Despite assertions to the contrary, the New Deal's fiscal policies were key to ending the Great Depression.

In the years following the financial crisis of 2008, many policymakers have turned to the recovery that led the West out of the Great Depression in the 1930s for inspiration of how to address current problems. While many have re-interpreted the policy actions of that period to emphasize the role of monetary over fiscal policy in the recovery, **Matías Vernengo** *urges caution. He argues that while much analysis asserts that expansionary monetary policy led to increased private consumption and investment, low rates from the Fed also made increased public spending more sustainable, thus leading to positive effects on GDP and employment.*

It is increasingly common to hear stories of how government intervention led the economy astray during the Great Depression, and how FDR's New Deal actually delayed a recovery that was on its way, e.g. the popular book my Amity Shlaes *The Forgotten Man*. This view is at odds with the conventional notion in the accepted historiography of the period and with old Keynesian views as exposed by Galbraith (1954), but not with the mainstream of the economic profession. It is important to note that not only old Monetarists like Friedman and Schwartz (1963) or Meltzer (2003), but also New Keynesians like Romer (1992) suggest that the recovery was essentially caused by monetary policy and that the fiscal policies associated with the New Deal were essentially of secondary importance for the recovery.

In a recent paper, my co-author Nathan Perry and I suggest that this conventional interpretation of the recovery is misleading. We argue that Romer's measures of the fiscal and monetary policy role in the recovery, which are typical of the New Keynesian literature, are biased since they tend to measure together fiscal and monetary multipliers. Worse, the measures presume that money supply is exogenous and causes changes in nominal income, something that while accepted by Old Monetarists, is at odds with modern macroeconomics, meaning the new consensus macroeconomics (NCM) model, that assumes that money is endogenous and the central bank controls the rate of interest.

Benneville Power Dam, Columbia River, Oregon. Spillway." US Army Corps of Engineers. Credit: Franklin D. Roosevelt Presidential Library & Museum

In the view of the New Keynesians, the essential forces behind the recovery which ended the Depression were the inflows of gold associated with European political instability, which were not sterilized by the Federal Reserve, that is, the Fed did not sell bonds to reduce the money supply that increased as a result of gold purchases, and that reversed the 'great contraction,' to use Friedman's expression, that had caused the Depression in the first place, at least for some of these authors. New Keynesians tend to limit the role of fiscal policy to that of credible inflationary expectations. In this view, expansionary fiscal policy is not completely irrelevant, but its main role was to provide a credible commitment to higher inflationary expectations, which in turn led to an anticipation of spending and the recovery.

In this view, fiscal policy is a complement to the expansionary monetary policy and the role of gold inflows in leading to the recovery is still central. All in all, the New Keynesian view of the Great Depression, very much like the old Monetarist view, suggests that fiscal policy was at best of secondary importance to the recovery. The New Deal, if it is not explicitly seen as harmful in the New Keynesian perspective, as it is in many modern popular views of the Great Depression, is at least seen as irrelevant, while monetary policy and the war are seen as the real causes of the recovery. The view fits the NCM according to which a monetary policy rule, which manages expectations, is sufficient to maintain the economy around the natural rate and that fiscal policy should fundamentally maintain a cyclically adjusted balance.

Romer's analysis presumes that the money supply caused changes in the rate of interest and that this, in turn, led to an increase in investment and consumption. Yet, the causal relations may very well be more complex than is assumed by conventional wisdom. The money supply is only one of the influences on the rate of interest. Two other important variables that affect the rate of interest are the discount rate, a policy variable determined by the Fed, and open market operations, including quantitative easing, i.e. not just the change in the composition of the Fed's balance sheet, but also a change in its size. In other words, it is far from clear that monetary policy should be seen as fundamentally associated with the control of the money supply in general or in that particular period. Also, the evidence for the effects of lower rates of interest on spending is not particularly strong, and not just in this period.

The reduction in the rate of interest might have significant effects on the level of activity, but not necessarily or even primarily because it stimulated private spending. Marriner Eccles, chairperson of the Fed in that period, was adamant that by maintaining a low rate of interest on government securities, fiscal deficits could be expanded on a sustainable basis, as I have already noted. It was public spending that was made sustainable with low nominal and negative real interest rates. Our calculations of fiscal multipliers (the change in national income compared to the change in government spending) are between 1.15 and 1.69, which would be more than sufficient to explain the expansion of GDP of around 31% between 1933 and 1936, given an increase in government spending of nearly 28%. Also, the effect of the New Deal fiscal and employment programs on unemployment levels, which included the workers in the emergency government labor force as employed—the most important being the Civil Works Administration and the Works Progress Administration, later renamed Work Projects Administration—was considerable. Once the workfare programs are accounted for, the level of unemployment fell from 22.9% in 1932 to 9.1% in 1937, a reduction of 13.8%, which can hardly be seen as a failure, even if the 1937 level is certainly not full employment.

By denying incorrectly the importance of fiscal policy, and incorrectly emphasizing the effects of monetary policy, the revisionist view diminishes the accomplishments of the New Deal and promotes the anti-New Deal agenda of the conservative movement. This misrepresentation of the lessons of history plays an important role in the ascendancy of austerity after the 2008 Great Recession, and the transiency of the Keynesian moment right after the crisis.

This article is based on the paper "What ended the Great Depression? Re-evaluating the role of fiscal policy" in the Cambridge Journal of Economics.

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Matías Vernengo is an Associate Professor at Bucknell University. He has co-authored one book, edited four books and published over fifty academic and popular articles, and contributes to the blogs Naked Keynesianism and Triple Crisis. He is also the co-editor of the Review of Keynesian Economics (ROKE). His methodological view emphasizes the importance of the history of ideas for the development of economic theory, and is based on the surplus approach of the classical political economy authors and Marx, as reinterpreted by Sraffa, and the heterodox followers of Keynes, like Kalecki and Kaldor.

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