

Mike Price

Mrs. Olsen

English 110

April 29, 2009

The Myths of the Great Depression

When the government chooses which history is told, 'patriotic,' myths and pro-state propaganda abound. This is the case with the current perception of the Great Depression. Most people believe the Great Depression was first caused by Laissez Faire, then Hoover didn't intervene enough, FDR didn't spend enough and it was the massive government program, otherwise known as World War II, that finally 'pulled' the US economy out. In reality, there was no Laissez Faire policy leading up to the Depression, nor in Hoover's positions or actions; FDR pushed the economy down, by spending too much and holding it in the Depression for 14 years following his first election, and finally, the end of WWII and the end of the massive spending, not the massive spending caused by WWII, is what allowed the free market to heal *itself* and pull *itself* out of the Depression.

Before delving into the myths surrounding the Great Depression it is necessary to gauge the severity of it, and find why it was so Great. The unemployment rate rose from 8.9% in 1930 to 28% in 1933, during the same time production fell 27%, and thousands of banks fell, causing \$1.3 billion in losses (Murphy 7, 8). Unemployment started to fall, but again rose up to 20% in April of 1937 and didn't subside until the unemployed workers were all drafted into World War II (13).

The four great myths and the reasons why the Depression was so deep will be explored in the sections following.

Causes

The Keynesian Explanation

John Maynard Keynes set forth his explanation of the Great Depression and his solutions in *The General Theory of Employment Interest and Money*. His text and explanation is standard in the economic community. To explore the Keynesian explanation of the Depression I will use lectures I attended from economics professor Dr. Richard Chapman.

The first step in Keynes' explanation was his 'refutation,' of Say's Law¹. According to Dr. Chapman, Keynes adopted Malthus' view of Say's Law, saying there would be a break in the cycle of supply to demand if people hoarded money, causing a leakage and a general over production of goods, which would, in turn, cause a depression (Chapman Keynes).

Next, Keynes redefined Investment and Savings. The classical economists had defined² Investment and Savings as solely a function of interest rates (Chapman Classical). Keynes changed this totally, in his view Savings was in no way a function of the current interest rate, he believed it was a function of income and introduced the 'Keynesian Cross,' which showed that on average savings went up as income went up. On Investment Keynes believed interest rates were a factor, but he believed expectations, the possible return and the price of the capital are all factors that matter more to entrepreneurs (Chapman Keynes).

With the foundation of Keynes' theory laid it is easy to show his theory of the Great Depression. Keynes believed that in 1929, as the Chairman of the Fed predicted bad times, the expectations of Entrepreneurs fell causing a drop in Aggregate Demand³. As Aggregate Demand fell, GDP

¹ Say's Law was put forth by Jean-Baptiste Say, an 18th century French economist and Political Philosopher, the law basically states that supply creates its own demand (the entrepreneurs who are supplying things are creating their demand for the products of other entrepreneurs), because of this there cannot be a recession or depression because of a lack of demand or money.

² In economics Investment is loans that entrepreneurs get to run their businesses and invest in the future, Savings are the Savings of everyday Americans.

³ Aggregate Demand is equal to the total Consumption, Investment, Government Spending and Net Exports in a country. This is the same formula for GDP.

fell, causing a drop in income (GDP is essentially a measure of the total income of a nation), which caused a drop in consumption and started the cycle over again (Chapman Keynes).

Keynes believed Economic depressions were caused by drops in Aggregate Demand, which was only possible because he refuted Say's Law, and the solution to depressions was substantially more government spending, which would push the Aggregate Demand back up to equilibrium with Aggregate Supply (Chapman Keynes).

Refutation of Keynes

The most effective refutation of Keynes, though there have been many, comes from the so-called Austrian School of Economics⁴. On Keynes' supposed refutation of Say's Law Ludwig von Mises said, "Keynes did not refute Say's Law. He rejected it emotionally, but he did not advance a single tenable argument to invalidate its rational" (Mises 70). On Keynes' adoption of Malthus' problem with hoarding, Murray Rothbard shows it does not matter, because when people hoard cash and decrease the money supply, there is less money spent to bid up prices and suppliers are forced to lower them, effectively increasing the value of money, which means there is no leak from the cycle (Rothbard, What Has Government Done to Our Money 31). This refutation kills Keynes' theory that a depression could be created by a fall in Aggregate Demand.

The Austrian Theory of the Business Cycle

The Austrian School also holds the best theory for the business cycle^{5,6} one that has predicted and explained all of the Depression since the start of the Industrial Age.

⁴ It is called the Austrian School because the founder and most members until the 1920's were from and resided in Austria.

⁵ The business cycle is when the economy goes from growth to recession or depression, then cycles back.

⁶ For more reading on how the Austrian Business Cycle Theory explains all the panic and depressions in American history and Tulip mania and other historical bubbles see: Meltdown by Thomas Woods, A History of Money &

Before one can effectively understand the Austrian theory it is necessary to understand the nature of the entrepreneur. In a free market an entrepreneur forecasts the demand of consumers and changes his supply based on that forecast. Over time the entrepreneurs who incorrectly forecast consumer demand are weeded out through losses (Rothbard, *Economic Depressions* 71). In an economic depression all, or the vast majority of, these entrepreneurs simultaneously mis-forecast the consumer demand, as Rothbard says, “How is it that, periodically, in times of the onset of recessions and especially in steep depressions, the business world suddenly experiences a massive cluster of severe losses?” (72)

This is where the Austrian Theory comes in. In a free market, as Tom Woods shows, the interest rate allows for a compatible mix of producers Investment and Consumer Savings, if the interest rate is high because there is little savings and much consumption, entrepreneurs will not invest in the future. But if the interest rate is low, because of an excess of savings and little consumption, the entrepreneurs will invest in the future (Woods, *33 Questions about American History* 176).

When a Central Bank (the Federal Reserve in the US) manipulates the interest rate⁷, lowering it below the market level, it changes the structure of production - the entrepreneurs can easily borrow money to invest and they invest in projects that will only be profitable in the future. They do this, however, when consumers are not saving and want to buy things now, thus the investments are malinvestments and are not wanted by the market (177). The following recession or depression, as the entrepreneurs realize their losses is hard, but necessary as the malinvestments must be liquidated (178).

Banking in the US by Murray Rothbard and Early Speculative Bubbles and Increases in the Supply of Money by Douglas French.

⁷ The fed manipulates the interest rate by increasing the supply of money, which gives the banks an excess of money to lend, forcing them to lower the interest rate to attract people to take it in loans.

*The Austrian Theory Applied*⁸

As Murray Rothbard shows, the money supply increased 61.8% or 7.7% annually from 1921-1929. In addition to this the actual money in circulation had a negligible change, but the loans to businesses, which causes the business cycle according to the Austrians, was the driving force in the enormous increase in the money supply (Rothbard, *America's Great Depression* 92-93).

Hoover

“His refusal to provide direct aid brought bitter public reaction and negative publicity” (Cayton et al. 526). This quote comes from a standard high school US History text book, showing that myth of Hoover's non-intervention is taken as fact in the US.

The truth, however, is that Hoover was far from a non-interventionist. As economist Thomas DiLorenzo explains, “Hoover deserves a share of blame for the Great Depression, not because he did nothing; rather he did *too much*” (DiLorenzo 160). He started by signing the Hawley-Smoot Tariff⁹ into law, in March of 1930 which raised the average tariff by 59%, ignited the Depression, caused the eventual loss of 83% of foreign American trade and started a trade war which likely allowed political extremists to take over in Japan (172).

He was not done here however, after the depression was well underway he tried to prop it up with continuously failing statist solutions. In 1929, barely after the Depression had started, his total public works spending was already 13% of the budget, and by 1931 it was as high as any point during FDR's presidency (168). This public works spending all took away from the market uses for the capital, as

⁸ There is not sufficient space to fully explore the Austrian theory and the Great Depression here, for more info on this topic see: *America's Great Depression* by Murray Rothbard and *The Causes of the Economic Crisis* by Ludwig von Mises

⁹ A tariff is a tax on foreign imports. Also, Hoover did this despite a petition signed by more than a thousand economists begging him not to.

DiLorenzo puts it, “Government intervention into capital markets always slows down or blocks the efficient reallocation of capital that is constantly occurring in a dynamic economy¹⁰” (173).

Unfortunately, Hoover also held the fallacious argument that wages needed to be held up in the depression, and convinced the major business leaders of the day to artificially prop up wages (Woods 184). As Woods shows, “...wage adjustments were essential if the downturn was to be brought to an end. The necessary readjustments required flexible wage rates in order to direct labor out of areas in which the boom had created unsustainable expansion” (185). This policy of keeping wages up accounted for 77% of the increase in unemployment from 1929 to 1933 (187).

FDR

Franklin Delano Roosevelt helping the economy or even the country in any way is quite possibly the most wide-spread historical myth around today, even, then Republican Speaker of the House, Newt Gingrich said, “...[FDR] did bring us out of the depression” (Higgs How FDR Made the Depression Worse, 1). But, again contrary to the myth, the fact is he continued Hoover’s already failed policies, pushing them to a greater extent than even Hoover did which prolonged the Great Depression (The unemployment rate never fell below, and was still at around 14% in 1940 when the draft was instituted (DiLorenzo 181)).

As explained by economist Robert Higgs, Roosevelt’s bad economic policy stemmed from the fact that he believed falling prices and wages had caused the depression, not that they were caused by the depression (Higgs 2). Thus the logical correction for this was for the government to prop up prices and wages. This was done by the creation of government cartels¹¹ to force the prices up. These cartels

¹⁰ This is called opportunity cost; the opportunity cost of something is the next best opportunity that was passed up.

¹¹ The Cartels set low and high prices for everything and consolidated industries. The government paid for the destruction of millions of dollars of food while the nation was starving in an effort to prop up prices.

were obviously not effective and the laws they had established would not have been followed without extreme police measures, as Old Right Journalist John T. Flynn explained in *The Roosevelt Myth*:

The NRA was discovering it could not enforce its rules. Black markets grew up. Only the most violent police methods could procure enforcement. In Sidney Hillman's garment industry the code authority employed enforcement police. They roamed through the garment district like storm troopers. They could enter a man's factory, send him out, line up his employees, subject them to minute interrogation, and take over his books on the instant. Night work was forbidden. Flying squadrons of the coat-and-suit police went through the street at night, battering down doors with axes looking for men who were committing the crime of sewing together a pair of pants at night. But without these harsh methods many code authorities said there could be no compliance because the public was not back of it (Flynn 45).

While it may sound like a good policy to hold wage and prices up during a depression, in an effort to force the market back up with them this is not how the economy works in reality. The market is a dynamic thing; it is constantly allocating resources to their most efficient uses through prices¹², but when the government interferes in the economy it disrupts this system. So not only did the Fed disrupt the whole system by interfering with the structure of production in the '20's, but the government did not allow the market to readjust itself in the '30's and it prolonged what would have been a quick downturn into the greatest depression in American History.

World War II

¹² This has been called the 'Invisible Hand,' by Adam Smith and Spontaneous Order by F.A. Hayek. Slimmed down the theory says that in a free market the entrepreneurs who most needs a resource will bid it away from all other uses. As consumers decide to buy or not to buy the end product entrepreneurs will either gain profits and continue or suffer losses and be forced to stop.

It follows logically from Keynesianism that if government spending is the only solution for a depression that massive government controls and spending during a war would cure a depression. This idea has engulfed economics and popular opinion (Chapman Keynes).

First, I will concede that World War II caused a huge drop in unemployment; this naturally follows the massive conscription of workers. As Higgs shows total hours worked in the US changed from 108.5 billion to 160 billion from 1939 to 1944, but over the same time period military hours worked almost tripled from 10.7 billion to 37.4 billion (Higgs A Revealing Window on the US Economy in Depression & War, 3).

As for the inane idea of wartime prosperity, we once again visit the concept of opportunity cost, as Robert Murphy puts it, "When a nation diverts millions of its most productive workers, as well as...scarce resources away from the production of...consumer goods, and into the production of tanks, bombers, and munitions that will be shipped overseas and destroyed...well, that makes people on the home front poorer" (Murphy 145).

The theory is all well and good, but what about the statistics? Keynesians will cite the impressive rise of GDP from barely \$1 billion in 1940 to over \$1.8 billion by 1944, but they fail to show that while government represented less than 20% of GDP in 1940 it was over 70% by 1944 (151,154).

Conclusion

I have gone through each of the four greatest myths surrounding the Great Depression, and shown how each myth eventually ties back into a proposition of more government and less freedom; taking into account how little effort it takes to puncture each myth it should not surprise anyone that they abound most at public schools.

Works Cited

Cayton, Andrew, Elisabeth Isreal Perry, Linda Reid, and Allen M. Winkler. *America: Pathways to the Present*. 2nd. Pearson Prentice Hall, 2007. Print.

Chapman, Richard. "Keynes." Westminster College. Salt Lake City, Utah. Spring Semester 2009.

---- "Classical." Westminster College. Salt Lake City, Utah. Spring Semester 2009.

DiLorenzo, Thomas. *How Capitalism Saved America*. Three Rivers Press, 2005. Print.

Flynn, John T. *The Roosevelt Myth*. 50th Anniversary. Fox & Wilkes, 1998. Print.

Higgs, Robert. "How FDR Made the Depression Worse." *The Free Market* 13, Art. 2(1995)

---- "A Revealing Window on the US Economy in Depression and War: Hours Worked, 1929-1950." *Libertarian Papers* 1, Art. 4(2009): Print.

Murphy, Robert. *The Politically Incorrect Guide to The Great Depression*. Regnery, 2009. Print.

Rothbard, Murray. *America's Great Depression*. 5th. Ludwig von Mises Institute, 2000. Print.

---- *What has Government Done to Our Money*. Ludwig von Mises Institute, 2008. Print.

---- *Economic Depressions*. 2nd. Ludwig von Mises Institute, 1996. Print.

von Mises, Ludwig. *Planning for Freedom*. The Liberty Fund, 2008. Print.

Woods, Thomas. *33 Questions about American history You're not Supposed to Ask*. Three Rivers Press, 2008. Print.