Stock Market Crash of 1929

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**Introduction**

Stock Markets are considered as a strong indicator of the economic activity of a country. The index of the stock market precisely describes the confidence level of investors over the current economic conditions. Stock markets are also considered as the opinion-makers for businessmen as decisions about investments are made on the bases of conditions in the stock market. Investment plans are based upon the historical trends and future expectations of stock markets. Stock markets are crucial for the expansion of existing businesses as it provides necessary capital for future investment plans. Thus, it can play a very constructive role in the economic development of a country. The importance of stock markets is not limited to the domestic aspects of an economy, but provides a picture of the overall business conditions in an economy. Any stock market has to face many ups and downs, over time. The situation where stock prices tend to decline, significantly, is called a stock market crash. This dramatic and sudden decline in the stock prices can be a result of overall bad economic conditions and can also give birth to many economic miseries.

The stock market of the US has had to face the most severe crash in 1929, when the market collapsed and had continued for four consecutive days. This was considered the worst crash as the Dow Jones Industrial Average dropped by 25% and this loss was estimated to be as huge as 30 billion dollars. The US economy had to bear an estimated loss of over 396 billion dollars. This huge loss amounted to more than the total cost of World War One. This stock market crash started on October 29, 1929, and the New York Stock Exchange was the first victim of this crash. Later on, the stock markets of other industrial economies also started to crash and converted this disaster into a global phenomenon.

The business cycle is one of the most fundamental concepts of economic theory as it studies the fluctuations in different segments of an economy. The Great Depression of the 1930s was an event that entirely changed the outlook of all the major economies of the world. This event became a historical reference point in the economic theory. Many of the basic concepts and principles of economics needed to be revised. It provided basics for the establishments of new theories and models that could better elaborate on the functioning of an economy and its components. The Great Depression raised many questions about the popular Classical framework of the economy that was greatly praised and practiced before the Great Depression. The Classical theories failed to justify the reasons behind this unexpected depression that affected all the major economies of that time. This event of history became a rising point for the Keynesian economic theory. In 1936, John Maynard Keynes published his famous book “The General Theory of Employment, Interest and Money” that empirically tried to explain the events of the Great Depression.

This essay will present the economic background before and after the stock market crash of 1929. This study will also explore the linkages between different segments of an economy. The impacts of the stock crash will also be analyzed. We will also try to figure out the key factors behind this stock market crash and its relation to the Great Depression.

**The Great Crash and the Great Depression**

The stock market crash of 1929 was the most severe economic downfall in the history of mankind. It lost its value by more than 90% and could not fully recover, for the next 25 years. This gave birth to many other economic crises and was the major reason behind the Great Depression of 1930s[[1]](#footnote-1). The effects of this crash of the stock market, resulted in global economic crises lasting for more than one decade. Most of the European economies tended to recover from these crises after 1933[[2]](#footnote-2). But it took a lot more time to fully recover from these shocks. The economy of the US managed to fully recover from this depression in 1939. The following, are some of the effects of this Great Crash of stock markets:

* The stock market of any country is the front face of its economic wellbeing. The crises of 1929 were so severe that the stock market lost its more than 90% of value in 1929 to 1930. All the major economies were affected by this shock. The effect of this stock market crash was more prominent in the industrialized and developed economies. But it was the economy of the US that faced the most severe conditions.
* This stock market crash became a major source of economic crises that affected all major economies. Almost every sector of the economy had to face this crisis.
* More than 11,000 financial institutions went bankrupt as a result of these crises. The public trust in financial institutions was shaken at that time[[3]](#footnote-3).
* Unemployment rates increased dramatically during the Great Crash. Initially, the unemployment rate of the US was just 3 % at the beginning of 1929. This rate of unemployment rate rose to 30% within the next four years.
* People had to face many economic crises as a result of this financial and economic crisis. The average income of American families dropped by 40%. This drop in income decreased the purchasing power of the citizens and lower demand for goods and services became a source of further economic destruction.
* More than 300,000 companies had to close their businesses due to lower demands. This was the key reason behind the high rates of unemployment.
* Thousands of families could not pay their loans and mortgages due to lower levels of income and high rates of unemployment.
* The industrial production drastically decreased, as alone, the American economy had to face a 47% drop in its industrial sector. Prices also tended to decrease due to lower levels of demand. The overall GDP was badly affected by this depression as the GDP of the American economy decreased by 6.4% in 1931. This contraction continued for the next three years and the GDP of the US was 57 billion USD in 1933 which was half of the GDP of 1929.
* Deflation was another severe result of these crises. The Consumer Price index fell by 27% during the first four years of the Great Depression.
* Agricultural production also decreased due to the lack of availability of finances. Low prices of agricultural goods also become a source for further contraction.

**Factors behind the Great stock Market Crash**

The stock market of the US enjoyed great expansion during the 1920s. The prices of stocks seemed to be increasing, smoothly. The banking sector also contributed a lot to the boom of the 1920s. The availability of easy loans made the stock market a favorite place for investors. Investors got a loan from the banking sector and invested in the stock market. This increase in the prices of stock created future expectations for higher profits[[4]](#footnote-4). The business of most of the companies was also performing well and it was on expansionary trajectories. This gave birth to higher levels of production and even overproduction. The demand for products was not as high as the supply. As a result, the prices for the stock tended to drop in early October of 1929. The speculation and forecasts of investors were very difficult to bring down. The investors were still overconfident about the market.

Just two weeks before the Great Crash, the government of the US increased the interest rate by one percentage point from 5% to 6%. This increased the cost of borrowing for the investors. Most of the investment in the stock market was borrowed from the commercial banks[[5]](#footnote-5). The decrease in the stock prices and an increase in the interest rate urged people to trade more to earn more profits, which gave birth to the early crash of the market. Panic media reports about the stock market increased the magnitude of this shock by creating a sense of no-confidence. Most of the investors wanted to sell their stock shares to avoid any future miss-happening. As a result, there were a lot more sellers in the market as compared to the buyers. Higher supply of shared and lower demands became a source of further decline in the stock prices. The continuation of this panic behavior on the behalf of media and investors burst the confidence of the entire market.

**Economic Lessons from the Great Crash**

The economic theory as highly influenced by the ideas of classical economists at the time of the Great Crash and its resultant, the Great Depression. Many prominent theories of classical economists were widely questioned at the time of Great Crash. Classical economists believed that there was no possibility of overproduction as "Supply creates its demand". It was also believed that unemployment could not exist in a free and competitive economy. But practically, overproduction was observed during the early boom of the 1920s. The deflation during the time of recession was also associated with this overproduction. This also becomes a source of higher unemployment rates. Classical economists also believed that money was neutral as it had no real effect on the economy. Money was considered as a nominal variable and could not affect any real variable like GDP. But it was observed that the changes in the money supply were also contributed to increasing the magnitude of the crises. The money supply was kept low just before the crash of the stock market. An increase in the money supply could change the conditions as the general price level could be increased by increasing the money supply. Moreover, the sudden increase in the interest rate also became a source of a decrease in the money supply. These deficiencies in the theories of classical economists gave space to the Keynesian economists. John Maynard Keynes published his famous book "The General Theory of Employment, Interest, and Money" in 1936. He tried to explain the reasons behind this Great Depression. He suggested the active role of government in economic decision making.

**Conclusion**

The sudden and dramatic crash of stock markets in 1929 was one of the most studied events of economics. This was the event that changed the course of theoretical economics. Many researchers tried to explain the key factors behind this unusual behavior of key economic indicators. Some common findings of these researchers described this event as a result of inefficient monetary policies by the government. The monetary policy of that time was not according to the economic conditions. This event increased the importance of monetary regularizations in the economy. Investors’ future expectations about the economic conditions also play a crucial role in the working of the stock market. There were unrealistic expectations among the investors at that time. Overconfidence of investors was also among the key reasons for the Great Crash.

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2. “US History: The Great Depression,” accessed December 23, 2019, https://www.ducksters.com/history/us\_1900s/great\_depression.php. [↑](#footnote-ref-2)
3. by Charles W. Calomiris and Joseph R. Mason, “Consequences of Bank Distress during the Great Depression,” *American Economic Review* 93, no. 3 (2003): 937–47. [↑](#footnote-ref-3)
4. Ben S. Bernanke, *Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression* (National Bureau of Economic Research Cambridge, Mass., USA, 1983). [↑](#footnote-ref-4)
5. James D. Hamilton, “Monetary Factors in the Great Depression,” *Journal of Monetary Economics* 19, no. 2 (1987): 145–69. [↑](#footnote-ref-5)