COUNCIL on FOREIGN RELATIONS

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**A Second Look at the Great Depression and New Deal**

Cohosted by the Council on Foreign Relations and NYU Stern School of Business
Symposium Rapporteur Report
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*Cosponsor of this symposium is Dean Thomas Cooley of the Leonard N. Stern School of Business, New York University. The conference is also supported by a special grant from the Ewing Marion Kauffman Foundation.*

In the nearly seven decades since the Great Depression ended, a number of theories have emerged as to its causes, consequences and conclusion. Today, the United States and the world again face an economic crisis. It isn't yet clear whether another depression is to unfold. However, the current recession is undoubtedly more than a routine contraction and its ramifications will likely prove deep and enduring. It's natural, then, to ask whether history offers any guidance. The last time the United States experienced an economic crisis of this magnitude was in the 1930s. What lessons does that decade have to offer, both from positive examples of government action and from negative examples? To assess these critical questions, the Council on Foreign Relations and the New York University Stern School of Business co-hosted a symposium on a second look at the Great Depression and the New Deal at the Council's New York headquarters on March 30, 2009.

In his opening remarks, Council President **Richard Haass** underscored that the current global crisis was not inevitable. It was the result of flawed policies, poor decisions and questionable behavior. "The lesson is not that market economies should be avoided; the problem lies with the practice of capitalism, not the model itself." How to prevent the financial system from collapsing is a primary challenge for policymakers. **Michael Bordo**, director of the Center for Monetary and Financial History at Rutgers University, highlighted the importance of FDR's "bank holiday" for ending the banking panic of the early 1930s and successfully clearing away the problem of bank insolvency. **Benn Steil**, senior fellow and the Council's director of international economics, discussed the need for the Federal Reserve to take into account the credit and gold markets as it determines monetary policy. "Gold still plays a monetary role, and the fact that the gold price was soaring in the early part of the decade, I think, was at least a warning." While policymakers perhaps missed the warning signs of trouble, they are now taking enormous steps to address the crisis. **Richard Sylla**, professor of economics, entrepreneurship and innovation at the Stern School, predicted that today's recession likely won't become a Depression because of the multiple measures currently being taken to shore up the financial system. On the other hand, government intervention may have the effect of subsidizing inefficiency. **Edward Prescott**, 2004 Nobel Laureate in Economic sciences and W.P. Carey Chair in Economics at Arizona State University, questioned monetary explanations and prescriptions for economic crises and predicted the U.S. will lose a decade of growth as marginal tax rates increase and other productivity-depressing policies are adopted. A pertinent policy question today is the effectiveness of government stimulus in fostering growth. **Price Fishback**, professor of economics at University of Arizona, suggested that Depression-era public works programs didn't result in significant increases to private sector job creation. The cost of resources, including labor, is also a significant factor. **Richard Vedder**, economics professor at Ohio University, highlighted government policies that kept wages artificially high during the Depression to suggest that markets generally work, but government interventions often have adverse, unintended consequences. As unemployment levels rise, however, government comes under pressure to address labor unrest. **Peter Temin**, professor of economics at the Massachusetts Institute of Technology, discussed how high wages were as much a consequence of the Depression as a contributing factor. At bottom, said **Lee Ohanian**, economics professor of the University of California at Los Angeles, the most severe recessions tend to be significantly caused by "crisis management" government policies. Such policies aim to cushion the impact of a decline but substantially worsen the situation by impeding market forces. There is also the question of how much federal intervention is enough, rather than too much. **Jeff Madrick**, director of policy research for the Schwartz Center for Economic Policy Analysis at the New School, argued that FDR didn't spend enough on stimulus for sustained recovery. Additional factors are speed and duration. **Nick Taylor**, author of *American-Made: The Enduring Legacy of the WPA: When FDR Put the Nation to Work*, said the New Deal's Works Progress Administration was slow in spending and cut short by calls to balance the budget. **Ellen McGrattan**, monetary adviser at the Federal Reserve Bank in Minneapolis, highlighted Federal Reserve models that suggest that such stimulus programs produce close to no effect on economic output. Japan's lost decade of growth also raises doubt about fiscal stimulus. **Anna Schwartz**, economist at the National Bureau of Economic Research, said fiscal stimulus was tried and failed in Japan and the Great Depression, and instead called for monetary stimulus to end recessions. Indeed, with interest rates already close to zero, monetary stimulus can encompass other policy actions. Keynote speaker **Robert Lucas**, 1995 Nobel Laureate in Economic Sciences and economics professor at the University of Chicago, said current Fed Chairman Ben Bernanke is applying that lesson to today's situation by purchasing assets to grow the money supply. In considering how to reform the financial system going forward, **Thomas Cooley**, dean of the Stern School, highlighted the importance of the Glass-Steagall Act in addressing market failure and putting an end to the banking crisis. **Charles Geisst**, finance professor at Manhattan College, said Glass-Steagall's contribution was defining what banks couldn't do while refraining from creating new mandates. The major issue, said **Ingo Walter**, vice dean of faculty and finance professor at the Stern School, is the systemic dimensions of the intermediation process and how to effectively charge for the systemic risk that individual firms generate. The effects of regulatory uncertainty are also important to consider. **John Cochrane**, finance professor at the University of Chicago, said that today's response to the crisis has been chaotic and hampered willingness to invest. To be sure, the restoration of public confidence is necessary for recovery. **Jonathan Alter**, senior editor and columnist at *Newsweek*, said FDR's leadership restored hope in the nation and called for a similar sense of shared sacrifice today. **James Galbraith**, Lloyd M. Bentsen Jr. chair in government and business relations at the Lyndon B. Johnson School of Public Affairs of the University of Texas at Austin, called for long-term policy commitments to building a new economy as FDR did during the Depression, rather than focusing on short-term stimulus programs. The limits of government intervention are of concern. **Harold Cole**, economics professor at the University of Pennsylvania, highlighted Japan's decision to prop up insolvent banks and the subsequent cessation of growth in that country for years. Government is also but one actor in the economy. **Amity Shlaes**, a senior fellow at the Council for economic history, suggested a need for faith in the private sector to play its role in leading the way toward recovery.

**Session I: "**The 1920s: Bubble, Growth, or Gold?**"**

### *1929 Crash*

– Contrary to popular belief, the stock market crash of 1929 wasn't a major cause of the Great Depression, said Richard Sylla. The Dow Jones Industrial Average fell from roughly 300 to 200 between October and November of 1929. However, by April 1930 the Dow had recovered nearly all of those losses and the crash was receding from people's memories, Dr. Sylla said.

– Dr. Sylla believes the crash and Depression were perhaps related events. But the major causes of the Great Depression happened after the first half of 1930, namely the banking crisis in which the Bank of United States failed, Dr. Sylla said. Moderator Robert Rubin said one of the key questions of the Great Depression is why it on was so much more severe and lasted so much longer in the United States than was in many other countries.

– Moderator Robert Rubin said one of the key questions of the Great Depression is why it was so much more severe and lasted so much longer in the United States than in many other countries. Mr. Rubin believes factors in the 1920s as well policies of the 1930s played a role.

– Mr. Rubin also noted that when thinking about policy responses to economic crises, psychology and confidence must be taken into consideration, as he witnessed during the Mexican and Asian financial crises of the 1990s.

### *Monetary Policy and the Gold Standard*

– Benn Steil suggested that the Federal Reserve helped cause the Great Depression by pursuing price stabilization policies in the 1920s without regard to activity in the credit markets. A global credit boom occurred as countries followed a new gold "exchange" standard after World War I, in which they were able to borrow from each other without reducing their gold stocks, Dr. Steil said.

– Dr. Steil noted the parallels to today's recent credit bubble and subsequent crash. He cited U.S. lending to and borrowing from China, which allowed credit to expand in the United States. Because overall U.S. prices remained stable the Fed didn't tighten monetary policy, allowing a credit bubble to form.

### *Hoover and Roosevelt*

– The 1920s was a period of healthy economic growth until President Herbert Hoover instituted anti-market, anti-globalization, anti-immigration, and pro-cartelization policies, Edward Prescott said. The expansion thus ended and a great depression began. Later, President Franklin D. Roosevelt's policies prolonged the depression for over six more years, Dr. Prescott said.

– Dr. Prescott also believes that high tax rates were a minor factor during the 1930s. Rather, he suggested that the Cole and Ohanian cartelization policies played a larger role. In addition, Dr. Prescott said the U.S. economy only began recovering in 1939 when FDR proclaimed the New Deal to be dead.

**Session II: "The Role of Labor Policy"**

***Labor Costs & Unrest***

– Richard Vedder said that government policies caused the price of resources, including labor, to deviate significantly from their natural rates in the 1930s. This was the major culprit for the severity and longevity of the period's economic decline, Dr. Vedder said.

– Dr. Vedder believes the economy turned downward in 1929 as part of the routine business cycle. President Hoover pressured U.S. businesses to keep wages stable as sales declined, rather than let them fall. This devastated corporate profits and balance sheets, which hampered businesses' ability to make loan payments and ultimately led to the banking crisis, Dr. Vedder said.

– Peter Temin countered the idea that high wages caused or worsened the Depression. Labor unrest grew and was politically difficult to resist as unemployment rose and in the absence of unemployment insurance, Dr. Temin said. Therefore the growth of unions and high-wage polices was partly a result of the Depression.

– Dr. Temin added that unemployment levels stayed high even as GDP recovered because of extraordinary growth in productivity after 1933.

***Effects of Government Job Programs***

– Price Fishback suggested that government attempts to create jobs yielded mixed results. When unemployment was higher in the first part of the 1930s, public works expenditures created one additional private-sector job for every eight public jobs created, Dr. Fishback said. As unemployment fell, however, in the second part of the 1930s, an increase in government jobs resulted in a loss of as much as 0.3 or 0.5 jobs as the public sector crowded out the private.

***Labor Policy Amid Today's Recession***

– Responding to a question about Obama administration proposals that could affect labor costs, Lee Ohanian said the closest and most relevant parallels to labor policy of the Depression include pending "card check" legislation and expected increases in marginal tax rates. Card check is meant to increase unionization, which would increase wages, Dr. Ohanian said.

– However, because workers now compete in a more global marketplace, the ability of unions to extract premium wages today is significantly less than it was in the past, Dr. Ohanian said.

**Session III: "Infrastructure Spending to Grow"**

***Lessons of FDR's Fiscal Stimulus***

– From a Keynesian perspective, the FDR Administration didn't spend enough in order to stimulate the economy after its dramatic decline, said Jeff Madrick, noting that the U.S. budget deficit neared 5% in the mid-1930s. Mr. Madrick said FDR was concerned with balancing the budget and cut public spending while the Fed tightened monetary policy, which combined to depress growth.

– Nick Taylor said FDR's chief stimulus program, the Works Progress Administration, was slow to spend and didn't begin until two and a half years into the administration. Between 1935 and 1937, the economy perhaps turned the corner. Treasury Secretary Henry Morgenthau persuaded FDR that it was time to balance the budget, Mr. Taylor said.

– At this point, FDR greatly reduced his stimulus spending – by two-thirds, Mr. Taylor said. Social Security also began to be taken out of paychecks, and employers contributed as well. Mr. Taylor believes the withdrawal of money from the economy produced the 1937 recession.

***Fiscal vs. Monetary Stimulus***

– Commenting on whether bigger fiscal stimulus will yield larger effects, Ellen McGrattan said the current administration's advisors estimate that $1 of government spending will generate $1.50 in output. However, Federal Reserve models designed to measure private responses to government spending suggests that stimulus packages yield much smaller effects of closer to $0 in output, McGrattan said.

– Anna Schwartz said fiscal stimulus was tried and failed in the Great Depression, and during Japan's recession of the 1990s. Instead of fiscal stimulus, Dr. Schwartz believes monetary stimulus is what ends recessions.

– In terms of today's recession, in which interest rates are already near zero, what is the difference between further monetary stimulus via quantitative easing and fiscal stimulus? Dr. Schwartz underscored that increased money supply provides an incentive for businesses and households to reduce the size of their money balances relative to other assets.

– In a recession, firms and households will first purchase bonds. As demand for bonds grows, prices rise. Firms and households then have an incentive to buy stocks, which is why the stock market historically begins to rise before the real economy does, Dr. Schwartz said. As stock prices also rise, investors look for better-priced assets in consumer durables, leading producers to increase production again, Dr. Schwartz said.

***Lessons from Japan's Infrastructure Spending***

– Although Japan's decade-long recession is often cited as an example of a failure of fiscal policy, wasn't a greater problem the government's failure to confront toxic assets in its banking system? Dr. Schwartz agreed that Japan was slow to confront its banks' problems with non-performing loans and shielded banks from failure.

– However, Dr. Schwartz said that failure was a separate one from Japan's undertaking of major fiscal projects. Dr. Schwartz said Japan built infrastructure that wasn't needed, highlighting the difference between government and private spending. The private sector can't afford to lose money on building projects for which there isn't demand, Dr. Schwartz said.

***Effects Of Infrastructure On The Economy***

– Commenting on the benefits of infrastructure, Mr. Taylor underscored that the WPA's infrastructure programs built much of the electricity and water systems that have aided economic growth, increased business efficiency and improved quality of life since the Depression.

– Mr. Taylor agreed that government infrastructure spending must be done efficiently, but he disagreed that private spending is necessarily more efficient versus government. Furthermore, the private sector can't be relied on to build necessary infrastructure, Mr. Taylor said.

– The New Deal's work relief project programs also provided the nation with needed morale, by alleviating the distress of unemployed citizens, Mr. Taylor said.

## Session IV: "Why A Second Look Matters"

***Today's U.S Recession***

– The current U.S. recession is among the most serious since the Great Depression, and there is no guarantee that it won't get worse, said keynote speaker Robert Lucas. GDP was about 5 percent below trend at the end of 2008, and is predicted to be 8 percent below trend by this year's end, Dr. Lucas said.

– However, Dr. Lucas underscored that while today's situation has parallels to the Depression, he doesn't want to suggest that he believes it is of equal importance or danger. In the 1930s, GDP fell over 30 percent below tend.

***Lessons of the Fed's Depression Response***

– During the Depression, people built up their cash holdings, Dr. Lucas said. The Federal Reserve could have responded by creating more reserves, growing money supply and adding liquidity to the system. Instead, the Fed limited itself to cutting interest rates, Dr. Lucas said.

– Citing the work of Milton Friedman and Anna Schwartz, Dr. Lucas suggested that the Fed's passive response to the liquidity problem must bear the ultimate responsibility for the Depression's severity. Therefore, while many people today think of the Depression as evidence that monetary stimulus is ineffective in truth it wasn't used, Dr. Lucas said.

– Dr. Lucas said current Fed Chairman Ben Bernanke isn't repeating the mistakes made during the Depression. The current Fed has added significantly to its reserves in response to the liquidity crisis. Although some of the Fed's asset purchases are controversial, Dr. Lucas believes it is the right policy action.

– One caveat is that the Fed will eventually need to reverse course as confidence returns, in order to avoid 1970s level inflation, Dr. Lucas said. This will require political courage and independence to unwind these Fed positions quickly, Dr. Lucas said.

### *Role of Fiscal Stimulus*

– Would a fiscal stimulus help the U.S. economy recover today, or add another weapon to fight the problem? Dr. Lucas doesn't believe so. If the government builds a bridge and the Fed prints money to pay the bridge builders, that is also monetary policy at work; the bridge is irrelevant, Dr. Lucas said.

– In addition, if the government pays for a bridge by taking tax money away from somebody else the effect is a wash, Dr. Lucas said.

– Commenting on the timing of fiscal stimulus, and whether it makes sense to build infrastructure or cut taxes during a recession, Dr. Lucas said it might make sense but not on stimulus grounds. Dr. Lucas said such policies can be beneficial, but for reasons other than temporary recovery from the current recession.

## Session V: "The New Financial Deal"

### *Addressing Uncertainty with Regulation*

– Thomas Cooley highlighted the Glass-Steagall Act of 1933 for ending the banking crisis and preventing bank runs since. The reason Glass-Steagall was successful is it addressed a problem of market failure. An important feature was the creation of the Federal Deposit Insurance Corporation (FDIC), which required banks to pay for deposit insurance and made uncertainty about bank soundness essentially irrelevant, Dr. Cooley said.

– Although Dr. Cooley doesn't believe the Glass-Steagall Act should be reinstated, he suggested it may be useful for policymakers to consider today in terms of how it addressed the risks of combining commercial and investment banking.

– John Cochrane said today's policy response has so far been chaotic, from the government taking over large sectors unrelated to the financial markets to ex post taxation of corporate bonuses. Who would invest in this climate? Dr. Cochrane believes the current uncertainty is preventing markets from resuming functionality, and could cause an otherwise routine credit crunch to turn into a Great Depression.

### *Taking Over the Banks*

– Dr. Cooley said the government is putting off facing the hard decision of how to deal with banks that are insolvent due to lack of political will. He suggested, however, that current bankruptcy laws might not be adequate for restructuring systemically important institutions such as banks.

– What is the problem with senior bank debt holders losing money? Dr. Cochrane said that bankruptcy doesn’t have to be disruptive; stockholders would lose everything and senior debt holders would lose some money. Dr. Cochrane believes the danger is that the government handles the banks the way it has Detroit automakers, supporting their inefficiencies.

**Session IV: “The Path To Growth: What Do the 1930s Tell Us About Now?”**

***Lessons of the New Deal***

– James Galbraith said capitalism had collapsed in 1932 and lost the people’s confidence. The seeming alternatives at the time were Bolshevism and fascism, Dr. Galbraith said. FDR and his New Deal showed that there was another path, consistent with the Constitution, toward recovery, Dr. Galbraith said.

– Dr. Galbraith believes the U.S. has reached a similar point today in which it must face the weaknesses of the systems built over the last 30 years and take action to repair it.

– Amity Shlaes said the institutions of financial governance from the New Deal and Hoover period that made markets transparent and the rules clear are ones we should emulate today to unfreeze the financial markets.

– Ms. Shlaes underscored the need to move away from arbitrary policy-making and toward a rules-based system. In addition, Ms. Shlaes said the private sector's job is to pull the economy forward; what we discovered in the 1930s was that perhaps the public sector too often got in the way of the private sector, Ms. Shlaes said.

***Comparisons To Today***

– Responding to a question about where we are today, in comparison with the Great Depression years, Dr. Galbraith said we're in 1930. Dr. Galbraith believes we are in the beginning stages, but with the advantage of having a bigger government and automatic stabilizers in addition to the stimulus package that can help the economy reach a floor more quickly.

– Ms. Shlaes suggested we are in a stage similar to 1937. What characterized that period is the economy wanted to recover, but there were obstacles in the way. Ms. Shlaes suggested that one obstacle is the precedence of political deal-making vs. market price-making. Putting off the pricing of assets causes a general freezing of the economy, as seen in the later 1930s, Ms. Shlaes said.

***Deficit Spending***

– Responding to a question on how government spending creates wealth since it either has to borrow or tax to fund spending, Jonathan Alter said the government can print more money. Mr. Alter also said that sometimes borrowing can help redress some of the problems caused by excessive borrowing.

*Restoring Public Confidence*

– Mr. Alter underscored a need for shared sacrifice and the willingness for the country to engage in experimentation, admit failure when necessary and try another path as FDR did in the 1930s. The effect of FDR's willingness to do so was a restoration of hope for the future, which will be necessary to put the economy on the path toward a more permanent level of growth, Mr. Alter said.

– Ms. Shlaes noted that there are different types of public confidence needed for recovery. In addition to the confidence that one can get a job, Ms. Shlaes highlighted the need for businesses to have the confidence to create jobs. This includes the ability to predict labor costs. A major question for policymakers in today's crisis then is, what are the obstacles to businesses rehiring?