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LESSONS FROM THE NEW DEAL

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ECONOMIC POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

WHAT LESSONS CAN CONGRESS LEARN FROM THE NEW DEAL THAT CAN HELP DRIVE OUR ECONOMY TODAY

MARCH 31, 2009

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C O N T E N T S

TUESDAY, MARCH 31, 2009

LESSONS FROM THE NEW DEAL

TUESDAY, MARCH 31, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Subcommittee on Economic Policy,
Washington, DC.

The Subcommittee met at 2:44 p.m., in room SD–538, Dirksen Senate Office Building, Senator Sherrod Brown (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. The Subcommittee on Economic Policy will come to order.

This is the first meeting of our Subcommittee. Unfortunately, it is being delayed. I apologize for starting about 10 or 12 minutes late. Dr. Romer, thank you for joining us, and the other panel members, who I will introduce in a moment.

There are three votes. I just cast a vote. Senator Merkley will wait until the second vote starts, will vote, and then come back, and then I will go back and cast another two votes, and then come back. So we will keep this Committee going as Dr. Romer and the second panel testify.

We are facing an economic challenge few among us have witnessed. Unemployment in Ohio is 9.4 percent, the highest in 25 years. Several counties have rates in my State of more than 15 percent. My colleague Senator DeMint's State—Senator DeMint is the Ranking Republican on this Subcommittee. In his State of South Carolina, the unemployment figure is 11 percent. With all respect to the economists in the room, these numbers do not tell the entire story. Millions of men and women, as we know, are struggling to make ends meet, trying to shield their families as best they can, wrestling with the emotional problems all too common to job loss.

We are unfortunately becoming accustomed to the refrain "Worst since the Great Depression." Unemployment reached one in every four workers 75 years ago, and economic output fell by a quarter from 1929 to 1933. While not so severe, the policy challenges faced by President Obama and the Congress parallel some of those that Franklin Roosevelt confronted when he took office in March 1933. Financial institutions are wounded and hesitant to lend. Demand has fallen as consumers lose jobs and see their savings diminish. Businesses are cutting workers while scrambling for credit. We are learning to fear fear itself. Fear of the unknown, whether it is job security or health security or asset-backed Securities, is pervasive.

We cannot draw lessons from every aspect of the Great Depression or from FDR's response. The one lesson we should draw is the United States did indeed recover from the Great Depression, and we will indeed recover from today's recession.

What lessons can Congress learn from the New Deal that can help drive our economy today? That is the purpose of today's hearing. The New Deal era remains historic for its ambition, for its aid to the neediest, and for its lasting policies that helped strengthen the economy and improve the lives of three generations of Americans. While not all perfect, the New Deal kept millions out of poverty. By 1940, unemployment was down to 12 percent, and real GDP by one estimate had grown 65 percent from 1933.

Much of the New Deal's legacy remains with us today. Investments in infrastructure paved the way for the most dynamic economy the world has ever seen. The Fair Labor Standards Act has guaranteed decent wages and working conditions for millions of Americans, and Social Security has provided a secure retirement for generations of our senior citizens.

And think where we would be today without the Securities and Exchange Commission and the FDIC and the Banking Act. Americans know that despite the troubles on Wall Street, their savings at the bank on Main Street are secure.

Until recently, there was not much debate on whether the New Deal helped or hurt efforts to recover. But recently, some of my colleagues have suggested that the New Deal failed. They argue that it was World War II spending that pulled us out of the Great Depression. But this is a false choice, in my opinion. Nothing I have seen or heard disputes the economic impact of our becoming the arsenal of democracy. But this is not the same as saying that the New Deal was harmful or did no good. Discussion of the New Deal over the past several months has served as a proxy debate for current economic planning and recovery planning. It is a topic worthy of our examination today.

Thomas Paine many years ago wrote, "By comparing what is past with what is present, we frequently hit on the true character of both, and we become wise with very little trouble." Let us see if we should be so lucky today.

We are honored to have a distinguished group of witnesses with us today. I look forward to their testimony.

We will begin. When Senator DeMint comes and Senator Merkley comes and Senator Tester, if he can make it, they certainly can feel free to make opening statements when that happens.

We will start with Christina Romer. She is Chair of the Council of Economic Advisers. She was a class of 1957 Wilson Professor of Economics at the University of California–Berkeley. Before teaching at Berkeley, she taught economics and public affairs at Princeton from 1985 to 1988. She went to high school in northeast Ohio, so she is a Buckeye at heart.

Until her nomination, she was co-director of the Program on Monetary Economics at the National Bureau of Economic Research and served as Vice President of the American Economic Association, where she also was a member of the executive committee. She is a fellow of the American Academy of Arts and Sciences. Dr.

Romer is known for her research on the causes and recovery of the Great Depression and on the role that fiscal and monetary policy played in the country's economic recovery. Her most recent work, authored with her husband, David Romer, also an economics professor, shows the impact of tax policy on government and on economic growth.

Dr. Romer, thank you for joining us.

STATEMENT OF CHRISTINA D. ROMER, CHAIR, PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

Ms. ROMER. Well, thank you, Chairman Brown. Thank you for inviting me to join you today. As you noted, in my previous life as an economic historian at Berkeley, one of the things that I studied was the Great Depression. And in my current life, as Chair of the Council of Economic Advisers, I have been on the front lines of the administration's efforts to end what is arguably the worst recession our country has experienced since the Great Depression. For this reason, I am delighted to be with you today to talk about the lessons learned from the Great Depression and President Roosevelt's New Deal and how they have helped to inform us—and I think will continue to help inform us—about the best way to approach dealing with today's crisis.

To start out, I think the first thing to say is that it is very important to point out that the current recession, while unquestionably severe, pales in comparison with what our parents and grandparents experienced in the 1930s. February's employment report showed that unemployment in the United States has reached 8.1 percent, an obviously terrible number that signifies a devastating tragedy for millions of American families. But, as you noted, at its worst unemployment in the 1930s reached nearly 25 percent. Likewise, following last month's revision of the GDP statistics, we know that real GDP has declined about 2 percent from its peak. But between the peak in 1929 and the trough of the great Depression in 1933, real GDP fell over 25 percent.

Now, I don't give these comparisons to minimize the pain that the United States economy is experiencing today but, rather, to provide some crucial perspective. Perhaps it is the historian and the daughter in me that finds it important to pay tribute to just what truly horrific conditions the previous generation of Americans endured and, again, as you pointed out, eventually triumphed over. And it is the new policymaker in me, I guess, that wants to be clear that we are doing all that we can to make sure that the word "great" never applies to the current downturn.

While what we are experiencing is less severe than the Great Depression, there are parallels that make it a useful point of comparison and a source for learning about policy responses today. Most obviously, like the Great Depression, today's downturn had its fundamental cause in the decline in asset prices and the failure or near-failure of financial institutions.

Over the course of the early 1930s, nearly one-half of American financial institutions went out of existence. This, in turn, had two devastating consequences: a collapse of the money supply, as stressed by Milton Friedman and Anna Schwartz, and a collapse in lending, as stressed by the current Fed Chair Ben Bernanke.

In the current episode, modern innovations such as derivatives led to a direct relationship between asset prices and severe strain in financial institutions. And over the fall, we saw credit dry up and learned just how crucial lending is to the effective functioning of American businesses and households.

I think the similarity of the causes between the Depression and today's recession means that President Obama began his Presidency and his drive for recovery with many of the same challenges that Franklin Roosevelt faced in 1933. Our consumers and businesses are in no mood to spend or invest; our financial institutions are severely strained and hesitant to lend; short-term interest rates are effectively zero, leaving little room for conventional monetary policy; and world demand provides little hope for lifting the economy. Yet the United States did recover from the Great Depression. So what lessons can modern policymakers learn from that episode that could help them make the recovery faster and stronger today?

In my written testimony, I discuss six lessons. In my oral remarks, let me at least highlight three of them.

I think one crucial lesson from the 1930s is that a small fiscal expansion only has small effects. I wrote a paper in 1992 that said fiscal policy was not the key engine of recovery in the Great Depression. From this, some have concluded that I do not believe fiscal policy can work today or could have worked in the 1930s. Nothing could be farther than the truth. My argument, in fact, paralleled E. Cary Brown's famous conclusion that in the Great Depression, fiscal policy failed to generate recovery "not because it does not work, but because it was not tried."

The key fact is that while Roosevelt's fiscal actions through the New Deal were a bold break from the past, they were nevertheless small relative to the size of the problem. When Roosevelt took office in 1933, real GDP was more than 30 percent below its normal trend level. For comparison, the U.S. economy is currently estimated to be somewhere between 5 and 10 percent below its trend.

The emergency spending that Roosevelt did was precedent breaking. Balanced budgets had certainly been the norm up to that point. But it was quite small. As a share of GDP, the deficit rose by about one-and-a-half percentage points in 1934. One reason the rise was not larger was that there had been a very large tax increase passed just at the end of the Hoover administration. Another key fact is that fiscal expansion was not sustained. The deficit as a share of GDP declined in fiscal 1935 by roughly the same amount that it had risen in 1934. And Roosevelt also experienced the same inherently procyclical behavior of State and local fiscal actions that President Obama is facing. Because of balanced budget requirements, State and local governments are forced to cut spending and raise tax rates when economic activity declines and State tax revenues fall. So at the same time that Roosevelt was running unprecedented Federal deficits, State and local governments were switching to running surpluses. The result was that the total fiscal expansion in the 1930s was actually relatively small. As a result, it could only have a modest direct impact on the state of the economy.

I think this is a lesson the Obama administration has taken to heart. The American Recovery and Reinvestment Act, passed by

Congress less than 30 days after the inauguration, is simply the biggest and boldest countercyclical fiscal action in American history. The nearly $800 billion of fiscal stimulus is roughly equally divided between tax cuts, direct government investment spending, and aid to the States and people directly hurt by the recession. And the fiscal stimulus is close to 3 percent of GDP in each of the next 2 years. We firmly expect this fiscal expansion to be extremely important to countering the terrible job loss that last month's numbers show now totals 4.4 million since the recession began 14 months ago.

A second lesson that we can draw from the recovery of the 1930s I think is that financial recovery and real recovery go together. When Roosevelt took office, his immediate actions were largely focused on stabilizing a collapsing financial system. He declared a national bank holiday 2 days after his inauguration, effectively shutting every bank in the country for a week while the books were checked. This 1930s version of a "stress test" led to the permanent closure of more than 10 percent of the Nation's banks, but improved confidence in the ones that remained. Roosevelt also temporarily suspended the gold standard, paving the way for increases in the money supply. And in June 1933, Congress passed legislation helping homeowners through the Home Owners Loan Corporation.

Now, the actual rehabilitation of the financial institutions actually, obviously, took much longer. Indeed, much of the hard work of recapitalizing banks and dealing with distressed homeowners and farmers was actually spread out over 1934 and 1935.

Nevertheless, the immediate actions to stabilize the financial system had dramatic short-run effects on financial markets. Real stock prices rose about 40 percent from March until May 1933, commodity prices soared, and interest rate spreads shrank. And the actions surely contributed to the economy's rapid growth after 1933.

But I would also point out that it was only after the real recovery was well established that the financial recovery took firm hold. The strengthening of the real economy improved the health of the financial system. Bank profits moved from large and negative in 1933 to large and positive in 1935. Real stock prices rose; business failures fell; and this virtuous cycle I think continued as the financial recovery led to further narrowing of interest rate spreads and increased willingness of banks to lend.

I would say that this lesson is another one that has been prominent in the minds of policymakers today. The administration has from the beginning sought to create a comprehensive financial sector recovery program. The Financial Stabilization Plan was announced on February 10th and has been steadily put into operation since then. It includes a program to help stabilize house prices and save responsible homeowners from foreclosure; a partnership with the Federal Reserve to help restart the secondary credit market; a program to directly increase lending to small businesses; the capital assistance program to review the balance sheets of the largest banks and ensure that they are adequately capitalized; and the program we announced just last week to partner with the FDIC, the Federal Reserve, and private investors to help move legacy or "toxic" assets off banks' balance sheets. This sweeping financial rescue program is central to putting the financial system back to work for American industry and households and should provide the lending and stability needed for economic growth. At the same time, the fiscal stimulus package enacted on February 17th was designed to create jobs quickly. And in doing so, it should lower defaults and improve balance sheets so that our financial system can continue to strengthen.

The third lesson that I would highlight from the Great Depression is that it is important not only to deal with the immediate economic crisis, but to put in place reforms that help prevent future crises. Bank runs, as you surely know, were one of the key factors in the downturn of the 1930s. In June 1933, President Roosevelt worked with Congress to establish the Federal Deposit Insurance Corporation. That act, together with subsequent legislation, established the insurance of bank deposits that we still depend on today.

The FDIC, I think, has been one of the most enduring legacies of the Great Depression. Financial panics largely disappeared in the 1930s and have never truly reappeared. The academic literature certainly suggests that deposit insurance played a crucial role in this development. One simple but powerful piece of evidence of the importance of Federal deposit insurance is that among the few bank runs that we have actually seen since the Depression were ones on non-federally insured savings and loans in Ohio and Maryland in the 1985. And a striking feature of the current crisis has been the continued faith of the American people in the safety of their bank deposits. I think in this way, the reforms instituted in response to the Great Depression almost surely helped prevent the current crisis from reaching Great Depression proportions.

I think the importance of putting in place more fundamental reforms is another lesson of the New Deal that the administration is following. The current crisis has revealed weaknesses in the regulatory framework. Most obviously, we have discovered that financial institutions have evolved in ways that left systemically important institutions inadequately capitalized and monitored. We have also found that the government lacks the tools necessary to resolve complex financial institutions that have become insolvent in a way that protects both the financial system and American taxpayers. We look forward to working with Congress to remedy these and other regulatory shortfalls. By doing so, we can make the U.S. economy more stable and secure for the next generation.

The very final lesson that I want to draw from the 1930s is perhaps the most crucial and it is one that Senator Brown already touched on, and that is that a key feature of the Great Depression is that it did eventually end. Despite the devastating loss of wealth, the chaos in our financial markets, and a loss of confidence so great that it nearly destroyed Americans' fundamental faith in capitalism, the economy came back. Indeed, the growth between 1933 and 1937 was the highest we have ever experienced outside of wartime.

This fact should give Americans hope. We are starting from a position far stronger than our parents and grandparents were in back in 1933. And the policy response has been fast, bold, and well conceived. If we continue to heed the lessons of the Great Depression, there is every reason to believe that we will weather this trial and come through to the other side even stronger than before.

Thank you.

Senator BROWN. Thank you for a very conclusive and comprehensive assessment and observation of that period.

Dr. Romer, you just mentioned that we had that high growth rate from 1933 to 1937. Critics of the New Deal will say that the recession within the Depression or the second big downturn in that decade that happened in 1937 illustrates that Roosevelt's New Deal did not work, that unemployment went back up—not as high as it was at the beginning of the decade.

What in your mind—answer those critics, if you will, and specifically what in your mind caused that downturn in 1937–38 that led the critics to make those observations?

Ms. ROMER. You actually bring up two very important points. One is when people talk about the Depression being slow or certainly the recovery from the Depression being slow, I think that is really a mischaracterization of the facts. And precisely as you pointed out, in the mid-1930s, we just grew incredibly quickly. We were growing. Real GDP went up at about 10 percent a year for those 3 years, sort of the first 3 years of the recovery. But part of what happened is then we do obviously have that second recession in 1938.

In my mind, it is caused by two fundamental things. I think here I listened very strongly to Milton Friedman and Anna Schwartz, who say it was a monetary contraction. And, actually, in my written testimony, it is one of the other lessons that I draw from the New Deal, is the importance of not cutting back on stimulus too soon, because I think one of the things that happened in 1937 is the Federal Reserve got nervous. They said, you know, they were worried that should they need to tighten the economy, there were so many excess reserves in the economy, they thought, well, gee, maybe we cannot do this. So what they did was to just raise reserve requirements, thinking it would not have any effect, they had just changed excess reserves to required reserves. What they did not count on was that banks were nervous. They had just been through the Great Depression and all of these banking panics, and so they scrambled to get more excess reserves over the new higher level.

And so we absolutely have a pretty severe monetary contraction in 1937 that pushes up interest rates, reduces lending, and I think that is an important part of it.

The other is you do get some fiscal contraction as well. In 1936, we had a big veterans bonus, so kind of a big sort of chunk of government spending that then disappeared in 1937. Nineteen-thirty-seven is when we first collect Social Security taxes, and so we do have a certain fiscal contraction, and I think that also played a role.

But I think neither of those would you say are in any way an indictment of the New Deal policies. I think they are an indictment of using those tools of monetary and fiscal policy not very well and sort of inadvertently doing monetary and fiscal contraction.

Senator BROWN. Some critics will argue then that the recession of 1937–38 was in part a response to wage hikes; minimum wage had been implemented; a 40-hour work week, I believe, was beginning; that there was collective bargaining; that wages were going up; that some critics will say that that was a distortion, sort of an artificial distortion of the marketplace.

Weigh in on that, if you would. In other words, do higher wages in effect cause less employment and, therefore, a contraction in the economy?

Ms. ROMER. So, you know, I think that was a story that was out there. The way it is usually described was that firms, in anticipation, say, of labor strife that might be coming because of the new collective bargaining rules, sort of produced a lot in 1936 and 1937, kind of got a big run-up in inventories, and then cut back in 1938.

My own read of the evidence is that there is just not much sign that that was really the key thing going on, and I guess here I would invoke Milton Friedman. If there was ever a person that would tend to think that unionization or high wages or things might cause a recession, he would be one of them. And yet he is probably the—he and Anna Schwartz are the strongest proponents of the monetary explanation for what happened in 1937 and 1938.

So I certainly think that the evidence is much more strongly on the side of—that it was an aggregate demand contraction that was the main reason for that downturn.

Senator BROWN. And fiscal stimulus, my understanding—you touched on this—is Roosevelt in 1937, 1938, pulled back on—well, one, with the tax increase in Social Security. That was the only tax increase?

Ms. ROMER. That was——

Senator BROWN. That was relatively significant in that day's economy.

Ms. ROMER. It was not very large. I think, again, if you are doing the weighing of these things, I would say the monetary contraction was more important. I would say the tax increase at the time—I mean, it was significant, but it was not large. I do not think it was certainly large enough to cause the kind of downturn we saw by any means.

Senator BROWN. But he also pulled back on government expenditures.

Ms. ROMER. Absolutely. And, again, it is almost a little bit of an accidental thing in the sense that we had had a big surge in expenditures in 1936. There was a veterans bonus, a bonus to World War I veterans.

Senator BROWN. But not in 1937–38. That did not——

Ms. ROMER. Right, so it was 1936 and then it disappeared in 1937. So if you look at the path of government spending, it goes way up and then back down.

Senator BROWN. As an economist, teach me something from sort of a bird's-eye view here. Many of my colleagues are concerned about the level of spending and borrowing. That same group was not all that concerned a year or two ago with spending and borrowing, but that is more of a political point that I do not want to get into.

Can we do this through the—well, why can't we do this through the Federal Reserve rather than fiscal stimulus? Talk me through what the difference is and why we need both in the economy rather than just the Fed—rather than pursuing monetary policy?

Ms. ROMER. Gladly. So I would have said, you know, sort of again if you look at my sort of life's research, a big part of it has been pointing out that monetary policy is very effective. And I think if you had asked me 5 years ago, in response to a recession, sort of what is the main tool that one uses, it is monetary policy. And the usual reason for that is to say that it, one, is very effective; and, second, it is something that can be changed pretty quickly. And certainly the usual view, if you do sort of the history of post-war policy, you know, the record on using fiscal policy well had not been very strong, that, you know, the times we had tried to do fiscal expansion, we often did it too late, and so it tended to come after the recession was already over and things like that.

So that is all kind of a way of background of saying I think this time is different. The first is, you know, a typical post-war recession, quite honestly, was caused by monetary policy. A typical recession is the Fed would have tightened because they were concerned about inflation. The economy would go into a recession, and then it was pretty obvious how you got out of it. They just loosened again.

What was very striking in this recession is very different in that, you know, the interest rates were already quite low when the trouble in our financial markets, the collapse of housing prices started. And so sort of the amount of room that we had to expand monetary policy, bring interest rates down, was not particularly large.

The other thing to say is we used the tools that we had. Very quickly, the Federal Reserve did do a big monetary expansion, and I would certainly say the Fed has been quite creative in trying to restart lending markets and trying to do expansionary—their usual expansionary policy. The problem that we faced is it was not enough, and I think that is the key reason why we need the second tool now, why we need fiscal policy.

The other thing—and here I mainly want to compliment Congress in the sense that I think this really is a triumph that we passed such a big, bold fiscal stimulus act at the time before we even hit bottom of the recession. That is very unusual to get our act together and get the aid that the economy needed through the fiscal side as quickly as we did. But I think the main answer to your question is: In a recession this big, you needed both of them.

Senator BROWN. Thank you, Dr. Romer.

Senator Merkley.

Senator MERKLEY [presiding]. Thank you very much, Doctor, for coming to testify. We appreciate the work you are doing. I am just going to continue with some of the questions that folks were interested in.

When you were studying writing on the New Deal in the 1990s, did you ever imagine you might someday put that knowledge to use outside an academic setting?

Ms. ROMER. I have to tell you I didn't, and when I think back of the number of times that I would tell my introductory economics classes that, well, the one thing I was sure of was we would never face bank runs again, and so the first time that I saw people lining up outside a bank out in California last summer, it just—or last fall, I guess, I never dreamt that those kind of things would ever happen again.

So I do want to come back to the point that even though I think the research is quite useful now, I do want to make it clear conditions are quite different, that as bad as things are, what our parents and grandparents went through were certainly much worse. And I like to think it is because we have learned a great deal. I do think that we have spent the last 6 years getting a much better handle on the economy.

I would say that the shocks the economy has faced in this downturn are probably almost as big as what we saw in the Great Depression, the disruptions in our financial institutions, the collapse of asset prices. All of those have been just huge macroeconomic shocks, and I think the very fact that we are where we are today and not somewhere much worse is at some level because we have had a much better policy response.

Senator MERKLEY. Thank you. Your predecessor as Chair under President Bush, now Fed Chairman Ben Bernanke, endorsed fiscal action a little over a year ago. This suggests a pretty broad consensus among economists. As he put it, quote, "Fiscal monetary stimulus may provide broader support for the economy than monetary policy alone."

Is there a fairly broad consensus among economists for the need for such stimulus?

Ms. ROMER. I feel there is. I mean, certainly, there is always a certain amount of disagreement among economists, but I think one of the things that has been striking in this downturn is the degree to which there has been a professional consensus.

I know back in December when we were thinking about designing a fiscal stimulus and how big it should be, one of the jobs that I took on was just calling a wide range of economists from both ends of the ideological spectrum and there was just, you know, you got a few people that would say, no, I don't think we need any, and there were a number that would say, I think it should all be in the form of tax cuts. What was really striking is the consensus that we needed something, that it needed to be big, that we had tried monetary policy, we had done a lot there, but we needed more. So I do think there is a strong professional consensus.

Senator MERKLEY. You know, one of the things that I am interested in getting your perspective on is that we not only have substantial national governmental debt, but we also have sizable consumer debt. When those are taken together, consumer and government debt, is there any parallel to the Great Depression in terms of percent of GDP, or are we way beyond the level of debt that was carried even at the height of the Great Depression?

Ms. ROMER. I would say we—I mean, I should check the numbers, but I would say we certainly are higher. I mean, one of the things that is important to realize is right before the Depression started, very much the norm had been a balanced budget and so the debt-to-GDP ratio, we had made a lot of progress coming out of World War I and had retired a lot of it.

Likewise, in the 1920s, there had been sort of the beginning of the consumer durables revolution. People started to buy cars and appliances and things. But even so, consumers were certainly much less in debt than now. So that certainly, I think, is a change between the 1930s and today.

Senator MERKLEY. I saw a chart in a magazine article a year or so ago that seemed a little surreal to me. I believe that what it showed, and it was combining consumer debt and governmental debt, was that during the height of the Great Depression, the debt-to-GDP, the combined debt, reached about two-and-three-quarters times the GDP, not so much because the debt surged in the Depression, but because of the economy tanking, and then the chart showed this combined debt now, and now being about a year ago, had exceeded that height at the Great Depression and was still headed straight up.

Those numbers are not—I don't normally hear those numbers in the debate because we don't normally talk about the combination of consumer and governmental debt, but let us say this is—is it in the ballpark that we may be well over three times the GDP with the combination, and if so, how does that really constrain our ability to recover in this economic downturn?

Ms. ROMER. I think on the numbers, I just have to go back and check them. It is not one that I have on the top of my head.

I think the place where economists are thinking certainly about the consumer debt is both consumer debt—I guess the other thing we talk about a lot is consumers have seen their wealth decline. At the same time they add a certain amount of debt, they have also seen their 401(k)s and the value of their house go down, and so how that kind of change in the household balance sheet is going to affect what they do going forward, I think is an important question.

Certainly, I think most economists predict that we are going to see consumers having a higher savings rate. We are already seeing that, and my prediction is that is what is going to be true as we go forward, even once we are out of this particular downturn. And so that is going to be an adjustment for the American economy. To the degree that we have been sort of living on a consumer that was going into debt and sort of spending beyond their means, it is going to mean a readjustment, and I think it could be a very healthy readjustment in the sense that what would normally happen in an economy, if consumers start to save more, that tends to bring down interest rates in the economy. That tends to encourage investment. And certainly from an economic perspective, I think that would be good for the economy and would put us on a path to a more sustainable future and a higher growth future.

Senator MERKLEY. You know, so much of our effort now involves generating dollars through the Fed as well as appropriated response in terms of creating a stimulus, do we have a very good way of judging the tipping point at which the international community becomes concerned about the long-term health of the dollar?

Ms. ROMER. I think what I would say is we probably don't have a good way of judging it other than to say, I am virtually certain we are not anywhere close to being at a tipping point. So I think what we have seen in this particular downturn, especially with the uproar in financial markets, what I have found very striking is the degree to which in times of crisis everybody wants to invest in the United States. We have seen a lot of our interest rates, in fact, come down because foreigners want to hold American assets and the dollar.

So you raise, I think, a legitimate point. You know, the way I think about it is sort of going forward, we do know that our budget deficit is very large, mainly because, one, we inherited a large deficit. The economy is in a terrible way and we are having to spend a lot to get out of this.

But it is certainly something that I don't feel can or should be sustained, that it is something—you know, the President has certainly said he wants to get this down, is committed to bringing it down, and I think that is ultimately going to be important for everyone maintaining faith in the U.S. Government, that we need to show signs that we are going to get this deficit under control, make real progress, and I think that is something that the world will be looking at.

Senator MERKLEY. You know, within the stimulus plan, there are three major emphases in terms of restructuring our economy, and so I wanted to ask you about each of those, starting first with the energy side. And I apologize if I am repeating any questions that the Chair had before he left. But specifically, the argument that we need to insulate ourselves from foreign energy price spikes such as we had last year driving $4 a gallon gas and just kind of the vulnerability, perhaps the national security vulnerability as well as economic security issue. How important is it to use this opportunity to restructure our energy consumption, and are the strategies that are in the stimulus the right ways to do that?

Ms. ROMER. I think you raise a great point. I mean, there are a couple of things. One is your mention of the stimulus package. One of the things that the President, working with Congress, felt was important is that if we need to be spending money to get the economy out of recession, we ought to spend it wisely, and so one of the things that I think we all tried to do is to do things that we thought would benefit the American economy going forward, and I think you are absolutely right. Anything that helps to wean us off foreign oil, we think is going to be good for the economy.

We certainly think that in the Recovery Act, we had various incentives for alternative fuels, incentives for increased efficiency, like weatherization, Federal buildings, low-income housing. I think all of that are incredibly important and things that we probably should be doing more as we go forward, and that has certainly been one of the key areas that the President has identified, that even as tough as times are now, energy independence, weaning us off foreign oil, dealing with the long-run effects of climate change, are things that he very much thinks warrant important investments.

Senator MERKLEY. So one side of the energy puzzle is certainly using less energy, using less oil. Another side is putting the United States in a position of manufacturing products, both intellectual property products—patents, *et cetera*—and actual physical products—wind turbines, solar panels, *et cetera*—to sell to the world. How important is positioning ourselves in terms of the manufacturing side of the energy puzzle?

Ms. ROMER. Certainly, the President has identified that as sort of the alternative energies and the manufacturing that goes with wind turbines and solar panels as a win–win, right, so it is something that strengthens our economy, creates jobs here, and makes us be more efficient and able to use the kinds of energy that we have here that are renewable and aren't coming from abroad.

Senator MERKLEY. I heard a statistic today, I am not sure if this is accurate or not, that for every month of the last 8 years, for every single month, we have lost manufacturing jobs in this country. Is that accurate, every single month?

Ms. ROMER. I would have to check every single month. I certainly know it has actually been very striking. The Council of Economic Advisors—this has been an issue that we are very interested in. It is certainly a priority for the President. And so we have been doing some work looking at the decline in manufacturing. It is very striking. You go back to, say, the 1982 recession. What has really been true after sort of each recession is you never quite come back to where you were before, and that we do see this long-run decline in manufacturing.

So part of what we are experiencing now in Michigan, Ohio, Indiana, where we see not only the effects of the very severe recession that we are in, but this long-run decline in the manufacturing base, especially sort of the Midwestern heavy industrial manufacturing base, is absolutely a trend that is there.

Senator MERKLEY. Does the preservation and expansion of the middle class in our country depend upon the expansion of manufacturing, or are there alternative strategies to have a large percentage of Americans in the middle class?

Ms. ROMER. That is again a terrific question. What I would say, there is a sense that somehow there is something special about manufacturing, and for an economist, I think that is—we have less trouble, maybe, than most in saying, even if you can't see it, a service like providing a mammogram for someone, well, that is as much a good thing as if you make a motor or something.

So I wouldn't draw that kind of a distinction. But what has been true is that manufacturing jobs tended to be good, high-wage kinds of jobs, and so certainly one way to sort of maintain the middle class or grow the middle class is to grow that sector of the economy. If that doesn't work, what you absolutely need to do is to create other kinds of jobs that have those same characteristics. So whether they are, you know, services that require a certain amount of training, but whatever is the case, you certainly need to be creating the good jobs at good wages. That is what is fundamentally good for making a big, strong middle class.

Senator MERKLEY. Let me turn to the area of education. I have often said that the success of our economy a generation from now depends on our investment in education today, but that is—I am a layman. I am not an economist. Do we see a correlation as we look at economies around the world in terms of their investment in education paying off in terms of the strength of their economy years down the road? And what can we take from our observation of statistics around the world, performance of economies around the world, to help guide us in terms of our investment in education?

Ms. ROMER. This may be a very good question to ask Brad DeLong when he is on the next panel. Certainly, when you do the growth accounting, I think, across countries, what we call human capital formation, where there is mainly education, I think the evidence is that it is quite important to the development of countries and to their ultimate economic success.

Certainly the empirical literature on sort of the returns to education and how important it is, it is inherently hard precisely because rich countries tend to invest more in education and so disentangling the causation. But certainly my own read of the literature is that there is a strong correlation and I think the correlation runs from investments in education to indeed make you a stronger economy, able to produce more, able to command higher wages.

Senator MERKLEY. Are there kind of distinctions between the types of investment in education that we should be aware of as we think about this issue of strengthening our economy, getting the most bang for the buck for our investment in education?

Ms. ROMER. Certainly, I think if you had my colleague on the Council of Economic Advisors Cecilia Rouse, I think one of the things she would tell you is junior colleges are one of the places where you get some of the highest returns, sort of those—those, I think, have certainly shown to be a very good investment in terms of both how much costs to provide that education and the kind of jobs that you are able to get with an associate's degree.

In general, I think all types of education are good and certainly more is better. I think there is a certain amount of evidence that job training is very good.

Senator MERKLEY. Doctor, thank you. I have just one more question for you and that is turning to the health care side. We invest about a sixth of our economy, about 18 percent, a little more than a sixth, in health care, and yet Europe and Canada, many other modern manufacturing economies are spending a great deal less. Is our health care structure a competitive disadvantage and do we have to overhaul health care, not only for the quality of life of our citizens, but in order to be competitive internationally?

Ms. ROMER. I have to say it is. I think that is exactly why, again, even as tough as economic conditions are now, the President has identified reforming our health care system as just a priority that can't wait. I think he would have exactly the point of view that you just mentioned, that this fact that the cost of health care is rising so rapidly in the United States, faster than GDP and other costs, has been certainly something that is bankrupting businesses. It is hard on households. And it is ultimately very hard on the Federal Government. So I think it is crucial.

Senator MERKLEY. Thank you very much, Doctor. It is my turn to dash to the floor to vote. Thank you.

Ms. ROMER. Thank you.

Senator BROWN [presiding]. Thank you, Senator Merkley, and Dr. Romer, thank you for your time. Thank you for your testimony, and especially thank you for your public service.

Ms. ROMER. It has been lovely to be here. Thank you for having me.

Senator BROWN. The Chair will call up the next panel, Allan Winkler, James Galbraith, Lee Ohanian, and Brad DeLong, if the four of you would join us, please. We will take a moment's break until they come forward.

[Pause.]

Senator BROWN. We will come to order again. Thank you all for joining us.

Dr. Allan Winkler is—I will introduce all four panelists. I very much appreciate your coming and joining us today and sharing your wisdom and your thoughts and ideas with us. I will introduce all four panelists and then we will begin the testimony, Dr. Winkler, with you, from left to right.

Dr. Winkler is distinguished Professor of History at Miami University in the great State of Ohio. Thank you for joining us. He has taught at Yale University, the University of Oregon, and for 1 year each at the University of Helsinki in Finland, the University of Amsterdam in the Netherlands, and the University of Nairobi in Kenya. A prize-winning teacher, he is the author of ten books, including *Franklin Roosevelt and the Making of Modern America*.

Dr. James Galbraith, who I met in 1972 for the first time, teaches at the LBJ School. He holds degrees from Harvard and Yale, a Ph.D. in economics in 1981. He served in several positions on the staff of the U.S. Congress, including Executive Director of the Joint Economic Committee. Dr. Galbraith is a Senior Scholar of the Levy Economics Institute and Chair of the Board of Economists for Peace and Security, a global professional network. He writes a column for Mother Jones and occasional commentary in other publications, including the *Texas Observer,* the *American Prospect, Washington Monthly,* and *The Nation.*

Lee Ohanian has been a Professor of Economics and Director of the Ettinger Family Program in Macroeconomic Research at the University of California–Los Angeles since 1999. Thank you for joining us, Dr. Ohanian. He also taught at the University of Minnesota and the University of Pennsylvania. He is a Research Associate at the National Bureau of Economic Research and has consulted in various capacities for the Federal Reserve. He has published numerous studies on the New Deal. I read one of his recent articles in the *Wall Street Journal,* so welcome.

Brad DeLong is Professor of Economics at UC–Berkeley, Chair of the Political Economy of Industrial Societies Major and a Research Associate of the National Bureau of Economic Research. He was educated at Harvard. He received his Ph.D. from that institution in 1987. He joined Berkeley as an Associate Professor 6 years later and became a full professor in 1997. He has been a fellow of the National Bureau of Economic Research and Assistant Professor of Economics at Boston University and a lecturer at the Department of Economics at MIT. Professor DeLong also served in the U.S. Government as Deputy Assistant Secretary of the Treasury for Economic Policy from 1993 to 1995.

Dr. Winkler, let us begin with you. Thank you.

STATEMENT OF ALLAN M. WINKLER, PROFESSOR OF HISTORY, MIAMI UNIVERSITY, OXFORD, OHIO

Mr. WINKLER. Thank you very much. It is a pleasure to be here for two reasons. First of all, as an historian, I have spent a lot of time reading hearings and transcripts and to be here is something I appreciate very much. Second, my father was a beneficiary of the National Youth Administration during the Depression. That allowed him to continue his education at the University of Cincinnati and that made a huge difference in his life.

The New Deal basically was a response to the worst crisis in American history. It involved efforts to promote relief, to deal with the ravages of the Depression and create recovery, to reform elements of the American system, and it worked in all three different areas. And yet it wasn't a planned operation. It was haphazard. It was often contradictory, and elements in one area worked against the grain in terms of elements in another, and that is a large part of how we have to view it these days.

As Christina Romer indicated earlier, monetary policy played an important role. Fiscal policy, likewise, could have, but was not really tried, in part because the conventional wisdom of the day didn't really understand where things were at that point.

The New Deal revolved around Franklin Roosevelt, who was an extraordinary leader. In his inaugural address, when he talked about the need for action and action now, he sounded just the right note. His comment that the only thing we have to fear is fear itself was something that really created a sense of confidence in the American people, and that was hugely important in what followed.

In the first 100 days, launched almost immediately after the inauguration, the important element here is that there was no complete, coherent plan of what was going to happen. The banking crisis then, as now, was a major issue that had to be dealt with. The Emergency Banking Act was pushed through almost without having printed it and by a voice vote. And with that kind of momentum, Roosevelt proceeded from one thing to another and it went on from there.

Overall, the New Deal did a range of different things. In the relief sphere, there were a series of early initiatives that culminated in 1935 with the Works Progress Administration that put all kinds of people, ranging from artists and authors and the like, as well as laborers, back to work, and that was hugely important. Recovery was something the New Deal recognized it had to deal with, and the National Industrial Recovery Act creating the NRA was again important in that area, even though it never worked particularly well, as I will come back to.

Reform elements were hugely important in the New Deal, ranging from creation of the Securities and Exchange Commission to Social Security in 1935 to the Wagner Act to deal with collective bargaining and the like.

The New Deal was important. It made some huge contributions. It put people back to work. It saved capitalism. It restored faith in the American system and revived a sense of hope in the American people. And yet economically, it never worked as well as it could have.

As Christina Romer pointed out, monetary policy did lead to an expansion in the economy, and yet because we were starting at such a rock bottom low level, those elements were not as important as otherwise they might have been.

But fiscal policy was the real question. In 1936, John Maynard Keynes published his major work, *The General Theory of Employment, Interest and Money* in which he argued that Depression was not automatically going to disappear if you simply waited it out, that what was necessary to make that happen, in his phrase, was deliberate sustained countercyclical spending. It was necessary for private spending to occur, if that could happen. If not, the government needed to step in.

And yet Keynesian analysis never really caught hold during the Great Depression. Keynes and Roosevelt met one another on a couple of brief occasions. Neither man understood the other. Keynes understood the New Deal was not proceeding in the directions that he would have counseled, and that was important.

And the contradictions in economic policy, according to Keynesian analysis, really give us some perspective on what was happening. Acts like the Agricultural Adjustment Administration called for a processing tax that cut into the money that was being spent to pay farmers not to produce. Social Security, as was pointed out, was taking money out of people's pockets in 1937, with pensions not to begin until 1942. The cities and States trying to run surpluses or at least balance their budget worked against the grain of what was happening with regard to larger government spending.

When the economy tanked in 1937, when Roosevelt cut WPA rolls significantly, when he cut back on the budget so that it was about a third of what it had been before, the economy went into recession. The lesson learned then was that if you began to spend, you could bring it back, and that was what happened in the next couple of years.

What do we take from all of this? I would suggest the lessons are very clear. Government can make a difference. A major stimulus, according to Keynesian analysis, is necessary and essential and can promote recovery. It is above all important for us to ensure that measures do not work in contradictory ways and to allow the stimulus to take the effect that it can have.

Thank you very much.

Senator BROWN. Thank you, Dr. Winkler.

Dr. Galbraith.

STATEMENT OF JAMES K. GALBRAITH, LLOYD M. BENTSEN, JR., CHAIR IN BUSINESS/GOVERNMENT RELATIONS, LYNDON B. JOHNSON SCHOOL OF PUBLIC AFFAIRS, UNIVERSITY OF TEXAS AT AUSTIN, AND SENIOR SCHOLAR, LEVY ECONOMICS INSTITUTE

Mr. GALBRAITH. Thank you very much, Chairman Brown. It is a privilege to be here to discuss the New Deal and its relevance to our present troubles.

In my view, we can distill three main principles for economic policy from the Great Depression, the New Deal, and ultimately from the Second World War.

The first is that unregulated capitalism is not necessarily self-correcting; mass unemployment, which a previous generation of economists thought was always going to be a temporary aberration, can, in fact, occur and it can persist with no automatic tendency for it to disappear.

The second is that economic intervention by public policy works best when it is targeted directly to the broad population rather than filtered through those at the top, and, of course, when it is implemented on a sufficiently large scale. Now, we can come back to the discussion of whether the New Deal operated on a sufficiently large scale. Certainly in the Second World War we did.

Third—and Professor Winkler has already alluded to this—the fiscal cutbacks which produced the recession of 1937–38 showed that backtracking is disastrous. There will come a time when the private economy is sufficiently robust and resilient to launch and sustain economic growth on its own, but that time need not come particularly soon. And to anticipate it prematurely can lead to a severe interruption of the progress toward recovery.

In my brief remarks to follow, I shall summarize points that are made in great detail in my written testimony in four areas.

The first is that, like our present troubles, the Great Depression flowed from a collapse of the banking system and of asset values—the Great Crash of October 1929 and subsequent events. This was a fundamental and unprecedented development in the American economy in the depth and extent of the financial calamity, and it eliminated the possibility that recovery could be led by a revival of the financial system. The result of this was that Roosevelt effectively bypassed the financial system via public spending and also through direct lending to the private sector using the Reconstruction Finance Corporation and other vehicles.

I do not subscribe to the view that monetary policy caused the Depression—I think that view was and is advanced by those who seek to minimize the inherent instability of the financial sector in those days. Nor do I subscribe to the view that monetary policy played the principal role in getting us out.

The second point: Much of the New Deal was not, in fact, about fiscal expansion but about the creation of a comprehensive network of social insurance and social protections, and the construction of institutions for collective action inside the population, including trade unions. This was true, for example, of the philosophy behind deposit insurance, behind the creation of the Social Security system to protect the elderly, behind the Agricultural Adjustment Administration, and also the much maligned National Industrial Recovery Act, certainly true of the philosophy behind the National Labor Relations Act and the creation of the minimum wage.

Each of these institutions played an important role in reducing the amount of instability, insecurity, and privation in the broad population. Each played an important role in the moral and psychological recovery from the Great Depression, even if their contributions to aggregate effective demand and economic growth may appear in retrospect to be relatively modest. Strengthening social insurance is, therefore, extremely important.

Third, there were, of course, massive employment programs. From the beginning of the New Deal, 3.5 million or so people were employed in jobs directly in the public sector, and this had a very important effect.

It is important to say that the principle behind these programs was not a short-run Keynesian stimulus. It was not designed to return the economy quickly back to the allegedly normal condition of the 1920s but, rather, to provide immediate and necessary relief to legions of people who would otherwise not have been able to eat.

And it is important also to note that in terms of the effects on unemployment, the impact of these programs has been largely misstated in the literature, in a great deal of the literature, because economists in subsequent years have adopted the habit of not counting people who worked for the New Deal as employed, although, in fact, they were fully employed, working every day and being paid for their labors.

Finally, in addition to its employment programs, the New Deal embarked on a massive program of public investment, which was strongly oriented toward the long term, toward the benefits of education, transportation, art, culture, and conservation. Those programs also had macroeconomic effects, but the important thing about them is that they, in fact, rebuilt the country.

I just want to close with a brief quotation from a recent paper by an economist named Marshall Auerback, which I think captures the flavor of this particular aspect of the New Deal in a very effective way. He writes, "The government hired about 60 percent of the unemployed in public works and conservation projects that planted a billion trees, saved the whooping crane, modernized rural America, and built such diverse projects as the Cathedral of Learning in Pittsburgh, the Montana State capitol, much of the Chicago lakefront, New York's Lincoln Tunnel and Triborough Bridge complex, the Tennessee Valley Authority and the aircraft carriers Enterprise and Yorktown. It also built or renovated 2,500 hospitals, 45,000 schools, 13,000 parks and playgrounds, 7,800 bridges, 700,000 miles of roads, and a thousand airfields. And it employed 50,000 teachers, rebuilt the country's entire rural school system, and hired 3,000 writers, musicians, sculptors and painters, including Willem de Kooning and Jackson Pollock."

The point, I think, is that the New Deal was not an effort to return the country to the prosperity of the 1920s. Rather, it recognized that the conditions of that period could not be re-created, set out to do something quite different, and did so with very considerable success.

Senator BROWN. Thank you, Dr. Galbraith.

Dr. Ohanian, welcome. Thank you for coming all the way from California. Welcome.

STATEMENT OF LEE E. OHANIAN, PROFESSOR OF ECONOMICS, AND DIRECTOR, ETTINGER FAMILY PROGRAM IN MACROECONOMIC RESEARCH

Mr. OHANIAN. Thank you, Mr. Chairman.

Over the decade, much of my research has focused in the area of economic crises, including work on the Great Depression and the New Deal. My findings indicate that some New Deal policies, those that impacted industrial product and labor markets, delayed recovery by impeding the normal competitive forces of supply and demand from operating. My research also indicates similar policies put in place by President Hoover also had a significant contributing effect during the early 1930s.

In terms of the policies that I have studied, one stands out, which is the National Industrial Recovery Act. The NIRA was collusive. It permitted firms within industries to cooperate, coordinate on setting minimum prices, restricting expansion of plant and capacity, provided that they paid wages that were well above trend.

Expanding monopoly depresses output employment, and setting wages above trend or above levels consistent with market clearing makes labor expensive and leaves employers to scale back on employment.

The NIRA was declared unconstitutional in 1935, but my research indicates that New Deal-type policies continued after that through lax prosecution of antitrust and on the labor side through the National Labor Relations Act, which substantially increased labor bargaining power. During a short period of time, unions and workers used the sit-down strike in which workers occupied factories to prevent production, with great success against companies including GM and U.S. Steel.

Immediately after the Supreme Court upheld the constitutionality of the Wagner Act, wages in a number of industries considered by the FTC to be collusive jumped significantly. This was in, I believe, May 1937, right at the start of the 1937–38 contraction.

There is significant evidence that these specific New Deal policies impeded recovery. Some evidence is that the recovery was delayed. Figures 1 and 2 in my testimony show per capita output, consumption, and investment, and hours worked. Per capita consumption, relative to its normal 2-percent trend, recovers hardly at all. Per capita investment does recover, rising from about 80 percent below trend to this trough in 1933, but still remained more than 50 percent below trend by the end of the decade.

Other evidence in what I can point out is that the recovery failure seems particularly striking in that the economic fundamentals that were in place at the time seemed—a number of them seemed to be very healthy. Productivity growth grew very rapidly after 1933. As mentioned earlier, the banking system had been stabilized. Liquidity was plentiful. Deflation had been eliminated. And a number of economists ranging from Milton Friedman to Nobel Laureates Robert Lucas and Edward Prescott have pointed to the weak recovery and thought about whether the Government policies were important here.

Other evidence is that in the sectors that were covered by these New Deal policies, in particular much of major manufacturing, wages and prices did indeed jump after NIRA Codes of Fair Competition were adopted. Moreover, not only were prices and wages higher in these sectors, but employment was low. In sectors that were not impacted by the NIRA, for example, the agricultural sector, employment remained high and wages were below trend.

Perhaps the most compelling evidence about the failure of the market economy at that time, that it was distorted, comes from the fact that hours worked is low, consumption is low, but the real manufacturing wage is well above trend—10 to 15 percent above trend. The coincidence of such a high wage in conjunction with the Depression is puzzling because we would usually think competitive forces would push down that wage and raise employment, consumption, and output.

The main lesson, I believe, to be learned from the New Deal is that while a number of New Deal policies were really quite useful, some, those that distorted product and labor markets and impeded the normal forces of competition, delayed recovery and that when we consider policy in future crises and we adopt what I might call crisis management policies to cushion the impact of a crisis on the economy, that those policies be consistent with good, long-run economic incentives.

Thank you very much.

Senator BROWN. Thank you, Dr. Ohanian.

Dr. DeLong, thank you for coming all this distance to be with us.

STATEMENT OF J. BRADFORD DELONG, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA AT BERKELEY

Mr. DELONG. Thank you, Chairman Brown, Senator Merkley.

Drawing lessons from the New Deal requires, first, understanding what the New Deal was. Franklin Delano Roosevelt took everything that was on the kitchen shelf and threw it into the pot on March 4, 1933, and then began stirring, fishing things out that seemed not to be so tasty and having the Supreme Court fish a good deal of it out as well; adding spices, adding new ingredients, all the while watching the thing cook.

Now, the aspect of the New Deal we focus on today is the expansionary monetary policy aspect. The conventional interest rate reductions, the quantitative easing by the Federal Reserve in the late 1930s, banking sector nationalization and recapitalization, and fiscal policy expansion—how effective were these?

Well, I think there is a broad, near-consensus that the expansionary macroeconomic policies of the New Deal era were effective. Had Senator McCain won the Presidential election last November, the first panel here would not have had Christina Romer. She would be back at Berkeley, and I would not be having to teach her course this semester. Instead, it would have someone like Douglas Holtz-Eakin or Kevin Hassett or Mark Zandi, one of John McCain's senior economic advisers, all of whom would be arguing that New Deal-like monetary and fiscal stimulus programs were effective as part of arguing for the McCain fiscal stimulus program that would in all likelihood—or the McCain banking recapitalization program that would in all likelihood be proceeding through the Congress.

Now, back at the start of the Great Depression, none of the major industrial powers of the world pursued these expansionary macroeconomic policies. They held instead that the government is best which governs least as far as interventionist policy is concerned, and they bound themselves with the golden fetters of the gold standard. Only when these were broken could a New Deal begin in any of the major industrial countries, and we know when each of the five major industrial countries of the world back during the Depression case off its golden fetters and began its New Deal, we know also how quickly each of them recovered from the Great Depression. That is the chart up there on your right.

There is a very strong correlation between how early a country abandoned gold and began its own individual New Deal on the one hand and how rapid and complete its recovery was on the other, as this chart I have reproduced from Barry Eichengreen's 1992 article and then scribbled on myself shows. Those economies that abandoned the gold standard and started expansionary monetary and, to a lesser extent, fiscal policies in 1931 did best; those that abandoned the gold standard in 1933 did second best; France, which waited until the very end of the 1930s to start its New Deal, did worse.

Statisticians will tell you that if you thought before looking at this chart that it really did not matter what a New Deal did, that the pluses and the minuses of New Deal policies largely offset each other, that if you thought there was only 50–50 chance that New Deals mattered before looking at this chart, then after looking at this evidence you would be 95 percent sure that New Deals mattered.

Which part of the fiscal and monetary expansion of the New Deals in all the different countries mattered? Probably all of them. It is difficult to write down a model of the economy in which some tools work and others do not. All four of the aspects operate through boosting spending, either through boosting the money stock and hoping the velocity of money will remain unchanged, or through boosting the velocity of money and hoping that the money stock will remain unchanged. And any model of the economy in which increases in spending cause not just inflation but also boost employment and output will see that all four of these policy tools are likely to be effective.

Which of the four components of macroeconomic policy helped the most in the New Deal's aiding of recovery? That is a much more difficult question. Christina Romer, who was here before, places enormous stress on the quantitative easing policies of the late 1930s, the mammoth expansions of the money supply even after interest rates on Treasury securities had already been reduced to effectively zero, and says it played the most major role. Professor Galbraith earlier dissented from that.

Did the fiscal policy expansions help? Well, as Christina Romer said earlier, there were so little of them that it was hard to say. The gap between the size of the Great Depression in the United States and the magnitude of the extra-direct government spending was so large that it is truly hard to see whether fiscal policy might have mattered.

But as Professor Galbraith said, for evidence of the ability of fiscal policy to boost employment and production if used on a sufficiently large scale, we have to wait until World War II.

Monetary policy contraction, banking sector collapse, and the transformation of irrational exuberance into unwarranted pessimism carried the U.S. unemployment rate up from 3 percent to 29 percent—or to 23 percent from 1929 to 1932. Monetary expansion, banking reform, and small deficits then drove the unemployment rate down to 9.5 percent by the start of large-scale mobilization in 1940. And wartime government expenditures and deficits drove the unemployment rate down to 1.2 percent by 1944.

Thank you.

Senator BROWN. Thank you, Dr. DeLong.

I will sort of go left to right and ask each of you about 5 minutes' worth of questions if no other Senator shows up, and then certainly feel free to weigh in on any question I ask any of the other three.

Dr. Winkler, starting with you, first, tell me about the National Youth Administration and what it did for your Dad?

Mr. WINKLER. He was employed. He ended up working in the Federal Writers Project for a chunk of time as part of his responsibilities there. He worked with, oh, Harriet Arnow and a number of other people writing the Cincinnati and Ohio Guides.

Senator BROWN. You cautioned near the end of your testimony against measures—you cautioned that measures not work in contradictory ways. What is the potentially biggest damage that we can do in the way that we have pursued, President Obama and the House and Senate are pursuing our counterattack, if you will, on this terrible recession?

Mr. WINKLER. The biggest difference between then and now, in my estimation, is that then they did not really understand the impact that fiscal policy could have and now we do understand it. They were not aware of the processing tax in the AAA and the effect that it was going to have on larger fiscal policy. They did not really understand what the Social Security tax was going to do before you are beginning to pay out the pensions and the like.

We do understand those things now, but the debate about how much money you should spend and how extensive the spending should be is one that is comparable to this at this point in time as well.

It seems to me that with the awareness that we now have to back off of the kind of spending that we have begun to do would be a serious mistake in light of what happened during the Depression and particularly in the 1937 recession period.

Senator BROWN. So you are advocating depending on economic growth in the next 12 months, whether we do additional stimulus packages of some sort?

Mr. WINKLER. I think it is clear that the growth will come, whether it is in the next 12 months or thereafter, and I think that one has to basically have faith and confidence that that will happen and that the deficits will be retired in time. I think that was something that was not understood at the time of the Great Depression and during the New Deal, but that I think we do understand that now.

We had the huge deficits of World War II, and in time, with the prosperity that followed the war, we were able to get the country back on a very sound economic footing before long.

Senator BROWN. What did you mean when you said Keynes and FDR did not understand one another? And more importantly than personal issue is what did that mean to Roosevelt's pursuing Keynesian economics in any way or Keynes trying to advise Roosevelt from afar with that letter that was sent December 31, 1933, that open letter to FDR?

Mr. WINKLER. It meant that Keynesian economics at that time, when it perhaps could have had an impact or even a couple of years later, simply was not tried. It took time until people began to understand what Keynes was doing and saying. Mariner Eccles, who was head of the Federal Reserve Board during the 1930s, did understand by the end of the decade what was going on. Other people began to promote Keynesian theories, Alvin Hansen and others, and it began to catch on in ways that had not been the case in the 1930s.

But the fact that the two men basically were talking at cross purposes in the meeting that they initially had is simply reflective of the fact that Keynes was not going to be listened to very coherently at that time.

Senator BROWN. What do you make of Hoover's differences with Andrew Mellon in the last couple of years of his Presidency when Mellon wanted no government intervention and Hoover presumably did?

Mr. WINKLER. I wished that Hoover had responded, as he did in his memoirs, the same way much earlier, and I think it could have made a difference. I think the fact that he did listen to Mellon during the years after 1929 was catastrophic, and that I think Mellon's advice was all wrong, and that Hoover would have been far better off if he had taken advantage of the awareness that he later had.

Senator BROWN. Thank you.

Dr. Galbraith, you spoke of the much maligned NIRA. Dr. Ohanian pretty much maligned it. Talk to me about that.

Mr. GALBRAITH. Well, the NIRA was never popular with——

Senator BROWN. Your microphone, please.

Mr. GALBRAITH. The NIRA was never popular with the economics profession. The Act essentially authorized the creation of cartels and deflated the Antitrust Act. And it has been largely dismissed in the historical treatment of the New Deal, so I do not want to overemphasize my point. Let me simply say that I think we should be agnostic in retrospect about a program that was in effect during a 4-year period when industrial production, in fact, doubled. It would be very hard to argue that the NIRA impeded industrial recovery, because industrial recovery was proceeding between 1933 and 1936 at a very rapid rate.

Senator BROWN. There has been discussion from both the two of you, Dr. Ohanian and you, but really all four of the panelists, and certainly by critics of the New Deal and supporters of the New Deal, about the Wagner Act, about, if you will, the artificial market and intervention that increased wages, whether it was the sit-down strikes that Dr. Ohanian had mentioned, the minimum wage, the Wagner Act overall collective bargaining.

Talk to me, if you would, about—sort of answer his views that that, in fact, did cost jobs. I believe Dr. Ohanian—and I certainly want you involved in this discussion, Dr. Ohanian, what it meant that the lowest growth sectors in terms of jobs seemed to be the highest wage sectors. I think that is pretty much what you said. And talk about it in some immediate terms, Dr. Galbraith, if you would, and then its impact on economic growth in the 1950s and 1960s, the foundations of the New Deal, the Wagner Act, as wages were increasing what that did to employment. Dr. Galbraith, and then I would like to hear your thoughts, Dr. Ohanian.

Mr. GALBRAITH. Yes, it is, again, a commonly held view in the economics profession that high wages cause unemployment, but the evidence for that proposition has always been extremely weak. If one believes that the measures that supported trade unions in the middle 1930s produced unemployment, you have to then explain why unemployment reached 25 percent in the early 1930s before those measures took effect. And you have to explain why in the 1950s, very extensive trade union membership, which had reached 30 percent or more of the labor force, did not cause a reversion to high unemployment.

One can look at this question also in a comparative context in the modern world, and a very interesting way of doing that is to examine the European experience, where we find that quite systematically across a wide range of countries those which have more egalitarian wage structures—the Scandinavian countries and the Northern European countries—as a result of very long traditions of very high levels of trade union membership—tend to have systematically lower unemployment rates, better and more efficiently operating labor markets, than countries which tolerate very high degrees of inequality. And there are very good and very conventional theoretical economic reasons why that would be expected to be the case.

Senator BROWN. So why would some critical New Deal policies emphasize the total hours worked per adult in 1939 were 20 percent or more below their 1929 level? Isn't that an accurate indicator of what higher wages meant in terms of people with——

Mr. GALBRAITH. Well, no; 1929 was the peak of an enormous speculative boom, and one cannot, I think, argue fairly that the experience of the late 1920s was sustainable. It was not. It led to a collapse of the financial sector just as the speculative boom in housing in the middle part of this decade, toward the end of this decade, led to a collapse of the financial sector that we are just experiencing. So to draw a trend line through that period and then say that in 1939 we were far below the trend is intrinsically questionable.

Beyond that, there is the problem of counting unemployment, and Brad DeLong I think gave the accurate figures just now. The unemployment rate in the New Deal period fell from 25 percent to just under 10 percent by 1936. It then jumped back up again in the recession of 1937 and was brought down again, as Roosevelt relaunched the New Deal, back down below 10 percent, again, before the start of the war.

That is a dramatic accomplishment in the face of the extremely serious situation that he started with.

Senator BROWN. Dr. Ohanian, talk to me about distorted labor markets and the Wagner Act and minimum wage and what that did to employment.

Mr. OHANIAN. My pleasure. Can I respond to a couple of points that Mr. Galbraith made?

Senator BROWN. Of course, yes, as any of you can. Feel free in jumping in.

Mr. OHANIAN. OK. So I believe Professor Galbraith made three or four points I would like to respond to. One is the idea about benchmarking comparisons to the year 1929, and it actually does turn out that, statistically speaking, a 2-percent trend literally goes through the year 1929 and captures the rest of the economy going forward very closely. So a statistical procedure known as least squares drives that trend line on, going through 1929 and fitting the remainder of the economy really quite well.

Another point Dr. Galbraith made was how can it be that with a higher rate of unionization in the 1950s, that the economy improved so much compared to the New Deal period. In terms of how much employment loss is going to be sustained on the basis of unions or other types of institutions that raise wages, what is relevant is how high the wage is above this market-clearing level. The estimates I have produced indicate that the wage was much higher above this market-clearing level in the late 1930s than it was immediately after the war.

And, in fact, to get to your question about the Wagner Act, the Wagner Act, National Labor Relations Act, was significantly modified by the Taft-Hartley Act in 1947, which provided for States to have right-to-work States. It gave States the right to outlaw the closed shop. So what is really central for understanding how much work was lost is how high the wage is relative to trend or this market-clearing level rather than the actual amount of individuals and unions.

Another point Dr. Galbraith made was about unemployment versus hours worked. I use hours worked as a measure of labor, as do other macroeconomists, because that is the measure that we use for trying to understand how much production is occurring. Unemployment rates are tricky because for long-term issues, such as we are talking about in the Great Depression, you know, 9, 10 years, there is something called the discouraged worker effect in which individuals leave the labor force, which reduces unemployment.

The final point Dr. Galbraith made was about whether high wages do cause job loss. Most economists, in my view, do subscribe to the view that if wages are boosted above the market-clearing level, that will reduce jobs. The economic reasoning is well accepted among economists and there is significant evidence for that.

I am not sure if I covered your initial question about the Wagner Act, but I would be happy to——

Senator BROWN. You did. You did. You did. Thank you.

You acknowledged, Dr. Ohanian, that there are New Deal policies that were useful, as you said, Social Security, bank stabilization policies. What is the line between a useful social safety net and policies that are meddlesome to interventionist to distorting of the market? Can you share how you come to those conclusions, or do you just look at each one individually and make an educated sort of estimate?

Mr. OHANIAN. Sure. Well, in my view, among the most useful policies in the New Deal did establish the basic social safety net. So unemployment benefits, for example, in my opinion, were one of the most important parts of the New Deal. Establishing Social Security——

Senator BROWN. I am sorry. So you reject the view that unemployment extensions would cause some people to not seek work, therefore distorting the labor market? You don't buy those sort of conservative arguments that the unemployment system really causes fewer people to want to work?

Mr. OHANIAN. A number of economists have been working on the difficult issue of how to design unemployment insurance, disability insurance, other types of social insurance to try to get incentives right, which is, I believe, what you are talking about, and at the same time trying to provide enough insurance, and that is a difficult, difficult question.

What I can tell you is that current research indicates that the incentive issues become less problematic during periods when the chances of finding work are extremely low. So, for example, during the Great Depression when labor markets are quite distorted, you know, expanding unemployment benefits—well, they were adopted at that time. But that might have been a good idea.

In terms of trying to figure out which policies are useful and which aren't, good policymaking really needs to be consistent with getting economic incentives right. I believe there is a large level of agreement among economists about what constitutes guides for good long-run policy, increasing the incentives to work, save, and invest, increasing the incentives and maintaining incentives for financial intermediaries to intermediate capital efficiently. These are all good guides for policy.

When we see policies that sharply deviate from those good long-range goals, that is when I say these are policies that are going to have a negative impact on the economy.

Senator BROWN. Thank you.

Dr. DeLong, would you weigh in on the 1929–1939, 20 percent hours worked for adults, 20 percent lower? Do you think that is an accurate indicator of——

Mr. DELONG. It is a puzzling question that—and it is indeed the case that unemployment declined, the unemployment rate declined extremely sharply from 1932 to 1939, from 23 percent down to 11.3 percent, according to the Weir measure, and practically all of this is indeed an increase in the fraction of the labor force that has jobs and very little of it being a discouraged worker effect because that discouraged worker effect is not present, at least I at least can't see it in David Weir's Labor Force series.

But nevertheless, it is certainly true that hours of work per employed person were 13 percent lower in 1939 than in 1929, and Lee Ohanian wants to conclude that a substantial chunk of this decline is due to deficient demand, that the economy was getting better at sharing the available work hours among the workers but was not producing nearly as much demand for labor as we would want to see.

This is debatable. In 1949, hours worked per adult were 18 percent. In 1959, they were 17 percent below their 1929 level. But do we want to conclude that the economy was even more depressed in the 1950s than it was in 1939? No. The decline in hours worked tells us a lot about the cycle and the trend, that the decline in hours worked from 1914 to 1952 does not mean that the economy was performing much worse in 1952 than it was in 1914.

The Great Depression comes in the middle of the last sharp decline in the American work week we have seen and shows us that Americans back then were deciding collectively to take a substantial part of their increased technological wealth and use it to buy increased leisure. And for that reason, I am more skeptical of the work hours comparison of 1939 to 1932 and 1929 and I tend to think that it makes more sense to take the unemployment rate as an indicator of how complete recovery is.

Senator BROWN. Interesting answer. Thank you.

What role did the Fed play in reversing the Great Depression? What policies, in particular, should it have pursued?

Mr. DELONG. Well, this is—I think when you, in fact, talk about the Federal Reserve and the Great Depression, there really are three questions. The first is did the Federal Reserve cause the Depression? Was the economy going along doing its normal thing and then the Federal Reserve all of a sudden decided to do something bad, and as a result we fell into the Great Depression? And I think the answer to that is clearly no, that the Great Depression started for other reasons. The Federal Reserve was simply a bystander, that, as Professor Galbraith said earlier, there are signs of substantial natural instability, right, in the economy, at least as it stood in the interwar period. Then it starts down and it keeps going down.

The second question is, could the Federal Reserve have interrupted the Great Depression? Milton Friedman and Anna Jacobson Schwartz's *Monetary History of the United States* is a very large and very impressive book. I think Professor Galbraith calls it magisterial at some point in his written testimony. It argues the Federal Reserve could by itself have stopped the Great Depression in its tracks had it done enough to print up bank reserves, to encourage the Bureau of Engraving and Printing to print up currency, had it rescued threatened banks. But the Federal Reserve did not do so.

And this thesis of the *Monetary History of the United States* has, I think, taken profound damage over the last 2 years, for Chairman Bernanke of the Federal Reserve and his team have, via open market operations and now quantitative easing, they have done exactly what Friedman–Schwartz recommended and claimed would have stopped the Great Depression in its tracks. They have expanded bank reserves, the monetary base, and the money supply to an extent I would not have believed possible 3 years ago. Yet we all think that this was not enough, that we need banking policy and probably fiscal policy, as well, in order to keep the Great Depression currently the last depression that America has suffered.

I think this is a substantial intellectual loss for Friedman–Schwartz and an intellectual victory for Bernanke–Keynes, who argued that all the conventional interest rate and quantitative easing monetary policy in the world might not be enough if the capitalization of the banking sector vanished and the credit channel got itself well and truly clogged, which is where we seem to be.

The third question is what role did the Federal Reserve play in spurring recovery, and here we have the debate, and we have seen a piece of it in the debate between Chairman Romer and Professor Galbraith earlier, Christina Romer placing a very heavy weight on the quantitative easing policies of the Federal Reserve and of the gold inflow during the 1930s, arguing that even after the Federal Reserve has done everything it can to lower interest rates on Treasury securities to zero, if it continues to expand the money supply, well, that money burns a hole in people's pockets and they spend it and that boosts spending, and Professor Galbraith placing more stress on what fiscal expansion there was and on the recovery of the banking system.

Here, well, my office and Professor Galbraith's office is 1,000 miles away, but in her previous life, Christina Romer's office is only 50 steps down the hall and she is very, very impressive and very convincing, so I tend to side with Christina on that one.

Senator BROWN. Fair enough.

I will close with one question, particularly in light of his last comments about fiscal and monetary policy. I want to ask the same question of all four of you, and let us close with that. The question is, expand on whether it is fiscal policy or monetary policy that was primarily responsible for economic growth during the Depression in the 1930s and your views of what that means for today, if you would just take that question, Dr. Winkler, and each of you work through your thoughts on that sort of central question.

Mr. WINKLER. I have been thinking about fiscal policy and particularly with regard to the NIRA that came up earlier in this conversation. There is no question that the NIRA did not work very well. It was trying to stabilize prices and wages and hours and the like. In so doing, it probably reversed the deflationary cycle, but it also discouraged investment. Business people who were not making profits were not likely to invest. The point, though, is that they weren't going to invest anyway. Keynes was absolutely right. This was not working. Something else needed to be done.

My whole point, I think, has been that fiscal policy could have made a difference as we look at this in retrospect but did not because enough was not being spent, at least in the aggregate. I tend to side with Professor DeLong that monetary policy did make a difference. Would that fiscal policy have been permitted to be used in the ways that might have made a greater difference and ended the Depression sooner.

Senator BROWN. Thank you.

Dr. Galbraith.

Mr. GALBRAITH. The judgment of contemporaries was that monetary policy played a very minor role in the recovery from the Great Depression, and I tend to share that judgment. The Federal Reserve at the time was regarded as something of a backwater and I wonder to what extent the present emphasis on monetary policy in those years may be picking up the work of other agencies and in particular the Reconstruction Finance Corporation and the institutions that were set up to help recapitalize housing and to reconstruct the mortgage business.

But leaving that aside, public spending in the national income and product accounts increased over 50 percent between 1932 and 1936, and as a share of GDP, federal spending rose from 10 percent to around 17 percent. That is a substantial increase both in absolute numbers and in proportions. The argument that this is an insignificant factor, it seems to me, is deeply questionable. To establish it, we would need to know what the multipliers—what the multiplier effects, the knock-on effects, actually were at that time.

Earlier, you asked a question of Professor Winkler that I think is very pertinent to this issue, and that was "What are the biggest differences between the approach taken in the New Deal and the approach that we are taking today?" I would like just to close by coming back to two differences that I think are very instructive and important for the design of policy going forward.

I think in our present environment, in our present situation, we are placing much more reliance on policies intended to resurrect the existing structure of banking and to get credit flowing again than was true in the early and middle 1930s, and we are likely to fail at this. The present approach to the banking crisis is actually somewhat more reminiscent of the early 1930s than it is of the Roosevelt period and likely to meet the same disappointment as in those early years, insofar as the problem is not one of a blockage in the pipes of credit but rather a collapse of asset values and therefore of the collateral on which credit rests, the demand for credit as much as of the supply.

That problem can only be solved by reconstructing the financial position of America's households and businesses. In the Great Depression, that did not happen, and it didn't really happen until the Second World War completely recapitalized the private sector by giving them a vast stock of government bonds, which became the basis of their financial wealth, of middle-class prosperity in the post-war period.

The second point is that we are placing too much emphasis on the idea that by using the short-term Keynesian stimulus, we can bring ourselves out of this problem in a short period of time. I think if we do that, we are going to be prone to a policy reversal with the same danger that Roosevelt experienced in 1937, that is to say, when you reverse policy, the economy then punishes you by going back into the tank.

It would be appropriate to take a lesson from the early New Deal. What is needed here is a comprehensive set of measures that will build an economy for the future, an economy which, in particular, deals with two vital, very closely related challenges. One of them is energy security, because if we don't deal with our energy security problems, we are going to be at the mercy of rising oil prices just as soon as aggregate demand starts expanding aggressively. And second there is climate change, a problem which we have an opportunity now to deal with and which if we do not take that opportunity, we will both miss our chance to put the overall working of the American economy on an environmentally sustainable basis, and also an opportunity to take many millions of people and give them useful employment for many years to come.

Senator BROWN. Thank you, Dr. Galbraith.

Dr. Ohanian.

Mr. OHANIAN. If I might just briefly respond to one of the points Professor DeLong made about how much hours worked were depressed at the end of the 1930s, so one point I just want to make is that per capita hours in the 1950s are indeed higher than they are in the 1930s, just as they were in the 1920s.

The second point, Professor DeLong indicated that as people become wealthier, they increase their demand for leisure and hours worked falls. There is not a conclusion about this force within the Depression. It is an area of active research. But if that force was operative, the Depression is a period of declining wealth and income, which would suggest people would be demanding less leisure rather than more leisure.

Regarding your question about recovery and fiscal versus monetary policy, expansion output is necessarily due to expansion either in hours or output per hour. The numbers indicate there is not much expansion in hours in the 1930s, so the growth we do see in the 1930s is—most of it is coming from output per hour or productivity.

Economists don't have a good understanding about cyclical changes in productivity. Our basic economic reasoning doesn't point to a substantial link between either fiscal policy or monetary policy and expansions in productivity. Economic historian Alexander Field has indicated that the 1930s were a really remarkable period for productivity growth, true productivity growth in terms of efficiency gains. I don't see necessarily either monetary or fiscal policy playing a major role there.

In terms of today's economy, we face, as other panel members indicated, a different set of problems, in some sense related but in some sense really quite different. Re-regulating the financial system is a tall order to fill. It is not an easy question. There are a number of complicated issues. Currently, we have a system that has stocked a lot of risk onto the backs of taxpayers and incentives were in place to make that happen at some level. So in my view, the major challenge we face is re-regulating that financial system that became much more sophisticated and much faster than the current regulatory framework could deal with. That won't be an easy issue to make progress on, but in my view, that is the main challenge we face.

Senator BROWN. Thank you.

The last word, Dr. DeLong.

Mr. DELONG. I think that the lesson from viewing fiscal and monetary policy and government attempts to use them to serve as balance wheels of the economy since the Great Depression, of the abandonment of Herbert Hoover Treasury Secretary Andrew Mellon's dictum that liquidation is actually a healthy process, part of what economist Joseph Schumpeter called the natural breathing of the economic organism, that we have abandoned that and we think we have these policy tools and have been trying to use them and the question is how effective they are.

And I think the conclusion from 70 years of economists arguing and watching economies and watching the success of these tools is that almost all of the time monetary policy is more effective, and almost all of the time monetary policy is easier to implement and easier to change when conditions change, that it moves faster and it also is more flexible.

But then there come times like today, all right, times when the interest rate on safe short- and medium-term Treasury securities has been pushed all the way down to zero and in which you have to ask, if you undertake further expansionary monetary policy, well, whose incentives are you changing? We are economists. We believe that people respond to incentives, that government policies worked by changing the incentives that people face, but by the time you have pushed interest rates down to zero and can't push them any further, whose incentives are you changing by continuing to rely on monetary policy?

And it is in that situation that we are now, and that is when you start dragging out the other tools of trying to keep spending in the economy at a normal pace. You know, the quantitative easing part of monetary policy, that maybe you can give people so much money it burns a hole in their pocket and they spend it, that the aggressive banking sector recapitalizations and government loan guarantee programs that we see the Treasury trying to roll out now that have their parallel in operations conducted by the Reconstruction Finance Corporation during the Great Depression, which had, if I may say so, an easier time. The RFC had powers to bring banks into conservatorship without declaring that they were insolvent.

And so to the extent that there is a fear that declaring that banks are, in the view of the government, insolvent will cause some kind of crisis of confidence and a shrinkage of the money stock as people pull their money out of banks, well, the RFC had tools that would avoid this, and perhaps Tim Geithner's life would be a little bit easier at the Treasury if he had them now.

And last, there is the fiscal policy, that government spending, government tax cuts, with the idea that if the private sector is spending and is not staying stable, well, maybe the government can add to it and so keep things on an even keel. And I think the prudent thing is, when asked which of these should we be doing, is to say yes, all right, that when there is great uncertainty and when you have a number of tools for all of which there is some reason to believe they are at least somewhat effective, we will do what Roosevelt did, experimentation. Try them all and reinforce the ones that seem to be working.

Senator BROWN. Thank you, Dr. DeLong.

Thank you all for joining us. This is the first of several hearings that will help Congress shape our response and our reaction to this economic crisis. I appreciate all of the service all of you have given by being here today and the good work you do, each in your institutions.

The record will be open for 7 days for Senator DeMint and the two other Members of the Subcommittee, and if you want to revise your remarks or add anything or respond to any of the questions that you didn't feel that you got to respond to completely enough, certainly you are free to be in touch with the Subcommittee to do that, also.

The Committee is adjourned. Thank you very much.

[Whereupon, at 4:34 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF CHRISTINA D. ROMER

CHAIR,

PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

MARCH 31, 2009

Chairman Brown, Ranking Member DeMint, and Members of the Subcommittee, thank you for inviting me to join you today. In my previous life, as an economic historian at Berkeley, one of the things I studied was the Great Depression. And in my current life, as Chair of the Council of Economic Advisers, I have been on the front lines of the Administration's policies to help us to end what is arguably the worst recession our country has experienced since the 1930s. For this reason, I am delighted to talk with you today about the lessons learned from the Great Depression and President Roosevelt's New Deal that have helped inform us—and will continue to help inform us—about the right approach to dealing with today's economic crisis.

To start, let me point out that though the current recession is unquestionably severe, it pales in comparison with what our parents and grandparents experienced in the 1930s. February's employment report showed that unemployment in the United States has reached 8.1 percent—a terrible number that signifies a devastating tragedy for millions of American families. But, at its worst, unemployment in the 1930s reached nearly 25 percent.[1] And, that quarter of American workers had painfully few of the social safety nets that today help families maintain at least the essentials of life during unemployment. Likewise, following last month's revision of the GDP statistics, we know that real GDP has declined almost 2 percent from its peak. But, between the peak in 1929 and the trough of the great Depression in 1933, real GDP fell over 25 percent.[2]

I don't give these comparisons to minimize the pain the United States economy is experiencing today, but to provide some crucial perspective. Perhaps it is the historian and the daughter in me that finds it important to pay tribute to just what truly horrific conditions the previous generation of Americans endured and eventually triumphed over. And, it is the new policymaker in me that wants to be very clear that we are doing all that we can to make sure that the word "great" never applies to the current downturn.

While what we are experiencing is less severe than the Great Depression, there are parallels that make it a useful point of comparison and a source for learning about policy responses today. Most obviously, like the Great Depression, today's downturn had its fundamental cause in the decline in asset prices and the failure or near-failure of financial institutions. In 1929, the collapse and extreme volatility of stock prices led consumers and firms to simply stop spending.[3] In the recent episode, the collapse of housing prices and stock prices has reduced wealth and shaken confidence, and led to sharp rises in the saving rate as consumers have hunkered down in the face of greatly reduced and much more uncertain wealth.

In the 1930s, the collapse of production and wealth led to bankruptcies and the disappearance of nearly half of American financial institutions.[4] This, in turn, had two devastating consequences: a collapse of the money supply, as stressed by Milton Friedman and Anna Schwartz, and a collapse in lending, as stressed by Ben Bernanke.[5] In the current episode, modern innovations such as derivatives led to a direct relationship between asset prices and severe stress in financial institutions. Over the fall, we saw credit dry up and learned just how crucial lending is to the effective functioning of American businesses and households.

Another parallel is the worldwide nature of the decline. A key feature of the Great Depression was that virtually every industrial country experienced a severe contrac-

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[1] Unemployment data for the 1930s are from *Historical Statistics of the United States: Colonial Times to 1970* (Washington, DC: Government Printing Office, 1975), Part 1, p. 135, series D86.

[2] Real GDP data are from the Bureau of Economic Analysis, *http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=Y,* Table 1.1.3.

[3] Christina D. Romer, "The Great Crash and the Onset of the Great Depression," *Quarterly Journal of Economics* 105 (August 1990): 597–624.

[4] Data on the number of banks is from *Banking and Monetary Statistics* (Washington, DC: Board of Governors of the Federal Reserve System, 1943), Table 1.

[5] Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States: 1867–1960* (Princeton, NJ: Princeton University Press for NBER, 1963), and Ben S. Bernanke, "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression," *American Economic Review* 73 (June 1983): 257–276.

tion in production and a terrible rise in unemployment.[6] This past year, there was hope that the current downturn might be mainly an American experience, and so world demand could remain high and perhaps help pull us through. However, during the past few months, we have realized that this hope was a false one. As statistics have poured in, we have learned that Europe, Asia, and many other areas are facing declines as large as, if not larger than, our own. Indeed, rather than world demand helping to hold us up, the fall in U.S. demand has had a devastating impact on export economies such as Taiwan, China, and South Korea.

This similarity of causes between the Depression and today's recession means that President Obama began his presidency and his drive for recovery with many of the same challenges that Franklin Roosevelt faced in 1933. Our consumers and businesses are in no mood to spend or invest; our financial institutions are severely strained and hesitant to lend; short-term interest rates are effectively zero, leaving little room for conventional monetary policy; and world demand provides little hope for lifting the economy. Yet, the United States did recover from the Great Depression. What lessons can modern policymakers learn from that episode that could help them make the recovery faster and stronger today?

One crucial lesson from the 1930s is that a small fiscal expansion has only small effects. I wrote a paper in 1992 that said that fiscal policy was not the key engine of recovery in the Depression.[7] From this, some have concluded that I do not believe fiscal policy can work today or could have worked in the 1930s. Nothing could be farther than the truth. My argument paralleled E. Cary Brown's famous conclusion that in the Great Depression, fiscal policy failed to generate recovery "not because it does not work, but because it was not tried."[8]

The key fact is that while Roosevelt's fiscal actions through the New Deal were a bold break from the past, they were nevertheless small relative to the size of the problem. When Roosevelt took office in 1933, real GDP was more than 30 percent below its normal trend level. (For comparison, the U.S. economy is currently estimated to be between 5 and 10 percent below trend.)[9] The emergency spending that Roosevelt did was precedent-breaking—balanced budgets had certainly been the norm up to that point. But, it was quite small. As a share of GDP, the deficit rose by about one and a half percentage points in 1934.[10] One reason the rise wasn't larger was that a large tax increase had been passed at the end of the Hoover administration. Another key fact is that fiscal expansion was not sustained. The deficit as a share of GDP declined in fiscal 1935 by roughly the same amount that it had risen in 1934. Roosevelt also experienced the same inherently procyclical behavior of state and local fiscal actions that President Obama is facing. Because of balanced budget requirements, state and local governments are forced to cut spending and raise tax rates when economic activity declines and state tax revenues fall. At the same time that Roosevelt was running unprecedented federal deficits, state and local governments were switching to running surpluses.[11] The result was that the total fiscal expansion in the 1930s was very small indeed. As a result, it could only have a modest direct impact on the state of the economy.

This is a lesson the Obama Administration has taken to heart. The American Recovery and Reinvestment Act, passed by Congress less than 30 days after the Inauguration, is simply the biggest and boldest countercyclical fiscal action in history. The nearly $800 billion fiscal stimulus is roughly equally divided between tax cuts, direct government investment spending, and aid to the states and people directly hurt by the recession. The fiscal stimulus is close to 3 percent of GDP in each of the next 2 years. And, as I mentioned, a good chunk of this stimulus takes the form of fiscal relief to state governments, so that they do not have to balance their budg-

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[6] Christina D. Romer, "The Nation in Depression," *Journal of Economic Perspectives* 7 (Spring 1993): 19–39.

[7] Christina D. Romer, "What Ended the Great Depression?" *Journal of Economic History* 52 (December 1992): 757–784.

[8] E. Cary Brown, "Fiscal Policy in the Thirties: A Reappraisal," *American Economic Review* 46 (December): 857–879.

[9] The 2009 figure is an extrapolation to the current quarter based on estimates of potential output by the Congressional Budget Office, *http://www.cbo.gov/ftpdocs/99xx/doc9957/Background__Table2-2__090107.xls.* For 1933, the estimate is based on the facts that the economy does not appear to have been substantially above trend in 1929 and that real GDP fell 25 percent from 1929 to 1933. Normal growth would have added at least 10 percent to GDP over this period.

[10] The deficit figures are from *Historical Statistics of the United States: Colonial Times to 1970, Part 2,* p. 1194, series Y337. Nominal GDP data are from the Bureau of Economic Analysis, *http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=Y,* Table 1.1.5. I average calendar year figures to estimate fiscal year values.

[11] The data on state and local fiscal stance are from the Bureau of Economic Analysis, *http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=Y,* Table 3.3.

ets only by such measures as raising taxes and cutting the employment of nurses, teachers, and first responders. We expect this fiscal expansion to be extremely important to countering the terrible job loss that last month's numbers show now totals 4.4 million since the recession began 14 months ago.

While the direct effects of fiscal stimulus were small in the Great Depression, I think it is important to acknowledge that there may have been an indirect effect. Roosevelt's very act of doing something must have come as a great relief to a country that had been suffering depression for more than 3 years. To have a President step up to the challenge and say the country would attack the Depression with the same fervor and strength it would an invading army surely lessened uncertainty and calmed fears. Also, signature programs such as the WPA that directly hired millions of workers no doubt contributed to a sense of progress and control. In this way, Roosevelt's actions may have been more beneficial than the usual estimates of fiscal policy suggest. If the actions President Obama is taking in the current downturn can generate the same kind of confidence effects, they may also be more effective than estimates based on conventional multipliers would lead one to believe.

A second key lesson from the 1930s is that monetary expansion can help to heal an economy even when interest rates are near zero. In the same paper where I said fiscal policy was not key in the recovery from the Great Depression, I argued that monetary expansion was very useful. But, the monetary expansion took a surprising form: it was essentially a policy of quantitative easing conducted by the U.S. Treasury.[12]

The United States was on a gold standard throughout the Depression. Part of the explanation for why the Federal Reserve did so little to counter the financial panics and economic decline was that it was fighting to defend the gold standard and maintain the prevailing fixed exchange rate.[13] In April 1933, Roosevelt temporarily suspended the convertibility to gold and let the dollar depreciate substantially. When we went back on gold at the new higher price, large quantities of gold flowed into the U.S. Treasury from abroad. These gold inflows serendipitously continued throughout the mid-1930s, as political tensions mounted in Europe and investors sought the safety of U.S. assets.

Under a gold standard, the Treasury could increase the money supply without going through the Federal Reserve. It was allowed to issue gold certificates, which were interchangeable with Federal Reserve notes, on the basis of the gold it held. When gold flowed in, the Treasury issued more notes. The result was that the money supply, defined narrowly as currency and reserves, grew by nearly 17 percent per year between 1933 and 1936.[14]

This monetary expansion couldn't lower nominal interest rates because they were already near zero. What it could do was break expectations of deflation. Prices had fallen 25 percent between 1929 and 1933.[15] People throughout the economy expected this deflation to continue. As a result, the real cost of borrowing and investing was exceedingly high. Consumers and businesses wanted to sit on any cash they had because they expected its real purchasing power to increase as prices fell. Devaluation followed by rapid monetary expansion broke this deflationary spiral. Expectations of rapid deflation were replaced by expectations of price stability or even some inflation. This change in expectations brought real interest rates down dramatically.[16]

The change in the real cost of borrowing and investing appears to have had a beneficial impact on consumer and firm behavior. The first thing that turned around was interest-sensitive spending. For example, car sales surged in the summer of 1933.[17] One sign that lower real interest rates were crucial is that real fixed investment and consumer spending on durables both rose dramatically between 1933 and 1934, while consumer spending on services barely budged.[18]

In thinking about the lessons from the Great Depression for today, I want to tread very carefully. A key rule of my current job is that I do not comment on Federal

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[12] Romer, "What Ended the Great Depression?"

[13] For a comprehensive history of the role of the gold standard in the Great Depression, see Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (New York: Oxford University Press, 1992).

[14] Friedman and Schwartz, *A Monetary History of the United States,* Table A-1, column 1 and Table A-2, column 3. The growth rate refers to the period December 1933 to December 1936.

[15] The GDP price index data are from the Bureau of Economic Analysis, *http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=Y,* Table 1.1.4.

[16] Romer, "What Ended the Great Depression?"

[17] Peter Temin and Barrie A. Wigmore, "The End of One Big Deflation," *Explorations in Economic History* 27 (October 1990): 483–502.

[18] Data on the components of spending are from the Bureau of Economic Analysis, *http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=Y,* Table 1.1.3.

Reserve policy. So, let me be very clear—I am not advocating going on a gold standard just so we can go off it again, or that Secretary Geithner should start conducting monetary policy. But the experience of the 1930s does suggest that monetary policy can continue to have an important role to play even when interest rates are low by affecting expectations, and in particular, by preventing expectations of deflation.

This discussion of fiscal and monetary policy in the 1930s leads me to a third lesson from the 1930s: beware of cutting back on stimulus too soon.

As I have just described, monetary policy was very expansionary in the mid-1930s. Fiscal policy, though less expansionary, was also helpful. Indeed, in 1936 it was inadvertently stimulatory. Largely because of political pressures, Congress overrode Roosevelt's veto and gave World War I veterans a large bonus. This caused another one-time rise in the deficit as a share of GDP of more than 1½ percentage points.

And, the economy responded. Growth was very rapid in the mid-1930s. Real GDP increased 11 percent in 1934, 9 percent in 1935, and 13 percent in 1936. Because the economy was beginning at such a low level, even these growth rates were not enough to bring it all the way back to normal. Industrial production finally surpassed its July 1929 peak in December 1936, but was still well below the level predicted by the pre-Depression trend.[19] Unemployment had fallen by close to 10 percentage points—but was still over 15 percent. The economy was on the road to recovery, but still precarious and not yet at a point where private demand was ready to carry the full load of generating growth.

In this fragile environment, fiscal policy turned sharply contractionary. The one-time veterans' bonus ended, and Social Security taxes were collected for the first time in 1937. As a result, the deficit-to-GDP ratio was reduced by roughly 2‡ percentage points.

Monetary policy also turned inadvertently contractionary. The Federal Reserve was becoming increasingly concerned about inflation in 1936. It was also concerned that, because banks were holding such large quantities of excess reserves, open-market operations would merely cause banks to substitute government bonds for excess reserves and would have no impact on lending. In an effort to put themselves in a position where they could tighten if they needed to, the Federal Reserve doubled reserve requirements in three steps in 1936 and 1937. Unfortunately, banks, shaken by the bank runs of just a few years before, scrambled to build reserves above the new higher required levels. As a result, interest rates rose and lending plummeted.[20]

The results of the fiscal and monetary double whammy in the precarious environment were disastrous. GDP rose by only 5 percent in 1937 and then fell by 3 percent in 1938, and unemployment rose dramatically, reaching 19 percent in 1938. Policymakers soon reversed course and the strong recovery resumed, but taking the wrong turn in 1937 effectively added 2 years to the Depression.

The 1937 episode is an important cautionary tale for modern policymakers. At some point, recovery will take on a life of its own, as rising output generates rising investment and inventory demand through accelerator effects, and confidence and optimism replace caution and pessimism. But, we will need to monitor the economy closely to be sure that the private sector is back in the saddle before government takes away its crucial lifeline.[21]

The fourth lesson we can draw from the recovery of the 1930s is that financial recovery and real recovery go together. When Roosevelt took office, his immediate actions were largely focused on stabilizing a collapsing financial system. He declared a national Bank Holiday 2 days after his inauguration, effectively shutting every bank in the country for a week while the books were checked. This 1930s version of a "stress test" led to the permanent closure of more than 10 percent of the Nation's banks, but improved confidence in the ones that remained.[22] As I discussed before, Roosevelt temporarily suspended the gold standard, before going back on gold at a lower value for the dollar, paving the way for increases in the money supply. In June 1933, Congress passed legislation helping homeowners through the

[19] Industrial production data are from the Board of Governors of the Federal Reserve, *http://www.federalreserve.gov/releases/g17/iphist/iphist__sa.txt.*

[20] The data on interest rates are from *Banking and Monetary Statistics,* Table 120; the data on lending are from the same source, Table 2.

[21] Of course, every episode is different, and the Federal Reserve will come to its own independent management of monetary policy.

[22] See Friedman and Schwartz, *A Monetary History of the United States,* pp. 328, 421–428, for more information on the 1933 Bank Holiday.

Home Owners Loan Corporation.[23] The actual rehabilitation of financial institutions, obviously took much longer. Indeed, much of the hard work of recapitalizing banks and dealing with distressed homeowners and farmers was spread out over 1934 and 1935.

Nevertheless, the immediate actions to stabilize the financial system had dramatic short-run effects on financial markets. Real stock prices rose over 40 percent from March to May 1933, commodity prices soared, and interest-rate spreads shrank.[24] And, the actions surely contributed to the economy's rapid growth after 1933, as wealth rose, confidence improved, and bank failures and home foreclosures declined.

But, it was only after the real recovery was well established that the financial recovery took firm hold. Real stock prices in March 1935 were more than 10 percent lower than in May 1933; bank lending continued falling until mid-1935; and real house prices rose only 7 percent from 1933 to 1935.[25] The strengthening real economy improved the health of the financial system. Bank profits moved from large and negative in 1933 to large and positive in 1935, and remained high through the end of the Depression, with the result that bank suspensions were minimal after 1933. Real stock prices rose robustly. Business failures and home foreclosures fell sharply and almost without interruption after 1932.[26] And, this virtuous cycle continued as the financial recovery led to further narrowing of interest-rate spreads and increased willingness of banks to lend.[27]

This lesson is another one that has been prominent in the minds of policymakers today. The Administration has from the beginning sought to create a comprehensive financial sector recovery program. The Financial Stabilization Plan was announced on February 10, 2009, and has been steadily put into operation since then. It includes a program to help stabilize house prices and save responsible homeowners from foreclosure; a partnership with the Federal Reserve to help restart the secondary credit market; a program to directly increase lending to small businesses; the capital assistance program to review the balance sheets of the largest banks and ensure that they are adequately capitalized; and the program we announced just last week to partner with the FDIC, the Federal Reserve, and private investors to help move legacy or "toxic" assets off banks' balance sheets. This sweeping financial rescue program is central to putting the financial system back to work for American industry and households and should provide the lending and stability needed for economic growth. At the same time, the fiscal stimulus package enacted on February 17th was designed to create jobs quickly. In doing so, it should lower defaults and improve balance sheets so that our financial system can continue to strengthen.

The fifth lesson from the 1930s is that worldwide expansionary policy shares the burdens and the benefits of recovery. Research by Barry Eichengreen and Jeffrey Sachs shows that going off the gold standard and increasing the domestic money supply was a key factor in generating recovery and growth across a wide range of countries in the 1930s.[28] Importantly, these actions worked to lower world interest rates and benefit other countries, rather than to just shift expansion from one country to another.

The implications for today are obvious. The more that countries throughout the world can move toward monetary and fiscal expansion, the better off we all will be. In this regard, aggressive fiscal actions in China and other countries, and the recent reductions in interest rates in Europe and the U.K. are welcome news. They are paving the way for a worldwide end to this worldwide recession.

A sixth lesson from the Great Depression is that it is important not only to deal with the immediate economic crisis, but to put in place reforms that help prevent

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[23] For a good description of the various financial stabilization measures Roosevelt took, see Lester V. Chandler, *America's Greatest Depression, 1929–1941* (New York: Harper & Row, 1970), Chapter 9.

[24] Stock price data are from Robert Shiller, *http://www.econ.yale.edu/shiller/data.htm.* Temin and Wigmore, "The End of One Big Deflation," describe the behavior of commodity prices and interest-rate spreads in 1933.

[25] The data on bank lending are from *Banking and Monetary Statistics* (Washington, DC: Board of Governors of the Federal reserve System, 1943), Table 2; the data on house prices are from Robert Shiller, *http://www.econ.yale.edu/shiller/data.htm.*

[26] The data on bank suspensions and profits are from *Banking and Monetary Statistics* (Section 7 and Table 56, Column 5, respectively). The data on business failures are from *Historical Statistics of the United States: Colonial Times to 1970, Part 2,* p. 912, series V27. The data on home foreclosures are from *Historical Statistics of the United States: Colonial Times to 1970, Part 2,* p. 651, series N301.

[27] Data on U.S. and corporate bond yields are available in *Banking and Monetary Statistics,* Table 128.

[28] Barry Eichengreen and Jeffrey Sachs, "Exchange Rates and Economic Recovery in the 1930s," *Journal of Economic History* 45 (December 1985): 925–946.

future crises. Bank runs were clearly one of the key factors in the horrific downturn of the 1930s. The United States suffered four waves of banking panics between the fall of 1930 and the spring of 1933.[29] In June 1933, President Roosevelt worked with Congress to establish the Federal Deposit Insurance Corporation (FDIC). This act, together with subsequent legislation, established the insurance of bank deposits that we still depend on today.

The FDIC has been one of the most enduring legacies of the Great Depression. Financial panics largely disappeared in the 1930s and have never truly reappeared. The academic literature suggests that deposit insurance has played a crucial role in this welcome development.[30] One simple but powerful piece of evidence of the importance of Federal deposit insurance is that among the very few runs we have seen since the Depression were ones on non-federally insured savings and loans in Ohio and Maryland in the 1985.[31] And, a striking feature of the current crisis has been the continued faith of the American people in the safety of their bank deposits. Though near-runs occurred on some financial institutions this past fall and winter, for the most part Americans have remained confident that their bank deposits are secure. In this way, the reforms instituted in response to the Great Depression almost surely helped prevent the current crisis from reaching Great Depression proportions.

The importance of putting in place more fundamental reforms is another lesson of the New Deal that the Administration is following. The current crisis has revealed weaknesses in the regulatory framework. Most obviously, we have discovered that financial institutions have evolved in ways that left systemically important institutions inadequately capitalized and monitored. We have also found that the government lacks the tools necessary to resolve complex financial institutions that become insolvent in a way that protects both the financial system and American taxpayers. We look forward to working with Congress to remedy these and other regulatory shortfalls. By doing so, we can make the U.S. economy more stable and secure for the next generation.

The final lesson that I want to draw from the 1930s is perhaps the most crucial. A key feature of the Great Depression is that it did eventually end. Despite the devastating loss of wealth, chaos in our financial markets, and a loss of confidence so great that it nearly destroyed Americans' fundamental faith in capitalism, the economy came back. Indeed, the growth between 1933 and 1937 was the highest we have ever experienced outside of wartime. Had the U.S. not had the terrible policy-induced setback in 1937, we, like most other countries in the world, would probably have been fully recovered before the outbreak of World War II.

This fact should give Americans hope. We are starting from a position far stronger than our parents and grandparents were in during 1933. And, the policy response has been fast, bold, and well-conceived. If we continue to heed the lessons of the Great Depression, there is every reason to believe that we will weather this trial and come through to the other side even stronger than before.

PREPARED STATEMENT OF ALLAN M. WINKLER

PROFESSOR OF HISTORY,
MIAMI UNIVERSITY, OXFORD, OHIO

MARCH 31, 2009

The New Deal was a response to the worst economic crisis in American history. As the United States suffered from the ravages of the Great Depression, the administration of Franklin D. Roosevelt, which took office in March 1933, tried a host of different, often contradictory measures in an aggressive effort to provide relief for the unemployed, to prompt the recovery of the faltering economic system, and to propose the kind of structural reform that could protect people in future crises. But the New Deal was never a coherent, interconnected effort to deal with the various dimensions of the Depression in a systematic way. Rather it was a multi-faceted attempt to deal with different elements of the catastrophe in ways that sometimes seemed haphazard and occasionally were contradictory. On balance, though, the

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[29] See Friedman and Schwartz, *A Monetary History of the United States,* Chapter 7, for a description of the four waves of panics.

[30] See, for example, Douglas W. Diamond and Philip H. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy* 91 (June 1983): 401–419.

[31] See *http://www.fdic.gov/bank/historical/s&l/*.

New Deal enjoyed some notable accomplishments, even if it failed to promote full-scale economic recovery.

The Great Depression was an economic disaster. While the stock market crash of 1929 need not have precipitated a depression, structural weaknesses in the economy, unbridled speculation in financial markets, and lack of regulation on Wall Street led to an unprecedented economic calamity that soon affected the entire world economy. In the United States, unemployment was the chief symptom of the depression, and by the time FDR took office there were approximately 13 million people unemployed—fully one quarter of the working population—with another quarter underemployed. In some cities, unemployment reached 75 percent.

The response of President Herbert Hoover did little to alleviate distress. Though he took a more activist role that many of his predecessors, his own commitment to individualism and belief that government should not play an aggressive role in an economic bailout impeded action, and the few measures he did take had little impact. Even the Reconstruction Finance Corporation, established as a result of Democratic pressure, proved unable to reduce unemployment in the Hoover years.

Franklin D. Roosevelt, elected in 1932, had no clear sense of what he might do when he assumed office. Some people viewed him as something of a lightweight. Journalist Walter Lippmann called him an "amiable boy scout," and on another occasion said, "He is a pleasant man who, without any important qualifications for the office, would like very much to be president. But Roosevelt's experience as Governor of New York for two terms taught him how he might respond to the economic crisis.

FDR struck just the right note in his inaugural address. At a time when bank failures across the country swept away the savings of millions of small investors, he promised "action, and action now," and he boosted spirits with his stunning assertion that "the only thing we have to fear is fear itself." It was clear evidence of a sense of self-confidence and self-assurance that played a powerful part in helping Americans feel better in the midst of hard times. Just as the presidency had been a "bully pulpit" for Theodore Roosevelt, it was "preeminently a place of moral leadership" for FDR.

Then he embarked on what came to be called the First Hundred Days. There was no blueprint. Roosevelt needed to do something about the banks, and so, working with officials left over from the Hoover administration, he proposed a bank holiday. The Emergency Banking Act authorized the Federal Reserve Board to issue new bank notes, allowed the reopening of banks that had adequate assets, and arranged for the reorganization of those that did not.

With that somewhat surprising success, he pushed ahead with a measure to cut the budget, for the conventional wisdom held that a balanced budget was necessary for economic health, and then a bill to legalize 3.2 beer, to help make people happy as Prohibition came to an end. By the time the First Hundred Days came to an end, he had made 10 major speeches, sent 15 messages to Congress, and helped push through the passage of 15 major pieces of legislation. It was, in short, the most extraordinary period of legislative activity in American history. And it set the tone and template for the rest of the New Deal.

Overall, what did the New Deal do?

First, it addressed the unemployed. A Federal Emergency Relief Administration provided direct assistance to the states, to pass it on to those out of work. The next winter, a work-relief program provided jobs in the brief period it existed. Then, in 1935, FDR created the Works Progress Administration, which paid all kinds of people, including artists, actors, and authors, to work and built new schools, bridges, and other structures around the country. It was expensive, to be sure, but it made a huge economic and emotional difference to the people it assisted.

Second, the New Deal sought to do something to promote recovery. The National Recovery Administration attempted to check unbridled competition which was driving prices down and contributing to a deflationary spiral. It tried to stabilize wages, prices, and working hours through detailed codes of fair competition. Meanwhile, the Agricultural Adjustment Administration sought to stabilize prices in the farm sector by paying farmers to produce less.

Finally, over the course of the New Deal, the administration addressed questions of structural reform. The Wagner Act, which created the National Labor Relations Board in 1935, was a monumental step forward in giving workers the right to bargain collectively and to arrange for fair and open elections to determine a bargain agent, if laborers so chose. The Social Security Act the same year was in many ways one of the most important New Deal measures, in providing security for those reaching old age with a self-supporting plan for retirement pensions. But there were other reform measures as well. The Securities and Exchange Commission and Federal Deposit Insurance Corporation were new. And the Glass–Steagall Act, only recently repealed with frightful consequences, separated commercial and investment banking.

The New Deal was responsible for some powerful and important accomplishments. It put people back to work. It saved capitalism. It restored faith in the American economic system, while at the same time it revived a sense of hope in the American people. But economically, it was less successful. Monetary policy, as Christina Romer has suggested, made the most difference. Fiscal policy didn't really work because it wasn't really tried.

Why, then did the New Deal fail to achieve economic recovery? The answer rests with the theoretical speculations of English economist John Maynard Keynes. In 1936, he published his powerfully important book *The General Theory of Employment, Interest and Money,* but he had been lecturing about the concepts for several years to his Cambridge University students. Basically, Keynes argued that depressions would not disappear of their own accord. It was rather necessary to take aggressive action to jump start the economy. Ideally, such action should come from the private sector. But if such a response was not forthcoming, the government could act instead. It could spend massive amounts of money on public works or other projects, or cut taxes, or both. What was necessary, in Keynes's phrase, was deliberate, sustained countercyclical spending.

Keynes came to the United States and had one ill-fated meeting with FDR. Neither man understood the other. Keynes remarked that he had "supposed that the President was more literate, economically speaking." FDR simply commented that Keynes "left a whole rigamarole of figures. He must be a mathematician rather than a political economist." And that was that.

Furthermore, the New Deal often worked in counterproductive ways, at least economically. Whereas Keynes demanded what we would today call a major stimulus package, and while the New Deal did spend more than ever before, it also embarked on contradictory initiatives. For example, the Agricultural Adjustment Administration spent large amounts of money to take land out of circulation, to cut down on production and thereby raise prices. But it diminished the effect of that spending by paying for it with a sizeable processing tax. Likewise, Social Security, which aimed to plow a huge amount of money into pensions, was not slated to make payments until 1942, but began taking money out of circulation through a withholding tax long before then.

The New Deal also alienated businessmen, something Keynes counseled against. "Businessmen have a different sense of delusions from politicians," he once said. "You could do anything you liked with them, if you would treat them (even the big ones) not as wolves and tigers but as domestic animals by nature, even though they have been badly brought up and not trained as you would wish." The NRA alienated business, and never did encourage private expansion or investment. It may have halted the deflationary spiral, but it failed to create new jobs. And it contributed to a measure of ill will. As Roosevelt got frustrated, his rhetoric marginalized business interests. Speaking of business interests in the reelection campaign of 1936, he proclaimed, "They are unanimous in their hate for me—and I welcome their hatred." That may have helped politically, but it hurt economically.

Fiscal policy, in short, along the lines Keynes counseled, did not work because it was never really tried. The unemployment rate never dropped below 14 percent, and for the entire decade of the 1930s, it averaged 17 percent.

Slowly, however, the New Deal learned fiscal lessons In 1937, assuming that the economy was improving and could manage without assistance, Roosevelt slashed half of all WPA jobs and cut the allocation to less than a third of what it had been. At the same time, workers were just beginning to contribute to Social Security, though payout were still in the future. Industrial production fell precipitously. The stock market plunged. Unemployment soared back to 19 percent. A quick restoration of spending brought matters under control.

But spending for World War II really vindicated Keynes and his theories. With the onset of the war, even before American entrance, defense spending quadrupled, and unemployment vanished virtually overnight. The lesson was clear. There was no need to suffer the ravages of depression any longer. We now had the tools to help the economy revive.

Some parts of the New Deal worked; some did not. The New Deal restored a sense of security as it put people back to work. It created the framework for a regulatory state that could protect the interests of all Americans, rich and poor, and thereby help the business system work in more productive ways. It rebuilt the infrastructure of the United States, providing a network of schools, hospitals, and roads that served us well for the next 70 years.

Did the New Deal, as has sometimes been charged, exacerbate and extend the Great Depression? Hardly. The regulatory state provided protections that benefited all Americans. The administration could have treated business interests better, but they were often responsible themselves for the antagonism that persisted throughout the 1930s. Fiscal policy would certainly have worked better had it been better understood. The fact that we were slow to embrace Keynesian theory is one of the disappointments of the decade.

Today, the lessons are clear. Government can make a difference. A major stimulus is essential and can promote recovery. We need to ensure that measures do not work in contradictory ways against the stimulus. We can do something about unemployment. It is as important today as it was in the 1930s to bolster security, as we turn our attention to health care reform just as the New Deal crafted a program, pathbreaking for us, for retirement assistance. The New Deal made a profound difference in people's lives and in the lives of our Nation. Now it behooves us to learn from the lessons of the 1930s and take the actions necessary to promote a return to prosperity.

PREPARED STATEMENT OF JAMES K. GALBRAITH

LLOYD M. BENTSEN, JR., CHAIR IN BUSINESS/GOVERNMENT RELATIONS,
LYNDON B. JOHNSON SCHOOL OF PUBLIC AFFAIRS,
UNIVERSITY OF TEXAS AT AUSTIN, AND
SENIOR SCHOLAR, LEVY ECONOMICS INSTITUTE

MARCH 31, 2009

Chairman Brown, Ranking Member DeMint, and Members of the Subcommittee, it is a privilege to appear today to discuss the New Deal and its relevance to our present troubles.

In my view three main principles for economic policy emerged from the Great Depression, the New Deal, and ultimately from World War II. The first is that unregulated capitalism is not necessarily self-correcting; mass unemployment can occur and persist. The second is that direct economic intervention works best when it is targeted directly to the broad population—not filtered through those at the top—and when it is implemented on a sufficiently large scale. Third, the fiscal cutbacks which produced the recession of 1937–38 showed that backtracking is disastrous. Once embarked on a policy of expansion and economic growth, it is essential to see it through to the end.

In what follows, I shall emphasize four points:

- Like our present troubles, the Great Depression flowed from a collapse of the banking system and of asset values—the Great Crash. This eliminated the possibility that recovery could be led by a revival of the financial system.
- Much of the New Deal involved the creation of comprehensive social insurance and the construction of institutions for collective action, including trade unions.
- The employment effects of New Deal policies have been under-rated and misstated in much recent work, in part because of a widespread misreading of the statistics.
- The early New Deal's employment policies were not conceived as "fiscal stimulus" but rather as programs to create jobs and for public investment. The investment programs were strongly oriented toward the long-term benefits of education, transportation, art and culture, and conservation. These programs had important macroeconomic effects but they also rebuilt the country.

1. The New Deal emerged from the Great Depression, and the Roosevelt administration understood very well that the Depression originated in the Great Crash of 1929 and in the collapse of the banking system in 1930. At the heart of the problem, as the Pecora investigations revealed, lay a culture of corruption, speculation, and self-dealing on Wall Street, and a well-justified loss of confidence by the public in the captains of finance.

Virtually every bank in America was shut when Roosevelt took office. His first act, the bank holiday, permitted them to be inspected and reopened; the public understood that those that reopened could be relied on. Other early actions were to institute federal deposit insurance so as to put an end to panics and runs, the passage of the Glass–Steagall Act separating commercial from investment banking, and the creation of the Securities and Exchange Commission, and the end of the gold standard. Taken together, these measures amounted to a comprehensive assertion of state power over finance. This power was reinforced in 1944 by the creation of the Bretton Woods system of fixed-but-adjustable exchange rates along with capital controls, and was largely maintained until that system was abandoned by Richard Nixon in 1971. The principal result was that economic growth was comparatively strong, stable and free of financial crises for a generation following the war, and with stable growth came a slow but steady decline in the inequality of income and wealth.

The early New Deal marked a fundamental break with the previous role of the banks. In the Hoover administration and also in England in the early 1930s, a reflexive concern of financial policy was to reassure the markets—hence the phrase "prosperity is just around the corner"—and to support the major banks by staying on the gold standard. This was the natural viewpoint of men who had spent their lives at the center of the New York and London financial worlds. But banks did not resume lending, in the depths of the depression, simply because they had gold in their vaults. There was no one to lend to, nothing to lend against. A first lesson of the Depression is that stuffing the banks with money does not solve a credit freeze.

The New Deal dealt with this problem bypassing the banks, or in some cases running them directly, through the Reconstruction Finance Corporation. Roosevelt also created new institutions, new public agencies to provide jobs and stabilize prices, wages and purchasing power. Thus the initial and indeed the later phases of the New Deal had three especially important elements beyond the regulation of finance: the introduction of comprehensive social insurance, the use of public spending to create jobs, and vast programs of conservation and public investment, effectively rebuilding the entire country from one end to the other.

2. Social insurance addressed a fundamental problem of capitalism: unregulated private markets are unstable. They cannot be relied on to provide an adequate minimum living standard for the working population. They cannot be relied on to provide a secure repository for savings. They cannot be relied upon to provide decent incomes in retirement. The problem of the Depression was perhaps above all a problem of insecurity, or as Roosevelt put it, of "fear itself." For most Americans, what was "just around the corner" was not prosperity but destitution.

Social innovation under the New Deal was motivated by a desire to deal with this fact. Deposit insurance, Social Security, farm price supports, the National Industrial Recovery Act, the minimum wage and the National Labor Relations Act were all, in different ways, aimed at establishing stability and decent minima. Some of this horrified the economists of that day and ours, particularly where the push for stability contradicted their deep philosophical and even emotional commitment to competition and antitrust. The NIRA was ruled unconstitutional by the Supreme Court. And some economists have ever since labored mightily to demonstrate that unions and minimum wages increased unemployment, that farm price supports were wasteful and inefficient, that Social Security discouraged savings. New Dealers would counter, very simply, that the proven alternatives to these things were poverty, migration and early death.

3. When Roosevelt took office in March, 1933 the macroeconomic tools and understanding we have today did not fully exist.[1] Mass unemployment had not been persuasively explained by the economics profession, and was variously blamed in academic circles on trade unions, on technological change, and on "events beyond our control." Then as now, a large body of academic opinion sought the remedy in lower wages. Then as now, a fair number of economists understood and favored the use of public works projects to keep people from starving or revolution. But the idea that public works could be run on a scale sufficient to end the Depression was not yet fully worked out. Nor did the country have the national income statistics or the unemployment statistics we presently use to analyze these problems: from a macroeconometric perspective, the government was flying blind.

The New Deal's approach to employment policy was direct and open-ended. Under Harry Hopkins, jobs were created, as quickly as possible, to help millions get through the year. The budget was, essentially, an afterthought. There was no particular emphasis on achieving a high economic growth rate, for the concept of economic growth (as we know it) did not yet exist. Nevertheless, the public spending initiatives of the New Deal did have powerful macroeconomic effects. Industrial production doubled between December 1932 and December, 1936. This is worth mentioning because it is sometimes denied: for example, in her recent book, The Forgotten Man, the journalist Amity Shlaes writes that industrial production did not rise in the United States after 1932. In point of fact, it rose very rapidly.

The New Deal's effects on unemployment are behind a widely stated belief that "only the war ended the Depression." But as the economist Marshall Auerback has pointed out in a recent paper, widely used unemployment figures (constructed after

[1] Simon Kuznets published the first national income statistics in 1934.

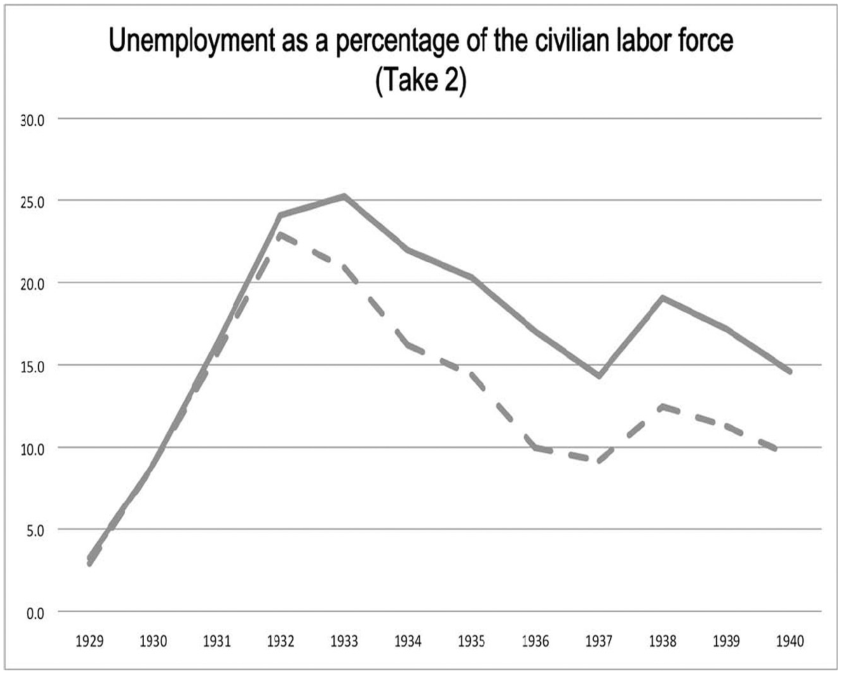
the fact) treat the 3.5 million workers who at the peak were employed by New Deal agencies as though they were unemployed. The original rationale for this was essentially ideological, insofar as recovery was defined as recovery of the private sector. But in practical terms the distinction is absurd. It supposes that someone building a private house on a temporary construction project in 1928 is employed, but that the same worker working on the Lincoln Tunnel in 1935 is not.

I take the liberty here of quoting from Auerback at length:

> Even pro-Roosevelt historians such as William Leuchtenburg and Doris Kearns Goodwin have meekly accepted that the millions of people in the New Deal workfare programs were unemployed, while comparable millions of Germans and Japanese, and eventually French and British, who were dragooned into the armed forces and defense production industries in the mid- and late 1930s, were considered to be employed.
>
> This made the Roosevelt administration's economic performance appear uncompetitive, but it is fairer to argue that the people employed in government public works and conservation programs were just as authentically (and much more usefully) employed as draftees in what became garrison states, while Roosevelt was rebuilding America at a historic bargain cost.
>
> If these workfare Americans are considered to be unemployed, the Roosevelt administration reduced unemployment from 25 per cent in 1933 to 9 per cent in 1936, up to 13 per cent in 1938 (due largely to a reversal of the fiscal activism which had characterized FDR's first term in office), back to less than 10 per cent at the end of 1940, to less than 1 per cent a year later when the U.S. was plunged into the Second World War at the end of 1941. The reasons for the discrepancies in the unemployment data that have historically arisen out of the New Deal are that the current sampling method of estimation for unemployment by the BLS was not developed until 1940, thus unemployment rates prior to this time have to be estimated and this leads to some judgment calls. The primary judgment call is what do about people on work relief. The official series counts these people as unemployed. . . . A lot of people looked at these numbers without reading the notes . . . and concluded just that.
>
> Then in 1976, an economist named Michael R. Darby wrote an article with the delightfully self-explanatory title, "Three-and-a-Half Million U.S. Employees Have Been Mislaid." What Darby did was read the notes. Here is what Lebergott had to say about counting unemployment in the 1930s:
>
> "These estimates for the years prior to 1940 are intended to measure the number of persons who are totally unemployed, having no work at all. For the 1930's this concept, however, does include one large group of persons who had both work and income from work-those on emergency work. . . . This contrasts sharply, for example, with the German practice during the 1930's when persons in the labor-force camps were classed as employed, and Soviet practice which includes employment in labor camps, if it includes it at all, as employment."
>
> We would normally not consider people who painted murals for the WPA to be deemed worse off than those who "worked" in Mauthausen or the Soviet gulag. And yet, until we adjust the "workfare" discrepancy, incredibly we count such individuals as unemployed, even though their position was considerably better someone generating no income, or working in abysmal conditions in a slave labor camp. [2]

To give a sense of the actual reduction in unemployment under the New Deal, I borrow a chart from Auerback, showing the official series with (dashed line) and without (solid line) counting those working for New Deal programs as employed. The chart illustrates that New Deal policies in fact brought unemployment down from 25 to below 10 percent before the policy reversal and recession of 1937, and again by 1940—still before the war.

[2] Marshall Auerback, "Time for a New New Deal," mimeo, 2009.



The New Deal validated the ideas of the economist Richard Kahn, a close associate of Keynes, who had worked out the "employment multiplier" in the early 1930s; the idea that an increase of governmental expenditure on public improvements would create jobs both directly and indirectly: directly in the public service and indirectly in the private sector. In 1936, Keynes's *General Theory* translated this insight from employment to output, giving us the now-familiar concept of the multiplier effect of increased government spending on national income. And then, of course, the vast scale of new spending during the war not only eliminated unemployment but stopped the discussion: the case that public spending could cure unemployment had, for that generation, been proved.

By the same token, domestic monetary policy in this period played a very minor role, to the point where economists of that generation tended to feel that the Federal Reserve was a backwater. I do not buy for a single minute the currently fashionable view that "quantitative easing" was primarily responsible for the economic expansion that occurred after 1933, unless one counts federal loan guarantees and direct lending as monetary policy.[3] If somehow the 1930s were a new golden age of private bank lending (at zero interest rates!) and of new business fixed investment, that fact completely escaped contemporary notice. Indeed the phrase "pushing on a string" was invented to describe the impotence of monetary policy at that time.

Finally, my difference with Professor DeLong on the role of fiscal policy is that it is by *ex ante* public spending, not *ex post* deficits, that one must measure the strength of fiscal expansion. Public expenditures rose 55 percent between 1932 and 1934; as a share of (collapsing) GDP they rose from 10.2 percent in 1932 to 17.4 percent in 1934. I have also never understood how the gold inflow in advance of WWII was supposed to have been a stimulus, insofar as gold at that time had been stripped of its monetary role. What stimulated the economy in 1939–1940, of course, was still more public spending, now motivated for the first time by Keynesian ideas, and export orders.

4. A fourth great area of New Deal achievement lay in the physical, moral and artistic reconstruction of the Nation. In 1932 the country was underdeveloped—to

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[3] The work of Professor Thomas Ferguson on the early New Deal covers these issues well, especially "Monetary policy, loan liquidation and industrial conflict: The Federal Reserve and open market operations of 1932" *Journal of Economic History,* 1984 and "From Normalcy to New Deal", International Organization 1984.

take one example, in 1930 my father drove a Model T Ford from his home in Ontario to Berkeley California, and noted that from Lincoln, Nebraska to the California line the roads were unpaved. Auerback has an elegant description of what happened during the following decade:

> The government hired about 60 percent of the unemployed in public works and conservation projects that planted a billion trees, saved the whooping crane, modernized rural America, and built such diverse projects as the Cathedral of Learning in Pittsburgh, the Montana State capitol, much of the Chicago lakefront, New York's Lincoln Tunnel and Triborough Bridge complex, the Tennessee Valley Authority and the aircraft carriers Enterprise and Yorktown. It also built or renovated 2,500 hospitals, 45,000 schools, 13,000 parks and playgrounds, 7,800 bridges, 700,000 miles of roads, and a thousand airfields. And it employed 50,000 teachers, rebuilt the country's entire rural school system, and hired 3,000 writers, musicians, sculptors and painters, including Willem de Kooning and Jackson Pollock. [4]

These accomplishments had important Keynesian effects, but they were not incidental to a short-term Keynesian expansion policy, and would not have been possible if they were. Major construction projects require advance planning and they take time to complete. But FDR did not limit himself to the "shovel ready" projects on the ground that the economy needed only a "stimulus" in order to "get credit flowing again" and to return to the happy days of the 1920s. He had no interest in ever returning to those days. The money-changers had fled the temple, and he was not about to let them come back. The New Deal built for the ages, as shown by the fact that its greatest achievements—from the TVA to Social Security—are still in use.

It is true that there was tension with Roosevelt's team between Hopkins, head of short term employment at the WPA, and Harold Ickes, head of the major investment projects of the PWA. My father liked to tell of a morning when FDR met both men in sequence, heard Hopkins' case for immediate jobs programs and then Ickes' for worthwhile capital projects. He told each man, "You're exactly right!" After the meetings, Mrs. Roosevelt remonstrated with her husband: hadn't he contradicted himself by supporting these two precisely opposed opinions? The President's response was, "Eleanor, you're exactly right."

5. Let me round out this brief overview by noting something the New Deal did not achieve: it never resurrected the commercial banking system. The New Deal renegotiated short-term mortgages that could not be refinanced, creating the 30-year, fixed-rate mortgage that was the staple of housing finance for the next half-century. It fostered savings-and-loans through strict regulation of interest rates, and began the secondary markets for prime mortgages. It ran many failed or otherwise-failed banks. The Reconstruction Finance Corporation provided a lending lifeline to private businesses. But private commercial bank lending remained a minor feature of the recovery picture. By and large, the collapse of asset values meant that very few people or businesses could qualify for private commercial bank loans, and the flight to cash insured that despite low interest rates very few would have wanted them anyway.

What eventually began the resurrection of private banking was the creation of net financial wealth during World War II. In this period, national income doubled, while output available for civilian use was held roughly constant. Thus working families had roughly twice the income they could spend, and rigorous price controls prevented inflation that would have absorbed the nominal incomes. Americans were therefore willing to lend their excess incomes back to the government to finance the war effort, and the resulting war bonds, amounting to 125 percent of GDP by the war's end, formed the foundation of the financial position of the post-war middle class. It was only then (and following the further contributions to private wealth of the Korean War in 1950), that the American public became once more a profitable clientele for private banks. And it was not until considerably later yet, that the public began to rediscover the stock market.

My final argument is therefore that a banking calamity of the type experienced in the 1930 and, I would argue, repeated for the first time beginning in August, 2007, has very long-term effects on the resilience of the banking system no matter what steps the government may take to restore output, employment and total capital formation, and no matter how effective those steps are. There is no easy or swift way back to rapid credit expansion. And the path is slower and more difficult, if policy energies are devoted to futile attempts to revive a Paradise Lost, an economy

[4] Auerback, *op. cit.*

led and directed by private commercial banking interests. Even if it were desirable, it probably cannot be done.

6. As part of an exercise yesterday at the Council on Foreign Relations, I reviewed some of the recent academic literature which alleges that the New Deal prolonged or even deepened the Great Depression. The central logic of this argument is the following. In normal times, it is alleged, without government interference, falling real wages rapidly restore the conditions for full employment. Since this did not happen in the 1930s, the argument goes, wages must not have fallen enough. If one asks why not, the answer is close at hand: the New Deal's efforts to raise prices and wages, to promote unions, and to impose a minimum wage were all counter-productive from the standpoint of maintaining employment. The New Deal is then faulted for the failure of total output to return to the trend line of the 1920s until after the start of the Second World War.

In the opening chapters of *The General Theory,* Keynes specifically showed that the cuts in money-wages then (as now) being demanded of workers would not produce the cuts in real wages that were required by theory, since prices would also fall. Correspondingly, raising both prices and wages does not raise real wages as the argument claims.

But the argument has other flaws as well. First, it ignores the depth of the Great Depression, and begs the question of how and why unemployment rose to 25 percent by the end of 1932—before Roosevelt took office and therefore before any of the alleged mistakes of the early New Deal had been made. Second, it ignores the extremely rapid recovery of 1933–36, or rather simply demands to know why that recovery wasn't more rapid still, asserting in effect that it would have been still more rapid if nothing by way of policy had been done. This assertion is simply an act of faith. Third, it assumes that the speculative bubble of the late 1920s was not unsustainable, and that in principle growth of the same type could have continued for another decade (or even indefinitely). This is tantamount to asserting that the Great Crash had no roots in the unsafe banking practices of that earlier time, and no implications for the ensuing Depression.

Suffice to say, I don't think so.

Thank you very much again for your attention.

PREPARED STATEMENT OF LEE E. OHANIAN

PROFESSOR OF ECONOMICS, AND DIRECTOR,
ETTINGER FAMILY PROGRAM IN MACROECONOMIC RESEARCH

MARCH 31, 2009

Chairman Brown, it is a pleasure to have the opportunity to speak with you about economic policy and lessons from the New Deal. The New Deal was a collection of policies adopted in response to the Great Depression that were designed to alleviate economic hardship and promote economic recovery. Today's economic crisis has prompted many comparisons to the Great Depression, and has led many to ask whether a "New" New Deal is warranted. My research shows that some New Deal policies significantly delayed economic recovery by impeding the normal forces of supply and demand, and that the economy would have experienced a robust recovery in the absence of these policies.

One implication of my research, and other recent research on protracted economic crises, is that short-run policies designed to moderate the effects of a crisis—crisis management policies—can prolong the crisis if those policies impede competitive market forces. Another implication is that the policymaking process can benefit from current research on economic crises. Much of the evidence that crisis management policies can prolong economic downturns is from research that utilizes recent developments in economic theory and methodologies. These new research developments can inform the policymaking process. These views are detailed below.

The recovery from the Depression was indeed slow, and this has been recognized by a number of economists, including 1976 Nobel Laureate Milton Friedman (Friedman and Schwartz(1963)), 1995 Nobel Laureate Robert Lucas, (Lucas and Rapping (1972)), and 2004 Nobel Laureate Edward Prescott (1999). My work with Harold Cole (2007) details this slow recovery. Total hours worked per adult, which is the standard measure of labor input used in macro-economics, was 27 percent below its 1929 level in 1933, and remained 21 percent below that level in 1939. There was even less recovery in private hours worked per adult. Per-capita investment, which declined by nearly 80 percent relative to trend (2 percent annual growth), remained more than 50 percent below trend at the end of the 1930s. Per-capita consumption, which was about 25 percent below trend in 1933, remained roughly at that level for the remainder of the 1930s. Figures 1 and 2 show these data on real output and its components, and hours worked. The Depression clearly continued throughout the 1930s.

The failure to recover is puzzling, because economic fundamentals improved considerably after 1933. Productivity growth was rapid, liquidity was plentiful, deflation was eliminated, and the banking system was stabilized. With these fundamentals in place, the normal forces of supply, demand, and competition should have produced a robust recovery from the Depression. Figure 3 shows the recovery in productivity, real bank deposits, and the level of the GNP deflator, which stops falling after 1933, and rises modestly afterwards. Why wasn't the recovery stronger?

My research shows that one policy that delayed recovery was the National Industrial Recovery Act (NIRA), which was the centerpiece of New Deal recovery policy. The NIRA prevented market forces from working by permitting industry to collude, including allowing firms within an industry to set minimum prices, restrict expansion of capacity, and adopt other collusive arrangements, provided that firms raised wages considerably. These policies worked. Following government approval of an industry's "code of fair competition", industry prices and wages rose significantly.

Promoting collusion reduces employment and output, while setting the wage above its market-clearing level depresses employment by making labor expensive. Employers respond to high wages by reducing employment relative to the market-clearing level that is jointly determined by supply and demand. Figure 2 shows hours worked and the real manufacturing wage. The most striking feature of the graph is that the continuation of the Depression coincides with rising real wages. This fact stands in sharp contrast to standard economic reasoning, which indicates that normal competitive forces should have reduced industry wage levels and increased employment and output. This coincidence of high industry wages and low hours worked is one of the most telling signs that the market process was considerably distorted.

While declared unconstitutional in 1935, the NIRA *de facto* continued, with virtually no antitrust activity despite substantial evidence of collusion documented by the Federal Trade Commission (Cole and Ohanian (2004)). Wages rose even higher following the Wagner Act in 1935, which greatly increased union bargaining power in wage setting and which also facilitated unionization. The share of non-agricultural workers in unions rose from about 12 percent in 1934 to nearly 27 percent in 1938 (Freeman (1998)). During the mid-1930s, the sit-down strike, in which workers occupied factories and prevent production, was used most notably against G.M. and the threat of a sit-down strike was successful against U.S. Steel. Wages jumped in many industries shortly after the NLRA was upheld by the Supreme Court in 1937, and our research shows that these higher wages played a significant role in the 1937–38 economic contraction.

By the late 1930s, these New Deal policies began to reverse. Anti-trust activity was resumed, the Supreme Court ruled against the sit-down strike, and the growing gap between wages and productivity began to narrow, particularly during the War, as the National War Labor Board ruled against wage increases that exceeded cost of living.

After the war, The National Labor Relations Act was substantially weakened by the Taft-Hartley Act of 1947. Since then, industry wages have never risen so high above their normal levels.

Despite the fact that several New Deal policies were useful, including those that established a basic social safety net, and those that stabilized the banking and financial system, Cole and I have found that Roosevelt's cartel-high wage policies prolonged the Depression by several years. In the absence of these policies, we estimate that the economy would have recovered back to trend quickly, with hours worked and investment rising well above their normal levels, rather than being significantly depressed.

In addition to Friedman and Schwartz (1963), Lucas and Rapping (1972), and Prescott (1999), there is more research on the New Deal that draws similar conclusions to mine, including work by Chari, Kehoe, and McGrattan (2006), and Bordo, Erceg, and Evans (2000). There is also relevant research on the impact of nonmarket policies on recoveries from financial crises in other countries. This research also concludes that nonmarket policies deepen and prolong crises.

Bergoeing, Kehoe, Kehoe, and Soto (2007) examined the recoveries in Chile and Mexico following financial crises in the early 1980s. Chile moved quickly to reorganize their banking system and also allowed inefficient banks and firms to fail. In contrast, Mexico tried to prop up their economy in the 1980s by maintaining incumbent banks, many of whom were inefficient, and by providing credit at below-market interest rates to large firms to keep them afloat. This impeded the necessary re-allocation of resources from inefficient to efficient producers.

Chile chose to pay the price of economic reorganization and had a deeper downturn than Mexico during the initial stages of their respective crises. But since the early 1980s, Chile has grown substantially. In contrast, the Mexican economic crisis worsened over time, with per-capita real output falling until the mid-1990s, and growing little since then. Today, per-capita output in Chile relative to Mexico has doubled compared to their respective levels prior to the early 1980s (Fernandez de Cordoba and Kehoe (2009)).

Japan's financial crisis of the early 1990s provides further evidence on the depressing effects of nonmarket policies that delay economic reform and prevent competition from working. Hayashi and Prescott (2007), and Caballero, Hoshi, and Kashyap (2005) studied the Japanese economy in the 1990s following their financial crisis. Both studies conclude that Japan's policies that kept otherwise insolvent banks operating, and that impeded the flow of capital to efficient firms, significantly prolonged the effect of Japan's crisis, resulting in a decade-long stagnation of the Japanese economy.

There are two principal messages from the New Deal and these other economic crises for our current crisis. One is that crisis management policies designed to reduce the cost of a financial crisis can actually prolong the depressing effects of these crises by impeding the normal forces of supply, demand, and competition. Instead, policies should be consistent with the broader, long-term goals of raising the incentives for households to work and save, for firms to hire and invest, for the financial system to efficiently intermediate capital, and for promoting competition, in which successful businesses thrive, and inefficient businesses exit.

There is relatively little debate among economists regarding the importance of these long-run guides for successful policy. Short-run policies that impede these economic forces can delay recovery and deepen crises, even if other aspects of the policy mix are well-designed. This means good short-run policy is *de facto* good-long run policy.

The second message is that policymaking can benefit considerably from current research on economic crises. Much of the evidence that short-run policies can prolong crises is from research that utilizes recent developments in economic theory and quantitative methods. Consequently, the profession's view about the costs and benefits of various types of polices has changed over time, including its views about fiscal policy, one of the key components in the response of policy to our current crisis.

Many recent discussions about fiscal policy focus on measuring a "multiplier", which aims to quantify how much output and employment will change from an increase in government spending. Much recent research no longer focuses on this idea, however, largely because there is no presumption from economic theory about how a change in government spending impacts employment and output. Instead, economy theory indicates that the impact depends critically on what the spending is on, and how it is financed (Baxter and King (1991)).

In practice, research shows that observed differences in the types of spending and the mix of taxes, over time and across countries, have a big effect on economic outcomes. My research shows that the effects of large increases in government spending in the United States are very sensitive to tax policies (Ohanian (1997)). Specifically, the effect of government spending on output is smaller if the spending is ultimately financed with capital income taxes. Edward Prescott (2002) shows that much of the large decline in hours worked that occurred over the last 40 years in several European countries can be accounted for by an expansion in government spending that substitutes closely for private consumption, coupled with a large increase in European tax rates. Prescott's work thus suggests that for these European countries, aggressive fiscal policy depressed their economies.

Good economic policymaking is consistent with getting economic incentives right. This is perhaps the most important lesson from the New Deal and from other protracted economic crises.

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Appendix: Responses to Professor DeLong

This addendum section responds to Professor DeLong's comments about my research, as presented in his March 31, 2009, testimony. [*http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore__id=06162 472-d0a4-486f-a25e-a9a83db42eed*]

1. Professor DeLong states that Milton Friedman blamed the 1937–38 recession in a recession on higher reserve requirements, not on New Deal-unionization policies.

- Friedman and Schwartz (1963) stated that New Deal policies that raised wages and prices delayed recovery. Friedman restated this view at his 90th birthday party conference at the University of Chicago in 2002, when he commented on my research about the New Deal prolonging the Depression.

2. Professor DeLong states that Ohanian's "impediments to competition" hypothesis is not supported by data from the late 1940s, as Professor DeLong argues that these impediments were even stronger at that time than during the New Deal.

- Measuring labor bargaining power is about wage premia, and wage premia data show that that bargaining power was considerably weaker after World War II than during the New Deal. Under the National Recovery Administration, the government bargained with industry on behalf of labor. The program did not rely on unionization to give labor bargaining power over wages, and wages rose considerably. After 1935, the Wagner Act initially increased unionized bargaining substantially, and this drove wages even above their NIRA levels. These wage increases, which follow the Supreme Court's ruling upholding the constitutionality of the Wagner Act, coincide with the 1937–38 recession. Cole and Ohanian (2004) document that manufacturing wages relative to productivity were exceptionally high during the New Deal, but return to their 1929 level after the war. They attributed this decline to the National War Labor Board, the Supreme Court's ruling against the use of the sit-down strike, and the Taft-Hartley Act, which substantially weakened labor's position viz-a-viz the original National Labor Relations Act. Labor bargaining power was lower, not higher, after the New Deal.

3. Professor DeLong states that "the same models that tell Professor Ohanian that starting in 1932 the Depression should have been over by 1936 also tell him if you start them in 1928 that the Great Depression did not happen at all."

- Professor DeLong's statement is false. As noted in my testimony at the hearing on March 31, 2009, my research shows that similar policies put in place by President Hoover—studied in a model very similar to my work with Cole (2004)—played a significant role in accounting for the depth of the Depression prior to the New Deal (Ohanian (2009)). In fact, Professor DeLong attended my lecture at U.C. Berkeley in April, 2008 on this topic. My research concludes that nonmarket policies are a critical factor in accounting for the Depression under both Presidents Hoover and Roosevelt.

4. My next response applies to Professor DeLong's statements about unemployment before and after the New Deal, and hours worked during the New Deal.

- I don't know what Professor DeLong is referring to regarding unemployment, as my research uses hours worked per capita, rather than unemployment, as a measure of labor market performance. I do not use unemployment statistics as those data do not tell us how much work was restored during the New Deal—they don't measure either employment or hours per worker. And unemployment is a notoriously difficult concept to measure, and becomes even more problematic when one takes into account factors such as discouraged workers exiting the labor force (see *http://www.bls.gov/cps/lfcharacteristics.htm*), which reduces the unemployment rate, and because there was a great deal of job sharing during the New Deal, which also biases unemployment as a measure of labor utilization.

  Hours worked is the standard measure of labor used in macroeconomics, as it is the measure that is relevant for production. It certainly is the measure to use when reporting how much work was restored during the New Deal. Cole and I have analyzed total hours to evaluate the overall impact of the New Deal, and private hours to examine how the increased market activity (as opposed to government) activity. There is little recovery in total hours, and even less in private hours.

  More broadly, Professor DeLong raises questions about the data of the recovery in my testimony. But as my March 31, 2009, testimony indicates, Figures 1 and 2 show real GDP, consumption, investment, and hours worked, in each year between 1929–39. None of these years show a significant recovery. The data are downloadable from *www.greatdepressionsbook.com.*

  But more important, any analysis of the New Deal must confront the substantial evidence that the labor market failed to clear. My research and other recent analyses of this period (*e.g.,* Chari, Kehoe, and McGrattan (2006), Mulligan (2008)) argue that the New Deal is an episode with industrial wages above normal, and/or employment and consumption well below normal, indicating a significant labor market failure. The chronic persistence of industrial wages well above normal during a Depression stands in sharp contrast to standard economic reasoning. Professor DeLong has offered no alternative explanation for these data, or why the labor market failure worsened during the New Deal. The decade-long Depression indicates that the central driving force behind this event was the failure supply and demand to reduce the wage and increase employment and output.

5. Professor DeLong claims that hours worked at the end of the 1930s were less depressed than the Cole–Ohanian numbers indicate because the workweek was declining over time as a consequence of rising wealth which led Americans to consume more leisure.

- Professor DeLong's argument is about increased leisure as choice of households arising from higher wealth. But the Depression was a period of declining income and wealth, meaning that this effect would not be operative during the 1930s. Instead, declining income and wealth would motivate households to choose less leisure. In any case, I am unaware of any debate that hours were not significantly depressed in the 1930s. After all, hours per adult were not only higher in the 1920s, but also higher in the 1950s and afterwards. Professor Valerie Ramey who has conducted recent research on trends in hours per worker and leisure, agrees with the premise that some New Deal policies delayed recovery, as indicated in Ramey's statements below about the New Deal in a recent interview: "Anytime you put in price and wage controls, you are more likely than not to make the economy worse off," says Valerie Ramey, professor of economics at University of California, San Diego. "That's the lesson of all economic history . . . You don't want to say, 'Oh, don't do any of it,' because some aspects did work, but they were impeded by other aspects that led the economy to be worse," says Ramey. *http://money.cnn.com/2009/02/10/news/economy/yang__newdeal.fortune/index.htm*

Other Questions about the New Deal and Recovery

The major questions that arose during the March 31, 2009, hearing were about the growth rate of output, and whether that data was strong evidence that the New Deal was successful in promoting recovery, and whether monetary and/or fiscal policy promoted recovery.

Q: Isn't the fact that growth rates of real GDP or industrial production strong evidence that the New Deal was successful?

A: Not in my view. Using data on output growth, or the growth of other economic indicators, as evidence on the speed of recovery, first requires a benchmark of how fast recovery should have occurred. My research with Cole (2004) indicates that recovery should have been much faster than observed. Moreover, it is striking that actual industrial production grew more than 60 percent between July, 1932, and July 1933. This indicates not only that the economy can generate remarkable growth rates coming out of a deep depression, but that a recovery was starting in the summer of 1932, despite the fact that deflation and banking crises were continuing. That recovery then accelerated considerably in the spring of 1933, which has been interpreted as business was producing in advance of the distortions that would be imposed by the NIRA. Industrial production then began to decline in the summer of 1933, which roughly coincides with the passage of the NIRA.

Q: Was recovery during the New Deal the result of monetary policy, fiscal policy, or both?

A: In my view, neither was the central factor. Changes in output are necessarily due to either changes in hours worked, or output per hour. The data in my testimony show that hours worked recovered little. Thus, the recovery in output that did occur in the 1930s was by definition the result of output per worker, or productivity. Cyclical changes in productivity are still not well understood, but there is no presumption that either monetary or fiscal stimulus—which typically are viewed as influencing demand—has strong links to productivity. Instead, research by Professor Alexander Field (2003) suggests that higher output per worker was due to changes in productivity gains brought about by innovation. Thus, the limited recovery of the 1930s was unlikely driven by demand stimulus.

Figure 1 - Per Capita Detrended Real GNP, Consumption and Investment

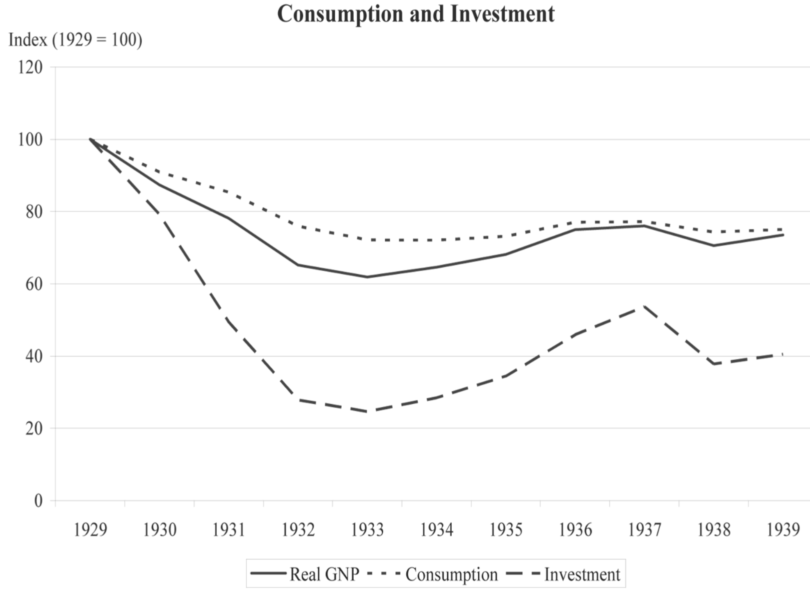


Figure 2 - Depressed Hours Worked and High Real Wages

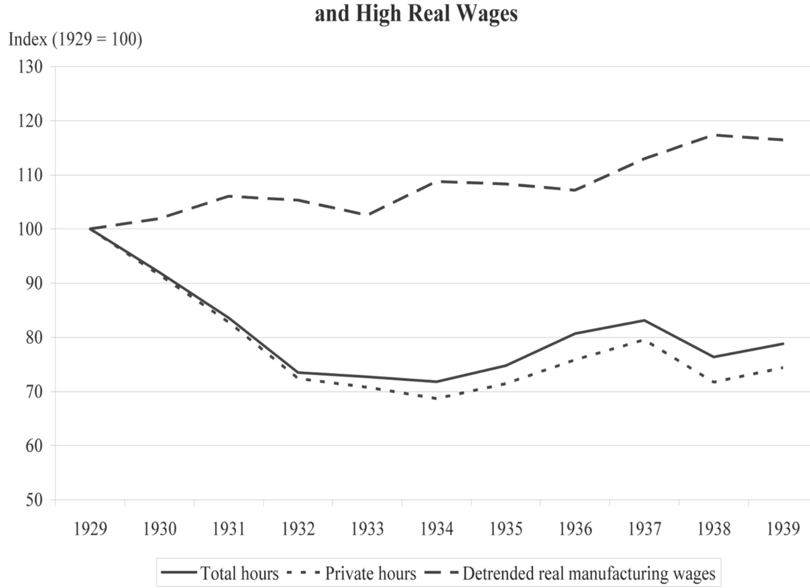
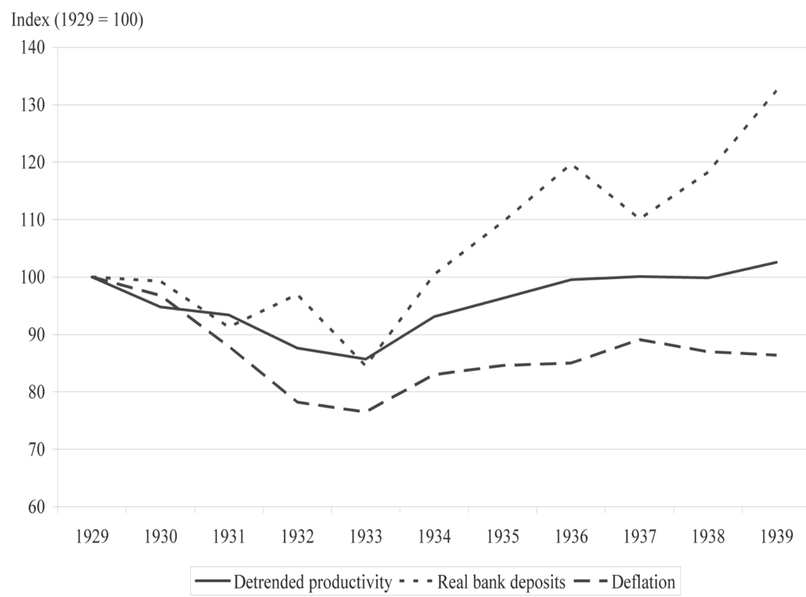


Figure 3 - Economic Fundamentals Recover



PREPARED STATEMENT OF J. BRADFORD DELONG

PROFESSOR OF ECONOMICS,
UNIVERSITY OF CALIFORNIA AT BERKELEY

MARCH 31, 2009

Chairman Brown, Senator DeMint, other Members of the Committee: It is always an honor to be invited here to participate in a small part in our self-rule via representative government here in the oldest and strongest and most successful large Republic in the world. We today face an economic crisis, and a crisis that has few parallels. Thus we are driven back to historical analogies. It can be said that economic theory is always crystallized history, is always us drawing on lessons from the past. But usually enough of the past has gone into making the theory that we are happy with the crystallized version. For this crisis, however, there is only one even close past parallel: the Great Depression and the New Deal. And so this time it is, I think, best to drink the history raw.

Drawing lessons from the New Deal for the Great Depression requires, first, understanding what the New Deal was. Franklin Delano Roosevelt took everything that was on the kitchen shelf and threw it into the pot on March 4, 1933, and then began stirring—fishing things out that seemed nasty (and watching the Supreme Court fish a bunch of stuff out too), adding spices, adding new ingredients as they came along, all the while watching the thing cook and trying to turn it into something tasty. Try everything—and then reinforce and extend the things that seem to be working well. Ellis Hawley's *The New Deal and the Problem of Monopoly* remains the best account of this process. As Franklin Delano Roosevelt said on May 23, 1932:

> The country needs and, unless I mistake its temper, the country demands bold, persistent experimentation. It is common sense to take a method and try it. If it fails, admit it frankly and try another. But above all, try something. The millions who are in want will not stand idly by silently forever while the things to satisfy their needs are within easy reach.

It is only after the fact that we can say what the New Deal was. And it is only after the fact that we can try to assess the parts of it that were worthwhile and the parts of it that were not. In the middle of it nobody was really sure what was going on.

I believe that in retrospect the New Deal is best divided into four components: (a) income redistribution to level the gross inequalities and inequities that had grown so large in the Gilded Age; (b) social insurance programs that diminished the risks that Americans would find themselves destitute and totally dependent on spotty and inadequate individual acts of charity; (c) structural reforms of the economy; and (d) what we now call macroeconomic policy—the government's taking responsibility for and acting as the balance wheel on the aggregate flow of spending and thus production and employment. Of these I believe (a) and (b), income redistribution and social insurance, surely made post-New Deal America a much better place but had little if any impact on recovery from the Great Depression. I also believe that (c), structural reforms of the economy, had little or no net impact on recovery as well. Some of the structural reforms appear to me to have been well thought-out—REA, NLRA, and Thurman Arnold's drives for enforcement of the antitrust laws come to mind. Others appear to me to have been neutral or worse—the NIRA and the PUHCA come to mind.

Indeed, last month I reread John Maynard Keynes's two substantial letters to Franklin Delano Roosevelt in the 1930s and found that my conclusions were the same as those of Keynes, who protested:

> [A] great deal of what is alleged against the wickedness of [utility] holding companies is surely wide of the mark. . . . No one has suggested a procedure by which the eggs can be unscrambled. Why not . . . leave the existing organizations undisturbed, so long as the voting power is so rearranged . . . that it cannot be controlled by . . . a minority . . . ? . . . Finally, the railroads. . . . Whether hereafter they are publicly owned or remain in private hands, it is a matter of national importance that they should be made solvent. Nationalise them if the time is ripe. If not, take pity . . . And here too let the dead bury their dead. [1]

and:

> You are engaged on a double task, Recovery and Reform . . . For the first, speed and quick results are essential. The second may be urgent . . . but haste will be injurious, and wisdom of long-range purpose is more necessary than immediate achievement . . . [T]he order of urgency between measures of Recovery and measures of Reform has [not] been duly observed . . . In particular, I cannot detect any material aid to recovery in NIRA . . . The Act is on the Statute Book; a considerable amount has been done towards implementing it; but it might be better for the present to allow experience to accumulate . . . NIRA, which is essentially Reform and probably impedes Recovery, has been put across too hastily, in the false guise of being part of the technique of Recovery. [2]

This leaves the fourth aspect of the New Deal—the recovery-generating aspect—macroeconomic policy, which I also divide into four components: (a) conventional monetary expansion, (b) quantitative easing, (c) banking-sector recapitalization and regulation, and (d) fiscal policy expansion. How effective was it? Let me pause to note that if this were 6 years ago in 2003 or 8 years ago in 2001 we would all be taking it for granted that the expansionary monetary and fiscal policies of the types tried during the New Deal were effective. Indeed, had Senator McCain won the presidential election last November the members of this and the previous panel would include one or more senior McCain economic advisors like Douglas Holtz-Eakin, Kevin Hassett, or Mark Zandi—all of whom would be arguing that New Deal-like monetary and fiscal stimulus programs were effective as part of the process of arguing for the McCain fiscal stimulus program or the McCain banking recapitalization program that would, had recent history taken another branch, now be moving through the Congress.

Back at the start of the Great Depression none of the major industrial powers of the world pursued expansionary macroeconomic policies. Instead, they held that that government is best which governs least as far as economic policy was concerned and bound themselves with the golden fetters of the classical gold standard. A bal-

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[1] John Maynard Keynes (1938), "Private Letter to Franklin Delano Roosevelt of February 1" *http://tinyurl.com/dl20090325a*.

[2] John Maynard Keynes (1933), "Open Letter to Franklin Delano Roosevelt of December 31" *http://tinyurl.com/dl20090325b*.

anced budget was necessary to maintain confidence that a country would maintain its gold parity—hence no fiscal policy expansion. Under the gold standard the domestic money supply was determined by the ebb and flow of gold reserves—hence no, or rather little, conventional monetary policy or quantitative easing. And under the gold standard countries except for Great Britain had very limited powers to support or recapitalize their own banks: when Austria tried in 1931 it found itself faced with an immediate choice of abandoning its banking policy or abandoning the gold standard.

So a New Deal was simply not possible as long as countries remained on the gold standard during the Great Depression—only after the golden fetters were cast off could the government even try to use its monetary, fiscal, and banking policy tools to promote recovery. This constraint gives us as clear evidence as we want that the New Deal—or rather New Deals, for each major industrial country during the Great Depression had its own—mattered for recovery. We know when each of the five major industrial countries cast off the gold standard fetters and began its New Deal. We know how quickly each of them recovered from the Great Depression.

There is a strong rank correlation between how early a country abandoned gold and began its New Deal on the one hand and how rapid and complete its recovery was on the other, as this chart that I have reproduced from Eichengreen (1992) and then added to shows.[3] Statisticians will tell you that if you thought before looking at the evidence summarized in this rank correlation that there was only a 50–50 chance that New Deals mattered for recovery, then after looking at this evidence you should rationally be 95.2 percent sure that New Deals mattered.

THE GREAT SLUMP REVISITED 233

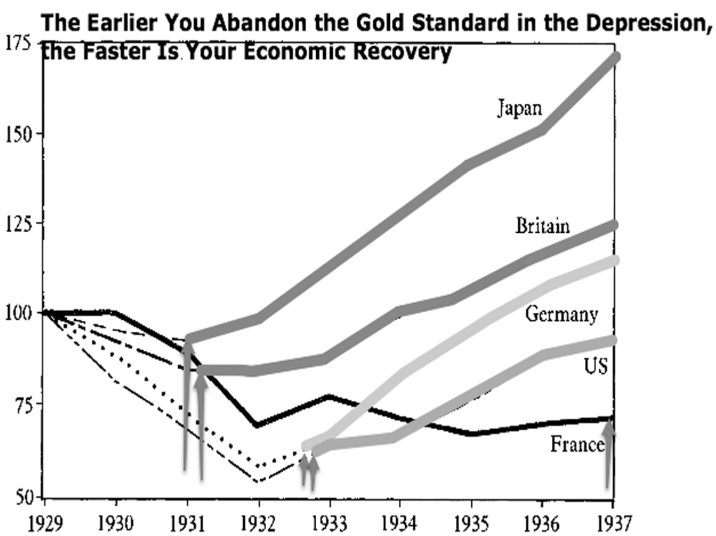

Figure 5. *Indices of industrial production, 1929-1937* (1929 = 100)
Source: League of Nations, *World production and prices, 1937/8*, p. 44.

We economists are pretty sure that all four components of macroeconomic policy helped. It is very hard to write down a model of the economy in which some tools work and others do not. All four operate through boosting spending—conventional monetary policy and banking-recapitalization policy by lowering the interest rates that businesses seeking funding to spend on expanding capacity are charged, quantitative easing by putting cash in people's pockets that burns a hole through them if not spent, fiscal policy expansion by having the government spend directly. Any model of the economy in which increases in spending boost not just prices but production and employment will see all four be effective. Any model of the economy in

[3] Barry J. Eichengreen (1992), "The Origins and Nature of the Great Slump Revisited," *Economic History Review* 45:2 (May), pp. 213–39.

which increases in spending just cause inflation but don't boost employment and output will see none of them be effective—but we already know that the odds of such being the right model are only 4.8 percent at best.

Which of the four components of macroeconomic policy helped the most in the New Deals' aiding of recovery? That is a much more difficult question. The Depression itself provides little evidence of the balance of power between monetary, banking, and fiscal policy.

Christina Romer argues powerfully that quantitative easing was decisive—that "nearly all the observed recovery of the U.S. economy [starting in 1933] prior to [the beginning of World War II] in 1942 was due to monetary expansion," and this monetary expansion was entirely quantitative easing because conventional interest-rate open-market policy had been tapped out before the recovery began.[4] One thing that students of the Great Depression do agree on is that it is next to impossible to evaluate how powerful fiscal policy expansion was in the Great Depression because it simply was not tried on a sufficiently large scale. As Eichengreen (1992) wrote a decade and a half ago:

> In the U.S., the most important fiscal change of the period, in 1932, was a tax increase, not a reduction, observed budget deficits were small. Cyclically-corrected deficits were smaller still. This is the conclusion of Brown . . . for the U.S.; Middleton . . . for Britain; and Jonung . . . for Sweden . . . In contrast, in countries like the U.S. (and to a lesser extent the U.K.) the [monetary] expansion of currency and bank deposits was enormous. The one significant interruption to monetary expansion in the U.S., in 1937, revealingly coincided with the one significant interruption to economic recovery . . . Even in Sweden, renowned for having developed Keynesian fiscal policy before Keynes, monetary policy did most of the work.

For evidence of the ability of fiscal policy to boost employment and production—if used on a sufficiently larges scale—we have to wait until World War II. Monetary policy contraction, banking-sector collapse, and the transformation of irrational exuberance into unwarranted pessimism carried the U.S. unemployment rate from 2.9 percent up to 22.9 percent from 1929 to 1932. Monetary expansion and banking reform then drove the unemployment rate down to 9.5 percent by the start of large-scale mobilization in 1940. And wartime government expenditure and deficits drove the unemployment rate down to 1.2 percent by 1944.

Thus my belief is that the principal lessons of the Great Depression and the World War II eras for economic recovery are twofold:

1. The government should not sit on its hands. The French government sat on its hands, relying on its commitment to the gold standard and the equilibrium-restoring forces of the market to handle the Depression. As of 1937—eight years after the previous business-cycle peak—it was still waiting, like Japan in the 1990s, for the self-correcting forces of the marketplace to come to its rescue.
2. All four macroeconomic policy tools are likely to have some power. A prudent policy will not rely on any of conventional monetary policy or quantitative easing or fiscal expansion or banking policy alone, but will instead combine all four—and, like Roosevelt, seek to reinforce success.

The New Deal: Lessons for Today—Questions and Answers

Q: How much has Ben Bernanke's reputation suffered as a result of his failure to stop the recession?

A: I don't think Bernanke's reputation as an economist has suffered at all. I think it is stronger than ever. Friedman and Schwartz's *Monetary History of the United States* argued that the Federal Reserve all by itself could have stopped the Great Depression in its tracks—but did not. This thesis of *The Monetary History of the United States* has taken a profound hit over the last 2 years, for Ben Bernanke has—via open market operations and quantitative easing—done exactly what Friedman–Schwartz recommended and claimed would have stopped the Great Depression in its tracks. Yet we all now think that that is not enough—that we need banking policy and fiscal policy as well. And this is an intellectual loss for Friedman–Schwartz. But it is an intellectual victory for Bernanke–Keynes, who argued that all the conventional interest rate and quantitative easing monetary policy in the

[4] See Christina D. Romer (1992), "What Ended the Great Depression?" *Journal of Economic History* 52:4 (December, pp. 757–784 *http://www.jstor.org/stable/2123226*.

world might not be enough if the capitalization of the banking sector vanished and the credit channel got itself well and truly wedged. This is where we seem to be.

Paul Krugman wrote:

> Has anyone else noticed that the current crisis sheds light on one of the great controversies of economic history? A central theme of Keynes's General Theory was the impotence of monetary policy in depression-type conditions. But Milton Friedman and Anna Schwartz, in their magisterial monetary history of the United States, claimed that the Fed could have prevented the Great Depression . . . if the Fed had done more—if it had expanded the monetary base faster and done more to rescue banks in trouble. So here we are, facing a new crisis reminiscent of the1930s. And this time the Fed has been spectacularly aggressive about expanding the monetary base: And guess what—it doesn't seem to be working well enough.

The Federal Reserve in the Great Depression

Q: Why do we need to do all this fiscal policy and banking policy stuff? Didn't Milton Friedman and Anna Schwartz prove that the Federal Reserve caused the Great Depression by inept and destructive policies?

A: I think you have to be careful here. Friedman and Schwartz's *Monetary History of the United States* argued not that the Federal Reserve caused the Great Depression but that the Federal Reserve all by itself could have stopped the Great Depression—but did not.

This thesis of *The Monetary History of the United States* has taken a profound hit over the last 2 years, for Ben Bernanke has—via open market operations and quantitative easing—done exactly what Friedman–Schwartz recommended and claimed would have stopped the Great Depression in its tracks. Yet we all now think that that is not enough—that we need banking policy and fiscal policy as well.

Government Workers and Unemployment

Q: Amity Shlaes writes that the New Deal did not diminish unemployment much—that unemployment was 25 percent in 1933 and still 19 percent in 1938. Doesn't this prove that the New Deal was ineffective?

A: Amity Shlaes is using the Lebergott unemployment series—and Christie Romer wrote the book, literally—it's her dissertation—on what is wrong with the Lebergott series. The Romer series or the Weir series paints a very different picture: a fall in unemployment from 23 percent in 1932 to 9 percent in 1937, a jump back up to 12 percent in the recession of 1938, and then a fall to 11 percent in 1939.

As Bush Administration Commerce Undersecretary Michael Darby pointed out, the big difference between the series that matters here concerns their treatment of government relief workers: is someone working for the WPA or the CCC employed or unemployed? From the perspective of "how good a job is the private sector doing at generating jobs," there is a case for counting them as unemployed. But if the question is "did the New Deal help?" then there is absolutely no case at all for using the Lebergott series because WPA and CCC workers had jobs and were very glad to have them. Shlaes has, I think, simply not read the footnotes to the edition of *Historical Statistics of the United States* that she got her numbers out of.

Herbert Hoover

Q: Wasn't the Great Depression really the fault of that dangerous leftist Herbert Hoover with all of his interventionist meddlings in the economy?

A: Herbert Hoover is an interesting case. He wanted to meddle—he wanted to be an activist president—but his Treasury Secretary Andrew Mellon persuaded him not too. Mellon persuaded him to raise taxes during the Great Depression to assure investors that the U.S. would stay on the gold standard and not fund government spending by printing money. Mellon persuaded him to avoid expansionary monetary policy of any kind. Herbert Hoover did call business leaders into the White House for conferences, and did plead with them not to fire workers or cut wages too much, but I have never been able to find any sign that this had an effect—no sign that industrialists called to the White House for meetings changed their business practices in any way. Herbert Hoover did start the Reconstruction Finance Corporation, but funded it at a very low level. Because of Mellon's blocking position in the administration, the New Deal could not get under way until 1933.

Afterwards, Herbert Hoover was very angry at himself for taking Mellon's counsel and at Mellon for giving it. Until George W. Bush unleashed his White House staff to slime Paul O'Neill, Herbert Hoover held the record for the most vicious attack by a President on his own Secretary of the Treasury, writing in his memoirs that he was very sorry about the influence exercised by:

> [T]he "leave it alone liquidationists" headed by [my] Secretary of the Treasury Mellon, who felt that government must keep its hands off and let the slump liquidate itself. Mr. Mellon had only one formula: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate." He insisted that, when the people get an inflation brainstorm, the only way to get it out of their blood is to let it collapse. He held that even a panic was not altogether a bad thing. He said: "It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people"

Fiscal Policy

Q: Many economists say that fiscal policy does not work—that Roosevelt's deficit spending did not pull the U.S. out of the Great Depression.

A: They are wrong. Roosevelt's deficit spending did pull the U.S. out of the Great Depression—but it did not do so until World War II, which was when the deficit spending really took place. The deficits of the New Deal era seemed large and shocking to people at the time, but they were small relative to the scale of the whole economy. Peak unemployment in the Great Depression hit 23 percent. To reduce that to 5 percent would have required deficits as large as 9 percent of GDP or more—which we did not have until World War II. Thus it is not surprising that unemployment stayed above 10 percent until the eve of World War II.

The NIRA and NLRA as Neutral

Q: Did structural reforms like the NIRA and the NLRA help recovery?

A: I think there is somewhat more than a grain of truth in the claim that much of the New Deal, especially its structural interventions in the economy, was ineffective and neutral—as far as its impact on recovery from the Great Depression was concerned. And there is a grain of truth in the claim that some of it was counterproductive.

John Maynard Keynes told Roosevelt so in a letter of February 1, 1938. And Keynes went on to argue that the reason the U.S. recovery had stalled out in1937–1938 was that Roosevelt's policies were not Keynesian enough—that "the present [renewed] slump could have been predicted with absolute certainty" by anybody knowing the year before how Roosevelt was going to try to reduce deficit spending and tighten money. But that the New Deal was not Keynesian enough does not mean that we should be even less Keynesian now than we are being. And the argument that Milton Friedman and John Maynard Keynes were both wrong when they blamed the renewed 1938 downturn on contractionary macroeconomic policies—well that is an argument that Ohanian is a very brave man indeed to make.

The NIRA and the NLRA as Harmful

Q: Wasn't the New Deal harmful to recovery because it introduced blockages into labor and product markets?

A: I don't think anyone has argued that the NIRA and the NLRA boosted aggregate demand and put more people to work. That said—output and employment were growing very rapidly in the period when the NIRA was in effect, so if it was doing harm it seems likely that other aspects of the New Deal—abandoning the gold standard, giving up the target of achieving immediate budget balance, quantitative easing—were doing good. The years during which the NRA was in effect saw the unemployment rate go from 22.9 percent down to14.4 percent.

And Milton Friedman was certain that the recession of 1937–38 was not due to the NLRA and to greater union power but rather to a bad mistake of monetary policy in raising reserve requirements. In early 1937 the Federal Reserve doubled required reserves out of fear of future inflation, and the economy fell off a cliff as a result. I don't know anybody who hated strong unions more than Milton Friedman—yet he did not blame them for the recession of 1937–38.

To step back, the "impediments to market competition" that Ohanian blames for the persistence of the Great Depression were still around and were stronger than ever in the late 1940s and 1950s. If they did not produce high structural unemployment then, what reason is there to think that they produced high structural unemployment in the U.S. in the 1930s?

The NIRA: More

Q: What is your view of Roosevelt's signature initiative of his first year in office—the National Recovery Administration, the National Industrial Recovery Act?

A: I believe that my view of the NRA is the same as John Maynard Keynes's view: that it was a mistake. When I read John Maynard Keynes's open letter to Franklin Delano Roosevelt of December 31, 1933, I can hear Keynes desperately trying not to be impolite while discouraging Roosevelt from any further policy moves along the lines of the NRA. Keynes wrote:

> I cannot detect any material aid to recovery in NIRA . . . The Act is on the Statute Book; a considerable amount has been done towards implementing it; but it might be better for the present to allow experience to accumulate . . . NIRA, which is essentially Reform and probably impedes Recovery, has been put across too hastily, in the false guise of being part of the technique of Recovery.

I think the NIRA could have done significant damage to the economy had it not been negated by the Supreme Court. As things were, however, I don't think it had a material effect. Output was too depressed and demand too low for the NRA codes to have materially depressed it further during the short time it was in operation.

The NLRA: More

Q: Some economists blame slow recovery from the Great Depression in the United States on the NLRA and the consequent rise to power of American labor unions—that they pushed up wages, and so priced workers out of the labor market.

A: The NLRA came too late to be blamed for the Great Depression. The most you can do is blame it for the 1937–38 recession. If you are going to blame strong unions for high unemployment in the late 1930s, you then have to come up with a reason for why even stronger unions in the 1950s did not produce high unemployment. And you have to explain why Milton Friedman disagrees withyou—why Milton Friedman does not see union power but rather the contraction of the money stock as the cause of the rise of unemployment in 1937–38.

Slow Recovery From The Depression

Q: Shouldn't the economy have recovered completely from the Great Depression by 1936? Doesn't the fact that the Great Depression continued through the 1930s suggest that the New Deal was harmful?

A: The same models that tell Professor Ohanian, starting in 1932, that the Great Depression should have been over by 1936 also tell him, if you start them in 1928, that the Great Depression did not happen at all.

The pattern across industrial economies is: the later you start your New Deal, the worse you do. That is a striking pattern.

Unemployment Lower Before Roosevelt

Q: If the New Deal was such a success why was unemployment lower before Roosevelt, as Professor Ohanian says?

A: This is true only for a very peculiar definition of "before Roosevelt"—a normal person would think that "before Roosevelt" meant 1932 or perhaps the winter of 1932–33. But Cole and Ohanian mean, instead, an average of 1930–1932. Nineteen-twenty-nine was a boom year of extremely high unemployment. Nineteen-thirty was an average year. Nineteen-thirty-one was a bad year. But it was only after the financial crises of late 1931, say Milton Friedman and Anna Schwartz, that the cratering of the system of financial intermediation and the sudden rise in the reserve-deposit and currency-deposit ratios turned the downturn into the Great Depression. To compare the new deal to the average of 1930–1932 is not just to move the goalpost—it is to pick up the goalposts and run as fast as you can out of the stadium.

Weekly Hours at the End of the 1930s

Q: Total hours worked per adult in 1939 remained about 21 percent below their 1929 level—doesn't that prove that the New Deal was a failure?

A: Cole and Ohanian work very hard to try to convince their readers that things got worse after Roosevelt took office. But, as they know well, they didn't: things got better—they just did not get enough better to get employment back to normal until the huge burst of federal deficit spending that was World War II.

Break their claim into two parts. The first part: unemployment was 22.9 percent in 1932 and down to 11.3 percent in 1939—yes, that tells us that recovery was incomplete.

The second part: hours of work per employed person were 13 percent lower in 1939 than in 1929. Cole and Ohanian assume that all of this decline in hours of work per week per employed person is due to deficient demand rather than to a much-desired increase in leisure. I don't think that is right. In 1949 hours worked per adult were 18 percent and in 1959, 17 percent below their 1929 level. But does that mean that the economy was even more depressed in the 1950s than it was in 1939? No. You don't want to maintain that the interwar decline in hours worked tells us about cycle and not trend. Is there anyone who will say that the decline in hours worked from 1914 to 1952 tells us that the economy was performing much worse along a business-cycle dimension in 1952 than it was in 1914? No. The 1914–1950 period saw the last sharp decline in the American workweek—a decline that does not mean that the economy was depressed and performing poorly in 1959 or 1949 (or 1939) relative to 1914 or 1929, but instead that Americans had decided to take a substantial part of their increased technological wealth and use it to buy increased leisure.

Private Investment

Q: Didn't Roosevelt's New Deal Policies destroy business confidence and deepen the Great Depression?

A: The most aggressive claim to this effect that I have seen comes from Professor Bryan Caplan of George Mason, who wrote that: "[Robert] Mugabe has made people afraid to invest in Zimbabwe. Why should [Brad] doubt that—on a smaller scale, of course—Roosevelt made people afraid to invest in the U.S.?"

The answer is: no, Franklin Delano Roosevelt bears no resemblance to Robert Mugabe.

And the answer is: no, Franklin Delano Roosevelt's policies did not depress private investment by making businessmen more scared to invest in America; when FDR took office, businessmen were already totally scared to invest in America—net investment was well below zero, and could hardly drop any further.

Public confidence in markets reached a nadir in 1933, when half the banks in the country had closed, when Wall Street was out of business, when the Dow stood at its appalling lows. Before the new deal there was no securities industry, no banking industry, no mortgage industry, no capital formation or lending of any kind. Forty percent of home mortgages were in default. It was only with the passage of New Deal efforts—the SEC, the FDIC, the FSLIC—that the mechanisms of private capital began to kick back into gear. Don't take it from me. Take it from Federal Reserve Chairman Ben Bernanke, who wrote in his essays on the Great Depression that: "only with the New Deal's rehabilitation of the financial system in 1933–35 did the economy begin its slow emergence from the Great Depression."