Slouching Towards Utopia?

The Economic History of the World in the Long Twentieth Century 1870-2010

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The Great Depression III: Climbing Out

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The Great Depression: Suspension of the Rules on Intervention

The Depression in America

The first instinct of governments and central banks faced with this gathering Depression began was to do nothing. Businessmen, economists, and politicians (memorably Secretary of the Treasury Mellon) expected the recession of 1929-1930 to be self-limiting. Earlier recessions had come to an end when the gap between actual and trend production was as large as in 1930. They expected workers with idle hands and capitalists with idle machines to try to undersell their still at-work peers. Prices would fall. When prices fell enough, entrepreneurs would gamble that even with slack demand production would be profitable at the new, lower wages. Production would then resume.

Throughout the decline—which carried production per worker down to a level 40 percent below that which it had attained in 1929, and which saw the unemployment rise to take in more than a quarter of the labor force—the government did not try to prop up aggregate demand. The Federal Reserve did not use open market operations to keep the money supply from falling. Instead the only significant systematic use of open market operations was in the other direction: to raise interest rates and discourage gold outflows after the United Kingdom abandoned the gold standard in the fall of 1931.

The Federal Reserve thought it knew what it was doing: it was letting the private sector handle the Depression in its own fashion. It saw the private sector's task as the "liquidation" of the American economy. And it feared that expansionary monetary policy or fiscal spending and the resulting deficits would impede the necessary private-sector process of readjustment.

The "liquidationist" doctrine—that in the long run the Great Depression would turn out to have been good medicine for the economy, and that proponents of stimulative policies were shortsighted enemies of the public welfare—drew anguished cries of dissent from those less hindered by their theoretical blinders. the "liquidationist" view carried the day. Even governments that had unrestricted international freedom of action—like France and the United States with their massive gold reserves—tended not to pursue expansionary monetary and fiscal policies on the grounds that such would reduce investor "confidence" and hinder the process of liquidation, reallocation, and the resumption of private investment.

Thus governments strained their muscles to balance their budgets—thus further depressing demand—and to reduce wages and prices—in order to restore competitiveness and balance to their economies. In Germany the Chancellor—the Prime Minister—Heinrich Bruening decreed a ten percent cut in prices, and a ten to fifteen percent cut in wages. But every step taken in pursuit of financial orthodoxy made matters worse. For once the declines in wages and prices in the Great Depression had passed some critical value, they knocked the economy out of its normal business-cycle pattern. Severe deflation had consequences that were much me than an amplification of the modest five to ten percent falls in prices that had been seen in past depressions.

When banks make loans, they allow beforehand for some measure of fluctuation in the value of the assets pledged as security for their loans: even some diminuation of the value of their collateral will not cause banks to panic, because if the borrower defaults they will still be able to recover their loan principal as long as the decline in the value of the collateral is not too high.

But what happens when deflation reaches the previously never seen amount of thirty, forty, or fifty percent—as it did in the Great Depression? Banks become keenly aware that their loan principal is no longer safe: that if the borrower defaults, they no longer have recourse to sufficient collateral to recover their loan principal. if the borrower defaults, and if bank depositors take the default as a signal that it is time for them to withdraw their deposits, the bank collapses.

As Keynes, wrote, once banks realize that deflation has significantly impaired the value of their collateral:

> ...they become particularly anxious that the remainder of their assets should be as liquid and as free from risk as it is possible to make them. This reacts in all sorts of silent and unobserved ways on new enterprise. for it means that banks are less willing than they would normally be to finance any project...

In looking at the tracks of interest rates in the Great Depression, you can see a steady widening of the gap between safe interest rates on government securities and the interest rates that borrowing companies had to pay. Even though credit was ample—in the sense that borrowers with perfect and unimpaired collateral could obtain loans at extremely low interest rates—the businesses in the economy (few of which had perfect and unimpaired collateral) found it next to impossible to obtain capital to finance investment. Thus the banking system freezes up. It no longer performs its social function of channeling purchasing power from savers to investors. As a result private investment collapses; falling investment produces more unemployment, excess capacity, futher falls in prices, and more deflation; and further deflation renders the banking system even more insolvent. Morever, not only past deflation but also expected future deflation depresses investment. Why invest now if you expect deflation, so that everything you would buy this year will be ten percent cheaper next year?

In the end the spiral of deflation will continue to depress the economy until something is done to restore solvency to the banking system, and break the anticipations of further falls in prices. A few economists understood this process at work during the Great Depression—Irving

Fisher, John Maynard Keynes, R.G. Hawtrey—but they did not walk the corridors of power at the nadir of the Great Depression.

Golden Fetters: The Great Depression in Europe

Countries without massive gold reserves that wanted to play by the rules of the gold-standard game did not have the luxury of even attempting to expand their economies, at least not until they abandoned the gold standard, let their exchange rates float freely, and so cast off their "golden fetters." A government that wished to stimulate demand in the Great Depression would seek to inject credit and bring down interest rates to encourage investment. But additional credit would mean higher imports, and lower interest rates would encourage domestic investors to invest abroad. The result would be a balance-of-payments gap: economic expansion at home was inconsistent with gold convertibility. And few countries wished to abandon the gold standard at the start of the Great Depression.

There were exceptions that proved the rule. Scandinavian countries cast off their golden fetters at the start of the Great Depression, pursued policies of stabilizing nominal demand under the intellectual influence of the Stockholm School of economists, and did relatively well. In Japan fiscal orthodoxy and budget balance were abandoned in 1931, when Korekiyo Takahashi became Minister of Finance. Industrial production in Japan in 1936 was half again as much as it had been in 1928; in Japan the Great Depression was over by 1932.

But these were unusual exceptions. Before World War I the major industrial economies might have had some freedom of action. Before the war major industrial countries' commitment to the gold standard was unquestioned. Whenever an exchange rate fell to the lowest "gold point", the bottom of the band and the point at which it was profitable to begin shipping gold out of the country, capital would flow in betting on the future recovery of the exchange rate to the mid-point of its band, making the central bank's task of maintaining convertibility easy.

In the 1920s, with governments under greater pressure from newly expande electorates to generate prosperity, it was not clear that the country was committed to the gold standard. Speculators, instead, began to pull their capital out of a country facing a balance-of-payments deficit, on the principal that the loss they would suffer should the currency recovery would be dwarfed by their profits if they could take advantage of a full-fledged devaluation. With the growth of concern about currencies, central bankers wondered if the gold-exchange standard—by which they kept their reserves in sterling or in dollars—was wise. What if the pound or the dollar devalued? As the Great Depression gathered force, central banks fell back on gold as their principal reserve, increasing strains on the system.

One might have thought that those countries that had restored their pre-World War I parities would be immune from destabilizing speculation. Had not Britain returned to the gold standard at the pre-World War I parity precisely to give investors confidence that its commitment to the gold standard was absolute? But governments like Britain and the United States that had maintained pre-World War I parities found themselves lacking credibility. Because they had not experienced the 1920s as a decade of inflation, they lacked the tacit political consensus that inflation was to be avoided at all costs. By contrast countries that had undergone inflation in the 1920s found for the most part that they had high credibility, and that their exchange rates came under little speculative attack.

The Credit-Anstalt

Austria's major bank, the Credit Anstalt, was revealed to be bankrupt in May 1931. Its deposits were so large that freezing them while bankruptcy was carried through would have destroyed the Austrian economy, hence the government stepped in to guarantee deposits. The resulting expansion of the currency was inconsistent with gold-standard discipline. Savers liquidated their deposits and began to transfer funds out of the country in order to avoid the capital losses that would have been associated with a devaluation.

In order to keep its banking system from collapsing and in order to defend the gold standard, the Austrian central bank needed more gold to serve as an internal reserve to keep payments flowing and an external reserve to meet the demand triggered by incipient capital flight. The Bank for International Settlements began to host negotiations to coordinate international financial cooperation.

It is possible that rapid and successful conclusion of these negotiations might have stopped the spread of the Great Depression in mid-1931. Austria was a small country with a population well under ten million.

There was not that much capital to flee. A sizable international loan to Austria's central bank would have allowed it to prop up its internal banking system and maintain convertibility. A month later those whose capital had fled would realize that the crisis was over, and that they had lost a percent of two of their wealth in fees and exchange costs in the capital flight. Other speculators would observe that the world's governments were serious in their commitment to the gold standard, that the potential foreign exchange reserves of any one country were the world's, and thus that the likelihood of a speculative attack succeeding in inducing a devaluation was small.

Perhaps investors would then have begun returning gold to central banks in exchange for interest-bearing assets, would have begun to shrink down their demand for liquidity, and would have begun to boost worldwide investment. The Economist's Berlin correspondent thought that it might well have done the job:

> It was clear from the beginning... that such an institution [as the Credit-Anstalt] could not collapse without the most serious consequences, but the fire might have been localized if the fire brigade had arrived quickly enough on the scene. It was the delay of several weeks in rendering effective international assistance to the Credit Anstalt which allowed the fire to spread so widely…

We do not know because it was not tried. The substantial loan to Austria was not made. Speculators continued to bet on devaluation, investors continued to hoard gold, the preference for liqidity continued to rise, and investment continued to fall.__The substantial loan to Austria was not made because French internal politics entered the picture. At the beginning of his political carreer French Premier Pierre Laval had styled himself a politician of the left: the Clarence Darrow of France. But by the early 1930s he was shifting to the position of a strong nationalist. He blocked the proposed international support package for Austria, insisting that if France was to contribute France had to get something out of it. The price that Laval demanded was made up of a series of diplomatic concessions, most important of which was the renunciation of a prospective customs union with Germany. To Laval, playing the nationalist card in French politics, nothing that benefited Germany could be allowed by France.

The Austrian government refused to make the required political concessions fast enough for negotiations to be completed in time to be of use. Austria lost: the support package collapsed, and the Austrian economy abandoned the gold standard and went into recession. In the long run France lost too: what might have been a chance to moderate the Great Depression was lost. The ultimate consequences for France were dire. The rise of Adolf Hitler in Germany is inconceivable in the absence of the Great Depression. Nine years after the Credit-Anstalt crisis the French government surrendered to the Nazis.

Pierre Laval was not greatly inconvenienced at first by the Nazi conquest of Europe. He discovered that he was not a leftist at all but a Fascist. He became the second most powerful figure, and the true focus of decision making, in France's wartime collaborationist Vichy government. He was executed for treason after the end of World War II.

Absence of an International Lender of Last Resort

Back in 1931, speculators observed that the international financial community did not support currencies that came under pressure. They wondered which country would be next to devalue—and thus which country to pull their money out of fast if they did not want to lose the thirty percent or so of gold value that would be lost in a devaluation. The wave of bear speculation moved on to Hungary, Germany, and Britain. By the fall of 1931 Britain had abandoned the gold standard.

Thus international capital flows—in this case driven by fear of being caught in a devaluation—triggered devaluations and brought down the interwar gold standard. In a well-functioning gold standard, such impulses would have been damped by the credibility of the commitment to gold and by international cooperation. But in the early 1930s the commitment to gold had no credibility. And there was no international cooperation.

In the absence of international cooperation, the legacy of the gold standard was to make it impossible for any country to fight the Depression within its borders. Stimulative monetary and fiscal policies were inconsistent with the gold standard. And efforts to contain domestic banking crises were thwarted and rendered counterproductive because of the fear that rescuing the banking system or lowering interest rates was the prelude to devaluation.

As Eichengreen has pointed out, once countries had cast off the golden fetters of the interwar gold standard, the crisis was transformed into an opportunity. Policies to expand demand and production no longer required international cooperation once the gold standard framework had been abandoned. But as he has also pointed out, "liquidationism"—and fears of financial and political chaos—kept governments from beginning to fight the Depression in a serious manner for much of the 1930s.

The Great Depression is the greatest case of self-inflicted economic catastrophe in the twentieth century. As Keynes wrote at its very start, in 1930, the world was

> ... as capable as before of affording for every one a high standard of life.... But today we have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand.

Keynes feared that "the slump" that he saw in 1930

> may pass over into a depression, accompanied by a sagging price level, which might last for years with untold damage to the material wealth and to the social stability of every country alike.

He called for resolute, coordinated monetary expansion by the major industrial economies to

> restore confidence in the international long-term bond market... restore [raise] prices and profits, so that in due course the wheels of the world's commerce would go round again.

Absence of a Hegemon

Charles Kindleberger has pointed out that such action never emerges from committees, or from international meetings. Before World War I the international gold standard was kept on track because there was a single, obvious, dominant power in the world economy: Britain. Everybody knew that Britain was the "hegemon", and so everyone adjusted their behavior to conform with the rules of the game and the expectations of behavior laid down in London. Similarly, after World War II the "hegemon" for more than a full generation was the United States. And once again, the existence of a dominant power in international finance—a power that had the capability to take effective action to shape the pattern of international finance all by itself if it wished—led to a relatively stable and well-functioning system. But during the interwar period there was no hegemon: no power could shape the international economic environment through its own actions alone. Britain tried, attempting to restore confidence in the gold standard by the restoration of sterling, and failed. America might have succeeded had it tried—but successful policy requires that the hegemon recognize its leading position, which the interwar U.S. did not do.

Thus throughout the North Atlantic, for the most part the climbing-out of the Great Depression was very slow.

Climbing Out

Throughout most of the world recovery from the Great Depression was stubbornly slow. Not only was the Depression very deep, but it was very long.

The Great Depression was long for three reasons. The first was the memory of the gold standard. The belief that economies ought to be on the gold standard, and that the long-run goal of economic policy was to get back to the gold standard, kept governments in the 1930s from taking many of the steps they could have taken to boost production and employment in the 1930s. Even after the gold standard had been abandoned, its ghost continued to exert deflationary pressure on the world economy.

The second was the shift in the structure of the labor market induced by prolonged high unemployment. Prolonged, high unemployment makes risk-taking by workers seem extremely generous. Few people are willing to give up what they have—even if what they have is very small—if economic disorder means that their risks are likely to turn out badly, and that they may wind up with nothing at all.Whether in the U.S. in the 1930s, Europe in the 1930s, or Western Europe in the 1990s, prolonged high unemployment makes mass joblessness a near-permanent feature of the economy.

The third was that the world economy in the 1920s and 1930s lacked a hegemon, lacked a single economic power that could and did take the lead in international monetary affairs. Thus even had governments grasped what kind of coordinated action was called for, they would have found themselves unable to undertake it.

The Earlier You Start Your New Deal, the Better

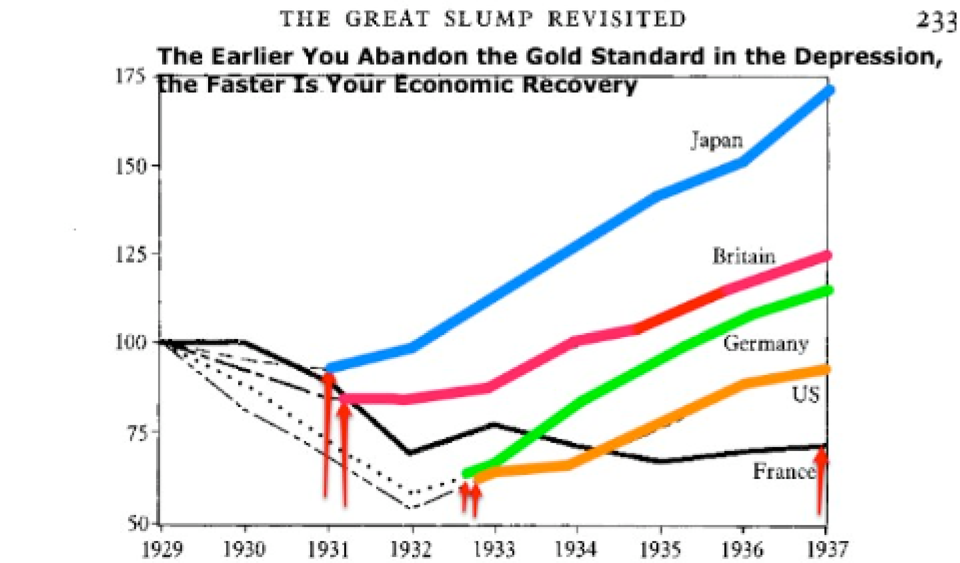


Figure 5. *Indices of industrial production, 1929–1937* (1929 = 100)
Source: League of Nations, *World production and prices, 1937/8*, p. 44.

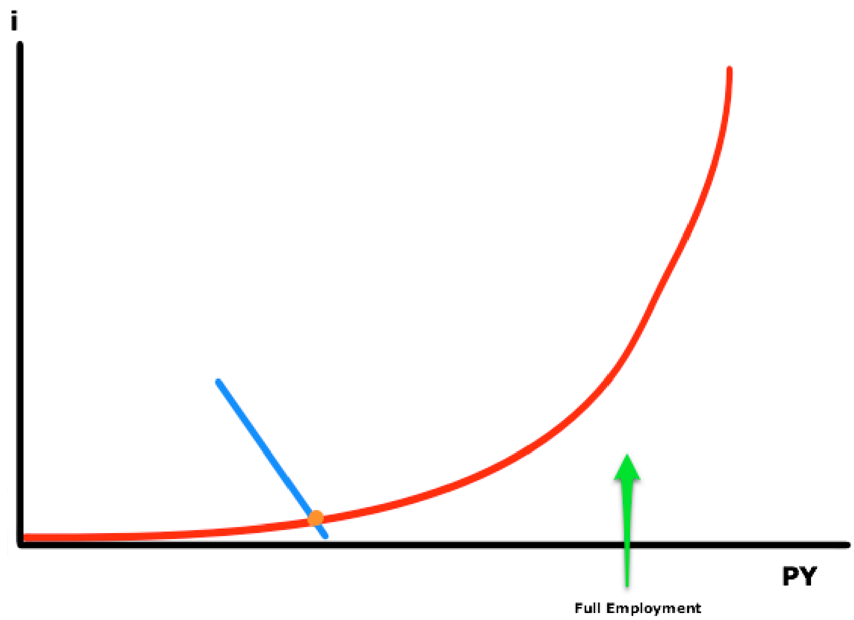
The Sooner You Start Your New Deal, the Better

The first lesson of recovery from the Great Depression is this: the earlier you abandon the gold standard—and "liquidationist" schools of thought—and start your national "New Deal," the better. Attachment to the gold standard prevents expansionary monetary policy, buying-up Treasury bonds for cash, that might have boosted demand and output. Attachment to the gold standard prevents the government budget deficits—fiscal policy—that might have boosted demand and output. Attachment to "liquidationist" schools of thought prevents the banking rescues: failures are, after all, good things—a pruning-back of speculative excess. And banking rescues help with equilibrium in the flow of funds market.

The earlier you start your New Deal, the better. Japan and Britain abandoned the gold standard and started their New Deals in 1931; Germany and the U.S. started their New Deals in 1933. France had not started its New Deal as of 1936. Those (plus Canada, which is so integrated into the United States so as not to have its own interwar business cycle) are the major industrial powers of the globe in the 1930s.

They spread out remarkably in their speed of recovery depending on when they started their New Deals.

Money Market and Flow of Funds Equilibrium



The Simple Theory of Great Depressions

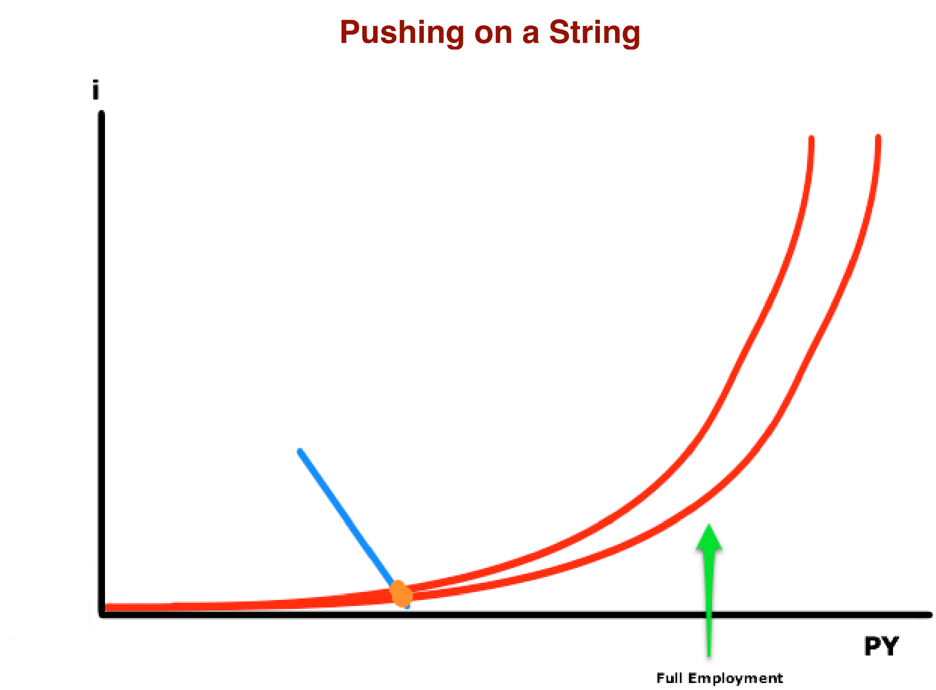
Let's go back to our diagram of equilibrium in the money market and in the flow-of-funds through financial markets, and to our picture of how wedged the world economy was then.

Once you are off the gold standard, you are allowed to expand your money stock. But—given how low interest rates are, and how close substitutes money and government bonds are, there is the fear that expanding the money stock by buying government bonds for cash won't do much. When you buy bonds for cash you reduce the supply of safe government bonds out there. A lower supply means a higher price. A higher price of safe government bonds means a lower interest rate. A lower interest rate means even less pressure to spend the cash in your pocket—a further reduction in the velocity of money. In a deep depression, therefore, trying to use normal monetary policy to boost the economy is like trying to move a toy across the floor by pushing on a string.

Remember what the blue line is: it shows what combinations of interest rates and spending balance the supply and demand of loanable funds flowing through financial markets:

$$S(Y) = (G - T) + I(i + \rho)$$

Savings, which are a function of income Y, are equal to uses of savings, which are the sum of the government deficit G-T and of investment spending I, which is itself a function of the short-term nominal interest rate on government bonds i and the spread ρ between safe short-term nominal government bonds and long-term risky real corporate bonds. How do you move this blue line?

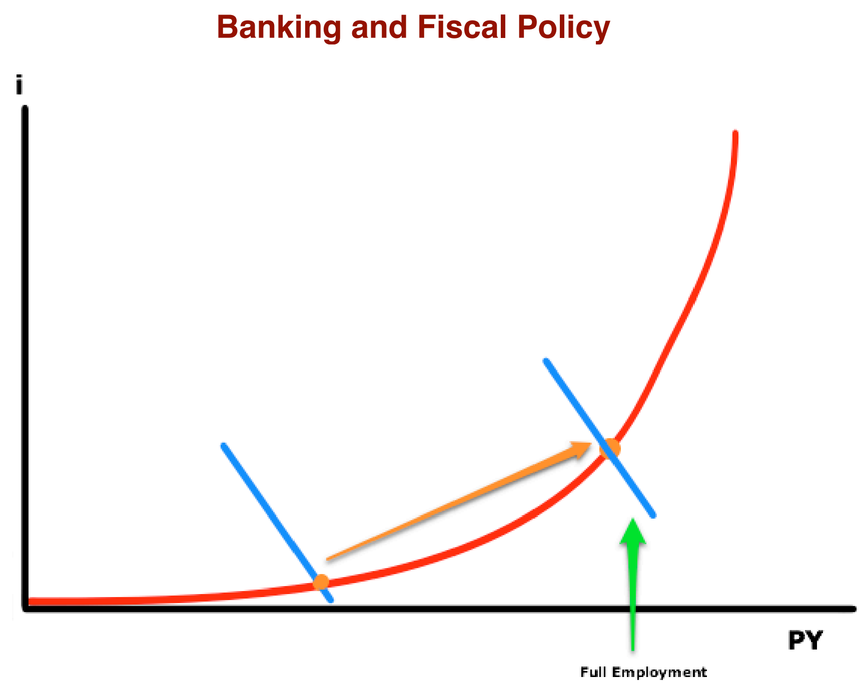


Much better, it would seem, to try to use government policy to move the blue line—the blue line that corresponds to equilibrium in financial markets, to the flow-of-funds.

Well, let's do a very little algebra. Let's write down an equation for saving:

$$S = (1-b)(Y-T) - a$$

If households had no income, there savings would be –a. As their incomes rise, they take a fraction 1-b of their after-tax incomes and save it.



And let's write down an equation for business investment spending:

$$I = c - d(i + \rho)$$

When Treasury nominal interest rates i and the spread are zero, investment is c. For each unit that the interest rate or the spread rise investment falls by d.

And let's assume that the interest rate i is not going to be moving around—that we are and will remain in the liquidity trap portion of the graph, where the red line is flat. (If we move out of the liquidity trap portion then we would be very happy: normal monetary policy tools would then be effective again.) What does our little bit of algebra tell us?

Well:

$$S = G - T + I$$
$$(1-b)(Y-T) - a = G - T + c - d(i+\rho)$$
$$(1-b)Y = a + c + G - bT - d(i+\rho)$$
$$Y = \frac{a+c}{1-b} + \frac{G-T}{1-b} + T - \frac{d(i+\rho)}{1-b}$$

And we can look at a few changes:

$$\Delta Y = \frac{\Delta G}{1-b}$$
$$\Delta Y = \frac{-\Delta T}{1-b} + \Delta T = \frac{-b\Delta T}{1-b}$$
$$\Delta Y = \frac{-d\Delta\rho}{1-b}$$

These are, respectively, fiscal policy I (government spending side), fiscal policy II (tax side), and banking policy.

(Note that another way to have gotten to exactly the same equations would have been to start out not with the money market and the flow-of-funds through financial markets but with the goods market with demand for consumption and investment and with the national income identity:

$$C = a + b(Y-T)$$
$$I = c - d(i+\rho)$$
$$Y = C + I + G$$

Different road, same destination.)

Perhaps the saddest thing about the Great Depression is that these aggressive policies weren't tried—except for large-scale government spending in Nazi Germany. The end of the gold standard and "liquidationism" and the coming of New Deals saw the end of pressure to cut government spending, raise taxes, put a lid on the money supply, and encourage bankruptcies. It did not see much pressure for aggressive expansionary policies—those, with the exception of Nazi Germany, had to wait until the coming of World War II.

Recovery in Western Europe

Germany recovered from the Great Depression relatively rapidly once Hitler had taken power. With the Gestapo in the background to suppress agitation for higher wages, better working conditions, or the right to strike, and with strong demand from the government for public works and military programs, unemployment fell rapidly in Germany in the 1930s.

Things were very different in the two other major western European powers, Britain and France.

In Britain the Great Depression broke the left-of-center Labour Party into two. The Labour Party had won 47 percent of the seats in the last general election, that of 1929. The Conservative Party had won 43 percent of the seats. The centrist Liberal Party had won 10 percent of the seats. The government formed after that election was Labour Party-led, but depended on liberals for its support.

The Prime Minister was Ramsey MacDonald. He, Chancellor of the Exchequer Philip Snowden, and the bulk of the cabinet believed that the gold standard needed to be maintained—and the budget needed to be balanced.1 The members of Parliament and the Labour Party's members in the country were violently opposed to any reductions in unemployment benefits or in public-sector pay scales. The Liberals violently opposed tax increases, especially tariffs.

In August 1931 Ramsey MacDonald solved this dilemma by breaking his party. Together with three other Labour Party ministers, he joined with two Liberal cabinet members and four Conservative Party ministers to form a "National" government. The following month—September of 1931—large-scale capital flight began.

The Bank of England took next to no steps to raise interest rates to reduce the gold outflow. It increased its short-term interest rate to 3.5 percent, but no higher: unemployment was at 20 percent, and a Labour government was in power. The Bank of England appears to have believed that it had no further room for maneuver.

Eichengreen (1997) describes what happened next:

> Realizing that there were [nearby] limits on how far the Bank of England was prepared to go, and that the Bank [of England] and the [Labour] Government were likely to reduce interest rates and switch to

> a policy of "cheap money" once their investment in the gold standard was lost, the markets forced the issue…. [T]hey precipated the abandonment of a parity that would otherwise have remained viable…

On September 19 Great Britain abandoned the gold standard.

Britain's abandonment of the gold standard was not followed by large-scale reflation. By cutting their links with the gold standard, governments had gained freedom to pursue independent—and reflationary—economic policies. The Bank of England did its part, cutting back on the discount rate. The National-Conservative government did not do its. In October the Conservative Party swept the general election, winning 78 percent of seats in the House of Commons. The government that followed (even though it retained ex-Labourite Ramsey MacDonald as Prime Ministers for several years) was a Conservative government, committed to cutting back unemployment benefits and other spending, and to imposing higher regressive taxes, most notably a tariff. Monetary expansion was coupled with fiscal contraction, and Britain's recovery from the Great Depression was slow and painful.

For the first two years of the Great Depression, France was barely affected. Anglo-Saxon monetary historians have always placed a more-than-fair share of the blame on France for the structural weaknesses in international monetary affairs that laid the foundation for the Great Depression. The franc parity established in mid-1926 was certainly an undervalued one—although in large part because the Bank of France wanted to make sure that it would not have to devalue than out of an attempt to gain strategic advantage in international trade. As a result France had a large gold inflow throughout the late 1920s. By the end of 1931 France was clearly the world's second-leading holder of gold (behind the United States). And the increase in the Bank of France's gold holdings did not flow through to increases in domestic credit and to domestic inflation.2

Thus when the Great Depression began, it had little initial effect on France. The value of the Bank of France's holdings of foreign exchange fell as other countries abandoned the gold standard and devalued their currencies.3 The value of French exports fell somewhat as devaluation elsewhere led to declines in its competitiveness. But these were minor annoyances for the first few years of the Depression compared to the catastrophes going on elsewhere: unemployment remained low.

In the end, however, no one could remain on the gold standard. As country after country devalued, those that had not found their industries uncompetitive, their payments in deficit, and their maintenance of convertibility a source of domestic unemployment. Of those few countries that remained on the gold standard after the U.S. abandoned it in 1933, Belgium abandoned gold convertibility in 1935, and the rest—the Netherlands, Switzerland, and France—in 1936.

Throughout the early 1930s the government and Bank of France repeatedly rejected any ideas of monetary inflation. They feared that any steps toward reflation would reignite the inflation that France had experienced in the early and mid-1920s. Official statistics show only small increases in officially-measured unemployment in the 1930s. But the frame of mind of the French appears to have undergone as large a shift towards a "depression mentality" as in other countries where officially-measured unemployment rose more.4 And estimates of national product show a deep depression by the mid-1930s: not the deepest in Europe, but not the shallowest either. And France's then-traditional revolving-door governments of center and center-right politicians fighting over spoils and tarred with financial scandals prevented anyone from even thinking about a change in economic policy.

Rising fears of fascism and reaction brought the French "Radical" Party together with the Socialist Party in 1935. Stalin's orders that Maurice Thorez's Communist Party cease attacking the Socialist Party as "social fascists" and ally with them against the real fascists brought the Popular Front political coalition together in 1936, as an alternative list to the Right's National Front.

The Popular Front won the election of 1936—with its right-most member, the Radical Party, holding a crucial 1/6 of the parliamentary seats. Leon Blum became Price Minister. Blum promised to restore pensions and public-sector wages to the levels they had held before the budget cuts of the preceding two years. He promised to greatly increase unemployment benefits. He promised to defend the franc—no devaluation.5 And he promised to balance the budget.

Accompanying this were plans to cut back on military spending, and to share the work and the wealth by cutting back on working hours and supporting strikes.

Plans to cut back on military spending—in the face of Hitler's rearmament of Germany—were never implemented. Plans to maintain the franc went as well: the election of the Blum government meant capital flight, and everyone could see that a Socialist-led government was not going to deepen the Depression in order to defend the gold standard. Any chance that Leon Blum's government might have been able to avoid devaluation ended when the victory of the Popular Front was the signal for a massive and unexpected wave of strikes. By the end of June 1936 France had taken several steps to the left in industrial relations: wage increases of fifteen to twenty percent, a forty-hour week, paid vactions, and mandatory arbitration of industrial disputes by the Ministry of Labor.

All of these raised costs—thus diminishing aggregate supply—and panicked the employers and the investors, leading to the abandonment of the gold standard. But abandonment of the gold standard did not mean substantial expansion of aggregate demand: the government's belief that the government should be trying to balance the budget led to the scaling-back of its non-military spending programs. The investing public's—correct—belief that socialism meant inflation meant that internal price rises quickly more than offset the positive, stimulative effects of a devaluation on the money supply and on exports (particularly since the devaluations were done only under pressure of necessity).6

France entered the last year before the beginning of World War II in Europe with its level of industrial production still less than the level attained in 1929.

Patterns of Incomplete Recovery

The major monetary powers of the world regularly passed up their chances to do something constructive to help the world monetary system as late as 1933, when the London Economic Conference collapsed in disagreement. The French believed that they should try to maintain the gold standard. The British, who had long since abandoned the gold standard, were unwilling to, in Eichengreen's words, "…tie their policies to those of a foreign partner [the United States] of whose intentions they were unsure." Thus:

> …those [relatively few] reflationary measures that were undertaken in the 1930s were initiated unilaterally… [and] involved currency

> depreciation… switching demand toward [home-produced goods] and stimulating net exports. The improvement in the initiating country's competitiveness was, of course, a deterioration in the competitiveness of its trading partners. This led commentators to disparage currency depreciation for its beggar-thy-neighbor effects. But the fact that these depreciations were beggar-thy-neighbor should not be allowed to obscure their effectiveness.[7]

Barry Eichengreen and others have successfully demonstrated that the earlier (and the further) countries depreciated their currencies in the Great Depression, the faster (and the sooner) was their recovery. Depreciation removed the necessity of cutting government spending and raising taxes to ensure international confidence in a country's commitment to the gold standard. Depreciation allowed countries to expand their money supplies. Depreciation allowed countries to rescue their banking systems without worrying about the consequences of bank rescue for international investor confidence.8

But depreciation and reflation were not very effective as measures for curing the Great Depression because they were not fully tried. Depreciation was near-universal. Reflation was not.

[Eichengreen diagrams: Devaluation and recovery]

Central banks did not pursue aggressive expansionary monetary policies. Fiscal authorities did not cease pursuing the mirage of a balanced budget. Instead, countries acted as though the abandonment of the gold standard was something of which they should be ashamed—and that they should keep on following, albeit in a half-hearted way—the domestic fiscal and monetary policies necessary under the gold standard. Hence the recovery of world aggregate demand from its depressed levels of the early 1930s was very slow until the very end of the decade, when the threat of war made governments realize that spending public money building weapons was more important than trying yet again to balance the budget.

The Scandinavian Model

In one region of western Europe alone was the Great Depression shallow, short, and followed by a decade of strong economic growth: Scandinavia. Scandinavia's politics during the 1930s prefigures the successful pattern of social democracy that was to come to dominate politics and economic management in the industrial core after World War II.

Consider Sweden, the heart of the Scandinavian model. Swedish socialism had been relatively strong even at the beginning of the twentieth century. And in the interwar period the Swedish socialists won enough votes to exercise power. In sharp contrast to their counterparts in Britain and France—who had no idea of what a left-wing exercise of political power would be (in large part because they bought their own propaganda that the cruelties of interwar capitalism were an inevitable part of the functioning of a market economy).

In the 1930s the Swedish socialists established housing subsidy programs, required firms to offer paid holidays and maternity benefits, set up programs to give government loans to newly-married couples short on cash, and expanded public-sector employment markedly.

All this was made possibly by a monetary policy that early cut loose from the gold standard, and pursued the goal of domestic balance through easy money and stimulated exports through the consequent low value of the real exchange rate. The countercyclical policies of the Wicksell and Wigforss-led Stockholm School were successful in rapidly eliminating the Great Depression without setting off fears of imminent hyperinflation.

As the Swedish socialists attained and successfully exercised political power in the interest of social reform, they lost their commitment to the apocalyptic doctrines of socialism: lost their belief that all private property was inherently evil, and that only a great and sudden revolutionary transfomation could bring about a better society. As historian of socialism Donald Sassoon puts it, even before the start of World War II the Swedish socialists had transformed themselves into social democrats:

> … the welfare state was the new goal; nationalization and class conflict had been dropped; democracy was valued for itself rather than as a tactic; the national road, based on a relatively insulated national economy, had come to prevail over internationalism. The Swedish model had come into being.[9]

And all of the North Atlantic industrial core was to—successfully—follow the Swedish model or some variant thereof for the generation after World War II.

The United States: FDR and the First New DeL

Before the 1930s it was unheard of for a presidential candidate to appear at the national political convention of an American party. Candidates were supposed to remain at their homes, tending to their private affairs, until informed (a week or so after the convention) by party officials that they had been chosen. They were supposed to emulate the Roman politician Cincinnatus, who mythically remained on his small farm ploughing his crops until told that he had been elected commander-in-chief of the Roman army and dictator of Rome. The conventional pretense was that the man did not seek the office: the office sought the man.10

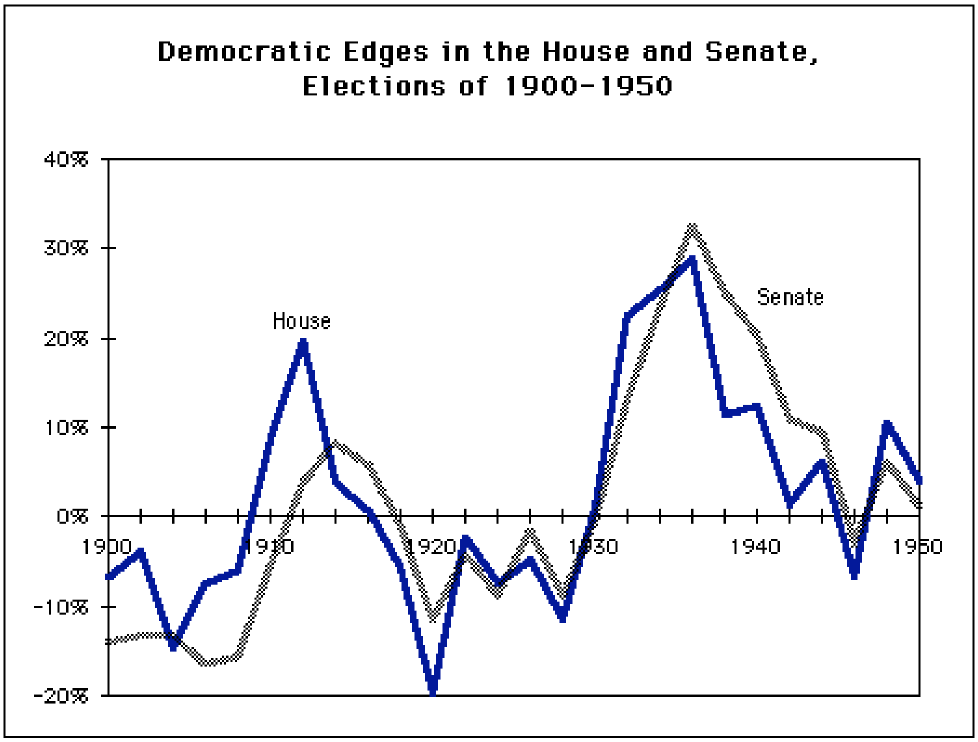
When the Democratic Party convention in Chicago nominated Franklin Delano Roosevelt, then governor of New York, as its presidential candidate in July 1932, Roosevelt broke tradition. He flew to Chicago—in part, historian Frank Leuchtenburg says, to disprove whispers that a polio victim with paralyzed legs was too frail to undertake a full-scale American presidential campaign—and spoke to the convention, saying:

> I have started out on the tasks that like ahead by breaking the absurd tradition that the candidate should remain in professed ignorance of what has happened.... You have nominated me... I know it... I am here to thank you for the honor.... [I]n so doing I broke traditions. Let it be from now on the task of our Party to break foolish traditions.... I pledge you, I pledge myself to a new deal for the American people...

What was Roosevelt's "New Deal"?

First, it was a unique moment in American political history. Usually American politics is the politics of gridlock. James Madison and company constructed the American political system so that it would be broken by design: maneuvering programs and policies through several layers of committees, two legislative houses, past the president, and into execution is very complex, and overwhelming procedural obstacles can be erected by determined opponents at almost every step along the path. Legislative majorities for one party or the other in either house of the legislature are almost always small. American is governed by increments, from the center. Between 1900 and 1950 there were times when one party had a solid majority in the House, but its majority in the Senate then was small.

The elections of the 1930s were different. Roosevelt won 59 percent of the vote in 1932—an eighteen percentage-point margin over Herbert Hoover. Congress swung heavily Democratic in both houses. The 1930s would see Democratic political dominance in the congress to an extent never before seen since the Civil War. For the first and only time, the president and his party had unshakable working majorities in both houses of the legislature.



The figure shows the majoriity or minority status—as a percentage of the total number of seats in the body—of the Democrats in all the congressional elections from 1900 to 1950

But the new majority in congress had no idea what it was to do. It was looking for direction from the newly-elected president: whatever Roosevelt sent down, the congress would probably pass.

Roosevelt had no idea what he was to do, either. But he did have a conviction that he could do something important. So was born the strategy of the New Deal: try everything you can think of to cure the depression; drop and abandon the things that do not seem to be working; push the things that do seem to be working. And the important thing was action to change how America worked for two reasons. First because action would raise hopes, and as Roosevelt said in his inaugural address:

> Let me assert my firm belief that the only thing we have to fear is fear itself—nameless, unreasoning, unjustified terror.

Second because the old way of doing things was clearly broken:

> We are stricken by no plague of locusts. Plenty is at our doorstep, but a generous use of it languishes in the very sight of the supply. Primarily this is because rulers of the exchange of mankind's goods have failed through their own stubbornness and their own incompetence, have admitted their failure, and have abdicated.... The money changers have fled from their high seats in the temple of our civilization. We may now restore that temple to the ancient truths.

There was even a hint in Roosevelt's inaugural address that he would have limited patience with a congress that failed to follow his not-yet-constructed program for fighting the Great Depression. If so:

> I shall not evade the clear course of duty that will then confront me. I shall ask the Congress for the one remaining instrument to meet the crisis—broad Executive power to wage a war against the emergency, as great as the power that would be given to me if we were in fact invaded by a foreign foe.

The day after his inauguration President Roosevelt exceeded his statutory powers by forbidding the export of gold and declared a bank holiday—a nationwide banking shutdown to freeze the then-ongoing banking crisis. Within four days the House and Senate had convened and—the House unanimously—passed Roosevelt's banking reform bill, arranging for the reopening of solvent banks, the reorganization of other banks, and giving Roosevelt complete control over gold movements.

The second bill Roosevelt submitted to congress—also passed immediately—was an "economy" bill, cutting federal spending and bringing the budget closer to balance. The third submission was a request for an end to Prohibition—for the repeal of the consitutional amendment banning alcohol. On March 29 Roosevelt called on congress to regulate financial markets to prevent fraud and overspeculation like that the U.S. had seen in the stock market crash.

On March 30 congress established Roosevelt's civilian conservation corps. On April 19 Roosevelt took the United States off of the gold standard. On May 12 congress passed Roosevelt's Agricultural Adjustment Act, promising federal aid to farmers nationwide and low-interest federal credit so farmers could refinance their mortgages. (In June congress was to extend low-interest federal credit to distressed homeowners as well.) On May 18 Roosevelt signed the bill creating the Tennessee Valley Authority, the first large government-owned utility corporation in the United States.

Also on May 18, President Roosevelt submitted to congress the center-piece of his first hundred days: the National Industrial Recovery Act, or NIRA. All factions within the newly-constituted administration won something in the legislation:

> Businesses won the ability to collude—to draft "codes of conduct" that would make it easy to maintain relatively high prices, and to "plan" to match captacity to demand.
> Socialist-leaning planners won the requirement that the government—the National Recovery Administration, or NRA—approve the industry-drafted plans.
>
> Labor won the right to collective bargaining, and the right to have minimum wages and maximum hours incorporated into the industry-level plans.
>
> Spenders won some $3.3 billion in public works.

Congress adjourned on June 16, 1933, one hundred days after Roosevelt had called it into special sesson. Congress had committed the country to a strong "corporatist" program of joint government-industry planning, collusive regulation, and cooperation; put the entire farm sector on the federal dole indefinitely; promised to build and operate utilities; undertaken huge amounts of public works spending; established meaningful federal regulation over the financial markets; and provided insurance for small depositors' bank deposits. Congress had passed all fifteen bills submitted by Roosevelt.

What did it all add up to?

The NIRA did break the back of expectations of future deflation. The creation of deposit insurance and the reform of the banking system made savers willing to trust their money to the banks again, and began the reexpansion of the money supply. Corporatism and farm subsidies did spread the pain of the Great Depression to some extent. These three policy moves kept things from getting worse, and probably made things somewhat better.

[Diagram: New Deal alphabet soup]

But the rest of Roosevelt's "hundred days"? It is not clear whether the balance sheet of the rest of the hundred days is positive or negative. The "economy" bill that cut spending and relief did harm. Much of financial market regulation (save deposit insurance) was simply irrelevant to the Great Depression. Farm subsidies set the American government on a path that would prove expensive and counterproductive for the next sixty years.

More important, perhaps, people relatively soon decided that they did not like the combination of "corporatist" government-business cooperation and business collusion embodied in the NRA. Consumers complained that the NRA raised prices. Workers complained that it gave them insufficient voice. Businessmen complained that the government was telling them what to do. Progressives complained that the NRA created monopoly. Spenders worried that collusion among businesses raised prices, reduced production, and increased unemployment. A committee to study the NRA headed by progressive lawyer Clarence Darrow denounced the NRA for promoting monopoly, urged a return to free competition, and then for good measure denounced competition as "savage and wolfish" and called for socialism: government nationalization of industry.

In May 1935 the Supreme Court unanimously declared the NIRA and its implementing agency, the NRA, unconstitutional. Roosevelt's experiment with "corporatism"—which crusty Democrats like Senator Carter Glass denounced as "the utterly dangerous effort of the federal government at Washington to transplant Hitlerism to every corner of this nation" was over. It was not a success.

By the end of 1933 Roosevelt had shifted his attention to monetary matters: recovery was to be promoted by raising the prices of commodities in dollars, and the prices of commodities in dollars were to be raised by devaluing the dollar in terms of gold. By the end of January 1934 Roosevelt fixed the value of the dollar at 1/35 of a (troy) ounce of gold, fifty-nine percent of its pre-1933 gold-standard parity. But the full-fledged policy of monetary inflation and mammoth fiscal deficits that might have pulled the country out of the Great Depression quickly—that did pull

Germany under Hitler out of the Great Depression quickly—was not tried. 1934 was a better economic year than 1933, 1935 was better than 1934, and 1936 was better than 1935, but not by much.

The slide in which each year was worse than the one before had been ended by the Depression. Some ground had been regained. But happy days were not here again.

The New Deal II: Roosevelt Tries Again

Therefore Roosevelt kept trying different things. If business-labor-government "corporatism" did not work, perhaps a safety net would. The most enduring and powerful accomplishment of the New Deal was to be the Social Security Act, which provided federal cash assistance for widows, orphans, children without fathers in the home, and the disabled; and which also set up a near-universal system of federally-funded old-age pensions. If pushing up the price of gold did not work, perhaps strengthening the union movement would: another enduring accomplishment of the New Deal was the Wagner Act, that set down a new set of rules for labor-management conflict, strengthened the union movement, and meant that the wave of unionization in the United States in the 1930s survived for half a century (rather than being rolled back within half a generation, as had happened to previous expansions of the union movement in the United States. Massive public works an dpublic employment programs restored some self-esteem and transferred some money to households without private-sector jobs—but at the probable price of some delay in recovery, as firms and workers saw higher taxes.

Antitrust policy? The breaking-up of utility monopolies? A more progressive income tax? Finally, a hesitant embrace of deficit spending not just as an unavoidable temporary evil but as a positive good? All were tried. In the end they probably did little to cure the Great Depression in the United States. But they did turn the U.S. into a modest European-style social democracy.

And as the decade came to an end Roosevelt's concerns shifted to the forthcoming war in Europe and to the Japanese invasion of China. Dr. New Deal was replaced by Dr. Win the War.

In the long run Franklin D. Roosevelt's policies mattered not because they cured the Great Depression, but because they left behind a different—a much more social democratic—America. In sector after sector, the Great Depression encouraged and allowed to do things that brought the U.S. government much closer to the social democracies of Europe.

The most important social programs of twentieth century America all started in the 1930s. The Social Security system, federal provision of a right to old-age assistance even outside the contributory Social Security system, the framework within which labor unions operate and bargain with their employers, aid to families with dependent children—although that "right" is gone: in today's America poor children receive government support only to the extent that their parents' behavior is pleasing to the state—unemployment insurance, the peculiar American farm subsidy system, and our system of financial regulation are all parts of the policy reaction to the Great Depression. Perhaps most important, the Great Depression produced and solidified the idea that the government was responsible for the health of the economy.11

Without the Great Depression, and the New Deal policy reaction to it, the government's role in the United States today would be very, very different. Some historians interested in continuity trace the roots of New Deal programs back to World War I or to the progressive era: proposals for changing financial market regulations to require disclosure, the income tax, wartime agricultural price supports, support for labor in northeastern and midwestern states, and others. But progressive-era policies and proposals had by and large failed of enactment, and the progressive era had come to a close. Social experiments involving steps toward social democracy in Minnesota or Wisconsin or Massachusetts had not attracted large-scale support elsewhere. And wartime government control over the economy had been followed by postwar decontrol, and a return to "normalcy."12

It may well be that the key is that the Great Depression changed Americans' hearts and minds about the role and place of government. The Great Depression underlined how private might fail, and how public might succeed in ameliorating if not resolving problems. Michael Bordo, Claudia Goldin, and Eugene White look at America today and see, as a result of the experience of the Great Depression, a "…general acceptance of some governmental role in public goods provision, social insurance, regulation, the completion [through information-provision or adverse selection-reduction] of various markets, the internalization of externalities, and even outright redistribution. Did the Great Depression alter the public's view concerning the functions of government, particularly those at the national level? It would certainly appear that it did."13 Capitalism had failed—at least partially failed—and it was hard to argue to workers without jobs (or who remembered that they or their parents had been without jobs), to farmers who had lost their farms (or to those who remembered that they or their parents had lost their farms) that government intervention would inevitably destroy a near-utopian near-laissez faire economy.

Thus the Great Depression called forth a substantial increase in the government share of the economy, both in the scale of programs started during the New Deal and in people's willingness to consider other possible roles for the government. This increase was accelerated by the fact that in many cases the U.S. was simply playing catch-up to other advanced industrial countries that had been developing social insurance systems and welfare states since at least the days of Bismarck.

In government regulation of industry, agriculture, and banking; in the government's attitude toward trade liberalization; in the government's attitude toward labor relations; in social insurance; and in macroeconomic policy the Great Depression triggered massive changes in how Americans related to their government. It is unclear how much of the New Deal order will survive long into the twenty-first century: the shock of the Great Depression may have been an essential factor pushing the United States toward the social-democratic mold of other advanced industrial countries, and as the memory of the Great Depression dies away the U.S. may revert to earlier patterns. But it is impossible to understand the U.S. in the second half of the twentieth century without recognizing that the Great Depression truly was the nation's defining moment.

[U.S. Federal Government responsibilities and the Great Depression]

Winners and Losers from the Great Depression

At the time it was not so clear who were the long-run winners and who were the long-run losers from FDR's policies. It was clear that losers from the Depression were many. But there were some winners as well.

Workers who kept their jobs, even with reduced hours, and financiers whose money was invested in bonds prospered during the Depression. Their nominal incomes in dollars dropped, but prices dropped even more: the baskets of goods they could buy increased. Farmers, workers who lost their jobs, and entrepreneurs who had bet their money on continued prosperity were the big losers of the Depression. Production was a third less than normal and the distribution of income had shifted toward those who kept steady employment or who had invested their financial wealth conservatively. As a result, at the nadir the standard of living of losers taken all together was perhaps half of what it had been in 1929.

No large-scale social insurance programs compensated the losers from the Depression during the first few years of the Depression, during Herbert Hoover's presidential term. In contrast to Europe, the United States had no effective system of unemployment insurance to cushion job loss. The Federal government's only significant action before the New Deal was the Veterans' Bonus—granted over Hoover's objection. State governments, with limited abilities to tax, could not come close to finding the resources to significantly cushion the decline in living standards of the unemployed.

Recovery in the U.S. began with the inauguration of Roosevelt. The two initial planks of the New Deal were the abandonment of the gold standard with the concomitant attempt to force the dollar price of gold and other commodities up, and the National Industrial Recovery Act (later declared unconstitutional) with its explicit aim of keeping competition from pushing wages and prices down. These two broke the expectation of further deflation. The end of deflation caused a mini industrial boom. Thereafter output slowly increased and unemployment slowly decreased throughout the New Deal.

While the shift in expectations brought about by the announcement of the New Deal deserves credit for breaking the downward slide, it may be the case—such arguments are still controversial—that the New Deal hindered the recovery as well. New Deal spending was by and large not deficit spending: each dollar Harry Hopkins funneled into relief was matched by a dollar removed from private-sector pockets by taxation, causing little if any rise in aggregate demand. The alliance of the New Deal with organized labor may have led to policies biased toward maintaining the real incomes of those still employed, perhaps at the expense of the unemployed in the late 1930's.

Democracy and Its Vicissitudes

Could "It" Have Happened in the United States?

In June 1932 the "Bonus Expeditionary Force" converged on Washington. The American Expeditionary Force [A.E.F.] of 1917-1918 was made up those American soldiers who had been sent to France in the latter stage of World War I and who had made up the margin of victory for the allies. The B.E.F. of 1932 was a group of some 20,000 massed war veterans who traveled to and demonstrated in Washington to try to convince congress to pay them at once bonuses for World War I that congress had voted to pay in 1945. The B.E.F. marchers camped in "Hoovervilles" and shantytowns by the Anacostia River and in unused government buildings on Pennsylvania Avenue. The congress rejected the B.E.F. petition, but many of the marchers remained in Washington.

Hoover panicked. He ordered the chief of the District of Columbia police to clear the veterans out of the buildings along Pennsylvania Avenue. First the police and then the army—commanded by Douglas MacArthur, armed with tanks, cavalry sabers, tear gas, and bayonets—cleared Pennsylvania Avenue, crossed the Anacostia River, and burned the shantytowns.

Hoover's view of the situation was that:

> ...the march was in considerable part organized and promoted by the Communists and included a large number of hoodlums and ex-convicts determined to raise a public disturbance. They were frequently addressed by Democratic Congressmen seeking to inflame them against me for my opposition to the bonus legislation. They were given financial support by some of the publishers of the sensationalist press....
>
> When it was evident that no legislation... would be passed... [many] availed themselves of...aid [to return home], leaving behind about 5,000 mixed hoodlums, ex-convicts, Communists, and a minority of veterans in Washington... fewer than a third of them had ever served in the armies, and... [45 percent] were ex-convicts and Communists.

Herbert Hoover, writing his memoirs in his retirement, was a bitter man. But if he is to be trusted, he saw the unemployed veterans camped in Washington as the vanguard of a Communist Revolution.

In his memoirs Hoover tried to make it very very clear that not he, but his Treasury Secretary—Andrew Mellon—had made the decisions that led to the eviction of the marchers:

> Some old buildings on Pennsylvania Avenue had been occupied by about 50 marchers. These buildings stood in the way of construction work going on as an aid to employment in Washington. On July 28th the Treasury... requested these marchers to move to other quarters.
>
> Whereupon more than 1,000 of the disturbers marched from camps outside of the city armed with clubs and made an organized attack upon the police. In the melee Police Commissioner Glassford failed to organize his men. Several were surrounded... and beaten up; two policemen... fired to protect their lives and killed two marchers....
>
> In the midst of this riot the District Commissioners... asked military assistance to restore order.... General Douglas MacArthur was directed to take charge. General Eisenhower (then Colonel) was second in command. Without firing a shot or injuring a single person, they cleaned up the situation.
>
> Certain of my directives to the Secretary of War, however, were not carried out. Those directions limited action to seeing to it that the disturbing factions returned to their camps outside the business district. I did not wish them driven from their camps, as I proposed that the next day we would surround the camps and determine more accurately the number of Communists and ex-convicts among the marchers. Our military officers, however, having them on the move, pushed them outside the District of Columbia....

The version that Herbert Hoover gives in his memoirs is truly frightening.

If Hoover is correct, then commander of the army Douglas MacArthur disobeyed orders given by his civilian superiors and used military force against American citizens exercising their constitutional right to petition for the redress of grievances. Hoover and Douglas MacArthur both agreed that the B.E.F. was "a mob... animated by the essence of revolution," and MacArthur at least believed that if there had been any further delay in disbursing the marchers "the institutions of our government would have been very severely threatened."

An interpretation that puts less trust in Herbert Hoover's memoirs is even more frightening: Hoover thought that in the Great Depression a large class of American citizens—B.E.F. marchers, communists, ex-convicts, "inflammatory" Democratic congressmen, the "sensationalist" press—had become Enemies of the People in Hoover's mind.

Hoover's search for anti-American enemies conspiring against him was not limited to impoverished ex-veterans. It included the legislative barons of the Democratic Party (who); the legislative barons of the Republican Party (who); and the powers-that-be on Wall Street, who had, Hoover believed, turned into "bears" conducting "bear raids" on the market to push prices down, line their own pockets further, and deepen the Great Depression. Early in 1932 Hoover summoned Wall Street's powers-that-be to account: either they were to stop their "bear raids" on the market and restore stock prices, or he would encourage the Senate to go on an investigative witch-hunt.

We were still—even with the burning of the B.E.F. shantytowns—light-years away from Hitler's suppression of the German Social Democratic Party, or Pinochet's soccer-stadium massacres of Chilean leftists and supposed leftists after his coup. But Hoover's reaction to the Bonus March is not so singular. There were additional signs of proto-fascism in the Depression-era U.S.: Huey Long, the anti-semitic radio priest Charles Coughlin, Gerald L.K. Smith. But we were still far from Mussolini's murders of socialist legislators like Mateotti, or from French Premier Daladier's resignation from the Prime Ministership out of fear of the French fascist mobs in the Paris streets outside.

Would the United States have stayed as far from a breakdown of democracy in the absence of Roosevelt's New Deal? What would four years of continued deep depression with no visible signs of recovery—if Hoover had been reelected, if America had stuck to the gold standard, and if as a result America's economic trajectory in the mid-1930s had mirrored that of France, but from a 1933 base of a much deeper depression—have brought?

The Arrival of Social Democracy—and Other, Less Pleasant Things

The persistence of the Great Depression led to large changes in the internal politics of almost every country in the world. In Scandinavia the fact that social democratic parties had more-or-less successfully managed to navigate through the Great Depression was a powerful factor helping to put them into power for most of the succeeding half-century. In southern Europe Depression reinforced reaction: one of the gifts that the Great

Depression gave the world was Spain's long-lived fascist dictator, Generalissimo Francisco Franco. Another such gift was Adolf Hitler. In Western Europe the clash between politicians who believed that curing Depression required budget balance and the greatly-expanded welfare state and social insurance needs of the decade helped retard the growth of the welfare state.

Curiously enough, in the U.S. the Great Depression accelerated the growth of the social insurance state by providing the setting for Franklin Roosevelt's New Deal. Before the Great Depression the U.S. as a whole had shown few signs of following the same political trajectory toward social democracy that Western Europe had been following since the days when Germany's conservative Chancellor Otto von Bismarck introduced national health insurance. My guess is that in the grand counterfactual of the absence of the Great Depression, that what we now think of as the U.S. New Deal—Social Security and unemployment insurance, deposit insurance and subsidized home loans, large-scale public-works projects—would have been largely confined to a relatively few liberal states in the northern tiers of the United States. But the Great Depression convinced the middle class that it had strong interests in common with the working class, and the working class that it had strong interests in common with the underclass: all had an interest in a strong and secure safety net, in a program of social insurance to protect workers and families from the disasters that the capitalist economic system might deal them. Hence the enormous political popularity of the New Deal, even today.

From a Western European perspective the American social insurance state has always been anemic. Even someone as right-wing in today's European context as former British Prime Minister Margaret Thatcher is dumbfounded at the absence of any form of national health insurance in the United States. But in the absence of the Great Depression, America's social insurance state would have been not even a shadow of its present-day anemic self.

The Equilibrium-Restoring Forces of the Market?

Economists today have faith in market economies' abilities to eventually cure depressions even in the presence of unsound economic policies. Depressions and high unemployment arise when markets malfunction, or fail to find the correct equilibrium. But excess supply of labor and excess supply of goods should eventually register. Economists track channel after channel through which the market economic system can right itself from a depression and restore full employment equilibrium.

How well did these "natural" full employment equilibrium-restoring forces work in the Great Depression? The answer is: not at all well. Some nations—Scandinavian countries that abandoned the gold standard early—experienced the Great Depression as little more than an ordinary recession, albeit in some cases beginning from a position of relatively high unemployment in 1929. The collapse of international trade in the 1930s idled resources in specialized export industries, but for countries that had abandoned the gold standard early domestic manufacturing took up the slack and returned GNP and employment to relatively high levels by the middle of the decade. These fortunate nations experienced the Great Depression as more-or-less another episode of normal cyclical unemployment in response to a large shock, in this case the world market's signal that export sectors were too large.

Other countries—largely nations like the United States and France that remained on the gold standard beyond 1930-31—were not so fortunate. Their unemployment rose to and remained at levels that seemed too high to square with the normal mechanisms of standard business cycles. Their experience was a key factor leading economists away from monetary overinvestment theories and toward underemployment semi-equilibrium theories.

From Cyclical to Structural Unemployment

Even granted that policies to fight the Great Depression were not forthcoming, the persistence of the Depression still comes as a shock. In a normal pre-Great Depression business cycle, the economy the economy closes 97% of the gap back to usual employment in three years. But the Depression shows a different picture: the economy closed only half of the gap back to full employment in three years. It is helpful to group the explanations for why Depression-era unemployment was so high and lasted so long along two axes: there are two candidates to take the blame for the persistence of unemployment during the Depression: the government, and the market.

Government-Generated Unemployment

Government-generated unemployment was widespread. In Britain some unemployment (although a small share during the peak unemployment years of the early 1930s) was surely generated by the government's unemployment insurance system. Thomas cites Eichengreen's earlier work, which presented a best estimate that some two or three percentage points of unemployment in 1929-32 could be attributed to the operation of the relief system. Thomas attributes some unemployment among secondary workers and unskilled young men with large families to the "OXO" system in which firms would systematically rotate two platoons of workers between time at work and time receiving unemployment benefit, thus turning unemployment insurance into a highly-subsidized work sharing scheme. Men receiving the standard unemployment benefit in February 1931 had on average experienced 8.6 different spells of employment during the past year, working an average of 151 days. Given such rapid turnover it is not at all implausible to argue that the availability of unemployment benefit, even with relatively low replacement rates, allowed workers to remain in labor market positions in which they were employed only half the time instead of migrating to some other industry. Thus it is possible that an underlying four or five percent of excess British unemployment may well have been maintained by the government's social policy.

In the United States even at the very end of the Depression unemployment was high. In the 1940 census some 11.1% of U.S. heads of household were counted as unemployed, of whom almost half—4.9% of all heads of household—held relief jobs.

Michael Darby has argued that the government had managed to create a situation in which those on relief found themselves with little incentive to register their labor supply on the private-sector job market, and yet were doing little socially productive work. Relief jobs were attractive to many, in spite of their low levels of relief wages relative to average private sector wages. Relief jobs were secure and required little skill. The risk-averse or the lesser-skilled might well have found that their best option was to stay on relief jobs, and be counted as unemployed, rather than take even an immediately available private sector job.

In each of these cases there is no clear alternative way of organizing the unemployment insurance system that would have been a clearly better policy. A good society should offer support to those blocked from earning their wages in the market. And a well-functioning economy should create incentives for the unemployed to strongly register their excess supply of labor in the market. These two goals are inevitably in tension. The inescapable problem was that relief payments were too high for the short-term and too low for the long-term unemployed, and that there was no good way to structure relief programs to tell these two groups apart ex ante.

William Beveridge was among the first to lay out the policy dilemma: the long-term unemployed

> need... more money rather than less than those who have had short periods of unemployment. Yet they can hardly be given more money without... [creating an incentive] to settle down into permanent unemployment.

Moreover, few of the long-term unemployed "escape physical and psychological deterioration through long idleness."

Market-Generated Long-Term Unemployment

Nevertheless, a large part of the puzzle remains: roughly half of Depression unemployment was concentrated among long-term unemployed who could not take advantage of subsidized relief-work schemes. Long-term unemployment was strongly present in those countries that suffered worst from the Depression, including non-European nations like Australia, Canada, and the United States and European nations like Britain, Germany, Italy, and the gold block nations of France and Belgium. Of these only Germany achieved a strong recovery from the Depression in the 1930s.

Once an economy had fallen deeply into the Great Depression, devalued exchange rates, prudent and moderate government budget deficits (as opposed to the deficits involved in fighting major wars), and the passage of time all appeared equally ineffective ways of dealing with long-term unemployment. Highly centralized and unionized labor markets like Australia's and decentralized and laissez-faire labor markets like that of the United States did equally poorly in dealing with long-term unemployment. Fascist "solutions" were equally unsuccessful, as the case of Italy shows, unless accompanied by rapid rearmament as in Germany.

Even today, economists have no clean answers to the question of why the private sector could not find ways to employ its long-term unemployed.

The very extent of persistent unemployment in spite of different labor market structures and national institutions suggests that theories that find one key failure responsible should be taken with a grain of salt. But should we be surprised that the long-term unemployed do not register their labor supply proportionately strongly? They might accurately suspect that they will be at the end of every selection queue. In the end it was the coming of World War II and its associated demand for military goods that made private sector employers wish to hire the long-term unemployed at wages they would accept.

At first the unemployed searched eagerly and diligently for alternative sources of work. But if four months or so passed without successful reemployment, the unemployed tended to become discouraged and distraught. After eight months of continuous unemployment, the typical unemployed worker still searches for a job, but in a desultory fashion and without much hope. And within a year of becoming unemployed the worker is out of the labor market for all practical purposes: a job must arrive at his or her door, grab him or her by the scruff of the neck, and through him or her back into the nine-to-five routine if he or she is to be employed again.

This is the pattern of the long-term unemployed in the Great Depression; this is the pattern of the long-term unemployed in western Europe in the 1980s and 1990s. It appears to take an extraordinarily high-pressure labor market, like that of World War II, to successfully reemploy the long-term unemployed once they get into that situation.

Changes in Economic Thought

In response to the high persistence of unemployment in the interwar years, economists abandoned the idea that business cycles were the economy's best feasible response to inevitable shocks to present circumstances and expectations about the future, and that the Great Depression had been generated by the largest such shock ever seen. Instead, they turned to alternative—Keynesian—approaches to explain the persistence of high unemployment, even though these alternative approaches were not so much theories of business cycles as policy recommendations accompanied by promises that supporting theories would be constructed later.

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[1] It remains unclear to this day why dominant opinion in the Labour Party was so opposed to—Liberal Party—plans for reflation and economic expansion. In the final analysis, it truly does seem to be a case of "not invented here": the principal advocates of reflation were either Liberal intellectuals like John Maynard Keynes, or grass roots-based trade unionists like Ernest Bevin, or cabinet members on the make like future fascist Oswald Mosley. And Ramsey MacDonald and the other leaders of the parliamentary Labour Party were not particularly interested in advancing the political fortunes of Liberal intellectuals, or grass roots-based trade unionists, or junior ministers who wanted over-rapid promotion above their station.

Robert Skidelsky, by contrast, sees the sources of Labour Party opposition to reflation as ideological. Because they were "commit[ed] to a nebulous Socialism" they could not help but believe that the plans of "'economic radicals' such as Keynes as mere [ineffective] 'tinkering.'" See Robert Sidelsky (1967), *Politicians and the Slump: The Labor Government of 1929-1931* (London: Macmillan). Donald Sassoon and Ross McKibbin believe that "Britain faced specific international constraints which made any serious counter-cyclical budgeting problematic" (see Donald Sassoon (1996), *One Hundred Years of Socialism*(New York: New Press); Ross McKibbin (1975), "The Economic Policy of the Second Labour Government," *Past and Present* 68 (August), pp. 96-102). No, it didn't—or at least the constraints were much more in the minds of politicians than in markets.

[2] See Barry Eichengreen (1997), *Globalizing Capital: A Short History of the International Monetary System* ().

[3] And for other countries France took steps to make the Depression worse. In late 1931 the Bank of France began trying to turn all of its foreign-exchange holdings into gold, plaicng an additional amount of deflationary

pressure on the world economy. See Barry Eichengreen (1997), *Globalizing Capital* ().

[4] See Eugen Weber (1994), *The Hollow Years: France in the 1930s* (New York: W.W. Norton: 0393314790).

[5] Donald Sassoon cites Julian Jackson to the effect that France's devaluation under the Popular Front was delayed—and thus too little, too late—because only by delay could the Popular Front avoid British and American retaliation. This seems to me to grossly misread international monetary relations during the interwar period: neither Britain nor America had altered its monetary policy in order to avoid retaliation, nor had the French government worried about potential retaliation in choosing its parity for the franc in 1926. In my judgement the delay in the Popular Front devaluation—like French socialist attempts to hold the franc a high value when the socialists took power in 1981—reflects the incompetence of party leaders who heard from their economists only what they wanted to hear, not malevolent pressure from Anglo-Saxon countries. See Donald Sassoon (1996), *One Hundred Years of Socialism* (New York: New Press: 1565843738); Julian Jackson (1988), *The Popular Front in France* (Cambridge: Cambridge University Press).

[6] On the dilemmas faced by Leon Blum—and his failure to thread a way through them—see Joel Colton (1966), *Leon Blum: Humanist in Politics* (New York: Knopf).

[7] Barry Eichengreen (1997), *Globalizing Capital: A Short History of the World Monetary System* ().

[8] See Barry Eichengreen and Jeffrey Sachs (1985), "Exchange Rates and Economic Dynamics in the 1930s," *Journal of Economic History* 45:3 (September), pp. 825-846; Barry Eichengreen (1988), "The Australian Recovery of the 1930s in International Comparative Perspective, in Robert Gregory and Noel Butlin, eds., *Recovery from the Great Depression: Australia and the World Economy in the 1930s* (Cambridge: Cambridge University Press:); Jose Campa (1990), "Exchange Rates and Economic Recovery in the 1930s: An Extension to Latin America," *Journal of Economic History* 50:4 (December), pp. 677-682.

[9] Donald Sassoon (1996), *One Hundred Years of Socialism* (New York: New Press: 1565843738), p. 46.

[10] In the phrase "conventional pretense" the emphasis should be on the word *pretense*. See Gil Troy (), *See How They Run* ().

[11] See J. Bradford De Long (1996), "Keynesianism, Pennsylvania-Avenue Style," *Journal of Economic Perspectives*.

[12] Some claim that the Depression-era consensus in favor of a relatively large government and social democracy would have quickly eroded away in the absence of World War II and the Cold War to cement a large government premise. Such grand counterfactuals are very difficult to evaluate. See Robert Higgs (1987), *Crisis and Leviathan* (New York: Oxford University Press).

[13] Michael Bordo, Claudia Goldin, and Eugene White (1997), "The Defining Moment Hypothesis," in Michael Bordo, Claudia Goldin, and Eugene White, eds., *The Defining Moment: The Great Depression and the American Economy in the Twentieth Century* (Chicago: U. of Chicago Press: 0226065898).