A Great Crisis, A Long Debate

BY VANESSA SUMO

Throughout the decades of discussion on the causes of the Great Depression, this remarkable event is the standard against which economic theory and policy are put to the test

The Great Depression is the enduring symbol of what an economic catastrophe looks like: a stock market crash, bank runs, closed down factories, abandoned farms, soup and bread lines, and families moving from one town to another in desperate search of work. It was a tragic event that devastated the lives of many around the world, and yet fascinating to those who seek to fully grasp what went wrong. To this day, an economic debate rages over what caused and prolonged the Great Depression. "To understand the Great Depression is the Holy Grail of macroeconomics," wrote Fed Chairman Ben Bernanke in his book *Essays on the Great Depression*.

Before the Depression, brisk economic growth had characterized most of the "Roaring '20s." It was a time of great prosperity, despite the two mild recessions that occurred during that decade following the sharp downturn in 1921. Large enterprises emerged that benefited from the latest mass production technologies. New roads, telephone lines, power plants and other public infrastructure were constructed, which in turn increased people's appetite for cars, refrigerators, and other durable goods. The introduction of installment credit likewise spurred households' consumption. But this period of plenty was put to an abrupt halt when the stock market crashed in October 1929.

Soup kitchens were probably the only places where the hungry and unemployed could get a meal during the Great Depression.

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Many view Wall Street's Black Tuesday as the start of the Great Depression. In his book, *The Great Crash 1929*, economist John Kenneth Galbraith argued that the bullish market of the 1920s had created a "bubble," or a situation where stocks trade at prices much higher than can be reasonably explained given a company's expected future earnings. However, there continues to be a debate about whether the stock market was indeed overvalued. Economist Irving Fisher, who wrote *The Stock Market Crash and After* a year after the crisis, thought that the "market went up principally because of sound, justified expectations of earnings, and only partly because of unreasoning and unintelligent mania for buying." In the last 20 years, post-Depression economists have laid out their arguments on either side.

Nevertheless, many public officials, including those at the Fed, probably believed that a speculative bubble was driving the stock market boom, and thus tried to squeeze the flow of money into the system in order to prick that bubble. "There should be no doubt that the United States adopted a policy of tight money at the beginning of 1928, nor should there be much dispute as to what motivated this policy," wrote economist James Hamilton of the University of California at San Diego. Hamilton says that despite repeated assertions by the Fed that it did not see itself as an arbiter of security prices, most of those who have studied Fed policy during this period agree that it followed contractionary measures to curb the stock market boom.

With the pressure applied and investor confidence waning, the stock market crashed. While the crash and the Depression are two distinct events in the eyes of economists, the former

was arguably responsible for the sharp reduction in consumption and investment that ensued. Household budgets took a hit, but that loss was probably not such a large share of their total wealth. Nonetheless, Black Tuesday warned of a gloomy economic outlook, enough to discourage households from spending on durable goods and housing. Firms would hold back or postpone investments for the same reason. "It changed the atmosphere within which businessmen and others were making their plans, and spread uncertainty where dazzling hopes of a new era had prevailed," wrote economists Milton Friedman and Anna Schwartz in their classic *A Monetary History of the United States.*

To make matters worse, a wave of banking panics gripped the country just a year later. So severe was the crisis that by the end of 1933, only about half the number of banks that existed in 1929 were still standing. The panics culminated when President Franklin Roosevelt declared a national "bank holiday" in March 1933. Roosevelt ordered all banks to close, allowing them to reopen only after government inspectors declared them solvent.

Bernanke says that bank failures were not uncommon during this time, largely due to regulatory restrictions on branch banking that resulted in many small, independent banks. "In this sort of environment, a significant number of failures was to be expected and probably even desirable," he wrote. For instance, rural banks closed when farmers who borrowed heavily couldn't pay their debts following a precipitous decline in farm commodity prices.

However, the banking crises of this period differed "both in magnitude and the degree of danger posed by the phenomenon of runs." The absence of deposit insurance and the fact that banks had relied heavily on very liquid deposits which could be withdrawn at any time resulted in a panic that affected not just banks that were on the margin but almost the entire system. Indeed, starting with the agricultural areas that experienced the most severe bank failures, "a contagion of fear spread among depositors ... But such contagion knows no geographical limits," wrote Friedman and Schwartz. (There is a debate about how much actual contagion there actually was. Some people say that it's hard to find evidence of healthy banks taken down by runs.)

Why did the stock market crash and bank failures lead to a long period of slump that, at its peak, forced one in four of working Americans out of a job? Economists have been trying for decades to fit long-held views as well as shape new ones to explain the depth and protracted decline in economic activity during the interwar period. Bernanke thinks that we do not have our hands on the Grail yet, but substantial strides have been made in furthering that quest for answers.

The Liquidationists and Keynes

"Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate," said Andrew Mellon, President Herbert Hoover's Treasury secretary during the Depression. "It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people," Mellon said.

This was the prevailing sentiment among policymakers and economists at that time — that the Great Depression was the result of excesses that needed to be "washed out," as it were. And the best way to achieve this was to do nothing; that is, to watch idly as firms and factories went bankrupt. Perhaps this was an extreme view, but one which finds support in two well-established schools of thought.

Say's law, based on the early 19th century work of Jean Baptiste Say, convinced classical economists that "supply creates its own demand," such that it would only be a matter of time before wages and prices adjusted to let demand mop up that excess supply. Moreover, the economists of the Austrian school argued that the Depression was the result of an overinvestment in capital goods, fueled by an expansion in credit and monetary policy that was too loose during the 1920s. "The inflation [of the money supply] was clearly precipitated deliberately by the Federal Reserve," wrote Murray Rothbard, a prominent economist of the Austrian school. The abundance of credit, and the low interest rate that accompanied it, led businessmen to make investment decisions that perhaps would not have been made under "normal" conditions, that is, if the Fed had not intervened.

Eventually, the inflationary bubble would have to pop, and those investments would begin to unravel. "The 'boom,' then, is actually a period of wasteful misinvestment," wrote Rothbard. The only way to cure the Depression would be to let it run its course. "The Depression, then, far from being an evil scourge, is the necessary and beneficial return of the economy to normal after the distortions imposed by the boom," argued Rothbard. Moreover, trying to ease the economic malaise with more policy intervention would not only delay the resolution but also magnify the pain. For instance, pursuing expansionary monetary and fiscal policies would only exacerbate this imbalance and prevent labor and capital from being redistributed to more productive uses.

But as the Depression wore on, this view of the world became steadily unpopular, for it did it not seem to adequately explain why the economy was languishing for so long. Was there really nothing that could be done? British economist John Maynard Keynes assured that there could be, postulating that wages and prices do not adjust quickly but rather very sluggishly, so that the economy can fall out of equilibrium for a very long time. This miserable slump was not due to an excess in production capacity, but rather to a shortfall in demand. Hence the government can step in to revive demand and take the economy out of the Depression.

The Great Money Contraction

The series of severe banking panics from 1930-1933 was a crucial moment in the Great Depression, for the impact of bank failures would reach much further than bank shareholders and depositors simply losing their money. It would, as Friedman and Schwartz painstakingly analyzed, lead to such a drastic decline in money supply that they called this phenomenon the "great contraction."

The spate of panics and runs that ensued made people incredibly distrustful of banks, as they worried that banks were no longer safe. Indeed, people felt more secure holding on to their money at home, perhaps even hiding it under a mattress. Also, in anticipation of bank runs, and probably to convince depositors that they had ample money in the vault, banks increased their reserves.

People holding on to more currency and banks keeping more reserves, relative to deposits, had the perilous effect of pulling down the "money multiplier." The amount of money available to keep the economy running depends on the ability of banks to turn deposits into loans a multiple number of times. But if people keep more of their money at home and banks decide to increase the amount sitting in their vault, instead of putting them to work as deposits, then this process is impeded. The result, as Friedman and Schwartz find, is that the money supply plunged by over a third between 1929 and 1933.

Could anything have been done to stem this dangerous decline? Friedman and Schwartz place the blame squarely on the shoulders of the Federal Reserve. "At all times throughout the 1929-1933 contraction, alternative policies were available to the System by which it could have kept the stock of money from failing, and indeed could have increased it at almost any desired rate," Friedman and Schwartz wrote.

At the height of the wave of banking panics, the Federal Reserve could have aggressively loaned money to banks or suspended the convertibility of deposits into currency, similar to the resolution of the 1907-1908 banking crises. However, the Fed did not yet exist in that earlier episode, so a group of private banks took the lead in lending money and refusing to convert deposits into currency. (The Treasury also assisted by making money available to the troubled banks.) But with the Federal Reserve System in place, these banks probably deemed such a concerted move unnecessary. After all, it was the Fed's responsibility to orchestrate a solution, as would be expected of a "lender of last resort." Thus, the Great Depression was arguably as bad as it was because of policy failures at the Fed.

But critics of Friedman and Schwartz's view, led by economists Peter Temin of the Massachusetts Institute of Technology and Barry Eichengreen of the University of California at Berkeley, think that the fall in money supply was beyond the Fed's control. Under the gold standard, the United States had to keep a constant rate of exchange between the dollar and gold. As gold flowed out of the country, the Fed had no choice but to correspondingly contract the supply of money in order to maintain the peg.

Other countries on the gold standard faced a similar trade-off between expanding their money supply and stimulating their economies in times of hardship, and their commitment to keeping the value of their currencies aligned with the rest of world. Indeed, many studies have shown that the sooner a country abandoned the gold standard, the more quickly that country, including the United States, recovered from the Depression. (In 1944, a modified form of the gold standard was agreed upon that would fix a country's currency exchange rate to the dollar. In turn, the dollar would peg its value to gold. This monetary arrangement, commonly known as the Bretton Woods system, ended in 1971.)

Deflation and Credit Channel

While there is much support for Friedman and Schwartz's monetary view of the Great Depression, Bernanke argues that the contraction in money supply cannot fully explain why the banking crisis would lead to such a protracted decline in output in the 1930s. While monetary shocks are important, he thinks that credit shocks help explain the link between the financial sector and the lengthy duration of the output decline.

Bernanke finds inspiration in Fisher who argues that deflation and its impact on the real value of debt is an important ingredient in understanding the great depressions. If debt forces households and firms into bankruptcies and the health of bank balance sheets to deteriorate, then banks will likely move away from providing loans and put their money in safer assets. At the same time, many borrowers will begin looking like riskier bets, because the value of their assets (or the collateral attached to the loan) relative to their debt has sharply eroded with deflation. Hence, borrowers, particularly smaller ones, will find it very difficult to obtain bank credit in bad times. Even if they do find it elsewhere, credit will likely be available only at a substantially higher price than what they could otherwise have obtained with banks. Presumably, banks have the most expertise with respect to screening and monitoring borrowers and thus have the lowest cost of intermediating credit.

Various accounts of the credit conditions at the time of the Great Depression portray the effect of the banking crisis on the supply of credit. Bernanke points to one made by the National Industrial Conference Board in 1932: "During 1930, the shrinkage of commercial loans no more than reflected business recession. During 1931 and the first half of 1932 (the period studied), it unquestionably represented pressure by banks on customers for repayment of loans and refusal by banks to grant new loans." Others observed that groups that relied heavily on bank loans – households, farmers, unincorporated business, and small corporations — were most affected. Moreover, the contraction of bank credit in the United States was twice as large as

those of other countries, even when compared to those with similar output declines.

Bernanke argues that these credit effects do a good job of explaining the protracted nature of the decline in output. His view implies that the way to get out of the Depression is to establish new or revive old channels of credit and rehabilitate insolvent debtors, which could be a very long and slow process. A story on why the economy was slow to recover based on the importance of monetary shocks alone, in contrast, depends on the slow diffusion of information or unexplained stickiness of wages and prices. Indeed, Bernanke says that although the financial system did not improve immediately after a government-directed financial rehabilitation program was put in place, it could be argued that this was "the only major New Deal program that successfully promoted economic recovery."

An Explanation in Equilibrium

Friedman and Schwartz's money view and Bernanke's credit view generally rely on interruptions to the normal functioning of the market, such as sticky wages and prices, or limits to borrowing. However, there is an alternative story to the Great Depression that does not rely on such frictions. In this view of the world, markets function very well, such that the trade-offs which households and firms face when making optimal decisions on how much to save, consume, and work, determine economic activity, and change in response to certain shocks. Typically "real" shocks are held responsible for the peaks and troughs of the business cycle.

How can this "real business cycle" approach explain the Great Depression? Its proponents have focused their attention mostly on explaining why the recovery took so long. As economists Harold Cole and Lee Ohanian of the University of California at Los Angeles assert, "The weak recovery is puzzling because the large negative shocks that some economists believed caused the 1929-1933 downturn — including monetary shocks, productivity shocks, and banking shocks — become positive after 1933. These positive shocks should have fostered a rapid recovery." By some measures, the economy had not significantly recovered even by 1939.

Cole and Ohanian suspect that the Roosevelt's New Deal cartelization policies go a long way in explaining the protracted character of the slump. Roosevelt believed that the severity of the Depression was due to excessive competition that led to lower wages and prices and consequently to lower demand and employment. To remedy this, the National Industrial Recovery Act (NIRA) permitted collusion in some sectors, but only if wages were raised immediately and collective bargaining with labor unions was permitted. Even after the courts struck down the NIRA, the government ignored collusive arrangements for as long as those industries paid high wages. The government then passed the National Labor Relations Act, which gave more bargaining powers to workers than under the NIRA.

But these measures did not bring about the outcomes that Roosevelt had imagined. Instead, these policies significantly raised wages and prices and restricted employment, thus prolonging the pain of the Depression. Though others have pointed to the ills of the New Deal cartelization policies before, Cole and Ohanian present a model which finds that the cartelization policies explain 60 percent of the slow recovery.

So why is there no consensus about the explanation of the Great Depression more than six decades since it ended? This may seem surprising, but it probably reflects the wider debates among macroeconomists — which are still very lively — about the origins of business cycles. With no consensus about the "small" fluctuations, it is perhaps no surprise that the "Holy Grail" of macroeconomics is still beyond reach. But the Great Depression has always prompted economists to think about the origins of cycles. **RF**

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