Myths and Facts About the Great Depression

Lee E. Ohanian
UCLA & Hoover Institution, Stanford University

December, 2013
Textbook View of Great Depression

- Depression began as "garden variety recession"
- Fed policy & banking panics turned it into the Great Depression
- 1/3 of banks exited
- Hoover was a "Laissez-Faire" president
- Recovery due to FDR's policies that restored employment
Myths and Facts

- Depression began as "garden variety recession"
- Fed policy and banking panics made it the Great Depression
  - No. Depression immediately severe - before panics and money supply decline
- 1/3 of banks exited
  - Deposits in failed banks less than 1 percent per year of total deposits
- After 1933, strong recovery from FDR’s policies that restored employment
  - In 1939, Output and employment more than 20 percent below normal
Figure 1 - Manufacturing Hours and the Money Supply
Index (Jan 1929=100)
Hours Worked Per Capita 1929-39
(1929 = 100)
What Caused Depression, Why Was Recovery Weak, What was Fed’s Role?

- Cartel policies forced wages and prices above normal levels → Depression
- Interfered with normal process of supply and demand
- Accounts for:
  - Why Depression was "one off" event
  - Why monetary contraction was so damaging
  - Why farm sector employment did not fall
  - Why employment didn’t recover
- Hoover started policies to foster cartels - FDR doubled-down
  - *Hoover* - "fix the economic wrongs that spring up under the pressure of competition"
  - *FDR* - "A builder of more plants... an organizer of more corporations, will do as much harm as good"
Hoover & FDR Believed Market Economy Didn’t Work Well

- Both firmly believed competition in markets depressed economy
  - Hoover - "fix the economic wrongs that spring up under the pressure of competition"
  - FDR - "A builder of more plants... an organizer of more corporations, will do as much harm as good"

- Both believed that artificially raising prices and wages would restore prosperity
- "Higher wages meant workers could buy more, and higher prices meant higher profits"
Deflation Doesn’t Always = Depression

- Deflation of early 1920s more severe than Great Depression
  - 18% deflation in 1921, 7% deflation in 1922
  - GDP fell 3.5 percent in 1921, then rose in 1922
- Private spending increased
- Recession due to lower gov’t purchases - end of WWI spending
• Met with CEOs, told them to maintain/raise wages and share work among employees
• Hoover would keep unions at bay - 1928 Supreme Court landmark decision changed labor relations
• Industry agreed - Henry Ford held press conference to advertise he raised wages
• First wholesale episode of government telling business what to do
Consequences of Hoover’s Policy

- Labor costs rose substantially as productivity fell and wages were fixed
- Industry asked Hoover to allow wage cuts proportional to deflation
- Hoover declined: "There will be hell to pay with Unions"
- People wanted to work, but couldn’t - wages didn’t fall
- Situation Wanted Ads - people willing to work for 30 percent less than wages paid
- Farm sector not impacted by Hoover policy - employment didn’t fall - wages did
National Industrial Recovery Act - full-scale cartelization of US industry

Industry collusion provided that they raised wages substantially

"Codes of Fair Competition" - permitted minimum prices, output restrictions

Result: wages and industry prices 20 percent above full employment levels

Depressed employment by 15 percent

Economy would have recovered to trend by 1937 in absence of cartel policies
Figure 3 - Manufacturing Wages
(Sept 1929 = 100)
Very Different View of Depression

- Depression one-off decade-long event because of wholesale cartel policies
- Fed could have limited damage from Hoover by preventing deflation
- But couldn’t have done much to offset FDR policies
- Capitalism wasn’t broken…
- Interference with market mechanisms depressed the economy