THE CRISIS

Their Great Depression and Ours

James Livingston

It is broad conventional wisdom that a financial collapse in the early 1930s was the principal cause of the Great Depression. And those lessons are being applied in solving today’s economic crisis. This historian argues that the causes were more fundamental and can be found in the poor wage performance before the Depression, leading to large profits in search of few investment opportunities.

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

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

But the argument that government was the problem, not the solution, has no predictable political valence. David Leonhardt (2008) offered the liberal version of the same argument—if government does its minimal duty and restores liquidity to the credit markets, this crisis will not devolve into the debacle that was the Great Depression. Niall Ferguson (2008) takes a similar line: “Yet the underlying cause of the Great Depression—as Milton Friedman and Anna Jacobson Schwartz argued in their seminal book A Monetary History of the United States 1867–1960, published in 1963—was not the stock market crash but a ‘great contraction’ of credit due to an epidemic of bank failures.”

Ben Bernanke’s argument for the buyouts and the bailout derives, of course, from the same intellectual source. At Friedman’s 90th birthday party in 2002, Bernanke, then a member of the Fed’s board, said, “I would like to say to Milton and Anna: Regarding the Great Depression: You’re right, we did it. We’re very sorry. But thanks to you, we won’t do it again” (as quoted in Carney 2008).

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

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

From this standpoint, the Great Depression and today’s economic crisis are comparable not because they resulted from similar macroeconomic causes but because the severity of the credit freeze in both moments is equally great, and the scope of the financial solution must, then, be equally far-reaching. Then and now, as Anna Schwartz explained in an interview with the Wall Street Journal (Carney 2008), a “credit tightening” accounts for the collapse of the boom.

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

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

The problem with the “long wave” approach—the reason it has less traction than the tidy alternative offered by Friedman and Schwartz—is that it cannot specify any connection between macroeconomic realities and conditions in the financial markets. Michael Bernstein’s (1988)
brilliant book on the origins of the Great Depression, for example, treats the stock market crash of 1929 as a “random event” that complicated and amplified events happening elsewhere in the economy.

This theoretical standoff has crippled our ability to provide a comprehensive explanation for the Great Depression and thus to offer a convincing comparison between it and the current crisis. So let us start over—let us ask the kind of questions that are already foreclosed by the competing models.

Was the Great Depression just another business cycle that the Fed screwed up because it did not understand the money supply? Or was it a watershed event that registered and caused momentous structural changes in the sources of economic growth? Or would more astute crisis management have saved the day?

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

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

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

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

These three trends were the key ingredients in a recipe for disaster. At the very moment that higher private-sector wages and thus increased consumer expenditures became the only available means to enforce the new pattern of economic growth, income shares shifted decisively away from wages, toward profits. For example, 90 percent of taxpayers had less disposable income in 1929 than in 1922; meanwhile corporate profits rose 62 percent, dividends doubled, and the top 1 percent of taxpayers increased their disposable income by 63 percent. This happened just when net investment became unnecessary to enforce increased productivity and output. For example, the value of fixed capital declined at the cutting edge of manufacturing—in steel and automobiles—even as productivity and output soared, because capital-saving innovations reduced both capital/output ratios and the industrial labor force.

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

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

At any rate, that is what corporate CEOs outside the financial sector did between 1926 and 1929, to the tune of $6.6 billion. They had no place else to put their increased profits—they could not, and they did not, invest these profits in expanded productive capacity, because merely maintaining and replacing the existing capital stock was enough to enlarge capacity, productivity, and output.
No wonder the stock market boomed, or rather, no wonder a speculative bubble developed there. It was the single most important receptacle of the surplus capital generated by a decisive shift of income shares away from wages, toward profits—and that surplus enforced rising demand for new issues of securities even after 1926. By 1929 about 70 percent of the proceeds from such IPOs were spent unproductively (that is, they were not used to invest in plant and equipment or to hire labor), according to Moody’s Investors Service.

The stock market crashed in October 1929 because, in my view, nonfinancial firms abruptly pulled their $6.6 billion out of the call loan market. They had experienced the relative decline in demand for consumer durables, particularly autos, since 1926, and knew better than the banks that the outer limit of consumer demand had already been reached. Demand for stocks, whether new issues or old, disappeared accordingly, and the banks were left holding the proverbial bag—the bag full of “distressed assets” called securities listed on the stock exchange. That is why they failed so spectacularly in the early 1930s—again, not because of a “credit contraction” engineered by a clueless Fed, but because the assets they were banking on and lending against were suddenly worthless.

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

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

How did this unprecedented recovery happen? In terms of classical, neoclassical, and supply-side theory, it couldn’t have happened. In these terms, investment out of profits must lead the way to growth by creating new jobs, thus increasing consumer expenditures and causing their feedback effects on profits and future investment. But as H.W. Arndt explained long ago, in The Economic Lessons of the Nineteen-Thirties (1944),

Whereas in the past cyclical recoveries had generally been initiated by a rising demand for capital goods in response to renewed business confidence and new investment opportunities, and had only consequentially led to increased consumers’ income and demand for consumption goods, the recovery of 1933–37 seems to have been based and fed on rising demand for consumers’ goods.

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

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


