THE GREAT RECESSION, THE GREAT RECESSION, AND WHAT'S AHEAD

Robert B. Reich

1

ECCLES'S INSIGHT

The Federal Reserve Board, arguably the most powerful group of economic decision-makers in the world, is housed in the Eccles Building on Constitution Avenue in Washington, D.C. A long, white, mausoleum-like structure, the building is named after Marriner Eccles, who chaired the Board from November 1934 until April 1948. These were crucial years in the history of the American economy, and the world's.

While Eccles is largely forgotten today he offered critical insight into the great pendulum of American capitalism. His analysis of the underlying economic stresses of the Great Depression is extraordinarily, even eerily, relevant to the crash of 2008. It also offers, if not a blueprint for the future, at least a suggestion of what to expect in the coming years.

A small, slender man with dark eyes and a pale, sharp face, Eccles was born in Logan, Utah, in 1890. His father, David Eccles, a poor Mormon immigrant from Glasgow, Scotland, had come to Utah, married two wives, became a businessman, and made a fortune. Young Marriner, one of David's twenty-one children, trudged off to Scotland in 1910 as a Mormon missionary but returned home two years later to become a bank president. By age twenty-four he was a millionaire; by forty he was a tycoon – director of railroad, hotel, and insurance companies; head of a bank holding company controlling twenty-six banks; and president of lumber, milk, sugar, and construction companies spanning the Rockies to the Sierra Nevadas.

In the Crash of 1929, his businesses were sufficiently diverse and his banks adequately capitalized that he stayed afloat financially. But he was deeply shaken when his assumption that the economy would quickly return to normal was, as we know, proved incorrect. “Men I respected assured me that the economic crisis was only temporary,” he wrote, “and that soon all the things that had pulled the country out of previous depressions would operate to that same end once again. But weeks turned to months. The months turned to a year or more. Instead of easing, the economic crisis worsened.” He himself had come to realize by late 1930 that something was profoundly wrong, not just with the economy but with his own understanding of it. “I awoke to find myself at the bottom of a pit without any known means of scaling its sheer sides....I saw for the first time that though I’d been active in the world of finance and production for seventeen years and knew its techniques, I knew less than nothing about its economic and social effects.” Everyone who relied on him – family, friends, business associates, the communities that depended on the businesses he ran – expected him to find a way out of the pit. “Yet all I could find within myself was despair.”

When Eccles’s anxious bank depositors began demanding their money, he called in loans and reduced credit in order to shore up the banks’ reserves. But the reduced lending caused further economic harm. Small businesses couldn’t get the loans they needed to stay alive. In spite of his actions, Eccles had nagging concerns that by tightening credit instead of easing it, he and other bankers were saving their banks at the expense of community – in “[s]eeking individual salvation, we were contributing to collective ruin.”

Economists and the leaders of business and Wall Street – including financier Bernard Baruch; W. W. Atterbury, president of the Pennsylvania Railroad; and Myron Taylor, chairman of the United States Steel Corporation – sought to reassure the country that the market would correct itself automatically, and that the government's only responsibility was to balance the federal budget. Lower prices and interest rates, they said, would inevitably "lure 'natural new investments' by men who still had money and credit and whose revived activity would produce an upswing in the economy." Entrepreneurs would put their money into new technologies that would lead the way to prosperity. But Eccles wondered why anyone would invest when the economy was so severely disabled. Such investments, he reasoned, "take place in a climate of high prosperity, when the purchasing power of the masses increases their demands for a higher standard of living and enables them to purchase more than their bare wants. In the America of the thirties what hope was there for developments on the technological frontier when millions of our people hadn't enough purchasing power for even their barest needs?"

There was a more elaborate and purportedly "ethical" argument offered by those who said nothing could be done. Many of those business leaders and economists of the day believed "a depression was the scientific operation of economic laws that were God-given and not man-made. They could not be interfered with." They said depressions were phenomena like the one described in the Biblical story of Joseph and the seven kine, in which Pharoah dreamed of seven bountiful years followed by seven years of famine, and that America was now experiencing the lean years that inevitably followed the full ones. Eccles wrote, "they further explained that we were in the lean years because we had been spendthrifts and wastrels in the roaring twenties. We had wasted what we earned instead of saving it. We had enormously inflated values. But in time we would sober up and the economy would right itself through the action of men who had been prudent and thrifty all along, who had saved their money and at the right time would reinvest it in new production. Then the famine would end."

Eccles thought this was nonsense. A devout Mormon, he saw that "[w]hat passed for the God-given aspect in the operation of economics was nothing more than a determination of this or that interest, specially favored by the status quo, to resist any new rules that might be to their disadvantage." He wrote, "It became apparent to me, as a capitalist, that if I lent myself to this sort of action and resisted any change designed to benefit all the people, I could be consumed by the poisons of social lag I had helped create. I saw at this time, moreover, that men with great economic power had an undue influence in making the rules of the economic game, in shaping the actions of government that enforced those rules, and in conditioning the attitude taken by people as a whole toward those rules. After I had lost faith in my business heroes, I concluded that I and everyone else had an equal right to share in the process by which economic rules are made and changed." One of the country's most powerful economic leaders concluded that the economic game was not being played on a level field. It was tilted in favor of those with the most economic power.

##

Eccles made his national public debut before the Senate Finance Committee in February 1933, just weeks before Franklin D. Roosevelt was sworn in as President. The committee was holding hearings on what, if anything, should be done to deal with the ongoing economic crisis. Others had advised reducing the national debt and balancing the federal budget, but Eccles had different advice. Anticipating what British economist John Maynard Keynes would counsel three years later in his famous *General Theory of Employment, Interest, and Money*, Eccles told the senators that the government had to go deeper into debt in order to offset the lack of spending by consumers and businesses. Eccles went further. He advised the senators on ways to get more money into the hands of the beleaguered middle class. He offered a precise program designed "to bring about, by Government action, an increase of purchasing power on the part of all the people."

Eccles arrived at these ideas not by any temperamental or cultural affinity – he was, after all, a banker and of Scottish descent – but by logic and experience. He understood the economy from the ground up. He saw how average people responded to economic downturns, and how his customers reacted to the deep crisis at hand. He merely connected the dots. His proposed program included relief for the unemployed, government spending on public works, government refinancing of mortgages, a federal minimum wage, federally-supported old-age pensions, and higher income taxes and inheritance taxes on the wealthy in order to control capital accumulations and avoid excessive speculation (we'll learn later why these latter two steps were important). Not until these recommendations were implemented, Eccles warned, could the economy be restored.

Eccles then returned to Utah where he watched Roosevelt hatch the first hundred days of his presidency. To Eccles, the new president's initiatives seemed barely distinguishable from what his predecessor, Herbert Hoover, had offered – a hodgepodge of ideas cooked up by Wall Street to keep it afloat but do little for anyone else. "New York, as usual, seems to be in the saddle, dominating fiscal and monetary policy," he wrote his friend George Dern, the former governor of Utah who had become Roosevelt's secretary of war.

In mid-December 1933, Eccles received a telegram from Roosevelt's treasury secretary, Henry Morgenthau, Jr., asking him to return to Washington at the earliest possible date to "talk about monetary matters." Eccles was perplexed. The new administration had shown no interest in his ideas. He had never met Morgenthau, who was a strong advocate for balancing the federal budget. After their meeting the mystery only deepened. Morgenthau asked Eccles to write a report on monetary policy, which Eccles could as easily have written in Utah. A few days later Morgenthau invited Eccles to his home, where he asked about Eccles's business connections, his personal finances, the condition of his businesses, and whether any had gone bankrupt. Finally, Morgenthau took Eccles into his confidence. "You've been recommended as someone I should get to help me in the Treasury Department," Morgenthau said. Eccles was taken aback, and asked for a few days to think about it.

"'Here you are, Marriner, full of talk about what the government should and shouldn't do,'" Eccles told himself, as he later recounted in his memoirs. "'You ought to put up or shut up....You're afraid your theory won't work. You're afraid you'll be a damned fool. You want to stick it out in Utah and wear the hair shirt of a prophet crying in the wilderness. You can feel noble that way, and you run no risks. [But] if you don't come here you'll probably regret it for the rest of your life.'" Eccles talked himself into the job.

For many months thereafter, Eccles steeped himself in the work of the treasury and the Roosevelt administration, pushing his case for why the government needed to go deeper into debt to prop up the economy, and what it needed to do for average people. Apparently he made progress. Roosevelt's budget of 1934 contained many of Eccles's ideas, violating the President's previous promise to balance the federal budget. The President "swallowed the violation with considerable difficulty," Eccles wrote.

The following summer, after the governor of the Federal Reserve Board unexpectedly resigned, Morgenthau recommended Eccles for the job. Eccles had not thought about the Fed as a vehicle for advancing his ideas. But a few weeks later, when the President summoned him to the

White House to ask Eccles if he'd be interested, Eccles told Roosevelt he'd take the job if the Federal Reserve in Washington had more power over the supply of money, and the New York Fed (dominated by Wall Street bankers), less. Eccles knew Wall Street wanted a tight money supply and correspondingly high interest rates, but the Main Streets of America – the real economy – needed a loose money supply and low rates. Roosevelt agreed to support new legislation that would tip the scales toward Main Street. Eccles took over the Fed.

For the next fourteen years, with great vigor and continuing vigilance for the welfare of average people, Eccles helped steer the economy through the remainder of the Depression and World War II. He would also become one of the architects of the Great Prosperity that the nation and much of the rest of the world enjoyed after the war.

##

Eccles retired to Utah in 1950 to write his memoirs and reflect on what had caused the largest economic trauma ever to have gripped America, the Great Depression. Its major cause, he concluded, had nothing whatever to do with excessive spending during the 1920s. It was, rather, the vast accumulation of wealth and income in the hands of the wealthiest people in the nation, which siphoned purchasing power away from most of the rest of the nation. This was Eccles's biggest and most important insight. It has direct bearing on the Great Recession that started at the end of 2007. In Eccles's words:

> As mass production has to be accompanied by mass consumption, mass consumption, in turn, implies a distribution of wealth – not of existing wealth, but of

> wealth as it is currently produced – to provide men with buying power equal to the amount of goods and services offered by the nation's economic machinery. Instead of achieving that kind of distribution, a giant suction pump had by 1929-1930 drawn into a few hands an increasing portion of currently produced wealth. This served them as capital accumulations. But by taking purchasing power out of the hands of mass consumers, the savers denied to themselves the kind of effective demand for their products that would justify a reinvestment of their capital accumulations in new plants. In consequence, as in a poker game where the chips were concentrated in fewer and fewer hands, the other fellows could stay in the game only by borrowing. When their credit ran out, the game stopped.

The borrowing had taken the form of mortgage debt on homes and commercial buildings, consumer installment debt, and foreign debt. Eccles understood that this debt bubble was bound to burst. And when it did, consumer spending would shrink.

And so it did. When there were no more poker chips to be loaned on credit, debtors were forced to curtail their consumption in an effort to create a margin that could be applied to the reduction of outstanding debts. This naturally reduced the demand for goods of all kinds and brought on what seemed to be overproduction, but was in reality underconsumption. This, in turn, brought about a fall in prices and employment. Unemployment further decreased the consumption of goods, which further increased unemployment.

Eccles singled out widening inequality as the main culprit.

> Had there been a better distribution of the current income from the national product – in

> other words, had there been less savings by business and the higher-income groups and more income in the lower groups – we should have had far greater stability in our economy. Had the six billion dollars, for instance, that were loaned by corporations and wealthy individuals for stock-market speculation been distributed to the public as lower prices or higher wages and with less profits to the corporations and the well-to-do, it would have prevented or greatly moderated the economic collapse that began at the end of 1929.

2

PARALLELS

If Eccles's insight into the cause of the Great Depression sounds familiar to you that's no coincidence. Although the Depression was far more severe than the Great Recession that officially began in December 2007, the two episodes are closely related. As Mark Twain once observed, history does not repeat itself but it sometimes rhymes. Had America not experienced the Great Depression, policymakers eighty years later would not have learned how to use fiscal and monetary policies to contain the immediate economic threat posed by the Great Recession. But we did not learn the larger lesson of the 1930s: that when the distribution of income gets too far out of whack, the economy needs to be reorganized so the broad middle class has enough buying power to rejuvenate the economy over the longer term. Until we take this lesson to heart, we will be living with the Great Recession's aftershock of high unemployment and low wages, and an increasingly angry middle class.

The wages of the typical American hardly increased in the three decades leading up to the crash of 2008, considering inflation. In the 2000s, they actually dropped. According to the Census Bureau, in 2007 the male worker earning the median male wage (that is, smack in the middle, with as many men earning more than him as earning less) took home just over $45,000. Considering inflation, this was less than the typical male worker earned thirty years before. Middle-class family incomes [1] were only slightly higher.

But the American economy was much larger in 2007 than it was thirty years before. If those gains had been divided equally among Americans, the typical person would be more than 60 percent better off than he actually was by 2007. Where did the gains go? As in the years preceding the Great Depression, a growing share went to the top. It was just like Eccles's "giant suction pump," drawing "into a few hands an increasing portion" of the nation's total earnings.

Economists Emmanuel Saez and Thomas Pikety have examined tax records extending back to 1913. They discovered an interesting pattern. The share of total income going to the richest 1 percent of Americans peaked in both 1928 and in 2007, at over 23 percent (see Figure 1, below). The same pattern held for the richest one-tenth of one percent (representing about 13,000 households in 2007): Their share of total income also peaked in 1928 and 2007, at over 11 percent. And the same pattern for the richest 10 percent, who in each of these peak years received almost half the total.

Between the two peaks is a long, deep valley. After 1928, the share of national income

[1] There is no strict definition of the "middle class." For the purposes of simplicity and clarity, I define it broadly to include the 40 percent of American families with incomes above the median family income and the 40 percent below.

going to the top 1 percent steadily declined from over 23 percent to around 16 to 17 percent in the 1930s; then to 11 to 15 percent in the 1940s; 9 to 11 percent in the 1950s and 1960s; finally reaching the valley floor of 8 to 9 percent in the 1970s. After this, the share going to the richest 1 percent began to climb again: 10 to 14 percent of national income in the 1980s; 15 to 19 percent in the late 1990s; and over 21 percent in 2005, until reaching its next peak of over 23 percent in 2007. (At this writing, there are no data after 2007.) If you look at the shares going to the top 10 percent or even top one-tenth of one percent you'd see the same long valley in between the two peaks.

[Figure 1]

In the 1920s, when Marriner Eccles was still a banker in Utah, it looked as if American capitalism was splitting by class. Sociologists Robert S. Lynd and his wife, Helen Merrell Lynd, after observing life in Muncie, Indiana (a small city of 35,000 which the Lynds took to be representative of America and which they called "Middletown"), recorded the growing division:

> At first glance it is difficult to see any semblance of pattern in the workaday life of a community exhibiting a crazy-quilt array of nearly four hundred ways of getting its living....On closer scrutiny, however, this welter may be resolved into two kinds of activities. The people who engage in them will be referred to throughout this report as the Working Class and the Business Class. Members of the first group, by and large, address their activities in getting their living primarily to things, utilizing material tools in the making of things and the performance of services, while the members of the second group

> address their activities predominantly to people in the selling or promotion of things, services, and ideas....There are two and one-half times as many in the working class as in the business class....[I]t is after all this division into working class and business class that constitutes the outstanding cleavage in Middletown. The mere fact of being born upon one or the other side of the watershed roughly formed by these two groups is the most significant single cultural factor tending to influence what one does all day long throughout one's life.

By 2007, America's "working class" was making fewer "things" and offering more personal services, but the gap between them and the executives at the top had grown as large as it was in the 1920s. Big manufacturers that once provided jobs to Muncie's working class – Delco Remy, Westinghouse, Indiana Steel and Wire, General Motors, and Borg Warner – had closed in the 1980s and 1990s. By 2007, Muncie's largest employers were Wal-Mart, Ball Memorial Hospital and Cardinal Health Services, Ball State University, Muncie Community Schools, the quasi-government financial corporation Sallie Mae, and the City of Muncie. Meanwhile, Muncie's (and America's) old "business class" had become smaller, better educated, and more professional – increasingly centered in the executive suites of large corporations and financial firms. The two sets of activities – working class and business class – once again summoned vastly different wages and benefits and entailed sharply different ways of life.

Across the nation, the most affluent Americans have been seceding from the rest of the nation into their own separate geographical communities with tax bases (or fees) that can underwrite much higher levels of services. They have moved into office parks and gated communities, and relied increasingly on private security guards instead of public police, private spas and clubs rather than public parks and pools, and private schools for their children (or elite public ones in their own upscale communities) rather than the public schools most other children attended. Being rich now means having enough money you don't have to encounter anyone who isn't. The middle class and the poor, meanwhile, rely on public services whose funding is ever more precarious: schools whose classrooms are more crowded; public parks and libraries open fewer hours and often less attended to; and buses and subways that are more congested. The adjective "public" in public services has often come to mean "inadequate."

There is another parallel. In the years leading up to 2007, with the real wages of the middle class flat or dropping, the only way they could keep on buying – raising their living standards in proportion to the nation's growing output – was by going deep into debt. "As in a poker game where the chips were concentrated in fewer and fewer hands, the other fellows could stay in the game only by borrowing," as Eccles had put it. By the end of the 1990s average savings were just 3 percent of after-tax income; by 2007, around 1 percent (they had averaged 9 to 10 percent from the 1950s to the early 1980s). The drop in savings had its mirror image in household debt (including mortgages) that rose from 55 percent of household income in the 1960s to an unsustainable 138 percent by 2007. Ominously, much of this debt was backed by the rising market value of peoples' homes.

The years leading up to the Great Depression saw a similar pattern. Between 1913 and 1928, the ratio of private credit to the total national economy nearly doubled. Total mortgage debt was almost three times higher in 1929 than in 1920. Eventually, in 1929, as in 2008, there were "no more poker chips to be loaned on credit," in Eccles' words. And "when their credit ran out, the game stopped."

A third parallel: In both periods, richer Americans used their soaring incomes and access to credit to speculate in a limited range of assets. With so many dollars pursuing the same assets, values exploded. The Dow Jones Industrial Average reached 8,000 on July 16, 1997, and 11,000 on May 3, 1999. More money poured into dot-coms than could be efficiently used, then into more miles of fiber-optic cable than could ever be profitable. The Dow dropped when these bubbles burst but recovered on self-fulfilling expectations of even higher share prices to come – rising to 12,000 on October 19, 2006, then to 13,000 on April 25, 2007. With easy access to credit, the middle class joined in the party, boosting housing prices to all-time highs. Yet it is an iron law of economics, as well as physics, that expanding bubbles eventually burst.

In the 1920s, richer Americans created stock and real estate bubbles that foreshadowed those of the late 1990s and 2000s. The Dow Jones Stock Index ballooned from 63.9 in mid-1921 to a peak of 381.2 eight years later, before it plunged. There was also frantic speculation in land. The Florida real estate boom lured thousands of investors into the Everglades, from where many never returned, at least financially.

Wall Street cheered them on in the 1920s, almost exactly as it did in the 2000s. In 1928, Goldman Sachs and Company created the Goldman Sachs Trading Corporation, which promptly went on a speculative binge, luring gullible investors along the way. Four years later, after the giant bubble burst, Mr. Sachs appeared before the Senate.

> Senator Couzens [Republican from Michigan]: Did Goldman, Sachs and Company organize the Goldman Sachs Trading Corporation?
>
> Mr. Sachs: Yes, sir.
>
> Senator Couzens: And it sold its stock to the public?
>
> Mr. Sachs: A portion of it. The firm invested originally in 10 percent of the entire issue....

Senator Couzens: And the other 90 percent was sold to the public?

Mr. Sachs: Yes, sir.

Senator Couzens: At what price?

Mr. Sachs: At 104....

Senator Couzens: And at what price is the stock now?

Mr. Sachs: Approximately 1 3/4.

Meanwhile, National City Bank, which eventually would become Citigroup, repackaged bad Latin American debt as new securities that it then sold to investors no less gullible than Goldman Sachs's. After the Crash, National City's top executives helped themselves to the bank's remaining assets as interest-free loans, while their investors and depositors were left with pieces of paper worth a tiny faction of what they had paid for them.

Yet however much Wall Street's daredevil antics in the 1920s and in the 2000s were proximate causes of the giant bubbles of these two eras, the bubbles also reflected deeper problems – the growing imbalance between what most people earned as workers and what they spent as consumers, and the increasingly lopsided share of total income going to the top. Had the share going to the middle class not fallen, middle-class consumers would not have needed to go as deeply into debt in order to sustain their middle-class lifestyle. Had the rich received a smaller share, they would not have bid up the prices of speculative assets so high.

##

The biggest difference between the two eras was in what happened *next*, after the bubbles burst. In the wake of the Great Crash of 1929, the economy went into a vicious downward cycle. Unemployed workers, with little or no access to credit, were unable to purchase much of anything. This caused businesses to lay off even more workers, which further contracted spending, leading to even more layoffs. The resulting Great Depression shook America to its core. The magnitude of that crisis forced the nation to seek ways to overcome both the widening economic divide that had contributed to it, along with the economic insecurities it fueled. The undeniable reality that almost all Americans shared the ravages of the Depression resulted in an unusual degree of social cohesion, giving the nation the political will to make the needed reforms.

Government policies in the wake of the Great Depression led to a new economic order, including many of the programs Marriner Eccles proposed on the eve of Roosevelt's inauguration – social insurance, and improvements in the nation's infrastructure, schools and public universities. Initially, these were financed by government borrowing. They made the American middle class in subsequent years vastly more secure, prosperous, and productive. As we shall examine in more detail, unemployment insurance, Social Security in old age, disability benefits, and eventually Medicare and Medicaid propped up incomes even when misfortune struck. After World War II, a vast expansion of public higher education, interstate highways, and defense-sponsored research and development of sophisticated technologies improved workers' productivity and wages. And support of their rights to form labor unions, work at a base of forty hours and get time and a half overtime, and receive a minimum wage, improved their bargaining power. During the war, government spending reached unprecedented levels. The nation put its full industrial capacity to use, employing almost all working-age Americans. And even though most of that capacity was dedicated to military demands, the sheer volume of production also met civilian needs. By the end of the war, most people were better off than they had been at its start, and the

Great Depression had irrevocably ended. America's debt was huge, to be sure, but in subsequent years a buoyant economy enabled government to repay a substantial portion.

But the Great Recession that started at the end of 2007 has produced no new economic order. Instead, the government stepped in quickly with enough money to contain the downward slide. America had at least learned the superficial lesson Marriner Eccles had offered to deal with downdrafts of this magnitude: when demand evaporates, government must act as purchaser of last resort, temporarily filling much of the vacuum created by fast-retreating consumers, and it must make borrowing so cheap as to keep banks solvent and credit moderately available. In 2008 and 2009, the Obama administration and the Federal Reserve played their parts with $700 billion in bank bailouts, a subsequent stimulus package of similar magnitude, and a massive expansion of the money supply.

The government thereby averted what in all likelihood would have become another Great Depression. No rational person could wish for a repeat of the that. Yet, ironically, President Obama's success in containing the immediate financial damage and forestalling economic collapse in 2008 and 2009 has reduced the urgency of dealing with the underlying, cumulative problem of widening inequality – Eccles's deeper insight into what caused the Great Depression. After the stimulus and loose money wear off, therefore, it is unlikely that growth can be sustained. We are almost certainly in store for many years of high unemployment. There is no reason to suppose that the underlying trend of the last thirty years will change: Median incomes will remain flat or decline, and most families will stay economically insecure. Inequality will continue to widen. Consequently, the middle class will not be able to buy nearly enough to keep the economy going. Neither richer Americans nor foreign consumers will fill the gap. All of this will constitute the Great Recession's aftershock. From it will emerge either a political backlash – against trade, immigration, foreign investment, big business, Wall Street, and government itself – or large-scale reforms that reverse the underlying trend.