

## Lecture 6 – Crash and Depression (1929)

### 1. Crash vs. Depression

- **Stock market crash (Oct 1929)** and **Great Depression (1930–33)** are **distinct**.
  - Crash caused short-term recession, but:
  - Depression driven by **monetary contraction** and **bank failures**, not the crash.
  - Stock market partly recovered in 1930 before later macro shocks.
  - Connection: only mild effects via consumer sentiment and spending.
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### 2. Competing Views on the 1920s Boom

- **Galbraith & “irrational exuberance” view:**
  - Investors were naive, arrogant, and fueled a bubble.
  - **Empirical research (serious finance literature):**
  - Much stock price growth was tied to **technological innovation** and fundamentals.
  - Some evidence of **overpricing at the margins** (esp. banks in 1928–29).
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### 3. Fundamental Drivers

- 1920s = extraordinary **technological innovation**:
- Kodak, GE, DuPont, GM = “Teslas of their time.”
- Patents from 1920s heavily cited decades later → proved long-term transformative.
- Investors discriminated:
  - Utilities & industrial innovators ↑.
  - Railroads flat → no new tech.

- **Evidence from patents (Tom Nicholas, HBS):**
  - Citation-weighted patent scores explained which stocks rose.
  - Stock increases lined up with true innovation value.
  - **Evidence from professionals (Ali Kabiri):**
  - Contemporary valuation models justified prices.
  - Investors not “dumb money” → pricing consistent with fundamentals.
  - **Bond markets confirmed optimism:**
  - Lenders allowed firms to leverage more → saw asset risk falling, future prospects rising.
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#### 4. Signs of Excess

- **Rappaport & Whyte:**
  - Aggregate link between **credit supply** and stock run-up.
  - Suggests “easy credit” contributed to prices.
  - **NYC banks (Calomiris research):**
  - Delisted from NYSE in 1928, thinking shares overpriced.
  - Prices still rose → suggests **some overvaluation**.
  - **Short-sale constraint bias:**
  - Optimists buy easily; pessimists face costs to short → markets lean optimistic in booms.
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#### 5. The Fed’s Role in the Crash

- Fed explicitly **targeted the stock market** in 1929:
- Believed policy had been “too easy.”
- Tightened credit, especially call loans for brokers.
- Publicly declared intent to stop speculation.
- Crash = **policy-induced sell-off**, not random panic.
- Fed misread signals (as in the Depression):
- Falling rates = misinterpreted as easy policy.

- Reserve accumulation = misread as excess liquidity.
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## 6. Lessons & Legacy

- Crash ≠ Depression → different causes.
  - 1920s stock boom:
  - **Mostly fundamentals (tech-driven).**
  - **Some marginal excess.**
  - Central banks are risky when they **discretionarily target asset markets:**
  - Fed caused crash via poor judgment.
  - Parallels today: post-2008 rise of “macro-prudential” central banking.
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## 7. Discussion Questions

1. Was the 1929 stock boom a bubble or a rational response to technological innovation?
2. Did the Fed act irresponsibly by deliberately tightening to burst the market?
3. What lessons should we draw about central banks targeting asset prices?
4. Why did some sectors (industrials, utilities) soar while others (railroads) stagnated?