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The Fallacies of Another New Deal, Part 1

by William L. Anderson

As the financial panics on Wall Street seem to be never-ending, a lot of commentators are openly asking whether the United States will slide into something akin to the Great Depression of nearly 80 years ago. Certainly, there is real fear in the air, and at this writing, the current and future states of the economy are front-and-center in people's minds.

There can be no doubting the seriousness of these recent financial meltdowns. Trillions of dollars have disappeared as asset values have plunged, venerable banks and brokerage houses either are teetering on the brink of bankruptcy and insolvency or have gone under altogether. The housing market, which a couple of years ago was roaring along has become moribund, and markets where houses once sold in a matter of days now see houses for sale for a year or longer.

In response to these financial crises, the federal government and the Federal Reserve System have moved to shore up some of the markets and, in the case of AIG Insurance Corp., the Fed actually has taken a huge ownership share in the business itself, a first in U.S. history. Congress passed a bill, signed into law by President Bush, authorizing the U.S. Department of the Treasury to purchase \$700 *billion* worth of mortgage-backed securities from banks and brokerage houses that had seen their asset values tumble. The Fed has been purchasing assets such as commercial paper, and the government is going to be taking equity positions in some companies. At last report, the U.S. government itself is taking an equity position with some banks, an unprecedented move in this country's history.

A number of people, including economist (and 2008 Nobel Prize-winner) Paul Krugman of Princeton University and a columnist for the *New York Times*, have called for the installation of another series of government programs akin to the New Deal, a "new" New Deal. For example, William Greider, writing for *The Nation*, declares,

Let me be clear. The scandal is not that government is acting. The scandal is that government is not acting forcefully enough — using its ultimate emergency powers

to take full control of the financial system and impose order on banks, firms and markets.

He adds,

The government, meanwhile, may have to create another emergency agency, something like the New Deal, that lends directly to the real economy — businesses, solvent banks, buyers and sellers in consumer markets. We don't know how much damage has been done to economic growth or how long the cold spell will last, but I don't trust the bankers in the meantime to provide investment capital and credit. If necessary, Washington has to fill that role, too.

Because "New Deal" talk is in the air, perhaps we need not only to understand the programs of Franklin Roosevelt's New Deal, but also to understand why the economic conditions existed that made his series of radical programs politically possible. Fear and economic chaos give politicians an opening they might not otherwise have when times are normal or even good. However, most, if not all, of the time, politicians and government policy-makers are the ones who are responsible either for the crises themselves or for creating the conditions that brought the crises into existence. The events leading up to the Great Depression were no exception, just as the current financial crises have government intervention stamped all over them.

In looking at the New Deal and the things that led up to it, we first have to understand the economic events that occurred *before* the huge stock-market crash in 1929. Furthermore, we have to understand that the crash did *not* cause the Great Depression. In a recent article in the *Wall Street Journal*, Amity Shlaes, author of *The Forgotten Man*, a book about the 1930s, points out,

The stock-market crash of October 1929 and the Great Depression were not the same thing. What made the depression great was not magnitude but duration — the fact that unemployment was still 20 percent 10 years later. In the 1930s, policies like the ones described above (such as stopping short selling of stocks) did not speed recovery; they impeded it.

Thus, in making sense of the Great Depression and the New Deal, we have to examine a number of things. First, we must look at the economic conditions that led to the 1929 crash; and second, find why the policies that both Herbert Hoover and Franklin Roosevelt put into place "impeded" the economic recovery. Both have relevance in the discussion of what to do in the current situation. Third, we must look at the specific policies of the New Deal, what they were supposed to accomplish, and their actual results.

Whether or not George Santayana ever made that famous statement attributed to him about knowing history, the advice implicit in it is valuable. There *are* real lessons from history about the Great Depression; unfortunately, because statism triumphed over freedom during that sorry decade, most people have never heard the lessons even for the first time.

Inflation and the Roaring '20s

The decade of the 1920s is an era associated with good times and economic growth, with speakeasies where people drank illegal liquor, with the growth of the automobile industry, and as a time when the nation pursued “normalcy” after the madness of World War I. Typical history textbooks portray the 1920s as a time of uneven economic growth, where some prospered at the expense of others, and where greed and rampant capitalism combined to create a huge bubble in the stock market.

As the story goes, the stock bubble burst in October 1929, and then the country began a slow but sure slide to depression. Herbert Hoover, a staunch “true believer” in laissez faire and the “invisible hand,” stood by and did next to nothing while increasing numbers of people slid into poverty as the economy fell apart. Banks failed by the thousands; people lost their homes, farms, and businesses; but all Hoover did was to start an agency, the Reconstruction Finance Corporation, that lent money to big businesses in the hope that money given to the rich ultimately would “trickle down” to everyone else.

Alas, Hoover’s inaction was fatal, as prices plummeted, factories were closed, and the nation plunged into rates of unemployment of 25 percent and more. In 1932, the voters overwhelmingly elected Franklin Roosevelt, who promised a “new deal” to the country. After he took over, Roosevelt vigorously fought to bolster the economy by helping the poor instead of the rich. Although the rich resisted by staging what Roosevelt’s attorney general, Robert Jackson, called a “strike by capital,” nonetheless the economy slowly recovered, but it was only after World War II began that the nation really came out of the Great Depression.

The supposed history lessons here are simple: if government wants to help the economy grow, it must do so by taking away from the rich capitalists and giving to everyone else. By ensuring that everyone has “purchasing power,” a government can keep an economy on its feet and avoid the economic calamities of the past. On the other hand, if the government permits a laissez-faire regime, ultimately only the rich will benefit, as the “gap” between the wealthy and everyone else will grow until the economy slides back into the doldrums.

For example, Krugman says that the way to “stimulate” the present economy to keep it out of recession is for government to raise the minimum wage to improve “purchasing power” for workers, encourage more labor-union growth so other workers can receive raises, increase marginal taxes on the wealthiest Americans, increase business and financial regulation, and have a government takeover of the medical-care industry. These measures, he has argued in a number

of his columns, will not only improve individual incomes, but also ensure that dire circumstances will not put someone into poverty.

The Federal Reserve and the Great Depression

Like so much retelling of history, the standard story is close to a big lie. To gain a much clearer — and factual — understanding of both the Great Depression and the decade of the 1920s, a good place to start is Murray Rothbard's *America's Great Depression*, a book that covers the 1920s and the Hoover years. (Rothbard does not deal with the Roosevelt administration, something done by other writers in the Austrian free-market tradition.)

The first thing that Rothbard notes is that there was a large growth in the stock of money during the 1920s, with the overall money supply nearly doubling during that period. Austrian economists differ from other economists in that they *define* inflation as a growth in the money stock, while most economists define inflation as an increase in the overall level of prices. If one holds to the latter, then the 1920s would be seen as a time of *deflation*, since prices as measured by official government price indices either held steady or even dropped slightly.

Rothbard, however, is undaunted. He looks squarely at the role of the Federal Reserve System, which had been created in 1913 ostensibly to help serve in a backup role to U.S. banks in order to help prevent bank runs and financial panics. The Fed, and especially the New York Federal Reserve Bank, according to Rothbard, aggressively pursued a policy of “open market operations,” which involved the purchase of U.S. government bonds in the financial markets, which then greatly increased the reserves of private banks.

One reason for the expansion of the U.S. money supply was that the Federal Reserve System was attempting to help Great Britain keep the pound sterling at its pre-World War I level of \$4.86. Following the war, which had exhausted the British economy, the pound was trading in open markets at about \$3.50, but British authorities wanted to establish the old relationships, even if the market was saying something different.

As a result, the decade of the 1920s, with the pound being well overvalued (and the U.S. dollar subsequently undervalued), saw high rates of unemployment in Great Britain, as British exports were expensive relative to products made elsewhere. At the same time, the undervalued U.S. dollar (which was becoming the world's “reserve” currency after World War I had destroyed the international gold standard) made U.S. exports attractive, thus fueling the American production machine — for a while.

Whenever monetary authorities aggressively expand a currency, as was done during the 1920s, the new money has to flow somewhere. In a system such as that in the United States, where new money comes through the banking system, the people who obtain it first are people receiving loans, and the largest loans tend to be business-capitalization loans. (In countries where

governments own a lot of the assets, such as Argentina or Bolivia, the new money comes in directly as payment to government workers.)

The new capital spending then sets off a whole chain of events. First, the markets anticipate new production and higher asset prices, and that optimism is reflected in the stock market and elsewhere (often real-estate markets). Second, at some point in the future, it becomes obvious that the overinflated markets do not have the fundamentals to match the financial optimism, and then there is a correction.

The Florida Land Boom of the mid 1920s was one of the first manifestations of U.S. monetary policy, as new money flowed into that state, which stood to gain greatly from the increased prosperity of the times. Even before a series of hurricanes put an absolute end to the land boom, it was obvious that the property values could not be sustained. The economic fundamentals there could not support the building of new hotels and other projects that were supposed to accompany the rush of nouveau riche who were going to “remake” the southern beaches of Florida.

Although U.S. productivity did increase greatly during the 1920s and economic output also increased, the boom itself was unsustainable. What often confuses people about this boom, however, is that according to government statistics, consumer prices actually fell slightly. That fact is held as “proof” that there was no inflation during the 1920s. Yet, if we see inflation as the expansion of the stock of money, there is no confusion. During the 1920s, output increased at a level that outstripped some of the effects of the expansion of money.

By the fall of 1929, however, the frenzied pace of the stock exchanges could not be continued and in October of that year, the market crashed. That part is understood by all historians; however, the aftermath of the crash is where the confusion begins.

Hoover’s response to the crash

As stated before, the typical explanation of the Great Depression is that Herbert Hoover was a staunch believer in *laissez faire* and that he refused to involve the government in trying to stem the downward cycle in the economy. While Hoover did oppose *direct* relief to individuals, nonetheless he intervened in a way that no U.S. government had done in previous economic downturns.

This point is important, because the standard description of the “laissez-faire” Hoover is a falsification of what really happened, and plays to government activists such as Greider and Krugman who hold that only rigid state control can provide long-term prosperity. As Rothbard and others have noted, Hoover was a prominent *progressive*, not a proponent of free markets. Writes Rothbard,

Herbert Clark Hoover was very much the “forward-looking” politician. We have seen that Hoover pioneered in attempts to intimidate investment bankers in placing foreign loans. Characteristic of all Hoover’s interventions was the velvet glove on the mailed fist: i.e., the businessmen would be exhorted to adopt “voluntary” measures that the government desired, but implicit was the threat that if business did not “volunteer” properly, compulsory controls would soon follow.

When Hoover returned to the United States after the war and a long stay abroad, he came armed with a suggested “Reconstruction Program.” Such programs are familiar to the present generation, but they were new to the United States in that more innocent age. Like all such programs, it was heavy on government planning, which was envisaged as “voluntary” cooperative action under “central direction.” The government was supposed to correct “our marginal faults” — including undeveloped health and education, industrial waste, the failure to conserve resources, the nasty habit of resisting unionization, and seasonal unemployment. Featured in Hoover’s plan were increased inheritance taxes, public dams, and, significantly, government regulation of the stock market to eliminate “vicious speculation.” Here was an early display of Hoover’s hostility toward the stock market, a hostility that was to form one of the *leitmotifs* of his administration. Hoover, who to his credit had never pretended to be the stalwart of *laissez-faire* that most people now consider him, notes that some denounced his program as “radical” — as well they might have.

So “forward-looking” was Hoover and his program that Louis Brandeis, Herbert Croly of *The New Republic*, Colonel Edward M. House, Franklin D. Roosevelt, and other prominent Democrats for a while boomed Hoover for the Presidency.

Progressives long had been hostile to free markets and proposed programs that combined government ownership of some industries (such as railroads and electric-power companies) and other industries to be organized in a series of cartels. Their first success had come during World War I, in which the government took over operations (and had de facto ownership) of the railroads, while the industries deemed vital to the war effort were cartelized for the duration of the conflict.

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