

Why the Great Depression Matters

BY STEPHEN SLIVINSKI

Economic analysis is, at its core, a form of storytelling. When you strip away the math and the jargon, what you're left with is a tale about how people respond to the world around them and how their actions influence everything else. And economists do indeed have a variety of stories they like to tell. Yet the one that seems to be told most — and nowadays with increasing frequency — is the one about the Great Depression.

This story, while consisting of the same basic facts, can have a different tone depending upon who tells it. Some say that between 1929 and 1933, a sudden decline in expectations about the future of economic growth led to a collapse in consumer and investor demand that could not be quickly corrected by the market.

This school of thought suggests that government policy provides a way around this shortcoming. The policies that supporters of this thesis propose are aimed at increasing weak demand in a variety of ways, particularly through government spending and employment programs. This would serve, in the former case, to prop up demand and, in the latter, prop up employment and wages.

A competing explanation comes from the neoclassical school of thought. Proponents of this view argue that what the economy really suffered from wasn't an inherent weakness. Instead, it was impaired by the shock of policy missteps, particularly those of the Federal Reserve which severely contracted the money supply and choked off economic activity. The neoclassical economists think that over time the economy can right itself in the absence of shocks without widespread government direction. Instead, the remedy is to reverse the misguided policies that weigh the economy down.

Both schools acknowledge that policy has the power to shape economic growth. Yet the forms those policies take are important. Those that are aimed at "fixing" a perceived shortcoming of the market are by nature intended to keep the market from the opportunity to correct itself on its own. Still other policies can be geared to helping the market correct itself by assisting the mechanisms of self-correction. This could include the lowering of barriers to competition.

So, one way to arbitrate this dispute would be to determine whether the activist fixes succeeded in helping achieve a higher growth path for the economy. That begs a question: Why did the Great Depression last as long as it did? After all, by 1939 — 10 years after the start of the downturn — employment and output were well below their 1929 levels.

The best example of this line of inquiry is the work of economists Harold Cole and Lee Ohanian, both of the University of California at Los Angeles. They start by looking at some fundamental economic data.

For instance, the ability of the economy to produce goods more efficiently — illustrated by the substantial increase in "productivity" after 1933 — should have increased economic output midway through the decade. But it didn't. Wages and prices should have gone down as a result of the reduced output, but that didn't happen either. "These data contrast sharply with neoclassical theory, which predicts a strong recovery [from the Great Depression] with low real wages," write Cole and Ohanian in their 2004 article in the *Journal of Political Economy*.

They suggest that what was hindering the labor adjustment process was President Roosevelt's New Deal labor and

industrial policies. The National Industrial Recovery Act of 1933 (NIRA) actually had the effect of limiting entry of competitors into the market, mainly in manufacturing. It also allowed incumbent firms to set minimum prices in exchange for raising worker wages. When the Supreme Court ruled that the NIRA was unconstitutional in 1935, the National Labor Relations Act of that year carried

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on several of the NIRA goals directed at limiting competition in the labor market and, consequently, inflating wages. So, in short, the New Deal policies artificially inflated prices and wages. That kept the market's self-correcting forces from working and made it tougher for the economy to recover from the Great Depression.

While there is still debate about whether this is a robust explanation of what prolonged the Great Depression, it helps us understand the assumptions economists use when they describe the Great Depression. Those who argue that federal policies during that era helped bring the United States out of the economic doldrums have to assume that policymakers, all of whom are fallible and under pressure from a variety of interest groups, were able or willing to craft sensible policy under economic and political duress. This is a tall order, even for the best-intentioned policymaker.

So, perhaps the most important lesson to take from all the competing renditions of the Great Depression story is that policymakers should follow the Hippocratic Oath: First, do no harm. And more often than not, that means avoiding the temptation to intervene and, thus, intruding on the market's self-correction mechanisms. **RF**