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Two Ways to Fight an Economic Depression

by Gregory Bresiger

“There was a depression in 1920? Really?”

That was the comment I received recently from a smart, usually well-informed editor. Yes, there was a depression. But it was over so fast that few people seem to have heard of it.

Yet almost everyone knows about the Great Depression, which began in the late 1920s and extended into the late 1930s. Urban legend, however, is that a laissez-faire president, Herbert Hoover, made it worse by not saving failing businesses, not pumping money into the economy, and not running deficits.

The second part of the legend is that another president, Franklin Roosevelt, using countercyclical, interventionist economic policies for the first time in American history, restored prosperity through large doses of inflation and deficit spending. This is much the same as what leaders in Congress and President Obama now propose for the ailing U.S. economy. These economic recipes are likely to be applied in part because of the myth of Roosevelt as an economic savior. It is a myth, as anyone who studies the unemployment figures of the 1930s knows.

For instance, in 1933, the year Roosevelt entered office, unemployment was 24.9 percent. At the end of his first term and after repeated government stimulus packages, it had declined to 16.9 percent in 1936. That was better than in 1933, but nowhere near approaching prosperity. Two years later, in the midst of the recession of 1938, it was back up to 19 percent.

Two years later, as the United States was beginning to build up in preparation for World War II, joblessness was down to 14.6 percent. That was a little better. Still, to call it prosperity or to say that Roosevelt’s management promoted a strong recovery through his big-spending policies — many of which have been used by the Bush administration and will probably be expanded by the Obama administration — is wrong.

Yet there is another way of treating economic depressions. It is a way so old that many people probably have never heard of it.

Few know that there was another depression before the Great Depression. It was a short-lived one, one in which traditional laissez-faire measures were accidentally but successfully used. The depression of 1920-21 began near the end of the presidency of Woodrow Wilson.

It was the result of the huge money creation and red ink run up by the government in World War I. In 1919, the federal government recorded a \$13.4 billion deficit, a tremendous amount of red ink for that time. Blunders by the relatively new American central bank, the Federal Reserve Board, aggravated inflation.

The parallels to our time are stark. An unpopular war combined with the depression meant that President Wilson, like lame-duck President Bush, left office with his reputation shattered. In the case of Wilson, millions of Americans called him “a madman,” according to Walter Karp in *The Politics of War*. The nation, at the end of 1920 as Wilson was leaving office, was in a depression.

This little-known depression continued into the early part of the next presidency, the administration of Warren Harding. But it ended in the summer of 1921. The key point is how it ended: It ended too fast for any counter-cyclical, inflationary policies to be applied. In other words, the depression cured itself as the economy naturally purged bad investments. This little-known episode in history triggers several questions.

Why don't Americans know about it? And why has the average American, even a historically literate American who seems to have heard something of “the Great Depression” and of presidents Herbert Hoover and Franklin Roosevelt, never heard of that not-so-great depression?

Roosevelt and the New Deal

Why do so many Americans believe that Hoover, who served in the Harding and Coolidge administrations in the 1920s before later becoming president, was a laissez-faire president who left the economy alone while it floundered? The second part of the legend tells us that Roosevelt was the enlightened president whose bold unprecedented policies reversed the Great Depression and revived the economy.

In this article, I will explain why the depression of 1920-21 is relevant to us today. It is important to understand these very different economic strategies. The wrong ones can consign a nation to a Hoover/Roosevelt depression that goes on for more than a decade. The choice is critical.

We are in a time when the United States is on the verge of a deep recession and possibly another protracted depression. It is a time when the failed economic policies of Congress and the Bush administration, rather than being condemned, will very likely be repeated and expanded, just as the failed interventionist policies of Hoover were extended by Roosevelt. This could lead to a continuing cycle of disaster for more than a decade.

Indeed, by end of the 1930s, even many of Roosevelt's supporters privately conceded that the New Deal was not working. Roosevelt, by the late 1930s, was upset when the economic numbers supplied by Dan Roper, his commerce secretary, showed the New Deal wasn't working.

"Dan, you've got to stop issuing these Hooverish statements all the time," he told Roper, as quoted in *Jim Farley's Story: The Roosevelt Years*, by James Farley.

By the way, Farley, Roosevelt's postmaster general and once one of his key political advisors, fell out with Roosevelt over his decision to run for a third term. But he also believed that Roosevelt's economic policies hadn't worked. Sixty years later, even pro-Roosevelt historians such as Doris Kearns Goodwin (in her *No Ordinary Time*) concede that the inflationary solutions never worked.

Economist Joseph Schumpeter, another critic of the New Deal, wrote that the Great Depression had begun as a normal downturn. But government policy, especially banking policy that prohibited branching, "had made it much worse," according to Schumpeter, as quoted in *Prophet of Innovation: Joseph Schumpeter and Creative Destruction*, by Thomas K. McCraw. Schumpeter wrote to a friend that he was so disgusted by the New Deal that Roosevelt "is going to turn me into a fan of [Ludwig von Mises]." (Mises had been a former classmate at the University of Vienna.)

So why was one depression a disaster and the other a short-term problem? We know the economic policies designed to cure them were different. In the 1920-21 depression, laissez-faire policies were inadvertently followed long enough to allow for a dynamic recovery. In the Great Depression Hoover and Roosevelt applied flawed countercyclical and cheap-money strategies, just as our leaders today, after the failure of one stimulus package and bailouts earlier this year, now call for bigger ones.

Which policy will it be? Unfortunately, the inflationary, bail-out-the-bad- investments-and-create-more-money-out-of-thin-air policies will very likely be used. That's because today these inflationary, anti-depression policies are enshrined as an economic bible beyond debate.

Indeed, even "conservative" George Bush — in some ways similar to "laissez-faire" Hoover — has run huge deficits and recently given every American a rebate check, thereby running up even more deficits. He has used the central bank or Congress to bail out investment banks, a large insurance company, and even a giant hedge fund. Still, the country remains headed for a recession or even worse. Politics aside, the Democrats' main objection to the Bush policies is that he hasn't done enough, a scary repeat of history from the early 1930s.

So why do the same things even though they don't promote a recovery? Historical illiteracy. Millions of people believe these policies cured the Great Depression, even though many of Roosevelt's supporters, we have seen, concede that prosperity was not restored. However, that is the way the government has responded and continues to respond to the economic problems that it causes.

The depression of 1920-21

And the same historical illiteracy covers the depression of 1920-21. Even though it lasted only about a year, it was quite a depression. The unemployment rate, in that one-year period, went up by more than 100 percent, going from 5.2 percent to 11.7 percent.

“The severe depression of 1921 was over so rapidly, for example, that Secretary of Commerce Hoover, despite his interventionist inclinations, was not able to convince President Harding to intervene rapidly enough; by the time Harding was persuaded to intervene, the depression was already over, and prosperity had arrived,” Murray Rothbard wrote in the Introduction to the Third Edition of *America’s Great Depression*.

Herbert Hoover had been Harding’s commerce secretary and a liberal one who favored various new techniques of government management of the economy. Back then, before he became president, he was praised by Franklin Delano Roosevelt as a man who could run for president from either major party. A biographer, Joan Hoff Wilson, called Hoover a “forgotten progressive.”

But his advice for curing the 1920 depression was not acted on quickly by Harding. Yet later on, as president, he would put interventionist policies into effect. These policies have become the standard for presidents from Truman to Nixon to Carter to today’s administration. Yet they have all produced and prolonged recessions. They were followed by recoveries that inevitably produced still deeper recessions until today we seem to be on the brink of a depression.

Indeed, even a business writer, in a new book on a big investment-bank bailout, in trying to calm investors by predicting that markets will recover, unintentionally explained exactly how this vicious cycle works: “Somewhere in the next recovery will be seeds of the next new financial mania,” writes John Waggoner in *Bailout: What the Rescue of Bear Stearns and the Credit Crisis Mean for Your Investments*.

So the policies of bailouts for big firms and of the government’s spending its way out of a recession or depression are now the standard for political and economic leaders.

Yet something very different happened in the recovery of 1920-21. Benjamin M. Anderson, an economic historian, compared the two styles of leaving things alone and the countercyclical “start inflating again” school: “In contrast, in 1920-21, we took our losses, we readjusted our financial structure, we endured our depression, and in August 1921, we started up again,” he writes in *Economics and the Public Welfare: A Financial and Economic History of the United States, 1914-1946*.

Two other economic historians write of this depression, “Resources and workers were quickly thrown into unemployment, prices were reduced, wages were reduced — all to be absorbed in more efficient employment in the ensuing expansions,” according to *American*

Economic History, by Jonathan Hughes and Louis P. Cain. By 1922, unemployment dropped to 6.7 percent and in 1923 it was 2.4 percent.

The result of a policy of laissez faire and no bailouts? Prosperity was quickly restored as economic forces were allowed to purge malinvestments. Weak firms were “promptly” eliminated, writes eminent economic historian Joseph Schumpeter in his book *Business Cycles*. “Over eight percent of the manufacturing firms which were in business in 1919 had disappeared by 1921.” He wrote that the recovery was so quick and strong owing to an “abnormally effective liquidation.”

The case of 1920, Schumpeter explains, “also shows better than any theory could how the system pulls itself out of troughs under its own steam and how it succeeds in doing so while the price level is falling.” Prices and wages were allowed to drop, he adds. And those industries such as textiles and clothing, where they dropped first, were the first to come back.

Lessons for today

What is important about America’s little-known depression is that it would be the last economic collapse in which the staples of government economic planning — cheap money; big deficits; and bailing out various mismanaged, politically connected, big financial institutions with friends on both sides of the aisle — were not used to bring about a recovery. A policy of laissez faire was applied and it succeeded miraculously in the 1920s, while the reverse failed in the 1930s.

Yet, just as today, there were plenty of Americans who yearned for what Hoover called “positive action” by the government to reverse the economic problems. Those were the policies he would use a decade later after the crash of 1929.

That’s when he bragged that he was the first president to use the new methods. He bragged in his memoirs of having “the greatest program of offense and defense” against depression ever attempted. “For the first time in history,” Hoover wrote, “the Federal Government has taken an extensive and positive part in mitigating the effects of the depression and expediting recovery.”

Unfortunately for Hoover, the formula didn’t work. And it didn’t work any better, when expanded by Roosevelt. Yet the Great Depression’s recovery formula remains with us, as do its hard lessons.

We must learn why this formula doesn’t work and has never worked. Otherwise, we risk repeating a brutal period in American economic history.

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