The Great Depression According to Milton Friedman

BY IVAN PONGRACIC, JR.

Few events in U.S. history can rival the Great Depression for its impact. The period from 1929 to 1941 saw fundamental changes in the landscape of American politics and economics, including such monumental events as America's going off the gold standard and the founding of Social Security. It was a watershed for the growth of the federal government.

The Great Depression created a widespread misconception that market economies are inherently unstable and must be managed by the government to avoid large macreconomic fluctuations, that is, business cycles. This view persists to this day despite the more than 40 years since Milton Friedman and Anna Jacobson Schwartz showed convincingly that the Federal Reserve's monetary policies were largely to blame for the severity of the Great Depression. In 2002 Ben Bernanke (then a Federal Reserve governor, today the chairman of the Board of Governors) made this startling admission in a speech given in honor of Friedman's 90th birthday: "I would like to say to Milton and Anna: Regarding the Great Depression, you're right. We did it. We're very sorry."

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Friedman, the great free-market champion of the last 50 years and one of the most influential economists of the last 200 years, died in November 2006 at 94. He left us an immense intellectual legacy, including his explanation of the Great Depression, which, while persuading a majority of the economics profession, has yet to fully trickle down to the public. It is truly a great mystery why Friedman's explanation has not been more widely recognized and accepted, especially given its influence among economists. Maybe the reason is that it does not lend itself to quick sound bites by politicians eager to justify more power. Or maybe it is usually presented in a way that makes it too difficult for the layperson to understand. Or maybe it is just that people find it easier to blame the "capitalists" rather than the hallowed Federal Reserve. Whatever the case, it would be beneficial to revisit Friedman's argument.

The standard explanation of the Great Depression, found in most American high-school history texts, is that it was created by the wild and irrational stock-market speculation that ultimately led to the Great Crash of October 1929. Investor speculations were so excessive—so the story goes—that once the bubble popped, it triggered the most severe decline in economic activity in U.S. history. The key point of this story is that the crash and the subsequent depression were due to factors that are innate to the capitalist system, unchecked under the supposedly laissez-faire policies of Herbert Hoover. It was only once Franklin Delano Roosevelt came into office that the government jump-

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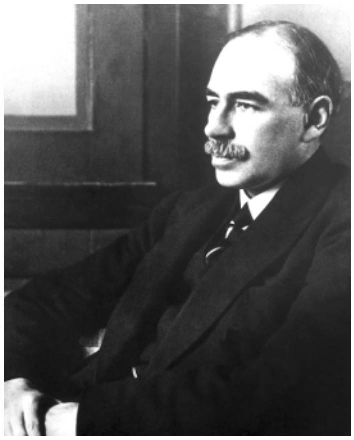
started the recovery. It is thus claimed that FDR's policies were responsible not only for the recovery, but in fact for "saving capitalism from itself" when many Americans were willing to consider adopting full-blown socialism in the 1930s as a way to deal with the downturn.

Most people do not realize how much of this explanation had been shaped by Keynesian economics, the dominant economic paradigm from the 1940s to the 1970s. Keynesian economics got its start with the publication of John Maynard Keynes's *General Theory of Employment, Interest, and Money* in 1936. There Keynes proposed a view of the Great Depression that was at odds with the rest of the economics profession at the time. Most economists of the era tended to agree that market economies are "self-adjusting" and that they cannot get stuck in a recession for very long. However, this view seemed to be at odds with the ugly reality of the time: persistent unemployment rates of 20 percent and more, even as high as 25 percent in 1933—with no end in sight.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Keynes seemed to be the right man for the time as he was reflecting the increasingly common view that blamed the capitalists themselves for the situation. In the *General Theory* Keynes rejected the view that the boom-bust cycle was due to over-expansive government monetary policy and that the stubbornness of the Depression was due to government interference with market mechanisms. He labeled all economists who believed such views as "classical"—in other words, hopelessly out of touch with reality. Instead, Keynes proposed a "general theory" that he thought capable of explaining not only the good times but also the bad.

According to Keynes, what drives the economy is aggregate demand or aggregate expenditures. Aggregate demand can be broken down into three main components: personal consumption (C), private investment (I), and government expenditures (G). The relationship can be summed up with this formula: AD = C + I + G. If Aggregate Demand is strong, the economy will be strong. However, if Aggregate Demand falters, businesses will end up with large unsold inventories and will cut back on production to avoid surpluses in the future. As they cut back they will of course need fewer inputs—including labor—and high unemployment will result.

The culprit in this story, the element that throws the entire system out of whack, is private investment. Private investment consists of business expenditures on machines, buildings, factories, and so on. In other words, investment is capital formation. Keynes claimed that private investment is inherently unstable due to what he called the "animal spirits" of businessmen/capitalists. He believed that businessmen are ultimately irrational and prone to herd-like behavior. Like sheep that blindly follow other sheep in the herd, it is easy for businessmen to become "irrationally exuberant"—as well as irrationally lethargic. Investment lethargy would trigger a large decrease in private investment, thus decreasing aggregate expenditures and triggering an economic downturn.

From Downturn to Depression

How do we go from this downturn to a full-blown recession or even a depression? As the economy slows down, unemployment rises and leads to a loss of consumer confidence. Consumer pessimism will lead to more saving and less spending, thus decreasing the personal-consumption component of aggregate demand, exacerbating the downturn. Notice that both I and C are therefore driven by the expectations of private individuals (irrational in the case of business investors): if both investors and consumers become pessimistic and expect a recession, they will cut back on their expenditures and thus cause the aggregate demand to be too low to bring about full employment of available resources. According to Keynes, a recession is, in a nutshell, a self-fulfilling prophecy.

The Great Depression was therefore a long stubborn period of dismally low aggregate expenditures, and according to Keynes, there were no economic forces working to pull the economy out of this situation automatically. In other words, he thought there is no self-corrective mechanism (or invisible hand) in a free-market economy. Instead, irrational changes in expectations would regularly lead to wide and destructive fluctuations in the macroeconomy. So we see that the business cycle is the natural and expected consequence of the unfettered operation of a market economy. Therefore if an unfettered market economy results in depressions, it is clearly undesirable. It also should be obvious now that the standard high-school history-book explanation is basically just a simplified version of this Keynesian story.

What is required to avoid a recession, then, is for the government to insure that the aggregate expenditures are enough to achieve full employment. The government can do that through either fiscal policy (taxation and government spending) or monetary policy (control of the money supply). Keynes favored fiscal policy and recommended that the government engage in massive deficit spending. Deficit spending would allow for an increase in government spending without an offsetting increase in the tax burden on private individuals and businesses. Thus increased government spending could neutralize any decreased expenditures in the private sector, preserving employment and incomes and ultimately reversing the pessimistic expectations that led to the downturn in the first place. Keynesian "demand management" clearly prescribed an important role for the government.

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Keynes's explanation, in addition to creating a new way of analyzing the economy as a whole, heavily influenced policymakers and ordinary people around the world. It was soon accepted that the government *must* engage in a countercyclical policy of demand management to stabilize the market economy. Both FDR and Keynes were proclaimed the "saviors of capitalism"!

Friedman Follows the Facts

In the 1950s, Friedman and Anna Schwartz began compiling historical data on monetary variables without any particular agenda or intention of overturning the dominant explanation of the Great Depression. But it became obvious that the data were at odds with the standard Keynesian explanation. So in their 1963 book, *A Monetary History of the United States, 1867–1960*, they presented the empirical evidence that led them to a completely different explanation.

As a result of examining more closely the key years between 1929 and 1933, Friedman and Schwartz first concluded that the Great Depression was not the necessary and direct result of the stock-market crash of October 1929, which they attribute to a speculative investment bubble. (The popping of the "bubble" may have been instigated by the Federal Reserve's raising of the discount rate—the interest rate the Fed charges on loans to commercial banks—in August 1929. The cause of the speculative bubble that led to the crash is a somewhat controversial topic. Whereas Friedman and Schwartz accepted that the bubble was caused by investors, seemingly endorsing—at least partly—the Keynesian "animal spirits" explanation, Austrian economists have argued otherwise.) In fact, they believed that the economy could have recovered rather rapidly if only the Fed—the central bank of the United States—had not engaged in a series of disastrous policies in the aftermath of the crash.

The Fed had only been in existence for 15 years at the time of the crash, having opened its doors in 1914. The United States had two central banks before the Fed (the Bank of United States, 1792–1812; and the Second Bank of the United States, 1816–1836), but had been without a central bank of any sort for over 75 years until the creation of the Fed. It was created primarily to act as a "lender of last resort" from which private banks could borrow money in times of crisis. The need for a lender of last resort in the U.S. banking system was due to a systemic weakness caused unintentionally by state and federal banking regulations. (Canada, with a freer banking system, had no such systemic weakness and no need for a lender of last resort.) Weak banks are subject to crisis when their depositors are no longer confident that their bank holds sufficient reserves to satisfy all withdrawal demands at a certain time. This can trigger a "bank run," where depositors attempt to get to the bank before the other depositors in order to withdraw their money before the bank's limited reserves run out. A run on a bank can easily generate other bank runs as depositors become worried about the financial health of their own similarly weak banks.

The problem with bank runs is that when depositors withdraw money and stuff it under their mattresses rather than trust it to other banks, the money supply shrinks. To understand this phenomenon, we have to explain how we measure the money supply. The simplest measures include not only currency but also checking deposits, since they are commonly used to make payments. What complicates things is that fractional-reserve banking leads to a multiple expansion of deposits. When someone puts money in a bank his checking account reflects the deposit, but the bank does not keep all the money on hand—it's not a warehouse. Instead, it keeps only a fraction as "reserves" and lends the rest to a borrower, who in turn buys goods or services. The seller then deposits her new income in a bank, where she gets a checking account. The money supply increases by the amount of the new deposit. This process will continue, though in ever-decreasing amounts since banks have to keep some part of the new deposits as reserves. Yet each cycle will increase the money supply by increasing the overall amount of deposits held at banks.

Bank crises continued to come in waves until the spring of 1933.

This process works in reverse too. When banks lose reserves due to bank runs, the economy experiences a multiple contraction of deposits. The deposits that are removed from the economy greatly exceed the additional currency that the public now holds, so the money supply decreases.

The stock-market crash of October 1929 made it more difficult for many businesses to repay their loans to the banks, and many banks found their balance sheets impaired as a result. But the most important cause of the bank runs that began in October 1930 was bad times in the farm belt, where the banks were especially weak and poorly diversified. The number of bank runs increased exponentially in December 1930—in that single month 352 banks failed. Most of the failing banks were in the Midwest, their failures caused by farmers who defaulted on their loans because they were hit hard by the economic downturn. No sooner did the first wave of bank runs subside than another got underway in the spring of 1931, creating what Friedman and Schwartz described as a "contagion of fear" among bank depositors. Bank crises continued to come in waves until the spring of 1933.

Roosevelt Comes In

FDR was inaugurated on March 4, 1933, and two days later he declared a "bank holiday," allowing banks legally to refuse withdrawals by depositors; it lasted ten days. With his famous phrase, "The only thing we have to fear is fear itself," he intended to dissuade depositors from running on their banks, but by then it was far too late. In 1929 there were a total of 25,000 banks in the United States. As the bank holiday ended, only 12,000 banks were operating (though another 3,000 were to reopen eventually). The effect on the money supply was equally dramatic. From 1929 to 1933 it fell by 27 percent—for every $3 in circulation in 1929 (whether in currency or deposits), only $2 was left in 1933. Such a drastic fall in the money supply inevitably led to a massive decrease in aggregate demand. People's savings were wiped out so their natural response was to save more to compensate, leading to plummeting consumption spending. Naturally, total economic output also fell dramatically: GDP was 29 percent lower in 1933 than in 1929. And the unemployment rate hit its historic high of 25 percent in 1933.

Friedman and Schwartz argued that all this was due to the Fed's failure to carry out its assigned role as the lender of last resort. Rather than providing liquidity through loans, the Fed just watched as banks dropped like flies, seemingly oblivious to the effect this would have on the money supply. The Fed could have offset the decrease created by bank failures by engaging in bond purchases, but it did not. As Milton and Rose Friedman wrote in *Free to Choose*:

> The [Federal Reserve] System could have provided a far better solution by engaging in large-scale

open market purchases of government bonds. That would have provided banks with additional cash to meet the demands of their depositors. That would have ended—or at least sharply reduced—the stream of bank failures and have prevented the public's attempted conversion of deposits into currency from reducing the quantity of money. Unfortunately, the Fed's actions were hesitant and small. In the main, it stood idly by and let the crisis take its course—a pattern of behavior that was to be repeated again and again during the next two years.

According to Friedman and Schwartz, this was a complete abdication of the Fed's core responsibilities—responsibilities it had taken away from the commercial bank clearinghouses that had acted to mitigate panics before 1914—and was the primary cause of the Great Depression.

The obvious question is: Why didn't the Fed act? We don't know for sure, but Friedman and Schwartz proposed several possible explanations: 1) the Fed officials did not fully understand the disastrous consequences of letting so many banks go under. Friedman and Schwartz wrote that Fed officials may have "tended to regard bank failures as regrettable consequences of bank management or bad banking practices, or as inevitable reactions to prior speculative excesses, or as a consequence but hardly a cause of the financial and economic collapse in process"; 2) Fed officials may have been acting out of their own self-interest since many of them were affiliated with large Northeastern banks. Bank failures, at least in the early stages, "were concentrated among smaller banks and since the most influential figures in the system were big-city bankers who deplored the existence of smaller banks, their disappearance may have been viewed with complacency"; 3) The inactivity may have been caused by political infighting between the Federal Reserve Board in Washington, D.C., and regional Fed banks, in particular the New York district bank, which was the most important part of the system at that time. But we may never know the real reason.

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Dangers of Centralized Power

There is an important lesson to be learned from this episode: When we centralize great responsibility and power in one institution, its failure will have far-reaching and terrible consequences. The Fed was instituted to act decisively in the exact circumstances that occurred in 1930–33. Friedman and Schwartz pointed out that the Fed's failure was all the more serious and difficult to understand given how easily it could have been avoided:

> At all times throughout the 1929–1933 contraction, alternative policies were available to the system by which it could have kept the stock of money from falling, and indeed could have increased it at almost any desired rate. Those policies did not involve radical innovations. They involved measures of a kind the system had taken in earlier years, of a kind explicitly contemplated by the founders of the system to meet precisely the kind of banking crisis that developed in late 1930 and persisted thereafter. They involved measures that were actually proposed and very likely would have been adopted under a slightly different bureaucratic structure or distribution of power, or even if the men in power had had somewhat different personalities.

This is the most worrisome fact. The institution failed because of the people within it. And given the immense power and influence it had over the economy, its failure was disastrous. It is important to understand that the Great Depression could have been avoided if the Fed had not so badly botched its monetary policy. In fact, Friedman and Schwartz claimed that the depression would not have been a Great Depression if there had been no Federal Reserve in the first place: "[I]f the pre-1914 banking system rather than the Federal Reserve System had been in existence in 1929, the money stock almost certainly would not have undergone a decline comparable to the one that occurred."

That point was effectively elaborated by Milton and Rose Friedman in *Free to Choose*:

> Had the Federal Reserve System never been established, and had a similar series of runs started, there is little doubt that the same measures would have been taken as in 1907—a restriction of payments. That would have been more drastic than what actually occurred in the final months of 1930. However, by preventing the draining of reserves from good banks, restriction would almost certainly have prevented the subsequent series of bank failures in 1931, 1932, and 1933, just as restriction in 1907 quickly ended bank failures then. . . . The panic over, confidence restored, economic recovery would very likely have begun in early 1931, just as it had in early 1908.
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> The existence of the Reserve System prevented the drastic therapeutic measure: directly, by reducing the concern of the stronger banks, who, mistakenly as it turned out, were confident that borrowing from the System offered them a reliable escape mechanism in case of difficulty; indirectly, by lulling the community as a whole, and the banking system in particular, into the belief that such drastic measures were no longer necessary now that the System was there to take care of such matters.

In the February 15, 2007, *New York Review of Books* economist and columnist Paul Krugman charged Friedman with "intellectual dishonesty" because Friedman repeatedly called for a significant reduction of the Fed's power or even its outright abolition as a result of his work on the Great Depression. Krugman, however, concluded that the real lesson to be learned from Friedman's explanation is that government institutions should be *more* active, not less. Krugman believes his conclusion to be so obvious that he is convinced that Friedman's contrary recommendation must be driven by an ideological agenda and thus is an example of intellectual dishonesty. However, Krugman is clearly missing the point.

Friedman's conclusion was perfectly logical given his belief that had the Fed not been created, the downturn of 1929 would not have become a major depression. Friedman claims in the paragraph above that without the Fed "the same measures would have been taken [in 1930] as in 1907—a restriction of payments," which he believes would have prevented the crisis from spreading to "stronger banks," those not guilty of overextending themselves through over-risky loans. Monetary economist Lawrence H. White of the University of Missouri-St. Louis filled in the blanks in Friedman's "institutional counter-factual" on the Division of Labour blog (March 12, 2007):

> Friedman understood . . . that before the Federal Reserve Act financial panics in the US were mitigated by the actions of private commercial bank clearinghouses. Friedman and Schwartz's view of the 1930's was that the Fed, having nationalized the roles of the clearinghouse associations [CHAs], particularly the lender-of-last-resort role, did less to mitigate the panic than the CHAs had done in earlier panics like 1907 and 1893. In that sense, the economy would have been better off if the Fed had not been created. This position is perfectly consistent with the position that, provided we take the Fed's nationalization of the clearinghouse roles for granted, the Fed was guilty of not doing its job.

Thus the Fed's failure in the early '30s shows the dangers of excessive centralization of important market functions that were previously dispersed among multiple private institutions. Friedman's bottom line remains intact: The Fed caused the Great Depression.

The Perfect Storm

In the decades following Friedman and Schwartz's work economists started examining other government-policy failures in the aftermath of the crash. They have found an abundant supply of them. Here are several key examples of these bad policies: 1) In response to a sharp decrease in tax revenues in 1930 and 1931 (caused by a slowdown of economic activities), the federal government passed the largest peacetime tax increase in the history of the United States, which clearly applied the brakes on any recovery that could have taken place; 2) the federal government also passed the Smoot-Hawley Tariff Act in 1930, substantially increasing tariffs and leading to retaliatory restrictions by trading partners, which resulted in a considerable decrease in demand for U.S. exports and a further slowdown in production (not to mention a loss of mutually advantageous division of labor); 3) the federal government also instituted all sorts of "public works" programs, beginning under Herbert Hoover and increasing dramatically under FDR; the programs removed hundreds of thousands of people from the labor market and engaged them in economically wasteful activities, such as carving faces of dead presidents into the sides of a mountain, preventing or delaying necessary labor-market adjustments; 4) another federal policy that prevented (labor and other) market adjustments was the price and wage controls enacted under the National Recovery Administration and in effect from 1933 until 1935 (when ruled unconstitutional); this policy massively distorted relative market prices, impairing their ability to function as guides to entrepreneurs; 5) the Fed was not blameless after 1933 either. It increased bank-reserve requirements in three steps in 1936 and 1937, leading to another significant decrease in the money supply. The result was the 1937–38 recession within the Depression, adding insult to injury.

Economists have come to understand the Great Depression as a "perfect storm" of policy failures. A truly frightening number of destructive policies were carried out nearly simultaneously. In retrospect it seems as though whenever the economy began showing the slightest inkling of recovery, a policy would be enacted that would put a quick stop to it.

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The better explanation of the Great Depression revealed it was not caused by unfettered market forces. There is nothing in the operation of free markets that would create depressions or even recessions. Rather, we now know that we must look for causes of these phenomena in mismanaged and erroneous government policies. And much of the credit for this change in the way economists look at the Depression must go to Friedman and Schwartz's groundbreaking work on the Fed's role. Friedman provided—and ultimately persuaded most economists of—this alternate explanation because of his insistence on honest intellectual inquiry, untainted by ideological biases. It was a courageous thing to do at the time of absolute Keynesian dominance of the economics profession, and it could have been damaging or even destructive to his career. But Friedman's personal strength of character and intellectual honesty obliged him to stick to the truth, and we are all much better for it today.

Ironically, as a result of the banking crisis of 1930–33, the Fed was granted *more* responsibilities and more control over banking. As is often the case in politics, failure was used to justify an expansion of power. That expansion of the Fed's power resulted in a great amount of economic destruction through the subsequent decades. In 1980 Milton and Rose Friedman wrote of the Fed's record over the 45 years after the banking crisis of 1930–33:

> Since 1935 the [Federal Reserve] System has presided over—and greatly contributed to—a major recession of 1937–38, a wartime and immediate postwar inflation, and a roller coaster economy since, with alternate rises and falls in inflation and decreases and increases in unemployment. Each inflationary peak and each temporary inflationary trough has been at a higher and higher level, and the average level of unemployment has gradually increased. The System has not made the same mistake that it made in 1929–1933—of permitting or fostering a monetary collapse—but it has made the opposite mistake, of fostering an unduly rapid growth in the quantity of money and so promoting inflation. In addition, it has continued, by swinging from one extreme to another, to produce not only booms but also recessions, some mild, some sharp.

The Fed's performance has improved since 1980, but that does not mean it is no longer capable of mistakes that would have devastating consequences for our lives. Friedman's work should serve as a warning of what can happen when so much power is artificially concentrated in one institution. It is for this reason that it is so vitally important that people today be taught the real story of the Great Depression. Their faith in government institutions might be considerably undermined if they understood what really happened.