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The Great Depression, the New Deal, and the Current Crisis

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In recent years one of the most salient philosophical divides between those on the right and those on the left has involved the putative ability of government to improve our lives. Ronald Reagan became famous for reiterating the adage that the most feared words in the English language were, “We’re from the government and we’re here to help.” The consequences of putting a political party that frequently disparaged government in charge of providing essential government services became clear, however, in the Federal government’s response to Hurricane Katrina. While the micropolitics may have seemed like a win for ideologically driven Republicans - provision of shoddy government services could reinforce the claim that only the private sector could provide decent services, the philosophy eventually turned a cropper at the polls, and has been decisively rejected. It is clear that the American public wants well thought out government programs and policies, competently executed.

Whereas the political economic landscape has changed dramatically in recent months, the gut level response of many with conservative inclinations to blame the government has not. We are now in the midst of what will likely be the most serious economic and financial crisis since the Great Depression. How did we get into this mess, what responsibility does government bear in allowing this to happen, and what does the history of the Great Depression tell us about how we should go forward?

In the presence of an unusual decline in consumption spending as households come off a debt-fueled binge, a collapse of private sector investment spending, much of which until recently was for residential housing, and export weakness due to worldwide recession, the federal government is the only entity now that can step in to fill the gap in aggregate demand. For these reasons, the 2009 stimulus plan is basically well motivated, although probably too small. The current administration has not however, put forward a fully persuasive plan to deal with the financial/banking/insurance crisis. Ben Bernanke, Larry Summers and Timothy Geithner all seem to believe that what we have here is a classic liquidity problem, that the large banks only look insolvent because wealth holders irrationally don’t want to buy securitized debt obligations at much more than twenty to thirty cents on the dollar. I have heard several times from colleagues who share the Bernanke/Summers view that ultimately these financial assets, if held to maturity, will yield sixty to seventy cents on the dollar.

That outcome seems to me unlikely, although the probability depends in part on what policy initiatives are pursued. The reality is that the ratio of housing prices to income soared to unsustainable levels, and prices in many parts of the country are unlikely to return to pre-crash levels for a very long time. Without the prospect of that happening, it's hard to see how collateralized mortgage obligations can come anywhere near to yielding what they were expected to.

That means that banks like Citibank, Bank of America and probably others are insolvent. Ben Bernanke denied this in his March 2009 60 Minutes interview. But it is a time honored tradition for debtors hounded by creditors to complain that if one only gave them a little more time, their investments would turn out to have been sound. Sometimes the argument has merit. In this case I think it does not. Vikram Pandit is no George Bailey, this is not Bedford Falls, and Citigroup is not Bailey Building and Loan. Nor is the solution to our problems to prettify bank balance sheets by relaxing mark to market ("fair value") accounting rules. These rules already included a number of procedures and exceptions for dealing with assets which trade infrequently.

In 1991, in the aftermath of the Savings and Loan debacle, to which the ill advised 1982 Garn-St. Germain legislation contributed, Congress passed FDICIA, which requires that the FDIC take prompt corrective action to deal with failing banks. In the late 1980s insolvent savings and loans continued to borrow by issuing insured CDs and then did the equivalent of putting everything on black in Las Vegas and figuring it was the government's problem if it came up red. It often did come up red, with the consequence that the S and L balance sheets were in even worse shape when the government finally stepped in than they had been earlier. The objective of prompt corrective action is to protect taxpayers by forcing banks to stop making risky loans if their capital ratios fall below a certain level, and to require the government (in the agency of the FDIC) to take them over promptly if their balance sheets continue to deteriorate.

Risky lending by impaired institutions is not our problem today. Banks are not making riskier and riskier loans to try and gamble themselves out of a hole. Indeed they are criticized now not for lending too much but for lending too little. But the ultimate concern that prompted FDICIA remains, which is that if we do not step in now and clean up zombie banks taxpayers will end up on the hook for more.

Ultimately, the lesson of the 1930s is that capitalist financial institutions require a government regulatory structure to forestall the probability of crises which threaten the entire economic system. There is no question that we need a new, comprehensive regulatory apparatus to deal with not just commercial banks but the entire shadow banking system. The challenges we face today represent in part a failure of government, in the sense that government did not maintain adequate regulatory machinery. That indictment needs to be tempered, however, by the observation that it was private sector innovations such as collateralized debt obligations and credit default swaps, and private sector behavior, that lie at the heart of the bonfire we are currently experiencing.

The bailout of AIG is in fact a bailout of counterparties who were able to create, market and hold mortgage backed securities under the belief that risk was adequately hedged through inexpensive “insurance” contracts sold by AIG. Because these contracts were not technically insurance, they were not regulated by state authorities and AIG was not required to hold adequate reserves against them. Now taxpayers are making good on them.

Retrospectively, one of the most egregious regulatory mistakes was not heeding Brooksley Born’s 1998 call to require credit default swaps to be traded and cleared as are futures contracts on a centralized exchange rather than in an entirely unregulated over the counter market. Born, then head of the Commodity Futures Trading Commission, was essentially shouted down by Alan Greenspan, Arthur Levitt, Robert Rubin, and Larry Summers. Their victory over Born was consolidated in December 2000 legislation which explicitly prohibited regulation by any government entity of credit default swaps. The rationales given by these individuals (in Greenspan’s case it was largely ideological) do not stand up well in the light of history, and Ben Bernanke as well as Tim Geithner are now effectively advocating a somewhat weaker version of Born’s original proposal. George Soros wants to go even further, restricting such “insurance” contracts to those who actually hold the underlying asset. Right now you can do the equivalent not only of insuring your own home against burning down, but taking out a policy on everybody else’s house in the neighborhood as well.

A second set of mistakes were the 2004 decisions by the Securities and Exchange Commission under Christopher Cox to remove controls that limited leverage of investment banks to the 10 to 11 range – roughly what was historically true for commercial banks. This regulatory relaxation allowed what were then the five large investment banks to enter a “Consolidated Supervised Entity” program allowing them to escape the traditional debt to equity limitation, and substituting for it an “alternative net capital rule.” The consequence was that leverage in these firms soared to 33 to 35 to 1, with disastrous results, once house prices ceased to appreciate at the same rate.

But to say that these sorry episodes show that government is the source of all of our problems is like blaming President Bush for 9/11. It is true that he and his staff failed to heed explicit warnings about an imminent attack, but surely we should not let Mohammed Atta and his crew off the hook. The financial and economic distress we find ourselves in today reflects the operation of human proclivities whose consequences have been evident in a history of speculative bubbles and crashes that stretches back hundreds of years.

Although the banking/financial situation remains a mess, President Obama deserves credit for pushing through a stimulus plan which, although too small, is certainly far superior to inaction or Republican calls for a spending freeze. This view is of course not universally shared across the political spectrum. Over much of the discussion of the need for or likely success of the stimulus package looms the shadow of the 1930s. Indeed a running battle is taking place in the pages of the Wall Street Journal and elsewhere regarding the historical legacy of Franklin Delano Roosevelt and the New Deal. In the

context of this discussion, a number of misconceptions and frankly silly claims have been made, by economists and non-economists.

First, did New Deal spending get us out of the Depression in the sense of restoring us to full employment? Of course not – that’s been the consensus of economists and economic historians for over half a century – going all the way back to E. Cary Brown’s famous 1956 article. The increase in government spending was simply too small to compensate for the collapse of private sector autonomous spending in the 1930s. Autonomous spending is spending not closely linked to or induced by current receipts of income, and includes investment spending -- purchases of plant and equipment including residential housing -- as well as big ticket consumer items such as cars, furniture, and large appliances. Both types of spending plummeted between 1929 and 1933.

Although they did not restore us to full employment until the war, New Deal fiscal policies nevertheless operated in the right direction through Roosevelt’s first term. Both real output and employment grew very strongly between 1933 and 1937, with unemployment falling more than ten percentage points. The expansion reversed itself in 1938 because of tightened fiscal policy (a modest reduction in government spending and the institution of a new payroll tax to finance the social security system) as well as tightened monetary policy (the Fed pushed interest rates up because it was concerned that the rising quantities of unborrowed reserves held by banks for precautionary reasons presaged inflation). These moves toward tight money and fiscal “responsibility” drove the unemployment rate up almost five percentage points, to 19 percent.

Lee Ohanian has been arguing that the New Deal kept the economy from recovering through such policies as the National Industrial Recovery Act and the National Labor Relations Act. For several reasons, these arguments are unpersuasive. First, although the NIRA undoubtedly introduced some distortions at the microeconomic level, at the macro level it played a role, in conjunction with monetary and fiscal policies, including the abandonment of gold, in arresting deflation. In any event, the NIRA was gone by 1935. As far as the NLRA, high unionization did not pose an obstacle to prosperity during the golden age (1948-73), and an examination of data show that it is unlikely it did so in the 1930s. A simple look at GDP data confirms this.

The latest methodology for calculating real GDP uses the chained index method. The problem in comparing the magnitude of output or its components at different times is that prices change, and calculations of growth vary depending on whether one uses current prices or prices of a previous year. This is the famous index number problem, a staple of first year economics courses. The solution now adopted by the Bureau of Economic Analysis is, for each year, to calculate the change in GDP using last years’ prices and then again using this year’s prices, and then take a geometric average of the two (multiply the two together and take the square root of the product).

The old way of doing this was to choose a given base year, calculate changes using base period prices, and then periodically change the base year, which resulted in revisions of what one thought to have been established as the historical record. The current

procedures eliminate this problem, but at the cost of producing estimates for GDP components that do not necessarily sum to GDP. The chained index method is good for looking at the growth of real magnitudes over time, of interest here, but if one wants to see how GDP breaks down into its different components in a given year, current dollar numbers are better.

That said, what do the latest calculations of GDP and its major components, consumption, investment, and government spending show (<http://www.bea.gov/national/nipaweb/SelectTable.asp?Popular=Y> , Table 1.1.6)? They show that real GDP, which (in chained 2000 dollars) had fallen from \$865.3 billion in 1929 to \$635.5 billion in 1933, had risen to \$911 billion in 1937. In other words, GDP had completely recovered from its collapse during the Hoover administration and by 1937 was, in real terms, more than 5 percent above its 1929 peak. Gross Private Domestic Investment, which plummeted disastrously from \$91.3 in 1929 to \$11.5 in 1932, had come within a hair's breadth of reattaining 1929 levels in 1937 (\$91.1 billion). Both real consumption and real GDP surpassed 1929 levels in 1936.

To be sure, unemployment was still far too high in 1936 and 1937, the result of growth in the labor force, very strong productivity advance, which contributed to something of a "jobless recovery", and the failure of investment in residential housing to recover. The latter was in part the consequence of poor land planning policies of the 1920s and the wreckage of the real estate/residential construction boom that had peaked in 1926.

Real government spending, which remained at roughly the same level in 1930-33 (about 10 percent above 1929 levels) accelerated under Roosevelt, particularly after 1935. The idea that the multipliers associated with such spending were less than 1 or possibly even 0 has been advanced by a number of economists, in particular Robert Barro. Barro (2009) makes this claim based on what happened during the Second World War. But we had already reached potential output by 1942. No serious Keynesian ever argued that there would be a real spending multiplier if one started at potential. The argument had to do with being inside the production possibility frontier, with slack labor and capital that could be sucked into production if the government primed the pump with spending.

Parenthetically, the argument that tax cuts are preferable as stimulus ignores the fact that in a heavily indebted economy, most tax cuts will simply be used to reduce debt, rather than increase spending on goods and services, which is what we need now. It is regrettable that we have reached this point (in 2009) after a long orgy of both private and governmental consumption. It would have been better, now that we need to run large deficits, if President Bush had foregone some of his tax cuts and military initiatives, and left us with a smaller government debt. But these are the cards we've been dealt; the past can't be changed.

On the aggregate supply front, the argument, repeated over and over again, that tax cuts benefit aggregate supply by reducing disincentives to work focuses exclusively on the substitution effect, with no mention of possible income effects. As a result of the recent crisis most academics have had their salaries frozen and also taken a big hit on their

pension accumulations. The salary freeze is equivalent in its effects on after tax income to a tax increase. I know not a single academic who, as a consequence of the economic crisis, plans to retire earlier. The facts are that within the ranges we're discussing, reductions in take home pay can as easily increase desired labor supply as reduce it.

In thinking about the stimulus provided by government spending, it is critical that we distinguish between effects on aggregate demand and effects on aggregate supply. For the former, it makes no difference whether the spending is of long term value to the economy. Keynes is famous for suggesting that in a deep recession it would pay to divide the unemployed into Team A and Team B, pay Team A to dig holes and Team B to fill them in. Useless pork barrel projects such as bridges to nowhere and wasteful military spending add nothing of permanent value to the economy, but if the economy is severely depressed, it is better to have such spending than not.

Ideally, of course, stimulus spending would consist of government investment that produces something of value. On this account, Depression era spending, some started under Hoover, continued and ramped up under Roosevelt, measures up pretty well. Government infrastructure projects contributed in important ways to the largely unheralded expansion of potential output between 1929 and 1941. That expansion underlay the successful prosecution of the Second World War and laid the foundation for the age of high mass consumption that followed. My studies indicate that the build out of the surface road network contributed to the very high rate of total factor productivity (TFP) and labor productivity growth across the Depression years, generating private sector spillovers in both transportation, where it facilitated a growing complementarity between rail and trucking, and in wholesale and retail distribution.

Combined with TFP growth within manufacturing that was world class by any standard of comparison other than the 1920s, one ended up with TFP growth between 1929 and 1941 for the private nonfarm economy (about 75 percent of the aggregate; agriculture and government are excluded) of 2.31 percent per year without a cyclical adjustment or 2.78 percent per year with one. No other comparable period, including the golden age (1948-73), or the IT period (1995-2005), approaches this.

Virtually all of the growth in private sector output, as well as output per hour during the Depression years is attributable to TFP advance. In part this reflected the maturing of a private sector research and development system, before its trajectory was distorted by the Manhattan project and postwar military spending. The number of scientists and engineers in manufacturing R and D almost tripled in the United States between 1933 and 1940, and one sees similar trends in National Research Council data charting the establishment of R and D labs or spending.

It's true that TFP growth in manufacturing was higher in the 1920s (but not in the private nonfarm economy as a whole, because not much was happening outside of manufacturing). The 1920s record in manufacturing was largely the result of transitioning from internal power distribution using overhead metal shafts with leather belts bringing power to each machine's drive shaft to distribution based on electricity

flowing through wires to small electric motors. This was, however, a one time shift, which produce a large boost to TFP levels in the sector but could not be expected to generate a permanent acceleration in TFP growth.

The other main contributor to the Depression era growth in potential output in the absence of growth in hours or private sector physical capital was Roosevelt's public spending. The rise in real wages for those employed across the Depression years was certainly consistent with Roosevelt's efforts to facilitate the growth of unions. But high TFP growth would have had to have been reflected in some combination of growth in real wages and the return to capital. Both wages and earnings, which bottomed out in 1932, went up dramatically under Roosevelt. In particular, recipients of capital income, who had, with the exception of holders of fixed income securities, done terribly under Hoover, did far better in the New Deal. Both proprietors' income and corporate earnings recovered very strongly between 1933 and 1937. The Dow Jones Industrial Average advanced from a nadir of 43 in 1932 to 187.70 in 1937, although it fell by almost half in the 1938 recession.

Finally, in ways that are sometimes not fully recognized, Franklin Roosevelt's New Deal laid the foundation for postwar prosperity. Banking and financial legislation, such as the Securities Act and the Securities and Exchange Act, provided a basis for several decades of financial stability. Whereas its short run macroeconomic effects were contractionary, Social Security established a basis for dealing with the problem of old age security. Innovations in the layout and design of residential housing developments pioneered, along with amortized mortgages, by the FHA, combined with street and highway construction to create preconditions for the postwar housing boom, allowing serious construction in this sector to resume after more than a two decade hiatus. Hydropower, flood control, and rural electrification projects provided benefits to many parts of the country. In addition to highways, bridges, and tunnels, the country was dotted with libraries, municipal airports, and improvements in national parks which have been of lasting benefit to citizens. Roosevelt's New Deal spending was indeed too small to restore the economy to full employment prior to the War. But, on the aggregate supply side, it contributed to the extraordinary expansion of potential output that took place between 1929 and 1941.

The country today is navigating perilous waters. President Obama's administration, as was Roosevelt's, is called socialist or worse by some on the right. The problem, if anything, however, is that key economic advisors, in particular Larry Summers and Tim Geithner, have been too deferential towards Wall Street, have seemed too accepting of the idea that what is good for Goldman Sachs is also good for the country. They need help in finding the right path, not hopes that they will fail. And in studying history for lessons about the future, we need to be clear eyed. Slipping into New Deal denialism, as some have called it, will no more help the progress of economic science or the practice of economic policy than will endorsing creationism facilitate advance in evolutionary biology.

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