



20 Century

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Slouching Towards Utopia?: The Economic History of the Twentieth Century

-XIV. The Great Crash and the Great Slump-

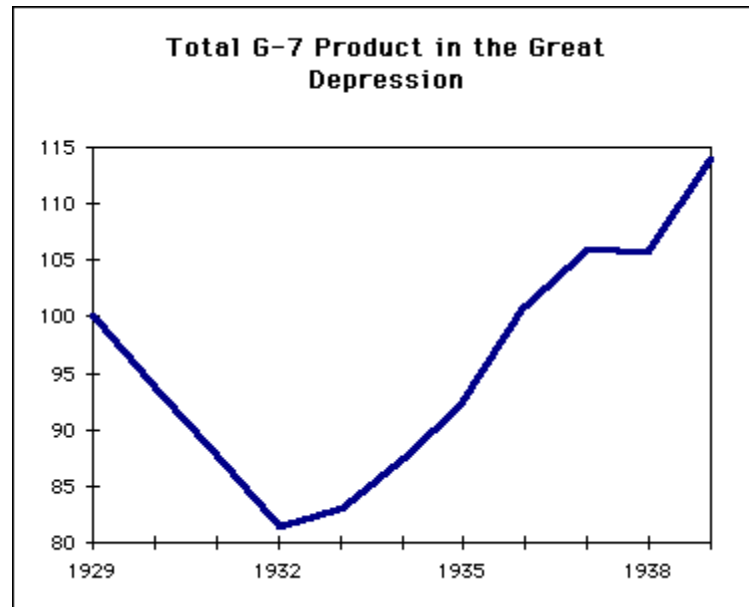
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The Great Depression in Outline

It is straightforward to narrate the slide of the world into the Great Depression. The 1920's saw a stock market boom in the U.S. as the result of general optimism: businessmen and economists believed that the newly-born Federal Reserve would stabilize the economy, and that the pace of technological progress guaranteed rapidly rising living standards and expanding markets. The U.S. Federal Reserve's attempts in 1928 and 1929 to raise interest rates to discourage stock speculation brought on an initial recession.



Caught by surprise, firms cut back their own plans for further purchase of producer durable goods; firms making producer durables cut back production; out-of-work consumers and those who feared they might soon be out of work cut back purchases of consumer durables, and firms making consumer durables faced falling demand as well.

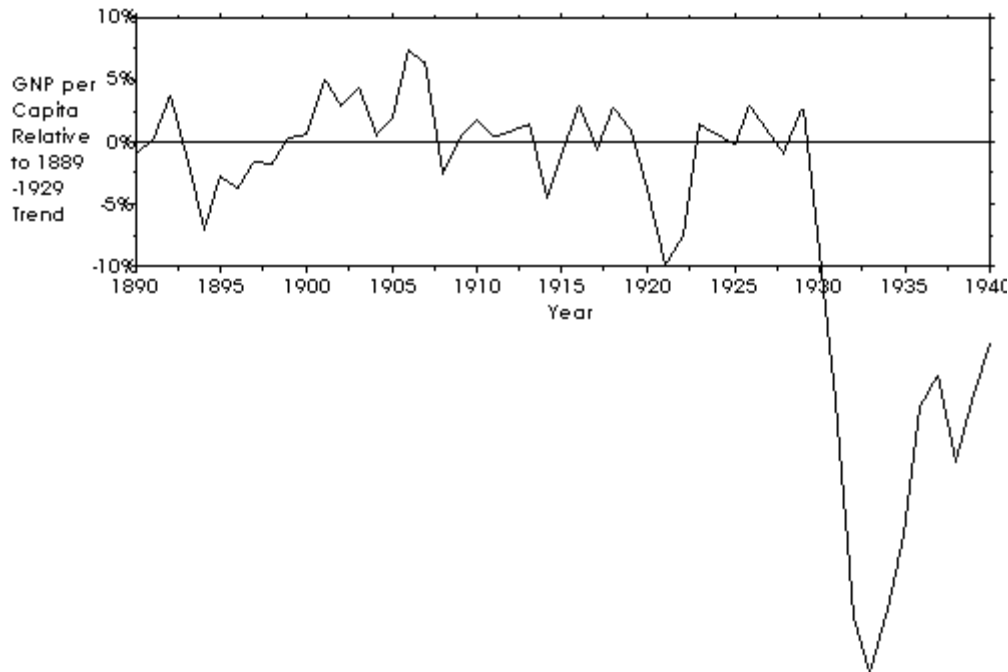
Falls in prices--deflation--during the Depression set in motion contractions in production which triggered additional falls in prices. With prices falling at ten percent per year, investors could calculate that they would earn less profit investing now than delaying investment until next year when their dollars would stretch ten percent further. Banking panics and the collapse of the world monetary system cast doubt on everyone's credit, and reinforced the belief that now was a time to watch and wait. The slide into the Depression, with increasing unemployment, falling production, and falling prices, continued throughout Herbert Hoover's Presidential term.

There is no fully satisfactory explanation of why the Depression happened when it did. If such depressions were always a possibility in an unregulated capitalist economy, why weren't there two, three, many Great Depressions in the years before World War II? Milton Friedman and Anna Schwartz argued that the Depression was the consequence of an incredible sequence of blunders in monetary policy. But those controlling policy during the early 1930s thought they were following the same gold-standard rules of conduct as their predecessors. Were they wrong? If they were wrong, why did they think they were following in the footsteps of their predecessors? If they were not wrong, why was *the* Great Depression the only Great Depression?

At its nadir, the Depression was collective insanity. Workers were idle because firms would not hire them to work their machines; firms would not hire workers to work machines because they saw no market for goods; and there was no market for goods because workers had no incomes

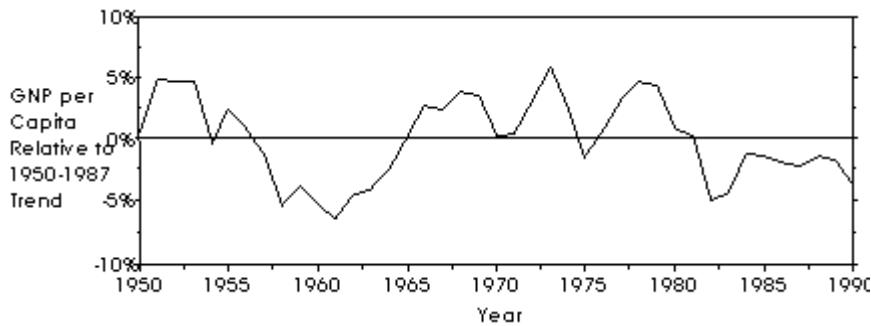
to spend. Orwell's account of the Depression in Britain, *The Road to Wigan Pier*, speaks of "...several hundred men risk[ing] their lives and several hundred women scrabl[ing] in the mud for hours... searching eagerly for tiny chips of coal" in slagheaps so they could heat their homes. For them, this arduously-gained "free" coal was "more important almost than food." All around them the machinery they had previously used to mine in five minutes more than they could gather in a day stood idle.

The United States Business Cycle, 1890-1940



The Great Depression has central place in twentieth century economic history. In its shadow, all other depressions are insignificant. Whether assessed by the relative shortfall of production from trend, by the duration of slack production, or by the product-depth times duration-of these two measures, the Great Depression is an order of magnitude larger than other depressions: it is off the scale. All other depressions and recessions are from an aggregate perspective (although not from the perspective of those left unemployed or bankrupt) little more than ripples on the tide of ongoing economic growth. The Great Depression cast the survival of the economic system, and the political order, into serious doubt.

The United States Business Cycle, 1950-1990



The Great Crash

The U.S. stock market boomed in the 1920s. Prices reached levels, measured as a multiple of corporate dividends or corporate earnings, that made no sense in terms of traditional patterns and rules of thumb for valuation. A range of evidence suggests that at the market peak in September 1929 something like forty percent of stock market values were pure air: prices above fundamental values for no reason other than that a wide cross-section of investors thought that the stock market would go up because it had gone up.

By 1928 and 1929 the Federal Reserve was worried about the high level of the stock market. It feared that the "bubble" component of stock prices might burst suddenly. When it did burst, pieces of the financial system might be suddenly revealed to be insolvent, the network of financial intermediation might well be damaged, investment might fall, and recession might result. It seemed better to the Federal Reserve in 1928 and 1929 to try to "cool off" the market by making borrowing money for stock speculation difficult and costly by raising interest rates. They accepted the risk that the increase in interest rates might bring on the recession that they hoped could be avoided if the market could be "cooled off": all policy options seemed to have possible unfavorable consequences.

In later years some, Friedrich Hayek for one, were to claim that the Federal Reserve had created the stock market boom, the subsequent crash, and the Great Depression through "easy money" policies.

pp. 161-2: "[U]p to 1927 I should have expected that the subsequent depression would be very mild. But in that year an entirely unprecedented action was taken by the American monetary authorities [who] succeeded, by means of an easy-money policy, inaugurated as soon as the symptoms of an impending reaction were noticed, in prolonging the boom for two years beyond what would otherwise have been its natural end. And when the crisis finally occurred, deliberate attempts were made to prevent, by all conceivable means, the normal process of liquidation."

Those making such claims for over-easy policy appear to have spent no time looking at the evidence. Weight of opinion and evidence on the other side: the Federal Reserve's fear of excessive speculation led it into a far too deflationary policy in the late 1920s: "destroying the village in order to save it."

The U.S. economy was already past the peak of the business cycle when the stock market crashed in October of 1929. So it looks as though the Federal Reserve did "overdo it"--did raise interest rates too much, and bring on the recession that they had hoped to avoid.

The stock market did crash in October of 1929; "Black Tuesday", October 29, 1929, saw American common stocks lose something like a tenth of their value. That it was ripe for a bursting of the bubble is well known; the exact reasons why the bubble burst then are unknowable; more important are the consequences of the bursting of the bubble.

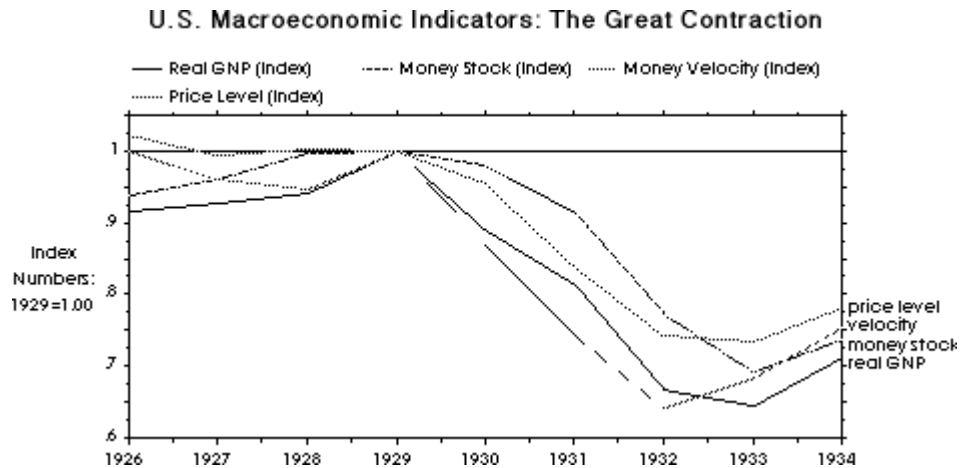
The stock market crash of 1929 greatly added to economic uncertainty: no one at the time knew what its consequences were going to be. The natural thing to do when something that you do not understand has happened is to pause and wait until the situation becomes clearer. Thus firms cut back their own plans for further purchase of producer durable goods. Consumers cut back purchases of consumer durables. The increase in uncertainty caused by the stock market crash amplified the magnitude of the initial recession.

Even a Panic Is Not Altogether a Bad Thing:

The first instinct of governments and central banks faced with this gathering Depression began was to do nothing. Businessmen, economists, and politicians (memorably Secretary of the Treasury Mellon) expected the recession of 1929-1930 to be self-limiting. Earlier recessions had come to an end when the gap between actual and trend production was as large as in 1930. They expected workers with idle hands and capitalists with idle machines to try to undersell their still at-work peers. Prices would fall. When prices fell enough, entrepreneurs would gamble that even with slack demand production would be profitable at the new, lower wages. Production would then resume.

Throughout the decline--which carried production per worker down to a level 40 percent below that which it had attained in 1929, and which saw the unemployment rise to take in more than a quarter of the labor force--the government did not try to prop up aggregate demand. The Federal Reserve did not use open market operations to keep the money supply from falling. Instead the only significant systematic use of open market operations was in the other direction: to raise interest rates and discourage gold outflows after the United Kingdom abandoned the gold standard in the fall of 1931. The Federal Reserve thought it knew what it was doing: it was letting the private sector handle the Depression in its own fashion. It saw the private sector's

task as the "liquidation" of the American economy. And it feared that expansionary monetary policy would impede the necessary private-sector process of readjustment.



Contemplating the wreck of his country's economy and his own political career, Herbert Hoover wrote bitterly in retrospect about those in his administration who had advised inaction during the downslide:

The 'leave-it-alone liquidationists' headed by Secretary of the Treasury Mellon 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 held that even 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'

But Hoover had been one of the most enthusiastic proponents of "liquidationism" during the Great Depression. And the unwillingness to use policy to prop up the economy during the slide into the Depression was backed by a large chorus, and approved by the most eminent economists.

For example, from Harvard Joseph Schumpeter argued that there was a "presumption *against* remedial measures which work through money and credit. Policies of this class are particularly apt to produce additional trouble for the future." From Schumpeter's perspective, "depressions are not simply evils, which we might attempt to suppress, but forms of something which has to be done, namely, adjustment to change." This socially productive function of depressions creates "the chief difficulty" faced by economic policy makers. For "most of what would be effective in remedying a depression would be equally effective in preventing this adjustment."

From London, Friedrich Hayek found it:

...still more difficult to see what lasting good effects can come from credit expansion. The thing which is most needed to secure healthy conditions is the most speedy and complete adaptation possible of the structure of production. If the proportion as determined by the voluntary decisions of individuals is distorted by the creation of artificial demand resources [are] again led into a wrong direction and a definite and lasting adjustment is again postponed. The only way permanently to 'mobilise' all available resources is, therefore to leave it to time to effect a permanent cure by the slow process of adapting the structure of production...

Hayek and company believed that enterprises are gambles which sometimes fail: a future comes to pass in which certain investments should not have been made. The best that can be done in such circumstances is to shut down those production processes that turned out to have been based on assumptions about future demands that did not come to pass. The liquidation of such investments and businesses releases factors of production from unprofitable uses; they can then be redeployed in other sectors of the technologically dynamic economy. Without the initial liquidation the redeployment cannot take place. And, said Hayek, depressions *are* this process of liquidation and preparation for the redeployment of resources.

As Schumpeter put it, policy does not allow a choice between depression and no depression, but between depression now and a worse depression later: "inflation pushed far enough [would] undoubtedly turn depression into the sham prosperity so familiar from European postwar experience, [and]... would, in the end, lead to a collapse worse than the one it was called in to remedy." For "recovery is sound only if it does come of itself. For any revival which is merely due to artificial stimulus leaves part of the work of depressions undone and adds, to an undigested remnant of maladjustment, new maladjustment of its own which has to be liquidated in turn, thus threatening business with another [worse] crisis ahead"

This doctrine--that in the long run the Great Depression would turn out to have been "good medicine" for the economy, and that proponents of stimulative policies were shortsighted enemies of the public welfare--drew anguished cries of dissent from those less hindered by their theoretical blinders. British economist Ralph Hawtrey scorned those who, like Robbins and Hayek, wrote at the nadir of the Great Depression that the greatest danger the economy faced was inflation. It was, Hawtrey said, the equivalent of "Crying, 'Fire! Fire!' in Noah's flood."

John Maynard Keynes also tried to bury the liquidationists in ridicule. Later on Milton Friedman would recall that at the Chicago where he went to graduate school such dangerous nonsense was not taught--but that he understood why at Harvard--where such nonsense was taught--bright young economists might rebel, reject their teachers' macroeconomics, and become followers of Keynes. Friedman thought that Keynesianism was wrong--but not crazy.

However, the "liquidationist" view carried the day. Even governments that had unrestricted international freedom of action--like France and the United States with their massive gold reserves--tended not to pursue expansionary monetary and fiscal policies on the grounds that such would reduce investor "confidence" and hinder the process of liquidation, reallocation, and the resumption of private investment.

Debt-Deflation

Thus governments strained their muscles to balance their budgets--thus further depressing demand--and to reduce wages and prices--in order to restore "competitiveness" and balance to their economies. In Germany the Chancellor--the Prime Minister--Heinrich Bruening decreed a ten percent cut in prices, and a ten to fifteen percent cut in wages. But every step taken in pursuit of financial orthodoxy made matters worse.

For once the declines in wages and prices in the Great Depression had passed some critical value, they knocked the economy out of its normal business-cycle pattern. Severe deflation had consequences that were much more than an amplification of the modest five to ten percent falls in prices that had been seen in past depressions.

When banks make loans, they allow beforehand for some measure of fluctuation in the value of the assets pledged as security for their loans: even some diminution of the value of their collateral will not cause banks to panic, because if the borrower defaults they will still be able to recover their loan principal as long as the decline in the value of the collateral is not too high.

But what happens when deflation reaches the previously never seen amount of thirty, forty, or fifty percent--as it did in the Great Depression? Banks become keenly aware that their loan principal is no longer safe: that if the borrower defaults, they no longer have recourse to sufficient collateral to recover their loan principal. If the borrower defaults, and if bank depositors take the default as a signal that it is time for them to withdraw their deposits, the bank collapses.

As Keynes, wrote, once banks realize that deflation has significantly impaired the value of their collateral:

...they become particularly anxious that the remainder of their assets should be as liquid and as free from risk as it is possible to make them. This reacts in all sorts of silent and unobserved ways on new enterprise. For it means that banks are less willing than they would normally be to finance any project...

In looking at the tracks of interest rates in the Great Depression, you can see a steady widening of the gap between safe interest rates on government securities and the interest rates that borrowing companies had to pay. Even though credit was ample--in the sense that borrowers with perfect and unimpaired collateral could obtain loans at extremely low interest rates--the businesses in the economy (few of which had perfect and unimpaired collateral) found it next to impossible to obtain capital to finance investment.

Thus the banking system freezes up. It no longer performs its social function of channeling purchasing power from savers to investors. As a result private investment collapses; falling investment produces more unemployment, excess capacity, further falls in prices, and more deflation; and further deflation renders the banking system even more insolvent.

Moreover, not only past deflation but also expected future deflation depresses investment. Why invest now if you expect deflation, so that everything you would buy this year will be ten percent cheaper next year?

In the end the spiral of deflation will continue to depress the economy until something is done to restore solvency to the banking system, and break the anticipations of further falls in prices. A few economists understood this process at work during the Great Depression--Irving Fisher, John Maynard Keynes, R.G. Hawtrey--but they did not walk the corridors of power at the nadir of the Great Depression.

Golden Fetters

Countries without massive gold reserves did not have the luxury of even attempting to expand their economies, at least not until they abandoned the gold standard, let their exchange rates float freely, and so cast off their "golden fetters." A government that wished to stimulate demand in the Great Depression would seek to inject credit and bring down interest rates to encourage investment. But additional credit would mean higher imports, and lower interest rates would encourage domestic investors to invest abroad. The result would be a balance-of-payments gap: economic expansion at home was inconsistent with gold convertibility. And few countries wished to abandon the gold standard at the start of the Great Depression.

There were exceptions that proved the rule. Scandinavian countries cast off their "golden fetters" at the start of the Great Depression, pursued policies of stabilizing nominal demand under the intellectual influence of the Stockholm School of economists, and did relatively well. In Japan fiscal orthodoxy and budget balance were abandoned in 1931, when Korekiyo Takahashi became Minister of Finance. Industrial production in Japan in 1936 was half again as much as it had been in 1928; in Japan the Great Depression was over by 1932.

But these were unusual exceptions.

Before World War I the major industrial economies *might* have had some freedom of action. Before the war major industrial countries' commitment to the gold standard was unquestioned. Whenever an exchange rate fell to the lowest "gold point", the bottom of the band and the point at which it was profitable to begin shipping gold out of the country, capital would flow in betting on the future recovery of the exchange rate to the mid-point of its band, making the central bank's task of maintaining convertibility easy.

But in the 1920s, with governments under greater pressure from newly expanded electorates to generate prosperity, it was not clear that the country was committed to the gold standard. Speculators, instead, began to pull their capital out of a country facing a balance-of-payments deficit, on the principal that the loss they would suffer should the currency recovery would be dwarfed by their profits if they could take advantage of a full-fledged devaluation.

With the growth of concern about currencies, central bankers wondered if the *gold-exchange standard*--by which they kept their reserves in sterling or in dollars--was wise. What if the pound or the dollar devalued? As the Great Depression gathered force, central banks fell back on gold as their principal reserve, increasing strains on the system.

One might have thought that those countries that had restored their pre-World War I parities would be immune from destabilizing speculation. Had not Britain returned to the gold standard at the pre-World War I parity precisely to give investors confidence that its commitment to the gold standard was absolute? But governments like Britain and the United States that had maintained pre-World War I parities found themselves lacking credibility. Because they had not experienced the 1920s as a decade of inflation, they lacked the tacit political consensus that inflation was to be avoided at all costs. By contrast countries that had undergone inflation in the 1970s found for the most part that they had high credibility, and that their exchange rates came under little speculative attack.

Austria's major bank, the Credit Anstalt, was revealed to be bankrupt in May 1931. Its deposits were so large that freezing them while bankruptcy was carried through would have destroyed the Austrian economy, hence the government stepped in to guarantee deposits. The resulting expansion of the currency was inconsistent with gold-standard discipline. Savers liquidated their deposits and began to transfer funds out of the country in order to avoid the capital losses that would have been associated with a devaluation.

In order to keep its banking system from collapsing and in order to defend the gold standard, the Austrian central bank needed more gold to serve as an internal reserve to keep payments flowing and an external reserve to meet the demand triggered by incipient capital flight. The Bank for International Settlements began to host negotiations to coordinate international financial cooperation.

It is possible that rapid and successful conclusion of these negotiations might have stopped the spread of the Great Depression in mid-1931. Austria was a small country with a population well under ten million. There was not that much capital to flee. A sizable international loan to Austria's central bank would have allowed it to prop up its internal banking system and maintain convertibility. A month later those whose capital had fled would realize that the crisis was over, and that they had lost a percent or two of their wealth in fees and exchange costs in the capital flight. Other speculators would observe that the world's governments were serious in their commitment to the gold standard, that the potential foreign exchange reserves of any one country were the world's, and thus that the likelihood of a speculative attack succeeding in inducing a devaluation was small.

Perhaps investors would then have begun returning gold to central banks in exchange for interest-bearing assets, would have begun to shrink down their demand for liquidity, and would have begun to boost worldwide investment. The *Economist's* Berlin correspondent thought that it might well have done the job:

It was clear from the beginning... that such an institution [as the Credit-Anstalt] could not collapse without the most serious consequences, but the fire might have been localized if the fire brigade had arrived quickly enough on the scene. It was the delay of several weeks in rendering effective international assistance to the Credit Anstalt which allowed the fire to spread so widely.

We don't know because it was not tried. The substantial loan to Austria was not made. Speculators continued to bet on devaluation, investors continued to hoard gold, the preference for liquidity continued to rise, and investment continued to fall.

The substantial loan to Austria was not made because French internal politics entered the picture. At the beginning of his political career French Premier Pierre Laval had styled himself a politician of the left: the Clarence Darrow of France. But by the early 1930s he was shifting to the position of a strong nationalist. He blocked the proposed international support package for Austria, insisting that if France was to contribute France had to get something out of it. The price that Laval demanded was made up of a series of diplomatic concessions, most important of which was the renunciation of a prospective customs union with Germany. To Laval, playing the nationalist card in French politics, nothing that benefited Germany could be allowed by France.

The Austrian government refused to make the required political concessions fast enough for negotiations to be completed in time to be of use. Austria lost: the support package collapsed, and the Austrian economy abandoned the gold standard and went into recession. In the long run France lost too: what might have been a chance to moderate the Great Depression was lost. The ultimate consequences for France were dire. The rise of Adolf Hitler in Germany is inconceivable in the absence of the Great Depression. Nine years after the Credit-Anstalt crisis

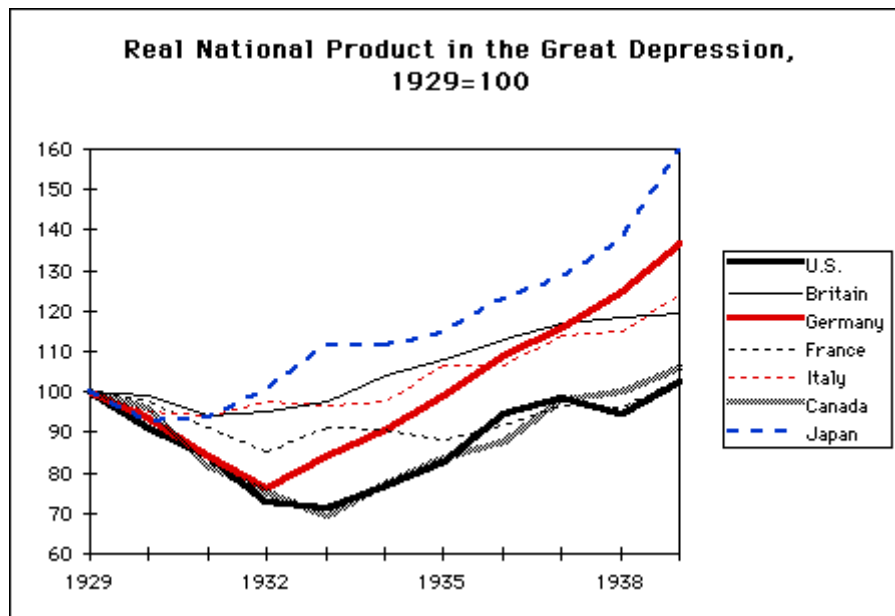
the French governmentsurrendered to the Nazis.

Pierre Laval was not greatly inconvenienced at first by the Nazi conquest of Europe. He discovered that he was not a leftist at all but a Fascist. He became the second most powerful figure, and the true focus of decision making, in France's wartime collaborationist Vichy government. He was executed for treason after the end of World War II.

Back in 1931, speculators observed that the international financial community did *not* support currencies that came under pressure. They wondered which country would be next to devalue--and thus which country to pull their money out of fast if they did not want to lose the thirty percent or so of gold value that would be lost in a devaluation. The wave of bear speculation moved on to Hungary, Germany, and Britain. By the fall of 1931 Britain had abandoned the gold standard.

Thus international capital flows--in this case driven by fear of being caught in a devaluation--triggered devaluations and brought down the interwar gold standard. In a well-functioning gold standard, such impulses would have been damped by the credibility of the commitment to gold and by international cooperation. But in the early 1930s the commitment to gold had no credibility. And there was no international cooperation.

In the absence of international cooperation, the legacy of the gold standard was to make it impossible for any country to fight the Depression within its borders. Stimulative monetary and fiscal policies were inconsistent with the gold standard. And efforts to contain domestic banking crises were thwarted and rendered counterproductive because of the fear that rescuing the banking system or lowering interest rates was the prelude to devaluation.



As Eichengreen has pointed out, once countries had cast off the golden fetters of the interwar gold standard, the crisis was transformed into an opportunity. Policies to expand demand and production no longer required international cooperation once the gold standard framework had been abandoned. But as he has also pointed out, "liquidationism"--and fears of financial and political chaos--kept governments from beginning to fight the Depression in a serious manner for much of the 1930s.

The Great Depression is the greatest case of self-inflicted economic catastrophe in the twentieth century. As Keynes wrote at its very start, in 1930, the world was "... as capable as before of affording for every one a high standard of life.... But today we have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand." Keynes feared that "the slump" that he saw in 1930 "may pass over into a depression, accompanied by a sagging price level, which might last for years with untold damage to the material wealth and to the social stability of every country alike." He called for resolute, coordinated monetary expansion by the major industrial economies to "restore confidence in the international long-term bond market... restore [raise] prices and profits, so that in due course the wheels of the world's commerce would go round again."

Charles Kindleberger has pointed out that such action never emerges from committees, or from international meetings. Before World War I the international gold standard was kept on track because there was a single, obvious, dominant power in the world economy: Britain. Everybody knew that Britain was the "hegemon", and so everyone adjusted their behavior to conform with the rules of the game and the expectations of behavior laid down in London. Similarly, after World War II the "hegemon" for more than a full generation was the United States. And once again, the existence of a dominant power in international finance--a power that had the capability to take effective action to shape the pattern of international finance all by itself if it wished--led to a relatively stable and well-functioning system.

But during the interwar period there was no hegemon: no power could shape the international economic environment through its own actions alone. Britain tried, attempting to restore confidence in the gold standard by the restoration of sterling, and failed. America might have succeeded had it tried--but successful policy requires that the hegemon recognize its leading position, which the interwar U.S. did not do. Thus "resolute, coordinated" action to expand demand and halt the depression did not emerge from the leading industrial power. And it was very unlikely to be generated by any committee operating via consensus.

So the action was not forthcoming. And Keynes's fears came to pass.

The Persistence of the Great Depression

The "liquidationist" monetary-overinvestment view of business cycles collapsed in the Great Depression. It had provided a framework for economists to analyze the busts of the nineteenth and early twentieth century, but its interpretation of the Great Depression was absurd. Periods of high unemployment lasted not for months or years but for decades. They lasted too long to be dismissed as frictions that resulted as the market reallocated productive resources away from what were now seen as low value goods.

In response to the high persistence of unemployment in the interwar years, economists abandoned the idea that business cycles were the economy's best feasible response to inevitable shocks to present circumstances and expectations about the future, and that the Great Depression had been generated by the largest such shock ever seen. Instead, they turned to alternative--Keynesian--approaches to explain the persistence of high unemployment, even though these alternative approaches were not so much theories of business cycles as policy recommendations accompanied by promises that supporting theories would be constructed later.

Economists today have faith in market economies' abilities to eventually cure depressions even in the presence of unsound economic policies. Depressions and high unemployment arise when markets malfunction, or fail to find the correct equilibrium. But excess supply of labor and excess supply of goods should eventually register. Economists track channel after channel through which the market economic system can right itself from a depression and restore full employment equilibrium. How well did these "natural" full employment equilibrium-restoring forces work in the Great Depression?

The answer is: not at all well.

Some nations--Scandinavian countries that abandoned the gold standard early--experienced the Great Depression as little more than an ordinary recession, albeit in some cases beginning from a position of relatively high unemployment in 1929. The collapse of international trade in the 1930s idled resources in specialized export industries, but for countries that had abandoned the gold standard early domestic manufacturing took up the slack and returned GNP and employment to relatively high levels by the middle of the decade. These fortunate nations experienced the Great Depression as more-or-less another episode of "normal" cyclical unemployment in response to a large shock, in this case the world market's signal that export sectors were too large.

Other countries--largely nations like the United States and France that remained on the gold standard beyond 1930-31--were not so fortunate. Their unemployment rose to and remained at levels that seemed too high to square with the normal mechanisms of standard business cycles. Their experience was a key factor leading economists away from "monetary overinvestment" theories and toward "underemployment semi-equilibrium" theories.

Even granted that policies to fight the Great Depression were not forthcoming, the persistence of the Depression still comes as a shock. In a normal pre-Great Depression business cycle, the economy closes 97% of the gap back to usual employment in three years. But the Depression shows a different picture: the economy closed only half of the gap back to full employment in three years.

It is helpful to group the explanations for why Depression-era unemployment was so high and lasted so long along two axes: there are two candidates to take the blame for the persistence of unemployment during the Depression: the government, and the market.

Government-generated unemployment was widespread. In Britain some unemployment (although a small share during the peak unemployment years of the early 1930's) was surely generated by the government's unemployment insurance system. Thomas cites Eichengreen's earlier work, which presented a best estimate that some two or three percentage points of unemployment in 1929-32 could be attributed to the operation of the relief system. Thomas attributes some unemployment among secondary workers and unskilled young men with large families to the "OXO" system in which firms would systematically rotate two platoons of workers between time at work and time receiving unemployment benefit, thus turning unemployment insurance into a highly-subsidized work sharing scheme. Men receiving the standard unemployment benefit in February 1931 had on average experienced 8.6 different spells of employment during the past year, working an average of 151 days. Given such rapid turnover it is not at all implausible to argue that the availability of unemployment benefit, even with relatively low replacement rates, allowed workers to remain in labor market positions in which they were employed only half the time instead of migrating to some other industry. Thus it is possible that an underlying four or five percent of excess British unemployment may well have been maintained by the government's social policy.

In the United States even at the very end of the Depression unemployment was high. In the 1940 census some 11.1% of U.S. heads of household were counted as unemployed, of whom almost half-4.9% of all heads of household-held relief jobs. Michael Darby has argued that the government had managed to create a situation in which those on relief found themselves with little incentive to register their labor supply on the private-sector job market, and yet were doing little socially productive work. Relief jobs were attractive to many, in spite of their low levels of relief wages relative to average private sector wages. Relief jobs were secure and required little skill. The risk-averse or the lesser-skilled might well have found that their best option was to stay on relief jobs, and be counted as unemployed, rather than take even an immediately available private sector job.

In each of these cases there is no clear alternative way of organizing the unemployment insurance system that would have been a clearly better policy. A good society should offer support to those blocked from earning their wages in the market. And a well-functioning economy should create incentives for the unemployed to strongly register their excess supply of

labor in the market. These two goals are inevitably in tension. The inescapable problem was that relief payments were too high for the short-term and too low for the long-term unemployed, and that there was no good way to structure relief programs to tell these two groups apart *ex ante*. William Beveridge was among the first to lay out the policy dilemma: the long-term unemployed "need... more money rather than less than those who have had short periods of unemployment. Yet they can hardly be given more money without... [creating an incentive] to settle down into permanent unemployment." Moreover, few of the long-term unemployed "escape physical and psychological deterioration through long idleness."

Nevertheless, a large part of the puzzle remains: roughly half of Depression unemployment was concentrated among long-term unemployed who could not take advantage of subsidized relief-work schemes.

This form of unemployment, principally long-term and somewhat of a residual category is, in the eyes of Eichengreen and Hatton and their contributors, the key to the persistence of the Depression. Long-term unemployment was strongly present in those countries that suffered worst from the Depression, including non-European nations like Australia, Canada, and the United States and European nations like Britain, Germany, Italy, and the gold block nations of France and Belgium. Of these only Germany achieved a strong recovery from the Depression in the 1930's.

Long-term unemployment means that the burden of economic dislocation is unequally borne. Since the prices workers must pay often fall faster than wages, the welfare of those who remain employed frequently rises in a depression. Those who become and stay unemployed bear far more than their share of the burden of a depression. Moreover the reintegration of the unemployed into even a smoothly-functioning market economy may prove difficult, for what employer would not prefer a fresh entrant into the labor force to someone out of work for years? The simple fact that an economy has recently undergone a period of mass unemployment may make it difficult to attain levels of employment and boom that a luckier economy attains as a matter of course. Once an economy had fallen deeply into the Great Depression, devalued exchange rates, prudent and moderate government budget deficits (as opposed to the deficits involved in fighting major wars), and the passage of time all appeared equally ineffective ways of dealing with long-term unemployment. Highly centralized and unionized labor markets like Australia's and decentralized and *laissez-faire* labor markets like that of the United States did equally poorly in dealing with long-term unemployment. Fascist "solutions" were equally unsuccessful, as the case of Italy shows, unless accompanied by rapid rearmament as in Germany.

Even today, economists have no clean answers to the question of why the private sector could not find ways to employ its long-term unemployed. The very extent of persistent unemployment in spite of different labor market structures and national institutions suggests that theories that find one key failure responsible should be taken with a grain of salt.



But should we be surprised that the long-term unemployed do not register their labor supply proportionately strongly? They might accurately suspect that they will be at the end of every selection queue. In the end it was the coming of World War II and its associated demand for military goods that made private sector employers wish to hire the long-term unemployed at wages they would accept.

At first the unemployed searched eagerly and diligently for alternative sources of work. But if four months or so passed without successful reemployment, the unemployed tended to become discouraged and distraught. After eight months of continuous unemployment, the typical unemployed worker still searches for a job, but in a desultory fashion and without much hope. And within a year of becoming unemployed the worker is out of the labor market for all practical purposes: a job must arrive at his or her door, grab him or her by the scruff of the neck, and through him or her back into the nine-to-five routine if he or she is to be employed again.

This is the pattern of the long-term unemployed in the Great Depression; this is the pattern of the long-term unemployed in western Europe in the 1990s. It appears to take an extraordinarily high-pressure labor market, like that of World War II, to successfully reemploy the long-term unemployed.

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