

Understanding Economic Recovery in the 1930s

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Endogenous Propagation in the
Great Depression

Frank G. Steindl

The University of Michigan Press

Ann Arbor

To David, Andrew, Peter, and Matthew

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Published in the United States of America by

The University of Michigan Press

Manufactured in the United States of America

⊗ Printed on acid-free paper

2006 2005 2004 2003 4 3 2 1

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A CIP catalog record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data

Steindl, Frank G. (Frank George), 1935–

Understanding economic recovery in the 1930s : endogenous
propagation in the Great Depression / Frank G. Steindl.

p. cm.

Includes bibliographical references and index.

ISBN 0-472-11348-8 (Cloth : alk. paper)

1. United States—Economic policy—To 1933. 2. United
States—Economic policy—1933–1945. 3. Depressions—United
States—1929. 4. Business cycles—United States. 5. United
States—Economic conditions—1918–1945. 6. United States—Politics
and government—1933–1945. I. Title.

HC106.3 .S7275 2003

330.973'0917—dc21

2003005020

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Preface

The Great Depression continues to captivate scholars, and not only senior ones for whom reminiscing may be a most enjoyable, important activity. This book is concerned with the Great Depression, but in contrast to so much of the literature, its ambit is the economic recovery from the disastrous economic dive culminating in the spring of 1933. The particular focus is on the macroeconomic developments responsible for the move back to the trend rate of growth of output, to a high-employment economy more in keeping with its performance in the early half of 1929.

By far the dominant concern of those writing about the 1930s is with the three and a half year decline into early 1933, so much so that one hears frequently the term *Great Depression* assigned to those years of Contraction. In contrast, the recovery, which lasted more than twice as long as the slide, receives scant attention. That an economy could deteriorate so much and to such depths seemed inconceivable; it demanded an explanation. It thus captured the attention of scholars as it called out for analysis and understanding, and therefore explication, of its causes, processes, and likely options for recovery. This activity so consumed investigators in their quest for answers that it is only in the past decade or so that professional attention has shifted to the recovery.

Economists of course were not alone in writing about the 1930s. Certainly historians, political scientists, essayists, and the media devoted much energy and many words to those times, again however the bulk concentrating on the Contraction. To the extent that the recovery was considered, it was largely incidental to the many studies dealing with Franklin D. Roosevelt and the politics, policies, and programs spawned by his New Deal—these being largely microeconomic forays owing to belief that the capitalist system needed to be restructured. Much of the material that interests them is the same as that which absorbed the

energies of the policymakers in that decade, namely, microeconomic restructuring actions, of which the National Industrial Recovery Act is a prototype.

In contrast, the present essay says virtually nothing about the 1929–33 cataclysm. It similarly does not deal in any detail with specific happenings that so fascinated Roosevelt scholars, except as any of them clearly affected the march to a high-employment economy, that is, as any one had a discernible macroeconomic impact.

Postwar studies have taken as their point of departure examination of macroeconomic impulses, which almost without exception are investigations of aggregate demand actions. And that is fully understandable given the attention devoted to the cyclical behavior of the aggregative economy. The present study proceeds likewise; it concentrates on the influences of four macroeconomic mechanisms, the first three of which are aggregate demand forces: monetary, as captured in the behavior of the quantity of money; fiscal as measured by federal government deficits; and the credit channel as supplementary to monetary actions affecting commercial bank lending. The last of the macroeconomic forces examined is what here is called endogenous propagation, a mechanism that underlies a mean-reversion propensity of the economy to move back to trend, an aggregate supply consideration.

The odyssey by which this book came to be written may be of interest. In my previous work, which culminated in *Monetary Interpretations of the Great Depression*, I was impressed by the extent to which some scholars identified the economy's collapse with the shrinkage of the quantity of money, a theme associated with the seminal work of Friedman and Schwartz (1963), which appeared three decades after the nadir of the Contraction. At the same time, no one writing in the 1930s had the main ingredients central to the Friedman and Schwartz analysis, their analytical core. That interpretation, controversial when it appeared, is now a central element, if not the canonical tale, in economists' turn-of-the-century understanding of the momentum of the Contraction.

It thus seemed natural to inquire into the extent to which the writers living during the recovery looked to the behavior of quantitative monetary measures as important. That is, were there economists who interpreted the recovery in terms of the growing stock of money? It was this that piqued an interest in the issue of what drove the recovery. A difficulty however was that there were no official series on the money stock available in the Depression decade. It thus became necessary to construct one, from the point of view of a series to which those living then

would most likely have turned in their attempts to understand the recovery in terms of growth of the quantity of money.

Having thus been prodded into thinking about the recovery in terms of the behavior of the money stock, a direct carryover of its role in the Contraction, it was a natural step to look for evidence of the relationship between the two in the professional literature, and in the data. It was not hard in coming. If one were living then, how would one have proceeded? An obvious way would be to get each month's data on money, industrial production, and wholesale prices as it appeared and then plot them on scatter-diagrams, an approach favored by economists in the 1930s. Within two or so years of so doing, the interpretation would have become increasingly clear, and straightforward; it would have been, for the most part, singular in establishing the case for a money-led recovery. Postwar analyses of the recovery were based on more sophisticated empirical methods as well as on a wider array of data; their conclusions were similar, as they argued for an overarching role of the behavior of the money stock in the recovery.

Chapters 3 through 5 are concerned with presenting this evidence, where the latter two deal with economists who wrote in the post-1933 period. The results of the inquiry into economists' monetary analyses of the recovery appeared initially in the *Journal of Macroeconomics* (Steindl 1998) and the *Journal of the History of Economic Thought* (Steindl 1997).

Midway through the recovery, the sharp, severe depression of 1937–38 hit. Could it and the subsequent revival be understood in terms of the behavior of the quantity of money? This is the subject of the sixth chapter. Here again, the behavior of the stock of money is of consequence in understanding what induced that depression, though there was little discussion of it at that time. It is a bit surprising that the late-1930s depression and in particular the subsequent revival has received so little professional attention, and what it has received is in large part due to the fact that it was then that the notion of fiscal actions as a deliberate policy tool was born. The seventh chapter deals with the evidence of fiscal policy on the recovery. The following chapter considers the credit channel in conjunction with the monetary and fiscal forces; it stands as a summary chapter of the accumulating empirical evidence. The credit channel is considered as a logical extension of the influence that was found for it during the Contraction.

Discussions of the Great Depression, certainly those in the postwar era, are heavily conditioned on aggregate demand considerations—what caused demand to fall in the 1929–33 and 1937–38 contractions

and what were the factors at play in causing it to increase relative to trend during the recovery. In discussions with many other economists of the general topic of the recovery, I would ask how they would go about studying the recovery. Without exception, each talked about one or more aggregate demand influences, generally with emphasis on one of them. And this is quite understandable. The rise in importance of macroeconomics is in large part the story of variations in aggregate demand and their influences on income, prices, unemployment, and the balance of payments. We have been conditioned to think in terms of the instability of aggregate demand relative to aggregate supply as the first line of inquiry, and I was no different.

It is of interest to note that this stands in contrast to the way in which many economists perceived the Depression in the 1930s. The observed surfeits of goods then were thought to be the result not of a deficiency of aggregate demand but of an excess of productive capacity, of which the farm situation was a patently clear case. The notion of production outrunning consumption was a common theme, and indeed was at the heart of the NIRA. Today, the orientation is on deficiency of aggregate demand.

It thus took some time and thought before I brought myself to view the economy's course during the recovery as having a strong, inherent tendency to move back to trend, that is, to think in terms other than aggregate demand phenomena. The key insight came when trying to understand the revival from the 1937–38 depression. For it was here that the monetary interpretation that seemed so robust was now unable to give a satisfactory explanation, though I tried. My initial attempt appeared in the *Cato Journal* (Steindl 2000), but I now believe it was flawed, the reason being that I was still caught up with an aggregate demand orientation as I tried to highlight the behavior of the money stock in the robust revival from that depression. The view to which I at last subscribed is detailed in the ninth chapter, one that may seem surprising to economists.

Acknowledgments

This book was written largely during the course of a sabbatical leave at the University of Iowa. The support of the College of Business Administration at Oklahoma State University was crucial to bringing the pro-

ject to completion. I also thank the Ardmore Foundation whose professorship funds materially aided the research. I want to single out for special thanks Junhui (Grace) Yan for her outstanding assistance.

I wish also to acknowledge and thank Charles H. Whiteman who extended the invitation to visit at Iowa. Of more consequence, he also was an active participant in discussions of the book's material. It was in conversations with Chuck that the subtitle of the book emerged. Others who supplied informed and spirited comment were Thomas F. Pogue and Gerald P. Dwyer. Tom and I spent many hours over lunch discussing issues in the book. Gerry extended an invitation to present a seminar at the Federal Reserve Bank of Atlanta where the material in the book received its first public airing. His quizzical comments resulted in reorienting several chapters. Mark Snead was the source of much good econometric advice and economic sense.

The best is saved for last. Anyone who has been wrapped up in an extended intellectual enterprise knows the enormous contributions made by a spouse, some perhaps in material germane to the inquiry but of much more consequence mostly in all those things necessary for stability of family life. Those who have engaged in such research activity know well the sacrifices made and joys contributed by a spouse. I am indeed grateful to and lucky for Joyce. Because my earlier book was dedicated to her, she demurred from being so acknowledged in the present enterprise. And so, it is to our sons—David, Andrew, Peter, and Matthew—that the book is dedicated.

As part of this work, I have quoted extensively from several publications. I thank the following for permission to use their materials.

A Monetary History of the United States, 1867–1960 by Milton Friedman and Anna J. Schwartz (Princeton University Press, 1963), reprinted by permission of Princeton University Press. For permission to adapt and use material appearing in earlier articles of mine, I thank the History of Economics Society for “Was Fisher a Practicing Quantity Theorist?” *Journal of the History of Economic Thought* 19 (fall 1997): 241–60 as well as “Fisher’s Last Stand on the Quantity Theory: The Role of Money in the Recovery,” *Journal of the History of Economic Thought* 22 (December 2000): 493–98; Elsevier Science, B.V. for “The Decline of a Paradigm: The Quantity Theory and Economic Recovery in the 1930s,” *Journal of Macroeconomics* 20 (fall 1998): 821–41; and the *Cato Journal* for “Does the Fed Abhor Inflation?” *Cato Journal* 20 (spring/summer 2000): 215–21.