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Abstract

Financial Reforms and Are We in for Another Great Depression?

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The Great Depression of the 1930s depressed the U.S. economy by 35 percent relative to trend. What led to this Great Depression? First the experiences of various economies were very different. Some economist, for lack of an economic argument, argued that it was caused by a financial crisis and the failure of the Federal Reserve to provide needed liquidity to the system. This argument has not stood up to scrutiny, though many still believe it. There was no shortage of funds to finance investment in the 1930s. Corporations in the 1929-33 period were making huge dividend payments and investing little. Net investment in some years actually went negative. Clearly, they had the funds to finance investments.

Another problem for the monetary story is that the banking system was healthy and interest rates were low beginning in late 1933 and continuing throughout the decade. However, the Depression continued for the entire decade with hours worked being depressed by over 20 percent relative to 1929 levels on a per working-age person basis. Researchers are now looking at taxes as a reason for the low level of hours worked per working-age person. During the 1930s government revenue and expenditures doubled relative to gross national income. Given that deficits were small, this means that the average tax rate doubled. If the marginal effective tax rate on the 70 percent of output made up of payments for working, which is a reasonable assumption, over half the decline in hours worked per working-age person is accounted for by tax increases.

Taxes are not the whole story. Cole and Ohanian (2007) found that in the high wage industrial sector, wages increased dramatically and employment fell. They argue that this was due to cartelization. When Franklin Roosevel abandoned the New Deal and turned attention to World War II beginning in 1939, employment recovered. The recovery was before any increase in government spending.

Currently, Western Europe is depressed by nearly a third relative to the United States, and this depression is accounted for by the low market hours per working-age person in Western Europe. The reason Europeans work so much less than people in other advanced countries is that their marginal effective tax rate is much higher. Japan is currently depressed by about 25 percent relative to the United States. The reason is low productivity, which almost surely is due to mercantilist policies.

I turn now to the design of financial systems. The two connected primary functions of a financial system are to finance investments and to provide a mechanism for people to save for retirement. The private capital stock in the United States is about 3.6 times GDP. Currently, about half is financed by owners' equity and the other half by borrowing from households. People who own a share of a corporation effectively own a share of that corporation's capital and have a liability equal to their share of that corporation's debt. Thus, in this discussion I consolidate the nonfinancial business sector with the household sector. To handle savings for retirement, my view is to expand the use of mutual sharing arrangements.

Another function of a financial system is to handle payments and to provide for the liquidity needs of people and the organizations they own. Here, a 100 percent reserve commercial banking system, with interest on reserves, is a system that can handle the function with no risk of a banking crisis and the resulting need for taxpayers to bail out financial institutions. Basically, the government should not be in the business of subsidizing financial intermediaries.

Probably the best measure of the efficiency of the financial system is the difference in the average household borrowing and lending rates, which in the United States is over 2.0 percent. With a 100 percent reserve system, bank regulation costs could be reduced by 0.5 percent, which is a large increase in the efficiency of the financial system.

There is much to be discussed on this subject in the workshop, and I welcome the opportunity to learn more about the Slovakian system.

Reference

Kehoe, T. J. and E. C. Prescott, Chapter 1 in Great Depressions of the Twentieth Century, edited by Kehoe, T. J. and E. C. Prescott, Federal Reserve Bank of Minneapolis, 1-20, 2007.

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