

## Lessons From the New Deal

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The *New Deal* was a collection of policies adopted in response to the Great Depression that were designed to alleviate economic hardship and promote economic recovery. Today's economic crisis has prompted many comparisons to the Great Depression, and has led many to ask whether a "New" New Deal is warranted. My research shows that some New Deal policies significantly delayed economic recovery by impeding the normal forces of supply and demand, and that the economy would have experienced a robust recovery in the absence of these policies.

One implication of my research, and other recent research on protracted economic crises, is that short-run policies designed to moderate the effects of a crisis - *crisis management policies* - can prolong the crisis if those policies impede competitive market forces. Another implication is that the policymaking process can benefit from current research on economic crises. Much of the evidence that crisis management policies can prolong economic downturns is from research that utilizes recent developments in economic theory and methodologies. These new research developments can inform the policymaking process. These views are detailed below.

The recovery from the Depression was indeed slow, and this has been recognized by a number of economists, including 1976 Nobel Laureate Milton Friedman (Friedman and Schwartz (1963)), 1995 Nobel Laureate Robert Lucas, (Lucas and Rapping (1972)), and 2004 Nobel Laureate Edward Prescott (1999). My work with Harold Cole (2007) details this slow recovery. Total hours worked per adult, which is the standard measure of labor input used in macroeconomics, was 27 percent below its 1929 level in 1933, and remained 21 percent below that level in 1939. There was even less recovery in private hours worked per adult. Per-capita investment, which declined by nearly 80 percent relative to trend (2 percent annual growth), remained more than 50 percent below trend at the end of the 1930s. Per-capita consumption, which was about 25 percent below trend in 1933, remained roughly at that level for the remainder of the 1930s. Figures 1 and 2 show these data on real output and its components, and hours worked. The Depression clearly continued throughout the 1930s.

The failure to recover is puzzling, because economic fundamentals improved considerably after 1933. Productivity growth was rapid, liquidity was plentiful, deflation was eliminated, and the banking system was stabilized. With these fundamentals in place, the normal forces of supply, demand, and competition should have produced a robust recovery from the Depression. Figure 3 shows the recovery in productivity, real bank deposits, and the level of the GNP deflator, which stops falling after 1933, and rises modestly afterwards. Why wasn't the recovery stronger?

My research shows that one policy that delayed recovery was the National Industrial Recovery Act (NIRA), which was the centerpiece of New Deal recovery policy. The NIRA prevented market forces from working by permitting industry to collude, including allowing firms within an industry to set minimum prices, restrict expansion of capacity, and adopt other collusive arrangements, provided that firms raised wages considerably. These policies worked. Following government approval of an industry's "code of fair competition", industry prices and wages rose significantly.

Promoting collusion reduces employment and output, while setting the wage above its market-clearing level depresses employment by making labor expensive. Employers respond to high wages by reducing employment relative to the market-clearing level that is jointly determined by supply and demand. Figure 2 shows hours worked and the real manufacturing wage. The most striking feature of the graph is that the continuation of the Depression coincides with rising real wages. This fact stands in sharp contrast to standard economic reasoning, which indicates that normal competitive forces should have reduced industry wage levels and increased employment and output. This coincidence of high industry wages and low hours worked is one of the most telling signs that the market process was considerably distorted.

While declared unconstitutional in 1935, the NIRA de facto continued, with virtually no antitrust activity despite substantial evidence of collusion documented by the Federal Trade Commission (Cole and Ohanian (2004)). Wages rose even higher following the Wagner Act in 1935, which greatly increased union bargaining power in wage setting and which also facilitated unionization. The share of non-agricultural workers in unions rose from about 12 percent in 1934 to nearly 27 percent in 1938 (Freeman (1998)). During the mid-1930s, the sit-down strike, in which workers occupied factories and prevent production, was used most notably against G.M. and the threat of a sit-down strike was successful against U.S. Steel. Wages jumped in many industries shortly after the NLRA was upheld by the Supreme Court in 1937, and our research shows that these higher wages played a significant role in the 1937-38 economic contraction.

By the late 1930s, these New Deal policies began to reverse. Anti-trust activity was resumed, the Supreme Court ruled against the sit-down strike, and the growing gap between wages and productivity began to narrow, particularly during the War, as the National War Labor Board ruled against wage increases that exceeded cost of living. After the war, The National Labor Relations Act was substantially weakened by the Taft-Hartley Act of 1947. Since then, industry wages have never risen so high above their normal levels.

Despite the fact that several New Deal policies were useful, including those that established a basic social safety net, and those that stabilized the banking and financial system, Cole and I have found that Roosevelt's cartel-high wage policies prolonged the Depression by several years. In the absence of these policies, we estimate that the economy would have recovered back to trend quickly, with hours worked and investment rising well above their normal levels, rather than being significantly depressed.

In addition to Friedman and Schwartz (1963), Lucas and Rapping (1972), and Prescott (1999), there is more research on the New Deal that draws similar conclusions to mine, including work by Chari, Kehoe, and McGrattan (2006), and Bordo, Erceg, and Evans (2000). There is also relevant research on the impact of non-market policies on recoveries from financial crises in other countries. This research also concludes that non-market policies deepen and prolong crises.

Bergoing, Kehoe, Kehoe, and Soto (2007) examined the recoveries in Chile and Mexico following financial crises in the early 1980s. Chile moved quickly to reorganize their banking system and also allowed inefficient banks and firms to fail. In contrast, Mexico tried to prop up their economy in the 1980s by maintaining incumbent banks, many of whom were inefficient, and by providing credit at below-market interest rates to large firms to keep them afloat. This impeded the necessary re-allocation of resources from inefficient to efficient producers.

Chile chose to pay the price of economic reorganization and had a deeper downturn than Mexico during the initial stages of their respective crises. But since the early 1980s, Chile has grown substantially. In contrast, the Mexican economic crisis worsened over time, with per-capita real output falling until the mid-1990s, and growing little since then. Today, per-capita output in Chile relative to Mexico has doubled compared to their respective levels prior to the early 1980s (Fernandez de Cordoba and Kehoe (2009)). .

Japan's financial crisis of the early 1990s provides further evidence on the depressing effects of non-market policies that delay economic reform and prevent competition from working. Hayashi and Prescott (2007), and Caballero, Hoshi, and Kashyap (2005) studied the Japanese economy in the 1990s following their financial crisis. Both studies conclude that Japan's policies that kept otherwise insolvent banks operating, and that impeded the flow of capital to efficient firms, significantly prolonged the effect of Japan's crisis, resulting in a decade-long stagnation of the Japanese economy.

There are two principal messages from the New Deal and these other economic crises for our current crisis. One is that crisis management policies designed to reduce the cost of a financial crisis can actually prolong the depressing effects of these crises by impeding the normal forces of supply, demand, and competition. Instead, policies should be consistent with the broader, long-term goals of raising the incentives for households to work and save, for firms to hire and invest, for the financial system to efficiently intermediate capital, and for promoting competition, in which successful businesses thrive, and inefficient businesses exit.

There is relatively little debate among economists regarding the importance of these long-run guides for successful policy. Short-run policies that impede these economic forces can delay recovery and deepen crises, even if other aspects of the policy mix are well-designed. This means good short-run policy is *de facto* good-long run policy.

The second message is that policymaking can benefit considerably from current research on economic crises. Much of the evidence that short-run policies can prolong crises is from research that utilizes recent developments in economic theory and quantitative methods. Consequently, the profession's view about the costs and benefits of various types of policies has changed over time, including its views about fiscal policy, one of the key components in the response of policy to our current crisis.

Many recent discussions about fiscal policy focus on measuring a “multiplier”, which aims to quantify how much output and employment will change from an increase in government spending. Much recent research no longer focuses on this idea, however, largely because there is no presumption from economic theory about how a change in government spending impacts employment and output. Instead, economic theory indicates that the impact depends critically on what the spending is on, and how it is financed (Baxter and King (1991)).

In practice, research shows that observed differences in the types of spending and the mix of taxes, over time and across countries, have a big effect on economic outcomes. My research shows that the effects of large increases in government spending in the United States are very sensitive to tax policies (Ohanian (1997)). Specifically, the effect of government spending on output is smaller if the spending is ultimately financed with capital income taxes. Edward Prescott (2002) shows that much of the large decline in hours worked that occurred over the last 40 years in several European countries can be accounted for by an expansion in government spending that substitutes closely for private consumption, coupled with a large increase in European tax rates. Prescott's work thus suggests that for these European countries, aggressive fiscal policy depressed their economies.

Good economic policymaking is consistent with getting economic incentives right. This is perhaps the most important lesson from the New Deal and from other protracted economic crises.

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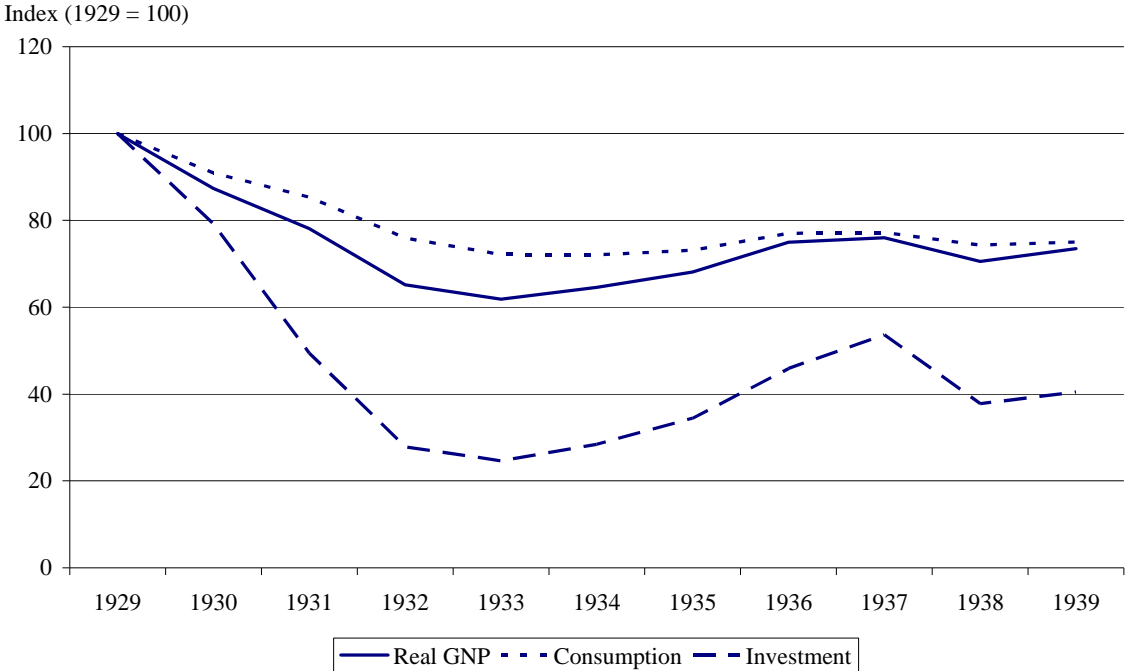
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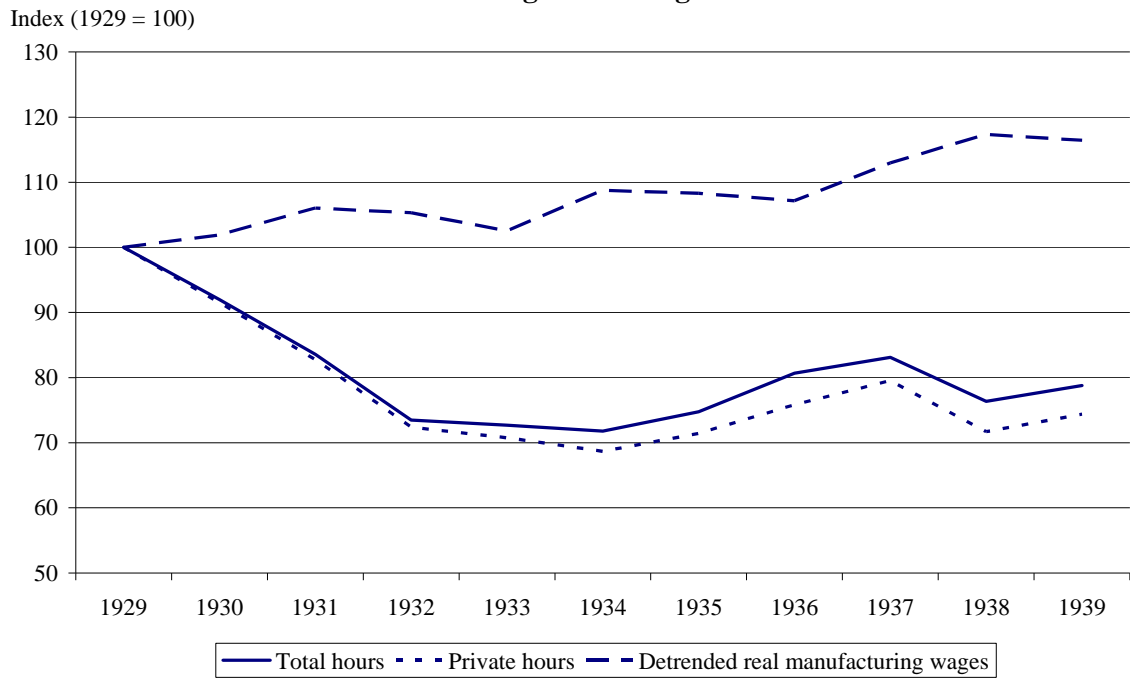
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**Figure 1 - Per Capita Detrended Real GNP,  
Consumption and Investment**



**Figure 2 - Depressed Hours Worked  
and High Real Wages**



**Figure 3 - Economic Fundamentals Recover**

