
HAVE WE LEARNED ANYTHING?

**LEONARD GASTON
CENTRAL STATE UNIVERSITY**

“This is like déjà vu all over again.”
Yogi Berra

BOOM AND BUST IN THE AMERICAN ECONOMY

The U.S. economy, over the long term, has been a huge success story. Rising productivity has brought economic growth, low unemployment, and rising real wages. But for various reasons - ranging from hiccups in the financial system to the natural swings between optimism and pessimism that John Maynard Keynes referred to as “animal spirits” - the progression toward increasing prosperity has not always been smooth. The National Bureau of Economic Research chronicles thirty two recessions between 1854 and 2001. Recessions were generally short, lasting less than two years - until the Great Depression. (Business Cycle Expansions and Contractions, 2001) The Depression began with a stock market crash on October 29, 1929 – “Black Tuesday”. It held on for more than ten years, with unemployment never falling below nine percent until the World War II draft began to take twelve million soldiers out of the civilian labor force. But, within the Great Depression itself, there were pronounced variations in economic activity.

Why Did the Great Depression Last More than a Decade?

The writer recalls a conversation from decades ago between a respected economics professor (a thorough Keynesian, as most were in those days) and a small group of graduate students. The professor said “If Keynesian principles were the right prescription for the times, as we say they were, you could ask ‘Why did the Great Depression last over a decade?’. Our answer would be simply that we did not do enough.” It was clear he sincerely believed that New Deal-style economic regulation, coupled with significantly higher levels of federal deficit spending, would have cured the problem quickly.

But would they? If we look a little more closely at the economic ups and downs within the Great Depression, it appears entirely possible that the economy might have done better if government had eased up on the accelerator after initial successes in the early 1930s, and backed off on its efforts to reform and control the economy.

EVENTS UNFOLD IN THE GREAT DEPRESSION

When we examine the level of economic activity during the course of the Great Depression we see a long decline of 43 months between 1929 and 1933. This is not surprising, considering the blunder of the Federal Reserve System in contracting the money supply by a third, and the psychological impact of a market collapse that continued for three years, until many stocks had lost 90 percent of their 1929 prices. Economic activity plummeted and the rate of unemployment, which had been some three percent in 1929, rose inexorably until, by 1933, a fourth of the labor force was unemployed. Then, however, economic activity turned back upward again and the official unemployment rate dropped below 15 percent by the end of 1936. (Stendl, 2008)

Perversely, in May 1937, the economy turned down again, falling to a new low point in June 1938. Then, as the winds of war in Europe began to blow in earnest, the economy began a period of sustained growth that lasted until 1945. (In the year 1938, for example, Adolph Hitler announced the “Anschluss” with Austria, the German military mobilized, and German troops occupied the Sudetenland.)

Why did the economy collapse in the first place, and why, when it was showing signs of recovery, did it collapse again in 1937? A closer look at events of the time can lead to some interesting speculations.

Perception Is Reality

Although the agricultural sector had been in recession for years prior to 1929, the stock market crash and subsequent events took the nation as a whole by surprise. In early October 1929, for example, Irving Fisher, a Yale economist, had predicted that stocks had “...reached what looks like a permanently high plateau”. But the 1929 crash turned extreme optimism into extreme pessimism. “The prosperous 1920s, with their speculation in equities and expanding sales of goods sold on credit, were over. Helpless and stunned, the nation fell captive to the creeping paralysis of depression.” (Patton and Warne, 1963, pp.288-299)

Fifteen million people were out of work, people rushed to get their money out of the bank, and they were not comforted when President Herbert Hoover called the depression “...a passing incident in our national lives” and told Americans it would be over in 60 days. Empty pockets turned inside out became known as Hoover Flags and decrepit shanty towns springing up around the country were called Hoovervilles.

FDR’s “New Deal”

In 1932, a distraught electorate turned on the party in power and voted Franklin D. Roosevelt into office. His administration launched what one commentator later called a campaign of headlong trial and error. FDR’s “New Deal” was born. A desperate Congress gave him carte blanche to expedite his policies. “The house is burning down” a Republican congressional leader said “give the president anything he needs to put out the fire.” (Documentary Life in the Thirties) To exert more control over the economy

FDR expanded the industry-specific regulation prototyped by the Interstate Commerce Act of 1887. To get the economy moving the new administration poured money into public relief and put people into emergency jobs.

Alarmed by widespread price and wage cuts, the administration tried to cure these symptoms of depression by paying farmers to destroy livestock and crops and by launching a program of government-enforced agreements on prices, wages, and hours administered by the National Recovery Administration. When the National Recovery Act was declared unconstitutional, a portion survived as the National Labor Relations Act, enacted to encourage unionization and raise wages through collective bargaining. (Patton and Warne, 1963)

For a While, Things Were Looking Up

Things did begin to improve in 1933. An uneven recovery of sorts set in. Was this due solely to a flurry of New Deal legislative activity? If it was, the favorable effect surely should have continued, and the economy should have continued to climb out the depression. But it did not.

Federal efforts that created temporary jobs in public works programs helped people eat, and put money into the economy, but two other possible contributors to this initially favorable recovery come to mind. It seems likely that they were working in tandem. The first is the simple fact that, historically, of the nineteen recessions that had come before 1929, only three had lasted longer than two years. The rest were shorter. Three lasted for less than one year. (Business Cycle Expansions and Contractions, 2001) If past behavior is the best predictor of future behavior, for economies as well as individuals, a move toward economic recovery might well have been due by 1933.

The second cause, possibly, was Roosevelt himself. Many were heartened by his charismatic leadership, and eagerly supported government activism. He once told Orson Wells "You and I are the two best actors in America". (Documentary Life in the Thirties) His greatest impact may have come, not from government edict, but from his "fireside chats". Roosevelt used the relatively new medium of radio to reassure the American people that he personally cared about their circumstances and that the federal government would fix the problem. In his inaugural address in March, 1933 he reassured the American people: "The only thing we have to fear" he said "is fear itself." (Patton and Warne, 1963, p. 292) He may have launched a self fulfilling prophecy.

The Economic Recovery Reverses Course

The initial economic plunge of the great depression was deep, and although economic output had begun a climb to its approximate long term trend line by 1935, it still had a long way to go to approach pre-depression levels. More people were beginning to criticize New Deal policies. (Hall and Ferguson, pp. 147-148) Then, in 1937, the economy began another plunge into the depths of depression. Why?

One factor may have been another bad move by The Federal Reserve (hereafter the FED). The FED's monetary expansion had helped cause a stock market boom in the 1920s - leading to speculative excesses that set the stage for the 1929 stock market crash. Then, just as the depression started, the FED had shrunk the money supply and made the economic collapse of 1930-33 worse. Now, in the middle of the Great Depression, the Federal Reserve bull blundered into the economic china shop again. Starting in August 1936 and ending in May 1937, the Federal Reserve doubled the reserve ratio, leading, once again, as Milton Friedman and Anna Schultz demonstrated later, to damaging reductions in the economy's money supply. (Hall and Ferguson, 1998, p 151)

The “Court Packing” Controversy

Another factor in this second economic collapse may have been Roosevelt himself. Following a landslide reelection in 1936, Roosevelt clearly overreached. Apparently frustrated by an uncooperative Supreme Court, FDR, in his March 4th Democratic Party Victory Dinner Speech, demanded enlargement of the court through appointment of additional, more cooperative, judges. He ignited a firestorm of controversy. It could be argued that one speech would not have the power to impact the economy. But it is undeniable that if investment tends to drive the economic cycle, and if FDR panicked the investment class with that speech, he may have contributed to the economic decline that began in 1937. Certainly, reaction to his speech was not confined to the economic elite; newspapers were filled with cartoons, and ordinary people became involved in a “court packing” controversy that extended into the summer of 1937 – a controversy that crystallized widening opposition to FDR's policies.

Legislation from the “Second New Deal”

The situation was compounded by additional New Deal legislation enacted in 1935 and 1936 – sometimes called the Second New Deal. In the Second New Deal, perhaps as a result of pressure from his more radical supporters or from a liberal congress elected in 1934, Roosevelt switched from a program of “relief” to one of “reform”. Researchers have summed up the impact of this move: “...a combination of fixing farm prices, promoting labor unions and passing a series of antibusiness tax laws would certainly have a negative effect on employment.” (Hall and Ferguson, 1998, p 147)

One element of the Second New Deal was the June 1935 Revenue Act or Wealth Tax. Although relatively ineffective at raising revenue (it raised only \$250 million) it was seen as an assault on the wealthy and big business.

The National Labor Relations Act, a section salvaged out of the National Recovery Act, also was enacted in 1935. It gave a strong impetus to labor union organizing efforts. In 1937, national attention was drawn to bitterly-contested organizational strikes occurring across America's major industries. Newsreels provided a close-up view of the UAW's “sit-down strike” at the GM complex in Flint, Michigan, which began on December 30, 1936, and lasted into February 1937. Scenes of rioting, brick throwing, and workers running along sidewalks swinging sticks to break auto plant windows were shown across the nation.

Between September, 1936 and June, 1937, almost 500,000 workers –rubber workers, glass workers, textile workers, and Woolworth clerks - took part in sit down strikes. The longest strike of this kind was that of 1,800 electrical workers in Philadelphia. Foster Rhea Dulles reports that, in this strike, “Two bridegrooms sat out their honeymoons and the wives of six other married strikers greeted their returning husbands with newly born babies.” (Dulles, 1960, p 307) Some began to wonder if the turmoil they saw breaking out in America’s basic industries was evidence that government was rewriting the country’s economic ground rules. Government’s attempts to bring prosperity, attempts that had seemed to begin with such promise, floundered. The economy sank back into the depths, to come up only when World War II brought production of arms and equipment, and universal conscription.

ARE THERE SIMILARITIES BETWEEN CONDITIONS SURROUNDING THE GREAT DEPRESSION AND THOSE OF TODAY?

Easy Money and Speculative Excess

A clear parallel exists between the speculative craze of the 1920s that set the stage for the Great Depression, and recent bubbles in tech stocks and housing and a prolonged stock market boom. In the 1920s, an expansionary monetary policy flooded the stock market with an abundance of money, money looking for a place to find paper profits. Entry of a mass of investors into the market added to the feeding frenzy.

“One story often advanced for the boom of 1928 and 1929 is that it was driven by the entry into the market of largely uninformed investors, who followed the fortunes of and invested in 'favorite' stocks. The result of this behavior would be a tendency for the favorite stocks' prices to move together more than would be predicted by their shared fundamentals. Our results (are) consistent with the possibility that a fad or crowd psychology played a role in the rise of the market, its crash and subsequent volatility. “ (White and Rappoport, 1994)

Evaluating the impact of the Federal Reserve System’s easy money policy, Friedrich Hayek, writing for the Austrian Institute of Economic Research Report in February 1929, predicted the coming economic downturn, stating "the boom will collapse within the next few months." Black Tuesday came eight months later.

There is a clear parallel with recent history. As one commentator summed up the situation in 2007:

“... stock market cheerleaders are oooing and ahing the Dow’s climb to 13,000, but it’s all a sham. Wall Street is just enjoying the last wisps of Greenspan’s helium swirling into the largest credit bubble in history. But there’s trouble ahead. In fact, the storm

clouds have already formed over the housing market. ... The reason the stock market is flying-high is because the Federal Reserve has been ginning up the money supply to avoid a Chernobyl-type meltdown. All that new funny-money has to go somewhere, so a lot of it winds up in the stock market. “ (Whitney, 2007)

The federal government, in the person of the Federal Reserve, has already repeated one mistake from the past. The monetary explosion, credit bubble, and resulting stock market excesses of recent years are eerily similar to the excesses of the 1920s.

Spending Programs

October 1929 saw a severe market crash. In October 2008 the economy wrestled with a stock market slump and a wave of failures by financial institutions. It appears that these events are the precursor to large federal spending programs. Even prior to the installation of a new president and a new Congress, in response to the housing and banking crisis, Congress passed a “seven hundred billion dollar” bailout bill with little debate, and it was promptly signed by the sitting president. As this is written there is talk of further action to bail out other sectors of the economy. The question seems to be, “Where do we stop?”

WHAT WILL HAPPEN NEXT?

The 2008 presidential election, as did the election of 1932, turned on voter dissatisfaction with the party in power, with attention centered on the economy. A new president has been elected on a slogan of “change” with the definition of that word left to the individual voter to fill in, based on his or her individual desires as to what might require changing. One commentator writes that the incoming president and his advisors are modeling their domestic agenda on Roosevelt’s New Deal. (Kuhner, 2008) Hints from the campaign trail do suggest that the new administration is on its way to repeating mistakes of Roosevelt’s New Deal.

Increased Regulation Appears Likely

Increased regulation of business may be on the way. Campaign speeches have blamed credit and market collapses on “deregulation”. If increased regulation places greater compliance burdens on business, particularly small business - the engine of job creation - without clear benefit to the economy, this will hurt, rather than help, the economy.

Payback for Campaign Support by Organized Labor

There have been promises to promote increased unionization of American companies through abolition of the secret ballots currently supervised by the National Labor Relations Board. Although this will not lead to alarming organizational strikes as

the original National Labor Relations Act did, it could have an even more damaging effect. How many businesses, forced to unionize when workers are subject to public pressure by union organizers and can no longer vote in secret on whether or not they want a union, will face a new barrage of union pay demands, work rules, and work stoppages that threaten profitability? Will more manufacturers and remote-location service providers move jobs overseas? It seems likely.

Direct Intervention in the Market Place

Will government intervene in the marketplace to benefit particular companies or industries, another New Deal policy? In the New Deal, for example, government planners paid farmers to plow under crops, slaughter hogs, and restrict planting acreages – all in an effort to raise prices for farm goods. To the extent it succeeded, families in towns and cities paid more for food. The National Recovery Administration, had it lasted long enough to implement policy, would have attempted to force prices to higher levels for the benefit of producers, through voluntary agreements to fix prices and wages. To the extent it would have succeeded, it would have raised costs to consumers. When government operates in this fashion, there is inevitably a loser for every winner, and the economy pays an additional price in regulatory red tape. Government efforts to pick winners and losers interfere with market signals and inevitably lead to inefficiencies. Foreign nameplate auto makers producing cars in America with American workers have operated efficiently, paid good wages, and produced products widely accepted by consumers. The traditionally-managed Detroit Big Three, on the other hand, hands tied by work rules and costly burdens for union-negotiated “job banks” and fringe benefits, seemingly cannot build the cars consumers want, or compete in price. But billions are currently proposed to go to Detroit to keep those companies in business. What impact will this have on workers in non-unionized auto plants in the Midwest and across the Sunbelt? Will these plants then be unionized, only to follow Detroit’s decline? Will restrictions on imports follow, with prices to consumers going up? Once intervention in the economy starts it is difficult to predict where it will end.

Restrictions on Imports

Campaign statements indicated that the future president intended to renegotiate trade agreements with foreign countries. Whether that was campaign rhetoric, or a matter of serious intent that may be carried out, is unknown. What is known is the harmful impact when government went down a similar road in the 1930s. “Just as the Great Depression was beginning, Congress passed the Smoot-Hawley Tariff Act of 1930 which imposed some of the highest tariffs in U.S. historyother nations raised trade barriers in retaliation ... Overall, the resulting contraction of world trade aggravated the decline in income and employment in many nations, making the Great Depression even worse.” (Hall and Ferguson, 1998, p 124)

Higher Income Tax Rates for Individuals and Businesses

The so-called wealth tax of the Second New Deal raised little additional revenue, and may not have been expected to. It may have been chiefly a symbolic gesture to show that the administration was on the side of ordinary voters – a move in a class warfare drama. In 2008, campaign rhetoric has included a call for higher taxes on the rich. The term “higher taxes” is commonly taken by the public to mean just that, more money taken from some group - in this case, those perceived as wealthy and able to afford it. What government actually does however is raise tax rates. These higher rates may or may not produce more revenue. In the past, they often have not. (Vedder and Galoway, 1985, pp 4-10) What they do produce is a reduction in the willingness to invest - to take risks in the hope of greater marketplace success – in other words, they reduce the incentive to create jobs. (Greenspan, 1993, pp 1-12)

There is no reason to believe that the present urgency to do something about the economy will abate in intensity, particularly if the recession continues to deepen. A variety of changes in tax and regulatory policy, with unknown impact, may be promoted under the banner of fairness, or fixing the economy.

Bigger Deficits and a Ballooning Federal Debt

What then will be left to appease a voting public clamoring for relief from economic distress? Increased deficit spending would seem to be the answer. Unfortunately, decades of government expansion and deficit spending since the New Deal already have saddled the federal government – and the taxpayer – with burdens undreamed of at the onset of the Great Depression. Entitlement expenditures for Social Security, Medicare, and Medicaid, for example, are surging inexorably toward levels that would exceed today’s federal budget in approximately three decades. Will the federal government, as it has in the past, resort to increasing levels of deficit spending to accommodate budget pressures? With federal debt holdings by foreign and international investors exceeding two trillion dollars and rising (Hewitt, 2008) these holders might bring such borrowing to a halt, either by unwillingness on their part to buy more of our debt, or an unwillingness to hold what they have. (Browne, 2007)

Recent years have seen an accelerating tendency to finance spending through debt: Approximately \$2.8 trillion of new debt was incurred in the 1990s, more than was created in the nation’s history before 1990. (Hodges, 2007) Current federal debt exceeds \$8 trillion. In 2005, holdings by foreign investors and foreign central banks were in excess of \$2 trillion with Japan owning approximately 31 percent and China 12 percent, with the rest largely held in the European Union or oil exporting countries. (Hodges, 2005) By 2007, China’s holdings exceeded Japan’s and were in excess of \$1 trillion. (Browne, 2007) As long as debt holders are content, and continue to invest when the federal debt is periodically refunded, the system is stable. As early as 2005 however, some foreign holders were announcing plans to move part of their dollar reserves to other currencies. (Giles, 2005)

The Danger of a Declining Dollar

If any central bank or other large investor suspected that another was liquidating its dollar holdings, it might move to do the same, creating a self-fulfilling prophecy. Something like the bank runs of the depression era could ensue, where depositors stormed banks to get their money before it ran out. A movement toward a weaker dollar could be precipitated by the principal oil exporting countries if they elected to shift to the Euro or some other standard in pricing of petroleum. It is possible that at some future time a country such as China could decide that deliberately weakening the United States by triggering a slide on the dollar would be more advantageous than merely continuing to sell large amounts of goods to U. S. consumers. (Browne, 2007) If the Federal Reserve resorted to monetization of ever-larger deficits, that would deflate the value of existing debt, possibly causing holders to dump their debt, savaging the U.S. dollar. If debt monetization leads to inflation, price controls could follow. While they might be seen as effective in the short run, they would scramble, as they always have, the price signals on which a market economy depends for efficient operation, further decreasing economic activity and tax revenues.

In short, policies likely to be tried by a government intent on curing the deep recession that appears to be developing in 2008 have been tried before and found wanting. The future looks like a rocky road indeed.

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