The Economic Lesson of 1938

Karl Widerquist

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Karl Widerquist
Georgetown University Qatar
Karl@Widerquist.com

If I use the phrase “lesson of 1938,” most people will probably think about Britain’s unsuccessful attempt to avoid war with Nazi Germany by giving away a piece of Czechoslovakia. There are important lessons in that event, but I want to talk about some very different events of that year, and so I have to call this essay “the economic lesson of 1938.” Economic events of that year are relevant to our handling of the global recession today.

By 1938, the Great Depression had been going on for eight years. Franklin Roosevelt’s New Deal programs had been stimulating the economy for five years, and they began to show significant signs of working. Industrial production and national income were coming back up. Employment was going back down. The economy appeared to be just about out of the depression—

—and then—

Roosevelt and Congress decided to balance the budget. They raised taxes. They reduced government spending. They contracted the money supply, and helped send the economy back into depression, where it remained for three more years. Unemployment was still 10 percent when the United States entered World War II at the end of 1941. At that point the government started spending massive amounts of money. They worried less about the budget deficit and more about spending what it takes to do the job. The depression disappeared almost overnight.
The economic lesson of 1938 is that the government cannot balance the budget during a major recession—even in the early stages of recovery. A depressed economy needs a stimulus. Although politicians usually won’t say it out loud, a stimulus often requires not only spending but deficit spending. One of the things that turn a financial crisis into a recession is that people and businesses stop spending in a reinforcing cycle. They can’t afford to spend because they’re not making money. They’re not making money because no one else is spending. Only the government has the size and budget flexibility to break the cycle. In a financial recession, concern for the government’s budget deficit can wait.

The government can get away with deficit spending because the government budget doesn’t work like an individual’s budget or even a corporation’s budget. Government creates the money supply; its spending is not limited to what it takes in or what it can borrow. If you or I spend more than we should, we will go broke. If the government spends more than it should, it will create inflation. If inflation becomes a problem, we can take action, but for now it is not a major concern.

We should be more concerned with making sure that the direct beneficiaries of government stimulus are the people most in need. Too often the government stimulates the economy by helping corporations (such as investment banks, automobile manufacturers, and defense contractors), telling us that the stimulus will indirectly make its way to help those who actually need help.

A more effective way to stimulate the economy and help people is with universal programs. Universal healthcare or a universal basic income guarantee would be excellent ways to do so.

-Karl Widerquist, Doha, Qatar August 9, 2009