

The New Deal: Lessons for Today

J. Bradford DeLong

University of California at Berkeley and NBER
brad.delong@gmail.com
<http://delong.typepad.com>
+1 925 708 0467

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Drawing lessons from the New Deal for the Great Depression requires, first, understanding what the New Deal was. It was a gumbo: 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. 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 counterproductive 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:

¹ John Maynard Keynes (1938), “Private Letter to Franklin Delano Roosevelt of February 1” <<http://tinyurl.com/dl20090325a>>.

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. Before the Great Depression none of the major industrial powers of the world pursued 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 balanced 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

² John Maynard Keynes (1933), “Open Letter to Franklin Delano Roosevelt of December 31” <<http://tinyurl.com/dl20090325b>>.

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. We know how quickly each of them recovered from the Great Depression. There is a perfect rank correlation between how early a country abandoned gold and how rapid and complete its recovery was, as this chart that I have added to from Eichengreen (1992) shows.³

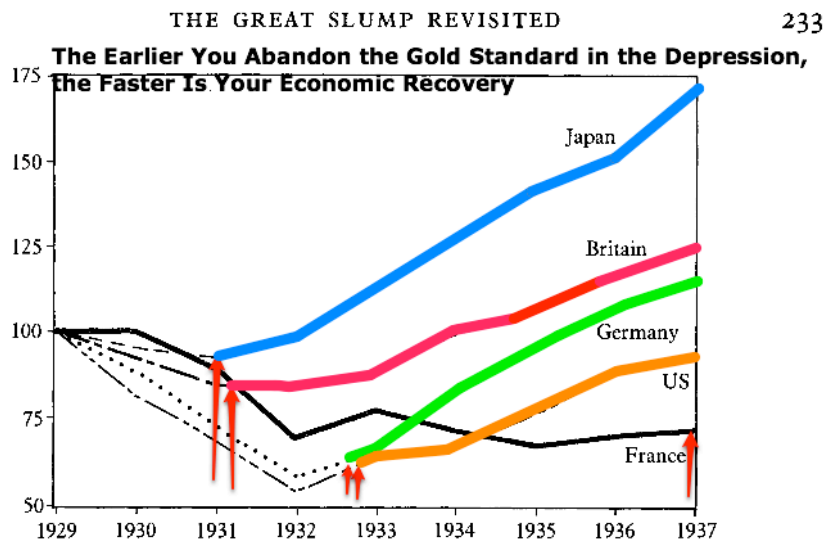


Figure 5. *Indices of industrial production, 1929-1937* (1929 = 100)
 Source: League of Nations, *World production and prices, 1937/8*, p. 44.

Such a perfect rank correlation would happen only one time in 120 if there were really no connection between a country’s adoption of a New Deal and economic recovery from the Great Depression. Statisticians will tell you that if you thought before looking at the evidence summarized in this perfect rank correlation that there was only one chance in ten that New

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

Deals mattered for recovery, then after looking at this evidence you should rationally be 93.023% sure that New Deals mattered.

We are pretty sure that all four components of macroeconomic policy helped. It is hard to write down a model of the economy in which conventional monetary policy expansion aids recovery but fiscal policy expansion does 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 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 6.9767% 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

⁴ See Christina D. Romer (19920, “What Ended the Great Depression?” *Journal of Economic History* 52:4 (December, pp. 757-784 <<http://www.jstor.org/stable/2123226>>.

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 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 from 2.9% up to 22.9% from 1929 to 1932. Monetary expansion and banking reform then drove the unemployment rate down to 9.5% by the start of large-scale mobilization in 1940. And wartime government expenditure and deficits drove the unemployment rate down to 1.2% by 1944.

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

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.

3. It is important not to let debates over reform block measures for recovery. Desirable reforms are always worth pursuing—and especially worth pursuing in times when the bounds of the politically possible are widened and thus previously-unattainable but always desirable reforms come within reach. But the policies that aid recovery the most and the fastest are likely to be different from the policies that enact desirable longer-term reforms.

1831 words,