



The Great Contraction, 1929–33

BY ROBERT HIGGS

The recession that began in mid-1929 need not have become a disaster. Many downturns had occurred previously in U.S. economic history, and nearly all of them had been fairly shallow and soon followed by recovery and continued growth. In the nineteenth century most people had believed that the government neither knew how nor possessed the constitutional authority to act effectively as an economic savior. They seem to have appreciated that, in Murray Rothbard's words, "[r]ecessions unhampered by government interventions almost invariably work themselves into recovery within a year or so."

The depression of the mid-1890s had been the most severe macroeconomic bust prior to 1929, but despite appeals for government assistance to suffering farmers, unemployed workers, and others, Grover Cleveland's administration staunchly resisted, insisting that the federal government lacked constitutional authority to intervene in that fashion and that the public ultimately stood to benefit the most by upholding free markets.

By the late 1920s, however, many reputable observers had come to believe that the economy had entered a "new era" in which government and business leaders understood how to counteract any recession that might occur before it became severe. Unfortunately, the knowledge they imagined themselves to possess in this regard was for the most part nothing more than an instance of what F. A. Hayek later called the *pretense of knowledge*—the conviction that government planners, including the monetary authorities, know how to make the world a

better place than it would be if people were simply left to their own devices.

So, although in previous economic downturns hardly anyone had expected the government to take vigorous action to bring about recovery, by 1929 the dominant ideology had changed substantially. Many opinion leaders and large segments of the general public had embraced the Progressive faith in activist gov-

ernment. To make matters worse, the economics profession for the most part had come to believe that the government could and should intervene actively in economic life.

These ideological and intellectual changes came as music to the ears of many politicians, who welcomed a plausible excuse to enlarge their powers and to turn the exercise of those enlarged powers to their own advantage. Organized special interests also seized on the new ideas and attitudes as pretexts for the creation of pensions, subsidies, insurance benefits, bailouts, barriers to competition, and other privileges they sought from government.

As officials at all levels responded to the newly strengthened demands that government "do something" in late 1929 and afterward, the government carried out an enormous number and

variety of interventionist measures, spanning every industry, region, and demographic group in the country. Many of these schemes simply reestablished under new

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names the measures that had been used during the recent war, on the ill-considered ground that since these policies and programs had proved successful in a previous emergency (war), they would prove successful again during the existing emergency (economic depression). As President Herbert Hoover declared, “We used such emergency powers to win the war; we can use them to fight the depression.” So, for example, the defunct War Finance Corporation was revived in 1932 and called the Reconstruction Finance Corporation.

Because the government’s economic-rescue programs often worked at cross purposes or impaired the operation of the private competitive economy, they exacerbated the downturn between 1929 and 1933, making it deeper than it otherwise would have been, and they slowed the economy’s recovery after 1933, so that even when the government began to shift the economy onto a war footing in mid-1940, full recovery had not yet been attained—the official unemployment rate in 1940 was 14.6 percent (if persons enrolled in government emergency employment programs are counted as employed, the unemployment rate was 9.5 percent). In short, the government’s cures made the disease much worse and slowed the patient’s natural recovery.

The dimensions of the disaster were shocking. For nearly four years, with only brief and abortive reversals, the economy fell deeper and deeper into the trough. By 1933 real gross domestic product had declined 30 percent. Production of consumer durables fell 50 percent, producer durables 67 percent, new construction 78 percent, and gross private domestic investment almost 90 percent. The real value of U.S. exports and imports dropped nearly 40 percent. The unemployment rate reached almost 25 percent, and perhaps one-third of those still employed in 1933 were working only part-time. Prices fell on average about 23 percent. Banks failed in waves, and by the end of 1933 nearly 10,000 of them had gone under.

In 1931, 1932, and 1933 the after-tax profits of all corporations added up to less than zero each year. Rental and proprietary income dropped more than 60 percent. The stock market hit bottom in 1932, having lost more than 80 percent of its value. Farm-product prices fell more than 50 percent; net income of farm operators declined nearly 70 percent, and thousands of

farmers surrendered their homes and farms to mortgage lenders and tax collectors. Three states—Arkansas, Louisiana, and South Carolina—and approximately 1,300 municipalities defaulted on their debts, and many other states and local governments verged on default.

Smoot-Hawley Act

Among the most harmful of the counterproductive policies implemented during the Great Contraction was the Smoot-Hawley Act in 1930, which lifted import taxes to an all-time high and set in motion a tariff war, a trade-constricting sequence of action and reaction around the trading world. In late 1929 President Hoover urged employers to maintain real wage rates despite the plummeting demand for their products. Many of the largest employers did so in 1930 and into 1931 and, as a result, unemployment increased much faster than it otherwise would have. The Revenue Act of 1932, which became fully effective in 1933, raised taxes by a greater percentage than any previous peacetime tax act, administering a stunning blow to already-struggling households and businesses.

Perhaps worst of all, at the Federal Reserve System, which had been created in 1913 to provide emergency liquidity to commercial banks during financial panics, officials stood by while banks failed by the thousands, bizarrely convinced that in the circumstances they had done all that they could and should do to prevent the banking system’s collapse. As a result, the money stock (M2 measure) fell by 32 percent between June 1929 and June 1933. As banks failed and depositors clamored to draw down their bank deposits and to augment their cash holdings, financial stringency took an enormous toll on households and businesses throughout the country.

Owing to the foregoing policies and many others that might be mentioned if space permitted, the economic downturn that began in 1929 turned out to be not simply another recession, quickly reversed, but a catastrophe that persisted for more than a decade. As the emergency spread across the entire trading world, it fostered takeovers by aggressive collectivist governments in several important countries, including Germany, where the ascendancy of the Nazis hastened the onset of World War II.

