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The Politically Incorrect Guide to the Great Depression and the New Deal (The Politically Incorrect Guides)

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47 Highlights | Geel (47)

Highlight (Geel) | Locatie 418

. Supporters of the first and second explanations are familiar with the basic historical facts, though they often sweep the most inconvenient ones under the rug. Keynesians, for example, realize that the federal government tried massive deficit spending during the 1930s, and yet this policy went hand-in-hand with chronic double-digit unemployment. Followers of Friedman, for their part, do not deny that the Federal Reserve slashed its rates immediately after the stock market crash, and in fact brought them to record lows in the following years, trying to stimulate the economy through monetary policy. So why then do today’s Keynesians (such as Paul Krugman) and today’s Friedmanites (such as Ben Bernanke) recommend what appear to be the exact same policies as a cure for our present financial crisis? If their prescribed medicines led to disaster the last time they were implemented, why in the world should we favor huge deficits or easy-money policies today?

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economy. The fan of the free market triumphantly points to the amazing economic growth of the 1920s, and attributes it to the conservative fiscal policies engineered by Secretary of the Treasury Andrew Mellon and President Calvin Coolidge. In 1921 the top income tax bracket was a shocking 73 percent, but Mellon reduced it to 25 percent by 1925. Mellon also cut taxes for the poor, with the lowest bracket falling from 4 to 1.5 percent in the same period. Perhaps most impressive of all, Mellon was able to slash tax rates while running federal budget surpluses every year of the Coolidge presidency.

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. The critic of the free market, on the other hand, tries to dismiss the apparent “prosperity” of the 1920s as a house of cards. To such a cynic, the laissez-faire policies of Calvin Coolidge were a prelude to disaster, as evidenced by the crash of 1929 and the following decade of Depression. The true story is more nuanced, and draws from both of these extremes. Much of the prosperity of the 1920s was real; households really did acquire cars, electricity, and appliances such as vacuum cleaners and toasters. The standard of living for the average American really did rise at an impressive rate throughout the decade. Much of this success can indeed be credited to Mellon’s conservative fiscal policies. However, at the same time, there were forces coming not from the free market, but from government intervention, that disturbed this legitimate economic growth. The Federal Reserve flooded the credit markets with cheap money, and it especially opened up the dollar spigot in 1927 (in an effort to ease the gold outflows from the Bank of England). Superimposed on the productive expansion of the United States economy, then, was an unsustainable boom fueled by the Fed’s inflation, particularly in the last few years of the decade. When the Fed became concerned and tried to put on the brakes, the stock market faltered and eventually crashed.

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The leftist critics of capitalism are therefore correct when they label the stock market boom as unsustainable, but these critics fail to see that the blame lies with government intervention into the banking and monetary system.

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However, the Friedmanites cannot get around the historical facts: there was nothing unprecedented about the speed of the collapse in the money supply, or in the price deflation, of the early 1930s. If Friedman is right that the Federal Reserve's inaction caused the Great Depression, then why didn't the U.S. experience even worse catastrophes before 1913, when the Fed didn't even exist?

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the price deflation, of the early 1930s. If Friedman is right that the Federal Reserve's inaction caused the Great Depression, then why didn't the U.S. experience even worse catastrophes before 1913, when the Fed didn't even exist? We know that there were no such catastrophes. Before the creation of the Fed, and back in the days when the federal government took no active role in fighting economic downturns, somehow depressions always managed to sort themselves out fairly quickly. It was only when both the federal government and the Federal Reserve rolled up their sleeves to really fight a downturn that America suffered through the worst economic crisis in its history. As we will see,

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. Note here the strength of Mellon's position. He didn't cherry pick his anecdotes by focusing on a mild downturn. On the contrary, he was recalling what had been, at that time, the longest depression in U.S. history. (According to the National Bureau of Economic Research, the contraction officially lasted from the third quarter of 1873 through the first quarter of 1879, about five and a half years.³) Even so, the "liquidationist" medicine eventually worked, and recovery kicked in apparently much faster than many observers had expected. Inasmuch as the 1930s depression turned out far worse—and lasted for twice as long⁴—after Hoover rejected Mellon's advice, one might think Hoover, in retrospect, would have given more credence to Mellon's counsel. But immediately following the

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m The skeptical reader can rest assured that Hoover's claims to have rejected Mellon's "liquidationist" advice were not merely self-serving lies penned in his diary after the fact. On the contrary, Herbert Hoover was a consistent critic of unfettered capitalism throughout his career in the government, even during the Roaring '20s when the (relatively) free market was working wonders. His documented actions of the time, as well as the reports of contemporaries—including labor leaders—prove that Herbert Hoover was not the free market ideologue people think he was. In fact, he often butted heads with his boss, Calvin Coolidge, who was a far better (though still impure) exemplar of the "small government fanatic" whom leftists love to ridicule. (We note in passing that laissez-faire Coolidge presided over a booming economy, while activist Hoover's economic record was decidedly subpar.)

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. True to his theory, Hoover not only wanted to bolster consumption, but he also sought to “close the gap” by restricting production. As president, Hoover ordered a massive increase in the deportations of immigrants. He supported spread-the-work schemes, whereby struggling businesses wouldn’t lay off the most inefficient workers, but would rather maintain staff levels with shortened workweeks. He even attributed partial blame for the hard times on the introduction of “labor-saving devices,”⁹ appealing to the Luddite fallacy that new machines are a curse because they throw people out of work. In light of his writings as well as his policies, Hoover clearly thought there was a fixed amount of work to be done in the economy, and he further believed that this delicate balance could be upset if the more capable employees worked too long, or if new immigrants and new machines “took jobs” from everyone else.

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. Though understandable—they infect our political leaders and financial pundits to this very day—Hoover’s theories were completely fallacious. High wages do not cause prosperity, they are rather an indication of prosperity. Ultimately, it doesn’t matter how many green pieces of paper employers hand out to workers. Unless workers have first physically produced the goods (and services), there will be nothing on the store shelves for them to buy when they attempt to spend their fat paychecks.

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. Even on its own terms, Hoover’s philosophy of high wages to support “purchasing power” makes no sense. It fails at the first step in the argument: If hard times hit and cause an employer to ask his twenty employees to accept a pay cut of \$10 per week, this doesn’t mean \$200 worth of “demand” has suddenly disappeared from the system. The reduction in total weekly paychecks is exactly counterbalanced by the employer’s earnings, which are now \$200 higher than they would have been without the pay cut. (Of course, even with the pay cut, the business’s earnings would be lower in a depression than they were during the boom period, but we are here looking at the impact of the wage cut per se.) Hoover was quite simply wrong when he said that cutting wages would reduce the demand for products in general; Hoover missed the fact that wage cuts give employers the means to increase their spending (either on personal consumption or to invest). It might strike some as unfair that workers should have to shoulder any of the pain during a depression, but it is patently false to argue that wage cuts reduce the total amount of income available to buy products.

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s “Nearly everything in this country is too high priced. The only thing that should be high priced in this country is the man that works. Wages must not come down, they must not even stay on their present level; they must go up.” —Henry Ford, following a White House conference, November 1929.

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2 Economic historians have shown that Hoover and Mellon were not blowing smoke to the voters. What economists call “real wages” actually rose during the early 1930s, because businesses cut money-wages either not at all or very reluctantly, while the prices of most goods and services were plummeting. This perversely made labor relatively more expensive for businesses to hire, and guess what? During a huge economic slump, when the relative price of workers rose (because of Hoover’s misguided worldview), businesses hired fewer workers. Economists Richard Vedder

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k Here’s a shocking statistic: if you managed to keep your job in the Great Depression, your buying power probably went up—and in fact rose faster than it did during the boom times. Herbert Hoover’s “high wage policy” was so successful that in the worst economic crisis in American history, real wages went up at a compounded annual rate of three percent for the years 1929 to 1933. That was significantly higher than wages rose during the Roaring ’20s. Of course these high wages came at a price: namely high unemployment, as struggling businesses, paying inflated salaries, couldn’t afford to employ as many workers. The economists Richard Vedder and Lowell Gallaway conclude that Hoover’s high wage policy “is the root cause for the extraordinary increase in unemployment in the years following the stock-market crash.”

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. Things were very bad—briefly—during the earlier depression. The annual unemployment rate peaked at 11.7 percent in 1921, but it had fallen to 6.7 percent by the following year, and was down to an incredible 2.4 percent by 1923.¹⁴ That is how a market with flexible wages and prices quickly corrects itself after a Fed-induced inflationary boom. But because the “compassionate” Hoover forbade businesses from cutting wages after the 1929 crash, unemployment went up and up and up, hitting the unimaginable monthly peak of 28.3 percent in March 1933.¹⁵ For the quarter of the labor force thrown out of work, the fact that “[f]or the first time in the history of depression, dividends, profits, and the cost of living have been reduced before wages have suffered,” was little consolation.

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8 Aside from Krugman's characteristic flair for the dramatic, the passages above are impressive because it would be difficult to render a more misleading account of Hoover's fiscal policies, without actually lying. First, Hoover did not balance the budget—or even come close—in 1932. In Fiscal Year (FY) 1933 (running from July 1, 1932 through June 30, 1933), the federal government ran a deficit of \$2.6 billion. To modern ears, that seems quite modest; Henry Paulson handed out more to bankers by breakfast. But Hoover's deficit was the result of spending \$4.6 billion while taking in \$2 billion in receipts. Thus, as a percentage of revenues, Hoover's profligacy—which remember, Krugman is describing as heartless budget-slashing—was enormous. For comparison, in FY 2007 the federal government would have needed to run a deficit of \$3.3 trillion—rather than the actual deficit of \$162 billion—to achieve the same proportion of overspending as Hoover did in his allegedly tight-fisted year.

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Contrary to the impression Krugman gives, the table illustrates that Hoover's response to the stock market crash was an enormous increase in government spending, with the budget exploding by 42 percent over his first two years. This huge surge in spending occurred amidst a collapse in receipts (due both to the decline in economic activity as well as falling prices). Immediately after the crash, Hoover and Mellon also pushed through a temporary one-point reduction in tax rates, applicable to the 1929 tax period.²¹ Hoover's handling of the situation was therefore the textbook Keynesian response to a collapse in “aggregate demand.” It is true that eventually Hoover blinked and tried to tame the unprecedented (at the time) peacetime deficits. But this was only after the “stimulus” approach failed horribly. By the time Hoover abandoned the textbook Keynesian remedies in 1932, the unemployment rate had already surpassed 20 percent. Of course, Krugman could contend that this simply proved how bad the situation was, and that Hoover had not been profligate enough with his unprecedented spending. Like Hoover himself, Krugman misses the obvious explanation that the unprecedented federal interventions to fight the Depression of the early 1930s were the cause of the unprecedented severity of the Depression.

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. During previous depressions in U.S. history, budget-conscious politicians had slashed spending in reaction to falling tax receipts; they really did behave the way Krugman misleadingly portrayed President Hoover's record. And yet, most Americans cannot associate any of those presidents with their respective depressions, the way everyone knows that “Hoover did nothing to fight the Depression.”

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) So how do the two strategies stack up? We already know that Hoover faced 20+ percent unemployment after the second full year of his Keynesian stimulus policies. Wilson/Harding, on the other hand, was Krugman's worst nightmare, taking the axe to federal spending in a way that would have given even Ron Paul the willies, and during a serious depression to boot! Yet as we already know, unemployment peaked at 11.7 percent in 1921, then began falling sharply. The depression was over for Harding, at the corresponding point when a desperate Hoover had decided to (try to) rein in his massive budget deficits.

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. In his swan song as Secretary of Treasury, Andrew Mellon advocated, in December, 1931, drastic increases of taxes, including personal income taxes, estate taxes, sales taxes, and postal rates. Obedient to the lines charted by Mellon and Hoover, Congress passed, in the Revenue Act of 1932, one of the greatest increases in taxation ever enacted in the United States in peacetime. The range of tax increases was enormous. Many wartime excise taxes were revived, sales taxes were imposed on gasoline, tires, autos, electric energy, malt, toiletries, furs, jewelry, and other articles; admission and stock transfer taxes were increased; new taxes were levied on bank checks, bond transfers, telephone, telegraph, and radio messages; and the personal income tax was raised drastically as follows: the normal [brackets were] increased from [an original] range of 1 1/2 percent—5 percent, [up to a new range of] 4 percent—8 percent; personal exemptions were sharply reduced, and an earned credit of 25 percent eliminated; and surtaxes were raised enormously, from a maximum of 25 percent to 63 percent on the highest incomes. Furthermore, the corporate income tax was increased from 12 percent to 13 3/4 percent, and an exemption for small corporations eliminated; the estate tax was doubled, and the exemption floor halved; and the gift tax, which had been eliminated, was restored, and graduated up to 33 1/3 percent .

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Paul Krugman is right to warn politicians not to repeat the fiscal mistakes of Herbert Hoover. Hoover showed that huge increases in federal spending wouldn't rescue an economy from depression, and that massive tax hikes only added insult to injury. At the risk of boring the reader, we point out once again that Treasury Secretary Mellon pursued the opposite program in the 1920s, and the result was prosperity.

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” Created in early 1932, the RFC was an important plank in Hoover's recovery plan. In that year it extended credits of \$2.3 billion, and advanced more than \$1.5 billion in cash.³² The program, flawed in itself, was made worse by the almost inevitable corruption attending Hoover's pet program. Historian Burt Folsom writes:

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. Bernstein could give the obvious response that deflation is worse than inflation because it's better to have people spending than hoarding. After all, businesses can't sell their products or keep people employed if everybody is holding out for bigger price cuts. But this (typical) argument proves too much. One could construct an analogous argument for the computer industry, in which the government passes regulation to slow down improvements in operating systems and processor speed. After all, how can computer manufacturers possibly remain viable if consumers are always waiting for a faster model to become available? What consumer would be foolish enough to spend money on a laptop when it will be obsolete in six months? The solution to this paradox, of course, is that consumers do decide to bite the bullet and buy a computer, knowing full well that they would be able to buy the same performance for less money, if they were willing to wait. This truism doesn't paralyze computer buyers, because if consistently followed the rule would never allow a person to buy a computer at all. The "deflation" that has always characterized the personal computer industry—that is, ever stronger computers getting ever cheaper to buy—is a sign of its health, not an explanation for its sickness.

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that business sales in general will suffer. Suppose a man had planned on buying a new car for \$20,000, but the local car dealership has bought far too much inventory and the man expects his desired car will sell for \$19,000 in three months. It is certainly worth it for the man to wait 90 days and earn, in essence, \$1,000 for his patience. But it is even more lucrative for him to wait 90 days and earn \$1,250, by reaping the \$1,000 from the falling car price, but also using the three-month window to earn \$250 in interest by putting his \$20,000 into bank CDs yielding a 5 percent annual return. As this example illustrates, falling prices don't encourage hoarding per se, they rather encourage saving. Many analysts who are terrified of deflation stress that in an environment of falling prices, cash stuffed under the mattress earns a positive return. This observation is certainly true, but nonetheless cash lent out earns an even greater return. Falling prices, then, encourage consumers to devote more of their income to savings, which in turn lowers interest rates and allows businesses to borrow and invest more. In effect, by postponing their big-ticket purchases, consumers free up resources so that businesses can buy more of their big-ticket items (a new copier, a new warehouse, and so on). One might wonder why businesses would borrow and invest if consumers are not spending on products, but we point again to the personal computer industry: if the price declines are expected to last, then at some point consumers will begin buying again. (There's no point in holding out for lower prices but never actually buying!) On the other hand, if the price declines are considered temporary, then consumers will begin buying again once they hit bottom. In either case, the mere fact of deflation doesn't paralyze business investment; consumers are buying fewer products today so that they can buy more products down the road.

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. In 1927, Great Britain was experiencing an alarming drain on its gold reserves, because it had pegged the British pound to gold at the pre-war parity, even though it had printed too much money during the war for this to be feasible. In order to take the pressure off the pound, the Fed lowered rates in 1927, which had the effect of increasing the supply of dollars and halted the outflow of gold from Britain. But this move fueled the stock market bubble, and the alarmed New York Fed began raising rates again in February 1928, reaching 6 percent by October 1929. On November 1, 1929, just three days after Wall Street's Black Tuesday, the Fed slashed its discount rate by a full percentage point. Then fifteen days later it cut again, to 4 1/2 percent. Throughout the following year, it cut five more times, so that by December 1930 the New York Fed's discount rate had fallen to 2 percent. This was already a record-low for the Fed, but it cut further still, reaching 1 1/2 percent in May 1931. The Fed only reversed course and began hiking rates in October 1931, after Great Britain (the month before) abandoned the gold standard and Federal Reserve authorities needed to staunch an outflow of gold from the country by panicked world investors.

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s After the sharp depression at the beginning of the decade following the First World War, the period from 1923 to 1929 was one of unrivaled prosperity. In this age of relatively limited government, real income per person rose 2.1 percent annually, even though the U.S. population increased from 111.9 million to 121.8 million people. Manufacturing output rose 23.5 percent over the whole period, while output per man-hour increased almost 14 percent.1

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. Rising incomes and slowly declining workweeks, along with the convenience of the automobile, led to a revolution in leisure activities. ... More people began to travel regularly, and motor hotels (or motels) and roadside diners that catered to the motoring crowd became common. ... Cities had to post policemen to direct traffic at intersections and finally began to install electric traffic signals to regulate the crush of city traffic. Suburbs sprang up around cities as the automobile allowed greater ease and flexibility in getting to work.... Sears, Roebuck and Montgomery Ward, the two largest mail order (or catalog) firms, opened retail stores on major streets leading to the downtown areas of cities. . . . 2

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4 Mellon's cuts were quite large. In 1921 the top income earners paid a stifling 73 cents to Washington for every additional dollar they earned. The next year the rate was slashed to 58 percent, and was cut every year thereafter down to 25 percent in 1925, where it remained until the Hoover Administration. The tax burden on poorer citizens was reduced as well, with the lowest bracket's rate being cut from 4 percent in 1921 down to 1.5 percent by 1925. The table below

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9 Readers familiar with modern Democratic rhetoric might think that Mellon's huge "giveaways to the rich" left gaping holes in the budget. On the contrary, income tax receipts actually increased over the decade, especially during the last few years. And unlike the Reagan years—when the growth in federal receipts was offset by even greater increases in spending—the federal government really did pay down a significant amount of its debt, which fell from \$24 billion in 1920 to about \$17 billion in 1929. In fact, Uncle Sam ran a surplus in every year of the 1920s. Despite the booming prosperity, the federal budget was significantly lower at the end of the decade than at the start.

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. The problem was that the free market exchange rate was lower, because the British had inflated more than the Americans had during the war. The British pound was no longer worth \$4.86, even though the Bank of England declared otherwise. The inevitable result was a drain of the Bank's gold reserves into American hands. It was this trend that led the British to plead with Federal Reserve officials in 1927 to boost American inflation. The upswing in the Wall Street boom at this time suggests that the Fed's loose policies played a large part in the later crash of 1929.

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strong, stable economic growth. Under the classical gold standard, there was nothing like the massive price inflations during the First World War—let alone the German hyperinflation in the 1920s—or the decade-long slump of the Great Depression.

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arguing that by 1939, total output was still 27 percent below its "trend" value established before the onset of the Depression. They find that investment was even worse, coming in just under 50 percent of where it should have been, had the New Deal truly gotten the economy out of the Depression.⁴

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The table above is important for several reasons. It reminds us that the Great Depression was not a singularly U.S. experience. Although the Canadian economy did not suffer to the same extent, its downturn was quite severe in its own right. The table also allows us to assess more fairly the potency of the New Deal, because the fortunes of the U.S. and Canadian economies were clearly tied together. Quick calculations reveal, however, that the average gap between U.S. and Canadian unemployment increased under FDR. During the Hoover years (1930 to 1933), American unemployment was, on average, 3.9 points higher than Canada's unemployment. Yet during the (peacetime) heyday of the New Deal from 1934 to 1941, U.S. unemployment, on average, was 5.9 points higher than Canada's. Thus, if one tries to excuse the lingering unemployment of the 1930s on "external shocks" outside of Roosevelt's control, we must nonetheless conclude that the Canadian government did a better job handling such shocks. (Incidentally, the Canadians did not institute a "Northern New Deal" during the 1930s.) In 1942, in fact, the famed economist Joseph Schumpeter blamed the New Deal as the only possible explanation "for the fact that the [United States] which had the best chance of recovering quickly was precisely the one to experience the most unsatisfactory recovery." ⁷

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. But FDR had an advantage. The severe price deflation under Hoover turned around just as Roosevelt took office. From March 1929 through March 1933, consumer prices fell a cumulative 26 percent, while from March 1933 to March 1937, they rose a cumulative 13 percent.⁸ One of the perverse advantages of inflation is that it can balance off government high-wage policies (as long as these policies aren't indexed to inflation). To that degree, inflation can help cure unemployment.

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Economists might point to the data on private investment. Adjusted for price inflation, private investment did not regain its 1929 level until 1941. In fact, those who controlled private capital largely walked away from the U.S. economy for the entire 1930s, refusing to pump in enough new investment even to replace the machinery and goods-in-process that were consumed during the decade. By this measure, what economists call "net investment," America actually went into the red with investment falling to less than zero for much of the Depression. During the period 1931 to 1935, net investment was negative \$18.3 billion, and it once again fell to negative \$800 million in 1938.¹³

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crash. Thousands of U.S. banks failed during the panics of the 1930s, most in states with unit banking laws. In contrast, Canada allowed branch banking and experienced zero bank failures during the Great Depression. According to Milton Friedman and Anna Schwartz, in Canada "10 banks with 3,000-odd branches throughout the country did not even experience any runs," even though Canada experienced the same decline in its quantity of money as the United States did.⁸

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wartime prosperity.³ Most obvious, how can we say that the war "cured" the unemployment problem, when it achieved this goal merely by shipping millions of men overseas? To give an analogy, suppose that FDR announced in 1940 that in an effort to fight the depression, all able-bodied unemployed men would be shipped to African jungles (where they would face lions and disease). That policy would have brought down the official unemployment rate, yet it obviously would not have promoted actual economic recovery. Had FDR suggested something this monstrous as a "cure" for mass unemployment, citizens would have rightfully recoiled in horror.

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. Flippant as the jungle analogy may seem, it is not too far from the truth, as Higgs explains: Between 1940 and 1944, unemployment fell by... 7.45 million ... while the armed forces increased by 10.87 million. Even if one views eliminating civilian unemployment as tantamount to producing prosperity, one must recognize that placing ... 146 persons ... in the armed forces to gain a reduction of 100 persons in civilian unemployment was a grotesque way to achieve prosperity, even if a job were a job.

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. Here is where the interpretation of the apparent wartime “prosperity” gets a little more complex. During the war the government imposed price controls, forcibly preventing the Consumer Price Index from rising as quickly as it otherwise would have done. But this means that the historical prices we have recorded for these years are meaningless, rendering it impossible for economic historians to adjust the data on historical dollar expenditures to account for the (suppressed) inflation. So the carefully constructed measures of “inflation-adjusted gross domestic output” during the 1940s are about as meaningful as the economic statistics reported by the Soviet Union. These wartime economic statistics, as Higgs concludes, are “essentially arbitrary.”⁵ The government effectively made it illegal for market prices to signal how much inflation the Fed was pumping into the system, and so it is very misleading to compute GDP during the war years with the traditional techniques.

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0 As we have seen, FDR had no problem demonizing and alienating big business in his fight against the Depression. But when it came to fighting Hitler, he wisely realized that fireside chats and ivory tower plans weren’t going to cut it. Many of the extreme New Dealers had to leave the administration, not only to reassure big business, but also because “only business managers had the practical knowledge required to run the war economy—politicians, lawyers, and economists have rather severe limitations when it comes to organizing the production of battleships, bombers, and tanks.”¹¹
