



Version Française

Lessons from the 1929 Crash and the Great Depression How to avoid a Remake of the Keynesian Debacle



Nederl.versie

"There will be no further Crash in our Lifetime", John Maynard Keynes

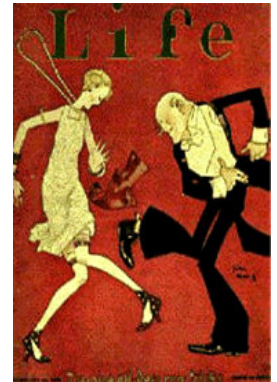


Calvin Coolidge
Republican President
1923-1929

historical recording of a speech in which Coolidge announces public spending cuts

1920-1929: an Era of exceptional Prosperity

The post war period was an era of great prosperity generally referred to as the roaring twenties. US President Coolidge was an advocate of "small government" and his supply side economics proved a real success story. Under his presidency, the top marginal tax rates were gradually reduced from 73% in 1922 to 24% in 1929. These "Mellon tax cuts" restored the incentives to work, save and invest and generated an atmosphere of great dynamism. The reduction of top tax rates particularly motivated the entrepreneurs to engage in the risky business of innovation with an unprecedented series of great discoveries and inventions as the logical consequence. Electrification, radio, phonograph and telephone date from this era and brought a wide range of new machinery and consumer goods. New tools and processes (Ford's assembly line) drastically increased productivity. All these brand new technologies boosted productivity and prosperity all over the world.



In the Soviet Union, the communist experiment was still young and initially looked like a success story. Many considered the economic model organised by central planners as a modern and rational alternative for the "irrational anarchy" of free markets. In Europe as well as in the U.S., the economic dispute between the socialist - interventionist ideas of J.M Keynes' and the classic liberal ideas of the "Austrian school" of Von Mises and Hayek was at the centre of the political debate.

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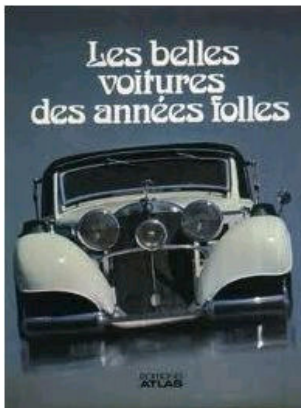
Percentage of Americans Owning Selected Items

Item	1920	1930
Autos	26%	60%
Radios	0%	46%
Electric lighting	35%	68%
Washing machines	8%	24%
Vacuum cleaners	9%	30%
Flush toilets	20%	51%

Source: Stanley Lebergott, *Pursuing Happiness: American Consumers in the Twentieth Century* (Princeton: Princeton University Press, 1993), pp. 102, 113, 130, and 137.

Easy access to cheap credit

By the end of the decade the economic boom culminated in a general euphoria, particularly in the U.S. Asset prices skyrocketed. Prior to the euphoria a long period of easy access to cheap credit had caused the money supply to grow at a much faster pace than the real economy.



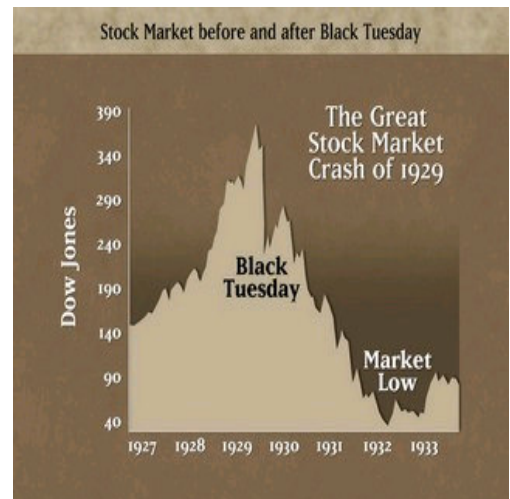
From 1921 to 1929 the US money supply increased by 61 percent. In Europe the fast money supply was exacerbated by the massive German compensations for war damages. English repayment of war loans inflated the US money supply even further. As a consequence inflationary pressures increasingly built up in Europe as well as in de U.S.

Between 1928 and 1929, the easy access to cheap credit caused reckless speculation on stock markets and on assets in general. Prices gradually inflated to an unsustainable asset bubble. In the 30 months from March 1926 to September 1929 the Dow Jones rose 230% from 166 to 381. A correction had become inevitable, but turned into a severe crash due to calamitous government intervention.

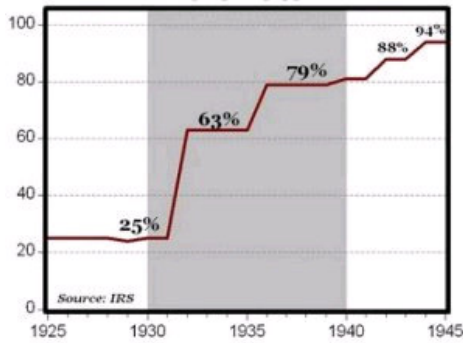
Political Blunders

Hoping to control the speculation, the political authorities and inexperienced Federal Reserve (1913) took some most unfortunate anticyclic measures. Today Most economists consider these as overdone. For free market economists the interventions were superfluous absurdities.

In an effort to control speculation, US government first banned bank loans for margin trades. Moreover the FED drastically raised its discount rate from 3.5% (Jan 1928) to 6% (Aug 1929). It caused an unexpectedly contraction of the money supply by a massive one third in the six months from August '29 till March '30. Markets reacted most vigorously. Stocks plummeted and asset prices crashed, causing a dramatic contraction of the real economy.



Marginal Individual Income Tax Rate
1925 - 1945



In an effort to remedy the accelerating recession the US Government then relied on protectionism. In the Smoot-Hawley act of 1930, the US raised import duties on 25,000 articles to an average rate of 65%. The American protectionism caused reprisal protective measures by most trading partners. The trade war that followed just killed international trade, with devastating effects on productivity and boosting unemployment to unprecedented levels.

Facing budget deficits as a result of declining revenues and increasing welfare demands President Hoover then decided to double income taxes. The 1932 Revenue act increased top tax rates from 25% to 63%. President Roosevelt later increased these rates even further to 79% and at one point even proposed a top tax rate of 99.5%. Moreover drastic reduction of most tax exemptions did particularly hurt middle income groups.

The 1932 landslide election victory of the democrats had sparked a true panic among savers. About three weeks before Roosevelt's inauguration, alarmed customers rushed to their banks to empty their accounts. These bank runs ruined numerous banks. On the day before Roosevelt took office, more than 5000 banks went under.



In an effort to halt the panic, Roosevelt two days after his inauguration declared a "bank holiday". For four days the nation's banks were closed and all financial transactions were halted. In the meantime the new president pushed the Emergency Banking Act through the legislative chain.



Roosevelt's Radio announcement of the bank holiday

Policy Unpredictability created a climate of fear.

Passed by Congress on March 9 1933, the Emergency Banking Act handed the president a far-reaching grip over bank dealings and foreign transactions. The act also allowed Roosevelt to seize peoples gold holdings, and devalue the dollar with 40%. The American devaluation set in motion a downward spiral of competitive depreciations by the trade partners all over the world, ruining the world trade and American exports even further. Only two months later the Agricultural Adjustment Act (AAA) was passed. In an effort to stabilise the depressed farming market and support food prices the act encouraged farmers to grow fewer crops and to destroy crops and cattle. As the crisis deepened ever further, panic spread to the political leaders. In an ever faster pace they declared new emergency measures.



The rapid succession and unpredictability of government interventions created a climate of legal uncertainty and deteriorated the poor business climate even further. Rapidly changing tax rates and subsidy regimes, regulations of wages, prices, interests and production were all government interventions on a scale the world had not known till then. The interventions created a general sence of uncertainty and fear. Faced with so much incalculable risk most industrialists decided to postpone investments till things had settled.

New Deal, bad Deal, with devastating Social Damage

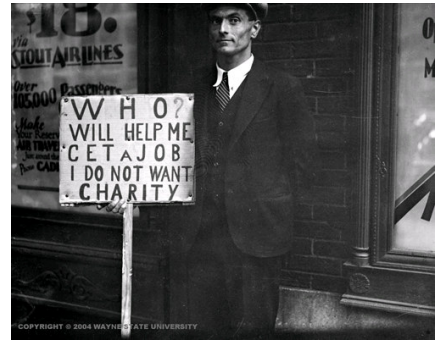
It was in deed not free market failure which produced the 1929 depression. It was interventionism and political bungling on a grand scale, with the one policy blunder succeeding the other: trade crushing tariffs, incentive-sapping taxes, mind-numbing controls on production and competition, senseless destruction of crops, coercive labor laws and not in the least the FED's mismanagement of the money supply.



The social cost of the political blunders was the severest crisis in history. Stocks fell to 10% of their pre-crash value, income fell by 28%, car sales fell by 75%, banks failed in record numbers, dragging down hundreds of thousands of customers. 13 million unemployed in the US causing poverty and rumors of revolt.

Conclusion

The specialists on the matter Murray Rothbard, Laurence Reed, Amity Shlaes unanimously agree: the great depression was not a crisis of capitalism but merely a crisis of interventionism. Politicians completely mishandled a mild recession. It was not market failure but the combined mistakes of Central Banks and Central Government. Irrational fear for deflation led them to distort the healing price mechanism. They prevented prices and wages from falling, hindering markets from adjusting to the new situation and finding a new equilibrium. The interventions caused such distortions that they lead to massive misallocation of scarce resources ultimately turning the natural slowdown of the business cycle into the deep depression.



Politicians and the FED would much better have left markets to themselves. The price mechanism guided by the collective wisdom of millions of individuals such as expressed in billions of free economic choices would have lead markets to a new equilibrium and stable prices in just a few quarters.

In his analysis "Great Myths of the Great Depression", Lawrence Reed convincingly demonstrates that Roosevelt's deficit spending did not boost demand at all. The massive resources spent in low productive public investments was merely outcrowding productive business investment as well as private consumption. In this way Roosevelt's Keynesian remedies of the socialist-style New Deal and the and excessive (near fascist) dirigism in the National Recovery Act (NRA) rather than remedying the 1929 crisis, prolonged it well into the 40's.

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<http://workforall.net>



Audio Podcasts on the great Depression

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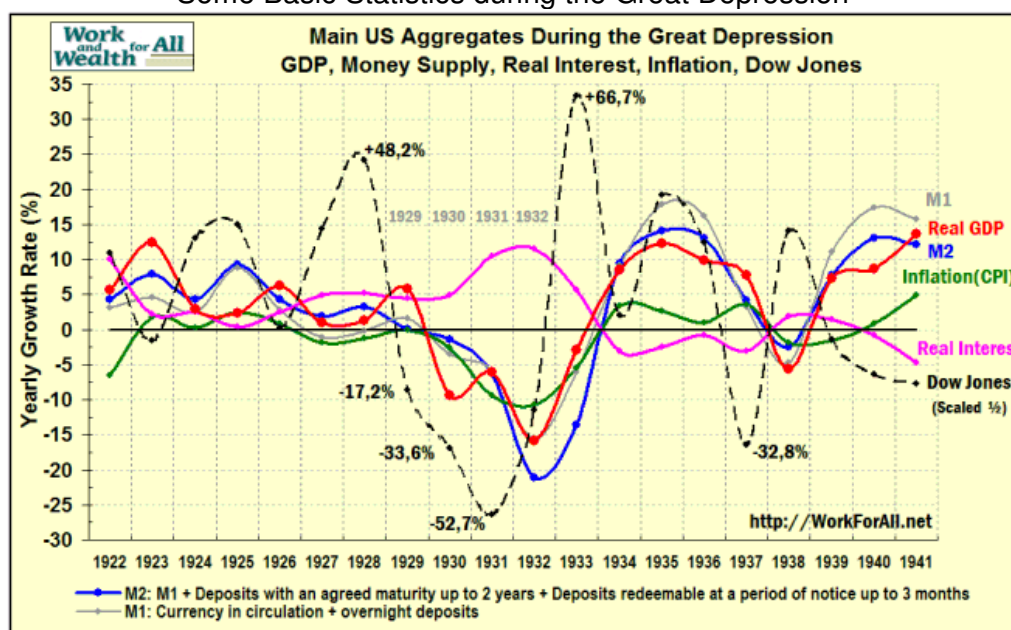


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Some Basic Statistics during the Great Depression



source <http://research.stlouisfed.org/wp/1997/97-011.pdf>

Year	Nominal GNP	% change	Real GNP	% Change	CPI	% Change	M1	% Change	M2	% Change	Bank Failures	Fail Deposits	Interest rate	Real Rate
	(1)		(2)		(3)		(4)		(5)		(6)	(7)	(8)	(9)
1920	88.9	11.93	73.3	-1.22	85.7	14.68	23592	9.80	34708	13.52	167	5.42	-9.26	
1921	74.0	-18.34	71.6	-2.35	76.4	-11.49	20955	-11.85	32212	-7.46	505	172188	4.83	16.32
1922	74.0	0.00	75.8	5.70	71.6	-6.49	21618	3.11	33646	4.36	366	91182	3.47	9.96
1923	86.1	15.14	85.8	12.39	72.9	1.80	22653	4.68	36411	7.90	646	149601	3.93	2.13
1924	87.6	1.73	88.4	2.99	73.1	0.27	23226	2.50	37992	4.25	775	210151	2.77	2.50
1925	91.3	4.14	90.5	2.35	75.0	2.57	25362	8.80	41691	9.29	618	167555	3.03	0.46
1926	97.7	6.78	96.4	6.32	75.6	0.80	26082	2.80	43539	4.34	976	260378	3.23	2.43
1927	96.3	-1.44	97.3	0.93	74.2	-1.87	25796	-1.10	44384	1.92	669	199329	3.10	4.97
1928	98.2	1.95	98.5	1.23	73.3	-1.22	25761	-0.14	45861	3.27	498	142386	3.97	5.19
1929	104.4	6.12	104.4	5.82	73.3	0.00	26189	1.65	45918	0.12	659	230643	4.42	4.42
1930	91.1	-13.63	95.1	-9.33	71.4	-2.63	25293	-3.48	45303	-1.35	1350	837096	2.23	4.86
1931	76.3	-17.73	89.5	-6.07	65.0	-9.39	23883	-5.74	42598	-6.16	2293	1690232	1.15	10.54
1932	58.5	-26.56	76.4	-15.83	58.4	-10.71	20449	-15.52	34480	-21.14	1453	706188	0.78	11.49
1933	56.0	-4.37	74.2	-2.92	55.3	-5.45	19232	-6.14	30087	-13.63	4000	3596698	0.26	5.71
1934	65.0	14.90	80.8	8.52	57.2	3.38	21068	9.12	33073	9.46	57	36937	0.26	-3.12
1935	72.5	10.92	91.4	12.33	58.7	2.59	25199	17.90	38049	14.02	34	10015	0.14	-2.45
1936	82.7	13.16	100.9	9.89	59.3	1.02	29630	16.20	43341	13.02	44	11306	0.14	-0.88
1937	90.8	9.34	109.1	7.81	61.4	3.48	30587	3.18	45195	4.19	59	19723	0.45	-3.03
1938	85.2	-6.37	103.2	-5.56	60.3	-1.81	29173	-4.73	44100	-2.45	54	10532	0.05	1.86
1939	91.1	6.70	111.0	7.29	59.4	-1.50	32586	11.06	47681	7.81	42	34998	0.02	1.52
1940	100.6	9.92	121	8.63	59.9	0.84	38763	17.36	54328	13.05	22	5943	0.01	-0.83
1941	125.8	22.35	138.7	13.65	62.9	4.89	45349	15.69	61296	12.07	8	3726	0.10	-4.79

- (1) \$ billions (Historical Statistics, F1)
 (2) \$ billions, 1929 prices (Historical Statistics, F3)
 (3) 1947-49=100 (Historical Statistics, E1 13)
 (4) \$ millions, June figure (Friedman and Schwartz, 1963, Appendix A1)
 (5) \$ millions, June figure (Friedman and Schwartz, 1963, Appendix A1)
 (6) suspended banks (Board of Governors, 1943, p. 283)
 (7) deposits insuspended banks (Board of Governors, 1943, p. 283)
 (8) yearly average yield on 3-6 month Treasury notes and certificates (1919-33) and bills (1934-41) (Board of Governors, 1943, p. 460)
 (9) short-term Government yield less CPI inflation rate insame year
 %change refers to year-to-year differences in the logs of the series to the left

source <http://research.stlouisfed.org/wp/1997/97-011.pdf>

more information from the FEDERAL RESERVE BANK OF ST. LOUIS