LESSONS FOR THE PRESENT FROM THE GREAT DEPRESSION

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The economic contraction that started in 1929 was the worst in history. Historians have compared it with the downturns of the 1840's and the 1890's, but the comparisons serve only to show the severity of the later movement. In the nineteenth-century depressions, there were banking panics, deflation, and bankruptcy, in various proportions. But there is no parallel to the massive underutilization of economic resources in the 1930's.

Given the magnitude and importance of this event, it is surprising how little we know about its causes. The reactions of people to the Depression, the policies undertaken during the Depression, and the effects of the Depression have all been the objects of extensive study. But the economic collapse itself has suffered a form of intellectual neglect. Too long ago to be part of the study of the current economy, too recent to be included in most courses in economic history, too complex to be explained simply, economists have—with a few prominent exceptions—left the study of the Depression to others. The inevitable result has been a neglect of the economic aspects of the Depression. While economists have advanced a variety of hypotheses to explain why depressions can take place, little attention has been given to the explicit application of these competing theories to the biggest depression in history.

One reason, often and correctly given for the magnitude of the Great Depression, is the absence of a concerted expansionary macroeconomic policy between 1929 and 1933. The monetary and fiscal policies that we now think could have been effective in moderating or eliminating the contraction
were not used to any perceptible extent.¹

But the question of what macroeconomic policy would have worked is only one question that can be asked about the Great Depression. It is of considerable interest also to know what happened to make such a corrective policy desirable.² What happened in the years around 1929 that (in the absence of offsetting government policies) led to the historically unique events of the 1930's? While this question is different from the question of what policies are appropriate for curing depressions, it is not unrelated, as the work of Milton Friedman and Anna Schwartz shows.

Friedman and Schwartz's classic Monetary History of the United States forms the base of an argument that movements of income have historically been caused by changes in the stock of money, which in turn are caused by a variety of exogenous factors.³ The Monetary History documents the last step of this argument, from which the other steps are derived.

Upon examination, however, the Monetary History turns out to be an account of the supply of money. Friedman and Schwartz never acknowledge the existence of the identification problem implicit in any attempt to partition changes in a quantity into changes in the supply and changes in the demand. Instead, they discuss the supply of money and ignore the demand—a procedure that can only be justified by the assumption that changes in the stock of money were attributable almost entirely to shifts of the supply curve. This proposition, which the Monetary History appears designed to prove, is instead an assumption on which the analysis of the book rests.⁴

For instance, the Monetary History asserts that the stock of money fell in the early 1930's because of an autonomous fall in the supply of money. The fall in the supply was caused in the first instance by a decline
in Federal Reserve credit outstanding in 1930, but far more importantly by the effects of the banking failures that started in late 1930. The fall in the supply of money induced a movement along the (stable) demand curve for money—that is, a decline in income and interest rates—to equilibrate the money market.\(^5\) The fall in income therefore was a result of the autonomous factors decreasing the supply of money.

Because of the incompleteness of the book's argument, however, there is nothing in the narrative of the *Monetary History* to refute the following completely different story: Income and production fell after 1929 for non-monetary reasons. Since the demand for money is a function of income, the quantity of money demanded fell also. The money market was equilibrated by the fall in the stock of money following the bank panics, but these panics did not in any way cause the decline in income.\(^6\)

It is not easy to resolve the implicit identification problem and choose between these two stories, and I have tried a variety of approaches. Space precludes anything more than a brief mention of my conclusions here as they are fully reported elsewhere (see Temin, 1976). I found that it is harder to discriminate between these two stories than one might imagine from the intensity of the debate among macroeconomists, but that there is no evidence of any effective deflationary pressure from the banking system between the stock-market crash in October, 1929, and the British abandonment of the gold standard in September, 1931.

As mentioned at the start of this discussion, this disagreement among historians is of more than passing interest. Our inability to settle on a single story of the Great Depression, or even to devise powerful tests of alternative stories, suggests that a certain diffidence with respect to
current policy prescriptions is in order. It also makes it hard to generalize from the experience of the 1930's because it is not clear which aspects of that time were critical in the economic decline. Nevertheless, a stab at comparison is worth making. Is there anything in current macroeconomic data that suggests that we are in for a period of substantial and sustained underutilization of economic resources on a scale approaching the experience of the 1930's?

Despite current optimism on this score, there are a number of similarities between the recent decline and the beginning of the Great Depression. Some of them are shown in Table 1, where annual data is used in preference to quarterly data to make the recent observations consistent with the available annual data from the 1930's. Annual rates of change of several macroeconomic variables are shown for the first two years of the Great Depression, for last year, and this year. The data for 1975 have been estimated from data on the first three quarters, but they should be accurate to the degree needed for this discussion.

The GNP deflator is listed in the first row of Table 1 because recent price history is so different from the price history of the late 1920's and early 1930's. It seems absurd to discuss, say, the nominal quantity of money without paying attention to the rate of inflation, but there are also objections (as we shall see shortly) to dealing solely with real balances. I therefore have shown the changes in a price index separately to emphasize the price movements removed in the calculation of real magnitudes.

The second and third rows of Table 1 show the growth rate of the real stock of money under two definitions. In nominal terms, the path of the money stock in the last two years was completely different than in 1929-31.
Table 1
Percentage Changes in Some Macroeconomic Variables, 1929-31 and 1973-75 (percent)

<table>
<thead>
<tr>
<th></th>
<th>1929-30</th>
<th>1930-31</th>
<th>1973-74</th>
<th>1974-75</th>
</tr>
</thead>
<tbody>
<tr>
<td>GNP Deflator</td>
<td>-3</td>
<td>-9</td>
<td>+10</td>
<td>+9</td>
</tr>
<tr>
<td>Real M₁</td>
<td>-1</td>
<td>+3</td>
<td>-4</td>
<td>-4</td>
</tr>
<tr>
<td>Real M₂</td>
<td>+1</td>
<td>+3</td>
<td>-1</td>
<td>-1</td>
</tr>
<tr>
<td>Real Stock Prices</td>
<td>-16</td>
<td>-26</td>
<td>-36</td>
<td>-5</td>
</tr>
<tr>
<td>Real Residential Construction,</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Consumption Expenditures,</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1958 Prices</td>
<td>-7</td>
<td>-4</td>
<td>-2</td>
<td>+1</td>
</tr>
<tr>
<td>Real GNP, 1958 Prices</td>
<td>-10</td>
<td>-8</td>
<td>-2</td>
<td>-3</td>
</tr>
</tbody>
</table>

In real terms, however, there is more similarity. The real money stock remained more or less constant in 1929-30 and rose in 1930-31; it fell slightly in 1973-74 and 1974-75. In neither period did the real money stock behave in an expansionary manner, and it fell more in the last two years than it did in the early 1930's.

What should we conclude from this comparison? If we believe that the demand for money is a stable function around which there is very little variation, that the interest-elasticity of the demand for money is low, and that the direction of causation runs from the stock of money to the arguments on the right-hand side of the familiar equation, we must look for a fall in real GNP. 7

This approach ignores interest rates and other financial markets; only an extreme monetarist would stop here. One financial market whose movements have been cited repeatedly as a cause of the Great Depression is the stock exchange. As can be seen in Table 1, prices on the New York Stock Exchange declined more from 1973 to 1974 than they did from 1929 to 1930, and the difference is quite large in real terms. And even though stock prices fell less in real terms this year than in 1931, the fall over a two-year period was almost exactly the same for 1929-31 and 1973-75. If the stock-market crash was a powerful deflationary force in 1930, there would seem to be cause for alarm now from this quarter also.

Turning to nonfinancial markets, the decline in housing in the 1930's often is cited as a primary cause of the Great Depression. And, as everyone knows, the construction industry is a serious casualty of the current financial picture. As Table 1 shows, the proportional decline in the real value of housing investment was only slightly smaller in 1973-74 than in
1929-30 and slightly larger in 1974-75 than in 1930-31. The data in Table 1 are only the tip of the iceberg; the history of construction is too complex to be summarized this simply. But a more detailed history would not refute the assertion that if a prosperous construction industry is needed for the health of the economy, as most Keynesian descriptions of the Depression seem to assume, then the recent decline in housing is extremely serious. (See Bolch and Pilgrim.)

So much for similarities. There are also several striking discrepancies between the recent record and the experience of the 1930's--differences that we hope are enough to justify the current optimism. The instability of foreign exchange markets, the difficulties attendant upon large shifts in international lending, and the problems of countries experiencing sharp changes in the terms of trade, all figure prominently in many stories of the 1930's. All of these problems are present today, but the structure in which they are taking place does not seem as vulnerable as the inter-war one. In particular, the era of floating exchange rates does not seem to be as vulnerable as the gold-exchange standard was.

In addition, the fall in real consumption expenditures was far smaller in 1973-74 than in 1929-30. The dramatic decline in consumer spending in 1930 was an important--possibly even critical--part of the story of the Great Depression. In my view, an autonomous fall in consumer spending in 1930 was a major factor blocking the recovery that contemporary observers expected until quite late in that year (see Temin, 1976, Chapter III). If this view is accepted, then the current relative steadiness of consumption expenditures is quite encouraging.

This raises an obvious question: Why didn't consumer spending fall as
much relative to the predictions of a standard set of expenditure functions last year as it did in 1930? A tentative answer is suggested by some recent work of Frederic Mishkin (1975a and b) of MIT. Consumer expenditures, Mishkin argues, are related to the balance-sheet position of households, in which the stock of money figures only marginally. It has by now become a commonplace that household spending plans are in part a function of the household's net wealth. In addition, Mishkin argues that the costs of selling illiquid assets—or of going bankrupt in the extreme—induce household spending to be a function of the household's leverage as well. At the same level of net wealth, consumption expenditures will be inversely related to the volume of debt.

People were increasing their indebtedness throughout the 1920's, and they borrowed heavily in 1929. When the stock-market crash came, the net wealth of households was reduced and their leverage was increased. (The decline in the value of their assets both reduced their net wealth and raised the ratio of their debts to their assets.) The combination of these two movements caused consumption expenditures to slump dramatically in 1930.

This effect was not present to the same degree in 1974 for two reasons. There was no accumulation of debt in 1973 comparable to the build-up in 1929. And the inflation of 1974 reduced the real value of debt while the deflation of 1930 increased it. Consequently, while the effect of the decrease in consumer liquidity was apparent in 1974, it did not have the dramatic macroeconomic implications that it did in 1930.

Finally (in our list of optimistic factors), there does not seem to be a substantial risk of repeating the sequence of bank failures that characterized the early 1930's. The FDIC was able to contain the failures of the
United States National Bank of San Diego in 1973 and the Franklin National Bank of New York in 1974 in ways that aborted any rise in destabilizing speculation against banks. There does remain—at the time of writing—the risk that a default by New York City might weaken banks holding the city's paper and lead to a banking panic, but this risk appears small. The Federal government probably will not let the city default, and investors probably will be happy with a negotiated write-down of assets in place of a court-directed write-down. Even if the city does default, this possibility has been extensively discounted. An event so fully anticipated should not initiate a panic, although it may have less dramatic contractionary effects by raising the interest rates at which many potential purchasers of real capital can borrow.

Our view of the Great Depression is hardly complete. In a serious discipline, it must be a cause of concern that one of the major events in our economic history is still so poorly understood. Nevertheless, our knowledge of the Great Depression is still sufficient to give us some assurance that the current position is not nearly as serious as the economic condition in 1930. It would be nice to say that this was the result of more enlightened macroeconomic policies by our current leaders, but the story just sketched does not support such a conclusion. We are the beneficiaries of some changes in the structure of the economy and luck, rather than the fruits of expert leadership.
Footnotes

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1 For the failure of monetary policy to be used, see Friedman and Schwartz, 1963a. For the failure of fiscal policy, see Brown, 1956. Norman, 1969, argues that a successful counter-cyclical fiscal policy would have had to exceed greatly the scale of anything even contemplated in the 1930's. Of course, the negative argument that macroeconomic policies were not used is hardly the same as the positive argument that these policies would in fact have been effective. This assertion is difficult, possibly even impossible, to prove, and the debate about it revolves on questions about the structure of the economy rather than the occurrence of specific historical events.

2 This is the question I have addressed in Temin, 1976.

3 Friedman and Schwartz, 1963a. The argument is implicit in the Monetary History, but made explicit in Friedman and Schwartz, 1963b, and Friedman and Meiselman, 1963.

4 This interpretation of the Monetary History is extensively documented in Temin, 1976, Chapter II.

5 Friedman and Schwartz's argument assumes that the bank failures had a much stronger effect on the demand for deposits than on the demand for money. For a first approximation, the latter may be ignored.
6 In Friedman and Schwartz's story, income would not have declined nearly as much as it did in the absence of the banking panics. In this alternative story, income would not have been much higher in the absence of the panics.

7 This argument typically is made in nominal terms by monetarists, and the inflation rate is then subtracted from the growth of nominal income to get the growth rate of real income. If the income elasticity of the demand for money is one, that is, if velocity is constant as is often assumed, the two procedures are the same.
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