The New Deal
History, Economics, and Law

Lecture 1: The Origins of the Crash

The American Economy in the 1920s

- Short-lived downturn of 1920-21; sharp declines in production and employment
- Joseph Schumpeter: the 1920 episode "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"
- (Woods, "Warren Harding and the Forgotten Depression of 1920," *Intercollegiate Review*, Fall 2009)

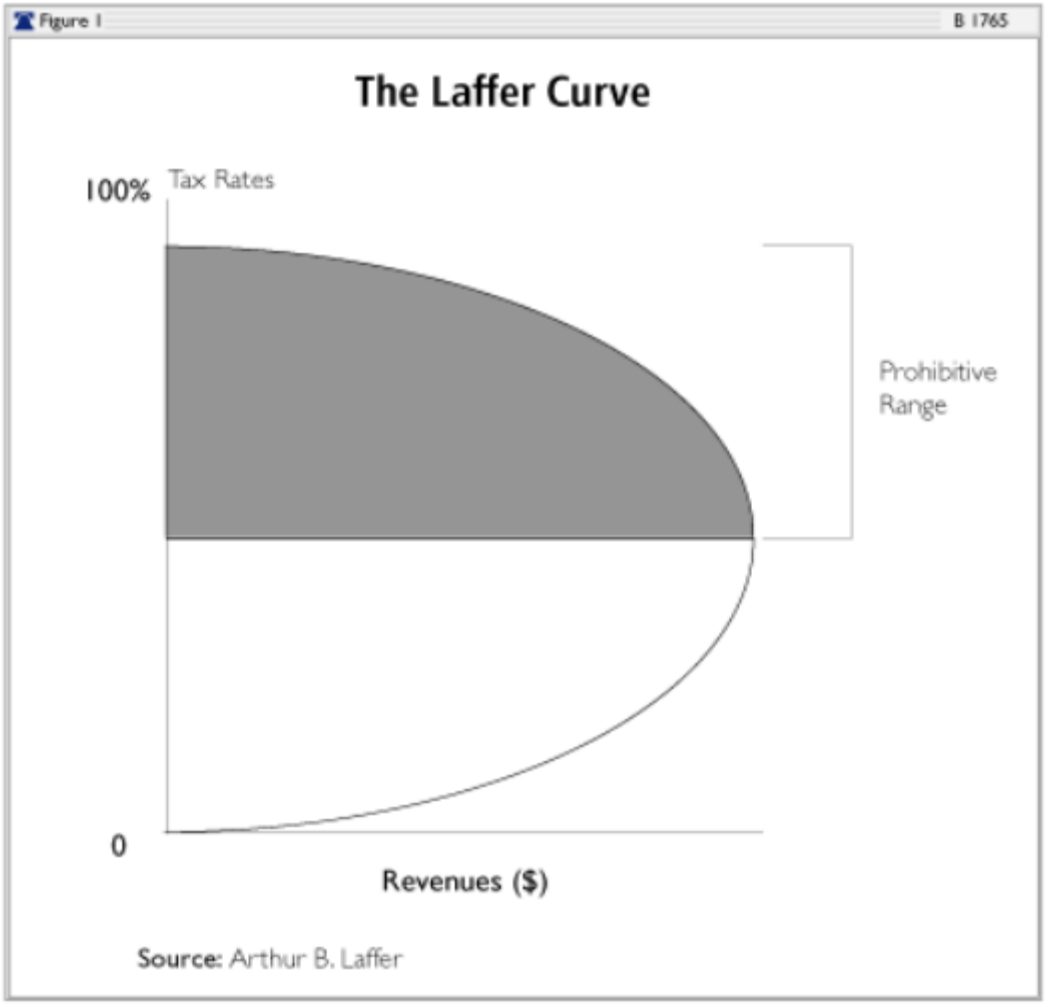
The American Economy in the 1920s

Prosperity of 1920s

- High rate of capital formation ==> growth in productivity and real incomes
- Unemployment remains under 4%, except for peaks of 5% and 4.2% in 1924 and 1928, respectively
- GDP (in 2000 dollars) rises from $595.1 billion in 1921 to $865.2 billion in 1929 -- a 45% increase in eight years
- As a share of world production, the U.S. in 1929 held 34.4%; the next-highest two economic powers, Britain and Germany, were tied with just over 10%

The American Economy in the 1920s

- Treasury Secretary Andrew Mellon favors (and wins) income tax reductions for all income groups
- Mellon anticipates Laffer Curve



The American Economy in the 1920s

- National debt reduced by one-third
- Annual earnings of workers in manufacturing rose by one-third, and hours worked fell by 5%
- Membership in American Federation of Labor fell from 4 million to 2.7 million

The American Economy in the 1920s

Major changes in American life, among them:

- Automobile production rose from 1,746,000 in 1917 to 4,587,000 in 1929
- Household electrification:
  - In 1920, 47.4% of urban and nonfarm households, 1.6 percent of farms, and 34.7% of all dwellings had electricity
  - By 1930, those numbers have increased to 84.8%, 10.4%, and 68.2%, respectively
  - Production of wide variety of appliances vastly increases
- Increased leisure and readily available transportation led to greater demand for various forms of entertainment, from movies to sporting events

The American Economy in the 1920s

1920s boom was particularly evident in capital goods industries

- Pig iron and steel production tripled
- Construction activity and machine tools output more than tripled
- Growth in industrial production was more than double that in consumer goods
- Stock market rises 50% in 1928, and another 27% between January and October 1929
- Significance of this aspect of the boom will become evident after discussion of Austrian business cycle theory

Sources for Statistics on 1920s

- Gene Smiley, *The American Economy in the Twentieth Century*
- Lawrence H. White, *The Clash of Economic Ideas*
- Larry Schweikart, *The Entrepreneurial Adventure*

The Economy Wasn't All Ham and Plaques

- Customary at the time to speak of a "new era" of prosperity, in which the business cycle has been overcome
- This was untrue, as everyone now knows, and as some knew then
- The most significant deviation from laissez-faire in the 1920s -- namely, the activities of the Federal Reserve System -- gave rise to a boom-bust cycle
- (Special bonus if you get the "ham and plaques" reference)

Austrian Business Cycle Theory

Why the "cluster of error" among entrepreneurs? Distortion of interest rates, on which they depend for proper resource allocation across time

Important Austrian concept: structure of production

If interest rates fall naturally:

- indicates the public is saving more
- in saving more, they are deferring more of their purchases
- in purchasing fewer consumption goods in the present, they cause consumption-goods industries to release resources
- perfect time for businesses to engage in long-term production, which the low interest rates encourage them to do anyway

Austrian Business Cycle Theory

If interest rates fall artificially (e.g., through the interventions of a monopoly central bank):

- the public's saving has not increased; may even fall
- thus the public is not deferring purchases for the future
- resources are not being released by consumer-goods industries
- result: a tug-of-war over resources between higher- and lower-order stages of production
- the resulting higher costs threaten the profitability of many of the new investment projects
- they are going to lose the tug of war, since reality is pulling at the other end

The Inflation of the 1920s

- Not evident in price indexes
- Productivity increases yielded greater output, which on its own would lower prices
- Combined with a Federal Reserve policy of inflation, though, result was essentially stable prices

The Inflation of the 1920s: Motivations

Stimulate foreign lending

- High U.S. tariffs meant foreigners could sell less to Americans
- With Americans not buying as many foreign goods, foreign sellers earning fewer dollars

The Inflation of the 1920s: Motivations

- How to get them some dollars so they can buy American exports?
- Lend them the money!
- Fed inflation leads to more lending in general, including more foreign lending
- Hoover: even bad loans, by helping U.S. exports, were a good source of employment

The Inflation of the 1920s: Motivations

Helping Britain

- Britain inflated massively during World War I, having gone off the gold standard
- When it returns to the gold standard in the 1920s, it does so at the prewar par of $4.86 (sometimes rounded to $4.87)
- But the pound is no longer worth $4.86; it's worth around $3.50
- Gold will tend to flow out of Britain, and its whole money and banking system will be thrown into turmoil

A Brief Digression

Price-Specie-Flow Mechanism

- First described by Richard Cantillon, though more famously by David Hume
- Increase in money supply ==> higher domestic prices ==> decline in U.S. exports, increase in U.S. imports
- balance of payments deficit; U.S. spending more abroad than foreigners spending in U.S.
- British, Germans, etc. don't want paper dollars; they want gold
- U.S. importers will need to turn these excess dollars in to get gold to ship abroad

A Brief Digression, cont'd

- commercial banks, in turn, take the dollars to the U.S. central bank (where gold reserves are centralized) and get the gold
- People become aware of the gold outflow and the corresponding shakiness of the system, and themselves begin to redeem their notes and deposits in exchange for gold
- Now the commercial banks and the central banks have to retrench, they have to reverse the initial inflation to halt this process before it takes the whole system down

Britain's situation is in essence an illustration of the price-specie-flow mechanism at work, and the British government's effort to frustrate it

The Inflation of the 1920s: Motivations

Because of divergence between exchange rate set by law and exchange rate on the market, arbitrage opportunities exist

What's the solution?

Encourage the U.S., as well as economically less significant countries, to debase their own currencies! Then the pound will be relatively strengthened.

The Inflation of the 1920s: Motivations

- Close relationship between New York Fed Governor Benjamin Strong and Montagu Norman, head of Bank of England
- Secret meetings between the two throughout 1920s concealed from Federal Reserve Board
- July 1927: Strong and Norman meet with Charles Rist and Hjalmar Schacht of French and German central banks
- Rist and Schacht refuse to go along with the inflationary plans of Strong and Norman
- Strong to Rist: I will give "a little *coup de whiskey*" to the stock market
- British admirer compares Strong to Walter Hines Page

The Inflation of the 1920s: Motivations

Helping farmers

- Stimulus to foreign lending gives foreigners the wherewithal with which to purchase U.S. farm exports
- Strong claimed his inflationary policies were aimed at helping the farmers, without mentioning his policy of helping Britain

The Inflation of the 1920s: Motivations

"Price Stability"

- The ideal of a stable price level becomes widespread by the 1920s, thanks largely but not exclusively to the work of economist Irving Fisher
- Prices should have fallen in the 1920s, as productivity increases brought about more output
- "Price stability" required inflationary monetary policy to keep prices propped up
- (On "price stability" as a chimera, see the brief section in chapter 11 of Rothbard's *Man, Economy, and State*)

The Crash: Fisher v. Mises

"There may be a recession in stock prices, but not anything in the nature of a crash. Dividend returns on stocks are moving higher. This is not due to receding prices for stocks, and will not be hastened by any anticipated crash, the possibility of which I fail to see." (Fisher, September 5, 1929)

Stocks have reached a "permanently high plateau," says Fisher (October 15), and he expected "to see the stock market a good deal higher than it is today within a few months." Did "not feel that there will soon, if ever, be a fifty- or sixty-point break below present levels."

The Crash: Fisher v. Mises

"The breaks of the last few days have driven stocks down to hard rock. I believe that we will have a ragged market for a few weeks and then the beginning of a mild bull movement that will gain momentum next year." (Fisher, October 22)

October 28-29, Dow Jones plummets 25%. Fisher (November 3): stock prices are "absurdly low." But they had a much steeper decline ahead of them: by the time bottom was reached, stocks were off nearly 90% of their peak.

The Crash: Fisher v. Mises

Fashionable opinion held that the U.S. had entered a "new era" in which the business cycle would be a thing of the past thanks to scientific management of the money supply.

Not Mises: "It is clear that the crisis must come sooner or later. It is also clear that the crisis must always be caused, primarily and directly, by the change in the conduct of the banks. If we speak of error on the part of the banks, however, we must point to the wrong they do in encouraging the upswing. The fault lies, not with the policy of raising the interest rate, but only with the fact that it was raised too late." (1928)

The Crash: Fisher v. Mises

"The only way to do away with, or even to alleviate, the periodic return of the trade cycle -- with its denouement, the crisis -- is to reject the fallacy that prosperity can be produced by using banking procedures to make credit cheap." (Mises, 1928)