As We See It

"... .the government offers to cure all ills of mankind. It promises to restore commerce, make agriculture prosperous, expand industry, encourage arts and letters, wipe out poverty, etc., etc. All that is needed is to create some new government agencies and to pay a few more bureaucrats."

Frederic Bastiat – 1845
French economist

Much has been written about the similarities between our recent economic situation and that of the 1930s. As noted in *The Forgotten Man: A New History of the Great Depression* by Amity Shales, the Great Depression of the 1930s was not caused by the Crash of 1929 as commonly believed, but rather by a series of government policy errors that took place afterwards.

First, in June, 1930, Congress passed the Smoot-Hawley Tariff Act against the advice of economists across the country who predicted retaliation by other nations. The economists proved right as Smoot-Hawley provoked retaliatory protectionist actions by nations all over the globe, depriving the United States of markets and sending the economy into a deep slump.

Second, the Federal Reserve maintained an anti-inflationary policy, adopted at the height of the 1920s boom, while the American economy underwent its greatest-ever deflation. In fact, the money supply declined by nearly 4 percent between the end of 1928 and the end of 1930 and continued to decline into 1933.

Finally, both the Hoover and Roosevelt administrations enacted policies which worsened and prolonged the economic decline. Hoover implored business leaders to keep wages up when economic conditions suggested they should go down. In an attempt to balance the budget, in 1932 Congress passed a tax increase signed by President Hoover raising the top tax rate from 25% to 63%. Roosevelt's errors had a different quality but were equally devastating. He created regulatory, aid, and relief agencies based on the promise that recovery could be achieved only through a large military-style effort. Some of these efforts, such as the Civilian Conservation Corps, the Security and Exchange Commission, and banking reform, were helpful. Other new institutions, such as the National Recovery Administration—which had the power to set prices, wages, and quotas—hurt business. The NRA and numerous other acts, including strengthening the power of unions, frightened away capital and discouraged employers from hiring workers. As a result, net investment was negative through much of the 1930s and unemployment was still 17.2% in 1939, after seven years of New Deal policies.

Hopefully, today's decision makers can avoid the mistakes of the 1930s. Certainly the Federal Reserve Board under Chairman Bernanke understands that its mission is to do the opposite of the Fed of the early 1930s. The early 1930's Fed contracted money supply which resulted in deflation. In contrast, the Bernanke Fed is greatly increasing the money supply.

We cannot be sure that some of the mistakes of the 1930s will not be repeated. We have already seen some actions by governmental authorities which are reminiscent of the vacillating policies in the 1930s. For example, Bear Stearns was saved while Lehman was allowed to go bankrupt. While the original intent of the Toxic Asset Recovery Plan was to purchase tainted securities from banks, that objective was suddenly changed to one of injecting capital into banks. Businesses need to know what the rules are or they will hold back and hoard cash as they did in the 1930s.

Most troublesome are issues regarding taxes and protectionism. The new administration has said it will lower taxes on the middle class, paying for it by raising taxes on the *wealthy*. The wealthy are the risk takers who start businesses and create jobs. In 1935, Roosevelt signed into law a new tax bill increasing the top rate to 79% along with corporate undistributed and excess profits taxes. Why would anyone form a new venture when more than three-quarters of any profits would be taken by income tax? "The president relished squeezing cash for the poor out of the well-to-do. . . ." (Amity Shales). While Smoot-Hawley type legislation is highly unlikely, protectionism could take many forms. For example, if upcoming international talks on climate change are unsuccessful, pressure could grow for some sort of *carbon tariff* on Chinese goods. Moreover, during the presidential campaign, the incoming President spoke critically about corporations *exporting jobs* and suggested NAFTA needs to be renegotiated.

Additionally, Barack Obama's pick for Secretary of Labor—Hilda Solis—says her goal is to expand the reach and power of unions in America, and she supports such union priorities as the Employee Free Choice Act, which would do the opposite of its name and end secret balloting to unionize a workplace. Anything that discourages businesses to hire and expand will be harmful to the economy.

We assume our leaders and/or their advisors have studied the mistakes that resulted in and prolonged the Great Depression. Unfortunately, politics sometimes overrules economics. The upcoming year bears close watching.

Year End 2008