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The Great Depression: Why It Started, Continued, and Ended

Nine thousand failed banks and unemployment at a fourth of the workforce; bread lines, soup kitchens, desperate human beings living in Hoovervilles in worn-out clothes: Those who lived through the Great Depression may not have known the exact figures that confirm the human misery of those bleak years, but they did know about their own experiences, and no one disputes that it was a desperate time.

From the time of the October 1929 stock market crash until 1932, manufacturing fell by half, with the production of automobiles dropping 75 percent (from 4.5 million vehicles to a mere 1.1 million). After four years of Herbert Hoover, the Republican Party's dominance in presidential politics was over. Only two men had won the White House as Democrats from 1856 to 1932 (Grover Cleveland and Woodrow Wilson). Beginning with the election of Franklin Roosevelt in 1932, the Democrats won five presidential elections in a row, and seven of the next nine.

Yet Roosevelt's New Deal never ended the Depression. Only World War II brought down the unbelievable high unemployment rates of the 1930s, and as we shall see, the greatest war in human history did not restore a normal economy. That only occurred after the war was over.

What caused the Great Depression? What caused it to last so long? (The very fact of its length is what gave it the name "Great" Depression, because the nation had seen depressions before, and some with deeper troughs, but none that lasted more than a decade). And finally, what ended it?

Jonathan Hughes wrote in *American Economic History,* "There is probably no historical subject that can raise so much heat among economists, even to this day, as the Great Depression. Every part of it is still the subject of controversy."

Certainly William Z. Foster, the head of the American Communist Party, had his theory. He said the cause of the Great Depression was "the capitalist system." And his solution was similarly simple: The United States needed to adopt the system of communism used in the Soviet Union. Foster's diagnosis is, unfortunately, not all that unique. Probably a majority of Americans who give this subject any thought at all believe the cause of swings in the economy are just some inherent defect of the free market. And while only a minority advocate Foster's prescription of a communistic system, there is no question that most Americans believe the government needs to "do something."

That was what some thought in 1920, when Warren Harding was elected president and inherited a depression from Woodrow Wilson. The gross domestic product had contracted by one-fourth in a year's time, wages had fallen by 20 percent, and 100,000 businesses had closed their doors. The steel industry was working at a mere 15-percent capacity. In such dire circumstances, it was certainly tempting for Harding to follow the activist course advocated by his secretary of commerce, Herbert Hoover, and "do something." But Harding opted to let the free market correct the downturn, rejecting the government interventionist policies favored by Hoover. Instead of tinkering with the economy, he allowed wages to fall to their natural level.

Writing in his book *The Forgotten Depression*, James Grant explained how the 1920-21 depression differed from the Great Depression of a decade later. "What we can observe, even at this great distance of years, is that the price mechanism worked more freely in 1920-21 than it was allowed to do in 1929-1933. Whereas 92 percent of reporting firms had reduced wages in 1921, only seven percent did so in 1930."

So the indication is that allowing a free market to operate would have shortened the Great Depression. It might have even prevented it. The free market does not cause any depression, unless one believes that several thousands of businesses just happen to make bad decisions all at once. The cause of the Great Depression — artificial credit expansion, in this case by the Federal Reserve System — was fundamentally the same as the cause of any economic depression.

When interest rates are low, that is an indication that people are willing to lend. When interest rates are high, that is an indication that money available for lending is in short supply. Left to the free market, interest rates provide an equilibrium in the economy that both restrains artificial booms and moderates any economic sluggishness.

But for reasons that have nothing to do with the free market, the government succumbed to the temptation to manipulate interest rates through artificial credit expansion. In the United States, this was accomplished in various ways by the Federal Reserve System (FRS). Artificially low interest rates resulted from FRS tinkering, and malinvestment (investment in the wrong things) occurred. For example, more houses will be built than for which there is an actual market, as happened with the Florida real estate boom and bust of the 1920s. A readjustment, sometimes called a crash or a bust, is inevitable.

Such boom and bust cycles are caused by government, and according to the Austrian theory of economics developed by the late Ludwig von Mises, America's major depressions, such as in 1837, 1892, and 1929, were all a result of this deliberate policy of artificially low interest rates instituted by government — not the free market.

In the case of the 1929 crash, it was a result of massive credit expansion during the 1920s by the Federal Reserve System, a private banking organization created by an act of Congress in 1913 in order to control the economy through financial manipulations. In the decade of the Roaring Twenties, whenever the economy showed signs of slowing, the Fed injected more money and credit (a 62-percent increase over the decade) into the system, not allowing necessary market corrections to take place. When the bust finally came in 1929, it was much more serious than it would have been had the Fed taken its foot off the money accelerator earlier.

Hoover Deepens the Depression

None of this was Herbert Hoover's fault. He did not "cause" the Great Depression any more than Franklin Roosevelt "brought us out" of it. But he did exacerbate the negative results. So did Roosevelt. They share responsibility for making the significant collapse of 1929 the "Great Depression" — a downturn that lasted well over a decade.

Hoover had great confidence in his ability to manage the American economy. When he accepted the

Republican Party nomination in 1928, he boldly proclaimed, “In America today we are nearer a final triumph over poverty than in any land.… We shall, with the help of God, be in sight of the day when poverty will be banished from this nation.”

Now that he was president, Hoover enacted all the supposed solutions to stop an economic downturn that Harding had rejected almost a decade earlier. First of all, the month after the October stock market crash, Hoover called a series of conferences and demanded that business leaders not lower wages in the face of declining sales because he had bought in to the idea that high wages cause prosperity. This is sort of like insisting that wet streets cause rain; however, Hoover wanted to make sure that wages did not fall as a result of the collapse.

The results were quite predictable. As business leaders bravely kept wages up for the next year, many businesses closed their doors, forcing widespread unemployment. By 1931, unemployment numbers reached eight million. Businesses that survived let go of workers as well, finding they could get by with fewer employees since their sales had fallen so precipitously.

Hoover was not finished. After he “helped” the factory worker, he moved to “help” the farmers. At Hoover’s urging, Congress created the Federal Farm Board (FFB), which made low-interest loans to farm cooperatives, and made efforts to keep farm prices from falling. The FFB subsidized farm prices, and naturally, at this artificially higher price, farmers expanded production, which added to the “surplus.” Predictably, farm prices collapsed even more. The government’s solution? More subsidies, which of course led to more surpluses, and an even greater drop in farm prices.

To combat rising unemployment, Hoover resorted to a billion-dollar public works program. This was followed by the creation of the Reconstruction Finance Corporation (RFC), to make loans to desperate businesses. The main effect of the RFC was to delay the inevitable liquidation of those businesses. To pay for all of the “help,” taxes on incomes and businesses were increased in 1932.

At the time, income taxes were due on April 15 of the following year — in a lump sum. This was before the present system of withholding. (Withholding, in which a worker’s income is docked for income taxes before he even sees it, came into effect during World War II, ostensibly as an “emergency” measure. The war ended in 1945, but tax withholding continues today.) To pay for the massive increase in taxes, money had to be withdrawn from bank accounts in even larger amounts than previously, and for many banks, this was too much. The winter of 1932-33 saw a string of bank failures. By the time Hoover left office, hardly a bank in America was open for business — because the only “business” most customers wanted to transact was to pull their money out of the bank.

In the election of 1932, Hoover had to face the voters with 12 million unemployed. It appeared that “Happy Days Are Here Again,” as in FDR’s famous campaign song, used to inspire delegates at the 1932 Democratic Convention. The Democrats had nominated Franklin D. Roosevelt, the governor of New York, who condemned the massive spending of Hoover and promised to balance the budget, cut government spending 25 percent, maintain the gold standard, and end the growth of government of the Hoover years.

The New Deal

In the campaign, Roosevelt promised a clean break with the Hoover approach, touting a “New Deal,” which would take a different path. “I accuse the present administration of being the greatest spending administration in peace time in all American history — one which piles bureau on bureau, commission on commission, and has failed to anticipate the dire needs or reduced earning power of the people. Bureaus and bureaucrats have been retained at the expense of the taxpayer…. We are spending altogether too much money for government services which are neither practical nor necessary. In addition to this, we are attempting too many functions and we need a simplification of what the federal government is giving to the people."

It is unfortunate that these words did not accurately forecast what Roosevelt actually did once in office. Had he followed the course that these words indicated he would, the Great Depression would have ended much sooner.

The truth is that Roosevelt's policies were not all that much different than Hoover's, largely because they were based upon the same incorrect economic assumptions. Rexford Tugwell, a top advisor to FDR, said later, "We didn't admit it at the time, but practically the whole New Deal was extrapolated from programs that Hoover started."

Both Hoover and Roosevelt bought in to the "under-consumption" theory, which held that the cause of the Great Depression was low wages, and that the way to prosperity was high wages. This theory is not supported by the facts, as wages actually *rose* during the 1920s as a percentage of corporate income from 55 to 60 percent. Peter Temin, an economist at the Massachusetts Institute of Technology, explained, "The ratio of consumption to national income was not falling in the 1920s."

This false theory — drive up wages, and prosperity will return — drove many of the New Deal policies of the 1920s. This necessitated government intervention into the American economy on a scale never seen before.

Congress gave Roosevelt extensive control over the nation's money. Using this power, of dubious constitutionality, Roosevelt issued an executive order to demand that all privately owned gold, in whatever form it was held, be turned over to Federal Reserve banks in exchange for payment in federal reserve notes, or in the form of credit. Then the gold was turned over to the U.S. Department of the Treasury. The intent was to remove any meaningful restraint on the power of the federal government to inflate, with the hope this would drive up wages and prices — and thus produce prosperity.

While this bold policy no doubt drove up wages and prices, it predictably did not wipe out the high unemployment rates of the Great Depression. It had the opposite effect, in two ways: (1) It increased the cost of doing business, since wages are generally the greatest expense of any business, and therefore made labor a more expensive cost; and (2) It frightened businessmen, causing uncertainty as to what a government that would confiscate property (gold) might do next and making businesses hesitate to expand (which, of course, precludes the hiring of more workers).

Another program that indicated Roosevelt's lack of regard for free enterprise was the National Recovery Administration (NRA). Again, the NRA was created based upon the mistaken idea that high wages and prices produce prosperity, instead of the other way around. The NRA established cartels in hundreds of different industries, with each industry developing codes of supposed fair competition. This meant, for example, that there was a *minimum* price for various goods and services within the industry. Large businesses, of course, dominated the decisions made in each industry. In the six months after the NRA began operations, industrial production fell 25 percent. Its minimum-wage laws priced many marginal laborers out of a job, and was a more crushing burden on small business than big business.

For example, the major tire manufacturers (Firestone, Goodyear, and Goodrich) wrote the NRA code for the entire tire industry, and they insisted on higher prices for tires.

Carl Pharis, the general manager of Ohio-based Pharis Tire and Rubber, explained the problem the NRA created for his small company and other smaller tire makers: “The government deliberately raised our prices up toward the prices at which the big companies wanted to sell, at which they could make a profit … where more easily, with much less loss, they come down and ‘get us’ and where, bound by NRA decrees, we could not use lower prices, although we could have lowered them and still made a decent profit.”

In one widely reported case, Jack Magid, a tailor, was arrested, convicted, fined, and sent to jail for pressing a suit for 35 cents, which was five cents below the NRA mandated price. Magid argued that he was getting too little business at 40 cents, so he dropped the price, which is, of course, a typical business response. While the publicity paid to such travesties eventually led to the NRA’s demise, such stories further discouraged American businessmen from expanding their businesses. The prospect of jail time simply for charging a nickel too little for a good or service certainly did nothing to encourage someone to go into business. And businesses that do not exist hire no workers.

The philosophy behind the creation of the American Agriculture Administration (AAA) was much the same. Under this scheme, farmers would be paid to cut back on production, with the hope that this decrease in supply would lead to an increase in farm prices. To kick off the program, six million pigs were slaughtered, milk was poured out onto the ground, and 10 million acres of cotton were plowed under, all with the goal of raising prices to produce prosperity — at a time when many Americans were going hungry.

Even today, the Roosevelt-era idea of farm price “parity” is thrown around as if it were gospel. In short, parity is an idea that farm prices today should be tied to an earlier time period when farmers were prosperous (the specific period chosen at that time was 1909-1914). If the price of a farm product was, say, one dollar then, and the cost of living had doubled, then the price should be two dollars now. This would keep a farmer’s “purchasing power” in line with the rest of the economy. Henry Hazlitt, author of *Economics in One Lesson*, questioned this concept, pointing out, “A Chevrolet six-cylinder touring car cost $2,150 in 1912; an incomparably improved six-cylinder Chevrolet sedan cost $907 in 1942; adjusted for ‘parity’ on the same basis as farm products, however, it would have cost $3,720 in 1942.”

The truth is that *lowering* prices leads to greater prosperity, as more consumers can take advantage of the product. Henry Ford exploited this understanding with his Model T, which he developed so that the price would be low enough to enable many Americans to purchase it. Before the Model T, few Americans could afford an automobile, then considered a toy for the wealthy. But Ford made more money producing less-expensive cars for the average buyer than could be made with higher-priced automobiles for only richer buyers. For all the demagogic calls to “share the wealth,” the greatest wealth-sharing idea we have ever had is the free market.

Continuing with the belief that higher wages would lead to prosperity, Roosevelt persuaded Congress to pass legislation favoring labor unions. While the support of labor unions for Roosevelt’s political campaigns (the Congress of Industrial Organizations, for example, dumped about a half million dollars into FDR’s campaign coffers in 1936) no doubt played a role in FDR’s love of the unions, the efforts of unions to increase wages matched Roosevelt’s goals perfectly.

The National Labor Relations Act of 1935 was very favorable to unions by supporting closed shops — compulsory union membership, for example. The 1930s saw a series of crippling strikes in major industries, the effect of which was to decrease production in many of them. With a decrease in production in one industry leading to a shortage of supplies for another industry, these strikes contributed to the continuation of the Great Depression in two ways: (1) When businesses could not obtain supplies to make their products, because these strikes had reduced the amount available or driven up the price when they finally did get them, businesses often resorted to reducing their workforce; and (2) The increased cost of labor when strikes did win wage increases, at a time when there were insufficient profits to pay for them, resulted in some businesses reducing their workforce — or going out of business altogether.

Recession Within a Depression

"Regime uncertainty" — the concern by businessmen about what the government would do to them next — was a major reason for the continuation of the economic stagnation. Economic historian Robert Higgs has argued that businessmen and investors simply stopped investing or expanding. When Roosevelt became president, he not only blamed Hoover for the economic collapse, he accused business leaders of the same, referring to them as an enemy to be defeated.

Dismissing businessmen as "economic royalists," FDR's inaugural address launched his anti-business tone: "The money changers have fled from the high seats in the temple of our civilization." In a society that still understood biblical allusions, it was clear to business leaders that they were being compared to the corrupt businessmen driven from the temple by Jesus. This certainly did not inspire business confidence in the administration.

Other policies of the Roosevelt administration could be cited for prolonging the Great Depression, including the massive tax increase in 1935, and the launching of Social Security. Whatever one thinks of Social Security as a program to provide pensions for older persons, its immediate effect, along with the 1935 Revenue Act, was to take money *out* of the economy. Social Security benefits would not begin to be paid until 1940, so instead of increasing purchasing power, it actually decreased it.

Still, the unemployment rate did decline, from its high of perhaps 27 percent when Roosevelt took office, to about 14 percent when he ran for reelection in 1936. This enabled him to run for a second term on the platform that the economy had "improved." Of course, 14 percent unemployment was still historically high, and was certainly at depression levels, but the average voter probably thought things would continue to get better if Roosevelt remained in office. After all, what was the alternative? Hoover and the Republicans had certainly failed to end the Depression.

After winning a second term, however, Roosevelt again faced a declining economy. By November 1937, unemployment had risen to above 17 percent. The stock market crashed again. Roosevelt had achieved a recession within a depression. Over the next several months, additional businesses folded, and unemployment continued to rise. By February 1939, it had reached 19.3 percent. A Gallup Poll released in March 1939 indicated that 67 percent of Americans believed that Roosevelt's negative attitude toward business was retarding recovery.

By April 1939, unemployment had soared to almost 21 percent. Confiding in two members of the House Ways and Means Committee, a distraught Treasury Secretary Henry Morgenthau admitted he and the rest of the Roosevelt administration simply did not know what else to do.

"Now, gentlemen," Morgenthau told them, "we have tried spending money. We are spending more money than we have ever spent before and it does not work.... I want to see this country prosperous. I want to see people get a job. I want to see people get enough to eat. We have never made good on our promises.... I say after eight years of this Administration we have just as much unemployment as when we started.... And an enormous debt.... I can't see any daylight."

World War II and the Depression

But if it is a commonly held myth that "Roosevelt's New Deal brought us out of the Great Depression," another widely believed myth is also repeated, even today — that World War II is what brought us out of the Great Depression.

Now, it is unlikely the folks making such a claim would advocate having a world war for economic reasons, but they rightly argue that the unemployment rate began to decline as the United States got fully involved in war production, and went away completely after the United States went to war against Germany, Italy, and Japan.

In one sense, there may have been some slight improvement in the economy as we entered the war, because Roosevelt was diverted from, in effect, making war on the American economy to making war on the Germans and Japanese. But the cause for the dramatic drop in unemployment came mainly because 22 percent of the pre-war labor force was now in the armed forces.

Other Americans were employed making bombs, guns, tanks, uniforms, and the like. Yes, the unemployment rate disappeared, but these factories were not making consumer items. Americans were still deprived of consumer items from cars to washing machines. Even in the trough of the Great Depression, a million cars were produced in one year, compared with none during the war — at least none for civilian use. Production of automobiles for the civilian market did not resume until after the war was over. Americans generally had jobs, but limited amounts of goods on which to spend their money from those jobs.

As historian Clarence Carson said, "It would be nearer the mark to say that World War II only spread the deprivation by rationing and other controls.... A measure of real prosperity only returned after World War II."

Similarly, historian Tom Woods argued that it was "neither economic legislation nor World War II" that finally cured the Depression. "Instead, it was the return to normal conditions following the war and the removal of the uncertainty that had haunted business during the FDR years." When the war ended, taxes and government spending declined, price controls were lifted on most items, and the free market brought us out of the Depression.

Bluntly put, the death of Roosevelt on April 12, 1945, removed the fear that he might try to re-impose the destructive policies of the pre-war years. A return to a normal economy, with the removal of the heavy hand of government on the economy, ended the Depression.

To those who argue that it was the massive government spending of the war years that finally restarted the economy, even FDR's secretary of the treasury, Henry Morgenthau rejected that thesis, when he said that they had spent more money "than we have ever spent before and it does not work." If government spending were the answer, one would think our multi-trillion dollar national debt would have our economy today really humming. Nations such as Japan that have consciously tried this Keynesian solution have also found that it does not work. And, of course, our wars in Afghanistan and Iraq were followed by the economic downturn in 2008, the worst since the Great Depression. If World War II's spending brought this country out of the Great Depression, it was certainly a first, because wars are generally followed by economic downturns (such as the post-World War I depression). Fortunately, President Harding let the free market cure that one, and we were off on the Roaring Twenties.

Sadly, the lessons we can learn from this history are rarely heeded in the heat of partisan passion. And some, of course, politically benefit from having large numbers of Americans dependent upon the government for their necessities of life.

Considering that Franklin Roosevelt was a huge political success, while at the same time it is demonstrable that he utterly failed to end the Great Depression, and in fact, prolonged it, perhaps there are political benefits to government intervention in the economy — even if it does not work.