Interpreting the Depression & the New Deal


Page 15. One Economist Who Got It Right. Friedrich Hayek, 1975 interview; quoted in Mark Skousen, “Who Predicted the 1929 Crash?” in The Meaning of Ludwig von Mises: Contributions in Economics, Sociology, Epistemology, and Political Philosophy; ed. Jeffrey Herbener (Norwell, MA: Kluwer Academic Publishers, 2003). “I was one of the only ones to predict what was going to happen. In early 1929, when I made this forecast … I said that there [would be] no hope of a recovery in Europe until interest rates fell, and interest rates would not fall until the American boom collapses, which I said was likely to happen within the next few months.

What made me expect this, of course, is one of my main theoretical beliefs that you cannot indefinitely maintain an inflationary boom. Such a boom creates all kinds of artificial jobs that might keep going for a fairly long time but sooner or later must collapse. Also, I was convinced that after 1927, when the Federal Reserve made an attempt to stave off a collapse by credit expansion, the boom had become a typically inflationary one.”

Page 16. Why Calvin Coolidge Would Have Voted Against Obama. Calvin Coolidge, quoted in Silent Cal’s Almanack: The Homespun Wit and Wisdom of Vermont’s Calvin Coolidge, ed. David Pietrusza (Create Space Books, 2008), 54. “When depression in business comes we begin to be very conservative in our financial affairs. We save our money and take no chances in its investment. Yet in our political actions we go in the opposite direction. We begin to support radical measures and cast our votes for those who advance the most reckless proposals.

“This is a curious and illogical reaction. When times are good we might take a chance on a radical government. But when we are financially weakened we need the soundest and wisest of men and measures.”


Pages 15–25. Just the Facts, Ma’am. The Need for Interpretation.

Scores of books have been written about the Great Depression and also the New Deal, chronicling the personal tragedies and demonstrations of heroism during those dark years. Yet economists need to answer a crucial question in order to guide policymakers today. Why was the Great Depression so severe and so long? And did the respective policies of Hoover and FDR help or hurt?

The reader will not be shocked to learn that economic historians do not agree. For good or ill, economic historians can’t help but color their interpretation of the historical record with their own view of capitalism. Those who glorify Big Government can construct a seemingly plausible account of the Great Depression and New Deal, in which FDR swoops in and saves the day. This has been the dominant version, the one most readers learned in school, and it makes a good story that fits neatly into the chain of events just described. But as economists continue to study the period, they keep digging up hard data that glaringly contradicts the official view. More and more economists and historians are beginning to realize that the corrupt politicians who manage to waste our money today were not wizards of efficiency in the 1930s. Some things remain the same: politicians and bureaucrats have always been incompetent and venal when they’ve chosen to intervene in the economy. That’s an economic fact of life.

The Reason Why. There are three basic explanations for what happened in the Great Depression.

Explanation #1: The wildcat free market caused the Great Depression, and the New Deal pulled us out of it.

This is the official view, and the one most Americans reflexively believe. It is trumpeted by President Barack Obama—when touting the need for his “stimulus” recovery plan—and has been pounded home over the years by Nobel Prize-winning economist Paul Krugman in his very popular New York Times column and blog. It relies on the economic worldview of John Maynard Keynes, and the notion of “aggregate demand.” In this interpretation, the inherent excesses of naked capitalism allowed the stock market boom and then crash in 1929. Businesses laid off workers, who then stopped buying products, in a vicious downward spiral. Herbert Hoover did not intervene in this short-circuiting market, because he respected the Constitution and did not believe the federal government should provide direct relief to the unemployed. In fact, they say, Hoover’s devotion to a balanced budget led him to raise taxes in 1932, when the economy was already very vulnerable. FDR’s New Deal started the road to recovery, but it was ultimately the massive deficit spending of the war years that rescued America’s economy from the Depression.

Naturally, those who subscribe to the Keynesian explanation of the Depression favor a huge government stimulus package to “jump start” the economy out of its current woes.

Explanation #2. A market economy goes through natural ups and downs, but the Federal Reserve let the money supply collapse in the early 1930s, turning a normal downturn into the Great Depression.

This view was popularized by Milton Friedman and Anna Schwartz in their classic work, A Monetary History of the United States. Many modern-day fans of the free market subscribe to it, because it places the blame for the Depression squarely on the shoulders of incompetent bureaucrats. The most important proponent for this explanation today is none other then Federal Reserve chairman Ben Bernanke. In his earlier life, Bernanke was an academic economist at Princeton. His specialty—ironically enough—was the Great Depression. Today, those who endorse the Friedmanite “monetarist” explanation of the Depression think that the Federal Reserve has responded to our current housing and financial crisis properly by cutting interest rates down to virtually zero percent. These analysts remind everyone that there are “lags” in monetary policy, and that the Fed still has plenty of “ammunition” with which to stimulate the economy.
Explanation #3. The Federal Reserve fueled the stock market boom of the 1920s with its easy-money policies. After the crash, the Fed did the wrong thing by cutting rates and propping up unsound institutions. Hoover and FDR’s interventions in the economy only made things worse.

This third explanation today is most notably associated with former Republican presidential candidate and Texas Congressman Ron Paul, and with investment manager Peter Schiff. Their thinking is based on the business cycle theory of the so-called Austrian school of economics, whose most famous member is 1974 Nobel laureate Friedrich Hayek. According to this explanation, the free market is even more robust and dependable than the Friedmanites give it credit for. The boom-bust cycle is not a natural feature of capitalism, but rather is caused by the Federal Reserve’s manipulation of interest rates. In this interpretation, what made the Great Depression so terrible was not the falling money supply of the early 1930s, but instead the injection of money into the credit markets during the boom of the late 1920s. Moreover, the extraordinary meddling with wage rates by Hoover and FDR prevented workers from moving to more sensible niches in the economy, thus guaranteeing a decade of massive unemployment.

The proponents of the third explanation argue that today’s crises was caused by Alan Greenspan’s low-interest rate policy in the mid-2000s. This fueled the housing bubble, which inevitably popped, causing enormous losses to investors. The Bush Administration compounded the problem by propping up the failed institutions, and the new Obama Administration threatens to do even more damage.

If a Policy Failed in the 1930s, Why Would It Work Today?

Supporters of the first and second explanations are familiar with the basic historical facts, though they often sweep the most inconvenient ones under the rug. Keynesians, for example, realize that the federal government tried massive deficit spending during the 1930s, and yet this policy went hand-in-hand with chronic, double-digit unemployment. Followers of Friedman, for their part, do not deny that the Federal Reserve slashed its rates immediately after the stock market crash, and in fact brought them to record lows in the following years, trying to stimulate the economy through monetary policy.

So why then do today’s Keynesians (such as Paul Krugman) and today’s Friedmanites (such as Ben Bernanke) recommend what appear to be the exact same policies as a cure for our present financial crises? If their prescribed medicines led to disaster the last time they were implemented, why in the word should we favor huge deficits or easy-money policies today?

The Keynesians and Friedmanites respond that things would have been even worse in the 1930s if their solutions hadn’t been implemented. In other words, they claim that things were so bad, that even the new remedies were not enough to bring quick relief.

But the problem with that rhetorical dodge is that it ignores history and the fact that America’s free market economy had always rebounded from its previous depressions—usually within two years and at most within five—with far less pain (and much less government intervention) before the 1930s. How is it that policies that coincided with the most shocking collapse and most sluggish recovery can ever be recommended? Well, for Keynesians, the answer is simple: it gives the government more power and authority, and there are plenty who applaud such statist measures for their own sake, believing that government manipulation of the economy can make it more “rational” or “just” or better direct its resources (that is, direct them where politicians or bureaucrats want them to go). And on the surface, it seemed as if the massive deficit spending during World War II finally ended the Depression, so a Keynesian true believer wouldn’t lose sleep over the failed decade or deficit spending during the 1930s.

For their part, the Friedmanites have a much more plausible explanation than the Keynesians. After all, the money supply really did shrink by a third from 1929 to 1933; that certainly seems like it would kick the economy while it was already down. What’s more, Friedman’s explanation is appealing to those who disapprove of massive government spending, because it allows for a technical fix by the Fed.

However, the Friedmanites cannot get around the historical facts: there was nothing unprecedented about the speed of the collapse in the money supply, or in the price deflation, of the early 1930s. If Friedman is right that the Federal Reserve’s inaction caused the Great Depression, then why didn’t the U.S. experience even worse catastrophes before 1913, when the Fed didn’t even exist?

We know that there were no such catastrophes. Before the creation of the Fed, and back in the days when the federal government took no active role in fighting economic downturns, somehow depressions always managed to sort themselves out fairly quickly. It was only when both the federal government and the Federal Reserve rolled up their sleeves to really fight a downturn that America suffered through the worst economic crisis in its history. As we will see, economic theory, historical fact, and common sense all lead to the same conclusion: the government caused the Great Depression, the New Deal prolonged the misery, and World War II hurt the private sector even more.

Page 21. Sounds Like Where We Are Now. Calvin Coolidge, quoted in Silent Cal’s Almanack, 54. “We may say that it [the Great Depression] was the result of greed and selfishness. But what body is to be specifically charged with that? Were the wage earners too greedy in getting all they could for their work? Were the managers of enterprise, big and little, too greedy in trying to operate at a profit? Were the farmers too greedy in their efforts to make more money by tilling more land and enlarging their production?

“The most we can say is that there has been a general lack of judgment so widespread as to involve practically the whole country. We have learned that we were not so big as we thought we were. We shall have to keep nearer the ground. We shall not feel so elated, but shall be much safer.”

Pages 22–23. The 1920s: Roaring Prosperity or Unsustainable Boom?

Depending on one’s ideological preconceptions, the “Roaring ’20s” were either a glorious success of relatively laissez-faire principles, or they showed the inherent instability of a pure capitalist economy. The fan of the free market triumphantly points to the amazing economic growth of the 1920s, and attributes it to the conservative fiscal policies engineered by Secretary of the Treasury Andrew Mellon and President Calvin Coolidge. In 1921 the top income tax bracket was a shocking 73 percent, but Mellon reduced it to 25 percent by 1925. Mellon also cut taxes for the poor, with the lowest bracket falling from 4 to 1.5 percent in the same period. Perhaps most impressive of all, Mellon was able to slash tax rates while running federal budget surpluses every year of the Coolidge presidency.

The critic of the free market, on the other hand, tries to
dismiss the apparent “prosperity” of the 1920s as a house of cards. To such a cynic, the laissez-faire policies of Calvin Coolidge were a prelude to disaster, as evidenced by the crash of 1929 and the following decade of Depression.

The true story is more nuanced, and draws from both of these extremes. Much of the prosperity of the 1920s was real; households really did acquire cars, electricity, and appliances such as vacuum cleaners and toasters. The standard of living for the average American family really did rise at an impressive rate throughout the decade. Much of this success can indeed be credited to Mellon’s conservative fiscal policies.

However, at the same time, there were forces coming not from the free market, but from government intervention, that disturbed this legitimate economic growth. The Federal Reserve flooded the credit markets with cheap money, and it especially opened up the dollar spigot in 1927 (in an effort to ease the gold outflows from the Bank of England). Superimposed on the productive expansion of the United States economy, then, was an unsustainable boom fueled by the Fed’s inflation, particularly in the last few years of the decade. When the Fed became concerned and tried to put on the brakes, the stock market faltered and eventually crashed.

The fans of the free market are correct to blame the government, not capitalism, for the stock market crash and the ensuing Great Depression. However, many of these writers think that everything was going fine into 1929, and that boneheaded government blunders at the last moment ruined a perfectly healthy stock market. The reality is that Andrew Mellon and Calvin Coolidge, though they implemented excellent tax and spending policies, did not understand the pernicious influence of the Federal Reserve. The leftist critics of capitalism are therefore correct when they label the stock market boom as unsustainable, but these critics fail to see that the blame lies with government intervention into the banking and monetary system.

**Books You’re Not Supposed To Read:**

*Great Myths of the Great Depression*, Lawrence Reed (Midland, MI: Mackinac Center for Public Policy, 2008).


*The Great Depression*, Lionel Robbins (Auburn, AL: The Ludwig von Mises Institute, 2007 [1934]).


*New Deal or a Raw Deal?*, Burton W. Folsom, Jr. (Threshold Editions, 2009).