Economic View

But Have We Learned Enough?

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LIKE most economists, those at the International Monetary Fund are lowering their growth forecasts. The financial turmoil gripping Wall Street will probably spill over onto every other street in America. Most likely, current job losses are only the tip of an ugly iceberg.

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Understanding the Great Depression and avoiding another one are two different things.

But when Olivier Blanchard, the I.M.F.'s chief economist, was asked about the possibility of the world sinking into another Great Depression, he reassuringly replied that the chance was "nearly nil." He added, "We've learned a few things in 80 years."

Yes, we have. But have we learned what caused the Depression of the 1930s? Most important, have we learned enough to avoid doing the same thing again?

The Depression began, to a large extent, as a garden-variety downturn. The 1920s were a boom decade, and as it came to a close the Federal Reserve tried to rein in what might have been called the irrational exuberance of the era.

In 1928, the Fed maneuvered to drive up interest rates. So interest-sensitive sectors like construction slowed.

But things took a bad turn after the crash of October 1929. Lower stock prices made households poorer and discouraged consumer spending, which then made up three-quarters of the economy. (Today it's about two-thirds.)

According to the economic historian Christina D. Romer, a professor at the University of California, Berkeley, the great volatility of stock prices at the time also increased consumers' feelings of uncertainty, inducing them to put off purchases until the uncertainty was resolved. Spending on consumer durable goods like autos dropped precipitously in 1930.

Next came a series of bank panics. From 1930 to 1933, more than 9,000 banks were shuttered, imposing losses on depositors and shareholders of about $2.5 billion. As a share of the economy, that would be the equivalent of $340 billion today.

The banking panics put downward pressure on economic activity in two ways. First, they put fear into the hearts of depositors. Many people concluded that cash in their mattresses was wiser than accounts at local banks.

As they withdrew their funds, the banking system's normal lending and money creation went into reverse. The money supply collapsed, resulting in a 24 percent drop in the consumer price index from 1929 to 1933. This deflation pushed up the real burden of households' debts.

Second, the disappearance of so many banks made credit hard to come by. Small businesses often rely on established relationships with local bankers when they need loans, either to tide them over in tough times or for business expansion. With so many of those relationships interrupted at the same time, the economy's ability to channel financial resources toward their best use was seriously impaired.

Together, these forces proved cataclysmic. Unemployment, which had been 3 percent in 1929, rose to 25 percent in 1933. Even during the worst recession since then, in 1982, the United States economy did not experience half that level of unemployment.

Policy makers in the 1930s responded vigorously as the situation deteriorated. But like a doctor facing a patient with a new disease and strange symptoms, they often acted in ways that, with the benefit of hindsight, appeared counterproductive.

Probably the most important source of recovery after 1933 was monetary expansion, eased by President Franklin D. Roosevelt's decision to abandon the gold standard and devalue the dollar. From 1933 to 1937, the money supply rose, stopping the deflation. Production in the economy grew about 10 percent a year, three times its normal rate.

Less successful were various market interventions. According to a study by the economists Harold L. Cole and Lee E. Ohanian, both of the University of California, Los Angeles, and the Federal Reserve Bank of Minneapolis, President Roosevelt made things worse when he encouraged the formation of cartels through the National Industrial Recovery Act of 1933. Similarly, they argue, the National Labor Relations Act of 1935 strengthened organized labor but weakened the recovery by impeding market forces.

LOOKING back at these events, it's hard to avoid seeing parallels to the current situation. Today, as then, uncertainty has consumers spooked. By some measures, stock market volatility in recent days has reached levels not seen since the 1930s. With volatility spiking, the University of Michigan's survey reading of consumer sentiment has been plunging.

Deflation across the economy is not a problem (yet), but deflation in the housing market is the source of many of our present difficulties. With so many homeowners owing more on their mortgages than their houses are worth, default is an unfortunate but often rational choice. Widespread foreclosures, however, only perpetuate the downward spiral of housing prices, further defaults and additional losses at financial institutions.

The Fed and the Treasury Department, intent on avoiding the early policy inaction that let the Depression unfold, have been working hard to keep credit flowing. But the financial situation they face is, arguably, more difficult than that of the 1930s. Then, the problem was largely a crisis of confidence and a shortage of liquidity. Today, the problem may be more a shortage of solvency, which is harder to solve.

What's next? Perhaps the most troubling study of the 1930s economy was written in 1988 by the economists Kathryn Dominguez, Ray Fair and Matthew Shapiro; it was called "Forecasting the Depression: Harvard Versus Yale." (Mr. Fair is an economics professor at Yale; Ms. Dominguez and Mr. Shapiro are at the University of Michigan.)

The three researchers show that the leading economists at the time, at competing forecasting services run by Harvard and Yale, were caught completely by surprise by the severity and length of the Great Depression. What's worse, despite many advances in the tools of economic analysis, modern economists armed with the data from the time would not have forecast much better. In other words, even if another Depression were around the corner, you shouldn't expect much advance warning from the economics profession.

Let me be clear: Like Mr. Blanchard at the I.M.F., I am not predicting another Great Depression. We have indeed learned a lot over the last 80 years. But you should take that economic forecast, like all others, with more than a single grain of salt.

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