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Was there a Keynesian Economy in the USA between 1933 and 1945?

The history of capitalist democracies like the USA between 1945 and 1975 was by and large a story of economic prosperity, full employment and steadily rising living standards. By contrast, the two decades between 1919 and 1939 had seen great economic instability. Nightmare inflation, collapsing banks, agrarian and industrial devastation, and mass unemployment brought fear and falling standards of living to millions. At different times and in different ways all the world's major capitalist industrial nations — the USA, Britain, France, Germany — experienced high unemployment and at least one of these other problems. By the 1960s, however, the spectre of instability and chronic, mass unemployment which had haunted the capitalist system between the two world wars appeared to have been exorcized, and it became commonplace for economists and political commentators to ascribe this change to acceptance of what was somewhat loosely called 'Keynesian economics'. This article examines the evolution of American economic policy between 1933 and 1945, concentrating on political events and discussing economists whose ideas influenced policy decisions. It argues that what could be called a 'Keynesian approach' to economic management had emerged by 1945, and that, because of the USA's position as the powerhouse of world capitalism, this decisively shaped the postwar world economy.

The Wall Street crash of October 1929 at first appeared to be a purely financial crisis. Earlier financial crises in the USA — such as the panic of 1907 — and later ones — such as Black Monday 1987 — occurred without triggering economic recession or depression, while serious economic downturns — such as that in 1920–21 — had not been preceded by stock market failure. So there was not necessarily a causal connection between Black Thursday 1929 and the Great Depression which was to shape American history in the 1930s. Yet serious weaknesses in the American economy of the 1920s — in distribution of income, in growing imbalance between the wealth of agriculture and industry, in tariffs and trade — were exposed by the vortex in share prices which occurred in 1929–30. So much spending power evaporated that, in the follow-

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ing years, demand fell more steeply and for longer than at any time in the nation's history. America's capacity to produce goods was tending to outstrip its capacity to consume them.[1]

In such circumstances, the Wall Street crash triggered the most serious economic crisis in American history. Stock market prices were in free fall, while unemployment seemed to be rising in geometrical progression. Manufacturing output halved in four years, farm prices fell 40 per cent from the low base of 1928, exports declined by a third in value. By 1933, national income had collapsed from 83 billion dollars in 1929 to just over 40 billion dollars. With (by a conservative estimate) 13 million unemployed, one quarter of America's total workforce, and nearly two-fifths of its non-agricultural workforce, were jobless. With no federal form of social security, and state systems, local welfare, savings and charity long since exhausted, purchasing power was at an all-time low. Agriculture had been laid waste, industry destroyed, while banking and the whole financial system was at the point of collapse.[2]

What made this bad situation worse was that the new Democratic President Franklin D. Roosevelt (FDR) had campaigned in 1932 on the overriding importance of cutting the cost of federal government by a quarter, and attacked the Republican incumbent Herbert Hoover for overspending and establishing too many federal agencies. As FDR came to power in 1933, this conventional wisdom, shared by employers, financiers and labour leaders alike, stressed the paramount need to continue with present retrenchment and budget balancing. The Senate Finance Committee hearings in February confirmed how widespread such views were. Yet the crisis stimulated academic economists to think hard about what had gone wrong and how it should be righted. Many schools of thinking were at work. Some underconsumptionists blamed boom and bust on employers taking too much of the product of rising productivity in the 1920s as profit, paying too little as wages for their workers to spend. Others blamed growing imbalance in wealth between factories and farms. Some blamed both. Classical economists believed that the system would regulate itself if the government adopted prudent policies and let the market operate freely. The Chicago school of economists argued that the collapse had come because aggregate demand had fallen so far and so fast that the gap would have to be filled. The academic economist William T. Foster, who blamed the depression on the 'riotous saving' of the 1920s, and bankers like Marriner Eccles, who in February 1933 urged Congress to spend its way out of the depression, agreed that government spending must be used to stimulate economic recovery. But even with hunger stalking the land, and fear of nationwide riot and even insurrection, this was not seen as a political option in 1932. Hoover had set up the Reconstruction Finance Corporation to put a mixture of public and private money to work. But no coherent approach to policy was emerging. During its first three months, between March and June 1933, Roosevelt's new administra-

1 J.K. Galbraith, *The Great Crash 1929* (New York 1980), passim.
2 A.M. Schlesinger, Jr, *The Crisis of the Old Order* (Boston 1958), 159–60.

tion cut federal salaries and refused to advance payment of an ex-servicemen's bonus, but at the same time tried to put America back to work by planning agriculture and industry, launching a large programme of public works, and giving other sections of the community — bankers, homeowners, labour unions, Wall Street — something of what they wanted.

From this chaos of improvisation the choice of economic reflation rather than further deflation was made. From the ferment of ideas and policy, some kind of consensus was starting to emerge so that the New Deal had political if not economic coherence. But until J.M. Keynes published *The General Theory of Unemployment, Interest and Money* in 1936, no economist had evolved a new and comprehensive philosophy relevant to the central problem of the 1930s — what Keynes called 'the paradox of poverty in the midst of plenty'[3] — which could be used to explain why it was necessary for the federal government to intervene to end depression.

Keynes himself, a member of that brilliant generation of British intellectuals who had graduated from Cambridge around the turn of the century, was, in the winter of 1932–3, only one of many struggling to find an answer to mass unemployment in the world's richest nation. His student Richard Kahn had in 1931 made a key contribution by establishing the theoretical basis for what Keynes had already intuitively grasped — that there was a formal mathematical relationship between the level of government expenditure and the level of economic activity, which he called 'the multiplier'.[4] Or as Keynes put it, 'The newly employed who supply the increased purchases of those employed on capital works will, in their turn, spend more, thus adding to the employment of others; and so on.'[5] But Keynes was still seeking that comprehensive formulation which slowly transformed economic thinking after publication of his *General Theory* five years later.

Despite its complex, technical approach, this seminal book's theoretical outline is explained in simple terms. After the classical economic ideas of Marshall and Pigou are elegantly demolished in chapters one and two, the argument's essential character emerges in chapter three. It was the same, Keynes explained, whether or not money-wages, prices and so on were liable to change. 'When employment increases, aggregate real income is increased', he wrote.

> The psychology of the community is such that when aggregate real income is increased aggregate consumption is increased, but not by as much as income. Hence employers would make a loss if the whole of the increased employment were devoted to satisfying the immediate demand for consumption. Thus, to justify any given amount of employment there must be an amount of current investment sufficient to absorb the excess of total output over what the community chooses to consume when employment is at the given level. For unless there is this amount of investment, the receipts of the entrepreneurs will be less than is required to induce them to offer the given amount of employment. It follows, therefore, that,

3 J.M. Keynes, *The General Theory of Employment, Interest and Money* (London 1936), 30.
4 R.F. Kahn, 'The Relation of Home Investment to Unemployment', *Economic Journal*, XLI (1931), 173–98.
5 J.M. Keynes, *The Means to Prosperity* (London 1933), 31.

> given what we shall call the community's propensity to consume, the equilibrium level of employment, i.e. the level at which there is no inducement to employers as a whole either to expand or contract employment, will depend upon the amount of current investment. The amount of current investment will depend, in turn, on what we shall call the inducement to invest; and the inducement to invest will be found to depend on the relation between the schedule of the marginal efficiency of capital and the complex of rates of interest on loans of various maturities and risks. . . . This level cannot be *greater* than full employment, i.e. the real wage cannot be less than the marginal disutility of labour. But there is no reason for expecting it to be *equal* to full employment. . . . It can only exist when, by accident or design, current investment provides an amount of demand just equal to the excess of the aggregate supply price of the output resulting from full employment over what the community will choose to spend on consumption when it is fully employed.[6]

Beyond noting the elegance of this method of discourse, the key phrase for the purposes of this article is 'accident or design'. Economic policy emerged between 1933 and 1945 out of political choices and by process of trial and error, by a mixture of accident and design. In March 1933 Roosevelt was wholly innocent of any Keynesian notions. As far as he was concerned when he took office, Micawber still applied: more spending than income, result misery. His advisers were divided into 'spenders' and 'savers'. The former included Harry Hopkins, at the Federal Economic Recovery Administration (FERA), Secretary of the Interior Harold Ickes and Secretary of Labor Frances Perkins. The savers, like Secretary of the Treasury Henry Morgenthau, Vice-President John Garner, and FDR's budget director Lewis W. Douglas, believed that government must balance the budget to restore business confidence and allow private enterprise to invest and take up the slack. Roosevelt had run for president in 1932 as a saver not only because it was politically safer to do so but also because, at this point in his life, he believed that government should balance its books. The 'Pittsburgh pledge', repeated many times, promised to cut the cost of federal government by 25 per cent.

Yet in office, facing the urgent necessity of rising unemployment, FDR imported from Europe the long tradition of using public works to alleviate recession. In March 1933, Congress voted 3.3 billion dollars for public works — equal to the entire cost of the federal government in 1930 — which it believed could be spent in two or three years. With unemployment stabilizing at around 22 per cent of the workforce by 1934, Keynes and Harold Laski argued the case for more of the same. The answer to the question, 'Can America spend its way to recovery?' they said was 'Why obviously!'. An economy produces in response to spending — it was absurd to suppose one could stimulate economic activity by declining to spend. When individuals failed to spend enough to maintain employment, the government must step in and do it for them. 'It might be better if they did it for themselves', the article concluded, 'but that is no argument for not having it done at all.'[7]

As it struggled to end mass unemployment, the federal government stumbled on this policy, whereby it was forced to act as compensating agent

6 Keynes, *General Theory*, op. cit., 27–8.
7 *The Red Book* (December 1934).

during economic downturn, spending public money to fill troughs in the trade cycle in order to stimulate revival, then cutting back in periods of boom. The depression of 1929–33 was thus followed by a recovery stimulated by federal government spending, which turned rapidly into a serious recession again when such spending was reduced. Thus the years 1933 to 1945 were a major turning-point. The use of deficit financing in peacetime America, and the role of government in regulating and controlling a modern, managed economy, which the nation adopted by process of trial and error between 1933 and 1945, was new not only in the USA. It was to form the basis on which America helped rebuild world capitalism after 1945.

Nevertheless, Keynes's first audience with the president in May 1934 was not exactly a meeting of minds. Keynes complained that he had 'thought the president more literate, economically speaking', and Roosevelt that Keynes must have been some kind of mathematician, who bored him with a long rigmarole of figures.[8] In fact, by then FDR had chosen reflation rather than deflation. Characteristically, his choice came not from conviction but from what was essentially political improvisation, as a net result of dozens of separate decisions taken for other reasons.

Here, the crucial opening was the Thomas amendment to the Agricultural Adjustment Act (AAA) in March 1933, which had come from outside the White House. Senator Elbert Thomas's amendment to the AAA conferred on the president powers of monetary expansion by issuing greenbacks, remonetizing silver and reducing the gold content of the dollar. Reflation continued thereafter as a consequence of 'pump priming' (spending to get the economy started again), the 'alphabet soup' of federal agencies like AAA, CCC, FERA, NRA, TVA and so forth and, most important, the steady and increasing use of public works. Further reflation was made possible by the decision in April 1933 to leave the gold standard, already weakened by devaluation through the Thomas amendment. 'Well, this is the end of Western civilization', budget director Douglas remarked of this last step.[9] In fact, it marked the start of a generation in which controlled inflation became an acceptable answer to mass unemployment.

Leaving the gold standard was key because it enabled the federal government to take on deeper debt, in order to finance budget deficits, without thereby driving up interest rates. It broke all conventional financial rules, as Douglas's reaction revealed. Yet as Keynes later explained,

> Under the system of domestic *laissez-faire* and an international gold standard such as was orthodox in the latter half of the nineteenth century, there was no means open to a government whereby to mitigate economic distress at home except through the competitive struggle for markets.[10]

8 R. Hofstadter, 'Franklin D. Roosevelt: the Patrician as Opportunist', *The American Political Tradition* (New York 1959), 332.

9 Raymond Moley, *After Seven Years* (New York 1939), 188.

10 Keynes, *General Theory*, op. cit., 382.

Despite brief diversions, like Roosevelt's ill-fated gold-buying programme, economic policy had become more coherent by summer 1933. During the winter of 1933–34, FDR's old friend Felix Frankfurter, on sabbatical from Harvard in Britain, acted as conduit for advice from Roy Harrod (later Keynes's first biographer) and other British economists about the vital importance of high, sustained public works to restore employment.[11] It appeared to work: in 1933–34 unemployment stopped rising for the first time in four years.

However, examining short-term conflict between economic and political arguments is only one way to explain how policy emerged. To test this article's contention that government spending created economic recovery between 1933 and 1945, the best starting point is United States government taxing and spending between 1910 and 1945 (Table 1). In this table and others, 1910 is used as a base line.

TABLE 1
United States Expenditures and Receipts, 1910–45 ($ billions, current)[12]

Year	Budget receipts	Budget expenditures	Surplus or deficit?	Total public debt
1910	0.67	0.69	–0.18	1.14
1919	5.13	18.49	–13.36	25.48
1920	6.54	6.35	+0.29	24.29
1921	5.57	5.06	+0.50	23.97
1922	4.02	3.28	+0.73	23.96
1923	3.85	3.14	+0.71	22.34
1924	3.87	2.90	+0.96	21.25
1925	3.64	2.92	+0.17	20.51
1926	3.79	2.92	+0.86	19.64
1927	4.01	2.85	+1.16	18.51
1928	3.90	2.96	+0.94	17.60
1929	3.86	3.12	+0.73	16.93
1930	4.05	3.32	+0.73	16.18
1931	3.11	3.57	–0.46	16.80
1932	1.92	4.65	–2.73	19.48
1933	1.99	4.59	–2.69	22.53
1934	3.01	6.64	–3.62	27.05
1935	3.70	6.49	–2.79	28.70
1936	3.99	8.42	–4.42	33.77
1937	4.95	7.73	–2.77	38.42
1938	5.58	6.76	–1.17	37.16
1939	4.97	8.84	–3.86	40.43
1940	5.15	9.08	–3.90	42.93
1941	9.20	14.00	–4.80	57.50
1942	15.10	34.50	–19.40	79.20
1943	25.10	78.90	–53.80	142.60
1944	47.80	94.00	–46.10	204.01
1945	50.20	95.20	–45.00	260.10

11 M. Freedman (ed.), *The Roosevelt–Frankfurter Correspondence 1928–1945* (New York 1967), 168–73.

Some points need to be made about these figures. Between 1910 and 1945 public debt rose 250-fold not because of the New Deal, nor pump priming and public works, still less because of welfare spending and social reform, but as a result of expenditure on war. Given that United States involvement in the first world war lasted barely 18 months, it is astonishing that between 1910 and 1919 budget spending rose nearly 27-fold and total public debt nearly 25-fold. Moreover, the budget deficit was 15 per cent of GNP in 1919, and 25 per cent in 1945 — figures usually only found in countries on the verge of economic collapse.

The second point is that a serious attempt had been made in the 1920s to pay back war debt. What the figures do not show is that this had only been achieved at the crippling cost of actually raising already high tariffs, thus causing a crisis in world trade, contributing to the depression after 1929 and inflicting long-term damage on the American economy. Tax rates for the rich were also substantially reduced in the 1920s in the belief that this would leave more capital free for investment and thus increase production and prosperity, which it did very unevenly. Despite the bright surface picture, the underlying pattern was incipient deflation — though none guessed how devastating it would be when it came.

Yet the size of public debt in 1919 was to be dwarfed by that in 1945. After spending 62 billion dollars during the depression, winning the war cost the USA 321 billion dollars — more than the federal government had spent on everything between 1790 and 1940. Accordingly, public debt, which rose by 27 billion dollars between 1930 and 1940, rose by 216 billion dollars between 1940 and 1945. Many accept that it was American involvement in the second world war, not New Deal policies, which ended the mass unemployment of the 1930s. Fewer understand that it was spending on war in 1914–18 and 1941–45 (and one might add in Vietnam in the 1960s), not spending on social or welfare reform at any time, which created the public debt conservatives criticized so angrily in the 1980s.

Unemployment figures (Table 2) are equally interesting. They show that, while in the 1920s falling government spending was accompanied by falling unemployment after the 1920–21 recession, the reverse was true after the depression of 1929–33.

As the budget figures in Table 1 show, the record deficits of 1932 and 1933 were caused by collapsing tax take, not by spending to stimulate the economy. Unemployment only started to fall in 1934–35, when government began to spend heavily on public works and other things. It rose very sharply in 1937–38, when Roosevelt, trying to redeem the Pittsburgh pledge, went into reverse and cut the cost of federal government. Spending fell by a quarter between 1936 and 1938, while unemployment rose by close to a quarter

12 *Historical Statistics of the United States: Colonial Times to 1970* (Bureau of the Census, Washington DC, 1975), Part 2, Series Y, 335–42, 1104–05.

TABLE 2
Unemployment, 1910–45[13]

Year	Total (millions)	% of workforce
1910	2.1	5.9
1919	0.54	1.40
1920	2.1	5.2
1921	4.9	11.7
1922	2.8	6.7
1923	1.0	2.4
1924	2.19	5.0
1925	1.4	3.2
1926	0.8	1.8
1927	1.5	3.3
1928	1.9	4.2
1929	1.5	3.2
1930	4.3	8.7
1931	8.0	15.9
1932	12.0	23.6
1933	12.8	24.9
1934	11.3	21.7
1935	10.6	20.1
1936	9.0	16.9
1937	7.7	14.3
1938	10.4	19
1939	9.4	17.2
1940	8.1	14.6
1941	5.5	9.9
1942	2.6	4.7
1943	1.0	1.9
1944	0.6	1.2
1945	1.0	1.9

between 1937 and 1938. Moreover, 38 per cent of the non-agricultural workforce was jobless in 1933, and 27 per cent in 1938. What made this 'Roosevelt recession' so frightening was not that unemployment in 1938 rose close to what it had been in 1933, but that economic decline was even steeper in 1937–38 than it had been in 1929–33. In terms of speed if not duration, economic contraction of 1937–38 was the most serious in the nation's history. In the nine months between September and June, industrial production declined by a third, industrial stock averages by 50 per cent, profits by 78 per cent, payrolls by 35 per cent.[14] Most important, the Roosevelt recession revealed that by 1936–37, the American economy was suffering from the same problem which had afflicted the British since 1921: even with the economy performing well, unemployment stuck at 14 per cent and did not fall below this figure until 1941. As America entered the second world war, it was plain to those who thought clearly that deficit spending, seen as a temporary evil by Roosevelt in

13 *Historical Statistics*, op. cit., Part 1, Series D, 85–8, 135, 138.
14 K.D. Roose, *The Economics of Recession and Revival* (New Haven, CT 1954), 237.

1933, had now become a key tool in managing a modern capitalist, industrial economy.

Growth in the gross national product (GNP) made this point even plainer, for the figures reveal rise and fall in percentage growth from year to year (Table 3).

TABLE 3
Growth Rate GNP, 1910–45 (annual % movement in real terms)[15]

Year	%	Year	%
1910	+2.6	1932	–14.7
1918	+12.3	1933	–1.8
1919	–3.5	1934	+9.1
1920	–4.3	1935	+9.9
1921	–8.6	1936	+13.9
1922	+15.8	1937	+5.3
1923	+12.1	1938	–5.0
1924	–0.2	1939	+8.6
1925	+8.4	1940	+16.1
1926	+5.9	1941	+12.9
1927	0.0	1942	+13.2
1928	0.6	1943	+7.2
1929	+6.7	1944	–1.7
1930	–9.8	1945	–11.9
1931	–7.6		

A comparison of Table 3 with those for the budget and unemployment (Tables 1 and 2) is revealing. In both the 1920s and 1930s, GNP follows a jagged switchback course. But the steep fall and rise during the postwar trade depression of 1920–21 was not matched by similar ups and downs in government spending. Thereafter, falling government spending in the 1920s accompanied rising growth until 1927, when GNP flattened. This was incipient deflation, so that the growth in GNP of nearly 10 per cent in 1929 was followed by the most castastrophic economic collapse in history. This pattern fits my argument above: capacity to produce was tending to outstrip capacity to consume. The growth of GNP in 1929, coupled with the Federal Reserve's raising interest rates, helped precipitate economic collapse after 1930. Thereafter, GNP was down 15 per cent in 1932 and up 14 per cent in 1936, but grew only just over 5 per cent in 1937 and fell 10 per cent in 1938. Yet a decisive change seems to have occurred. This time, in sharp contrast to the 1920s pattern, yearly rise and fall in government spending was accompanied by a similar rise and fall in economic activity (Tables 4–9 Appendix).

Figures in Table 4 (see Appendix) for total and per capita GNP further

15 *Historical Statistics*, op. cit., Part 1, Series F, 31, 226–7.

reveal how this rippled rapidly across the whole economy between 1933 and 1940. Table 5, for average annual income per capita, and Tables 6–9 (all in Appendix), which slice horizontal sections right through the economy, show how the rise and fall in taxing, spending and growth struck the grass roots of the economy between 1936 and 1940. To save space, years selected in Tables 5–9 have been chosen to show peaks and troughs in fluctuations between 1929 and 1945, when government spending and saving fluctuated most rapidly and sharply. Farming as a whole seemed to recover steadily after 1933, when the federal government began to pay agriculture subsidies, which continued until 1945 and beyond. Other sectors of the economy slumped more obviously between 1936 and 1939.

The small overall increase revealed in Table 5 for the income of fishermen and farmers not only coincided with federal subsidies, but also with significant rural depopulation. Moreover, though income rose, the value of gross farm product switchbacked between 1934 and 1938, while farmers' income and costs fluctuated sharply between 1936 and 1938, as Tables 6–9 reveal. Nevertheless, overall growth in agricultural wealth between 1910 and 1945 is surprising, especially when one recalls that the economic catastrophe of the 1930s coincided with the natural calamity of the Dust Bowl. The additional rural depopulation that the Dust Bowl created, the steep decline in sharecropping and sustained subsidy payments, all played a part in longterm farming prosperity.

If these changes throughout the American economy were not being caused, first by Roosevelt's attempt to balance the budget after 1937, and then by resumption of spending when recession hit in 1937–38, the historian must ask what was causing them? Sceptics might argue that changes in the level of spending and size of deficit were not large enough to have that kind of impact. But budget spending rose by between a third and a half in every year between 1932 and 1936. The entire cost of federal government in 1930 was 3.3 billion dollars; in 1933 Congress voted that sum for public works alone. Similarly, when the pendulum swung the other way, the deficit was nearly halved in 1936–37 and more than halved again the following year. By no yardstick can this be regarded as spending or saving on a small scale. By the same token, public debt was reduced in the fiscal year 1937–38 by 1.6 billion dollars — only the second time in the twentieth century the deficit had been cut on such a scale. Moreover, the whole point about the Keynesian multiplier Kahn had formulated in 1931 was that small changes in public spending are magnified in their impact on GNP. Finally, and most important, though the leverage federal spending exerted may have been small, in the 1930s it was small but rising. Judged against GNP we can see this in better proportion. Federal expenditure was 6.98 of GNP in 1930 and 10.27 in 1936. But judged against tax take, government spent about 70 cents for every tax dollar it collected in 1926–27, two dollars in 1935–36 and 1939–40 and three dollars in 1942–43 — boldness only equalled in recent time by Boris Yeltsin.

Yet cuts in federal spending between 1936 and 1938 had more complicated origins than the simple desire to 'slash' public works and welfare rolls. Two New Deal policies in particular influenced levels of spending between 1936 and 1938. First, with November 1936 elections in mind, Congress earlier that year passed the Veterans' Bonus Act, which the president himself had vetoed in 1935. Largely as a result of these payments, the 1936 deficit rose from 2.7 to 4.4 billion dollars. Second, during the fiscal year 1936–37 the 1935 Social Security Act came into operation, taking 2 billion dollars spending power from the pockets of employed workers in contributions.[16] Marriner Eccles, governor of the Federal Reserve, was quick to recognize the short-term danger of what was being done and wrote:

> We have made the mistake of accumulating a vast reserve in times of large unemployment, taxing it not out of those best able to pay, or those whose savings are idle, but out of the payrolls of those who otherwise doubtless would have kept the funds moving in the income stream.[17]

In these circumstances, with the economy growing stronger at the start of 1937 and unemployment still falling, thus apparently reducing the need for relief and public works payments, Roosevelt calculated that government spending need only be pruned to bring the budget into balance in the fiscal year ending June 1938. The president repeatedly announced this as his intention, sometimes reacting angrily when his motive and purpose were questioned. If government revenues had held firm, FDR believed that the budget would almost certainly have balanced as intended in 1938. But serious economic downturn in autumn 1937, which the Treasury did not admit until far too late, ruined all this. Morgenthau's desire to 'throw away the crutches' (an unfortunate metaphor given the president's polio) revealed that the patient could not even walk without them, much less make 'a dash for growth'. By 1937, businessmen were building up inventories again to supply expected demand, or guard against fear of future price rises. Labour disputes, like the epidemic 'sit-down' strikes of the previous year, stopped production at the very point when increased foreign demand for American goods was rising. In this situation, with consumer income cut by the new Social Security deductions, sudden withdrawal of government spending in 1937–38 proved decisive in bringing the economic recovery of 1935–37 to a sickening halt. General Motors alone laid off 30,000 in late December 1937 and by May 1938 Harry Hopkins was estimating that people were actually starving in 17 Southern states.[18]

By reversing the limited economic improvement which had happened since 1935, these events combined to strike at what the whole New Deal had clearly

16 D. Mawdsley, 'The Recession of 1937–38 and the Economic Inadequacy of the New Deal', MA dissertation, Sheffield University, 1995, 17.

17 Quoted in Roose, *Recession and Revival*, op. cit., 211.

18 Quoted in Leuchtenburg, *Franklin Roosevelt and the New Deal* (New York 1963), 249.

come to signify to most Americans. Moreover, it damaged the claim which liberal Democrats were making in the 1930s that democratic government was more effective than dictatorship in restoring prosperity, at the very time when the challenge of nazi or Soviet dictators was mounting. Secretary of the Treasury Morgenthau recalled that in November 1937,

> Roosevelt was depressed. Fascism, he said, was making gains throughout the world as the Rome–Berlin–Tokyo Pact suggested. Brazil was veering that way. . . . Of course [Morgenthau conceded], fascism was spreading. It was therefore vital for the United States to avoid an industrial slump because it would give the enemies of liberalism an opportunity to take solace in the failure of the world's strongest democracy.[19]

The immediate domestic repercussions of this budget crisis reopened the conflict within the administration between savers and spenders. Morgenthau, Vice-President Garner and Secretary of State Cordell Hull now led the savers; Labor Secretary Frances Perkins, Harry Hopkins and Marriner Eccles led the spenders. Moreover, the economic problem they were facing after 1936 had been compounded by federal government monetary policy, which reduced credit and forced banks to limit loans. The problem here was that rapid economic recovery since 1934 was building up excess bank reserves by attracting increasing in-flows of gold from abroad, thus fuelling Federal Reserve Board fears that economic recovery would lead to inflation.

So the government took restrictionary monetary measures, which proceeded in clear steps during 1936 and 1937. In February 1936, margin requirements on securities were increased by 15 per cent, and in August the Federal Reserve increased reserve requirements for member banks by 50 per cent. In December, the government began to 'sterilize' gold — that is, the Federal Reserve sold bonds, thus mopping up surplus funds and preventing expansion of money supply. Thus by August 1937 1.3 billion dollars worth of the metal had been neutralized. Furthermore, in January 1937 it was decided that, as the nation's central bank, the Federal Reserve would increase its reserve requirements by a further 50 per cent, the maximum allowed by law, effective in two stages on 1 March and 1 May. Eccles argued that these monetary measures were not deflationary but designed to reduce reserves 'which were serving no useful purpose'.[20] But the Federal Reserve had failed to recognize the fragility of business confidence in 1937 compared with other periods of economic recovery, such as had happened between 1922 and 1929. In that sense the Federal Reserve's policy — essentially a credit squeeze — intensified rather than caused the recession of 1937–39.

This tightened monetary policy was especially alarming to big business because it came at a time during the New Deal when policies of Progressive reformers, dating from the 1910s, were being refurbished. The debate about

19 Quoted in J.M. Blum, *From the Morgenthau Diaries: Years of Crisis, 1928–1938* (Boston 1959), 393–4.

20 Quoted in Lester V. Chandler, *America's Greatest Depression* (New York 1970), 177.

budget balancing, between savers and spenders, and over monetary policy, took place within a political context where the old Progressive demand for more 'trust busting' was being revived. Before 1917, Progressive reformers had urged government to break up the huge monopolies which industrial corporations and combinations, known as trusts, had become. Louis Brandeis, now on the Supreme Court, had been prominent amongst trust-busting lawyers. Many liberal Democrats and Republicans believed that the depression had been largely caused by the failure to destroy trusts and the selfish policies they pursued.

So, as Roosevelt began his second term in January 1937, Congress empowered the Temporary National Economic Committee (TNEC) to investigate the American economy in general, and the role of monopolies in particular. Further attack had been made on 'economic royalists' through the passage of wealth taxes since 1935. In that sense, New Deal economic policy now began to evolve from argument between 'regulators' on the one side and 'Keynesians' on the other. As historian A.M. Schlesinger put it, the New Deal after 1935 became a coalition of lawyers in the school of Brandeis and economists in the school of Keynes. The former were calling on the state to regulate capitalist institutions through TNEC, the latter merely urging government to stimulate economic growth through the use of its fiscal and monetary powers. Typically, President Roosevelt applied conflicting policies, and the divison was clear, but not rigid: Mordecai Ezekiel and Leon Henderson, two influential government advisers, were Keynesian economists who were also prominent in the early days of TNEC.

In the immediate situation, however, as it became clear in autumn 1937 that the economic downturn was going to be painful and prolonged, debate between savers and spenders grew more urgent. Treasury Secretary Morgenthau maintained that recovery could only come through reviving business confidence, and that the only way to achieve this was by balancing the budget. Eccles and Hopkins argued the reverse: that counter-cyclical spending had to be resumed to jump-start the economy.[21] While Roosevelt balanced between these two positions, their proponents continued to argue about them, both behind closed doors and in public. In November, with FDR's backing, Morgenthau gave an important speech renewing the administration's commitment to a balanced budget. But, almost at the same time as Morgenthau was making this speech, Roosevelt was reading a memorandum prepared by Lauchlin Currie, a Federal Reserve Board economist and convinced Keynesian, which argued that reduced government spending had caused the current recession.[22]

The following year, echoing what Keynes and Laski had said in 1934, Eccles told the Senate Unemployment and Relief Committee on 4 January 1938 that, while the Federal Reserve favoured balanced budgets as much as anybody, the

21 Anthony Badger, *The New Deal: The Depression Years 1933–1940* (London 1989), 112.
22 Marriner Eccles, *Beckoning Frontiers: Public and Private Recollections* (New York 1951), 304.

nation could only have them out of increased national income, that this could come only from economic growth, and that,

> To try to balance the budget either by substantially reducing expenditures, or by increasing taxes, would be deflationary. When private credit is contracting it seems to me necessary, if we expect to sustain buying power, that either private business must act to do it, and they must find a profit before they will act to do it, or government will be required to do it.[23]

Eccles proposed to raise public spending by a billion dollars, to increase purchasing power and stop the recession deepening. Henry Wallace, Secretary of Agriculture, supported him.[24]

Finally, at a decisive meeting in March 1938 at Warm Springs, Georgia, where Roosevelt went regularly to seek relief from the paralysis of his polio, the president was finally converted to the idea of a package of federal spending to act counter-cyclically on the now seriously depressed economy. Hopkins, himself being treated for the onset of cancer, and a small group of other advisers, including FDR's current economist, Henderson, persuaded Roosevelt to resume deficit spending in a big way. This sanctioned three billion dollars in new relief, of which half was to be paid in Reconstruction Finance Corporation loans, with nearly two billion dollars lent or given for new public works.[25]

Recent monetary policy (which, as we have seen, had been crucial in deepening recession) was now abruptly reversed. Reduced bank reserve requirements and de-sterilization of gold freed a further 2.15 billion dollars. Morgenthau, an old friend of Roosevelt who had visited him weekly when polio kept him on his back for two years after 1921, muttered that these measures 'might just bust us', while his Treasury adviser, Jacob Viner, resigned on a point of principle.[26] It was clearly a significant defeat for Morgenthau, who remained committed to balancing the budget as soon as possible. By spring 1938, the president had accepted the reality of the 'Roosevelt recession', as the newspapers called it. Though FDR's decision to resume deficit spending, announced on 14 April 1938, did not mark his conversion to Keynesian notions about how to manage the trade cycle of a capitalist economy, it did mark the end of the beginning of that process.

In the November 1938 mid-term elections, the Roosevelt recession took a heavy price at the polls. For the first time since 1930, the political pendulum swung against Roosevelt and his party. Some of the most effective liberal Democrats in state legislatures, governors' mansions and Congress, lost office in this Republican sweep. But within the president's circle of unelected

23 Testimony of Marriner Eccles to Hearings of the Special Senate Committee on Unemployment and Relief, 4 January 1938, 74–5.

24 Testimony of Henry A. Wallace, ibid., 349.

25 Robert M. Collins, *The Business Response to Keynes 1929–1964* (New York 1981), 4.

26 Henry Morgenthau, *Presidential Diaries* (Sheffield University microfilm), 12 April 1938.

advisers, spenders now clearly had the upper hand over savers. Lauchlin Currie later said that even if the second world war had not intervened and changed the situation, 'we [the New Deal spenders] were winning the fiscal policy-employment battle'.[27] Nevertheless, from April 1938 the president became increasingly preoccupied with foreign affairs as war clouds loomed and the international crisis deepened. Aware that the recession had lost him political support, he also accepted that the reflationary policy Currie had advocated at Warm Springs was reviving the economy and reducing unemployment. If this recovery could be sustained for two years it would give the Democratic candidate for president, whoever he was, a better chance of victory in 1940.

Such political considerations aside, however, the relative importance of people and ideas is crucial to understanding events between 1938 and 1942. The key figures here were Currie, Eccles and Harry Dexter White. While teaching at Harvard, Currie had so impressed senior colleagues that they arranged secondment to the Treasury, where he had met White and Eccles, at that time Morgenthau's assistant at the Treasury. All three agreed that the Federal Reserve bore the major blame for the Great Depression because, as the nation's central bank, it had restricted money supply during the onset of the depression after 1930. Currie had helped draft the 1935 Banking Act, which enhanced the Federal Reserve's power over both policy-making and reserve requirements. After a short break to complete his Harvard PhD, Currie transferred to the Federal Reserve, which Eccles now chaired. Because Currie never advocated a position before putting analysis and data together, he now did the work for which he is best remembered — documenting the Federal Reserve's contradictory actions since 1929 — and, with Eccles, helped to persuade FDR of the need to sustain public spending after 1938.

Harry Dexter White, the third influential New Deal economist, had been appointed assistant director of monetary research at the Treasury in 1934, and became director there in 1940 at the precise moment when Roosevelt was shifting the economy to a war footing during which federal spending would rise exponentially in the next five years. Leon Henderson had been a close economic adviser in the 1930s, but in 1940 Currie became the first professional economist to be appointed to the White House, paid out of extra funds that Congress had voted for FDR's presidential staff in 1938. There his impeccable statistical calculations, coupled with the work of the Office of Price Administration, helped to control wartime inflation. White, for his part, became Morgenthau's assistant at the Treasury in 1945–46 and is generally regarded, while working with Keynes at the 1944 Bretton Woods conference, as one of the architects of the postwar world economy, based upon American control, the centrality of the dollar, expansionist policies, and management by the World Bank and the International Monetary Fund, which White directed between 1946 and 1947.

27 Quoted in Alan Sweezey et al., 'The Revolution and its Pioneers, 1933–1939', *American Economic Review*, vol. 62 (1972), 14.

However, though presidential advisers were important, economic recovery after 1938, in peacetime at least, still ultimately depended on the attitude of the business community. They owned and controlled the American economy. Reading businessmen's testimony to the Special Congressional Committee on Unemployment and Relief held in early 1938, one understands the central importance they placed on confidence as the key to recovery. Here, the TNEC's trust-busting attacks on big business and monopoly did not help: as the banker Thomas Lamont put it, 'The business community cannot be spanked into prosperity.'[28] The real problem was their attitude to budget deficits and tax policy. Roosevelt's tax increases between 1935 and 1937 were important to them, because they believed tax increases would make future profits more uncertain and investment more expensive and risky. They were, in theory at least, equally opposed to budget deficits. But in practice, as David Mawdsley has shown, things worked out rather differently.[29] Unbalanced budgets had been traditionally regarded as a mortal sin, burdening future generations with deepening debt which would eventually have to be paid with even higher taxes, and threatening inflation which would mean the death of private enterprise.

The greatest depression in history persuaded businessmen to change these priorities. As early as August 1935, a Business Advisory Council report had pointed out that, 'The price of balanced budgets may be too high . . . for the country to pay at this time because collection of drastic taxes could literally paralyse business.'[30] Such sentiments grew stronger as the recession deepened after 1937. When Senator James F. Byrnes sent out a questionnaire to senior business executives and every daily newspaper in the nation in late 1937, asking what single measure would most benefit the economy, balancing the budget came third. Respondents placed repeal of undistributed profits tax first, followed by modification of capital gains tax. Some businessmen, such as Ralph Flanders, Morris Leeds, Lincoln Filene and Henry Dennison, associated with the Business Advisory Council (BAC), actually went so far as to publish a book, ghosted by a young Harvard economist named John Kenneth Galbraith, which advocated ideas about deficit spending and a 'flexible budget' which were to become more widely accepted by 1945. This book, entitled *Toward Full Employment*, argued that,

> Capitalism did not enjoy a built-in tendency towards equilibrium at a high level of employment. Depression-ridden economies required government spending in excess of receipts to shift money from the saving stream to the consumption stream. In short, the need was for a compensatory fiscal policy which would operate at times with an unbalanced budget and at times with an over-balanced budget.[31]

28 Quoted in Mark H. Leff, *The Limits of Symbolic Reform: The New Deal and Taxation 1933–1939* (New York 1984), 235.
29 Mawdsley, 'Recession of 1937–38', op. cit., 39–51.
30 Quoted ibid., 39.
31 Quoted in Collins, *Business Response*, op. cit., 65.

Few businessmen bought this idea in 1937–38. Sales of *Toward Full Employment* were slow, with many copies remaindered or bought by the four authors themselves.[32] Even the BAC, though liberal enough to have supported Social Security legislation in 1935, remained fixed to the idea of a short-term budget balance. But though business commitment to the ideal of a balanced budget may have been the goal, the political problem was how to achieve it in practice. A convinced conservative like William Kelly told the 1938 Special Congressional Committee on Unemployment and Relief hearings that, 'Public spending at the right time, connected with other things, is good. I have no objection to the public spending principle which has been followed during the last few years.'[33] Another conservative, J.D.A. Morrow, after being prompted to accept that unbalanced federal budgets did adversely affect business confidence, failed to find the issue important enough to raise it again during his testimony.[34]

Robert Wood of Sears Roebuck echoed both what Eccles had earlier told the committee and what Keynes and Laski had argued in 1934. Claiming that it was 'preferable' for private business ultimately to invest to provide income and employment and sustain prosperity, and adding that for 'government to continue its spending indefinitely . . . would be disastrous', Wood conceded that reduced government spending in 1937 had been the major cause of the recession. The following exchange then took place.

Chairman Jobs can be given by individuals or by government?
Wood Yes; one of the two.
Chairman Given by individuals if they can see profit and, if they do not, then government has to do it?
Wood Exactly.[35]

Finally, the National Association of Manufacturers (NAM) agreed in 1938 that recession had been brought about in part by 'a drastic instead of gradual reduction in federal cash deficit expenditures'.[36] As the historian Mark Leff puts it, 'In business circles "deficit" was a dirty word. But there were worse things than profanity.'[37] Compared to socialist planning, or the concerted attack on big business advocated by TNEC, deficit finance seemed a relatively conservative approach, the least of three evils.

Taxation, though, seemed much more important. In fact, taxing and spending were intertwined in businessmen's minds. For example, Social Security taxes, despite their major contribution to reducing the budget deficit in 1937, were opposed by business for two reasons: employer contributions reduced profits, which could otherwise have been used for investment; while

32 Ibid., 66.
33 Testimony of William Kelly to Senate Committee, op. cit., 13 January 1938, 471.
34 Testimony of J.D.A. Morrow to Senate Committee, 14 January 1938, 509–16.
35 Testimony of Robert Wood to Senate Committee, 7 January 1938, 226.
36 Quoted in Blum, *Morgenthau Diaries*, op. cit., 415.
37 Leff, *Symbolic Reform*, op. cit., 241.

employees' deductions reduced their purchasing power. Business leaders opposed Roosevelt's specific taxes on business between 1935 and 1937 more vigorously than federal budget deficits, especially the undistributed profits and capital gains taxes, which were particularly hated. Business believed — as supply-siders were to argue during the Reagan, Bush and Clinton presidencies in the 1980s and 1990s — that while higher taxes would bring an immediate increase in government revenue, in the long run they would reduce yield because they would diminish investment, and thus growth and tax take. Conversely, while lower taxes might lead to immediate loss of revenue, in the long term the extra money freed for investment would increase profits and hence total tax receipts.

The 1936 undistributed profits tax had been imposed specifically to offset increased government spending on paying the Veterans' Bonus ten years before it was due, and to offset loss of revenue from the agricultural processing tax, which had been used to finance farm subsidies. Though farm subsidies had been struck down by the Supreme Court in the Butler case in 1936, Congress had found other ways of subsidizing farming. Furthermore, corporations which retained profits rather than distribute them to shareholders were to be penalized. Businessmen complained that the undistributed profits tax stopped them building up much-needed reserves and discouraged investment. Answers to the National Conference Board survey which Senator Byrnes had sent to corporate America in 1937 showed that 24 per cent of the 360 corporations who responded admitted that they had had 'to rely more on outside sources for working capital', while a further 28 per cent claimed that the tax had forced them to 'curtail, abandon or postpone plans for plant or equipment expenditure'.[38] If true, this was all the more disastrous because reduced government expenditure now returned the burden of sustaining national production and income to private investment at precisely the time when the Federal Reserve's restrictionary monetary policy was increasing the cost of borrowing.

Responding to this, Eccles argued that total abolition of the undistributed profits tax would prove deflationary, because it would allow firms to accumulate idle reserves and pay back debt when what was needed was expansion of credit. But he did advocate that the tax be modified. Businesses which used earnings to invest in plant and equipment for expansion should be allowed to offset this against tax.[39] Bernard Baruch told the Senate Unemployment Committee in February 1938 that repeal of the undistributed profits tax would have a most beneficial effect on the business climate.[40] Senate Finance Committee hearings, held in March 1938 to review effects of the Revenue Act, revealed the depth of business disillusionment with government tax policy. Yet Roosevelt's bid to save something of the tax, while reforming it to help smaller

38 Quoted in Roose, *Recession and Revival*, op. cit., 215.
39 Testimony of Eccles to Senate Committee, op. cit., 69.
40 Quoted in Leff, *Symbolic Reform*, op. cit., 257.

corporations (the so-called 'third basket plan'), was defeated in the House by 184 votes to 124.

Morgenthau at the Treasury called this the 'worst slap in the face the president has had to take during his entire administration'.[41] Then the Senate axed the profits tax completely, because Roosevelt could not mobilize enough votes from the New Deal coalition in Congress to support it. Politically, this proved to be a landmark defeat. The Congressional conservative coalition of 'Dixiecrats' (Southern Democrats) and Republicans was emerging to put a cap on further social, welfare and civil rights reform, and so set the parameters of Congressional politics for a generation to come. In the end, the 1938 Revenue Act scrapped the undistributed profits tax in the fiscal year 1939–40, while a ceiling of 15 per cent was placed on capital gains taxes. The 1938 Revenue Act was an important economic measure in the short term. Yet in the long term it was even more significant as a symbol of what it was politically possible to ask business to bear. For as Keynes contended, 'Politics enter expectations and therefore economics.'[42]

Having won this tax relief, business had the further satisfaction of seeing the anti-trust campaign end in disarray too. Despite amassing thousands of pages, which now give historians an impressive picture of how the American economy actually worked in the 1930s, Thurman Arnold's efforts to revitalize the anti-trust section of the Department of Commerce with a series of high-profile prosecutions proved futile. In only two cases (*US v. Pullman Co.* and *US v. Paramount Pictures*) did the government succeed in forcing structural change, and future policy was not influenced significantly.[43] The old Progressive goal of 'trust-busting' was never revived. Arnold himself later recognized that 'FDR was to declare a truce in the fight against monopoly. He was to have his foreign war; monopoly was to give him patriotic support — on his own terms.'[44] Since 1935 the government had abandoned attempts to plan economic recovery in agriculture and industry. Now the old Progressive policy of trust-busting, through the TNEC, was again giving ground. But Keynesian ideas were becoming more influential. Economic recovery after April 1938 had happened, according to one's philosophy, either despite or because of federal government renewal of deficit spending. A further problem in analysing events is that even if one accepts that the Keynesian approach was the right one, had business persisted in believing it the road to ruin, then such policies would not have worked. In the event, as we have seen, budget-balancing was not the key to restoring business confidence; tax relief did that. So by 1940 government spending was widely seen to have caused recovery in 1933–34, and again in 1938–39. Business no longer believed unbalanced

41 Quoted in James T. Patterson, *Congressional Conservatism in the New Deal: The Growth of the Conservative Coalition in Congress 1933–1939* (Lexington 1967), 231.

42 Quoted in Robert Skidelsky, *John Maynard Keynes, A Biography: vol. 2, Economist as Saviour* (London 1992), 509.

43 Ellis W. Hawley, *The New Deal and the Problem of Monopoly* (Princeton 1966), 451.

44 Quoted in Badger, *New Deal*, op. cit., 107.

budgets necessarily depressed business confidence or led to runaway inflation, as conservatives feared.

By 1939 Roosevelt himself indicated that budget-balancers, on the one hand, and those who advocated a planned approach to the economy through TNEC, on the other, had lost his support, while the proto-Keynesians were gaining it. In an unedited transcript of a presidential press conference on 21 March 1939, Roosevelt told a questioner:

> We have the choice of following the policy recommended in the annual message, or of adopting the policy which has been advanced by perfectly well-meaning people: that is, cutting down certain expenditures of government. . . . They include: relief for the unemployed, all forms of public works, social security for the aged, slum clearance and various other items which today give work in large volume — all of those being predicated on the guess — again the guess — of so many well-meaning people that thereby, taking away employment from several million workers, business will automatically pick up and employ the entire slack plus the other large number of people who are out of work but not in any way being helped by the government. If there was some guarantee that this would happen, it would be worth considering. I doubt, however, whether this would meet with popular approval if it were tried out and the results were not attained. There is the answer. It is purely extemporaneous but I think I said a mouthful.[45]

In this light, if the Warm Springs meeting in 1938 had been the end of the beginning of Roosevelt's acceptance of Keynesian notions about demand management, his extemporized 'mouthful' marked the beginning of the end. It was the more significant because he spoke his mind *before* the American economy moved onto a war footing. Moreover, Roosevelt did not decide to run for president for a third time until summer 1940. When he campaigned then, Herbert Hoover, who had been accused of overspending in 1932, was now attacked for not having spent enough. The world war which started in Europe in September 1939 persuaded Congress to finance a rearmament programme which further enhanced the federal government's role managing the economy. Through 1940 and 1941, business found no difficulty in reviving investment as federal spending on military hardware deepened the deficit while stimulating the supply side of the American economy. Gross private investment rose from 42 in 1938 (1925 = 100) to 61 in 1939, 82 in 1940 and 103 in 1941, even before America joined the war.[46] The complete figures on coporate investment, however, show the true relationship between private and public investment between 1929 and 1945 (see Table 10).

Overall private investment rose dramatically between 1933 and 1934 and steadily throughout the period, despite a critical dip between 1934 and 1937, while the proportion taken by investment in government contracts rose steadily after 1934. Private investment actually fell steadily between 1938 and

45 Unedited transcript of presidential press conference 531, 23 March 1939, in president's secretary file (hereafter PSF) Box 186, Taxes, in Roosevelt collection, F.D. Roosevelt Library, Hyde Park, New York.

46 Chandler, *Greatest Depression*, op. cit., 132.

TABLE 10
United States Corporate Investment, 1929–45 (in millions of current dollars)[47]

Year	Government contracts	Private investment	Total
1929	10.3	55.8	66.1
1930	10.2	83.8	94.0
1931	10.6	73.5	85.9
1932	11.9	75.6	86.5
1933	13.5	76.4	89.9
1934	19	90.5	109.5
1935	21.8	90.1	111.9
1936	24.3	86.2	110.5
1937	23.9	85.9	109.8
1938	25.5	87.7	113.2
1939	27.3	81.1	108.4
1940	29.5	80.4	109.9
1941	36.5	80.3	116.8
1942	61.1	70.8	131.9
1943	86.6	72	158.6
1944	74.3	95.1	169.4
1945	74	92	166

1944, while investment in government contracts rose until it was the larger of the two figures in 1943. At the height of the war, private enterprise for the first time spent more on fulfilling government contracts than it did for its own purposes.

Moreover, as the supply side of the economy moved steadily ahead again after 1939 in recovery from the Roosevelt recession, it was now more widely accepted that rising national debt (which had doubled between 1932 and 1937) could be handled if accompanied by growth in GDP, which is what the whole spending approach was designed to achieve. This was the central belief in the emerging Keynesian consensus about managed capitalism. When Morgenthau refused to raise taxes in 1940 to pay for rearmament, political commentators realized that his refusal was to placate business, not defy budget-balancers.[48] The new situation was summed up by Currie in an ironic memorandum he sent to the president.

> I know that you will be pleased to learn that Secretary Morgenthau and Mr Eccles have had a long talk and, in the words of Mr. Eccles, have 'a complete and thorough understanding that they will cooperate closely . . . and acknowledge the perfect right of the other to differ as to method'.[49]

From that point on, Roosevelt paid more attention to the advice he received from Lauchlin Currie and the Federal Reserve than to what Leon Henderson or Morgenthau and the Treasury told him.

47 *Historical Statistics*, op. cit., Part 2, Series V, 108–40, 925.
48 Leff, *Symbolic Reform*, op. cit., 240.
49 Currie to Franklin Roosevelt, 1 February 1940, in PSF, Box 115, Roosevelt Library.

In 1940, Roosevelt presented an annual budget message to Congress which, for the first time, explained the government's role in regulating supply and demand in the economy through its power to tax and spend. He told Congress that reducing the deficit in the fiscal year 1937–38 had raised unemployment and hit business hard. Keynes remained unconvinced that this conversion to his ideas was genuine, arguing that the federal government had not yet done enough to sustain economic recovery through spending. 'It seems politically impossible', he explained in July 1940, 'for capitalistic democracy to organize expenditure on the scale necessary to make the grand experiment which would prove my case — except in war conditions.'[50] As Keynes wrote these words, France was falling into German hands. Within five months Roosevelt had won re-election for an unprecedented third term. Within a year Hitler had invaded the Soviet Union. Within 18 months the Japanese attack on Pearl Harbor brought America into the war. Spending was now organized on a scale which even Keynes could not have imagined possible. The conversion, to the practice if not the principle behind it, was complete.

More important, the war economy had transformed priorities. Hitherto, deficit spending had been primarily used to stimulate demand by creating jobs through public works programmes under the Public Works Administration, Civilian Conservation Corps and other federal agencies, and to sustain demand by a federal system of social security and minimum wages. War taxes and defence spending, which began in earnest in 1940–41, rose exponentially thereafter. Moreover, mobilization meant that 12 million young men, who would have been seeking work in the labour market, had been conscripted into the armed forces for the duration of the war, which looked like lasting for most of the rest of the decade. Soldiers were paid a minimum wage and were not seeking work, which took care of both demand and supply problems. War orders further transformed supply-side problems. Military hardware was built to be destroyed and replaced as rapidly as possible. Thus, with good management, both sides of the economic equation would move into balance. Moreover, with labour (especially skilled labour) suddenly scarce, the more powerful unions which had emerged since the passage of the 1935 Wagner Act would increasingly take care of demand by bidding up wages. Paying tax became a patriotic imperative. So wartime finance was similar to that which had accompanied peactime recovery in 1933–35 and 1937–39. While annual deficit and total public debt rose, government spent roughly two dollars for every one it raised, except in 1943, when it spent three. The cost of winning the war also meant government rationing of scarce commodities, like oil and rubber, and seeking control of inflation by trying to cap both pay and profits.

The part that labour unions played in the new political economy which emerged during the New Deal, world war and the two decades after, is not part of this article. But it is worth noting that, by making labour suddenly

50 J.M. Keynes, 'The United States and the Keynes Plan', *New Republic*, vol. CIII (29 July 1940), 158.

scarce, the war helped labour unionize most basic manufacturing, while employers began for the first time to use unions to enforce both contracts and shopfloor discipline. Unions were also expected to help combat wartime inflation, which (with some exceptions) they did. The legacy of all this was that strong unions were involved in a new economic order. Big business took care of production, big unions sustained aggregate demand, while government sought partnership with both, while controlling supply and demand through taxing and spending. This new order helped sustain American prosperity until it broke down in the 1970s.

The clearest indication that Roosevelt understood the new economic thinking which underpinned all this came in autumn 1944. Campaigning for a fourth term, with American forces fighting in France and Italy and victory over nazi Germany in sight, Roosevelt introduced his Economic Bill of Rights, envisaging huge public investment in industry. Such planning was not socialist, the president was at pains to point out. Its whole purpose was to make American capitalism work better. 'All the measures proposed in this program', he said at Soldier Field, Chicago, on 28 October 1944, 'are . . . designed to make American capitalism work in the same great manner in peace as in war.' War had, in fact, revealed how a capitalist economy could end mass unemployment and achieve prosperity in the second half of the century.

> Greater output is not the only benefit from this plant expansion. In fact, our benefits also include the wages paid to the labor employed in building these plants, in constructing the machinery to be used in these plants and in operating the plants after they are erected. These payments as wages all contribute to the nation's buying power so that as a nation we will have the money to buy the goods produced by these expanded plants. . . . Why, just the job of *building* these plants and the machinery for them would give America five million more jobs a year than we had in this work before the war. And this does not include the workers who would be needed to operate these plants after they are built.[51]

The Roosevelt administration had only chosen a reflationary route out of depression in 1933–34 via a chaos of improvisation. In 1936–38 it found to its cost that reducing government spending just as the economy was accelerating risked stripping the gears of the American industrial machine. Then in 1940–45 government adopted deficit spending on a scale large enough to end unemployment when war made this a patriotic imperative. Yet in a sense, war was not a true test-bed for Keynesian *economics*. Military conscription had solved unemployment, and there was nothing Keynesian about that. Yet war had shifted political power to the federal government. Roosevelt was recommending that America take the 'middle way', advocated by some of those influenced by Keynesian ideas, between unreconstructed capitalism on the one hand and socialism on the other. This would have combined sustained deficit financing with imaginative use of taxes to encourage private investment, as recommended in the TNEC report in 1940.[52] It might have included compre-

51 President's personal file 1017, 28 October 1944 (italics in original) in Roosevelt Library.
52 TNEC Report, monograph 25, Recovery Plans 1940, 40.

hensive health and welfare systems, as were to develop in Europe. Yet, though some economic advisers who helped shape economic policy between 1933 and 1945 were influenced by Keynes, or American disciples like Alvin Hansen, Marriner Eccles claimed never to have read anything but 'small extracts' of the British economist's work in his entire life, and explained that he had based his economic ideas 'on naked-eye observation and experience in the inter-mountain region', gained as a young banker in Utah.

As Eccles pointed out, counter-cyclical spending was really a conservative option which implied 'sustaining government contributions to general purchasing power while the obstacles to *private* spending are cleared away'.[53] The basic structure and values of capitalism, the ownership and control of the system, would not be disturbed in the long run if such policies were adopted. Yet despite such spending to make good the failure of private investment and so reduce unemployment in 1933–35, and again in 1938–39, almost one in six Americans were still out of work in 1939. In that sense, as Herbert Stein has argued, 'It is possible to describe the evolution of fiscal policy in America up to 1940 without reference to Keynes.'[54] Yet thinking counter-factually, what would have happened had the Democrats nominated the party's front runner, Al Smith, in 1932, if Hoover had won the presidency for the Republicans that year, or Alf Landon in 1936? Their determination to balance the budget at all costs would have created a deeper downward spiral, with spending cuts driving the economy into worse recession. This in turn would have reduced tax yield, thus triggering more spending cuts and possibly higher taxes. Something like that did happen in America under Hoover's leadership between 1930 and 1933 (as it did again in Britain under Margaret Thatcher's government between 1979 and 1983). Given the severity of the collapse after 1929, the economy would eventually have stabilized, but at a much lower level.

The real weakness of Stein's view, however, is that, by writing Keynes out of the script, it ignores the longer-term influence of ideas on action — a point which Keynes himself always believed crucial. By 1945, everyone who studied economics at university had to confront Keynes's notions, both because his *General Theory* was an elegant and convincing argument, and because events had shown that his ideas worked. In the political arena, the conflict between regulators, who called on government to control the capitalist economy, and Keynesians, who sought merely to encourage growth through spending, had finally been resolved in favour of the latter. But this only occurred when war had restored faith in capitalism's ability to sustain employment and the prosperity it brought. As Albert Romasco puts it, this was what ultimately ensured that 'the Keynesian vision . . . pushed the regulatory vision from the corridors of power'.[55]

In fact, the Economic Bill of Rights was to be largely nullified in Congress after 1944 by the Dixiecrat–Republican conservative coalition, when

53 Eccles, *Beckoning Frontiers*, op. cit., 231–2.
54 Herbert Stein, *The Fiscal Revolution in America* (Chicago 1969), 131.
55 Albert U. Romasco, *The Politics of Recovery: Roosevelt's New Deal* (New York 1983), 233.

Roosevelt's death in April 1945 only days before Germany capitulated left the spenders and social reformers leaderless. Between 1945 and 1950, FDR's successor, Harry Truman, and his administration struggled to control postwar inflation, while avoiding a return to pre-war depression. But a sea-change had occurred nevertheless. Shortly after Japan surrendered in August 1945, President Truman went on radio to tell the nation that the end of wartime government contracts with private industry meant that the nation's wage bill would shrink by 20 billion dollars in the next fiscal year. Therefore, substantial wage increases were 'imperative . . . to sustain adequate purchasing power and to raise the national income', so avoiding a rapid return to pre-war mass unemployment. Fortunately, Truman concluded, 'there is room in the existing price structure for business as a whole to grant increases in rates'.[56] That Roosevelt could seek to base postwar policy on the idea of the Keynesian economic multiplier, as explained in his Economic Bill of Rights speech, and Truman on the need to sustain purchasing power to sustain full employment, showed just how much political thinking about economic problems had changed since 1932.

Patrick Renshaw

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56 Broadcast quoted in the *New York Times*, 12 October 1945.

Appendix

TABLE 4
GNP, Total and per capita, 1910–45

Year	Current prices total ($ billion)	Per capita ($)	1958 prices total ($ billion)	Per capita ($)	Implicit price index (1958 = 100)
1910	35	382	120	1299	29.4
1918	76	740	151	1471	50.3
1919	84	804	146	1401	57.4
1920	92	860	140	1315	65.4
1921	70	641	128	1177	54.5
1922	74	673	148	1345	50.1
1923	85	760	166	1482	51.3
1924	85	742	166	1450	51.2
1925	93	804	179	1549	51.9
1926	97	826	190	1619	51.1
1927	95	797	190	1594	50.0
1928	97	805	191	1584	50.8
1929	103	847	204	1671	50.6
1930	90	734	184	1490	49.3
1931	75	611	169	1364	44.8
1932	58	465	144	1154	40.2
1933	55	442	141	1126	39.3
1934	65	514	154	1220	42.2
1935	72	562	169	1331	42.6
1936	82	643	193	1506	42.7
1937	90	701	203	1576	44.5
1938	84	651	193	1484	43.9
1939	90	691	209	1598	43.2
1940	100	754	227	1720	43.9
1941	125	934	264	1977	47.2
1942	158	1171	298	2208	53.0
1943	192	1401	337	2465	56.8
1944	210	1518	361	2611	58.2
1945	212	1515	355	2538	59.7

Source: *Historical Statistics*, Part 1, Series F, 1–5, 224.

TABLE 5
Annual Employee Income by Industry, 1910–45 ($ current)

	1910	1920	1929	1934	1937	1938	1940	1945
Farming and (after 1929) Fisheries	223	528	401	253	360	369	407	1125
Manufacturing	651	1532	1543	1153	1376	1296	1432	2517
All Mining	668	1684	1526	990	1366	1282	1388	2621
Anthracite	604	1777	1728	1452	1388	1315	1297	2685
Bituminous	657	1633	1293	748	1170	1050	1235	2629
Metal	685*	1639	1613	1040	1630	1453	1610	2551
Construction	827	1710	1674	869	1278	1193	1330	2600
All Transport	607	1645	1643	1334	1644	1676	1756	2734
Rail	662	1807	1749	1439	1774	1774	1906	2711
Water	430	1499	1275	1038	1536	1299	1648	3538
Local	575	1435	1598	1219	1505	1529	1559	2596
Communication and Utilities	516	1238	1478	1351	1600	1673	1717	2446
Gas & Electric	616	1489	1589	1453	1705	1749	1795	2596
Telephone & Telegraph	416	1115	1386	1245	1481	1508	1610	2246

* 1908 figure is given here as the one for 1910 is not available
Source: *Historical Statistics*, Part 1, Series D, 739–64, 166–7

TABLE 6
Value of Gross Farm Product, 1910–45 ($ billions, current)

1910	1920	1929	1934	1936	1937	1938	1939	1945
13.5	25.9	17.0	7.1	9.6	11.8	9.8	9.9	24.6

Source: *Historical Statistics*, Part 1, Series K, 220–39, 481

TABLE 7
Index of farm costs and prices, 1910–45 (Base: 1910–14 = 100)

Year	Prices received	Prices paid	Ratio of two	Wages	Land taxes
1910	102	96	106	97	90
1915	99	107	93	103	118
1919	215	198	109	207	160
1921	124	165	75	155	244
1925	156	169	92	176	265
1929	149	167	89	180	279
1932	68	124	55	96	254
1937	122	133	92	126	181
1939	95	124	77	123	183
1940	100	125	80	126	186
1945	202	172	117	350	181

Source: F.A. Shannon, *America's Economic Growth* (New York 1951), 721

TABLE 8
Farm income and expenses, 1910–45 ($ billions, current)

Year	1910	1919	1929	1934	1936	1937	1938	1940	1945
Gross farm expenses	3.5	8.3	7.6	4.7	5.6	6.1	5.9	6.8	13
Net income	3.9	9.6	6.2	3.8	5.1	5.2	4.2	4.2	12.7
Net change in farm inventories	212	–509	–122	–930	–806	816	132	281	–439

Source: *Historical Statistics*, Part 1, Series K, 256–85, 483–4

TABLE 9
Index of prices received and paid by farmers, and parity ratio, 1910–45 (1967=100)

	1910	1920	1929	1933	1937	1938	1939	1945
Prices received by farmers								
All farm products	41	83	58	28	48	38	37	81
Crops	46	93	65	31	54	43	42	92
Livestock and products	37	69	57	25	45	40	42	92
Prices paid by farmers								
Living	31	71	48	34	40	38	37	57
Production	34	68	51	34	46	43	42	
Payable per acre								
Interest	17	45	45	34	24	23	22	16
Taxes	10	23	31	25	20	21	21	22
Wage rates prices paid, including tax, interest and wage rates								
Wage rates	28	63	47	32	38	36	36	56
Parity ratio	107	99	92	64	93	78	77	109

Source: *Historical Statistics*, Part 1, Series K, 344–53, 489