Parallels With the Great Depression

As with our reluctant semantic retreat from "credit crunch" to "recession," the reality of another Great Depression will probably not be acknowledged until years after the fact. But America and the rest of the modern world, by doggedly pursuing the same mistaken policies of the 1920s and ’30s, have made a full-blown depression — lasting years, not months, and featuring catastrophic failures in entire economic sectors along with chronic double-digit unemployment and monetary malaise — all but inevitable. In fact, the parallels between the run-up to the Great Depression and today’s economic havoc are stunning.

The Roaring ’20s, ’80s, and ’90s

By 1929, the United States — and most of the rest of the industrial world — had been on a nine-year joy ride known as the "Roaring Twenties." It was an age of unparalleled new technology — the heyday of the silent film era and the Model T Ford, and the beginning of radio and commercial air service, among many other modern marvels. The first American generation to consecrate itself to mass entertainment came of age in the Twenties. It was the first recognizably modern decade, and the future, to the flappers, barnstormers, and other bons vivants that characterized the age, looked very bright indeed. Accordingly, it was also an age of bold enterprises — of the beginning of mass production and of skyscraper construction. For the first time ever, Americans had enough extra money to turn sports into a lucrative industry. From the vantage point of the mid-Twenties, the party was never going to end.

Like the Roaring Twenties, the long boom from approximately 1982 to 2000 was characterized by boundless optimism and an explosion of new technology. New forms of mass entertainment — MTV, cable television, video games, and the Internet — proliferated, turning the United States of America into the world’s entertainment capital. Men with big ideas — the leveraged-buyout moguls of the ’80s and the high-tech wizards of the ’90s chief among them — had no trouble finding capital to leverage their grandiose ambitions. Like the Twenties, the last two decades of the 20th century were a time of larger-than-life colossi like Donald Trump, Warren Buffett, and numerous flamboyant entertainers, from rock stars and hectomillionaire athletes to the instant celebrities of reality TV and *American Idol*. Risk and chutzpah were everywhere rewarded and nowhere penalized, or so it seemed. Old-school caution and frugality were cast to the wind; the world belonged to the extravagant, the glitzy, and the fully leveraged.

But behind these two parallel utopias, separated by more than six decades, lay a common reality that none but a very few astute, well-connected, or economically well-schooled were able to perceive: an artificial economic expansion created by the issuance of vast amounts of paper money. The great episodes of monetary expansion of the ’20s, ’80s, and ’90s resulted from the magic of central banking — in America’s case, of the Federal Reserve’s ability to create new debt by lowering interest rates far below any rational market pricing. This resulted in years of easy credit, abundant borrowing, and an illusion of far greater prosperity and growth rates than actually existed. The result was cultural and societal no less than economic: because so few Americans, then or more recently, understood how the banking and Federal Reserve System works, the illusion of unnatural prosperity encouraged waste, leisure, and the notion of American invincibility.

In both cases, the party came to a calamitous end. But despite what we assume nowadays, few in the late fall of 1929 — even after the storied stock market meltdown — imagined that more than a decade of economic hardship lay ahead. Indeed, had the federal government, and the Federal Reserve in particular, allowed the crisis to run its course, the American economy during the 1930s would have been far different, probably recovering after a severe recession at the beginning of the decade helped restore sanity to the markets.

Disastrous Intervention

Unfortunately, the Hoover administration chose to intervene in the markets to an unprecedented degree. In 1931, when the banking crisis was in full swing, President Hoover set up the short-lived and ineffective National Credit Corporation (NCC). This government agency aimed to induce banks to pool $500 million to help save failing financial institutions. Not surprisingly, banks, anxious to survive individually, were reluctant to participate. The NCC was only able to raise $150 million, and the program was soon terminated and replaced with the much more ambitious — and intrusive — Reconstruction Finance Corporation (RFC).

The RFC was not altogether a novelty. It was patterned after the War Finance Corporation (WFC), a government bailout fund set up to allow the government to shore up banks and other financial interests during the First World War. After the end of the war, the WFC, rather than being decommissioned, was transformed into a source of government loans for export industries and the farming sector, in which capacity it operated until the mid-’20s under the energetic leadership of one Eugene Meyer.

Meyer, whom Hoover made governor of the Federal Reserve Board in 1930, was appointed chairman of the new RFC in 1932. According to economist Murray Rothbard, "The RFC could make loans to banks and financial institutions of all types. The theory was that, ensured of freedom from failing, the timid banks would be emboldened to lend massively to business and industry, the money supply would rise, and prosperity would return." Additionally, the RFC was authorized to lend money to railroads, as these were deemed a critical industry in the day, too big and too pivotal to be allowed to fail. To achieve these ends, it was given $500 million outright, and authorized to issue up to $1.5 billion in additional securities — government debt, in other words.

The RFC was an abysmal failure, though not for want of trying. Under Meyer the new vehicle for bank and railroad bailouts doled out money right and left, only to see the bank and railroad failures continue apace. Hundreds of millions of dollars poured down various RFC rat holes were lost forever by hopelessly insolvent institutions whose only remaining aim was to service their debts and provide soft landings for major investors. The promised loosening of credit never took place, and commercial lending all but disappeared. The RFC, in a word, was a huge waste of taxpayer dollars at a time when America could ill afford such coerced largesse.

In our day, Congress allowed itself to be stampeded by President Bush, Ben Bernanke, Henry Paulson, and a throng of special interests into passing the now-infamous $700 billion bailout bill that created the Troubled Asset Relief Program (TARP).

With its emphasis on bank and financial bailouts, as well as more recent forays into Big Three automotive handouts (today’s "too-big-to-fail" transportation sector, precisely analogous to railroads in the early 20th century), TARP is eerily similar to Hoover’s RFC. From the results so far, TARP is having no more success than its predecessor organization in rescuing the financial and automotive sectors. At the time of this writing, with the full extent of the original subprime meltdown still unfolding, attention is shifting to banks’ exposure to the shaky commercial real-estate and so-called Alt-A mortgage market. On the day of President Obama’s inauguration, financial stocks swooned, with money-center and regional banks alike caught in the downdraft. The balance of 2009 will likely see many more bank failures, some of the magnitude of Washington Mutual or greater, while of the Big Three automakers, only Ford appears to have some chance of surviving independently. The still-growing financial storm is likely to take a terrible toll, and the $700 billion from TARP will be wasted just like the RFC's misspent millions.

Scapegoating the Free Market

During the Great Depression, as in our day, politicians and the news media blamed the crisis not on government malfeasance but on a failure of the free markets. This false conceit was responsible for a revolution in the relationship between the federal government and the private sector, transforming America from a free-market system into the largely managed economy that we have today.

One of the first steps taken by President Hoover to regulate the activity of the markets was to compel the New York Stock Exchange to curb the practice of short selling. Short selling, whereby an investor borrows securities for immediate resale at a high price, expecting to repurchase them at a lower price, return them to the lender, and pocket the difference, has long been held up as a scapegoat during financial downturns dating all the way back to the 17th-century Dutch tulip market mania. Short selling, however, is merely a way of making money when the market is down, the inverse of purchasing securities in the expectation of profiting from a rise in value. Unlike a straightforward stock purchase, short selling can be a very risky enterprise. Imprudent short selling has ruined many an investor, and the inherent risks associated with the practice act as powerful disincentives. At the same time, short selling acts as a natural counterpoise for the irrational exuberance of the herd that sometimes tends to propel stock valuations to unrealistic highs.

Nevertheless, Wall Street short sellers in the '30s bore the brunt of Hoover's wrath. Later, during the FDR administration, the newly created Securities and Exchange Commission formalized restrictions on short selling in the so-called uptick rule, which from 1938 until July of 2007 imposed a lower limit relative to previous sale prices on the prices of shares sold short. In this way, the ability of selling short to blunt unwarranted rises in stock prices was severely curtailed.

Not long after the repeal of the Depression-era "uptick rule," the stock market began to fall from its dizzying mid-decade gains. Unsurprisingly, the Bush administration on July 15, 2008, imposed restrictions on selling short shares in Fannie Mae, Freddie Mac, and 17 investment banks, in a desperate bid to keep these institutions' inflated share prices from falling still further. The ban was subsequently lifted, although a similar ban in the UK remained in force until mid-January. However, if the stock market malaise continues into the Obama administration, as it is likely to do, expect restrictions and even an outright ban on short selling (a truly calamitous step) to be foisted on already exhausted investors and financial markets.

As mentioned in the "Correction, Please!" column in this issue (page 41), the Roosevelt administration that followed President Hoover further compounded the economic crisis that had become a depression by effectively nationalizing the entire economy. The Glass-Steagall Act of 1933 imposed a welter of new federal regulations on banks and the rest of the financial sector, mandating among other things an artificial separation of commercial and investment banking. The Securities Act, passed the same year, created the overweening Securities and Exchange Commission (SEC), an entity that, like the rest of FDR's New Deal, had no constitutional legitimacy whatsoever and inflicted immense regulatory damage on the securities markets.

In our day, with a decades-old precedent for federal control over banking and finance, further federal controls likely to be imposed by Congress and the Obama administration will meet little principled resistance and, like the original New Deal, will only serve to further hamper the workings of the free market.

International Currency Crisis

The Great Depression, like the current crisis, was an international phenomenon. Bank failures, unemployment, and other economic problems took their toll across the entire industrial world. This was because central banks overseas did the same thing the American Federal Reserve did during the Roaring Twenties — printed money. They did this in a desperate attempt to rescue the ailing pound sterling, at that time the world's de facto international currency. Britain had gone off the gold standard with the rest of the belligerent nations in World War I, and had printed vast sums of pounds to finance the war effort. After the war, however, rather than accept the consequences in the form of a depreciated pound, Britain insisted on instituting a gold-exchange standard with other industrialized countries, with the pound valued at pre-war par. This meant that, although a true gold standard had been abandoned, foreign investors, banks, and government could still redeem pounds sterling in gold.

But if the artificially high valuation in gold were upheld, the precious metal would leave British shores as foreigners rushed to redeem overvalued pounds — unless other central banks could be persuaded to cooperate by debasing their own currencies in tandem with the pound.

The Americans proved particularly cooperative in this regard, thanks to the chummy relationship between Montagu Norman, the governor of the Bank of England, and Benjamin Strong, the head of the New York Federal Reserve and de facto boss of the entire Federal Reserve System. All through the '20s, Strong, at the behest of Norman, who traveled frequently to New York to cement the relationship, kept the Fed pumping new dollars into the economy, with most Americans oblivious to the fact that the artificial economic boom thereby created was a consequence of Benjamin Strong's desire to please the British banking establishment. When the bust hit, therefore, all of the major currencies had been massively inflated and their respective economies succumbed to the inevitable downturn.

The pound sterling, that supposedly indispensable currency, continued to be touted as unassailable, with Norman and the rest of the British financial nomenklatura promising that Britain would never default on her obligations to redeem the pound in gold. Yet in late 1931, after repeated assurances to the French, Dutch, and other large holders of pounds in reserve, the British government did precisely that, touching off an unprecedented international monetary crisis. In the havoc that followed, Britain and most of the rest of Europe went off even the gold-exchange standard, adopting for the first time an international fiat money regime (money not backed by a precious metal). The United States retained a gold standard, but, under FDR, that too was abandoned, although the dollar remained on an international gold-exchange standard until the Nixon administration.

The international currency crisis that accompanied the collapse of the gold standard in the early '30s prompted calls to "fix" the international currency markets by creating an international financial authority to restore order. The one concrete step in this direction was the establishment, in 1930 and at the behest of Montagu Norman, of the Bank of International Settlements (BIS) in Basel, a sort of bank for central bankers. Yet the BIS could neither forestall the abandonment of the gold standard (if such were ever its objective) nor mitigate the monetary chaos that followed.

The next attempt at an international financial order came in summer of 1933 with the World Economic Conference in London, convoked under the authority of the League of Nations. The purpose of the conference, to set up some kind of international stabilizing mechanism for the world's beleaguered currencies, was hampered from the start by widely divergent opinions among the participating nations as to the proper course to follow. France, Belgium, Holland, and Switzerland, for example, doggedly clung to the gold standard, while America, enamored of the new doctrine of monetarism (that is, of pursuing inflationary policies to keep the economic pump primed), had no use for what it viewed as outmoded restraints. The conference accomplished little except to prefigure the creation of the first true global financial regime at Bretton Woods little more than a decade later.

In our time, the dollar has replaced the pound as the world's currency. No longer restrained by the inhibiting factor of a precious-metal standard, the American government has for decades been willing to print dollars almost without limit, and the rest of the world has been willing to accept them on trust. However, the Federal Reserve has for many years collaborated closely with the world's other major central banks, coordinating its inflationary policies to ensure that everybody else (or at least those responsible for the so-called "hard currencies") is inflating in tandem with the United States.

And once again, when the inflationary chickens came home to roost, the crisis was and is international. The deluge of easy money worldwide has brought about an avalanche of bankruptcies and a burgeoning global recession. Other governments worldwide are pursuing feckless bailouts and other interventionist policies similar to those of our own government, with similarly negative results.

Parallel Problems and Pressures

And just like in the '30s, pressure is building for a new international financial regime — for the same political and financial elites who created the problems to try to solve them. This time around, the inaugural conference was held not in London but in Washington, at the behest of the UN and other modern global authorities rather than the old League of Nations. And as in 1933, the participants in the recent international economic conference expect their efforts to culminate in a Bretton Woods-like revolution in international finance.

In sum, very little has changed in 70 years except the names of the actors. Given how closely events in 2008-2009 have tracked those of 1929-1933, it appears increasingly probable that the consequences of those actions — a lengthy, debilitating depression — will be the same as well.

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