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Book Review

by Richard M. Ebeling

Rethinking the Great Depression
by Gene Smiley (Chicago: Ivan R. Dee, 2002); 179 pages; $24.95.

The Great Depression of the early 1930s has left a deep and lasting mark on the United States. For many in the general public the Great Depression still conjures up the image of mass unemployment caused by the failure of unregulated capitalism. For many in the economics profession, the Great Depression has permanently shown the need for activist government to prevent such events from happening again, or at least the need to mitigate their duration and intensity through various monetary and fiscal policy tools.

During the time of the Great Depression, there were a handful of economists, especially members of the Austrian school of economics, such as Ludwig von Mises and Friedrich A. Hayek, who argued that the Depression had been caused by monetary mismanagement by governments in the 1920s. And once the Depression had begun, they said, its severity was the result of misguided and counterproductive government interventions.

They, and the handful of economists who reasoned like them, were soon swamped by the rising Keynesian revolution of the late 1930s. John Maynard Keynes had argued in his famous 1936 book, *The General Theory of Employment, Interest and Money,* that the capitalist system was inherently unstable and susceptible to wide and unpredictable fluctuations in the general level of employment and output. Only government could ensure that its own spending could fill the gap when private-sector spending fell short of maintaining full employment.

The monetarists, led by Milton Friedman, argued that Keynes had been wrong. The Great Depression had been caused by the Federal Reserve's allowing the money supply to significantly contract when the economic downturn began in late 1929 and early 1930. If only it had pumped

in enough money to counteract the monetary deflation in 1931 and 1932, prices, wages, and profit margins would not have been dragged down, resulting in a collapse in the general economic situation, the monetarists argued.

Gene Smiley, in his new book, *Rethinking the Great Depression,* attempts to put the events of the 1920s and 1930s into a new perspective that strongly emphasizes that the entire economic tragedy of the time was caused by misplaced governmental policies that went terribly wrong.

The roots of the Great Depression

He first explains the "brute facts" leading up to and following the start of the Great Depression. He points out that the 1920s had been a period of dramatic economic growth and technological innovation that was lowering the costs of manufacturing and increasing the supplies of a wide variety of goods and services supplied to the consuming public.

Only agriculture remained to a great degree in the doldrums. With the end of the First World War, the global demand for American farm products had declined and the farming community had failed to adjust to the new international market situation. Once the Great Depression began, unemployment kept rising until it reached about 25 percent of the work force in late 1932. Both manufacturing output and construction decreased significantly, and international trade experienced a major decline.

But why had the prosperity of the 1920s turned into the economic catastrophe of the 1930s? Smiley argues, basically, that it was owing to the failure of the major Western countries to fully adjust to the economic realities of the postwar circumstances. He sees a primary source of the problem in the return to the gold standard by countries such as Great Britain at a rate of exchange that was too high relative to the domestic level of prices and wages that had been created by the wartime inflation. Either Great Britain's prices and wages had to fall enough to make British goods competitive on the world market once again or the exchange rate between the British pound and gold had to be devalued to reduce the cost of other countries' buying British goods. The problem was that the British trade unions had become too strong and wouldn't accept cuts in money wages, and the British government was not willing to devalue the pound. Hence, Britain went into the Great Depression already in a severe recession.

Smiley fails to present a fully coherent theory of why the downturn began in America in 1929, other than to correctly point out that in 1927 and 1928 the Federal Reserve had increased the

money supply to keep the stock market and construction booms going. Then the Fed brought the monetary expansion to a halt in late 1928 and 1929. That set the stage for the stock-market crash.

The follies of the New Deal

Smiley is at his best when analyzing the follies of government policies once the Depression had begun. The economic policies of the Hoover administration were an unmitigated disaster. Taxes were raised and the government set up subsidy programs to prop up both unprofitable industries and wasteful agricultural production. Congress passed the Hawley-Smoot tariff that raised import taxes to a historical high, which set off an international trade war that ruined import and export markets around the world.

Hoover also pressured business and labor unions to keep money wages artificially high in the misguided name of maintaining "purchasing power" in the economy. That merely succeeded in pricing more and more workers out of the labor market, creating an expanding circle of rising unemployment. Anti-competitive price and wage rigidities were the primary reason the Depression grew in intensity as the early 1930s progressed, Smiley emphasizes.

The growing circle of unprofitable businesses in the face of these price and wage rigidities undermined the banking system, as an increasing number of enterprises could not pay off their loans. Bank-depositor panics broke out that led to bank runs. The financial sector of the American economy, as a result, went into a tailspin. The banking crisis was at its worst in the period between the November presidential election of 1932 and Franklin D. Roosevelt's inauguration in March 1933.

Smiley persuasively shows with a thorough and detailed analysis of the facts that, contrary to many popular impressions, Roosevelt's New Deal did not end the Great Depression. Instead, it prolonged the imbalances and distortions and indeed in many cases made them worse. Modeled along the lines of Mussolini's fascist economic system in Italy, the National Recovery Administration (NRA) imposed industrial cartels over virtually every sector of the American economy.

At the same time, the Agricultural Adjustment Act (AAA) controlled the prices and production of American farming. The monetary system was thrown into confusion and instability with the abandonment of the gold standard. Taxes were raised even more, budget deficits added to the pressure on the banking industry, and giant public works projects were directly undertaken by the

federal government. Rather than stability and recovery, these programs generated only uncertainty and economic stagnation.

Economic improvement began only after the U.S. Supreme Court declared most of the New Deal systems of planning and controls to be unconstitutional in 1935 and 1936. To the extent that the private sector was freed from the heavy hand of direct government supervision, industries slowly began to adjust and expand output and add to their labor forces. But Smiley explains that Roosevelt undermined this recovery in 1936 and 1937. Angry that the Supreme Court had thrown out most of the central features of his New Deal, he went on an anti-business crusade that weakened business confidence in the political and economic future.

At the same time, Roosevelt began to institutionalize the welfare state with various social security and redistributive schemes, as well as by enacting the minimum-wage law and legislation strengthening union power and compulsory collective bargaining.

Then, in 1937-38, the American economy experienced a new depression within the Great Depression, owing to the Federal Reserve's raising reserve requirements on commercial banks, which induced a monetary contraction and a decline in investment lending. Durable-goods manufacturing fell by 67 percent between May 1937 and May 1938. By May 1938, the unemployment rate exceeded 20 percent after having declined to 12 percent in May 1937. The stock market fell more than 41 percent during the second half of 1937. And the Standard & Poor's index fell 52 percent between August 1937 and April 1938.

Finally, Smiley challenges the common view that the Second World War ended the Great Depression and began a return to prosperity for America. He points out that the disappearance of mass unemployment was due to the conscription of 12 million people into the armed forces. Production did increase during the war years, but it did not involve an improvement in economic conditions within the country, since practically all the new industrial and manufacturing activity was directed at the production of war materiel, not consumer-desired goods and services. In fact, Smiley calculates that during both the 1930s and the war years of the 1940s, the American economy experienced periods of *capital consumption,* when capital equipment and other durable production assets were not replaced as they were worn out.

The enduring legacy of the Great Depression, Smiley concludes, has been a total misunderstanding of this period: it was government mismanagement and intervention that created this economic crisis. And furthermore, what the government did during the decade of the 1930s left us with the institutional burden of the regulated economy and the welfare state. "What failed in the 1930s were *governments,* in their eagerness to direct activity to achieve political

ends," Smiley says at the end of this insightful and valuable work. "It has taken us a long time to begin to understand these costly lessons of the 1930s."

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