LESSONS FROM THE GREAT DEPRESSION FOR POLICY TODAY

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I. INTRODUCTION

It is an honor and a pleasure to be here today, and to participate in this wonderful all-day discussion of the Great Depression and World War II.

I took a detour out of academia and into economic policymaking when President Obama asked me to be chair of his Council of Economic Advisers back in 2008. After I had been in Washington for a few months, a reporter asked me why I had gotten the job. Since I didn't know and had always wondered, I asked Rahm Emanuel, the President's somewhat intimidating chief of staff. I was a little worried about what the answer might be—"Oh, we needed a woman," or "Nobody else would work with Larry Summers." Instead, Rahm gave an answer I just loved. He said: "You were an expert on the Great Depression, and we thought we might need one."

The President and his hiring team clearly believed there were lessons from the Great Depression that might be relevant to economic policymaking during those scary months of late 2008 and early 2009—when the United States faced the first widespread financial crisis we had had since the 1930s. In my talk this morning, I want discuss what some of those lessons might be.

I will be frank—not all of these lessons are things that I knew back in 2008. The learning has gone in both directions. The Great Depression informed many of my policy recommendations. But, living through another terrible crisis has changed some of my views on what is most relevant or important about the experience of the 1930s. And the recent crisis has generated a lot of interest and wonderful new research on the Depression.

To keep things manageable, I want to focus mainly on the recovery from the Great Depression—that is, the period starting in 1933. Why the American and world economies plummeted between 1929 and 1933 could fill many hours of its own lecture. The essential fact is that consumers and businesses stopped spending—we had a huge fall in aggregate demand. That mattered because when people stop buying, firms stop producing and hiring. People lose their jobs and the economy falls even further. Policy mistakes certainly played a role in why spending collapsed in the early 1930s. In particular, the fact that the Federal Reserve did little to stem the repeated waves of banking panics is a major reason why the downturn was so horrific and lasted so long.

But, in the spring of 1933, the American economy finally turned the corner. Shortly after Franklin Roosevelt's inauguration, consumers and businesses started to spend again. As a result, firms started to produce again, and unemployment began its long, hard journey down from more than 25 percent of the labor force.

I want to discuss the role that policy played in that turnaround and recovery. What seems to have worked, and why? Of course, policy isn't the whole story. Once the economy turned around, new innovations, business leadership, and plain old hard work were critical in driving the recovery. But I want to focus on the lessons we can learn from the Depression about the role that government policy can play in starting and sustaining a recovery.

The policy lessons fall into three broad areas: fiscal policy—the use of government spending and tax changes; monetary policy—decisions about the money supply and interest rates; and credit policy—measures to deal with consumer and mortgage debt, and the rising tide of defaults and foreclosures.

In each case, I will describe what policies were used in the 1930s, and how well they worked. I will try to give you a feel for the evidence that scholars have amassed about the impact of these policies on the recovery, and the lessons we have learned from the experience of the 1930s.

Then I will look at the degree to which those lessons from the Great Depression were or were not incorporated into the policy response to the recent crisis. Did we, in fact, learn from the past? The answer, you will see, is only partly.

Finally, I will suggest some ways that policy could evolve going forward. What does the experience from the Great Depression suggest could still to be done to make the American economy stronger and healthier going forward?

II. FISCAL POLICY

Let me start with fiscal policy. What do we learn about the effectiveness of changes in government spending and taxes as a recovery tool from the experience of the 1930s? I would sum it up this way: ***Fiscal policy works when it is tried.***

In theory, when output is low because demand is low, changes in the government budget can be helpful. A tax cut can put money into people's pockets and so encourage consumption. Government spending on things like roads and bridges can create demand for steel and concrete, and put construction workers back on the job.

What I think we learn from the Depression is that theory is confirmed by empirical evidence. When fiscal policy was used in the 1930s, it did help to spur recovery. The main problem is it wasn't used very much.

***<u>The 1930s</u>*.** Most of the academic research, my own included, has emphasized that relative to the size of the problem, Roosevelt's fiscal policy actions were pretty small.[1] In no year was the increase in the federal budget deficit more than a few percent of GDP. Against an unemployment rate of 25 percent, that was fairly weak medicine. And fiscal policy was also somewhat erratic. It varied between modestly expansionary in some years to somewhat contractionary in others. It is the fact that there was never a large, sustained fiscal expansion that led one scholar to famously conclude that fiscal policy was "an unsuccessful recovery device in the 'thirties—not because it did not work, but because it was not tried."[2]

While that is largely true, it overstates the case. There were times when fiscal policy was tried somewhat in the 1930s, and in those cases it appears to have been helpful.

One time was in the winter of 1933-1934. Faced with a destitute population and a harsh winter, the government established the Civil Works Administration to directly hire the unemployed in November 1933. CWA workers did everything from laying sewer pipes, to improving roads, to building playgrounds. What I find amazing is that the program managed to hire more than 4 million people in just a few months.[3] That is a speed and scale of results that policymakers could only dream of in 2009.

Another time fiscal policy was tried was in 1936 with the veterans' bonus. Back in the 1920s, veterans of World War I had been promised a bonus—to be paid in 1945. As the Depression dragged on, veterans pushed hard to get the bonus early. There were huge marches in Washington by what came to be called the Bonus Army. In 1936, Congress finally agreed to pay the bonus early. Interestingly, President Roosevelt vetoed the bonus bill—so it only became law because Congress overrode his veto.

The bonus was large. The total amount of money was about 2 percent of a year's GDP. And for the 3.2 million veterans who actually got it, it was huge. The average payment was \$547—which in today's prices is equivalent to about \$9,000. A wonderful new study looks at a wide range of evidence, and finds that it all points to the same conclusion: the bonus raised consumer spending and stimulated output and employment.[4]

One of my favorite pieces of evidence comes from a long-forgotten survey done by the American Legion. They asked their members directly what they would do with the bonus money. Many said they were planning to buy a new car—which, coincidently, cost around \$500 in 1936. And a look at new car registrations across states in 1936 confirms that states with a higher fraction of veterans had many more car sales per capita than states with fewer veterans.

All told, the study suggests that this one expansionary fiscal action reduced the unemployment rate by about 1½ percentage points in 1936. Given that the unemployment rate—even with the bonus—was 17 percent, this wasn't nearly enough. But it was unquestionably a help. Hence my lesson: fiscal policy works when it is tried.

Just to drive home the impact of fiscal policy in the 1930s, we have a good example from this period of contractionary fiscal policy working in the opposite direction. In 1937, fiscal policy swung strongly from expansion to contraction. Part of this was just the fact that the veterans' bonus swelled government expenditures in 1936 and then disappeared in 1937—so public spending dropped. But, we also increased taxes as well—1937 was the first year we collected Social Security taxes. All told, the budget deficit adjusted for the state of the economy fell dramatically—by about 4 percent of a year's GDP.[5]

And output plummeted. We had a second recession in 1938. Indeed, one reason why we think of the recovery from the Great Depression as being very slow was that there were, in fact, two severe downturns. Fiscal contraction was not the only cause of this second recession, but studies suggest it was an important contributor.[6] So that is another piece of evidence from the 1930s that fiscal policy matters.

Finally, I should mention the obvious impact of World War II. One of the notions that I often try to fight against is that World War II ended the Depression. I feel this claim sells short the tremendous progress that had been made toward recovery in the mid-1930s. Real GDP had increased by more than 40 percent between 1933 and 1937.[7] Had it not been for the second recession in 1938, the United States would likely have been much of the way back to its pre-Depression trend before the outbreak of the war.

At the same time, World War II was obviously a very large fiscal stimulus. Both taxes and government spending went up, but spending went up more—so the budget deficit clearly rose. And the economy responded to that stimulus: real GDP rose another 50 percent between 1941 and 1944. The fact that output and employment surged during the war, despite rationing and other methods to limit private consumption, is some of the strongest evidence we have that expansionary fiscal policy raises growth when it is used.

***The Recent Episode*.** Now this lesson from the Depression—that fiscal policy works when it is tried—is one that was followed somewhat in the response to the Great Recession. In fact, the fiscal policy response started very early. In February 2008, President Bush and Congress passed a tax rebate of up to $1200 per family. Though there is some debate among economists about what it accomplished, my own reading of the evidence is that it was helpful. A very careful study using individual level spending data suggests that people really did go out and spend their rebate checks.[8] Indeed, just like the veterans in 1936, a surprisingly large number went out and bought cars. This finding resonates with me, because the day my father got his rebate check, he went right out and bought a nice new Honda CRV.

The even larger fiscal policy response to the 2008 recession came with the American Recovery and Reinvestment Act of 2009. The Recovery Act, which was passed just a month after President Obama was inaugurated, was larger relative to the size of the economy than anything Roosevelt did in the Great Depression. It was a mixture of tax cuts, government spending, and aid to people directly harmed by the recession.

We could have a long discussion on what the Recovery Act accomplished. It remains a highly controversial action. Since I helped design it, I am clearly biased in favor of thinking that it was helpful. (I am such a fan that a few Christmases ago, my daughter made me a needlepoint Christmas tree ornament of that green Recovery Act sign you see posted at every construction site it funded.) My sense of the emerging academic research is that the act did contribute to recovery, though some parts of the act were decidedly more successful than others.[9]

Ironically, the mistake that I feel we made was exactly the one economic historians criticize Roosevelt for. As it turned out, the fiscal expansion included in the Recovery Act was too small relative to the problems we were facing. Even if it did shave 1½ to 2 percentage points off the unemployment rate relative to what otherwise would have happened, as a number of studies have suggested, the unemployment rate still went up to 10 percent. So clearly, we had not learned the lesson from the Great Depression nearly well enough.

Another place where I see countries throughout the world perhaps failing to learn from the 1930s is in understanding the costs of fiscal contraction. I mentioned that the switch to deficit reduction in 1937 was one of the factors leading to the recession in 1938. After the meltdown in Greece in 2010, countries throughout the world began to worry substantially about their budget deficits. And that led to fiscal austerity in a number of countries—tax increases and reductions in government spending. Interestingly, many governments convinced themselves that such austerity would not be painful, and that perhaps it would even be helpful for economic growth.

And yet, the results have been quite similar to what happened in the United States in 1938. Countries like the United Kingdom and many members of the Euro area have seen growth stop and unemployment rise as they have cut their budget deficits. And the outcome has been worse in the countries that moved more sharply to austerity.[10] Fiscal austerity is not the only cause of the problems in these troubled countries by any means, but it is unquestionably a factor.

Implications Going Forward. I have talked about fiscal policy in the Depression and how well we seemed to have learned from that experience. Are there implications going forward?

The lesson that fiscal policy works when it is tried, suggests that countries should try to keep themselves in a position to use this powerful tool. If you look at the countries that used fiscal policy most aggressively to fight the 2008 recession, it was countries that began with low levels of government debt.[11] Nations like China, Australia, and South Korea were able to take aggressive fiscal expansion because they had run very responsible fiscal policy earlier in the 2000s. That suggests that countries should work hard to run balanced or even surplus budgets in normal times, so that they can run budget deficits when their economy is hit by a severe recession.

The lesson from 1938 that cutting deficits is painful suggests that countries should move cautiously as they try to get their budget deficits under control. I believe strongly that countries like the United States need to deal with their long-run budget problems. We are on an unsustainable path and we have to fix it. But, we need to be smart about how we do it. Understanding that tax increases and spending cuts will tend to reduce growth and increase unemployment means we may want to phase the deficit reduction in gradually—as other factors start to strengthen the recovery.

III. MONETARY POLICY

So much for fiscal policy, what about monetary policy? Did we also learn something from the 1930s about how to use this policy tool? Again, I think the answer is yes. I would sum up the lesson for monetary policy this way: ***It takes a regime shift.***

Let me explain what I mean. Monetary policy normally refers to the actions that the central bank takes regarding interest rates and the money supply. The usual thing that a central bank does in times of depression is reduce interest rates. That makes it easier for businesses and families to borrow and spend—which helps put people back to work.

The problem in 1933, just like today, was that stated interest rates were already down to zero. Economists' buzz phrase for this situation is that we were at the "zero lower bound." That just means that nominal interest rates can't go below zero. So the usual tool of reducing nominal interest rates wasn't available in 1933.

At the zero bound, is there anything monetary policy can do? It turns out that President Roosevelt stumbled on a solution. Monetary policy can work on people's expectations. And it does this in a couple of ways.

During the declining phase of the Great Depression, there was a great deal of deflation. That is, prices fell dramatically. For example, the price of a bushel of wheat fell from $1.02 in 1929 to 36 cents in 1932.[12] Because prices had fallen so much, people expected them to keep falling.

Such expectations of deflation can affect consumer behavior. If people keep expecting goods to get cheaper and cheaper, they may put off spending. My husband's grandmother used to tell the story of buying furniture in the Great Depression. When she saw something she liked in a store, she would just wait a few months—because she knew the price would come down a lot. Now that made complete sense for her family's budget. But the problem was that everyone else had the same incentive to postpone their spending. And with falling spending, firms produced less, more workers lost their jobs, and so spending fell further.

Also, when people expect deflation, the cost of borrowing, even at a zero interest rate, is very high. Borrowers have to pay back loans or mortgages with dollars worth much more in terms of their buying power. So that is another reason that people held back on spending and firms did little investing in the 1930s.

If monetary policy can stop those expectations of deflation—and perhaps even turn them into expectations of a little inflation—that can be very helpful. Instead of waiting, consumers might want to spend right away—before prices go up. And if people expect inflation, a zero stated interest rate starts to look pretty good—because borrowers realize the dollars they will be paying back are going to be worth less. So both businesses and consumers might be more interested in taking out loans to buy a new machine or a new car.

It is not only price expectations that matter. In the early 1930s, expectations about future output and employment had also become very pessimistic. After 3 years of high unemployment and low sales, firms were nervous about building a new factory and consumers were hesitant to buy anything. If monetary policy can make people more optimistic about future growth, that can be a powerful incentive to start buying again. A worker who thinks he is likely to have a job next year is more likely to buy a car because he knows he will be able to make the payments. A factory owner who thinks sales are about to increase is much more likely to hire workers and buy new machines.

So, that's the theory. But how do you actually change people's expectations? One answer is what economists call "a regime shift." That just means policymakers take dramatic actions that are very different from what was done before. They shake up policy so much that people can't help but notice. And this may cause people to expect economic outcomes to be different.

***The 1930s*.** That's exactly what Franklin Roosevelt did in early 1933. A wonderful old paper by Peter Temin and Barry Wigmore, which I have come to appreciate more and more as time has gone by, says that Roosevelt's monetary actions were particularly important in changing expectations.[13] And the defining event of Roosevelt's regime shift was going off the gold standard.

To give you some background, the United States had been on some form of a gold standard since the late 1800s. And, though it worked pretty well for much of that period, in the Depression the gold standard was a burden. Having the currency tied to gold (and implicitly to every other currency) at a fixed price limits what a country can do. For example, in 1931, while the American economy was in the middle of a terrible banking panic, the Federal Reserve didn't take actions to stop it, and indeed raised interest rates by two percentage points, because it was worried about gold outflows and needed to defend the gold standard.[14]

Going off the gold standard was a very dramatic signal that Roosevelt was going to concentrate on the U.S. economy. He wanted to be able to take aggressive actions without any constraints from the foreign currency markets.

Roosevelt followed that dramatic action with old-fashioned monetary expansion. During the downturn, the money supply had fallen sharply. As people lost confidence in banks, cash had been pulled out of financial institutions and stuffed into mattresses. Because the Fed didn't counteract this change, the money in circulation dropped precipitously. This is one conclusion of Milton Friedman and Anna Schwartz's classic book, *A Monetary History of the United States*.[15]

Now the Fed was no more interested in increasing the money supply in 1933 than it had been in 1931. But Roosevelt's Treasury Department found a way to do it on its own.[16] It involved the fact that devaluation caused a large amount of foreign gold to flow to the U.S. The Treasury chose not to sterilize the gold inflow, but instead deliberately allowed it to swell the American money supply. Then, throughout the mid-1930s, gold kept flowing into the United States because of political tensions in Europe. As a result, the Treasury was able to keep increasing the money supply through this unusual method.

Finally, Roosevelt used the powerful tool of communications to drive home the regime shift. He spoke frequently of the need to return prices and incomes to their 1929 levels, and the measures his administration was taking to accomplish this. For example, in his second fireside chat in May 1933, Roosevelt talked extensively about the suspension of the gold standard. He explained to his listeners that "The Administration has the definite objective of raising commodity prices to such an extent that those who have borrowed money will, on average, be able to repay that money in the same kind of dollar which they borrowed."[17]

So clearly, through a variety of actions, policymakers were trying to change people's expectations. What's the evidence about whether Roosevelt's monetary regime shift actually made a difference?

One of the first things that happened was that stock prices soared. Stock prices are very sensitive to expectations about the future state of the economy. Stock prices had been falling steadily through the first three years of the 1930s. But, they rose 87 percent in the three months after Roosevelt abandoned the gold standard, and then just kept going up.

Price expectations also changed radically. Now people don't usually write down what they were expecting to happen to prices. But they do sign contracts to buy and sell agricultural goods in the future. One economist had the clever idea to use the prices agreed to in those futures contracts to deduce what people must have been expecting to happen to the price of key commodities in the mid-1930s.[18] He found that expectations switched in the spring of 1933 from a large expected deflation to a small amount of expected inflation. That was a huge swing—and quite surprising given that unemployment was still very high. It suggests that Roosevelt's policies really did affect expectations.

These expectations of price increases, along with the direct effects of devaluation on the price of some agricultural goods, led to a big rise in the expected incomes of farmers. The price of wheat jumped from 36 cents in 1932 to 87 cents in 1933. Temin and Wigmore show that one of the first things to take off in 1933 was truck sales. As farmers finally felt confident about their future income, they decided to invest in new trucks and tractors for their farms

More generally, the spending and output that took off in the spring of 1933 were things usually bought on credit: machines and vehicles for businesses, and consumer durable goods like cars and furniture.[19] This is consistent with the fact that Roosevelt's actions lowered the real cost of borrowing by ending expectations of deflation.

What we learn from the Depression is that even when interest rates are at zero, monetary policy isn't helpless. But for it to work, it has to change people's expectations about future prices and incomes. And to do that in a big way, it takes a regime shift.

Interestingly, in 1936, Roosevelt and other policymakers got cold feet. Though they had talked a lot about the benefits of inflation and rapid growth in the mid-1930s, after three years of rapid growth and mild inflation, they started to get nervous. Everybody started talking about the dangers of inflation.

We had a bit of a regime shift in the opposite direction. The Federal Reserve raised reserve requirements on banks to try to slow things down, and the Treasury stopped monetizing the gold that kept flowing to the U.S.[20] Just as we had a fiscal contraction in 1937, we also had a monetary contraction. And scholars believe that is another reason why the economy plummeted again in the recession of 1938.[21]

***The Recent Episode*.** So has this lesson for monetary policy from the Great Depression—that at the zero lower bound, it takes a regime shift—been followed in the recent episode? Here, I have to say not really. But there are signs that at least some countries are beginning to get the message.

In the United States, the Federal Reserve responded very aggressively to the evolving financial crisis in the summer and fall of 2008. By December of that year, they had brought the main interest rate they control, the federal funds rate, down to effectively zero. And, they have since taken a number of unusual measures. We have been through three rounds of quantitative easing—where the Fed has bought a lot of certain assets, like long-term government bonds or mortgage-backed securities—to try to lower the interest rates that are not yet down to zero. And those policies have been somewhat helpful.[22]

But unemployment has obviously remained very high. And inflation has come in consistently below the Fed's target of 2 percent over the past several years.

Exactly what the Fed hasn't been willing to do is something nearly as dramatic as what Roosevelt did. They have not been wanted to change their goals or operating procedures in a way that might seriously rock the boat of public expectations. So, what they have been doing is pushing the boundaries of their current regime, not changing the regime.

The place where we might be seeing a country try to follow the Depression lesson is actually Japan. Japan went through what the United States experienced in 2008 almost 20 years earlier. Back in the 1980s, their economy was the envy of the world. But they had a bubble and bust in their housing market that wreaked havoc on their financial system and caused a prolonged downturn. Japan hit the zero lower bound on interest rates in the late 1990s, and just sort of got stuck in a trap of low growth and steady price declines. Unlike almost every other advanced country in the world, Japan has had deflation for almost 15 years. But, like our Federal Reserve, the Bank of Japan has not wanted to take dramatic action.

That appears to be changing. In December, a new government was elected. The new Prime Minister, Shinzō Abe, is doing something of a Franklin Roosevelt imitation. He has proposed an expansion in government spending to help growth, and he has said very explicitly that he would like the value of the currency to be lower. And, not surprisingly, the yen has fallen by about 20 percent over the past few months. Prime Minister Abe also convinced the head of the Bank of Japan to resign early and has nominated a new governor who is committed to much more aggressive monetary policy—including a higher target for inflation and unlimited quantitative easing.

For economic historians who believe Roosevelt's regime shift was essential, Japan may be a key modern test. Abe is following the Depression playbook. We will all be watching to see if it works.

***Implications Going Forward*.** If the current actions being taken by the Federal Reserve don't do enough, and the U.S. recovery remains anemic, we may need to do more. The Fed may need to think of dramatic, visible actions.

One strategy that a number of economists have suggested is to adopt a whole new framework for monetary policymaking. For example, the Fed might commit itself to a target for the path of nominal GDP.[23] This is not the place to go into the details of the proposal. But the basic idea is that it's an approach that commits the Fed to low inflation and steady growth in the long run, but also to healing the economy more quickly in the near term.

From the perspective of today's discussion, what is most important about adopting a nominal GDP target is that it would be a pretty clear regime shift—a very different way of conducting and talking about monetary policy. And, so like Roosevelt's actions, it might have more impact on expectations than the incremental changes the Fed has been following so far.

IV. <u>CREDIT POLICY</u>

The third and final policy lesson from the recovery from the Great Depression that I want to highlight involves what to do about high levels of consumer debt. I would summarize this lesson as: ***It's important to get debt burdens down quickly.***

Many things affect how much consumers want to spend. Obviously, their income is a main determinant. And, as I have discussed, their expectations about future prices and employment prospects play an important role. But another thing that matters is the amount of debt they have.

One of the things that can happen in good times is that consumers may take on lots of debt and feel OK about it. But then a recession comes and people feel unsure about their jobs, and the value of their houses and their retirement savings falls. Suddenly, those debt burdens seem awfully scary. And consumers may respond by hunkering down and focusing on paying off debt, and so cut their spending. That may be good for their financial health, but it can be devastating to the economy.

If we find ourselves in this kind of a situation, government policies to try to help consumers repair their balance sheets more quickly may be very helpful.

<u>The 1930s</u>. Both the Great Depression and the more recent crisis were preceded by a large increase in consumer debt. The 1920s was the durable good revolution—when families first started to routinely own cars, washing machines, and refrigerators. And going along with that was a large expansion of consumer debt.[24] Mortgage debt also increased rapidly in the 1920s. And these were often not the long-term, amortizing mortgages that we have today. Many were quite short-term, interest-only loans, with a balloon payment of the principal due at the end.[25]

When stock prices plummeted in late 1929 and unemployment began to soar, those high debt loads started to cause problems. A nice paper by my colleague Martha Olney points out a peculiar feature of 1920s consumer loans.[26] Many of them stipulated that if you missed a payment and your car was repossessed, you lost all of the equity you had in the car. So even if it was mostly paid off, you received no compensation. She argues that this feature gave consumers a very strong incentive to cut back on groceries, clothes, everything else, and keep making their car payments. This may help explain why consumer spending fell so dramatically in 1930.

So what policies were used during the recovery from the Great Depression to deal with the high debts of consumers? The most important was surely the creation of the Home Owners Loan Corporation. Set up in the summer of 1933, the HOLC (or "The Incredible HOLC" as one author calls it) bought troubled mortgages from banks and issued new mortgages to the homeowners. The HOLC issued mortgages for more than a million homes, or almost 10 percent of all the homes in the country.[27]

Because the HOLC would only refinance 80 percent of the fair market value of a house, a bank wanting to get rid of a troubled mortgage often had to agree to principal reduction. Importantly, both sides benefited from this. Because the homeowner was typically far behind in their payments and likely to default, the bank was usually happy to write down the principal to get rid of the loan—and the HOLC was pretty generous to the banks in its interpretation of fair market value.[28] And, the homeowner got the benefit of a new government mortgage for the lower amount, and on very favorable terms. This program helped to get consumers out from under some of their debt burdens and into much more affordable mortgages.

Now we don't have much direct evidence that the HOLC and other New Deal programs to reduce debt burdens spurred recovery, but there is some indirect evidence. Most obviously, consumer spending on durable goods rebounded around the same time that the HOLC was renegotiating a lot of mortgages. Building starts began to rise around the same time as well, which could suggest that dealing with foreclosures and negative equity played a role in stabilizing the housing sector in the 1930s.[29]

The main reason I think that moves to reduce debt loads in the Depression were important to the recovery comes from the recent experience. This is a case where I feel we may have learned something about the Depression from living through the 2008 recession.

As in the 1920s, consumer debt burdens rose dramatically in the 2000s. Household debt as a fraction of personal income rose from about 80 percent in 2000 to 115 percent in 2007.[30] Much of that increase was in mortgage debt, including home equity loans.

Excellent new research shows how devastating high consumer debt loads were to consumer spending during the 2008 recession.[31] Researchers got data on the increase in consumer debt between 2002 and 2006 by county from one of the big credit-reporting bureaus. They then looked at car sales by county during and after the crisis. What they found is that counties with a bigger run-up in debt coming into the recession have seen much slower recovery of car sales than counties that started with smaller debt increases. Based on this finding—and a range of other studies—economists have come to appreciate just how much debt matters for consumer spending.[32] Looking back to the

1930s, this evidence suggests that the measures taken to get debt down quickly during the New Deal were likely very helpful.

***The Recent Episode*.** Unfortunately, this lesson—it's important to get debt loads down quickly—is not one that has been followed in the current episode.

When the bubble burst and incomes fell in 2007 and 2008, many families were in a very bad way. Delinquent mortgages and foreclosures surged. And, as I described, consumer spending fell as families concentrated on paying off debt.

Despite understanding the problem, we have not found a way to do widespread mortgage renegotiation for troubled homeowners who owe more on their mortgages than their homes are worth. Financial institutions have been very hesitant to do such renegotiations on their own. And the various government programs aimed at helping homeowners have mostly focused on reducing payments, not reducing principal. Also, far fewer people have participated in those programs than initially hoped.[33] As a result, we have been left to wait for consumers to gradually pay off their debts and get back on their feet. It has been a long hard process, and one that has contributed to the very slow recovery in the past few years.

***Implications Going Forward*.** So how does the experience of the 1930s suggest that credit policy should evolve going forward? Here there are several possibilities.

One involves thinking about ways to prevent unhealthy surges in consumer credit, so that we don't find ourselves with high debt loads in the first place. There has been much discussion about regulatory changes and improvements in financial education that might be worthwhile.

Another possibility involves what to do about the problem of overindebtedness if it arises. Early in my time in Washington, Congress debated reforming the household bankruptcy law. Under current law, bankruptcy judges are able to renegotiate most consumer debt contracts—but not mortgages. The only option for home mortgages in a bankruptcy is foreclosure.

One possible change going forward would be to let bankruptcy judges reduce principal and change other terms of a mortgage. This is something we let judges do in the case of farm bankruptcies, and it has worked quite well.[34] I suspect that in many cases it would be better for both the borrower and the lender, because so much value is lost when a home is sold through foreclosure. And if there is another period of high debt and problems in the housing market, it would be much better for the economy to have a way to reduce debt loads for very troubled families. So there's a concrete way that we could use a lesson from the Great Depression to make the economy more resilient going forward.

V. CONCLUSION

Where does all of this leave us? I will be the first to admit that the Great Depression is not a perfect model for today. The world has changed in important ways since the 1930s, and so has our economy.

But, I hope I have convinced you that this searing experience nevertheless still has lessons for today. The Depression teaches us that tax cuts and increases in government spending can help heal a depressed economy, but only if they are used on a sufficiently large scale. It shows that when interest rates are at zero, monetary policy can still be effective, but it will likely take a regime shift. Policy needs to be dramatic enough that it changes people's expectations about future prices and output growth. And finally, when debt burdens are high, measures to get them down quickly may be very beneficial not just to the people directly affected, but to the whole economy.

But perhaps the most important lesson about policy from the Great Depression is in some sense deeper than these three specific ones I have highlighted. More than anything, what I admire about policymakers in the mid-1930s was their sense of urgency and their willingness to experiment. Faced with a crisis of unprecedented pain and severity, they took bold action. Not everything they did worked as planned, and some policies were clear failures. But as I have discussed, many actions were successful in helping to jumpstart recovery and repair the devastated American economy.

As we face our own challenges—continued high unemployment, a terrible long-run deficit, and Europe perennially on the edge of a meltdown—we need some of that same sense of urgency and willingness to experiment. We need to learn from the past, of course. But we also need to forge new solutions for the future. That is the true lesson the Great Depression.

ENDNOTES

[1] Christina D. Romer, "What Ended the Great Depression?" http://elsa.berkeley.edu/~cromer/What Ended the Great Depression.pdf.

[2] E. Cary Brown, "Fiscal Policy in the 'Thirties: A Reappraisal," http://www.jstor.org/stable/1811908 .

[3] Lester V. Chandler, *America's Greatest Depression, 1929-1941*, p. 195.

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