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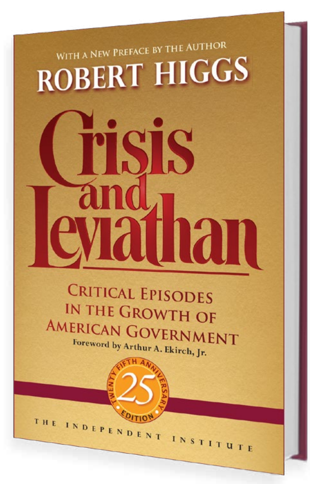

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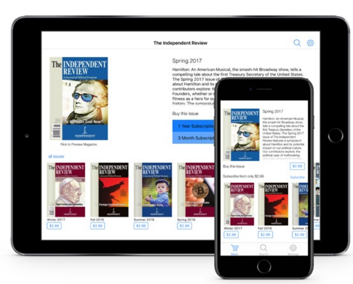

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REVIEW ESSAY

The Great Depression Revisited

ROGER W. GARRISON

Professors Thomas E. Hall and J. David Ferguson, both of Miami University of Ohio, have combined social history and macroeconomic theory to achieve an understanding of the world between the wars. Their book *The Great Depression: An International Disaster of Perverse Economic Policies* (Ann Arbor: University of Michigan Press, 1998) takes its place on library shelves among many others with the same main title. A search in Auburn University's library reveals more than a dozen such volumes, differentiated only by their subtitles, as well as numerous others that deal with the same subject. Though the authors break no new ground, their book is distinguished by its particular blend of monetarist and Keynesian ideas and by a presentation liberally colored with the prose of John Kenneth Galbraith and Frederick Lewis Allen.

Hall and Ferguson's account of the world's longest economic slump has the distinct advantage of being reader-friendly. It begins with a "Great Depression Timeline" that chronicles the major economic, political, and military events on a year-by-year basis from 1914 to 1941. And it ends with a glossary that includes key players, key writers, and technical terms. The opening chapter presents the authors' list of seven important questions to be answered. Among them are the critical questions about the depression's origins, scope, intensity, duration, and eventual resolution. Was the bust related to the preceding boom? What gave the depression its worldwide character? Why was it so deep and so long-lasting? How was recovery eventually achieved? Still

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other questions in their list deal with subsidiary issues concerning movements in the operating ratios of the banking system (reserves to deposits and currency to deposits) and with the coexistence of unemployment and inflation during portions of the 1930s. The book's subtitle establishes the theme underlying most of the answers, and the sequencing of the issues in the middle chapters is partly logical and partly chronological. The final chapter repeats the seven questions and offers summary answers. To help readers who are not trained in economics to follow the arguments, the authors digress at several points to explain some fundamentals, such as the significance of the parity ratio that relates the values of two gold-based currencies, the quantity theory of money, and the real-bills doctrine.

Contrasting Visions

Perspectives on the Great Depression can be categorized in terms of two contrasting visions of the relationship between the economy and the government. In one vision, the economy is inherently unstable, and government policy is stabilizing; in the other, the economy is inherently stable, and government policy is destabilizing. Ferguson and Hall's perspective is largely but not wholly consistent with the latter vision. Referring to a critical phase of the depression (1930–31) during which unemployment increased dramatically, the authors hold that the worsening conditions are attributable to "a combination of economic ignorance, confusion, and incompetence [of] U.S. policymakers" (p. 104). Evidently, though, those policy makers were able to overcome their ignorance, confusion, and incompetence when they turned their attention (in 1933–35) to matters of banking and finance. In that area, they produced what Hall and Ferguson call the "best legislation to come out of the New Deal" (p. 115), the establishment of the Federal Deposit Insurance Corporation being "the single most important change" (116). The anticompetitive effects of that legislation (the cartelization of the banking industry, the prohibition of interest on checking account balances, the imposition of interest-rate ceilings on savings) are downplayed. The cumulative and still ongoing effects of the moral-hazard problem inherent in subsidized deposit insurance get no mention at all.

From Boom to Bust

The raw facts are that times were good in the twenties and bad in the thirties. Why so? The stark contrast between the two decades begs for an explanation. It seems helpful (to this reviewer) to make a first-order distinction between two general questions: (1) What was the nature of the transformation from good times to bad times? (2) Why were those particular bad times so awfully bad? Although Hall and Ferguson make this distinction in some contexts (e.g., p. 75), the critical importance of the first question can easily be overshadowed by the dramatic stories told in answering the second. Hall and Ferguson draw on Barry Eichengreen to characterize their view: "What converted a garden variety recession into the Great Depression was a disastrous series of policy errors" (p. 164). The perverse economic policies highlighted by Hall and Ferguson certainly have a claim on our attention. But what about the characterization of the initial downturn? To call it a garden-variety recession is to be wholly dismissive of the most critical—though not the most dramatic—aspects of this boom-bust episode. The question of what made a bad situation get worse is allowed to crowd out the question of why the situation was bad in the first place. Further, "garden variety" suggests that recessions of the sort that occurred in 1929–30 are inherent in the nature of the market economy. (In fairness, we should note that Eichengreen may have been quoted out of context. Writing for *Challenge* [vol. 35, no. 2, 1992] about the international character of recessions, he refers to the shortsightedness of "'Voltairean Economics'—the idea that policymakers need only tend their own gardens." When, two paragraphs later, Eichengreen used the term "garden variety recession," did he mean a recession thought to be remediable without the cooperation of other countries?)

In an early chapter, Hall and Ferguson do raise the issue concerning the nature of the initial downturn. Unfortunately, their questions are ill framed, their analysis ignores the relevant literature, and their answers are ambivalent and unsatisfying. "Did factors building up during the 1920s set the stage for the Great Depression?" (p. 13). After raising that very reasonable question, the authors immediately recast it in terms of "payback time": "Did the Great Depression amount to 'payback time'? Was the Great Depression a natural correction following the prosperous twenties?" Here, the authors themselves have conflated the issue of the nature of the initial downturn with issues concerning subsequent exacerbations. There is no school of thought according to which the whole of the Great Depression, as defined by its unprecedented depth (25 percent unemployment) and spirit-breaking duration (more than a decade), is to be attributed to excesses of the 1920s or to ill-conceived policies that gave rise to those excesses.

There is a school of thought according to which policy-driven booms contain the seeds of their own undoing. The Austrian school distinguishes between genuine (and hence sustainable) economic growth and artificial (and hence unsustainable) booms. In a market economy, an intertemporal equilibrium, as maintained by the rate of interest, requires a consistency between the allocation of resources among the various stages of production at any given point in time and the desired pattern of consumption over time. A reduction of interest rates may reflect a change in intertemporal consumption preferences. In such a case, the resulting reallocation of resources away from current consumption and toward investment—and from relatively late stages to relatively early stages of production—will eventually play itself out as a temporal shifting, a forward shifting, of consumption. That, apart from technological advance, is the essence of (genuine) economic growth. By contrast, a reduction of interest rates may reflect credit creation by the central bank. In that case, the resulting process that governs the intertemporal allocation of resources will not play itself out but rather will do itself in. Artificial booms inevitably end in busts.

The unsustainability of credit-driven booms is the essence of the Austrian theory of the business cycle as set forth by Ludwig von Mises early in the century and developed by F. A. Hayek in the 1920s and 1930s. Whereas Hayek saw his theory of boom and bust as accounting for the transformation from good times to bad times, Hall and Ferguson fail to evaluate the claims made by Hayek or by modern Austrians, or even to recognize the existence of the Austrian theory of the business cycle. They assess instead a few selected remarks by "the great social historian" (p. 23) Frederick Lewis Allen and some conjectures by one of capitalism's harshest critics, John Kenneth Galbraith.

There can be no doubt that the United States experienced a boom in the 1920s. During an eight-year period (1921–29), the economy grew from trough to peak at the rate of 5.9 percent. Hall and Ferguson compare that growth rate to the country's long-run average of 3.0 percent and describe it as "quite remarkable" (p. 17). By itself, the unusually high growth rate gives some plausibility to the Austrian view: the boom may have been quite remarkable but not quite sustainable. Hall and Ferguson (e.g., p. 18) suggest that the boom stemmed from technological change. More specifically, after World War I the new assembly-line techniques had a dramatic effect in several key industries, including automobiles, household appliances, and food processing. This account of the boom implies a strong demand for investment funds and hence upward pressure on interest rates. Actual movements in interest rates and changes in credit conditions, however, serve to bolster the Austrian interpretation of the episode. The authors' own charts show that downward pressure was stronger than upward pressure: the corporate-bond rate and the commercial-paper rate declined throughout the boom (p. 7). The supply of credit evidently outpaced the demand for it. However, the credit was being supplied not by market participants who had suddenly become big savers but by a central bank that had just turned its attention from financing a war to fostering prosperity in a peacetime economy. These are the considerations that weigh in favor of an Austrian account of the economy's transformation from good times to bad. The Fed-fostered prosperity did not and could not last.

The question of the boom's sustainability is raised indirectly by Hall and Ferguson (p. 28) when they focus on stock prices just before the crash. They uncritically cite some recent studies, including Harold Bierman's *Great Myths of 1929* (New York: Greenwood Press, 1991), that purport to demonstrate that stocks were not overvalued even in 1929. The demonstration, however, is wholly question-begging. Conventional present-value calculations that might have been applied by a portfolio manager in the late 1920s are adopted as the critical test. It can easily—and tellingly—be shown on that basis that *if* we extrapolate the (high) growth rate into the indefinite future and *if* we discount the corresponding profits at the prevailing (low) rate of interest, then the resulting present value of capital assets are consistent with the actual (extraordinarily high) stock prices. "In other words, if investors expected earnings to continue growing from 1929 to 1934 at a rate similar to what had occurred from 1925 to 1929, then the stock prices prevailing in September 1929 were very much in line with fundamentals" (p. 28). Surely, though, the exercise leads us to a conclusion quite opposite to Bierman's, as summarized by Hall and Ferguson. The so-called "fundamentals" turned out to be "superficials." If, in retrospect, we see that stocks were dramatically overvalued in 1929, we conclude that interest rates were artificially low and that the growth rate was unsustainably high. The downturn was not some "garden variety recession" but rather the inevitable result of a credit-induced boom.

Hall and Ferguson rightly dismiss the argument that "the worsening distribution of income" (p. 20), or, as economic historian Jim Potter put it, "the failure to redistribute income" (p. 22), was responsible for a waning of consumption and hence for the downturn in 1929. But then, after pitting Galbraith's bubble-ready-to-burst view against Bierman's (and others') stocks-weren't-overpriced view, they conclude that "the jury is still out on whether the stock market advance of the late 1920s was due to speculative excess or to fundamentals" (p. 29). In their final chapter, however, the jury seems to have come back in. The authors report a hedged verdict of speculative excess (p. 161). Such courtroom metaphors inspire this reviewer to claim that the prosecutors simply failed to call on the most pertinent expert witnesses, namely Mises and Hayek. Those witnesses would have testified that a dramatic rise in asset prices is characteristic of an economy in the final throes of an unsustainable boom.

A Tiger by the Tail

Understanding the nature of the boom would seem to be a prerequisite to understanding the "cause" of the subsequent bust. But although Hall and Ferguson lack confidence in their assessment of the economic circumstances in 1929, they seem very confident in their judgment about the cause of the downturn. They share the widespread belief among economists that "restrictive monetary policy initiated by the Federal Reserve Board in response to the stock market boom was the cause of the initial economic slowdown that eventually turned into the Great Depression" (p. 30). If the stock prices in the late twenties were actually anchored in the fundamentals, then the (uncalled-for) restrictive monetary policy is rightly seen as the cause of the downturn. If, however, the speculative excesses were themselves the result of overly favorable credit conditions maintained by the Federal Reserve, then to attribute the downturn to subsequent monetary restrictions is, at best, misleading.

Borrowing imagery from Hayek, we can say that the Federal Reserve "had a tiger by the tail." How long could or should it hold on? How long could or should it try to sustain an ultimately unsustainable boom? Holding on meant continuing to fuel the speculative excesses; letting go meant putting an end to the boom. The Federal Reserve's decision to let go (though undoubtedly the tiger would soon have whipped the Fed loose) certainly helps to explain the timing of the downturn, but the cause of the downturn would have to be traced to the credit conditions that eventually culminated in the speculative excesses—and ultimately to the 1913 legislation that created an activist central bank. The tiger-by-the-tail metaphor is intended to imply that in 1929 a "soft landing" was not a possibility. The Austrian view does not deny that a soft landing may have been possible in, say, 1927, and it does not imply the inevitability of a catastrophic crash of the sort actually experienced. The recession ushered in by the inevitable hard landing could have been as short-lived as the recession of 1920–21.

Policies Exacerbating the Contraction

Hall and Ferguson are right to offer not a single cause but a list of causes for the depth and duration of the Great Depression. Smoot and Hawley's tariff of 1930, Hoover's tax hike of 1932, and Roosevelt's farm program (marketing quotas and price ceilings) of 1933 certainly belong on the list. Further, Hall and Ferguson are right in singling out the 1937–38 recession for separate attention. The 1935 labor legislation (the Wagner Act) gave awesome powers to organized labor (pp. 142–44), and the 1935 and 1936 tax legislation, which raised tax rates and made the tax schedule more steeply progressive (pp. 145–47), had predictable depressing effects.

Most important, the Federal Reserve, acting on a gross misperception of the operating ratios of commercial banks, committed a policy blunder of unprecedented proportions (pp. 148–51). The Fed interpreted the $3 billion in excess reserves held by commercial banks in early 1936 to mean that banks wanted to hold a high level of reserves—rather than as a sign that banks wanted to keep a good portion of their reserves out of the "required" category. To preclude the possibility of a monetary expansion outside the policy makers' control, the Federal Reserve raised the reserve requirement (in 1936 and 1937) to match the actual reserves being held. The subsequent efforts by commercial banks to reestablish a cushion of nonrequired reserves caused the money supply to collapse and sent the economy back into recession. As Hall and Ferguson's presentation affirms, that particular black mark on central banking is best viewed as an instance of "economic ignorance, confusion, and incompetence"—in spades.

In answering the question of what made a bad situation worse with respect to the early 1930s, Hall and Ferguson rely heavily on Friedman and Schwartz's *Monetary History of the United States, 1867–1960* (Chicago: University of Chicago Press, 1963). Perverse Federal Reserve policies were responsible for eleven thousand bank failures and a 33 percent reduction of the money stock. "The direct result was falling consumer expenditures and business investment, which led to the loss of millions of jobs" (p. 77). Departing from Friedman and Schwartz, at least in their emphasis, the authors see the perverse policies as stemming from the Federal Reserve's slavish adherence to the fallacious real-bills doctrine. As conventionally understood, that doctrine holds that as long as the central bank meets the needs of trade by rediscounting real bills only—that is, by accepting only short-term self-liquidating loans as collateral—the credit supplied by the central bank can exert no inflationary pressure. The doctrine is wrong, of course, because it ignores the effects of money creation on the prices that underlie those real bills.

Hall and Ferguson make use of the doctrine, or an implied corollary, in the context of an economy sinking into depression. The corollary is sufficiently distinct from the doctrine itself that it deserves its own statement. The authors' understanding of the doctrine as applied in good times (p. 82) suggests how the bad-times corollary might be stated: If the central bank rediscounts real bills only, even when the volume of real bills is dramatically diminished by continuing recessionary conditions and even when demands for liquidity are high, then the accompanying deflationary pressures are of no concern to the central bank. But, as Hall and Ferguson recognize, those pressures should be of paramount concern to the central bank. They are right to emphasize the role of monetary contraction in making a bad situation worse. It is true that the real-bills doctrine was on the minds of the framers of the Federal Reserve Act, as evidenced, for instance, by the act's preamble. But, can the reduction of the money supply to two-thirds its previous level in the span of three years be attributed to a dogged application of the real-bills doctrine? In the spirit of the rest of the book, we would surely have to suspect that the direct consequences of that fallacious doctrine were highly leveraged by more general "economic ignorance, confusion, and incompetence" on the part of the Federal Reserve.

Hall and Ferguson's account of the worsening of conditions in the early 1930s could have been strengthened by a greater emphasis on Hoover's high-wage policies. Their list of aggravating factors does include "the maintaining of high wages by the government" (p. 76), but that particular policy perversity, especially in conjunction with the precipitous fall in the money supply, deserves greater attention. Because labor is a major input in the production process, high wage rates translate into high prices. The equation of exchange, $MV = PQ$, helps us to see how the economy received a dizzying one-two punch from Hoover and the Federal Reserve. With M (and V) falling and P kept from falling, the economy could only adapt through a dramatic reduction of output, Q. When the authors protest that the Hoovervilles of the period should have been called "Federalreservevilles" (p. 104), they are only half right. Hoover deserves his share of the blame. Curiously, the authors cite in other contexts Gallaway and Vedder's *Out of Work: Unemployment and Government in Twentieth-Century America* (New York: Holmes and Meier, 1993) but fail adequately to incorporate that book's treatment of Hoover's high-wage policies. (None of the attention to Hoover here should be construed to deny that monetary deflation can cause major problems all by itself or to downplay the further damage done by the more direct interferences with price adjustments by Roosevelt's National Recovery Administration.)

A Shift in Perspective

In their chapter on economic recovery, the authors seem to lose their moorings and to take as givens many of the perversities they have earlier identified. The shift in focus from "How did we get into the depression?" to "How did we get out?" is accompanied by a shift in perspective from monetarist to Keynesian: "The root cause [of low output and high unemployment in 1933] was low aggregate demand" (p. 122). Aggregate demand was in fact low in 1933, but its lowness was not the cause, let alone the root cause, of low output and high unemployment. The authors' point seems to be that policy should have been aimed not at propping up prices but at pumping up demand. "The solution," they write, "was to stimulate aggregate demand to reverse the deflation . . . [not] to stop the deflation by simply fixing wages and prices."

Accordingly, Hall and Ferguson are critical of New Deal regulations but not of New Deal spending. Even the make-work programs administered by the infamous three-letter agencies (CCC, CWA, PWA, WPA), which "employed people to do a wide variety of things" and supported "artists, writers, and musicians," are seen as consistent with their understanding of the "root cause" of the economy's problem. Despite all the peacetime spending, though, the depression lingered on. Full recovery had to await the military mobilization that preceded the entry into World War II. When the authors ask in their final chapter what brought an end to the depression, they answer with one dose of monetarism and two doses of Keynesianism: It was a "combination of very rapid monetary growth that began in 1938, the 1940 increase in sales of war material to Britain, and the U.S. defense buildup that also began in 1940" (p. 163f).

Gold or Paper

The Keynesian twist to an otherwise monetarist story line may strike the reader as puzzling. Even more puzzling, however, is the authors' dim view of the gold standard, which runs as a strong subtheme throughout the book. Gold, they point out, provided the link that gave the Great Depression its international character. Their perspective on alternative monetary arrangements certainly supports the conclusion that an international gold standard and an activist central bank are incompatible institutions. It would seem, though, that their flagging of the many instances of gross mismanagement of the partly-and-then-mostly paper standard and of the "economic ignorance, confusion, and incompetence" that underlay the mismanagement would cause them to favor a decentralized, impersonal monetary system.

To favor a gold standard in that sense is not, of course, to defend Britain's attempt to maintain a prewar parity when it returned to the gold standard in 1925. And favoring gold entails condemnation of the U.S. policy of sterilization. Hall and Ferguson, however, ally themselves with those who "recognize that monetary systems are a proper sphere of influence for government" (p. 32); they account for the popular attraction to gold in terms of its supposed "mystical power" (p. 32); they poke fun at "grownups" (Steve Forbes and Jack Kemp) who see gold as a solution rather than a problem (p. 36); and they fantasize that, under a gold standard, teenagers could reduce the money supply—for instance, by their faddish demand for gold earrings following the public wearing of one by a U.S. president (p. 36).

But could teenagers or any other group on either side of the market for gold have as devastating an effect on the money supply and hence on the economy as the Federal Reserve had in the interwar period? Gold may have its faults, but if the choice is between gold and paper, the historical record, including Hall and Ferguson's account of the Great Depression, comes down on the side of gold.

Hall and Ferguson's *Great Depression* may have a substantial impact on both education and research. Its reader-friendliness makes it easy to use in the classroom. Its presentation as a stock-taking exercise makes it a convenient starting point for further research. Both qualities are signs of healthy progress toward a better understanding of the Great Depression. In short, the book helps to shift the focus of debate in the right direction. We can move on from the old debate between those who believe that depressions just happen and those who think that government policy makers may have contributed to their happening. New debate can aim at determining the precise scope of the perverse economic policies and identifying the particulars of the perversities that have for too long given the market system a bum rap.