

## **Reflections on the Economics of the Historic Great Depression of 1929**

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**Abstract.** This paper points out some of the failures of the general equilibrium theory in accounting for the historic crisis of 1929.

**JEL Classification Codes:** D50, N00.

**Key Words:** The Great Depression; General Equilibrium Theory.

It is a surprising irony of economic science that some of the central theories of the economic discourse whose scope is so inextricably fused with the everyday lives and problems of ordinary people and societies should remain so divorced from important historical realities. In very few instances has this divorce been as transparent as in the case of the historic Great Depression of 1929 which continues to pose a profound theoretical challenge to one of the greatest artifacts of the conventional economic paradigm, namely the general equilibrium theory, which fails to provide an adequate explanation of how and why such a crisis of historic proportions characterized by massive unemployment, negative net investment, negative growth of output, shrinking foreign trade, bank failures, a stock market crash and suboptimal (inefficient) allocation of resources could occur.<sup>2</sup>

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<sup>2</sup> There are a considerable number of works in the literature exploring various approaches to the Great Depression, such as Arcand (1993), Bernanke (1995), Esbitt (1986), Klausinger (1995), Steindl (1995), Temin (1994), and Yang (1995). There are a number of equilibrium approaches to the issue as well, such as Cooper and Ejarque (1995), and Dagsvik and Jovanovic (1994).

The general equilibrium theory describes a state of the economy in which all agents maximize utility subject to constraints, firms maximize profit, all markets (including labor markets) clear, and the atomistic interaction of self-interested individuals in markets leads to a Pareto optimal (efficient) allocation of resources. The phenomena associated with the Great Depression—massive unemployment, negative growth, etc.—render the general equilibrium description of the economy problematic, casting doubt on the practical value of some of the efforts of general equilibrium theorists to explain modern capitalist economies. As a scientific body of knowledge, the history of the general equilibrium theory in the last five decades has been marked by a relentless effort on the part of its practitioners to produce a discourse whose distinctive features are precision, rigor, and definiteness in the results it generates. The extensive use of mathematical techniques and physical metaphors borrowed from “hard” sciences is intended to serve that purpose. The road to becoming a rigorous science has not been an easy one, and the rigor achieved has often come at the expense of the relevance of the results to contemporary economic processes.<sup>3</sup> For instance, the possibility of general equilibrium in a competitive capitalist economy has been rigorously established, but the conditions under which it is established do not stand even a remote chance of being relevant to the conditions of contemporary capitalist economies. Abstracting from the technical nature of the conditions that establish the existence of general equilibrium, the resulting general equilibrium picture of the economy, where labor markets clear without involuntary unemployment, stands in sharp contradiction to the massive unemployment that, in part, characterized the historic Great Depression. Moreover, a state of the economy in which a quarter of the labor force is unemployed, as it was during the Great Depression, is not likely to be compatible with the kind of efficient allocation of resources that a general competitive equilibrium is supposed to lead to.

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<sup>3</sup> Though there is no common intertheoretic standard by which conventional and nonconventional paradigms judge the relevance of a certain set of conditions to those of contemporary capitalist economies, the nonconventional views expressed here on the issue are shared by some conventional scholars, e.g. Blaug (1996).

The power of the general competitive equilibrium analysis in understanding the Great Depression is further diminished by one of its intrinsically limiting features which has not, to our knowledge, received any attention in the discussions of the issue, namely that individual preferences (utility functions) are presumed to be independent of prices. This feature (assumption) is not likely to hold, especially in depression junctures. Paradoxical as it may seem, lower/depressed prices, reflective of economic depression and a pessimistic outlook, are likely to have a negative effect on individual utilities, effectively making them a function of (i.e. dependent upon) prices. In the presence of price-dependent utility functions, it would not be possible to secure the existence and stability of general equilibrium through conventional procedures (Darehshuri, 1976). That is to say, with price-dependent utilities (preferences), a general equilibrium need not exist; even if it does, it need not be unique, and (non-guaranteed) multiple equilibria need not have the kind of economic features and stability properties to explain the several-years-long depression of 1929-1933.

At those historic junctures characterized by a crisis or depression of the kind that occurred during the period 1929-1933, the kind of atomistically self-interested individual behavior postulated by the general equilibrium theory is likely to be susceptible to the Prisoners' Dilemma type of coordination failures, resulting in individually and socially suboptimal (inefficient) outcomes. In other words, because of the peculiar kinds of agent-specific interdependencies and externalities that might arise at such junctures, cooperative behavior might better enhance the individuals' interests than narrowly self-interested behavior. In a web of complex interdependencies and externalities where individuals' "survival" strategies may positively or negatively depend on one another, the ability of competitive market processes to produce conventionally efficient outcomes may be significantly diminished. Inefficiencies could arise because market processes might fail to reach equilibrium states, complex agents may not be able to optimize in the conventional sense of the term, or they may not always exhibit the conventionally postulated atomistically competitive behavior. Thus, market failure is likely to be a more pervasive phenomenon in depression junctures than it would be otherwise. The involuntary unemployment of extraordinary proportions, the bank failures, and the dramatic stock market crash in the Great Depression are indicative of the failures, respectively, in the labor and capital markets of that juncture, which, together with likely imperfections/failures in other factor and commodity markets, help account for the negative growth of the gross national product in the depression period.

In view of the pervasive market failures and the likely absence of any equilibria or equilibria that would characterize the state of the economy during the Great Depression, the current discursive structure of the general equilibrium theory is not likely to serve as a suitable framework for understanding the economics of the historic crisis of 1929.

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