The Great Depression

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Although the Great Depression engulfed the world economy many years ago, it lives on as a nightmare for individuals old enough to remember and as a frightening specter in the textbooks of our youth.

Some 13 million Americans were unemployed, "not wanted" in the production process. One worker out of every four was walking the streets in want and despair. Thousands of banks, hundreds of thousands of businesses, and millions of farmers fell into bankruptcy or ceased operations entirely.

Nearly everyone suffered painful losses of wealth and income.

Many Americans are convinced that the Great Depression reflected the breakdown of an old economic order built on unhampered markets, unbridled competition, speculation, property rights, and the profit motive. According to them, the Great Depression proved the inevitability of a new order built on government intervention, political and bureaucratic control, human rights, and government welfare. Such persons, under the influence of Keynes, blame businessmen for precipitating depressions by their selfish refusal to spend enough money to maintain or improve the people's purchasing power. This is why they advocate vast governmental expenditures and deficit spending — resulting in an age of money inflation and credit expansion.

Classical economists learned a different lesson. In their view, the Great Depression consisted of four consecutive depressions rolled into one. The causes of each phase differed, but the consequences were all the same: business stagnation and unemployment.

The Business Cycle

The first phase was a period of boom and bust, like the business cycles that had plagued the American economy in 1819–1820, 1839–1843, 1857–1860, 1873–1878, 1893–1897, and 1920–1921. In each case, government had generated a boom through easy money and credit, which was soon followed by the inevitable bust.

The spectacular crash of 1929 followed five years of reckless credit expansion by the Federal Reserve System under the Coolidge administration. In 1924, after a sharp decline in business, the Reserve banks suddenly created some $500 million in new credit, which led to a bank credit expansion of over $4 billion in less than one year. While the immediate effects of this new powerful expansion of the nation's money and credit were seemingly beneficial, initiating a new economic boom and effacing the 1924 decline, the ultimate outcome was most disastrous. It was the beginning of a monetary policy that led to the stock-market crash in 1929 and the following depression. In fact, the expansion of Federal Reserve credit in 1924 constituted what Benjamin Anderson in his great treatise on recent economic history (*Economics and the Public Welfare*, D. Van Nostrand, 1949) called "the beginning of the New Deal."

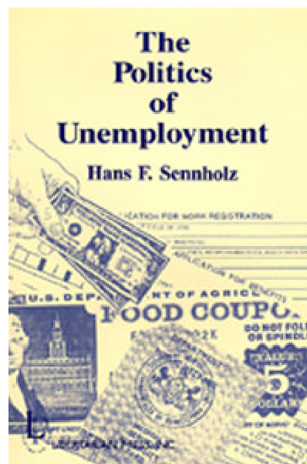
The Federal Reserve credit expansion in 1924 also was designed to assist the Bank of England in its professed desire to maintain prewar exchange rates. The strong US dollar and the weak British pound were to be readjusted to prewar conditions through a policy of inflation in the United States and deflation in Great Britain.

The Federal Reserve System launched a further burst of inflation in 1927, the result being that total currency outside banks plus demand and time deposits in the United States increased from $44.51 billion at the end of June 1924, to $55.17 billion in 1929. The volume of farm and urban mortgages expanded from $16.8 billion in 1921 to $27.1 billion in 1929. Similar increases occurred in industrial, financial, and state and local government indebtedness. This expansion of money and credit was accompanied by rapidly rising real-estate and stock prices. Prices for industrial securities, according to Standard & Poor's common stock index, rose from 59.4 in June of 1922 to 195.2 in September of 1929. Railroad stock climbed from 189.2 to 446.0, while public utilities rose from 82.0 to 375.1

A Series of False Signals

The vast money and credit expansion by the Coolidge administration made 1929 inevitable. Inflation and credit expansion always precipitate business maladjustments and malinvestments that must later be liquidated. The expansion artificially reduces and thus falsifies interest rates, and thereby misguides businessmen in their investment decisions. In the belief that declining rates indicate growing supplies of capital savings, they embark upon new production projects. The creation of money gives rise to an economic boom. It causes prices to rise, especially prices of capital goods used for business expansion. But these prices constitute business costs. They soar until business is no longer profitable, at which time the decline begins. In order to prolong the boom, the monetary authorities may continue to inject new money until finally frightened by the prospects of a runaway inflation. The boom that was built on the quicksand of inflation then comes to a sudden end.

The ensuing recession is a period of repair and readjustment. Prices and costs adjust anew to consumer choices and preferences.



(http://store.mises.org/Politics-of-Unemployment-The--P79.aspx)

And above all, interest rates readjust to reflect once more the actual supply of and demand for genuine savings. Poor business investments are abandoned or written down. Business costs, especially labor costs, are reduced through greater labor productivity and managerial efficiency, until business can once more be profitably conducted, capital investments earn interest, and the market economy function smoothly again.

After an abortive attempt at stabilization in the first half of 1928, the Federal Reserve System finally abandoned its easy-money policy at the beginning of 1929. It sold government securities and thereby halted the bank credit expansion. It raised its discount rate to 6 percent in August 1929. Time-money rates rose to 8 percent, commercial paper rates to 6 percent, and call rates to the panic figures of 15 percent and 20 percent. The American economy was beginning to readjust. In June 1929, business activity began to recede. Commodity prices began their retreat in July.

The security market reached its high on September 19 and then, under the pressure of early selling, slowly began to decline. For five more weeks, the public nevertheless bought heavily on the way down. More than 100 million shares were traded at the New York Stock Exchange in September. Finally it dawned upon more and more stockholders that the trend had changed. Beginning with October 24, 1929, thousands stampeded to sell their holdings immediately and at any price. Avalanches of selling by the public swamped the ticker tape. Prices broke spectacularly.

Liquidation and Adjustment

The stock market break signaled the beginning of a readjustment long overdue. It should have been an orderly liquidation and adjustment followed by a normal revival. After all, the financial structure of business was very strong. Fixed costs were low as business had refunded a good many bond issues and had reduced debts to banks with the proceeds of the sale of stock. In the following months, most business earnings made a reasonable showing. Unemployment in 1930 averaged under 4 million, or 7.8 percent of labor force.

In modern terminology, the American economy of 1930 had fallen into a mild recession. In the absence of any new causes for depression, the following year should have brought recovery as in previous depressions. In 1921–1922, the American economy recovered fully in less than a year. What, then, precipitated the abysmal collapse after 1929? What prevented the price and cost adjustments and thus led to the second phase of the Great Depression?

Disintegration of the World Economy

The Hoover administration opposed any readjustment. Under the influence of "the new economics" of government planning, the president urged businessmen *not* to cut prices and reduce wages, but rather to increase capital outlay, wages, and other spending in order to maintain purchasing power. He embarked upon deficit spending and called upon municipalities to increase their borrowing for more public works. Through the Farm Board, which Hoover had organized in the autumn of 1929, the federal government tried strenuously to uphold the prices of wheat, cotton, and other farm products. The GOP tradition was further invoked to curtail foreign imports.

The Smoot-Hawley Tariff Act of June 1930, raised American tariffs to unprecedented levels, which practically closed our borders to foreign goods. According to most economic historians, this was the crowning folly of the whole period from 1920 to 1933 and the beginning of the real depression. "Once we raised our tariffs," wrote Benjamin Anderson,

> an irresistible movement all over the world to raise tariffs and to erect other trade barriers, including quotas, began. Protectionism ran wild over the world. Markets were cut off. Trade lines were narrowed. Unemployment in the export industries all over the world grew with great rapidity. Farm prices in the United States dropped sharply through the whole of 1930, but the most rapid rate of decline came following the passage of the tariff bill.

When President Hoover announced he would sign the bill into law, industrial stocks broke 20 points in one day. The stock market correctly anticipated the depression.

The protectionists have never learned that curtailment of imports inevitably hampers exports. Even if foreign countries do not immediately retaliate for trade restrictions injuring them, their foreign purchases are circumscribed by their ability to sell abroad. This is why the Smoot-Hawley Tariff Act which closed our borders to foreign products also closed foreign markets to our products. American exports fell from $5.5 billion in 1929 to $1.7 billion in 1932. American agriculture customarily had exported over 20 percent of its wheat, 55 percent of its cotton, 40 percent of its tobacco and lard, and many other products. When international trade and commerce were disrupted, American farming collapsed. In fact, the rapidly growing trade restrictions, including tariffs, quotas, foreign-exchange controls, and other devices were generating a worldwide depression.

Agricultural commodity prices, which had been well above the 1926 base before the crisis, dropped to a low of 47 in the summer of 1932. Such prices as $2.50 a hundredweight for hogs, $3.28 for beef cattle, and 32¢ a bushel for wheat plunged hundreds of thousands of farmers into bankruptcy. Farm mortgages were foreclosed until various states passed moratoria laws, thus shifting the bankruptcy to countless creditors.

Rural Banks in Trouble

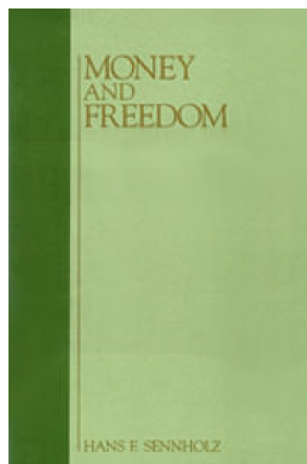
The main creditors of American farmers were, of course, the rural banks. When agriculture collapsed, the banks closed their doors. Some 2,000 banks, with deposit liabilities of over $1.5 billion, suspended between August 1931, and February 1932. Those banks that remained open were forced to curtail their operations sharply. They liquidated customers' loans on securities, contracted real-estate loans, pressed for the payment of old loans, and refused to make new ones. Finally, they dumped their most marketable bond holdings on an already depressed market. The panic that had engulfed American agriculture also gripped the banking system and its millions of customers.

The American banking crisis was aggravated by a series of events involving Europe. When the world economy began to disintegrate and economic nationalism ran rampant, European debtor countries were cast in precarious payment situations. Austria and Germany ceased to make foreign payments and froze large English and American credits; when England finally suspended gold payments in September 1931, the crisis spread to the United States. The fall in foreign bond values set off a collapse of the general bond market, which hit American banks at their weakest point — their investment portfolios.

Depression Compounded

Nineteen Thirty-One was a tragic year. The whole nation, in fact, the whole world, fell into the cataclysm of despair and depression. American unemployment jumped to more than 8 million and continued to rise. The Hoover administration, summarily rejecting the thought that it had caused the disaster, labored diligently to place the blame on American businessmen and speculators. President Hoover called together the nation's industrial leaders and pledged them to adopt his program to maintain wage rates and expand construction. He sent a telegram to all the governors, urging cooperative expansion of all public-works programs. He expanded federal public works and granted subsidies to ship construction. And for the benefit of the suffering farmers, a host of federal agencies embarked upon price-stabilization policies that generated ever larger crops and surpluses, which in turn depressed product prices even further. Economic conditions went from bad to worse, and unemployment in 1932 averaged 12.4 million.

In this dark hour of human want and suffering, the federal government struck a final blow. The Revenue Act of 1932 doubled the income tax, the sharpest increase in the federal tax burden in American history. Exemptions were lowered, "earned income credit" was eliminated. Normal tax rates were raised from a range of $1^{1}/_{2}$ to 5 percent to a range of 4 to 8 percent, surtax rates from 20 percent to a maximum of 55 percent. Corporation tax rates were boosted from 12 percent to $13^{3}/_{4}$ and $14^{1}/_{2}$ percent. Estate taxes were raised. Gift taxes were imposed with rates from $^{3}/_{4}$ to $33^{1}/_{2}$ percent. A *10 percent* gasoline tax was imposed, a 3 percent automobile tax, a telegraph and telephone tax, a 2¢ check tax, and many other excise taxes. And finally, postal rates were increased substantially.



(http://store.mises.org/Money-and-Freedom-P530.aspx)

When state and local governments faced shrinking revenues, they, too, joined the federal government in imposing new levies. The rate schedules of existing taxes on income and business were increased and new taxes imposed on business income, property, sales, tobacco, liquor, and other products.

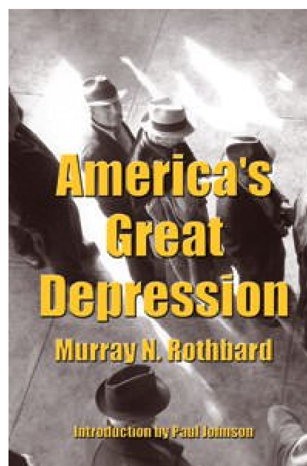
Murray Rothbard, in his authoritative work on *America's Great Depression* (http://store.mises.org/Americas-Great-Depression-P63.aspx) (Van Nostrand 1963), estimates that the fiscal burden of federal, state, and local governments nearly doubled during the period, rising from 16 percent of net private product to 29 percent. This blow, alone, would bring any economy to its knees, and shatters the silly contention that the Great Depression was a consequence of economic freedom.

The New Deal of NRA and AAA

One of the great attributes of the private-property market system is its inherent ability to overcome almost any obstacle. Through price and cost readjustment, managerial efficiency and labor productivity, new savings and investments, the market economy tends to regain its equilibrium and resume its service to consumers. It doubtless would have recovered in short order from the Hoover interventions had there been no further tampering.

However, when Franklin Delano Roosevelt assumed the presidency, he, too, fought the economy all the way. In his first 100 days, he swung hard at the profit order. Instead of clearing away the prosperity barriers erected by his predecessor, he built new ones of his own. He struck in every known way at the integrity of the US dollar through quantitative increases and qualitative deterioration. He seized the people's gold holdings and subsequently devalued the dollar by 40 percent.

With some third of industrial workers unemployed, President Roosevelt embarked upon sweeping industrial reorganization. He persuaded Congress to pass the National Industrial Recovery Act (NIRA), which set up the National Recovery Administration (NRA). Its purpose was to get business to regulate itself, ignoring the antitrust laws and developing fair codes of prices, wages, hours, and working conditions. The president's Re-employment Agreement called for a minimum wage of 40¢ an hour ($12 to $15 a week in smaller communities), a 35-hour work week for industrial workers and 40 hours for white-collar workers, and a ban on all youth labor.



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The Authoritative Work

This was a naive attempt at "increasing purchasing power" by increasing payrolls. But, the immense increase in business costs through shorter hours and higher wage rates worked naturally as an *antirevival* measure. After passage of the act, unemployment rose to nearly 13 million. The South, especially, suffered severely from the minimum-wage provisions. The act forced 500,000 Negroes out of work.

Nor did President Roosevelt ignore the disaster that had befallen American agriculture. He attacked the problem by passage of the Farm Relief and Inflation Act, popularly known as the First Agricultural Adjustment Act. The objective was to raise farm income by cutting the acreages planted or destroying the crops in the field, paying the farmers *not* to plant anything, and organizing marketing agreements to improve distribution. The program soon covered not only cotton, but also all basic cereal and meat production as well as principal cash crops. The expenses of the program were to be covered by a new "processing tax" levied on an already depressed industry.

NRA codes and AAA processing taxes came in July and August of 1933. Again, economic production which had flurried briefly before the deadlines, sharply turned downward. The Federal Reserve index dropped from 100 in July to 72 in November of 1933.

Pump-Priming Measures

When the economic planners saw their plans go wrong, they simply prescribed additional doses of federal pump priming. In his January 1934 budget message, Mr. Roosevelt promised expenditures of $10 billion while revenues were at $3 billion. Yet the economy failed to revive; the business index rose to 86 in May of 1934, and then turned down again to 71 by September. Furthermore, the spending program caused a panic in the bond market, which cast new doubts on American money and banking.

Revenue legislation in 1933 sharply raised income-tax rates in the higher brackets and imposed a 5 percent withholding tax on corporate dividends. Tax rates were raised again in 1934. Federal estate taxes were brought to the highest levels in the world. In 1935, federal estate and income taxes

were raised once more, although the additional revenue yield was insignificant. The rates seemed clearly aimed at the redistribution of wealth.

According to Benjamin Anderson,

> the impact of all these multitudinous measures — industrial, agricultural, financial, monetary and other — upon a bewildered industrial and financial community was extraordinarily heavy. We must add the effect of continuing disquieting utterances by the president. He had castigated the bankers in his inaugural speech. He had made a slurring comparison of British and American bankers in a speech in the summer of 1934…. That private enterprise could survive and rally in the midst of so great a disorder is an amazing demonstration of the vitality of private enterprise.

Then came relief from unexpected quarters. The "nine old men" of the Supreme Court, by unanimous decision, outlawed NRA in 1935 and AAA in 1936. The Court maintained that the federal legislative power had been unconstitutionally delegated and states' rights violated.

These two decisions removed some fearful handicaps under which the economy was laboring. NRA, in particular, was a nightmare with continuously changing rules and regulations by a host of government bureaus. Above all, voidance of the act immediately reduced labor costs and raised productivity as it permitted labor markets to adjust. The death of AAA reduced the tax burden of agriculture and halted the shocking destruction of crops. Unemployment began to decline. In 1935 it dropped to 9.5 million, or 18.4 percent of the labor force, and in 1936 to only 7.6 million, or 14.5 percent.

A New Deal for Labor

The third phase of the Great Depression was thus drawing to a close. But there was little time to rejoice, for the scene was being set for another collapse in 1937 and a lingering depression that lasted until the day of Pearl Harbor. More than 10 million Americans were unemployed in 1938, and more than 9 million in 1939.

The relief granted by the Supreme Court was merely temporary. The Washington planners could not leave the economy alone; they had to earn the support of organized labor, which was vital for reelection.

The Wagner Act of July 5, 1935, earned the lasting gratitude of labor. This law revolutionized American labor relations. It took labor disputes out of the courts of law and brought them under a newly created federal agency, the National Labor Relations Board, which became prosecutor, judge, and jury, all in one. Labor-union sympathizers on the board further perverted the law that already afforded legal immunities and privileges to labor unions. The United States thereby abandoned a great achievement of Western civilization: equality under the law.

"The vast money and credit expansion by the Coolidge administration made 1929 inevitable."

The Wagner Act, or National Labor Relations Act, was passed in reaction to the Supreme Court's voidance of NRA and its labor codes. It aimed at crushing all employer resistance to labor unions. Anything an employer might do in self-defense became an "unfair labor practice" punishable by the board. The law not only obliged employers to deal and bargain with the unions designated as the employees' representative; later board decisions also made it unlawful to resist the demands of labor-union leaders.

Following the election of 1936, the labor unions began to make ample use of their new powers. Through threats, boycotts, strikes, seizures of plants, and outright violence committed in legal sanctity, they forced millions of workers into membership. Consequently, labor productivity declined

and wages were forced upward. Labor strife and disturbance ran wild. Ugly sit-down strikes idled hundreds of plants. In the ensuing months, economic activity began to decline and unemployment again rose above the ten-million mark.

But the Wagner Act was not the only source of crisis in 1937. President Roosevelt's shocking attempt at packing the Supreme Court, had it been successful, would have subordinated the judiciary to the executive. In the US Congress, the president's power was unchallenged. Heavy Democratic majorities in both houses, perplexed and frightened by the Great Depression, blindly followed their leader. But when the president strove to assume control over the judiciary, the American nation rallied against him, and he lost his first political fight in the halls of Congress.

There was also his attempt at controlling the stock market through an ever-increasing number of regulations and investigations by the Securities and Exchange Commission. "Insider" trading was barred, high and inflexible margin requirements imposed and short selling restricted, mainly to prevent repetition of the 1929 stock-market crash. Nevertheless the market fell nearly 50 percent from August of 1937 to March of 1938. The American economy again underwent dreadful punishment.

Other Taxes and Controls

Yet other factors contributed to this new and fastest slump in US history. The Undistributed Profits Tax of 1936 struck a heavy blow at profits retained for use in business. Not content with destroying the wealth of the rich through confiscatory income and estate taxation, the administration meant to force the distribution of corporate savings as dividends subject to the high income-tax rates. Though the top rate finally imposed on undistributed profits was "only" 27 percent, the new tax succeeded in diverting corporate savings from employment and production to dividend income.

"When Franklin Delano Roosevelt assumed the presidency, he, too, fought the economy all the way…"

Amidst the new stagnation and unemployment, the president and Congress adopted yet another dangerous piece of New Deal legislation: the Wages and Hours Act or Fair Labor Standards Act of 1938. The law raised minimum wages and reduced the work week in stages to 44, 42, and 40 hours. It provided for time-and-a-half pay for all work over 40 hours per week and regulated other labor conditions. Again, the federal government thus reduced labor productivity and increased labor costs — ample grounds for further depression and unemployment.

Throughout this period, the federal government, through its monetary arm, the Federal Reserve System, endeavored to reinflate the economy. Monetary expansion from 1934 to 1941 reached astonishing proportions. The monetary gold of Europe sought refuge from the gathering clouds of political upheaval, boosting American bank reserves to unaccustomed levels. Reserve balances rose from $2.9 billion in January 1934, to $14.4 billion in January of 1941. And with this growth of member-bank reserves, interest rates declined to fantastically low levels. Commercial paper often yielded less than 1 percent, bankers' acceptances from $^1/_8$ percent to $^1/_4$ percent. Treasury-bill rates fell to $^1/_{10}$ of 1 percent and Treasury bonds to some 2 percent. Call loans were pegged at 1 percent and prime customers' loans at $1^1/_2$ percent. The money market was flooded and interest rates could hardly go lower.

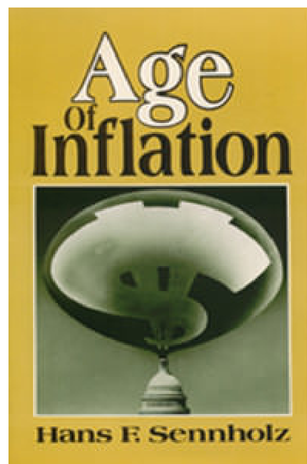
Deep-Rooted Causes

The American economy simply could not recover from these successive onslaughts by first the Republican and then the Democratic administrations. Individual enterprise, the mainspring of unprecedented income and wealth, didn't have a chance.

The calamity of the Great Depression finally gave way to the holocaust of World War II. When more than 10 million able-bodied men had been drafted into the armed services, unemployment ceased to be an economic problem. And when the purchasing power of the dollar had been cut in half through

vast budget deficits and currency inflation, American business managed to adjust to the oppressive costs of the Hoover-Roosevelt "Deals." The radical inflation in fact reduced the real costs of labor and thus generated new employment in the postwar period.

Nothing would be more foolish than to single out the men who led us in those baleful years and condemn them for all the evil that befell us. The ultimate roots of the Great Depression were growing in the hearts and minds of the American people. It is true, they abhorred the painful symptoms of the great dilemma. But the large majority favored and voted for the very policies that made the disaster inevitable: inflation and credit expansion, protective tariffs, labor laws that raised wages and farm laws that raised prices, ever higher taxes on the rich and distribution of their wealth. The seeds for the Great Depression were sown by scholars and teachers during the 1920s and earlier when social and economic ideologies that were hostile toward our traditional order of private property and individual enterprise conquered our colleges and universities. The professors of earlier years were as guilty as the political leaders of the 1930s.



(http://store.mises.org/Age-of-Inflation-P294.aspx)

"The professors of earlier years were as guilty as the political leaders of the 1930s."

Social and economic decline is facilitated by moral decay. Surely, the Great Depression would be inconceivable without the growth of covetousness and envy of great personal wealth and income, the mounting desire for public assistance and favors. It would be inconceivable without an ominous decline of individual independence and self-reliance, and above all, the burning desire to be free from man's bondage and to be responsible to God alone.

Can it happen again? Inexorable economic law ascertains that it must happen again whenever we repeat the dreadful errors that generated the Great Depression.

Hans F. Sennholz (1922–2007) was Ludwig von Mises's first PhD student in the United States. He taught economics at Grove City College, 1956–1992, having been hired as department chair upon arrival. After he retired, he became president of the Foundation for Economic Education, 1992–1997. He was an adjunct scholar of the Mises Institute and in October, 2004, was awarded the Gary G. Schlarbaum Prize for lifetime defense of liberty. See Lew Rockwell's tribute (http://mises.org/daily/2625) . See his article archives (http://mises.org/daily/author/163/Hans-F-Sennholz) . Comment on the blog (http://blog.mises.org/archives/010182.asp) .

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