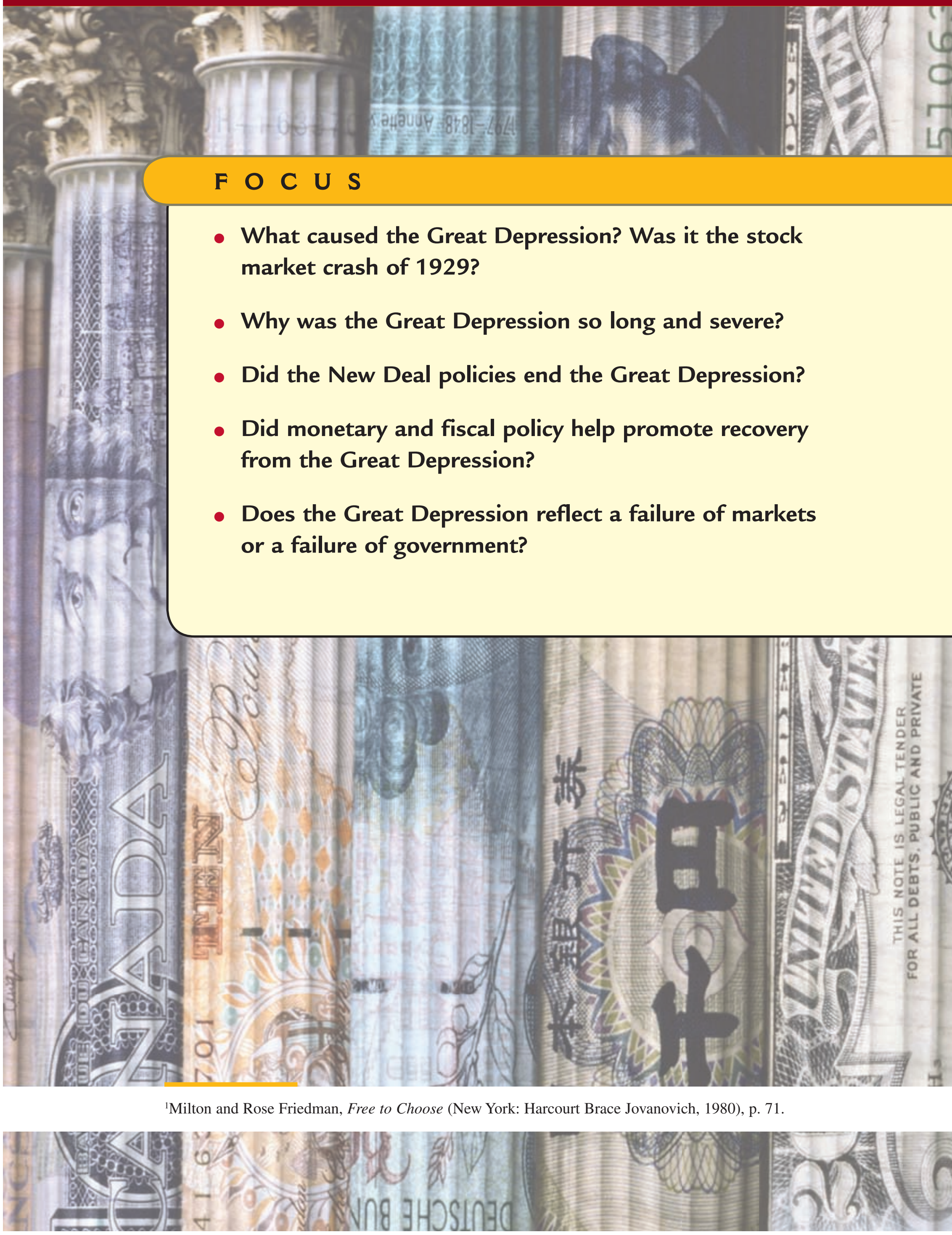
Special Note

This supplement is from *Economics: Private and Public Choice*, 13th edition (by James Gwartney, Richard Stroup, Russell Sobel, and David Macpherson (Cengage South-Western, 2010), a widely used college level principles of economics text. If you would like more information about this book, visit www.cengage.com/economics/gwartney.

SPECIAL TOPIC 6

Lessons from the Great Depression



FOCUS

- What caused the Great Depression? Was it the stock market crash of 1929?
- Why was the Great Depression so long and severe?
- Did the New Deal policies end the Great Depression?
- Did monetary and fiscal policy help promote recovery from the Great Depression?
- Does the Great Depression reflect a failure of markets or a failure of government?

We now know, as a few knew then, that the depression was not produced by a failure of private enterprise, but rather by a failure of government in an area in which the government had from the first been assigned responsibility.

—*Milton and Rose Friedman*[1]

[1]Milton and Rose Friedman, *Free to Choose* (New York: Harcourt Brace Jovanovich, 1980), p. 71.

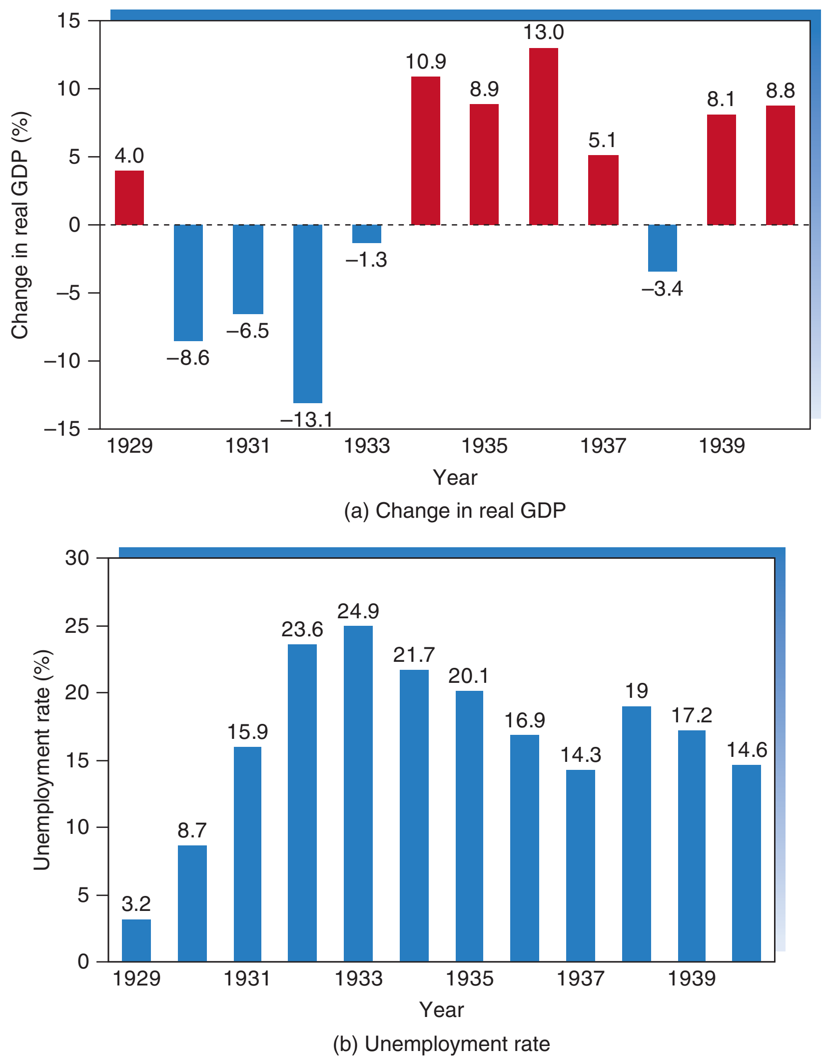
The Great Depression is perhaps the most catastrophic economic event in American history. It is also one of the most misunderstood. Misconceptions abound with regard to what actually happened. The Great Depression is a tragic story about economic illiteracy and the adverse impact of unsound policies. People who do not learn from the lessons of history are prone to repeat them. If we want to avoid similar experiences in the future, understanding of this experience and the forces underlying it is vitally important. ■

The Economic Record of the Great Depression

EXHIBIT 1 presents data on the change in real GDP and the rate of unemployment during 1929–1940. As part (a) illustrates, real GDP fell by 8.6 percent in 1930, 6.5 percent in 1931, and a whopping 13.1 percent in 1932. By 1933, real GDP was nearly a third less than that

EXHIBIT 1
Real GDP and the Rate of Unemployment, 1929–1940

The change in real GDP (part a) and rate of unemployment (part b) figures during the Great Depression are shown here. These data illustrate both the severity and length of the economic contraction. For four successive years (1930–1933), real output fell. Unemployment soared to nearly one-quarter of the workforce in 1932 and 1933. Although real output expanded and the rate of unemployment declined during 1934–1937, the economy again fell into the depths of a depression in 1938. In 1939, a decade after the economic plunge started, 17.2 percent of the labor force was still unemployed and real GDP was virtually unchanged from the level of 1929.



Sources: Real GDP growth rates for are from http://www.bea.gov The unemployment data is from the BLS at http://www.bls.gov.

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The Great Depression was a prolonged period of falling incomes, high unemployment, and difficult living conditions. The downturn that started in 1929 was different from others in American history. Why?

in 1929. There was a temporary rebound during 1934–1936, but growth slowed in 1937 and real GDP fell once again in 1938. In 1939, a full decade after the disastrous downturn started, the real GDP of the United States was virtually the same as it had been in 1929.

While output was declining during the depression era, unemployment was soaring. As Exhibit 1, part (b), shows, the rate of unemployment rose from 3.2 percent in 1929 to 8.7 percent in 1930 and 15.9 percent in 1931. During 1932 and 1933, the unemployment rate soared to nearly one-quarter of the labor force. Even though real GDP grew substantially during 1934 and 1935, the unemployment rate remained above 20 percent during both of those years. After declining to 14.3 percent in 1937, the rate of unemployment rose to 19.0 percent during the downturn of 1938, and it was still 17.2 percent in 1939, a full decade after the catastrophic era began. The unemployment rate was 14 percent or more throughout the ten years from 1931 through 1940. By way of comparison, the unemployment rate has averaged less than 6 percent during the past quarter of a century, and it has never reached 11 percent since the Great Depression. Moreover, the statistics conceal the hardship and suffering accompanying the economic disaster. It was an era of farm foreclosures, bank failures, soup kitchens, unemployment lines, and even a sharply declining birthrate. America would never quite be the same after the 1930s.

Was the Great Depression Caused by the 1929 Stock Market Crash?

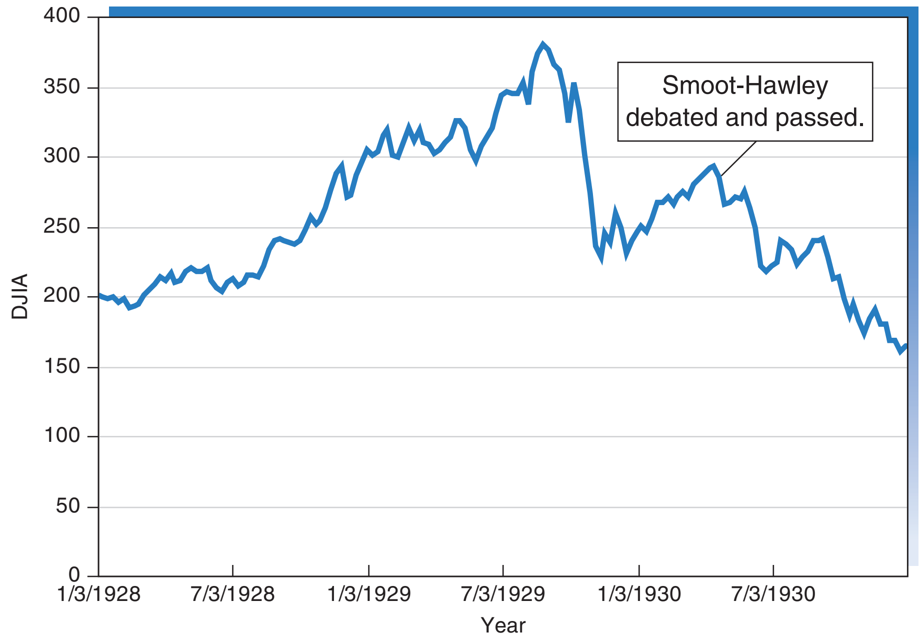
The prices of stock shares rose sharply during the 1920s. But this is not surprising because the 1920s were a remarkable decade of innovation, technological advancement, and economic growth. The production of automobiles increased more than tenfold during the 1920s. Households with electricity, telephones, and indoor plumbing spread rapidly throughout the economy. The radio was invented and developed, and it provided an amazing new vehicle for communication. Air conditioning received a boost from its use in "movie houses," as theaters were called at the time. There is good reason why the decade was known as the "roaring twenties." Perhaps more than any other era, the lives of ordinary Americans were transformed during the 1920s. To a large degree, the stock market was merely registering the remarkable growth and development of the decade.[2]

Generations of students have been told that the Great Depression was caused by the stock market crash of October 1929. Is this really true? Let's take a look at the figures.

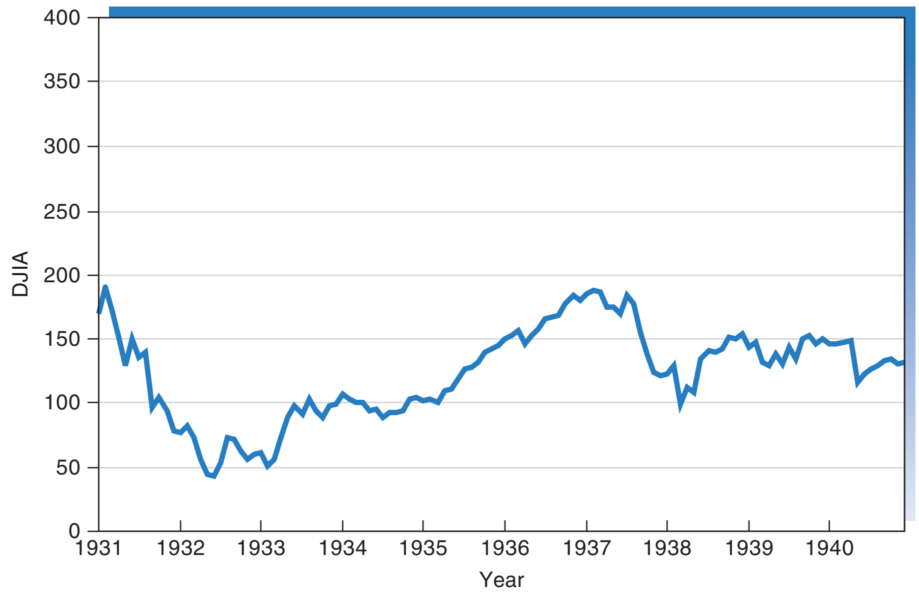
[2] Popular writers often argue that speculators drove the stock market to unsustainable highs in the late 1920s, but this view is an exaggeration. The price/earnings ratio for the Dow was 19 just prior to the crash. This places it at the upper range of normal but not at an unprecedented high. On October 9, 1929, *The Wall Street Journal* reported that railroad stocks were selling at 11.9 times earnings, which would place their P/E ratio toward the lower range of normal. RCA was the hot "high-tech" company of the era, and it earned $6.15 per share in 1927 and $15.98 per share in 1928. It traded at a high in 1928 of $420. This would imply a P/E ratio of 26, not unreasonable for a growth stock with outstanding future earning prospects.

EXHIBIT 2
The Stock Market (Dow Jones Industrial Average), 1928–1940

The figures for the Dow Jones Industrial Average are shown here. Clearly, stock prices plunged in September–October 1929, but note how they recovered during the five months from mid-November 1929 through mid-April of 1930. However, this recovery reversed as the Smoot-Hawley tariff bill was debated, passed, and eventually signed into law on June 17, 1930. As part (b) shows, the Dow continued to fall throughout 1931 and 1932 and never reached 200 throughout the remainder of the decade.



(a) Stock prices: 1928 to 1930



(b) Stock prices: 1931 to 1940

Sources: http://www.finance.yahoo.com and http://www.analyzeindices.com.

As **EXHIBIT 2**, part (a), shows, the Dow Jones Industrial Average opened in 1929 at 300, rose to a high of 381 on September 3, 1929, but gradually receded to 327 on Tuesday, October 22. A major sell-off started the following day, and the Dow began to plunge. By October 29, which is known as Black Tuesday, the Dow closed at 230. Thus, in exactly one week, the stock market lost nearly one-third of its value. A couple of weeks later on November 13, the Dow fell to an even lower level, closing at 199.

However, it is interesting to see what happened during the next five months. From mid-November 1929 through mid-April 1930, the Dow Jones Industrials increased every month, and by mid-April the index had risen to 294, regaining virtually all of the losses experienced during the late October crash. This raises an interesting question: If the

October crash caused the Great Depression, how can one explain that the stock market had regained most of those losses by April 1930?

But from mid-April throughout the rest of 1930, stock prices moved steadily downward and closed the year at 165. Apparently something happened during May–June 1930, which caused the stock market to head downward. We will return to this issue in a moment. Exhibit 2, part (b), presents data for the Dow Jones Industrials for 1931–1940. The index continued to fall in 1931–1932 and rebounded strongly in 1933 but then fluctuated between 100 and 200 for the remainder of the decade. Note the Dow stood at 131 at year-end 1940, even lower than the closing figure for 1930.

There have been several downturns in stock prices of the magnitude experienced during 1929, both before and after the Great Depression, and none of them resulted in anything like the prolonged unemployment and lengthy contraction of the 1930s. For example, the stock market price declines immediately prior to and during the recessions of 1973–1975 and 1982–1983 were as large as those of the 1929 crash, approximately 50 percent. But both of these recessions were over in about eighteen months. Moreover, in 1987, the Dow Industrials fell from 2640 on October 2 to 1740 on October 19, a decline of 34 percent. Whereas the collapse of stock prices in 1987 was similar to the October 1929 crash, that is where the similarity ends. The 1987 crash did not lead to economic disaster. In fact, it was not even followed by a recession.

Of course, the 1929 decline in stock prices reduced wealth and thereby contributed to the reduction in aggregate demand and real output. But stock prices have fallen by 50 percent or more during other recessions, and the economy nonetheless moved toward a recovery within a year or two at the most. Thus, although the decline in stock prices may well have triggered the initial economic decline, the length and severity of the Great Depression were the result of other factors. We will now consider this issue in more detail.

Why was the Great Depression so Lengthy and Severe?

The length and severity of the Great Depression were the result of bad policies. There were four major policy mistakes that caused the initial downturn to worsen and the depressed conditions to continue on and on. Let's take a closer look at each of them.

1. A SHARP REDUCTION IN THE SUPPLY OF MONEY DURING 1930–1933 AND AGAIN IN 1937–1938 REDUCED AGGREGATE DEMAND AND REAL OUTPUT. The supply of money expanded slowly but steadily throughout the 1920s. From 1921 through 1929, the money stock increased at an annual rate of 2.7 percent, approximately the economy's long-term real rate of growth. There was even a slight downward trend in the general level of prices during the decade.

In spite of this price stability, the Fed increased the discount rate, the rate it charges banks for short-term loans, four times between January 1928 and August 1929. During this twenty-month period, the discount rate was pushed from 3.5 percent to 6 percent. After the October stock market crash, the Fed aggressively sold government bonds, which drained reserves from the banking system and reduced the money supply. As **EXHIBIT 3**, part (a), shows, the money supply fell by 3.9 percent during 1930, by 15.3 percent in 1931, and by 8.9 percent in 1932. As banks failed and the money supply collapsed, the Fed did not inject new reserves into the system. Neither did it act as a lender of last resort. The quantity of money at year-end 1933 was 33 percent less than that in 1929.

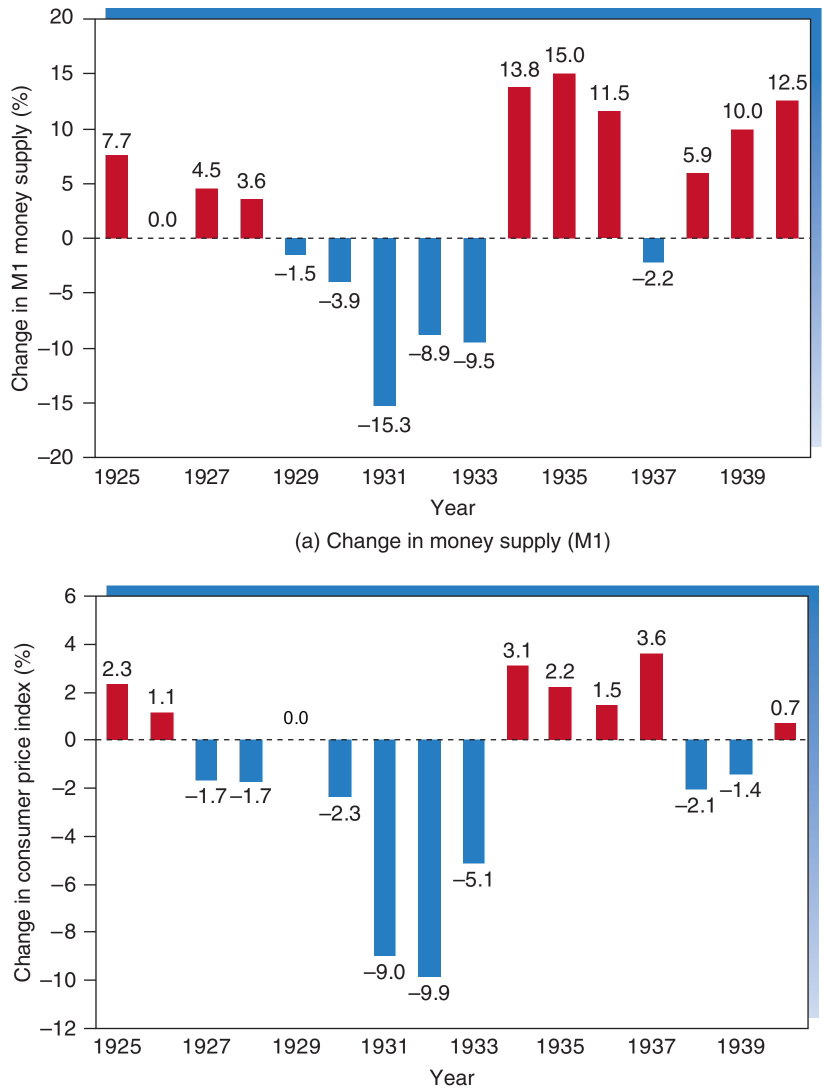
Predictably, this huge monetary contraction placed downward pressure on prices. As Exhibit 3, part (b), illustrates, the general level of prices fell by 2.3 percent in 1930, 9.0 percent in 1931, and 9.9 percent in 1932.

Economic activity takes place over time. The deflation during 1929–1933 meant that many people who bought businesses and farms in the late 1920s were unable to pay for

EXHIBIT 3

The M1 Money Supply and the Change in the General Level of Prices, 1925–1940

Note how the M1 money supply fell sharply during 1930–1933, rose during 1934–1937 but dipped again in 1938 (part a). The general level of prices followed the same pattern (part b). The sharp reduction in the supply of money and deflation during 1930–1933 changed the terms of loans, investments, and other economic activities that take place across time periods. This was a major factor underlying the initial plunge into the Great Depression. Further, the monetary contraction of 1938 stifled the recovery and contributed to still another downturn.



(a) Change in money supply (M1)

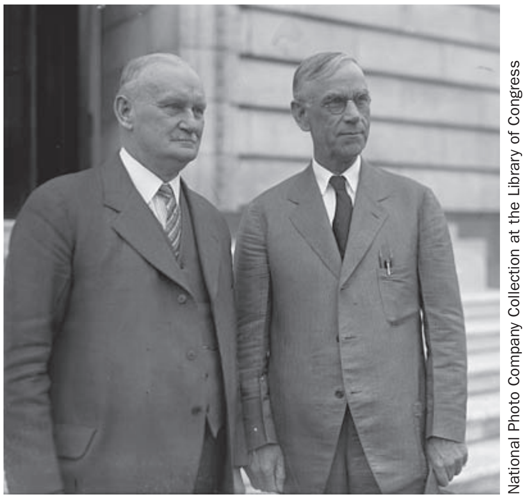
(b) Change in CPI

Sources: Change in the money supply is from December to December. The data are from Milton Friedman, and Anna J. Schwartz, A *Monetary History of the United States, 1867–1960* (Princeton: Princeton University Press, 1963); for CPI data: http://www.bls.gov.

them as the prices of their output fell during the 1930s. In essence, the monetary contraction caused unexpected changes in economic conditions. As a result, many people who undertook investments and borrowed funds suffered losses and were unable to fulfill their contracts. As the gains from trade dissipated and aggregate demand plunged, so, too, did output and employment. By 1933, real GDP was 29 percent lower than the 1929 level, and the unemployment rate had soared to nearly 25 percent.

During 1934–1937, the Fed reversed itself and expanded the supply of money. The monetary expansion halted the deflation, and the general level of prices increased. So, too, did the level of economic activity. Real GDP expanded and the unemployment rate fell during 1934–1937. But the Fed doubled the reserve requirements between August 1936 to May 1937, leading to another decline in the money supply and the general level of prices. This caused the economy to falter again and pushed the unemployment rate to almost 20 percent in 1938.

Sound monetary policy is about price stability—following a monetary policy that keeps the inflation rate low and steady. The Federal Reserve totally failed the American people during the 1930s. The severe monetary contraction led to near double-digit deflation. This was followed by a shift to monetary expansion, which generated inflation, but the Fed soon shifted again toward contraction, which caused still more deflation. Essentially, the monetary instability of the 1930s generated uncertainty and undermined the exchange process.[3]



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Senator Reed Smoot and Congressman Willis Hawley (shown here) spearheaded legislation passed in June 1930 that increased tariff rates by an average of more than 50 percent. They thought their bill would "save jobs" and promote prosperity. Instead, it did the opposite, as other nations retaliated with higher tariffs on American products and world trade fell substantially.

2. THE SMOOT–HAWLEY TRADE BILL OF 1930 INCREASED TARIFFS AND LED TO A HUGE REDUCTION IN THE VOLUME OF INTERNATIONAL TRADE. Signed into law on June 17, 1930, the Smoot–Hawley trade bill increased tariffs by more than 50 percent on approximately 3,200 imported products. Many of these tariff increases were in dollars per unit, so the subsequent deflation pushed them still higher relative to the price of the product.

Like their protectionist counterparts today, President Herbert Hoover, Senator Reed Smoot, and Congressman Willis Hawley argued that the trade restrictions would "save jobs." As Congressman Hawley put it, "I want to see American workers employed producing American goods for American consumption."[4] The proponents of the Smoot–Hawley legislation also believed the higher tariffs would bring in additional revenue for the federal government.

More than 100 years prior to the Great Depression, Adam Smith and David Ricardo explained how nations gained when they specialized in the production of goods they could supply at a low cost while trading for those they could produce only at a high cost. Trade makes it possible for both trading partners to generate a larger output and achieve a higher living standard. Moreover, a nation cannot reduce its imports without simultaneously reducing its exports. If foreigners sell less to Americans, then they will earn fewer of the dollars needed to buy from Americans. Thus, a reduction in imports will also lead to a reduction in exports. Jobs created in import competing industries will be offset by jobs lost in exporting industries. There will be no net expansion in employment. The view that import restrictions will generate a net creation of jobs is fallacious.

Having read both Smith and Ricardo, the economists of 1930 were well aware of the benefits derived from international trade and the harm generated by trade restrictions. More than a thousand of them signed an open letter to President Hoover warning of the harmful effects of Smoot–Hawley and pleading with him not to sign the legislation. He rejected their pleas, but history confirmed the validity of their warnings.

The higher tariffs did not generate additional revenue, and they certainly did not save jobs. The import restrictions harmed foreign suppliers, and predictably they retaliated. Sixty countries responded with higher tariffs on American products. By 1932, the volume of U.S. trade had fallen to less than half its earlier level. As a result, the federal government actually derived less revenue at the higher tariff rates. Tariff revenues fell from $602 million in 1929 to $328 million in 1932. Similarly, output and employment declined and the unemployment rate soared. The unemployment rate was 7.8 percent when Smoot–Hawley was passed, but it ballooned to 23.6 percent of the labor force just two years later. Moreover, the "trade war" helped spread the recessionary conditions throughout the world.

There was substantial opposition to the Smoot–Hawley bill and the Senate vote was close (44–42). Last minute changes in the rate schedules were made in order to gain the final votes needed for passage. Some businesses, seeking to gain advantage at the expense of consumers and foreign rivals, lobbied hard for the legislation. But, like the economists, other business leaders recognized that trade restrictions would harm rather than help the economy.

[3] For a comprehensive analysis of monetary policy during the Great Depression, see the chapter on the Great Contraction in Milton Friedman and Anna Schwartz, *A Monetary History of the United States, 1867–1960* (New York: National Bureau of Economic Research, 1963; ninth paperback printing by Princeton University Press, 1993): 411–15.

[4] Frank Whitson Fetter, "Congressional Tariff Theory," *American Economic Review* 23, no. 3 (September 1933): 413–27.

As we previously discussed, stock prices had increased for five straight months following the November 1929 lows, and by mid-April of 1930, the Dow Jones Industrials had returned to the level just prior to the October 1929 crash (see Exhibit 2). But as the Smoot–Hawley bill moved through Congress and its prospects for passage improved, stock prices moved steadily downward. In fact, the reduction in stock prices following the debate and passage of Smoot–Hawley was even greater than that of the 1929 October crash. By year-end 1930, recovery was nowhere in sight, and the Dow Jones Industrial index had fallen to 165, down from 294 in mid-April.

The combination of highly restrictive monetary policy and the Smoot–Hawley trade restrictions were enough to push the economy over the cliff, but Congress and the president were not through.

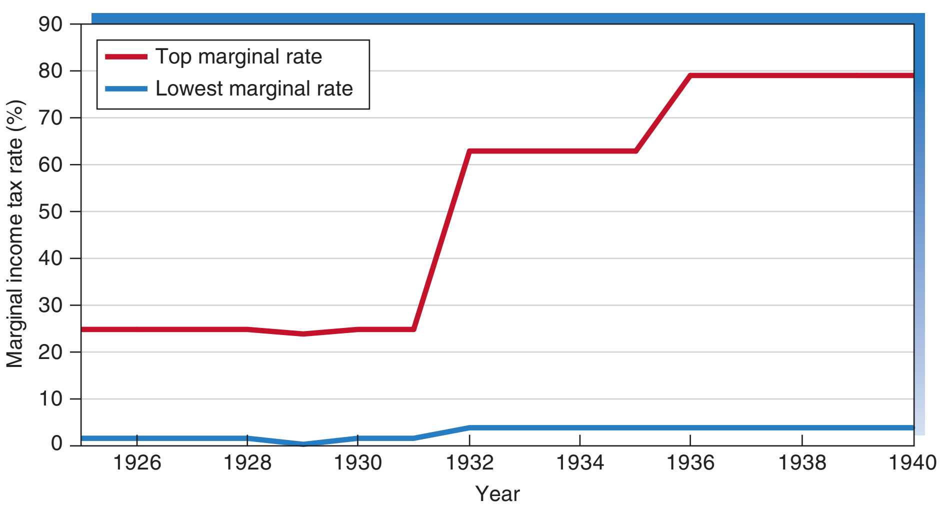
3. A LARGE TAX INCREASE IN THE MIDST OF A SEVERE RECESSION MADE A BAD SITUATION WORSE. Prior to the Keynesian revolution, the dominant view was that the federal budget should be balanced. Reflecting the ongoing economic downturn, the federal budget ran a deficit in 1931, and an even larger deficit was shaping up for 1932. Assisted by the newly elected Democratic majority in the House of Representatives, the Republican Hoover administration passed the largest peacetime tax rate increase in the history of the United States. As **EXHIBIT 4** indicates, the lowest marginal tax rate on personal income was raised from 1.5 percent to 4 percent in 1932. At the top of the income scale, the highest marginal tax rate was raised from 25 percent to 63 percent. Essentially, personal income tax rates were increased at all levels by approximately 150 percent in one year! This huge tax increase reduced both the after-tax income of households and the incentive to earn and invest.

Fiscal policy analysis indicates that a tax increase of this magnitude in the midst of a severe downturn will be disastrous. Review of Exhibit 1 shows that this was indeed the case. In 1932, real output fell by 13 percent, the largest single-year decline during the Great Depression era. Unemployment rose from 15.9 percent in 1931 to 23.6 percent in 1932.

In 1936, the Roosevelt administration increased taxes again, pushing the top marginal rate to 79 percent. Thus, during the latter half of the 1930s, high earners were permitted to keep only 21 cents of each additional dollar they earned. Moreover, the 1936 tax legislation also imposed a special tax on the retained earnings of corporations, a major source of funds for business investment. These 1936 tax increases further reduced both income levels and the incentive to earn and invest, prolonging the Great Depression and increasing its severity.

EXHIBIT 4
Marginal Income Tax Rates, 1925–1940

The lowest and highest marginal tax rates imposed on personal income are shown here for the period prior to, and during, the Great Depression. Note how the top marginal rate was increased from 25 percent in 1931 to 63 percent in 1932. Real GDP fell by 13.3 percent in 1932, and the unemployment rate soared to nearly a quarter of the labor force (see Exhibit 1). In 1935, the top rate was pushed still higher to 79 percent.



Sources: The Tax Foundation, http://www.taxfoundation.org; and the IRS at http://www.irs.gov.

4. PRICE CONTROLS, ANTICOMPETITIVE POLICIES, AND CONSTANT STRUCTURAL CHANGES DURING THE ROOSEVELT ADMINISTRATION GENERATED UNCERTAINTY AND UNDERMINED MARKETS. President Roosevelt was elected in 1932, and many history books still credit his New Deal policies with bringing the Great Depression to an end. Numerous policy changes were instituted during the Roosevelt years, and some of them were helpful. In 1933, President Roosevelt re-valued the price of gold from $20 per ounce to $35 per ounce, and this contributed to the expansion in the money supply during the years immediately following. The Roosevelt administration also passed the Federal Deposit Insurance program, which provided depositors with protection against bank failures and reduced the occurrence of "bank runs."

Franklin D. Roosevelt Library, courtesy of the National Archives and Records Administration

The Agricultural Adjustment Act of 1933 sought to increase the prices of farm products by reducing their supply. Under this Act, six million baby pigs were slaughtered in 1933. Did this help bring the Great Depression to an end?

However, it is equally clear that many of the major initiatives of the Roosevelt administration were counterproductive and prolonged the Great Depression. Roosevelt perceived that falling prices were a problem, but he failed to recognize that this was because of the monetary contraction. Instead, he tried to keep product prices high by reducing their supply. Under the Agricultural Adjustment Act (AAA) passed in 1933, farmers were paid to plow under portions of their cotton, corn, wheat, and other crops. Potato farmers were paid to spray their potatoes with dye so that they would be unfit for human consumption. Healthy cattle, sheep, and pigs were slaughtered and buried in mass graves in order to keep them off the market. In 1933 alone, six million baby pigs were killed under the Roosevelt agricultural policy. The Supreme Court declared the AAA unconstitutional in 1936, but not before it had kept millions of dollars of agricultural products from American consumers.

The National Industrial Recovery Act (NIRA) was another New Deal effort to keep prices high. Under this legislation passed in June 1933, more than 500 industries ranging from automobiles and steel to dog food and dry cleaners were organized into **cartels**. Business representatives from each industry were invited to Washington to work with NIRA officials to set production quotas, prices, wages, working hours, distribution methods, and other mandates for their industry. Once approved by a majority of the firms, the regulations were legally binding, and they applied to all businesses in the industry, regardless of whether they approved or participated in their development. Firms that did not comply were fined and, in some cases, owners were even thrown in jail. A tax was levied on all firms in these industries in order to cover the administrative cost of the Act. Prior to the NIRA, collusive behavior of this type would have been prosecuted as a violation of antitrust laws, but with the NIRA, the government itself provided the organizational structure for the cartels and prosecuted firms that dared to reduce prices or failed to comply with other regulations. Clearly, the NIRA reduced competition, promoted monopoly pricing, and undermined the market process.

Cartel

An organization of sellers designed to coordinate supply and price decisions so that the joint profits of the members will be maximized. A cartel will seek to create a monopoly in the market for its product.

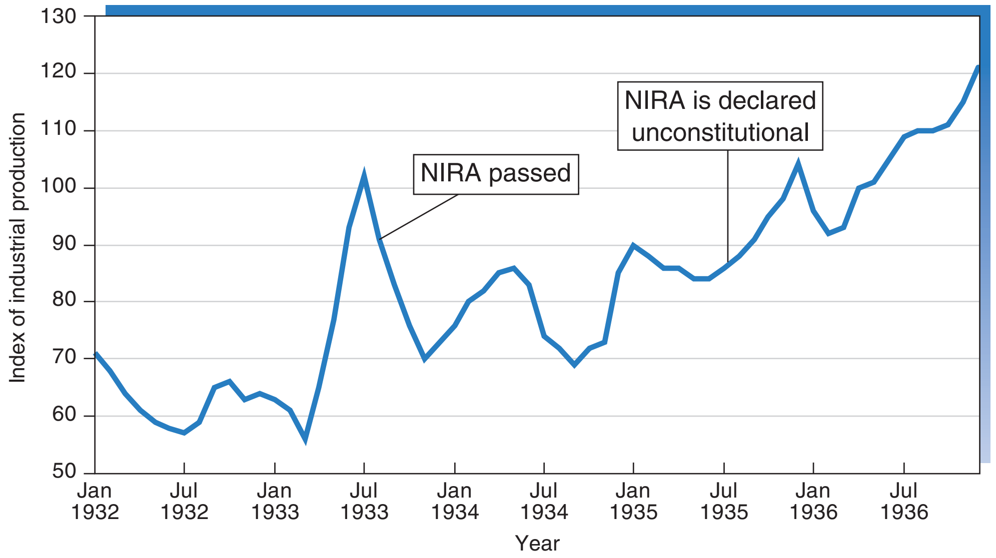
EXHIBIT 5 tracks industrial output prior to, and during, the NIRA's existence. Interestingly, a recovery had started during the first half of 1933. Industrial output increased sharply and factory employment expanded by 25 percent during the four months before the NIRA took affect. But, as the Act was implemented in July 1933, industrial output began to decline precipitously. By the end of 1933, output had fallen by more than 25 percent from its mid-summer high. There were some ups and downs during the next year, but industrial output never returned to its pre-NIRA level until after the Supreme Court in a 9-0 vote declared the Act unconstitutional in May 1935.[5]

The AAA and NIRA were just part of the persistent policy change during the Roosevelt years. The Wagner Act took labor law out of the courts and assigned it to a new regulatory commission, the National Labor Relations Board. Pro-union appointments to

[5]For additional details on the impact of the NRA, see Chapter 4 of the recent book by historian Burton Folsom, *New Deal or Raw Deal* (New York: Simon & Schuster, 2008).

EXHIBIT 5
The NIRA and Industrial Production, 1932–1936

The change in industrial production prior to and following the passage of the National Industrial Recovery Act (NIRA) is shown here. Note how industrial output increased sharply during April–July 1933. However, when the implementation of the NIRA began in July, industrial output fell by more than 25 percent over the next six months. It never reached the June 1933 level again until after the Act was declared unconstitutional in May 1935.



Source: Historical Statistics of the United States. The base period (equal to 100) was the average of the monthly figures during 1923–1925.

this new board dramatically changed collective bargaining and led to a sharp increase in unionization. The Works Progress Administration (WPA) and Civilian Conservation Corps (CCC) vastly expanded government employment. The Davis–Bacon Act required government contractors to employ higher wage union workers, which, in effect, reduced the employment opportunities of minorities and those with fewer skills. Unprecedented high marginal tax rates, establishment of a minimum wage, pay-as-you-go Social Security, and several other programs changed the structure of the U.S. economy.

This persistent introduction of massive new programs and regulations created what Robert Higgs calls "regime uncertainty," the situation in which people are reluctant to undertake business ventures and investments because the government is constantly changing the "rules."[6] Against this background, business planning was undermined and private investment came to a virtual standstill. Roosevelt's Treasury Secretary Henry Morgenthau tried to get the president to make a public statement to reassure investors and the business community. He was unsuccessful. Lammont duPont highlighted the uncertainty generated by the constant whirlwind of New Deal policy changes when he stated:

> *Uncertainty rules the tax situation, the labor situation, the monetary situation, and practically every legal condition under which industry must operate. Are taxes to go higher, lower or stay where they are? We don't know. Is labor to be union or non-union? Are we to have inflation or deflation, more government spending or less? Are new restrictions to be placed on capital, new limits on profits? It is impossible to even guess at the answers.*[7]

[6]Robert Higgs, "Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed After the War," *The Independent Review* 1, no. 4 (Spring 1997).

[7]Quoted in Herman E. Krooss, *Executive Opinion: What Business Leaders Said and Thought on Economic Issues, 1920s–1960s* (Garden City, NY: Doubleday and Co., 1970), 200.

Did the New Deal policies bring the Great Depression to an end?[8] Through the years, many students have been taught that this was the case. It is difficult to see how anyone could objectively review the data and accept this proposition. Prior to the Great Depression, recessions lasted only one or two years, three years at the most, and recovery pushed income to new highs. The Great Depression was different. In 1933, the monetary contraction was reversed, and there was evidence of a private sector recovery. But the NIRA, AAA, and 1936 tax increases dampened productive activity, and the second monetary contraction pushed the economy into another recession within the depression. In 1938, per capita real GDP of the United States was still below the level of 1929, and the rate of unemployment was 19 percent. In 1939, seven years after the beginning of the New Deal, 17 percent of the labor force was still unemployed. The Great Depression was eventually diminished by the increase in demand for military goods of the English and Russians and our own military buildup prior to World War II.[9]

Fiscal Policy During the Great Depression

What happened to fiscal policy during the Great Depression? This was, of course, prior to the Keynesian revolution, and the view that the government should balance its budget, except perhaps during wartime, was widely accepted. **EXHIBIT 6**, part (a), presents the data for government spending as a share of GDP. The size of the government was much smaller as a share of the economy during this era. Total government spending (federal, state, and local) increased from 8 percent of GDP in 1929 to 16 percent in 1933. To a large degree, however, this increase reflected the maintenance of nominal government expenditures during a period of deflation and declining GDP. After 1933, total government spending as a share of GDP remained in the 15 percent to 16 percent range for the rest of the decade, except during 1937, when the ratio fell to 13 percent.

Exhibit 6, part (b), provides the figures for the federal deficit. The budget was in surplus during both 1929 and 1930. After that, the deficit was generally around 2 percent of GDP, except during 1934 and 1936, and in 1937 when a small surplus was present. Measured as a share of the economy, the increases in government spending and federal deficits during the 1930s were relatively small. Thus, there is little reason to believe that fiscal policy exerted much impact on the economy. Certainly, there is no reason to believe that spending increases and budget deficits were a significant source of fiscal stimulus during the era.

Lessons from the Great Depression

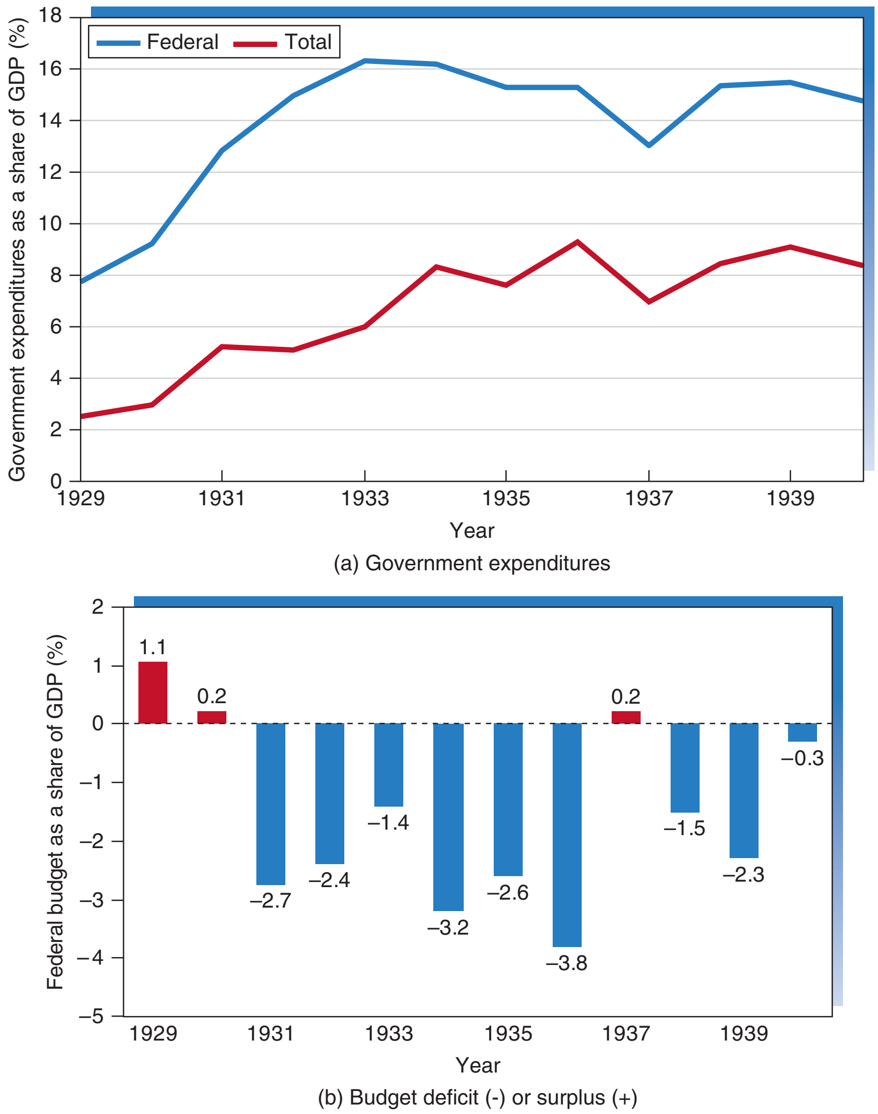
The Great Depression provides several lessons that can help us avoid severe downturns in the future. First, the Great Depression clearly indicates that a prolonged period of monetary contraction will undermine time–dimension economic activity and exert disastrous effects

[8]For additional details on the Great Depression, see Gene Smiley, *Rethinking the Great Depression* (Ivan R. Dee, Chicago, IL 2002); Robert J. Samuelson, "Great Depression," in *The Fortune Encyclopedia of Economics*, ed., David R. Henderson (New York: Warner Books, 1993), available online at http://www.econlib.org; Burton Folsom, *New Deal or Raw Deal?* (New York: Simon & Schuster, 2008); and Amity Shlaes, *The Forgotten Man: A New History of the Great Depression* (New York: HarperCollins Publishers, 2007).

[9]Many argue that the spending increases and large budget deficits of World War II provided sufficient demand stimulus to direct the economy back to full employment and solid growth. Robert Higgs challenges this view. Higgs notes that with 12 million young Americans drafted during the war, this would obviously reduce the unemployment rate to a low level. However, the growth of real GDP is more debatable because almost half of measured output was government spending, and it was added to GDP at cost. Moreover, the income of households was overstated because many goods they would have purchased were unavailable as a result of the price controls. The sharp decline in GDP following the war and the lifting of price controls also imply that the growth of GDP during the war was overstated. Thus, Higgs does not believe that real recovery from the Great Depression occurred until 1946. See Robert Higgs, "Depression, War, and Cold War: Studies in Political Economy" (New York: Oxford University Press), 2006.

EXHIBIT 6
Government Expenditures and Federal Budget Deficits as a Share of GDP, 1929–1940

Measured as a share of the economy, government spending increased during the 1930s, and the federal government generally ran a budget deficit. However, given the depth of the economic decline, the deficits were too small to provide much fiscal stimulus during this era.



Source: http://www.bea.gov.

on the economy. We seemed to have learned this lesson well. As the severity of the 2008 downturn increased, the Fed injected abundant reserves into the banking system and shifted to a highly expansionary monetary policy. However, it is also true that Fed policy during 2002–2006 contributed to the housing boom and bust and, thereby, the Crisis of 2008. Monetary and price stability is crucially important for the smooth operation of markets. The Great Depression, along with experience since that era, vividly illustrates the importance of monetary stability.

Second, the Great Depression illustrates the fallacy of the "trade restrictions will promote domestic industry" argument. Policies that reduce imports will simultaneously reduce exports. Foreigners will not have the dollars to purchase as much from us if they sell less to us. Trade restrictions will not save jobs. Instead, they will shift employment from sectors in which we are a low-cost producer to those in which we are a high-cost producer. The results are fewer gains from trade, a smaller output, and lower income levels. Both economic theory and the experience of the Smoot–Hawley trade restrictions are consistent with this view.

Third, raising taxes in the midst of a severe recession is a bad idea. Pushing taxes to exceedingly high rates is a recipe for disaster. All of the major macroeconomic theories—Keynesian, new classical, and supply side—indicate that tax increases will be counterproductive during a severe downturn. The experience with the tax increases during the Great Depression ref-enforces these views.

Fourth, the political incentive structure during a severe downturn is likely to encourage politicians to "do something." Even bad policies are likely to be popular, at least for a while. A better strategy would be the oath of the medical profession, "do no harm." The constant policy changes under both Hoover and Roosevelt created uncertainty and froze private sector investment and business activity. Everyone waited to see what the next new policy regime would be; and, as they did so, the depressed conditions were prolonged.

The experience of the 1930s highlights the importance of economic literacy. The decade-long catastrophic decline did not have to happen. It was the result of wrong-headed policies based on the economic illiteracy of both voters and policy makers.

Finally, as we noted in Chapter 1, good intentions are no substitute for sound policy. The Great Depression vividly illustrates this point. There is every reason to believe that Presidents Hoover and Roosevelt, Senator Smoot, Congressman Hawley, other members of Congress, and the monetary policy makers of the 1930s had good intentions. But, it is equally clear that their actions tragically turned what would have been a normal business cycle downturn into a decade of hardship and suffering. The good intentions of political decision makers do not protect the general citizenry from the adverse consequences of unsound policies. This was true during the Great Depression, and it is still true today. If we do not learn from the adverse experiences of history, we are likely to repeat them.

KEY POINTS

- The Great Depression was a severe economic plunge that resulted in unemployment rates of nearly 25 percent during 1932–1933 and rates of more than 14 percent for an entire decade. It was the longest, most severe period of depressed economic conditions in American history.
- Contrary to a popular view, the Great Depression was not caused by the 1929 stock market crash. We have had similar reductions in stock prices to those of 1929, both before and after the Great Depression, without experiencing prolonged depressed conditions like those of the 1930s.
- There were four major reasons why the Great Depression was long and severe:
    1. Monetary instability:The money supply contracted by 33 percent between 1929 and 1933, and it took another tumble during 1937–1938.
    2. Smoot-Hawley trade bill: This 1930 legislation increased tariffs by more than 50 percent and led to a sharp reduction in world trade.
    3. 1932 tax increase: This huge tax increase reduced demand and undermined the incentive to invest and produce.
    4. Structural policy changes: Persistent major changes, particuarly during the Roosevelt years, generated uncertainty and undermined investment and business planning.
- The budget deficits and increases in government spending were too small to exert much impact on total demand and the level of economic activity during the 1930s.
- The Great Depression highlights the importance of monetary stability; free trade; avoidance of high tax rates; and avoidance of price controls, entry restraints, and persistent policy changes that generate uncertainty and undermine the security of property rights. Perhaps most important, the Great Depression vividly illustrates that good intentions are not a substitute for sound economic policy.

CRITICAL ANALYSIS QUESTIONS

1. "The Great Depression was caused by the 1929 stock market crash. The 1929 collapse of stock prices was the most severe in U.S. history, and therefore it is not surprising that it caused a prolonged period of economic hardship." Evaluate this statement.

2. Do the length and severity of the Great Depression reflect a defect in the operation of markets? Do they reflect a failure of government policy? Discuss.

3. "Franklin Roosevelt is recognized as one of our greatest presidents because his New Deal policies brought the Great Depression to an end." Evaluate this statement.

4. Could the United States ever experience another Great Depression? Why or why not?

*__5.__ "I'm for international trade, but not when it takes jobs from Americans. If the American worker can produce the product, Americans should not buy it from foreigners." Do you agree with this statement? Why or why not?

6. What are the most important lessons Americans should learn from the Great Depression? Do you think we have learned them? Why or why not?

*Asterisk denotes questions for which answers are given in Appendix B.