Their Great Depression and Ours

James Livingston, *History News Network*, 2008

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Now that everybody is accustomed to citing the precedent of the Great Depression in diagnosing the current economic turmoil—and now that the Congress has agreed on a bail-out package—it may be useful to treat these episodes as historical events rather than theoretical puzzles. The key question that frames all others is simple: Are these comparable moments in the development of American capitalism? To answer it is to explain their causes and consequences.

Contemporary economists seem to have reached an unlikely consensus in explaining the Great Depression—they blame government policy for complicating and exacerbating what was just another business cycle. This explanation is still gaining intellectual ground, and it deeply informed opposition to the bail-out plan. The founding father here is Milton Friedman, the monetarist who argued that the Fed unknowingly raised real interest rates between 1930 and 1932 (nominal interest rates remained more or less stable, but as price deflation accelerated across the board, real rates went up), thus freezing the credit markets and destroying investor confidence.

But the argument that government was the problem, not the solution, has no predictable political valence. David Leonhardt's piece of last Wednesday in the *New York Times* (10/1/08) is the liberal version of the same argument—if government does its minimal duty and restores liquidity to the credit markets, this crisis will not devolve into the debacle that was the Great Depression. Niall Ferguson's essay for *Time Magazine* on "The End of Prosperity," takes a similar line: "Yet the underlying cause of the Great Depression—as Milton Friedman and Anna Jacobson Schwartz argued in their seminal book *A Monetary History of the United States 1867-1960*, published in 1963—was not the stock market crash but a 'great contraction' of credit due to an epidemic of bank failures." Ben Bernanke's argument for the buyouts and the bail-out derives from the same intellectual source.

The assumption that regulates the argument, whether conservative or liberal, is that these two crises are like any other, and can be managed by a kind of financial triage, by treating the immediate symptoms and hoping the patient's otherwise healthy body will bring him back to a normal, steady state. Certain fragile or flamboyant or fraudulent institutions will be liquidated in the normal course of this standard-issue business cycle, and that is a good thing—otherwise the “moral hazard” of validating the “corrupt and incompetent practices of Wall Street and Washington,” as John MCain puts it, will be incurred.

Crisis management, by this accounting, is an occasional activity that always addresses the same problems of liquidity and “moral hazard.” By the same accounting, the long-term causes of crisis must go unnoticed and untreated because they are temporary deviations from the norm of market-determined equilibrium, and because the system appears to be the sum of its parts—if the central bank steps in with “ready lending” when investor confidence falters, these parts will realign themselves properly and equilibrium will be restored..

So the Great Depression and today’s economic crisis are comparable not because they resulted from similar macroeconomic causes but because the severity of the credit freeze in both moments is equally great, and the scope of the financial solution must, then, be equally far-reaching.

There is another way to explain the Great Depression, of course. It requires looking at the changing structure or “long waves” of economic growth and development, digging all the while for the “real” rather than the merely monetary factors. This explanatory procedure focuses on “the fundamentals,” and typically treats the financial system as a tertiary sector that merely registers the value of goods on offer—except when it becomes the repository of surplus capital generated elsewhere, that is, when personal savings and corporate profits cannot find productive outlets and flow instead into speculative channels.

The “long wave” approach has fallen out of favor, as more mainstream economists have adopted the assumptions enabled by the Friedman-Schwartz rendering of monetary history. This structural approach does, however, make room for crisis management at the moment of truth; here, too, the assumption is that financial triage will suffice during the economic emergency. When things settle down, when normal market conditions return, the question of long-term trends will remain.

The problem with the “long wave” approach—the reason it has less traction than the tidy alternative offered by Friedman and Schwartz—is that it cannot specify any connection between macroeconomic realities and conditions in the financial markets. Michael

Bernstein's brilliant book on the origins of the Great Depression, for example, treats the stock market crash of 1929 as a "random event" that complicated and amplified events happening elsewhere in the economy.

This theoretical standoff has crippled our ability to provide a comprehensive explanation for the Great Depression, and thus to offer a convincing comparison between it and the current crisis. So let's start over—let's ask the kind of questions that are already foreclosed by the competing models. Was the Great Depression just another business cycle that the Fed screwed up because it didn't understand the money supply? Or was it a watershed event that registered and caused momentous structural changes in the sources of economic growth? Or would more astute crisis management have saved the day?

Does the current crisis bear any resemblance to the Great Depression? Or is it just another generic business cycle that requires an unprecedented level of government intervention because the staggering amount of bad debt has compromised the entire financial system?

The short answers, in order, are No, Yes, No, Yes, No.

Here are the long answers. The "underlying cause" of the Great Depression was not a short-term credit contraction engineered by central bankers who, unlike Ferguson and Bernanke, hadn't yet had the privilege of reading Milton Friedman's big book. The underlying cause of that economic disaster was a fundamental shift of income shares away from wages/consumption to corporate profits that produced a tidal wave of surplus capital that could not be profitably invested in goods production—and, in fact, was not invested in good production.. In terms of classical, neoclassical, and supply-side theory this shift of income shares should have produced more investment and more jobs, but it didn't. Why not?

Look first at the new trends of the 1920s. This was the first decade in which the new consumer durables—autos, radios, refrigerators, etc.—became the driving force of economic growth as such. This was the first decade in which a measurable decline of net investment coincided with spectacular increases in nonfarm labor productivity and industrial output (roughly 60% for both). This was the first decade in which a relative decline of trade unions gave capital the leverage it needed to enlarge its share of revenue and national income at the expense of labor.

These three trends were the key ingredients in a recipe for disaster. At the very moment that higher private-sector wages and thus increased consumer expenditures became the only available means to enforce the new pattern of economic growth, income shares shifted decisively away from wages, toward profits. At the very moment that net investment became unnecessary to enforce increased productivity and output, income shares shifted decisively away from wages, toward profits.

What could be done with the resulting surpluses piling up in corporate coffers? If you can increase labor productivity and industrial output without making net additions to the capital stock, what do you do with your rising profits? In other words, if you can't invest those profits in goods production, where do you place them in the hope of a reasonable return?

The answer is simple—you place your growing surpluses in the most promising markets, in securities listed on the stock exchange, say, or in the Florida real estate boom, particularly in view of receding returns elsewhere. You also establish time deposits in commercial banks and start issuing paper in the call loan market that feeds speculative trading in securities.

At any rate that is what corporate CEOs *outside the financial sector* did between 1926 and 1929. They had no place else to put their increased profits—they could not, and they did not, invest these profits in expanded productive capacity, because merely maintaining and replacing the existing capital stock was enough to enlarge capacity, productivity, and output.

No wonder the stock market boomed, or rather no wonder a speculative bubble developed there. It was the single most important receptacle of the surplus capital generated by a decisive shift of income shares away from wages, toward profits—and that surplus enforced rising demand for new issues of securities even after 1926, when, according to Moody's Investors Service, almost 80 percent of the proceeds from such IPOs were spent unproductively (that is, they were not used to invest in plant and equipment or to hire labor).

The stock market crashed in October 1929 because the non-financial firms abruptly pulled their $7 billion out of the call loan market. They had experienced the relative decline in demand for consumer durables, particularly autos, since 1926, and knew better than the banks that the outer limit of consumer demand had already been reached. Demand for stocks, whether new issues or old, disappeared accordingly, and the banks were left holding the proverbial bag—the bag full of “distressed assets” called securities listed on the stock exchange. That is why they failed so spectacularly in the early 1930s—again, not because of a “credit contraction” engineered by a clueless Fed, but because the assets they were banking on and loaning against were suddenly worthless.

The financial shock of the Crash froze credit, including the novel instrument of installment credit for consumers, and thus amplified the income effects of the shift to profits that dominated the 1920s. Consumer durables, the new driving force of economic growth as such, suffered most in the first four years after the Crash. By 1932, demand for and output of automobiles was half of the levels of 1929; industrial output and national income were similarly halved, while unemployment reached almost 20 percent.

And yet recovery was on the way, even though increased capital investment was not—even though by 1932 non-financial corporations could borrow from Herbert Hoover’s Reconstruction Finance Corporation at almost interest-free rates. By 1937, industrial output and national income had regained the levels of 1929, and the volume of new auto sales exceeded that of 1929. Meanwhile, however, net investment out of profits continued to decline, so that by 1939, the capital stock per worker was lower than in 1929.

How did this unprecedented recovery happen? In terms of classical, neoclassical, and supply-side theory, it *couldn’t have happened*—in these terms, investment out of profits must lead the way to growth by creating new jobs, thus increasing consumer expenditures and causing their feedback effects on profits and future investment. But as H. W. Arndt explained long ago, “Whereas in the past cyclical recoveries had generally been initiated by a rising demand for capital goods in response to renewed business confidence and new investment opportunities, and had only consequentially led to increased consumers’ income and demand for consumption goods, the recovery of 1933-7 seems to have been based and fed on rising demand for consumers’ goods.”

That rising demand was a result of net contributions to consumers’ expenditures out of federal deficits, and of new collective bargaining agreements, not the eradication of unemployment. In this sense, the shift of income shares away from profits, toward wages, which permitted recovery was determined by government spending and enforced by labor movements.

So the "underlying cause" of the Great Depression was a distribution of income that, on the one hand, choked off growth in consumer durables—the industries that were the new sources of economic growth as such—and that, on the other hand, produced the tidal wave of surplus capital which produced the stock market bubble of the late-1920s. By the same token, recovery from this economic disaster registered, and caused, a momentous structural change by making demand for consumer durables the leading edge of growth.

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Last time out, I asked five questions that would allow us to answer this one: Does the current economic turmoil bear the comparisons to the Great Depression we hear every day, every hour? On my way to these questions, I noticed that mainstream economists' explanations of the Great Depression converge on the idea that a "credit contraction" engineered by the hapless Fed was the "underlying cause" of that debacle. They converge, that is, on the explanation offered by Milton Friedman and Anna Jacobson Schwartz in 1963 in *A Monetary History of the United States, 1867-1960*. In this sense, the presiding spirit of contemporary thinking about our current economic plight—from Niall Ferguson to Henry Paulson and Ben Bernanke—is Friedman's passionate faith in free markets.

I am not suggesting that there is some great irony or paradox lurking in the simple fact that a new regulatory regime resides in the programs proposed by Paulson and Bernanke. Saving the financial system is a complicated business that will produce innumerable unintended consequences. Instead, my point is that rigorous regulation, even government ownership of the commanding heights, is perfectly consistent with the development of capitalism.

Here, then, are those five questions—the questions that are foreclosed by the theoretical consensus gathered around Friedman's assumptions about business cycles and crisis management. Was the Great Depression just another business cycle that the Fed screwed up because it didn't understand the money supply? Or was it a watershed event that registered and caused momentous structural changes in the sources of economic growth? Or would more astute crisis management have saved the day?

Does the current crisis bear any resemblance to the Great Depression? Or is it just another generic business cycle that requires an unprecedented level of government intervention because the staggering amount of bad debt has compromised the entire financial system?

The short answers are No, Yes, No, Yes, No. The long answers to the first two questions appeared in the last installment. Let's take up the next three questions here, always with the policy-relevant implications in view.

More astute crisis management could not have saved the day in the early 1930s, no matter how well-schooled the Fed's governors might have been. The economic crisis was caused by long-term structural trends that, in turn, devastated financial markets (particularly the stock market) and created a credit freeze—that is, a situation in which banks were refusing to lend and businesses were afraid to borrow. The financial meltdown was, to this extent, a function of a larger economic debacle caused by a significant shift of income shares, toward profits, away from wages and consumption, at the very moment that increased consumer expenditures had become the fulcrum of economic growth as such.

So even when the federal government offered all manner of unprecedented assistance to the banking system, including the Reconstruction Finance Corporation of 1932, nothing moved. It took a bank holiday and the Glass-Steagall Act—which barred commercial banks from loaning against collateral whose value was determined by the stock market—to resuscitate the banks, but by then they were mere spectators on the economic recovery created by net contributions to consumer expenditures out of federal deficits.

So the current crisis does bear a strong resemblance to the Great Depression, if only because its "underlying cause" is a recent redistribution of income toward profits, away from wages and consumption (of which more in a moment), and because all the unprecedented assistance offered to the banking system since the sale of Bear Stearns and the bankruptcy of Lehman Brothers in September—AIG, Fannie Mae, Freddie Mac, the bail-out package, the equity stake initiative, etc.—has not helped thaw the credit freeze. The markets have responded accordingly.

The liquidation of "distressed assets" after the Crash of 1929 was registered in the massive deflation that halved wholesale and retail prices by 1932. This outcome is precisely what Ben Bernanke and Henry Paulson have been trying desperately to prevent since August of 2007—and before them, it is precisely what Alan Greenspan was trying to prevent by skirting the issue of the "housing bubble" and placing his faith in the new credit instruments fashioned out of securitized assets derived from home mortgages. Their great fear, at the outset of the crisis, was not another Great Depression, but the deflationary spiral of Japan in the 1990s, after its central bank pricked a similar housing bubble by raising interest rates and disciplining the mortgage dealers.

On the one hand, these men feared deflation because they knew it would cramp the equity loan market, drive down housing prices, slow construction, erode consumer confidence, disrupt consumer borrowing, and reduce consumer demand across the board. Meanwhile, the market value of the assets undergirding the new credit instruments—securitized mortgages—would have to fall, and the larger edifice of the financial system would have to shrink. In sum, Greenspan, Bernanke, and Paulson understood that economic growth driven by increasing consumer expenditures—in this instance, increasing consumer debt "secured" by home mortgages—would grind to a halt if they didn't reinflate the bubble.

On the other hand, they feared deflation because they knew its effects on the world economy could prove disastrous. With deflation would come a dollar with greater purchasing power, to be sure, and thus lower trade and current account deficits, perhaps even a more manageable national debt. But so, too, would come lower US demand for exports from China, India, and developing nations, and thus the real prospect of "decoupling"—that is, a world economy no longer held together by American demand for commodities, capital, and credit. The centrifugal forces unleashed by globalization would then have free rein; American economic leverage against the rising powers of the East would be accordingly diminished.

So Greenspan is not to be blamed for our current conditions. Under the circumstances, which included the available intellectual alternatives, he did pretty much what he had to. So have Bernanke and Paulson done their duty. There may well be corruption, fraud, and chicanery at work in this mess, but they are much less important than the systemic forces that have brought us to the brink of another Great Depression.

The real difficulty in measuring the odds of another such disaster, and thus averting it, is that those available intellectual alternatives are now bunched on an extremely narrow spectrum of opinion—a spectrum that lights up a lot of trees but can't see the surrounding forest. Again, everyone, including Bernanke, now seems to think, along with Milton Friedman, that the "underlying cause" of the Great Depression was a "credit contraction" that froze the financial system between 1930 and 1932. Here is how Niall Ferguson put it in *Time Magazine* last week: "Yet the underlying cause of the Great Depression—as Milton Friedman and Anna Jacobson Schwartz argued in their seminal book *A Monetary*

History of the United States, 1867-1960, published in 1963—was not the stock market crash but a 'great contraction' of credit due to an epidemic of bank failures...."

By this accounting, pouring more money into the financial system will fix it, and when it's fixed, the larger economy will find a new equilibrium at a reflated price level. The goal is to "recapitalize" the banks so that they can resume lending to businesses at a volume that sustains demand for labor and to consumers at a volume that sustains demand for finished goods. By the terms of the $700 billion bail-out package and according to new (and unprecedented) initiatives by the Fed, this "recapitalization" will take three forms.

First, the Treasury can buy equity stakes in banks deemed crucial to reanimating the lifeless body of the financial system—to make this move is *not to nationalize these banks* by installing government as their owner, but rather to provide "start-up" capital free and clear, as if Paulson were backing an IPO. Second, the Fed can buy short-term commercial paper from firms which need money to maintain inventory, pay vendors, and hire labor. This move opens the central bank's discount window to non-financial firms, presumably small businesses that have neither cash reserves nor credibility with local bankers.

Third, and most important, the Treasury will conduct an auction through which the mortgage-related "distressed assets" now held by lenders are liquidated—that is, are bought by the government for more than their market value, but less than their nominal value. Once those assets are "off the books," banks will have sufficient unencumbered capital to resume loaning at volumes and rates conducive to renewed growth and equilibrium. Investor confidence will return as investment opportunities appear, so this logic runs, and new borrowing will soon follow. But because this auction can't take place until the Treasury sorts through the books of the firms holding "distressed assets"—a matter of months—the equity stake approach has become, at least for the time being, the government's most promising means of restoring investor confidence in the integrity of the financial system.

Let us suppose, then, that Ferguson, Paulson, and Bernanke are right to assume that monetary policy is both the necessary and the sufficient condition of crisis management under present circumstances. Let us suppose, in other words, that the "recapitalization" of the banks proceeds exactly according to plan, and that interest rates keep falling because the Fed wants to encourage borrowing. Does the reflation and recovery of the larger economy naturally follow?

In theory, yes—that is, if Friedman was right to specify a "credit contraction" as the "underlying cause" of the Great Depression, then a "credit expansion" on the scale accomplished and proposed by Paulson and Bernanke should restore investor confidence and promote renewed economic growth; it should at least abort an economic disaster. But if a "credit contraction" was not the "underlying cause" of the Great Depression and its sequel in our own time, then no amount of "credit expansion" will restore investor confidence and promote renewed economic growth.

The historical record of the 1930s and the slow motion crash of the stock market in recent weeks would suggest that Friedman's theoretical answer to our question lacks explanatory adequacy—and that Paulson and Bernanke's practical program, *which follows the Friedman line*, has not restored, and cannot restore, investor confidence. The effective freeze of interbank lending which, contrary to recent news reports, was already an alarming index as early as September 2007, would suggest the same thing. ("The system has just completely frozen up—everyone is hoarding," says one bank treasurer. "The published [London interbank overnight] rates are a fiction." [*Financial Times* 9/5/07, p. 23]).

Moreover, a severe recession now waits on the other side of "recapitalization," mainly because consumer confidence, spending, and borrowing have been compromised or diminished, if not destroyed, by the credit freeze and the stock market crash: "Discretionary spending is drying up as Americans grapple with higher food and energy prices, depressed home values and diminished retirement accounts." (*Wall Street Journal* 10/9/08, p. 1.)

Just as a "credit contraction" was not the "underlying cause" of the Great Depression, so the reflation and recovery of the larger economy were not, and are not, the natural consequences of a financial fix. Our questions must then become, what *was* the "underlying cause" of the Great Depression, and how does the current crisis recapitulate the historical sequence that produced the earlier economic disaster?

And finally, if monetary policy cannot solve the real economic problems that now face us, what more is to be done?

As I argue in Part I, the Great Depression was the consequence of a massive shift of income shares to profits, away from wages and thus consumption, at the very moment—the 1920s—that expanded production of consumer durables became the crucial condition of economic growth as such. This shift produced a tidal wave of surplus capital that, in the absence of any need for increased investment in productive capacity (net investment declined steadily through the 1920s even as industrial productivity and output increased spectacularly), flowed inevitably into speculative channels, particularly the stock market bubble of the late 20s; when the bubble burst—that is, when non-financial firms pulled out of the call loan market in October—demand for securities listed on the stock exchange evaporated, and the banks were left holding billions of dollars in "distressed assets." The credit freeze and the extraordinary deflation of the 1930s followed; not even the Reconstruction Finance Corporation could restore investor confidence and reflate the larger economy.

So recovery between 1933 and 1937 was *not* the result of renewed confidence and increased net investment determined by newly enlightened monetary policy (the percentage of replacement and maintenance expenditures in the total of private investment grew in the 1930s). It was instead the result of net contributions to consumer expenditures out of federal budget deficits. In other words, *fiscal policy validated the new growth pattern that first appeared in the 1920s*—the consumer-led pattern that was eventually disrupted by the shift of income shares to profits, away from wages and consumption.

That consumer-led pattern of economic growth was the hallmark of the postwar boom—the heyday of "consumer culture." It lasted until 1973, when steady gains in median family income and nonfarm real wages slowed, and even ended. Since then, this stagnation has persisted, although increases in labor productivity should have allowed commensurable gains in wages. Thus a shift of income shares away from wages and consumption, toward profits, has characterized the pattern of economic growth and development over the last twenty-five years.

We don't need Paul Krugman or Robert Reich to verify the result—that is, the widening gap between rich and poor, or rather between capital and labor. Two arch-defenders of free markets, Martin Wolf and Alan Greenspan, have repeatedly emphasized the same trend. For example, last September, Greenspan complained that "real compensation tends to parallel real productivity, and we have seen that for generations, but not now. It has veered off course for reasons I am not clear about." (FT 9/17/07, p. 8) A year earlier, Wolf similarly complained that "the normal link between productivity and real earnings is broken," and that the "distribution of US earnings has, as a result, become significantly more unequal." (FT 4/26/06, p. 13)

The offset to this massive shift of income shares came in the form of increasing transfer payments—government spending on social programs—since the 1960s; these payments were the fastest growing component of labor income (10 percent per annum) from 1959 to 1999. The moment of truth reached in 1929 was accordingly postponed. But then George Bush's tax cuts produced a new tidal wave of surplus capital with no place to go except into real estate, where the boom in lending against assets that kept appreciating allowed the "securitization" of mortgages—that is, the conversion of consumer debt into promising investment vehicles.

No place to go except into real estate? Why not into the stock market, or, better yet, directly into productive investment by purchasing new plant and equipment and creating new jobs? Here is how Wolf answered this question back in August of 2007, when trying to explain why the global "savings glut" was flowing to the US:

"If foreigners are net providers of funds, some groups in the US must be net users: they must be spending more than their incomes and financing the difference by selling financial claims to others. . . .This required spending is in excess of potential gross domestic product by the size of the current account deficit [the difference between spending and income]. At its peak that difference was close to 7 percent of GDP. . . .Who did the offsetting spending since the stock market bubble burst in 2000? The short-term answer was 'the US government.' The longer-term one was 'US households.'

"The US government moved massively from financial surplus into deficit, the total swing being 7 percent of GDP, between the first quarter of 2000 and the third quarter of 2003. It is right to criticize the structure of the Bush tax cuts. Yet once the stock market bubble burst, how could a deep recession have been avoided without a fiscal boost?

"Now look at US households. They moved ever further into financial deficit (defined as household savings, less residential investment). Household spending grew considerably faster than incomes from the early 1990s to 2006 [as wages stagnated, credit cards became ubiquitous, and mortgage lenders became more aggressive]. By then they ran an aggregate financial deficit of close to 4 percent of GDP. Nothing comparable has happened since the second world war, if ever. Indeed, on average households have run small financial surpluses over the past six decades."

And while consumers were going deeper into debt to service the current account deficit and finance economic growth, corporations were abstaining from investment: "The recent household deficit more than offset the persistent financial surplus in the business sector. For a period of six years—the longest since the second world war—US business invested less than its retained earnings." (FT 8/22/07, p. 13)

Greenspan concurred: "intended investment in the United States has been lagging in recent years, judging from the larger share of internal cash flow that has been returned to shareholders, presumably for lack of new investment opportunities." (*Age of Turbulence*, p. 387)

So the Bush tax cuts merely fueled the housing bubble—they did not, and could not, lead to increased productive investment. And that is the consistent lesson to be drawn from fiscal policy that corroborates the larger shift to profits, away from wages and consumption. *There is no correlation whatsoever between lower taxes on corporate or personal income, increased net investment, and job growth*.

For example, the 50 corporations with the largest benefits from Reagan's tax cuts of 1981 reduced their investments over the next two years. Meanwhile, the share of national income from wages and salaries declined 5 percent between 1978 and 1986, while the share from investment (profits, dividends, rent) rose 27 percent, as per the demands of supply-side theory—but net investment kept falling through the 1980s. In 1987, Peter G. Peterson, the Blackstone founder who was then chairman of the Council on Foreign Relations, called this performance "by far the weakest net investment effort in our postwar history."

The responsible fiscal policy for the foreseeable future is, then, to raise taxes on the wealthy and to make net contributions to consumer expenditures out of federal deficits if necessary. When asked why he wants to make these moves, Barack Obama doesn't have to retreat to the "fairness" line of defense Joe Biden used when pressed by Sarah Palin in debate—and not just by the lunatic fringe where hockey Moms and supply-siders congregate. The leader of the liberal media, the *New York Times* itself, has also admonished the Democratic candidate on his proposed fiscal policy: "Mr. Obama has said that he would raise taxes on the wealthy, starting next year, to help restore fairness to the tax code and to pay for his spending plans. With the economy tanking, however, it's hard to imagine how he could prudently do that." (NYT 10/7/08)

In fact, if our current crisis is comparable to the early stages of the Great Depression, it's hard to imagine a more prudent and more productive program.