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Great Depression

by Gene Smiley

About the Author

A worldwide depression struck countries with market economies at the end of the 1920s. Although the Great Depression was relatively mild in some countries, it was severe in others, particularly in the United States, where, at its nadir in 1933, 25 percent of all workers and 37 percent of all nonfarm workers were completely out of work. Some people starved; many others lost their farms and homes. Homeless vagabonds sneaked aboard the freight trains that crossed the nation. Dispossessed cotton farmers, the "Okies," stuffed their possessions into dilapidated Model Ts and migrated to California in the false hope that the posters about plentiful jobs were true. Although the U.S. economy began to recover in the second quarter of 1933, the recovery largely stalled for most of 1934 and 1935. A more vigorous recovery commenced in late 1935 and continued into 1937, when a new depression occurred. The American economy had yet to fully recover from the Great Depression when the United States was drawn into World War II in December 1941. Because of this agonizingly slow recovery, the entire decade of the 1930s in the United States is often referred to as the Great Depression.

The Great Depression is often called a "defining moment" in the twentieth-century history of the United States. Its most lasting effect was a transformation of the role of the federal government in the economy. The long contraction and painfully slow recovery led many in the American POPULATION to accept and even call for a vastly expanded role for government, though most businesses resented the growing federal control of their activities. The federal government took over responsibility for the elderly population with the creation of SOCIAL SECURITY and gave the involuntarily unemployed UNEMPLOYMENT compensation. The Wagner Act dramatically changed labor negotiations between employers and employees by promoting unions and acting as an arbiter to ensure "fair" labor contract negotiations. All of this required an increase in the size of the federal government. During the 1920s, there were, on average, about 553,000 paid civilian employees of the federal government. By 1939 there were 953,891 paid civilian employees, and there were 1,042,420 in 1940. In 1928 and 1929, federal receipts on the administrative budget (the administrative budget excludes any amounts received for or spent from trust funds and any amounts borrowed or used to pay down the debt) averaged 3.80 percent of GNP while expenditures averaged 3.04 percent of GNP. In 1939, federal receipts were 5.50 percent of GNP, while federal expenditures had tripled to 9.77 percent of GNP. These figures provide an indication of the vast expansion of the federal government's role during the depressed 1930s.

The Great Depression also changed economic thinking. Because many economists and others blamed the depression on inadequate demand, the Keynesian view that

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government could and should stabilize demand to prevent future depressions became the dominant view in the economics profession for at least the next forty years. Although an increasing number of economists have come to doubt this view, the general public still accepts it.

Interestingly, given the importance of the Great Depression in the development of economic thinking and economic policy, economists do not completely agree on what caused it. Recent research by Peter Temin, Barry Eichengreen, David Glasner, Ben Bernanke, and others has led to an emerging consensus on why the contraction began in 1928 and 1929. There is less agreement on why the contraction phase was longer and more severe in some countries and why the depression lasted so long in some countries, particularly the United States.

The Great Depression that began at the end of the 1920s was a worldwide phenomenon. By 1928, Germany, Brazil, and the economies of Southeast Asia were depressed. By early 1929, the economies of Poland, Argentina, and Canada were contracting, and the U.S. economy followed in the middle of 1929. As Temin, Eichengreen, and others have shown, the larger factor that tied these countries together was the international GOLD STANDARD.

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By 1914, most developed countries had adopted the gold standard with a fixed exchange rate between the national currency and gold—and therefore between national currencies. In World War I, European nations went off the gold standard to print money, and the resulting price INFLATION drove large amounts of the world's gold to banks in the United States. The United States remained on the gold standard without altering the gold value of the dollar. Investors and others who held gold sent their gold to the United States, where gold maintained its value as a safe and sound INVESTMENT. At the end of World War I, a few countries, most notably the United States, continued on the gold standard while others temporarily adopted floating exchange rates. The world's international finance center had shifted from London to New York City, and the British were anxious to regain their old status. Some countries pledged to return to the gold standard with devalued currencies, while others followed the British lead and aimed to return to gold at prewar exchange rates.

This was not possible, however. Too much money had been created during the war to allow a return to the gold standard without either large currency devaluations or price deflations. In addition, the U.S. gold stock had doubled to about 40 percent of the world's monetary gold. There simply was not enough monetary gold in the rest of the world to support the countries' currencies at the existing exchange rates. As a result, the leading nations established a gold exchange system whereby the governments of the United States and Great Britain would be willing, at all times, to redeem the dollar and the pound for gold, and other countries would hold much of their international reserves in British pounds or U.S. dollars.

The demand for gold increased as countries returned to the gold standard. Because the franc was undervalued when France returned to the gold standard in June 1928, France began to receive gold inflows. The undervalued franc made French exports less expensive in foreign countries' currencies and made foreign imports into France more expensive in francs. As French exports rose and French imports fell, their international accounts were balanced by gold shipped to France. France's government, contrary to the tenets of the gold standard, did not use these inflows to expand its MONEY SUPPLY. In 1928, the FEDERAL RESERVE SYSTEM raised its discount rate—that is, the rate it charged on loans to member banks—in order to raise INTEREST RATES in the United States, which would stem the outflow of American gold and dampen the booming STOCK MARKET. As a result, the United States began to receive shipments of gold. By 1929, as countries around the world lost gold to France and the United States, these countries' governments initiated deflationary policies to stem their gold outflows and remain on the gold standard. These deflationary policies were designed to restrict economic activity and reduce price levels, and that is exactly what they did. Thus began the worldwide Great Depression.

The onset of the contraction led to the end of the stockmarket boom and the crash in late October 1929. However, the stock market collapse did not cause the depression; nor can it explain the extraordinary length and depth of the American contraction. In most countries, such as Britain, France, Canada, the Netherlands, and the Nordic countries, the depression was less severe and shorter, often ending by 1931. Those countries did not have the banking and financial crises that the United States did, and most left the gold standard earlier than the United States did. In the United States, in contrast, the contraction continued for four years from the summer of 1929 through the first quarter of 1933. During that time real GNP fell 30.5 percent, wholesale prices fell 30.8 percent, and consumer prices fell 24.4 percent.

In previous depressions, wage rates typically fell 9-10 percent during a one- to two-year contraction; these falling wages made it possible for more workers than otherwise to keep their jobs. However, in the Great Depression, manufacturing firms kept wage rates nearly constant into 1931, something commentators considered quite unusual. With falling prices and constant wage rates, real hourly wages rose sharply in 1930 and 1931. Though some spreading of work did occur, firms primarily laid off workers. As a result, unemployment began to soar amid plummeting production, particularly in the durable manufacturing sector, where production fell 36 percent between the end of 1929 and the end of 1930 and then fell another 36 percent between the end of 1930 and the end of 1931.

Why had wages not fallen as they had in previous contractions? One reason was that President Herbert Hoover prevented them from falling. (See HOOVER'S ECONOMIC POLICIES.) He had been appalled by the wage rate cuts in the 1920-1921 depression and had preached a “high wage” policy throughout the 1920s. By the late 1920s, many business and labor leaders and academic economists believed that policies to keep wage rates high would maintain workers’ level of purchasing, providing the “steadier” markets necessary to thwart economic contractions. When President Hoover organized conferences in December 1929 to urge business, industrial, and labor leaders to hold the line on wage rates and dividends, he found a willing audience. The highly protective Smoot-Hawley Tariff, passed in mid-1930, was supposed to provide protection from lower-cost imports for firms that maintained wage rates. Thus, it was not until well into 1931 that the steadily deteriorating business conditions led the boards of directors of a number of larger firms to begin significant wage rate cuts, often over the protest of the firms’ top executives, who had pledged to maintain wage rates.

The Smoot-Hawley Tariff was another piece of Hoover’s strategy. Though there was not a general call for tariff increases, Hoover proposed it in 1929 as a means of aiding farmers. He quickly lost control of the bill and it ended up protecting American businesses in general with much less real protection for farmers. Many of the tariff increases in the Smoot-Hawley Tariff were quite large; for example, the tariff on Canadian hard winter wheat rose 40 percent, and that on scientific glass instruments rose from 65 percent to 85 percent. Overall on dutiable imports the tariff rate rose from 40.1 percent to 53.21 percent. There was some explicit retaliation for the American tariff increases such as Spain’s Wais Tariff. Some other countries’ planned tariff increases were encouraged and probably expedited by the action of the United States.

Firms also heeded Hoover’s call to let the contraction fall on PROFITS rather than on dividends. Dividends in 1930 were almost as large as in 1929, but undistributed corporate profits plummeted from $2.8 billion in 1929 to −$2.6 billion in 1930. (These numbers may sound small, but compared with the 1929 U.S. GNP of $103.1 billion, they were substantial.) The value of firms’ securities fell sharply, leading to a significant deterioration in the portfolios of banks. As conditions worsened and banks’ losses increased, BANK RUNS and bank failures increased. The first major bank runs and failures occurred in the Southeast in

November 1930; these were followed by more runs and failures in December. There was another flurry of bank runs and bank failures in the late spring and early summer of 1931. After Great Britain left the gold standard in September 1931, the Federal Reserve System initiated relatively large increases in the discount rate to stem the gold outflow. Overseas investors in nations still on the gold standard expected the United States to either devalue the dollar or go off the gold standard as Great Britain had done. The result would be that the dollars they held, or their dollar-denominated securities, would be worth less. To prevent this they sold dollars to obtain gold from the United States. The Fed's policy moves gave overseas investors confidence that the United States would honor its gold commitment. The rise in American interest rates also made it more costly to sell American assets for dollars to redeem in gold. The resulting rise in interest rates caused not only more business failures, but also a sharp rise in bank failures. In the late spring and early summer of 1932, the Federal Reserve System finally undertook open market purchases, bringing some signs of relief and possible recovery to the beleaguered American economy.

Hoover's **FISCAL POLICY** accelerated the decline. In December 1929, as a means of demonstrating the administration's faith in the economy, Hoover had reduced all 1929 income tax rates by 1 percent because of the continuing budget surpluses. By 1930 the surplus had turned into a deficit that grew rapidly as the economy contracted. By the end of 1931 Hoover had decided to recommend a large tax increase in an attempt to balance the budget; Congress approved the tax increase in 1932. Personal exemptions were reduced sharply to increase the number of taxpayers, and rates were sharply increased. The lowest marginal rate rose from 1.125 percent to 4.0 percent, and the top marginal rate rose from 25 percent on taxable income in excess of $100,000 to 63 percent on taxable income in excess of $1 million as the rates were made much more progressive. We now understand that such a huge tax increase does not promote recovery during a contraction. By reducing households' disposable income, it led to a reduction in household spending and a further contraction in economic activity.

The Fed's expansionary **MONETARY POLICY** ended in the early summer of 1932. After his election in November 1932, President-elect Roosevelt refused to outline his policies or endorse Hoover's, and he refused to deny that he would devalue the dollar against gold after he took office in March 1933. Bank runs and bank failures resumed with a vengeance, and American dollars began to be redeemed for gold as the gold outflow resumed. As financial conditions worsened in January and February 1933, state governments began declaring banking holidays, closing down states' entire financial sectors. Roosevelt's national banking holiday stopped the runs and banking failures and finally ended the contraction.

Between 1929 and 1933, 10,763 of the 24,970 commercial banks in the United States failed. As the public increasingly held more currency and fewer deposits, and as banks built up their excess reserves, the money supply fell 30.9 percent from its 1929 level. Though the Federal Reserve System did increase bank reserves, the increases were far too small to stop the fall in the money supply. As businesses saw their lines of credit and money reserves fall with bank closings, and consumers saw their bank deposit wealth tied up in drawn-out **BANKRUPTCY** proceedings, spending fell, worsening the collapse in the Great Depression.

The national banking holiday ended the protracted banking crisis, began to restore the public's confidence in banks and the economy, and initiated a recovery from April through September 1933. President Roosevelt came into office proposing a New Deal for Americans, but his advisers believed, mistakenly, that excessive **COMPETITION** had led to overproduction, causing the depression. The centerpieces of the New Deal were the Agricultural Adjustment Act (AAA) and the National Recovery Administration (NRA), both of which were aimed at reducing production and raising wages and prices. Reduced production, of course, is what happens in depressions, and it never made sense to try to get the country out of depression by reduc ing production further. In its zeal, the administration apparently did not consider the elementary impossibility of raising *all* real wage rates and *all* real prices.

The AAA immediately set out to slaughter six million baby pigs and reduce breeding sows to reduce pork production and raise prices. Since cotton plantings were thought to be excessive, cotton farmers were paid to plow under one-quarter of the forty million acres of cotton to reduce marketed production to boost prices. Most of the payments went to the landowners, not the tenants, making conditions desperate for tenant farmers. Though landowners were supposed to share the payments with their tenant farmers, they were not legally obligated to do so and most did not. As a result, tenant farmers, and especially black tenants, who were more easily discriminated against, received none of the payments and less or no income from cotton production after large portions of the crop were plowed under. Where persuasion was ineffective in inducing the many independent farmers to reduce production, the federal government intended to mandate production cutbacks and purchase the product to take it off the market and raise prices.

The NRA was a vast experiment in cartelizing American industry. Code authorities in each industry were set up to determine production and investment, as well as to standardize firm practices and costs. The entire apparatus was aimed at raising prices and reducing, not increasing, production and investment. As the NRA codes began to take effect in the fall of 1933, they had precisely that effect. The recovery that had seemed so promising in the summer largely stopped, and there was little increase in economic activity from the fall of 1933 through midsummer 1935. Enforcement of the codes was sporadic, disagreement over the codes increased, and, in smaller, more competitive industries, fewer firms adhered to the codes. The Supreme Court ruled the NRA unconstitutional on May 27, 1935, and the AAA unconstitutional on January 6, 1936. Released from the shackles of the NRA, American industry began to expand production. By the fall of 1935 a vigorous recovery was under way.

The introduction of the NRA had initially brought about a sharp increase in money and real wage rates as firms attempted to comply with the NRA's blanket code. As firms' enthusiasm for the NRA waned, money wage rates increased little and real average wage rates actually fell slightly in 1934 and early 1935. In addition, many workers decided not to join independent LABOR UNIONS. These factors helped the recovery. Unhappy with the lack of union power, however, Senator Robert Wagner, in the summer of 1935, authored the National Labor Relations Act to ensure that union members could force other workers to join their unions with a simple majority vote, thus effectively monopolizing the labor force. Internal dissension and the new Congress of Industrial Organizations' (CIO) development of strategies to use the new law kept labor unions from taking advantage of the new act until late in 1936. In the first half of 1937, the CIO's massive organizing drives led to labor union recognition at many large firms. Generally, the new contracts raised hourly wage rates and created overtime wage rates as real hourly labor costs surged.

Several other factors also pushed up real labor costs. One factor was the new Social Security taxes instituted in 1936 and 1937. Also, Roosevelt had pushed through a new tax on undistributed corporate profits, expecting this to cause firms to pay out undistributed profits in dividends. Though some firms did pay out part of the retained earnings in larger dividends, others, such as the firms in the steel industry, also paid bonuses and raised wage rates to avoid paying their retained earnings in new taxes. As these three policies came together, real hourly labor costs jumped without corresponding increases in demand or prices, and firms responded by reducing production and laying off employees.

The second major policy change was in monetary policy. Following the end of the contraction, banks, as a precaution against bank runs, had begun to hold large excess reserves. Officials at the Federal Reserve System knew that if banks used a large percentage of those excess reserves to increase lending, the money supply would quickly expand and price inflation would follow. Their studies suggested that the excess reserves were distributed widely across banks, and they assumed that these reserves were due to the low level of loan demand. Because banks were not borrowing at the discount window and the Fed had no BONDS to sell on the open market, its only tool to reduce excess reserves was the new one of varying reserve requirements. Between August 1, 1936, and May 1, 1937, in three steps, the Fed doubled reserve requirements for all classes of member banks, wiping out much of the excess reserves, especially at the larger banks. The banks, burned by their lack of excess reserves in the early 1930s, responded by beginning to restore the excess reserves, which entailed reducing loans. Within eighteen months, excess reserves were almost as large as before the reserve requirement increases, and, necessarily, the stock of money was lower.

By June 1937, the recovery—during which the unemployment rate had fallen to 12 percent—was over. Two policies, labor cost increases and a contractionary monetary policy, caused the economy to contract further. Although the contraction ended around June 1938, the ensuing recovery was quite slow. The average rate of unemployment for all of 1938 was 19.1 percent, compared with an average unemployment rate for all of 1937 of 14.3 percent. Even in 1940, the unemployment rate still averaged 14.6 percent.

Why was the recovery from the Great Depression so slow? A number of economists now argue that the NRA and monetary policy were important factors. Some maintain that Roosevelt's vacillating policies and new federal regulations hindered recovery (Gary Dean Best, Richard Vedder and Lowell Gallaway, and Gary Walton), while others emphasize monetary factors (**Milton Friedman** and Anna Schwartz, Christian Saint-Etienne, and Barry Eichengreen). The New Deal's NRA has received much criticism (Gary Dean Best, Gene Smiley, Richard Vedder and Lowell Gallaway, Gary Walton, and Michael Weinstein). A now discredited explanation from Alvin Hansen argued that the United States had exhausted its investment opportunities. E. Cary Brown, Larry Peppers, and Thomas Renaghan emphasize federal fiscal policies that were a drag on the return to full employment. Michael Bernstein argues that investment problems retarded the recovery because the older established industries could not generate sufficient investment while newer, growing industries had trouble obtaining investment funds in the depressed environment. Alexander Field argues that the uncontrolled **housing** investment of the 1920s severely reduced housing investment in the 1930s.

One of the most coherent explanations, which pulls together several of these themes, is what economic historian Robert Higgs calls "regime uncertainty." According to Higgs, Roosevelt's New Deal led business leaders to question whether the current "regime" of private **property rights** in their firms' capital and its income stream would be protected. They became less willing, therefore, to invest in assets with long lives. Roosevelt had first suspended the **antitrust** laws so that American businesses would cooperate in government-instigated **cartels**; he then switched to using the antitrust laws to prosecute firms for cooperating. New taxes had been imposed, and some were then removed; increasing **regulation** of businesses had reduced businesses' ability to act independently and raise capital; and new legislation had reduced their freedom in hiring and employing labor. Public opinion surveys of business at the end of the 1930s provided evidence of this regime uncertainty. Public opinion polls in March and May 1939 asked whether the attitude of the Roosevelt administration toward business was delaying recovery, and 54 and 53 percent, respectively, said *yes* while 26 and 31 percent said *no.* Fifty-six percent believed that in ten years there would be more government control of business while only 22 percent thought there would be less. Sixty-five percent of executives surveyed thought that the Roosevelt administration policies had so affected business confidence that the recovery had been seriously held back. Initially many firms were reluctant to engage in war contracts. The vast majority believed that Roosevelt's administration was strongly antibusiness, and this discouraged practical cooperation with Washington on rearmament.

It is commonly argued that World War II provided the stimulus that brought the American economy out of the Great Depression. The number of unemployed workers declined by 7,050,000 between 1940 and 1943, but the number in military service rose by 8,590,000. The reduction in unemployment can be explained by the draft, not by the economic recovery. The rise in real GNP presents similar problems.

Most estimates show declines in real consumption spending, which means that consumers were worse off during the war. Business investment fell during the war. Government spending on the war effort exceeded the expansion in real GNP. These figures are suspect, however, because we know that government estimates of the value of munitions spending, to name one major area, were increasingly exaggerated as the war progressed. In fact, the extensive **PRICE CONTROLS**, rationing, and government control of production render data on GNP, consumption, investment, and the price level less meaningful. How can we establish a consistent price index when government mandates eliminated the production of most consumer durable goods? What does the price of, say, gasoline mean when it is arbitrarily held at a low level and gasoline purchases are rationed to address the shortage created by the price controls? What does the price of new tires mean when no new tires are produced for consumers? For consumers, the recovery came with the war's end, when they could again buy products that were unavailable during the war and unaffordable during the 1930s.

Could the Great Depression happen again? It could, but such an event is unlikely because the Federal Reserve Board is unlikely to sit idly by while the money supply falls by one-third. The wisdom gained in the years since the 1930s probably gives our policymakers enough insight to make decisions that will keep the economy out of such a major depression.

About the Author

Gene Smiley is an emeritus professor of economics at Marquette University.

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