Understanding the Great Depression

Government Policies that Impeded Competition

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Depressions and Crises

- Remain a significant challenge for economic theory
- Particularly in economies that function well – US & other OECD countries.
  - Why does a good economy go so bad, and for so long?
  - What causes them, and what prevents rapid recovery?
- Today, focus on Great Depression in US 1930s
- Main themes
  - Depression was a more than decade long event
  - It is largely due to market failures
- Market failures: result of poorly designed policies by Hoover and FDR
- Depression would have been less severe and protracted in absence of these policies

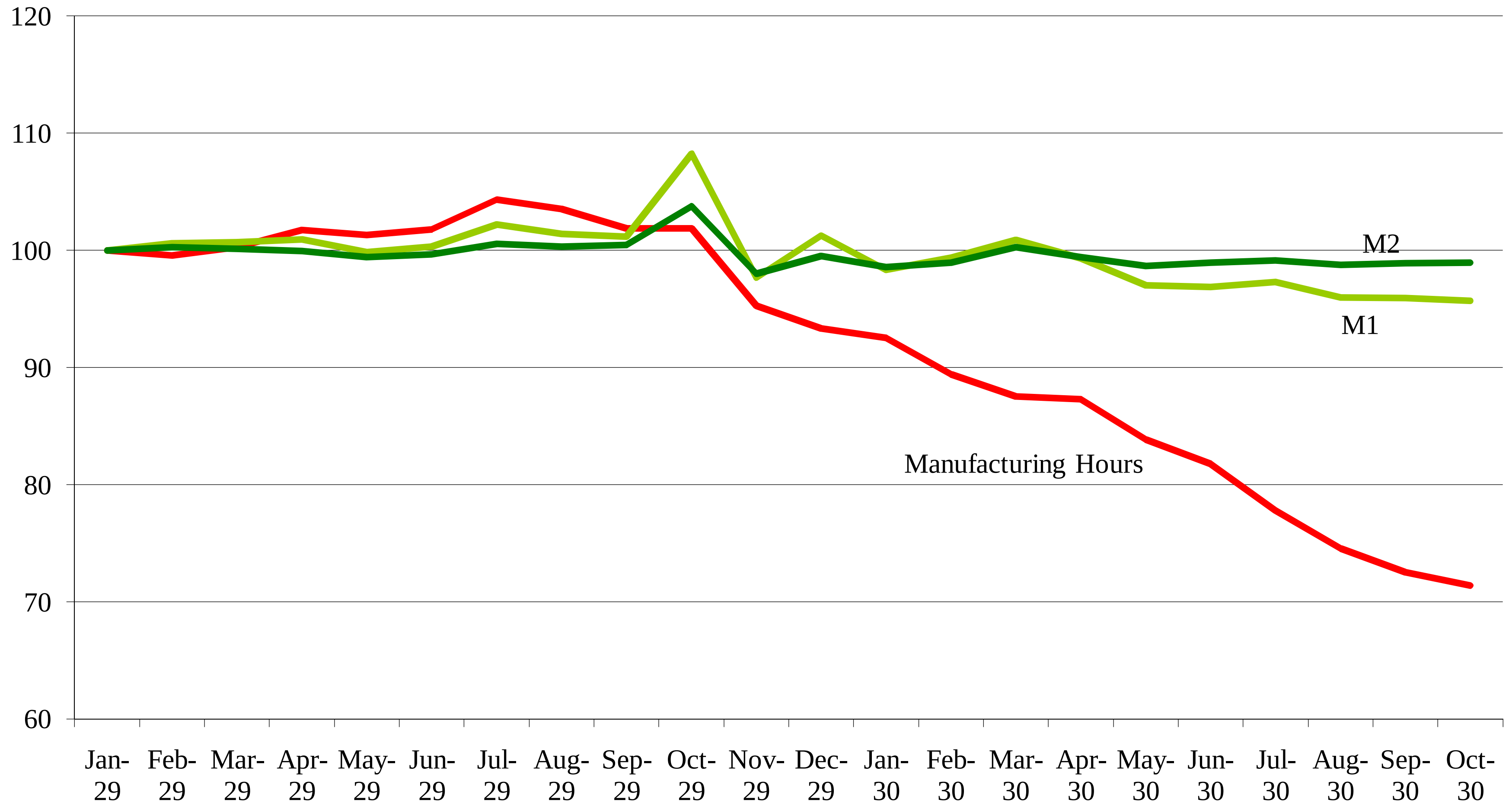
Background for presentation

- What - or Who - Started the Great Depression?, forthcoming, *Journal of Economic Theory*
- New Deal Policies and the Persistence of the Great Depression, with Hal Cole, *Journal of Political Economy*, 2004.

Surprising Facts About the Depression

- Textbook views about Depression
  - Started as "garden variety recession"
  - Monetary and banking declines made it severe
  - Significant recovery after 1933
- Depression immediately severe, and before monetary contraction and banking panics
- Banking pancis came much later, first major crisis August, 1931 - depression already bad
- Industry Depressed but not Agriculture...
- Agricultural hours worked and output change little

Figure 1 - Manufacturing Hours and the Money Supply
Index (Jan 1929=100)



If Money and Banking didnt start Depression, what did?

- Labor Market Failure beginning in late 1929
- Micro evidence - Curtis Simon, JEH, 2001
- Situation wanted advertisements provide data on *supply price* of labor
- Before depression, supply price of labor and wage very similar
- During depression, supply price *falls 30% lower than wage*
- Suggests wage too high, labor market not clearing, excess supply of labor

Macroeconomic evidence on labor market failure

- economic theory equates *marginal benefit of working* to *marginal cost*
- This marginal rate of substitution condition highly distorted during Depression
- consumption and employment much too low relative to real wage
- Means that people should have been working much more
- Micro and macro evidence indicate labor market failure
- agriculture - nominal wage fell a lot and hours/output remained high

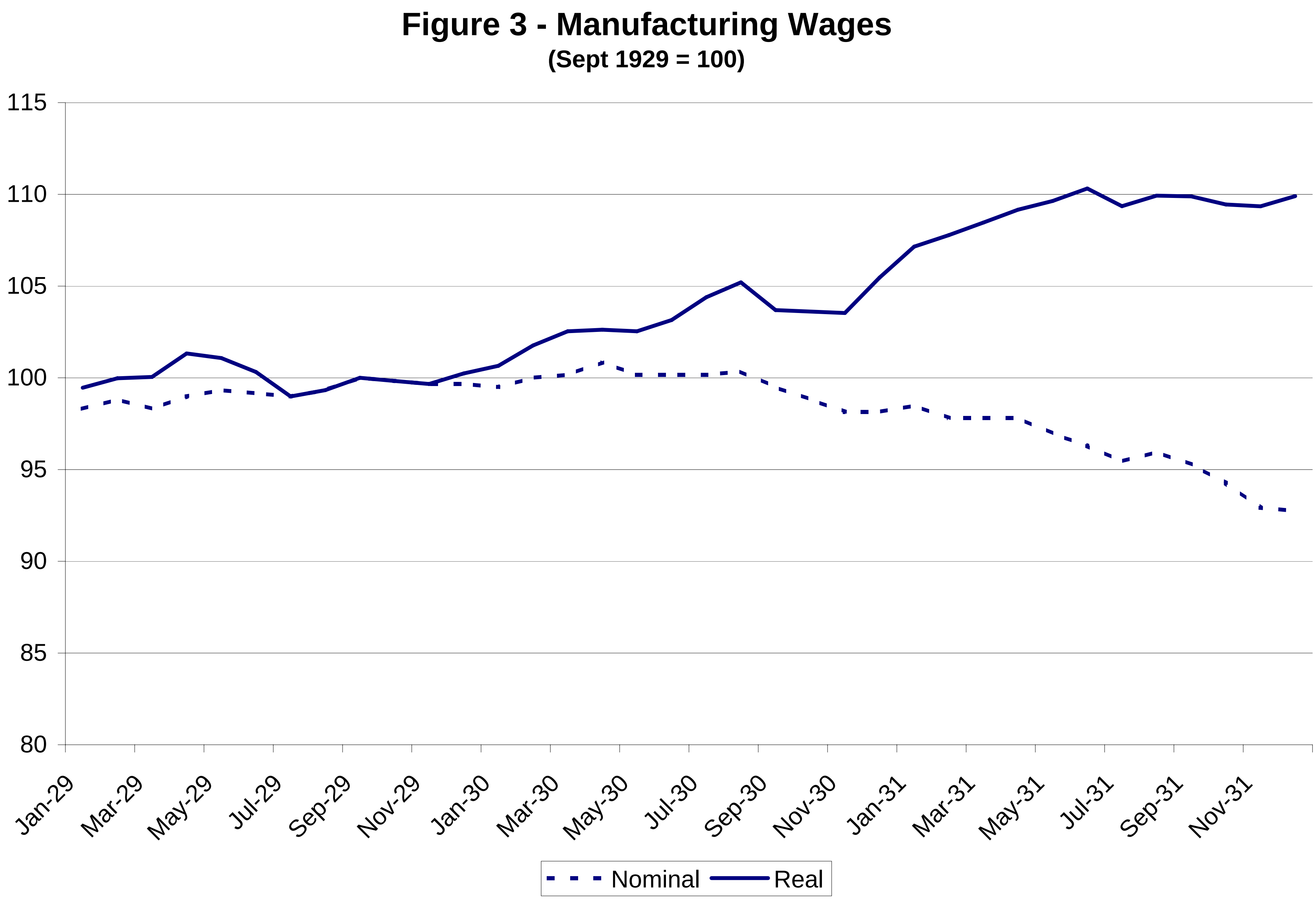


Figure 3 - Manufacturing Wages
(Sept 1929 = 100)
115
110
105
100
95
90
85
80
Jan-29
Mar-29
May-29
Jul-29
Sep-29
Nov-29
Jan-30
Mar-30
May-30
Jul-30
Sep-30
Nov-30
Jan-31
Mar-31
May-31
Jul-31
Sep-31
Nov-31
Nominal
Real

What - or who is the source of labor market failure?

- Herbert Hoover
- - promoted cartels and wage growth in excess of productivity growth
- Hoover on cartels:

".In 1927 as Secretary of Commerce, I wrote the foreword to a bulletin on "Trade Association Activities" in which I said: 'the national interest requires a certain degree of cooperation between individuals in order that we may reduce and eliminate industrial waste....the great area of economic wrong and unethical practices that spring up under the pressures of competition...the great field of economic waste through destructive competition...through failure of our different industries to synchronize.. we enlisted the different trade associations in creation of codes of fair business practice that eliminate abuses."

Hoover and Labor

- Hoover on high wages:

" not so many years ago, the employer considered it was in his interest to use the opportunities of unemployment and immigration to lower wages... the lowest wages and longest hours were then conceived as the means to obtain highest profits. But we are a long way on the road to new conceptions. The very essence of great production is high wages...

- Hoover supported and Railway Labor Act, supported and signed Davis-Bacon Act and Norris-Laguardia Act
- Railway Labor Act - led to series of Court decisions that permanently changed rules regarding unionzation and strikes

Hoover's labor program

- After stock market crash, Hoover meets with Industry at White House
- Advises
  - "Dont cut wages, this will help me keep the peace with labor"
  - "Share work as much as you can, rather than just layoffs"
- Firms unanimously agree (GM, Ford, Dupont, US Steel...)
- Meets with organized labor, and asks them not to strike
- Both sides keep their pledge
- As prices and productivity fell, real labor costs rose substantially
- During 1930-31, industry asked if Hoover would support wage cuts
- Hoover declines "If wages are cut, there will be hell to pay with unions"
- Industry keeps wage pledge until late 1931
- Hoover program key piece of watershed change in labor policies began in late 1920s

Analyzing Hoover's program

- Economic model - 2 sectors - industry (subject to policy), agriculture (not subject to policy)
- Experiment - feed into model observed real mfg wage (like a minimum wage) and observed productivity
- Hoover program accounts for roughly 2/3 of depression and asymmetry between industry and agriculture
- Labor market failure due to Hoover program, that prevents wage from falling and market from clearing

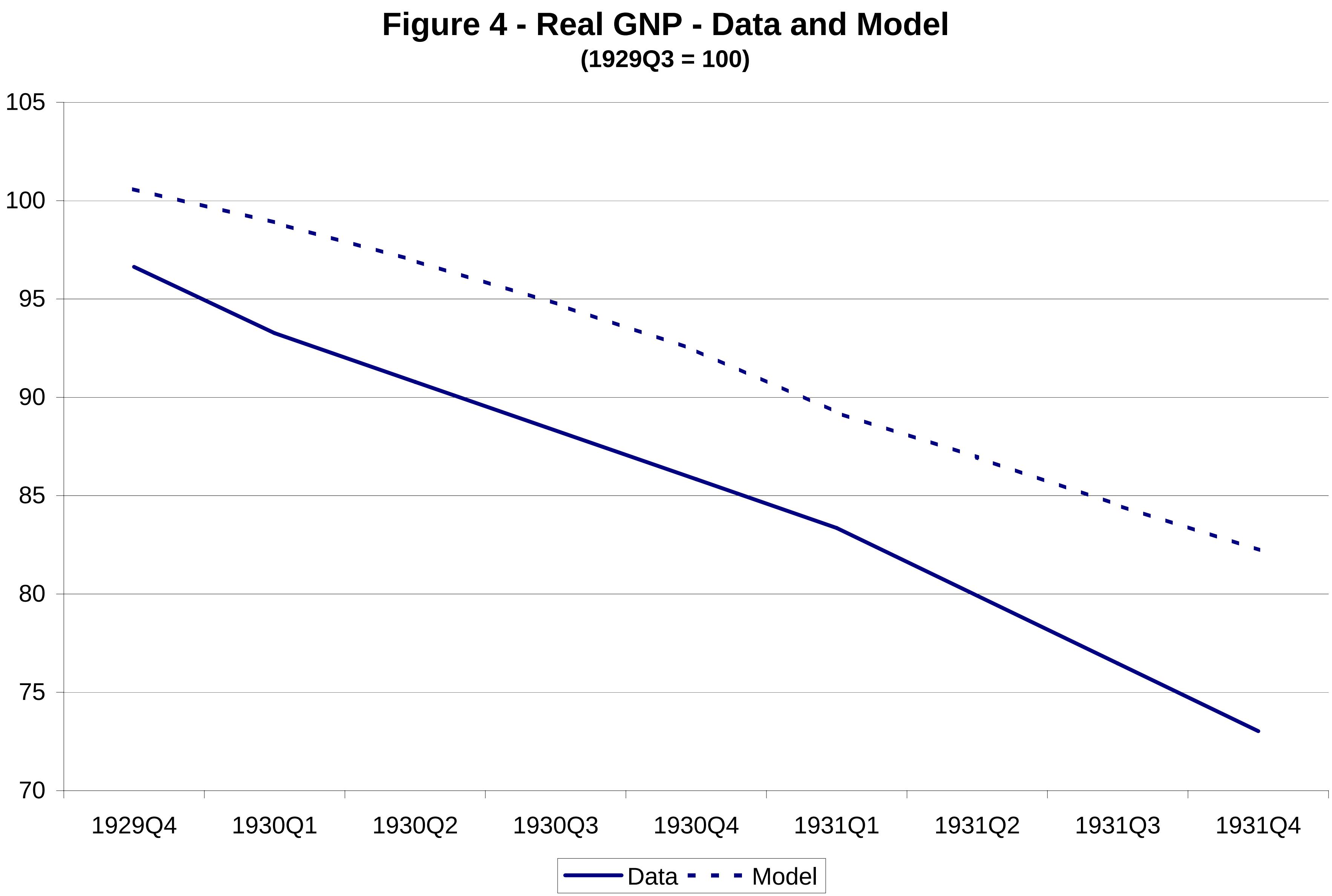


Figure 4 - Real GNP - Data and Model
(1929Q3 = 100)
105
100
95
90
85
80
75
70
1929Q4
1930Q1
1930Q2
1930Q3
1930Q4
1931Q1
1931Q2
1931Q3
1931Q4
Data
Model

Figure 7 - Manufacturing Hours - Data and Model
(1929Q3 = 100)

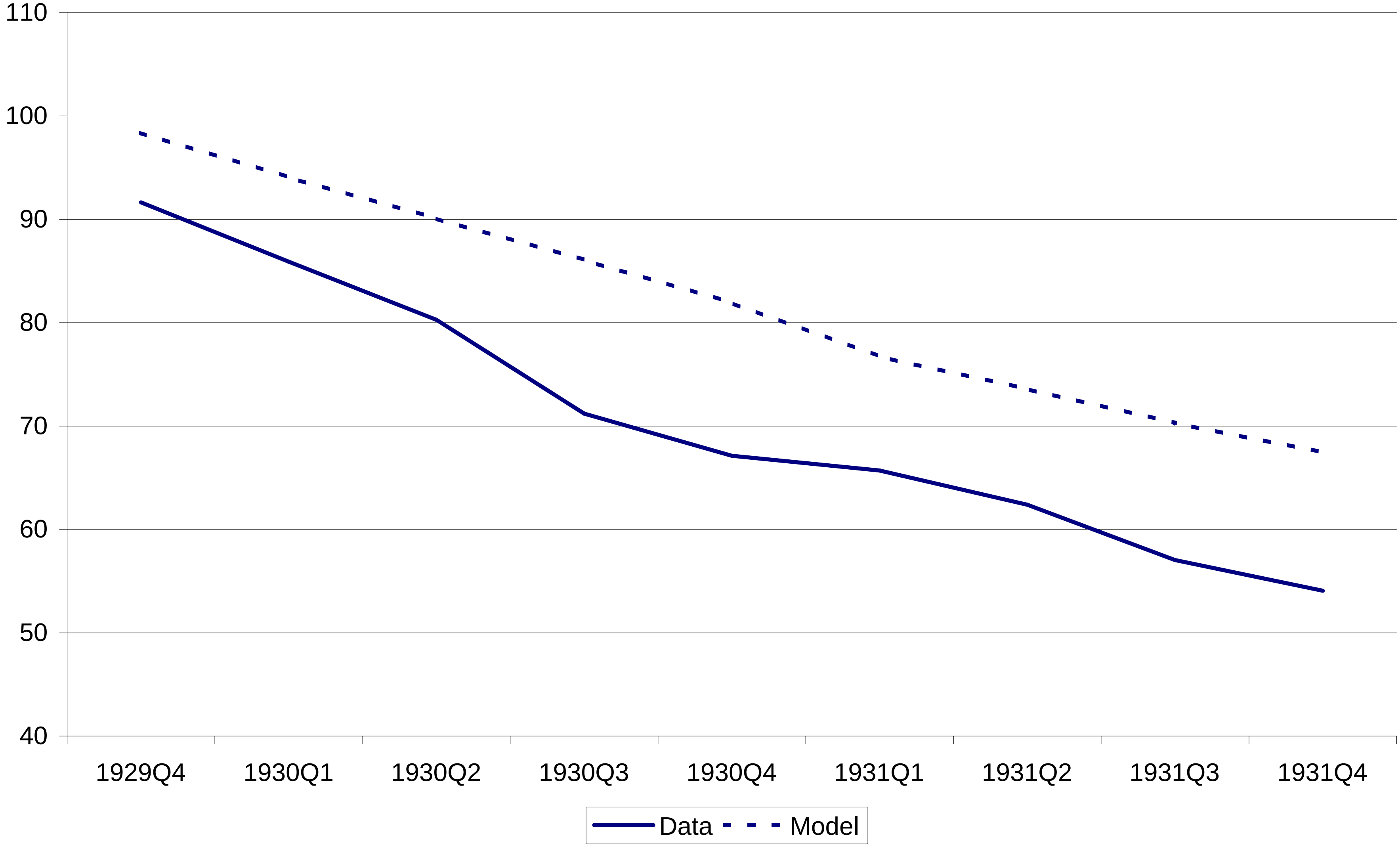
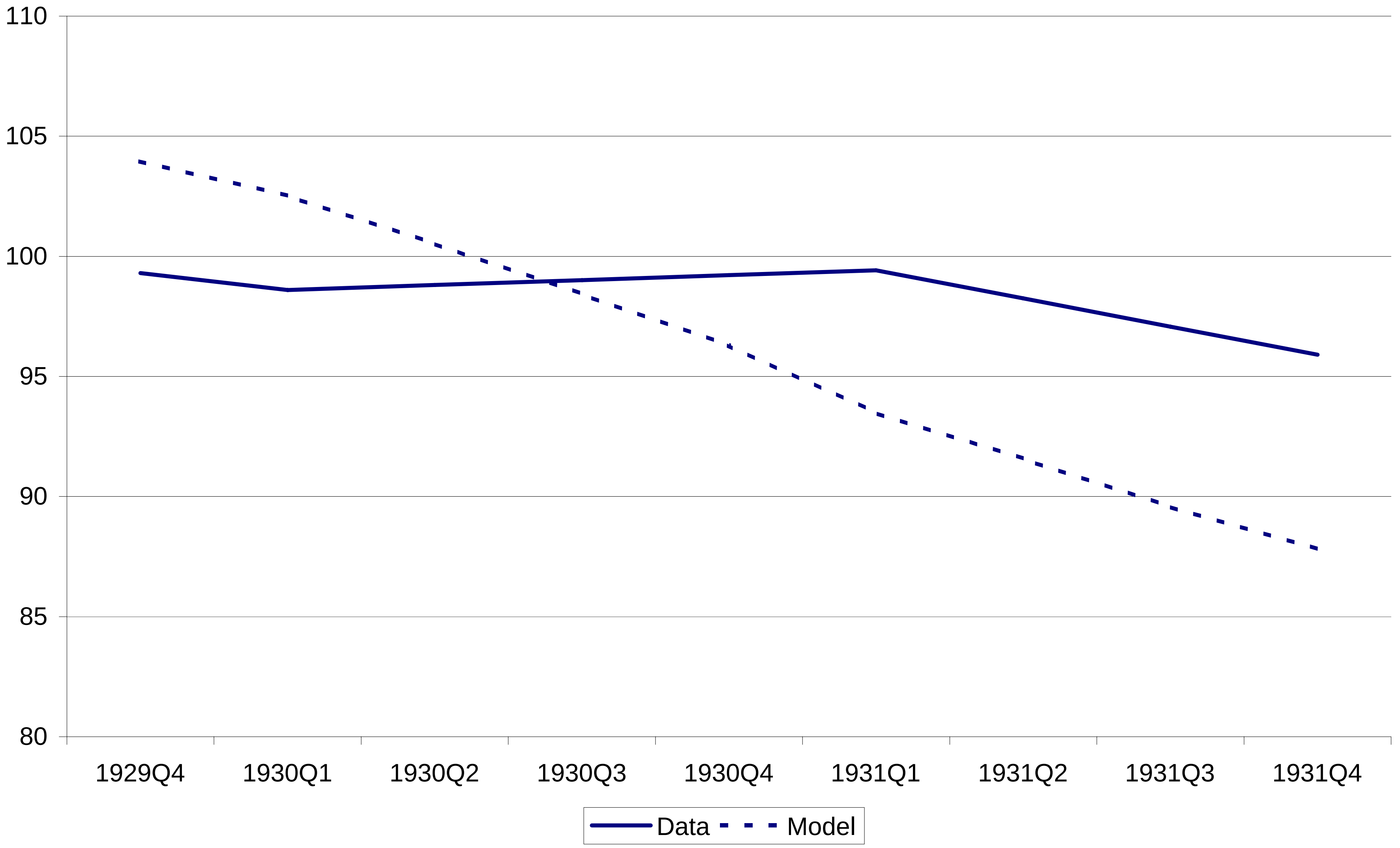


Figure 8 - Agriculture Hours - Data and Model

(1929Q3 = 100)



FDR's "New Deal" and the persistence of the Depression

- Economy remained depressed after Hoover
- Very little recovery in consumption and labor
- Almost all output growth due to productivity, not inputs
- FDR similar to Hoover - cartels and distorted labor markets

"A mere builder of more plants, a creator of more railroads an organizer of more corporations, is as likely to be a danger as a help"

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

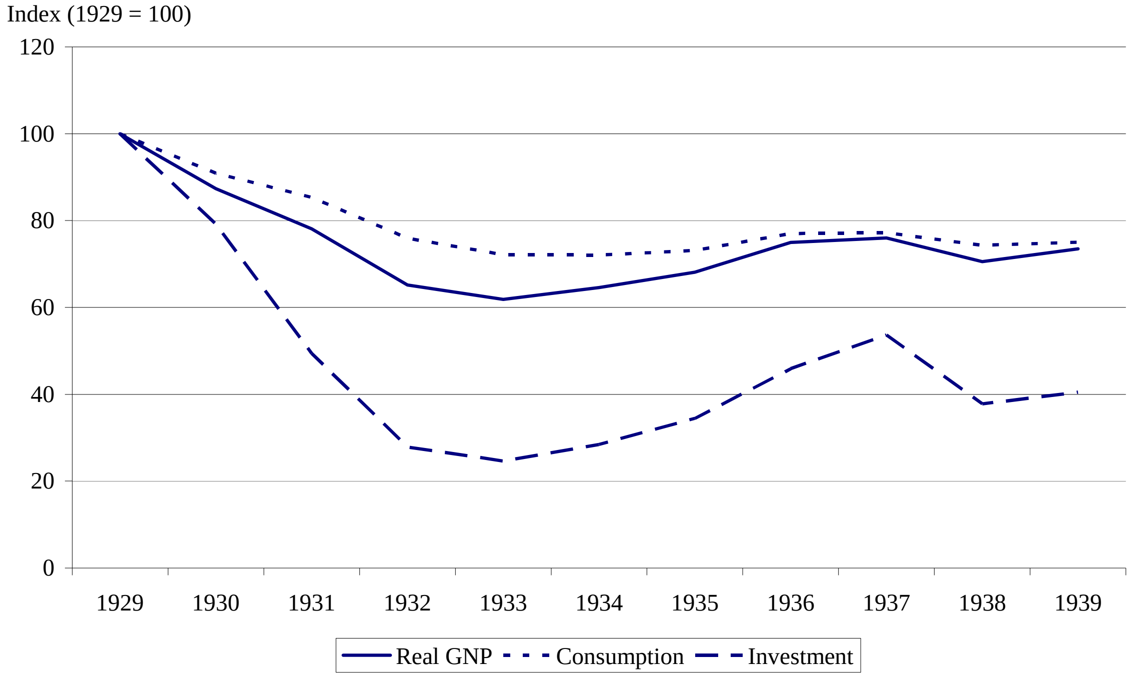


Figure 2 - Depressed Hours Worked and High Real Wages

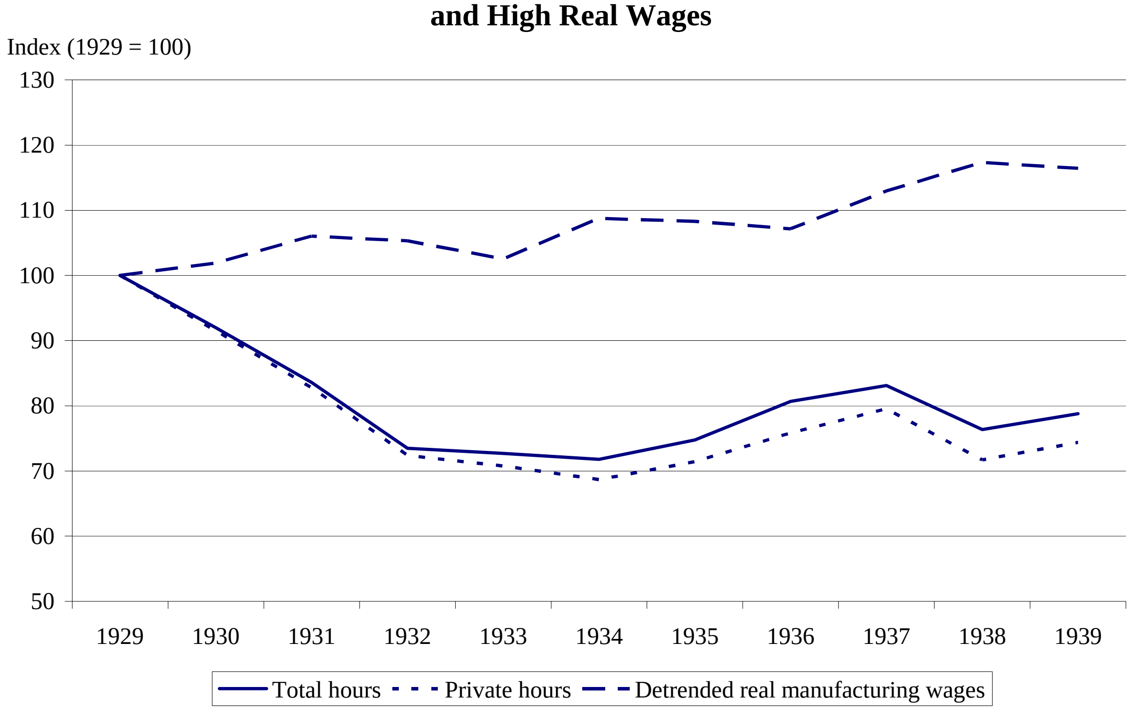
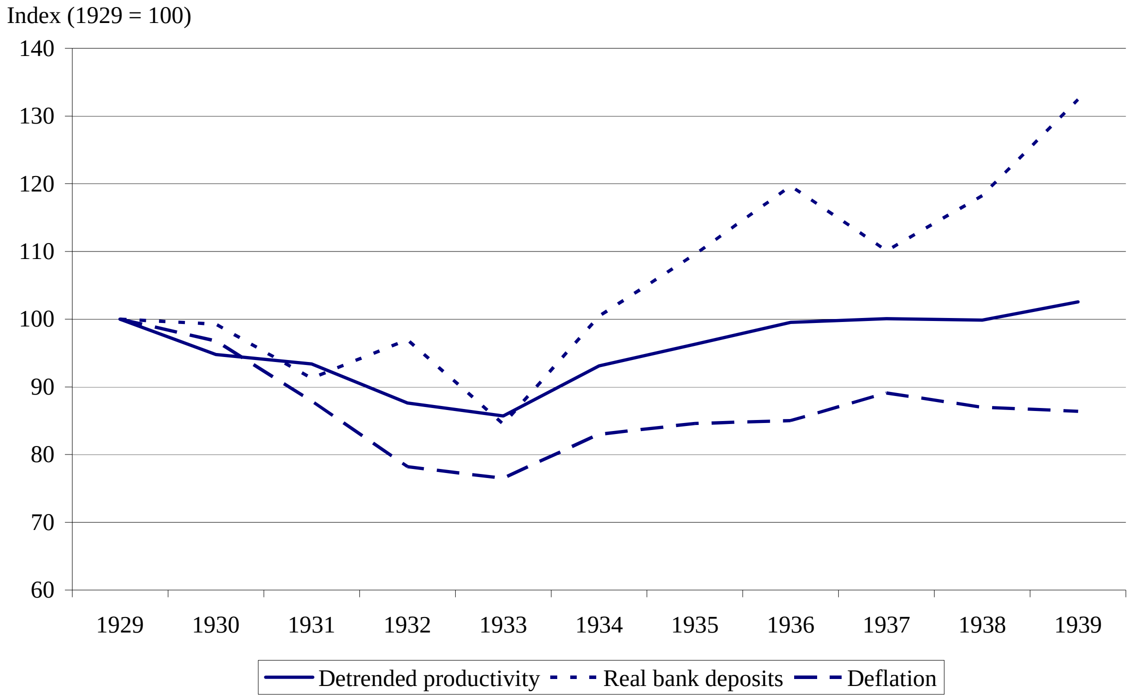


Figure 3 - Economic Fundamentals Recover



National Industrial Recovery Act

- FDR and Congress adopt the NIRA
- Covered over 500 narrowly defined industries
- Explicit collusion (no antitrust prosecution)
- Codes of "fair competition" were operating rules for industry
  - minimum prices
  - production and investment quotas - classic cartel
- Codes of fair competition negotiated between gov, industry, labor
- Code approved by government provided that:
  - wages rose significantly
  - industry agreed to collective bargaining

FDR Believed Competition Was The Problem

- Many of FDRs advisors were wartime economic planners
- Gov planning, not markets, was used to allocate many resources during WWI
- Planners interpreted higher output as result of planning and wage administration
- They believed reducing competition and increase wages - as in WWI - would foster recovery

Result of NIRA - high prices and wages

- prices & wages rise immediately following codes of fair competition
- mfg relative price and real wages rise 15 - 20%
- Explicit collusion (no antitrust prosecution)
- Codes of "fair competition" were operating rules for industry
  - minimum prices
  - production and investment quotas - classic cartel
- Codes of fair competition negotiated between gov, industry, labor
- Code approved by government provided that:
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  - industry agreed to collective bargaining
- NIRA ends in 1935, but policy continues with no anti-trust and Wagner Act

Analyzing New Deal Policies

- Similar model as before
- mfg relative price and real wages rise 15 - 20%
- Explicit collusion (no antitrust prosecution)
- Codes of "fair competition" were operating rules for industry
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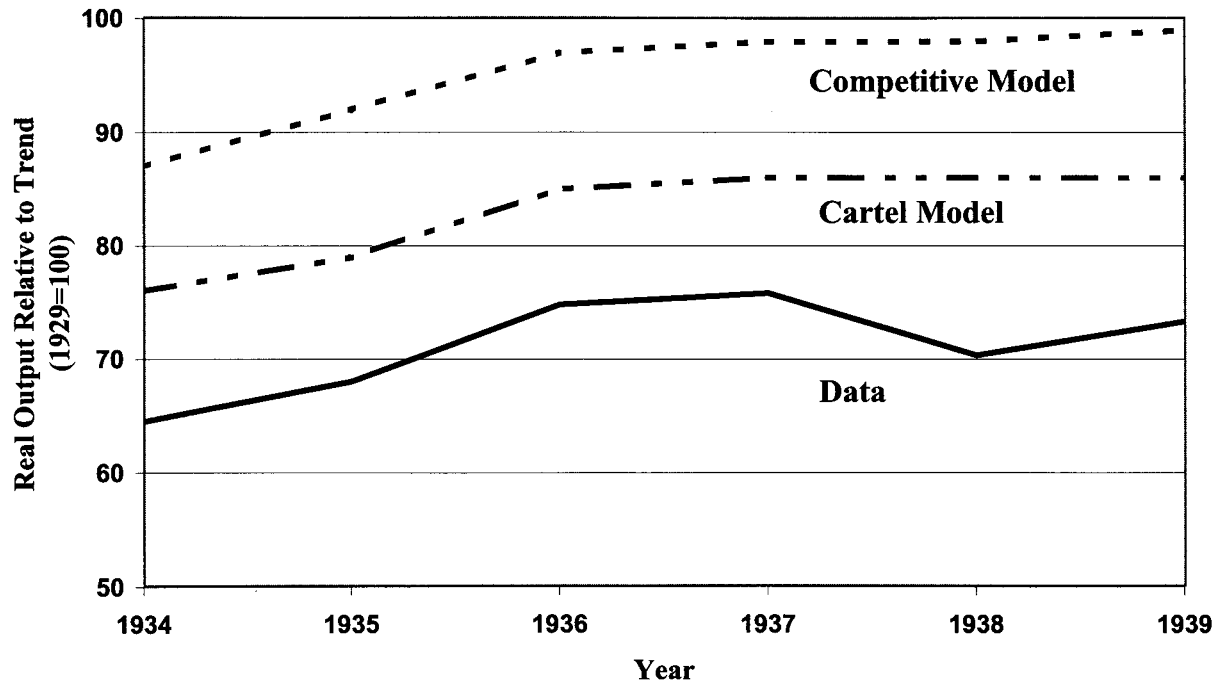

FIG. 2.—Output in the data and in the models

Understanding the Great Depression

- Depression severe long before monetary contraction & banking panics
- Remained depressed long after money supply grew and banking system was stabilized
- Wage, consumption, and employment data indicate labor market failure
  - Wage rates well above normal
  - comsumption and employment well below normal
- Depression would have been less severe in absence of Hoover and FDR policies