior to the Great Depression than

7 Friedman, Milton, Anna Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton: Princeton University Press, 1963), 301.

any period of time preceding. This is one way in which the real economy is bridging the financial economy in this time period, as increased credit on the consumer side is quite alongside those purchasing securities on credit. The Roaring Twenties was a time of restless growth, and it was a consumer economy, but in this section, the case for financial credit is examined. As the stock of money declines and credit purchases increase, that makes for a tighter money supply, which has to be more sensitive to slightly sudden needs for liquidity. Friedman calls the period “The Great Contraction,” as he discretely separates the real from the monetary, and public opinion from the truth. “The widespread belief that what goes up must come down and hence also that what comes down must do so because it earlier went up, plus the dramatic stock market boom, have led many to suppose that the United States experienced severe inflation before 1929 and the Reserve System served as an engine for it.”[8] He argues that this perspective on the 20s is far from the truth, citing the stagnant and slight decline in stock of money, and prices falling on “the average of 1 per cent per year.”[9] He rightly views that having money and price decline in a period of economic growth is an odd phenomenon, and although he writes that there could have been actions taken by the Fed to somewhat reduce the severity of the situation, the theme was general over-expectation. Having the stock of money decline at the same time as prices decline can only have consequences, especially when you have a market that is inflated by a credit bubble. “Borrowers were often willing to pay 20% interest rates on loans, being dead certain that the risk would be worth the rewards. The lender was so certain that the market would rise that such transactions became commonplace, despite warnings by the Federal Reserve Board against the practice. Clearly, there had to be a limit to how high the market could reach.”[10] At the same time,

8 Friedman, Milton, Anna Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton: Princeton University Press, 1963), 298.
9 Friedman, Milton, Anna Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton: Princeton University Press, 1963), 298.
10 "The Market Crashes." *Ushistory.org*. Independence Hall Association, 2008-2016. Web. 05 Mar. 2017. http://www.ushistory.org/us/48a.asp

investors began buying securities on margin, which is essentially credit. Altogether, this combination of overinflated security prices, paired with true price decline and an innocently oblivious consumer were some of the true conditions foreshadowing this collapse, not the stock market. Again, one of the most significant details of the value of the market is specifically the buyer's perception.

Speaking to illiquidity of public credit, the Roaring Twenties was a great time for the consumer. Expansion of credit markets allowed for greater amounts and choices of purchases. "'Buy now, pay later' became the credo of many middle class Americans of the Roaring Twenties… Over half of the nation's automobiles were sold on credit by the end of the decade. America's consumers could indeed have it all, if they had an iron stomach for debt. Consumer debt more than doubled between 1920 and 1930."[11] The 1920s were an important historical period, without doubt. They were also largely a determinant of the buildup that led to the large financial selloff. The ability to purchase goods based on credit allowed the consumer to exercise their flexibility in purchasing power, especially with the increasing number of ways to expend. Increased advertising encouraged the creation of fear and need for products that were not bought out of fear or need before. "Most large department stores found that sales on credit made up 50 percent to 70 percent of their business. The number of regulated small loan offices increased by a factor of six between 1913 and 1929."[12] As creditors increased, debtors increased. This does not solely apply to residential credit. As income increased, wealth increased, and the income disparity gap starting widening. As more people saw opportunity in the stock market, demand for investment increased. One could argue that just the sheer difference in volume in buyers and

11 "The Market Crashes." *Ushistory.org*. Independence Hall Association, 2008-2016. Web. 05 Mar. 2017. http://www.ushistory.org/us/48a.asp

12 Gordon, Robert J. *The Rise and Fall of American Growth.* (Princeton: Princeton University Press, 1963), 297.

sellers compared to today's market allowed for panics and the sort to be more prevalent. Either way, just like real financial purchases decreased relative to those done on a promissory basis, consumer credit portrayed a foreshadow of the crunch to come. "Although the stock market collapse of late 1929 is often cited as a major cause of the Great Depression, the overreliance of households on consumer credit and their increased leverage added to the downward spiral of collapse and deflation once incomes and jobs began to be cut in 1929-1930."[13] The liquidity crisis that ensued is not, as shown, due single-handedly to the stock market, but due to a cycle of over-inflated market prices, overindulged credit consumption in the financial and retail economy, too much demand, unease, banking failures, funds depleted in both sides of the economy resulting in declining market/asset values, resulting in the Depression.

---

13 Gordon, Robert J. *The Rise and Fall of American Growth.* (Princeton: Princeton University Press, 1963), 297.

Works Cited

Alchin, Linda. “Panic of 1893,” *American-Historama*, 2017, Web. 05 Mar. 2017.

Friedman, Milton, and Anna Jacobson. Schwartz. *A Monetary History of the United States 1867-1960*. Princeton: Princeton UP, 1963. Print.

Ganzel, Bill. "The Impact of the Stock Market's Crash on Rural America." *The Impact of the Stock Market's Crash on Rural America*. Living History Farm, 2003, Web. 05 Mar. 2017.

Gordon, Robert J. *The Rise and Fall of American Growth*. Princeton: Princeton UP, 2016. Print.

Investopedia. "What Caused the Stock Market Crash of 1929 That Preceded The Great Depression?" *Investopedia*. Investopedia, LLC. 21 Apr. 2015. Web. 05 Mar. 2017.

Lind, Michael. *Land of Promise*. New York City, New York: Harper Collins, 2012. Print.

"The Market Crashes." *Ushistory.org*. Independence Hall Association, 2008-2016. Web. 05 Mar. 2017.