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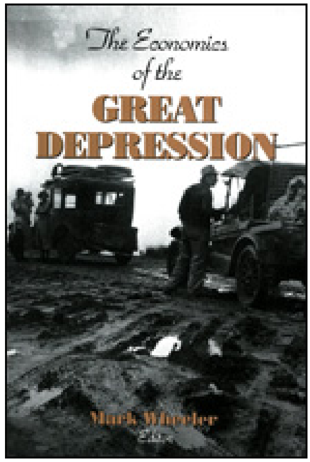
Introduction



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Introduction

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"To understand the Great Depression is the Holy Grail of macroeconomics" (Bernanke 1995, p. 1). It can be argued that understanding the Great Depression is the Holy Grail of *all* economics. The economics profession has paid much attention to the Depression years. As Stephen Cecchetti notes in this volume, "EconLit, the CD-ROM index compiled by the *Journal of Economic Literature*, lists over 400 articles on the Great Depression that have appeared since 1969 alone." However, as the various chapters demonstrate, the complexity of the subject warrants further investigation.

Drawing on a wide variety of subdisciplines within economics, the six authors in this volume explore the immediate effects of the Great Depression, the dramatic fall in output, and the legacy of the Great Depression's monetary policy.

In the first chapter, Margo examines the impact of the Great Depression on labor and labor markets. Unlike most previous studies, Margo analyzes labor during the Depression at both the macroeconomic and microeconomic levels. The main focus of the chapter is the microeconomic level.

Margo draws heavily on the public use microdata sample (PUMS) to examine the Great Depression. Drawing on his previous research (Margo 1988, 1991), he notes that "the unemployed were disproportionately young or older and tended to have fewer skills and less education than employed persons. These differences were starker comparing the employed with the long-term unemployed . . . or . . . with persons on work relief."

In addition, Margo notes that the PUMS is useful in examining New Deal work-relief programs. A particularly interesting question, which Margo also addressed in a series of previous papers (Margo 1988, 1991, 1993), concerns the impact of work relief on labor supply.

Conventional wisdom holds that the Great Depression helped produce a more equal income distribution. Margo examines this conventional wisdom and finds that the data do not support it. He finds that, "What appears to have happened is that wage differentials between skilled and unskilled labor widened in the early years of the Depression." Margo further states, "The wage structure snapped back, however, and by 1939 it appears to have been little different from its counterpart in the late 1920s." Margo goes on to note that the Great Compression of the 1940s "produced a substantial narrowing in wage inequality."

Margo also examines self-employment during the Great Depression and concludes, "Although there is much more work to be done, clearly it seems that self-employment *was* an option for many of the jobless . . ."

In the second chapter, Heim explores the effects of the Great Depression on different industries, regions, and nations. As Heim notes, "the impact of the Great Depression was highly uneven. . . Although one-quarter of the U.S. labor force was unemployed at the low point in 1933, those who kept their jobs saw their purchasing power increase as prices fell."

Heim examines the impacts of the Depression on different regions in the United States and the United Kingdom. She concludes that the Great Depression worsened the problems of the older industrial areas in the United Kingdom. In the United States, government policies that resulted from the Great Depression had positive long-run impacts on the South. Most important among these policies were the New Deal agricultural and minimum wage policies, which helped link southern labor markets with those in the rest of the U.S. economy.

Heim shows that in both the United Kingdom and the United States, some industries were much more affected than others. For example, Heim notes that shipbuilding in the United Kingdom fell by 90 percent during the 1929–1932 period. However, during the same period, output in the United Kingdom actually rose in industries such as paper and printing, leather, and food (Aldcroft 1970). Heim states that in the United States, "Throughout the 1930s, the food, leather, petroleum, and tobacco products sectors were relatively 'depression-proof.'"

Heim notes that industrialization accelerated in many less-developed countries during the Great Depression and subsequent decades. She concludes that this industrialization resulted from the less-developed countries being delinked from the international economy. This delinking caused countries in parts of Latin America, Africa, and Asia to shift production away from exports such as agricultural products and minerals and toward production of manufactured goods.

Bernstein provides an interesting mix of economic history and history of economic thought in the third chapter. Bernstein views the Great Depression through the eyes of several authors who, over the years, have tried to explain the event. Bernstein's analysis contains a summary of the well-known views of such macroeconomists as Friedman and Schwartz (1963), Keynes (1964), and Temin (1976). However, Bernstein's major contribution is an analysis of the views of economists who attempted to examine the Great Depression outside the realm of what we now consider standard macroeconomic theories. In this analysis, Bernstein draws on a rich body of economic theory.

Bernstein notes that Harris (1948) and Sweezy (1939, 1968) argued that the distribution of income had become increasingly skewed in the 1920s. This, they argued, decreased the average propensity to consume and reduced national income. Other economists, such as Kindleberger (1973) and Lewis (1950), "focused on a secular shift in the terms of trade between primary products and manufactured goods, due to the uneven development of the agricultural and industrial nations."

Bernstein also notes that industrial organization economists, such as Means and Berle (1968), "sought an explanation of the Depression in the increasing extent of imperfect competition in the American economy of the early 20th century." Schumpeter (1939, 1946), on the other hand, "held that the inter-war period was an era in which three major cycles of economic activity in the United States (and Europe) coincidentally reached their nadir." Bernstein goes on to discuss Steindl's (1945, 1966, 1976, 1984) ideas on economic maturity.

In the fourth chapter, Fackler reviews and tests theories of the propagation of the Great Depression. The money view, due to Friedman and Schwartz (1963), argues that inappropriate monetary policy played a key role in the propagation of the Great Depression. The autonomous spending view of Temin (1976) argues that a fall in autonomous consumption was the major cause of the decline in output during the Depression. Fackler also draws on the recent work of Romer (1988) who argues that "uncertainty effects due to stock market variability can explain most of the unusual behavior of consumer spending on durable and semidurable goods in the first year and a half of the Great Depression." Fackler also examines Bernanke's credit view and the debt-deflation hypothesis. As Fackler notes, "The credit view model demonstrates how a deflationary shock can disrupt the credit intermediation process and cause a sustained decline in output."

Fackler constructs an econometric model to examine the degree to which the various theories explain the path of output during the Depression. The model is an IS-LM, AD-AS model augmented to incorporate the various theories of the propagation mechanism.[1] Fackler finds that for the entire Depression period, there is not "a single, dominant explanation of the Depression." However, shocks to the IS curve best capture the characteristic phases of the Great Depression. Furthermore, the credit view works well in explaining the fall in output over the period of the stock market crash and around the bank panics in the early 1930s.

In the fifth chapter, Wheelock maintains that the Great Depression caused lasting changes in monetary institutions that ultimately gave monetary policy an inflationary bias.[2] Wheelock goes on to argue that the Federal Reserve's inflationary policy led to the collapse of the Bretton Woods System and abandonment of international linkages altogether. A key event in the collapse of the Bretton Woods System was President Nixon's 1971 decision to suspend the convertibility of the dollar into gold in response to the increasing balance of payments deficit in the United States.

Wheelock outlines the institutional reforms, enacted during the Great Depression that have the most important consequences for present monetary policy. Wheelock notes that the most significant reforms were

> the Glass-Steagall Act of 1932, which permitted the Federal Reserve to use government securities to back its note issues; suspension of the international gold standard by executive order on March 6, 1933 (ratified by Congress on March 9); the Thomas Amendment to the Agricultural Adjustment Act of 1933, which, among other things, permitted the Federal Reserve to adjust commercial bank reserve requirements; the Gold Reserve Act of 1934, which authorized the president to fix the dollar price of gold and established the Treasury's

> Exchange Stabilization Fund; and the Banking Act of 1935, which markedly altered the structure of the Federal Reserve System and expanded the Fed's authority to adjust reserve requirements.

According to Wheelock, these reforms, together with the rise of Keynesian policymaking, led to the Fed's inflationary bias.

As Wheelock notes, permitting Federal Reserve notes to be backed by U.S. government securities enhanced the Federal Reserve's ability to monetize government debt and removed a major constraint on monetary policy. Suspension of the gold standard made possible the rising balance of payments deficit, as well as Nixon's response to it.

In the final chapter, Cecchetti spells out lessons for current policy that can be gained from examination of monetary policy during the Great Depression. Cecchetti begins by examining four common beliefs associated with the Great Depression:

1. The Great Depression was caused by the stock market crash of 1929.
2. The banking system of the 1920s was fundamentally unsound.
3. The fact that nominal interest rates were approaching zero meant that Federal Reserve policy was loose and ineffective.
4. Tariff wars were primarily responsible for the spread and depth of the Depression.

Cecchetti demonstrates the fallacious nature of these four statements. Of particular interest is Cecchetti's discussion of the tightness of monetary policy during the Great Depression. He points out that nominal interest rates were low during the Depression, but that real interest rates were extremely high due to the nature of the period's deflation. If we consider real rates of interest, the Federal Reserve's monetary policy was, in fact, extremely tight.

Examination of the four fallacies leads Cecchetti to three lessons for current policy:

1. The central bank's function as the lender of last resort is of primary importance in the short-term stabilization of the financial system.

2. Deflation is extremely costly.
3. A gold standard is very dangerous.

Margo, Heim, Bernstein, Fackler, Wheelock, and Cecchetti expand our understanding of an important period in economic history. The papers in this volume take fresh approaches to the study of the Great Depression, evidence that the search for the Holy Grail of economics remains productive and interesting.

These papers developed from lectures given at Western Michigan University as part of the 1996–1997 lecture series entitled "The Economics of the Great Depression."

Notes

1. Shocks to the IS curve incorporate Temin's theory, in addition to capturing aspects of investment and shocks for the rest of the world.
2. In particular, an inflationary monetary policy emerged in the 1960s.

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