Remarks by James K. Galbraith, Lloyd M. Bentsen, jr., Chair in Business/Government Relations, Lyndon B. Johnson School of Public Affairs, The University of Texas at Austin, and Senior Scholar, Levy Economics Institute, to the Economic Policy Subcommittee of the Committee on Banking Housing and Urban Affairs, United States Senate, on "Lessons from the New Deal," March 31, 2009.

Chairman Brown, Ranking Member DeMint and members of the Subcommittee, it is a privilege to appear today to discuss the New Deal and its relevance to our present troubles.

In my view three main principles for economic policy emerged from the Great Depression, the New Deal, and ultimately from World War II. The first is that unregulated capitalism is not necessarily self-correcting; mass unemployment can occur and persist. The second is that direct economic intervention works best when it is targeted directly to the broad population – not filtered through those at the top -- and when it is implemented on a sufficiently large scale. Third, the fiscal cutbacks which produced the recession of 1937-38 showed that backtracking is disastrous. Once embarked on a policy of expansion and economic growth, it is essential to see it through to the end.

In what follows, I shall emphasize four points.

– Like our present troubles, the Great Depression flowed from a collapse of the banking system and of asset values – the Great Crash. This eliminated the possibility that recovery could be led by a revival of the financial system.

– Much of the New Deal involved the creation of comprehensive social insurance and the construction of institutions for collective action, including trade unions.

– The employment effects of New Deal policies have been under-rated and mis-stated in much recent work, in part because of a widespread misreading of the statistics.

– The early New Deal's employment policies were not conceived as "fiscal stimulus" but rather as programs to create jobs and for public investment. The investment programs were strongly oriented toward the long-term benefits of education, transportation, art and culture, and conservation. These programs had important macroeconomic effects but they also rebuilt the country.

1. The New Deal emerged from the Great Depression, and the Roosevelt administration understood very well that the Depression originated in the Great Crash of 1929 and in the collapse of the banking system in 1930. At the heart of the problem, as the Pecora investigations revealed, lay a culture of corruption, speculation, and self-dealing on Wall Street, and a well-justified loss of confidence by the public in the captains of finance.

Virtually every bank in America was shut when Roosevelt took office. His first act, the bank holiday, permitted them to be inspected and reopened; the public understood that those that reopened could be relied on. Other early actions were to institute federal deposit insurance so as to put an end to panics and runs, the passage of the Glass-Steagall Act separating commercial from investment banking, and the creation of the Securities and Exchange Commission, and the end of the gold standard. Taken together, these measures amounted to a comprehensive assertion of state power over finance. This power was reinforced in 1944 by the creation of the Bretton Woods system of fixed-but-adjustable exchange rates along with capital controls, and was largely maintained until that system was abandoned by Richard Nixon in 1971. The principal result was that economic growth was comparatively strong, stable and free of financial crises for a generation following the war, and with stable growth came a slow but steady decline in the inequality of income and wealth.

The early New Deal marked a fundamental break with the previous role of the banks. In the Hoover administration and also in England in the early 1930s, a reflexive concern of financial policy was to reassure the markets – hence the phrase "prosperity is just around the corner" – and to support the major banks by staying on the gold standard. This was the natural viewpoint of men who had spent their lives at the center of the New York and London financial worlds. But banks did not resume lending, in the depths of the depression, simply because they had gold in their vaults. There was no one to lend to, nothing to lend against. A first lesson of the Depression is that stuffing the banks with money does not solve a credit freeze.

The New Deal dealt with this problem by-passing the banks, or in some cases running them directly, through the Reconstruction Finance Corporation. Roosevelt also created new institutions, new public agencies to provide jobs and stabilize prices, wages and purchasing power. Thus the initial and indeed the later phases of the New Deal had three especially important elements beyond the regulation of finance: the introduction of comprehensive social insurance, the use of public spending to create jobs, and vast programs of conservation and public investment, effectively rebuilding the entire country from one end to the other.

2. Social insurance addressed a fundamental problem of capitalism: unregulated private markets are unstable. They cannot be relied on to provide an adequate minimum living standard for the working population. They cannot be relied on to provide a secure repository for savings. They cannot be relied upon to provide decent incomes in retirement. The problem of the Depression was perhaps above all a problem of insecurity, or as Roosevelt put it, of "fear itself." For most Americans, what was "just around the corner" was not prosperity but destitution.

Social innovation under the New Deal was motivated by a desire to deal with this fact. Deposit insurance, Social Security, farm price supports, the National Industrial Recovery Act, the minimum wage and the National Labor Relations Act were all, in different ways, aimed at establishing stability and decent minima. Some of this horrified the economists of that day and ours, particularly where the push for stability contradicted their deep philosophical and even emotional commitment to competition and antitrust. The NIRA was ruled unconstitutional by the Supreme Court. And some economists have ever since labored mightily to demonstrate that unions and minimum wages increased unemployment, that farm price supports were wasteful and inefficient, that Social Security discouraged savings. New Dealers would counter, very simply, that the proven alternatives to these things were poverty, migration and early death.

3. When Roosevelt took office in March, 1933 the macroeconomic tools and understanding we have today did not fully exist[1]. Mass unemployment had not been persuasively explained by the economics profession, and was variously blamed in academic circles on trade unions, on technological change, and on "events beyond our control." Then as now, a large body of academic opinion sought the remedy in lower wages. Then as now, a fair number of economists understood and favored the use of public works projects to keep people from starving or revolution. But the idea that public works could be run on a scale sufficient to end the Depression was not yet fully worked out. Nor did the country have the national income statistics or the unemployment statistics we presently use to analyze these problems: from a macro-econometric perspective, the government was flying blind.

The New Deal's approach to employment policy was direct and open-ended. Under Harry Hopkins, jobs were created, as quickly as possible, to help millions get through the year. The budget was, essentially, an afterthought. There was no particular emphasis on achieving a high economic growth rate, for the concept of economic growth (as we know it) did not yet exist. Nevertheless, the public spending initiatives of the New Deal did have powerful macroeconomic effects. Industrial production doubled between December 1932 and December, 1936. This is worth mentioning because it is sometimes denied: for example, in her recent book, *The Forgotten Man*, the journalist Amity Shlaes writes that industrial production did not rise in the United States after 1932. In point of fact, it rose very rapidly.

The New Deal's effects on unemployment are behind a widely-stated belief that "only the war ended the Depression." But as the economist Marshall Auerback has pointed out in a recent paper, widely-used unemployment figures (constructed after the fact) treat the 3.5 million workers who at the peak were employed by New Deal agencies as though they were unemployed. The original rationale for this was essentially ideological, insofar as recovery was defined as recovery of the *private* sector. But in practical terms the distinction is absurd. It supposes that someone building a private house on a temporary construction project in 1928 is employed, but that the same worker working on the Lincoln Tunnel in 1935 is not.

I take the liberty here of quoting from Auerback at length:

> Even pro-Roosevelt historians such as William Leuchtenburg and Doris Kearns Goodwin have meekly accepted that the millions of people in the New Deal workfare programs were unemployed, while comparable millions of Germans

[1] Simon Kuznets published the first national income statistics in 1934.

and Japanese, and eventually French and British, who were dragooned into the armed forces and defense production industries in the mid-and late 1930s, were considered to be employed.

This made the Roosevelt administration's economic performance appear uncompetitive, but it is fairer to argue that the people employed in government public works and conservation programs were just as authentically (and much more usefully) employed as draftees in what became garrison states, while Roosevelt was rebuilding America at a historic bargain cost.

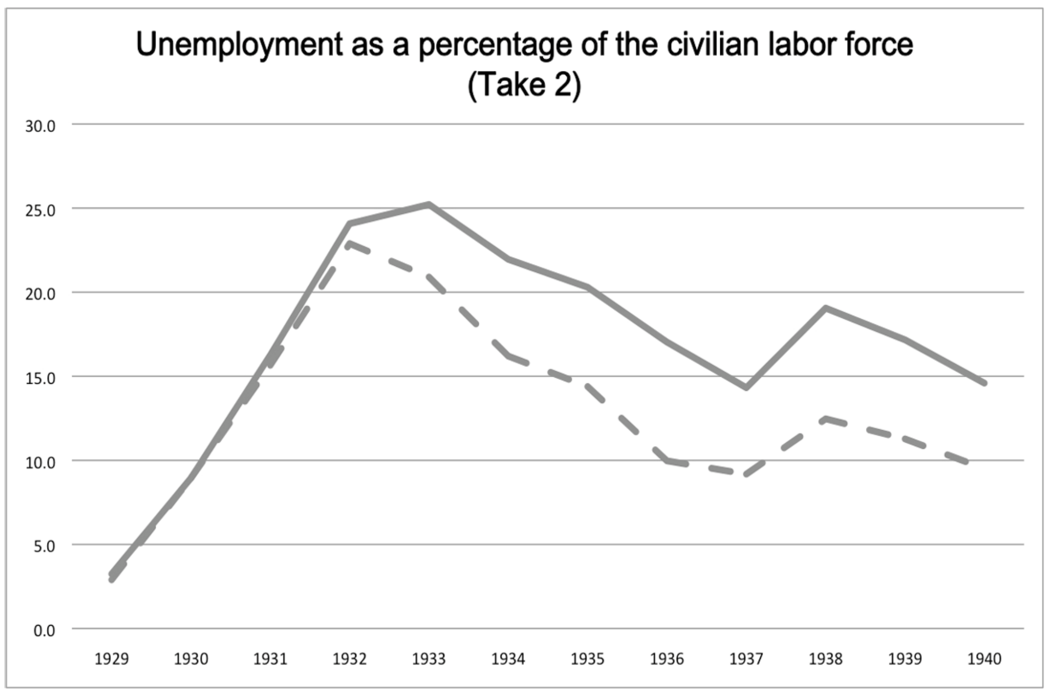
If these workfare Americans are considered to be unemployed, the Roosevelt administration reduced unemployment from 25 per cent in 1933 to 9 per cent in 1936, up to 13 per cent in 1938 (due largely to a reversal of the fiscal activism which had characterized FDR's first term in office), back to less than 10 per cent at the end of 1940, to less than 1 per cent a year later when the U.S. was plunged into the Second World War at the end of 1941. The reasons for the discrepancies in the unemployment data that have historically arisen out of the New Deal are that the current sampling method of estimation for unemployment by the BLS was not developed until 1940, thus unemployment rates prior to this time have to be estimated and this leads to some judgment calls. The primary judgment call is what do about people on work relief. The official series counts these people as unemployed.... A lot of people looked at these numbers without reading the notes... and concluded just that.

Then in 1976, an economist named Michael R. Darby wrote an article with the delightfully self-explanatory title, "Three-and-a-Half Million U.S. Employees Have Been Mislaid."2 What Darby did was read the notes. Here is what Lebergott had to say about counting unemployment in the 1930s:

> These estimates for the years prior to 1940 are intended to measure the number of persons who are totally unemployed, having no work at all. For the 1930's this concept, however, does include one large group of persons who had both work and income from work-those on emergency work. .... This contrasts sharply, for example, with the German practice during the 1930's when persons in the labor-force camps were classed as employed, and Soviet practice which includes employment in labor camps, if it includes it at all, as employment.

We would normally not consider people who painted murals for the WPA to be deemed worse off than those who "worked" in Mauthausen or the Soviet gulag. And yet, until we adjust the "workfare" discrepancy, incredibly we count such individuals as unemployed, even though their position was considerably better someone generating no income, or working in abysmal conditions in a slave labor camp.[2]

To give a sense of the actual reduction in unemployment under the New Deal, I borrow a chart from Auerback, showing the official series with (dashed line) and without (solid line) counting those working for New Deal programs as employed. The chart illustrates that New Deal policies in fact brought unemployment down from 25 to below 10 percent before the policy reversal and recession of 1937, and again by 1940 – still before the war.



The New Deal validated the ideas of the economist Richard Kahn, a close associate of Keynes, who had worked out the "employment multiplier" in the early 1930s; the idea that an increase of governmental expenditure on public improvements would create jobs both directly and indirectly: directly in the public service and indirectly in the private sector. In 1936, Keynes's *General Theory* translated this insight from employment to output, giving us the now-familiar concept of the multiplier effect of increased government spending on national income. And then, of course, the vast scale of new spending during the war not only eliminated unemployment but stopped the discussion: the case that public spending could cure unemployment had, for that generation, been proved.

By the same token, domestic monetary policy in this period played a very minor role, to the point where economists of that generation tended to feel that the Federal Reserve was a backwater. I do not buy for a single minute the currently-fashionable view that "quantitative easing" was primarily responsible for the economic expansion that occurred after 1933, unless

[2] Marshall Auerback, "Time for a New New Deal," mimeo, 2009.

one counts federal loan guarantees and direct lending as monetary policy.[3] If somehow the 1930s were a new golden age of private bank lending (at zero interest rates!) and of new business fixed investment, that fact completely escaped contemporary notice. Indeed the phrase "pushing on a string" was invented to describe the impotence of monetary policy at that time.

Finally, my difference with Professor DeLong on the role of fiscal policy is that it is by *ex ante* public spending, not *ex post* deficits, that one must measure the strength of fiscal expansion. Public expenditures rose 55 percent between 1932 and 1934; as a share of (collapsing) GDP they rose from 10.2 percent in 1932 to 17.4 percent in 1934. I have also never understood how the gold inflow in advance of WWII was supposed to have been a stimulus, insofar as gold at that time had been stripped of its monetary role. What stimulated the economy in 1939-1940, of course, was still more public spending, now motivated for the first time by Keynesian ideas, and export orders.

4. A fourth great area of New Deal achievement lay in the physical, moral and artistic reconstruction of the nation. In 1932 the country was underdeveloped – to take one example, in 1930 my father drove a Model T Ford from his home in Ontario to Berkeley California, and noted that from Lincoln, Nebraska to the California line the roads were unpaved. Auerback has an elegant description of what happened during the following decade:

> The government hired about 60 per cent of the unemployed in public works and conservation projects that planted a billion trees, saved the whooping crane, modernized rural America, and built such diverse projects as the Cathedral of Learning in Pittsburgh, the Montana state capitol, much of the Chicago lakefront, New York's Lincoln Tunnel and Triborough Bridge complex, the Tennessee Valley Authority and the aircraft carriers Enterprise and Yorktown. It also built or renovated 2,500 hospitals, 45,000 schools, 13,000 parks and playgrounds, 7,800 bridges, 700,000 miles of roads, and a thousand airfields. And it employed 50,000 teachers, rebuilt the country's entire rural school system, and hired 3,000 writers, musicians, sculptors and painters, including Willem de Kooning and Jackson Pollock.[4]

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[3] The work of Professor Thomas Ferguson on the early New Deal covers these issues well, especially "Monetary policy, loan liquidation and industrial conflict: The Federal Reserve and open market operations of 1932 (Journal of Economic History, 1984) and "From Normalcy to New Deal" (International Organization 1984.)

[4] Auerback, *op. cit.*

These accomplishments had important Keynesian effects, but they were not incidental to a short-term Keynesian expansion policy, and would not have been possible if they were. Major construction projects require advance planning and they take time to complete. But FDR did not limit himself to the "shovel ready" projects on the ground that the economy needed only a "stimulus" in order to "get credit flowing again" and to return to the happy days of the 1920s. He had no interest in ever returning to those days. The money-changers had fled the temple, and he was not about to let them come back. The New Deal built for the ages, as shown by the fact that its greatest achievements – from the TVA to Social Security -- are still in use.

It is true that there was tension with Roosevelt's team between Hopkins, head of short term employment at the WPA, and Harold Ickes, head of the major investment projects of the PWA. My father liked to tell of a morning when FDR met both men in sequence, heard Hopkins' case for immediate jobs programs and then Ickes' for worthwhile capital projects. He told each man, "You're exactly right!" After the meetings, Mrs. Roosevelt remonstrated with her husband: hadn't he contradicted himself by supporting these two precisely opposed opinions? The President's response was, "Eleanor, you're exactly right."

5. Let me round out this brief overview by noting something the New Deal did not achieve: it never resurrected the commercial banking system. The New Deal renegotiated short-term mortgages that could not be refinanced, creating the 30-year, fixed-rate mortgage that was the staple of housing finance for the next half-century. It fostered savings-and-loans through strict regulation of interest rates, and began the secondary markets for prime mortgages. It ran many failed or otherwise-failed banks. The Reconstruction Finance Corporation provided a lending lifeline to private businesses. But private commercial bank lending remained a minor feature of the recovery picture. By and large, the collapse of asset values meant that very few people or businesses could qualify for private commercial bank loans, and the flight to cash insured that despite low interest rates very few would have wanted them anyway.

What eventually began the resurrection of private banking was the creation of net financial wealth during World War II. In this period, national income doubled, while output available for civilian use was held roughly constant. Thus working families had roughly twice the income they could spend, and rigorous price controls prevented inflation that would have absorbed the nominal incomes. Americans were therefore willing to lend their excess incomes back to the government to finance the war effort, and the resulting war bonds, amounting to 125 percent of GDP by the war's end, formed the foundation of the financial position of the post-war middle class. It was only then (and following the further contributions to private wealth of the Korean War in 1950), that the American public became once more a profitable clientele for private banks. And it was not until considerably later yet, that the public began to rediscover the stock market.

My final argument is therefore that a banking calamity of the type experienced in the 1930 and, I would argue, repeated for the first time beginning in August, 2007 has very long-term effects on the resilience of the banking system no matter what steps the government may take to restore output, employment and total capital formation, and no matter how effective those steps are. There is no easy or swift way back to rapid credit expansion. And the path is slower and more difficult, if policy energies are devoted to futile attempts to revive a Paradise Lost, an economy led and directed by private commercial banking interests. Even if it were desirable, it probably cannot be done.

6. As part of an exercise yesterday at the Council on Foreign Relations, I reviewed some of the recent academic literature which alleges that the New Deal prolonged or even deepened the Great Depression. The central logic of this argument is the following. In normal times, it is alleged, without government interference, falling real wages rapidly restore the conditions for full employment. Since this did not happen in the 1930s, the argument goes, wages must not have fallen enough. If one asks why not, the answer is close at hand: the New Deal's efforts to raise prices and wages, to promote unions, and to impose a minimum wage were all counterproductive from the standpoint of maintaining employment. The New Deal is then faulted for the failure of total output to return to the trend line of the 1920s until after the start of the Second World War.

In the opening chapters of *The General Theory,* Keynes specifically showed that the cuts in money-wages then (as now) being demanded of workers would not produce the cuts in real wages that were required by theory, since prices would also fall. Correspondingly, raising both prices and wages does not raise real wages as the argument claims.

But the argument has other flaws as well. First, it ignores the depth of the Great Depression, and begs the question of how and why unemployment rose to 25 percent by the end of 1932 – before Roosevelt took office and therefore before any of the alleged mistakes of the early New Deal had been made. Second, it ignores the extremely rapid recovery of 1933-36, or rather simply demands to know why that recovery wasn't more rapid still, asserting in effect that it would have been still more rapid if nothing by way of policy had been done. This assertion is simply an act of faith. Third, it assumes that the speculative bubble of the late 1920s was not unsustainable, and that in principle growth of the same type could have continued for another decade (or even indefinitely). This is tantamount to asserting that the Great Crash had no roots in the unsafe banking practices of that earlier time, and no implications for the ensuing Depression.

Suffice to say, I don't think so.

Thank you very much again for your attention.