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Economic View

The New Deal Didn't Always Work, Either

By TYLER COWEN

MANY people are looking back to the Great Depression and the New Deal for answers to our problems. But while we can learn important lessons from this period, they're not always the ones taught in school.

The traditional story is that President Franklin D. Roosevelt rescued capitalism by resorting to extensive government intervention; the truth is that Roosevelt changed course from year to year, trying a mix of policies, some good and some bad. It's worth sorting through this grab bag now, to evaluate whether any of these policies might be helpful.

If I were preparing a "New Deal crib sheet," I would start with the following lessons:

MONETARY POLICY IS KEY As Milton Friedman and Anna Jacobson Schwartz argued in a classic book, "A Monetary History of the United States," the single biggest cause of the Great Depression was that the Federal Reserve let the money supply fall by one-third, causing deflation. Furthermore, banks were allowed to fail, causing a credit crisis. Roosevelt's best policies were those designed to increase the money supply, get the banking system back on its feet and restore trust in financial institutions.

A study of the 1930s by Christina D. Romer, a professor at the University of California, Berkeley ("What Ended the Great Depression?," Journal of Economic History, 1992), confirmed that expansionary monetary policy was the key to the partial recovery of the 1930s. The worst years of the New Deal were 1937 and 1938, right after the Fed increased reserve requirements for banks, thereby curbing lending and moving the economy back to dangerous deflationary pressures.

Today, expansionary monetary policy isn't so easy to put into effect, as we are seeing a shrinkage of credit and a contraction of the "shadow banking sector," as represented by forms of derivatives trading, hedge funds and other investments. So don't expect the benefits of monetary expansion to kick in right now, or even six months from now.

Still, the Fed needs to stand ready to prevent a downward spiral and to stimulate the economy once it's possible.

GET THE SMALL THINGS RIGHT It's not just monetary and fiscal policies that are important. Roosevelt instituted a disastrous legacy of agricultural subsidies and sought to cartelize industry, backed by force of law. Neither policy helped the economy recover.

He also took steps to strengthen unions and to keep real wages high. This helped workers who had jobs, but made it much harder for the unemployed to get back to work. One result was unemployment rates that remained high throughout the New Deal period.

Today, President-elect Barack Obama [-http://topics.nytimes.com/top/reference/timestopics/people/o/barack\\_obama/index.html?inline=nyt-pe-](http://topics.nytimes.com/top/reference/timestopics/people/o/barack_obama/index.html?inline=nyt-pe) faces pressures to make unionization easier, but such policies are likely to worsen the recession for many Americans.

DONT RAISE TAXES IN A SLUMP The New Deal's legacy of public works programs has given many people the impression that it was a time of expansionary fiscal policy, but that isn't quite right. Government spending went up considerably, but taxes rose, too. Under President Herbert Hoover and continuing with Roosevelt, the federal government increased income taxes, excise taxes, inheritance taxes, corporate income taxes, holding company taxes and "excess profits" taxes.

When all of these tax increases are taken into account, New Deal fiscal policy didn't do much to promote recovery. Today, a tax cut for the middle class is a good idea - and the case for repealing the Bush tax cuts for higher-income earners is weaker than it may have seemed a year or two ago.

WAR ISN'T THE WEAPON World War II did help the American economy, but the gains came in the early stages, when America was still just selling war-related goods to Europe and was not yet a combatant. The economic historian Robert Higgs, a senior fellow at the Independent Institute, has shown in his 2006 book, "Depression, War, and Cold War," just how much the war brought shortages and rationing of consumer goods.

While overall economic output was rising, and the military draft lowered unemployment, the war years were generally not prosperous ones. As for today, we shouldn't think that fighting a war is the way to restore economic health.

YOU CAN'T TURN BAD TO GOOD The good New Deal policies, like constructing a basic social safety net, made sense on their own terms and would have been desirable in the boom years of the 1920s as well. The bad policies made things worse. Today, that means we should restrict extraordinary measures to the financial sector as much as possible and resist the

measures to the financial sector as much as possible and resist the temptation to "do something" for its own sake.

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In short, expansionary monetary policy and wartime orders from Europe, not the well-known policies of the New Deal, did the most to make the American economy climb out of the Depression. Our current downturn will end as well someday, and, as in the '30s, the recovery will probably come for reasons that have little to do with most policy initiatives.

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