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Learning and Unlearning the Lessons of the Great Depression

As the Wisconsin school districts found out the hard way, banks and brokers can sell you dubious financial securities with little or no government oversight. This is not an accident. Financial institutions, in fact, are very good at resisting and undermining regulatory control. But sometimes by avoiding regulation, they create the conditions for their own meltdown.

As we've seen, the boom-and-bust cycle is a regular feature of our economic system. Major financial players seem to thrive with these gyrations, so long as they aren't too extreme. But in the absence of controls, the ups and downs can be cataclysmic. What if the bust is so deep that the entire economy collapses? Suddenly the ideology of deregulation gets tossed under the bus by even the staunchest of free-market advocates. This is precisely what happened during the Great Depression and is happening again in our current crisis.

We need to take a closer look at the Great Depression for several reasons. First, we may be heading there again. Second, in the 1930s our government enacted serious financial controls that for decades managed to put the kibosh on fantasy finance. And finally, scholars and policy makers are tackling today's financial crisis with lessons gleaned from the Great Depression. In fact, Federal Reserve chief Ben Bernanke, formerly a professor at Princeton, is a leading Great Depression scholar, and he views the current financial crisis through that prism. As Bernanke puts it, "I am a Great Depression buff, the way some people are Civil War buffs."[1]

By the time of the 1929 crash, the prevailing ideology was Social Darwinism (the survival of the fittest) fused with a laissez-faire approach to government. The boom-and-bust cycle was sometimes painful, but necessary—a way for capitalism to cleanse itself by getting rid of the weaker companies, taming labor, and thereby increasing overall efficiency and productivity. The strong would survive, prosper . . . and rule. This economic bleeding would strengthen our moral fiber and lead to the next boom. In his memoirs, Herbert Hoover attributed this harsh philosophy to Andrew Mellon, his wealthy treasury secretary. Hoover described Mellon and his followers as "leave it alone liquidationists" who "felt that government must keep its hands off and let the slump liquidate itself." Wrote Hoover:

> Mr. Mellon had only one formula: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate." He insisted that, when the people get an inflation brainstorm, the only way to get it out of their blood is to let it collapse. He held that even a panic was not altogether a bad thing. He said: "It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people. . . .[2]

It's not at all clear if Mellon actually said these things. Either way, Hoover's account provides an apt description of Social Darwinism at its cruelest.

During the 1920s, no one worried very much about an economic depression. America, now the world's largest creditor nation, seemed to have found the key to permanent prosperity. It was fueled by mass consumerism, rising productivity, thousands of new inventions, scientific management, and abundant natural and human resources. Rising debt seemed like a blessing rather than a curse. The "consumer" was invented during this period—

and so was the installment plan. It is estimated that by 1926, "65 percent of motorcars were purchased on installment credit. Department stores sold over 40 percent of goods on credit."[3] In the Roaring Twenties buying on margin became endemic. As stocks rose, you could borrow against them to buy more stocks, which in turn pushed the stock prices up even higher. Serious scholars during those years marveled at the boom and more than a few felt it would never end—that capitalism had finally escaped the boom-bust cycle.[4]

In the buildup to the crash, we can spot the usual suspects: easy credit, market manipulation, few regulatory safeguards, and a large dose of herd euphoria. But people felt confident anyway. For one thing, they thought the Federal Reserve, formed in 1913, would prevent a serious panic by adjusting the money supply, supervising the banking community, and halting bank runs.

People were not prepared for the financial bust—much less the utter devastation that followed in the "real" economy. To many it looked as though Karl Marx's prediction of capitalism's demise had finally come true. Not only did the stock market lose approximately 90 percent of its value in the space of two years, but the gross national product declined by half and more than a quarter of the nonagricultural workforce lost jobs. No economic system could endure such devastation for long. And no sensible nation would allow such a crisis to ever happen again.

The shock of the Depression led to a new "common sense" understanding among most academics and policy makers, as well as the public: The government had to regulate, and regulate heavily, to keep the economy from running amok. John Maynard Keynes, arguably the era's leading economic theorist, provided the lens through which most of post-Depression America viewed financial markets: "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes a bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill done."[5]

Andrew Mellon's "liquidationist," anti-regulation, social Darwinian, laissez-faire ideology was dead. The New Deal era consensus was that finance needed intensive regulation or it would destroy itself, taking the rest of us with it. The government created a slew of agencies and programs to protect us all from fantasy finance. The Securities and Exchange Commission regulated the stock market. The Federal Deposit Insurance Corporation protected individual bank accounts against bank runs and failures.[6] The Glass-Steagall Act of 1933 erected a firewall between investment banking and commercial banking to protect businesses and consumers from financial speculation and manipulation. The Federal Housing Administration enabled people with modest incomes to buy their own homes. And for the first time, bankruptcy laws were extended to average wage earners.

During the Depression, the financial "cauldron of innovation" came not from the free-market casino but from the government. Take the financial instrument called the mortgage. It had been kicking around since the twelfth century. English common law held that anyone who loaned money to you for a property had a claim on that property if you did not repay the loan. By the turn of the twentieth century in the New World, the terms of private-sector mortgages were exceedingly stringent. To get a home mortgage, you usually had to come up with a 50 percent down payment as well as interest payments over the next five years. At the end of the five years the loan balance came due in full, often forcing the borrower to find yet another five-year loan. As a result, home ownership was limited to those with means. So for nine hundred years, private financial markets were unable to reap the profits of mass home financing.

The housing market collapsed entirely during the Depression. The New Deal forcefully resurrected it by creating the long-term, fixed-rate, self-amortizing mortgage, and guaranteeing the loans of buyers who met certain guidelines. The New Deal's Home Owners' Loan Corporation introduced the fifteen-year

mortgage. The Federal Housing Administration then offered twenty-year terms. In the 1950s, the standard term increased to thirty years. Home ownership was finally within the grasp of the general population. And the government, not the private sector, had invented the financial instrument that made it all possible. (Sneak preview: When the private sector finally gets back to applying its creativity to the mortgage market, all hell breaks loose.)

The Depression so frightened America from top to bottom that most people welcomed the heavy hand of government to protect the economy from even deeper collapse. The government's draconian economic controls during World War II further legitimized strong federal supervision. It seemed that the power of financial markets was forever tamed.

Over time, however, the fast developing world economy would undercut the New Deal regulatory regime. It would take about fifty years, but the power of money-making-money prevailed. Eventually, the casino reopened.

Currency exchange rates were both the symbol of strict financial controls after World War II and the key battlefield. The allied leaders who gathered in Bretton Woods, New Hampshire, in July 1944 understood that the new postwar system would only work if global capital flows were tightly controlled. They feared currency speculation,[7] which they'd seen plenty of during the Depression. They recognized that allowing corporations, investors, and speculators to zing money from country to country to game the currencies was destabilizing. So they set the value of global currencies in dollars, pegged the dollar to gold at $35 an ounce, and instituted strict capital controls from country to country.

This system held together until 1970 or so. But then fixed exchange rates began to present a problem. Europe and Japan were rebuilding rapidly, fueling a rise in trade and renewed world

competition. The cost of containing communism kept climbing, and wars were breaking out all over. The United States pumped out billions of dollars for operations in Vietnam and around the globe. By 1971, the world was awash with dollars. Inflation was mounting and a run on U.S. gold seemed imminent.[8]

In response to all this, President Richard Nixon instituted World War II–like wage and price controls to constrain inflation. He also freed the dollar from the gold standard. The Bretton Woods era was over. The international arena was opened again to fast-moving funds, and once again speculators had plenty of room to maneuver.

But the memory of the Depression was still strong, and many New Deal regulations and attitudes held, constraining the U.S. financial sector. Meanwhile, the sixties revolt against authority was sowing new doubts about the private sector. In the movie *The Graduate*, the businessman whom Dustin Hoffman was cuckolding had one word to say to him: "plastics." The audience got the joke—modern corporate life was artificial and consumer life was shallow and trite. Like plastic, corporations had no soul. The cultural climate was not conducive to the financial casino.

Enter Milton Friedman. It would be an exaggeration to say that the University of Chicago economist single-handedly undermined New Deal ideology and repelled the New Left's assault on consumerism. But he certainly led the way.

With war raging and the environment under siege, many people, young and old, thought that corporations needed to become more "socially responsible." Friedman was appalled, especially when he saw some corporate leaders succumbing to such ideas. Friedman believed that capitalism was the best and only protection for individual freedoms—and yet it seemed to him that no one was willing to stand up for it. (He so detested government interference in the economy that he even opposed the existence of the Food and Drug Administration.) In a widely read *New York Times Magazine* article published on September 13, 1970, Friedman rejected "the present climate of opinion,

with its widespread aversion to 'capitalism,' 'profits,' the 'soulless corporation.'"

Like Adam Smith, Friedman argued that capitalism worked best when each person and enterprise was free to pursue maximum profit. Any additional economic goals, he said, would be foolish and dangerous. Pursuing profit made markets efficient, and through the invisible hand, enabled society to prosper. Furthermore, these profit-making pursuits protected society from "the iron fist of government bureaucrats." Freedom and economic necessity demanded that the government stay out of the economy. As Friedman put it: "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."[9]

But Friedman had his sights set on more than just the New Left and its semi-socialistic ideologies. He saw the entire New Deal as perilous to both the free market and individual freedom. He knew that to defeat the intrusive regulatory regime, he had to undermine the prevailing common sense about the causes of the Great Depression. People would continue to cling to New Deal controls if they thought that abandoning them would cause another crash.

Friedman tried to refute the whole idea that the Great Depression was caused by fundamental flaws of capitalism—the same flaws predicted by Marx and other leftist economic scholars. Many economists, even nonsocialists like Keynes, thought the Depression proved that capitalism was prone to cataclysmic cyclical crises. The crises were due to overproduction of goods that couldn't be sold, or to the underconsumption of goods that workers couldn't afford when their wages were depressed, or to the inherent instability within financial markets. This view of capitalism had led to reforms that, in Friedman's mind, shackled the capitalist spirit, hampered free markets, and threatened individual freedoms.

Friedman and coauthor Anna Schwartz argued in their ground-breaking book, *A Monetary History of the United States, 1867–1960*, that the economy collapsed in the 1930s not because of systemic faults, but rather because of human error: the Federal Reserve's poor management of the money supply. The problem was not the "internal contradictions of capitalism," but rather the Fed's tight money policies during and after the stock market boom.

Current Fed chairman Ben Bernanke fully supports this line of reasoning. As he put it in 2002,

> The correct interpretation of the 1920s, then, is not the popular one—that the stock market got overvalued, crashed, and caused a Great Depression. The true story is that monetary policy tried overzealously to stop the rise in stock prices. But the main effect of the tight monetary policy, as Benjamin Strong had predicted, was to slow the economy—both domestically and, through the workings of the gold standard, abroad. The slowing economy, together with rising interest rates, was in turn a major factor in precipitating the stock market crash.[10]

Friedman's revisionism was music to the ears of 1980s conservatives like Ronald Reagan and British prime minister Margaret Thatcher. During his administration (1980–88), Reagan proceeded to "unleash" the private sector, dismantling all manner of New Deal controls, and crippling labor unions along the way.

The Reaganites also reorganized the tax structure to allow more wealth to accumulate at the top. Under the newly minted theory of the "Laffer Curve," tax cuts would spur economic growth, which would increase federal revenue rather than deplete it. Prosperity would trickle up, down, and around for all. If the tax cuts caused a short-term jump in government debt, so be it. That would provide fiscal pressure to eliminate New Deal and Great Society programs that reduced the incentive to work and shackled free markets.

A remarkable statistic from the Reagan years shows just how well the tax cuts transferred wealth to the superrich. From 1983 to 1989, the top 0.5 percent of all families saw their combined wealth increase by $1.45 trillion, while the wealth of the bottom 40 percent of families went down by $256 billion. Remarkably, during those same years the federal debt rose by $1.49 trillion.[11] It was as if the entire federal debt had been awarded directly to the superrich. The financial casino now had the capital it needed to spin the wheel—as well as the freedom from regulation.

In fact, conditions were absolutely ripe for a new era of fantasy finance. Astute traders realized that all the new wealth that the rich had poured into the market needed to be deployed. Those who could offer high returns to the wealthy could themselves become fabulously wealthy.

As the Reagan administration eased antitrust regulations, leveraged mergers and acquisitions (buying up companies with borrowed money) became the rage. Companies were chopped up, shut down, and auctioned away, and investors took home the loot. People still argue about whether these mergers and acquisitions helped to modernize the American economy or undermine it. Certainly they hastened the decline of manufacturing in this country. Very often the buyouts were unproductive. There are shelves of books describing in graphic detail the pillaging of the industrial landscape, the junk bond high jinks of Michael Milken, and the indictments that rained down on some of the players. It's now clear that all that was just a sideshow to the main entertainment of fantasy finance.

President Reagan opened a new, lucrative casino when he deregulated savings and loans banks. The New Deal had clamped fairly strict regulations on what savings banks could and could not do. They were supposed to take in savings and give out home mortgages. The interest rates they could pay on deposits had a ceiling. Tight regulations governed how much of their

money they could lend to commercial enterprises and more risky investments.

In the 1980s, pressure from the banking community, the changing economic landscape, and the prevailing antiregulatory ideology enabled Reagan administration officials to drop many of these restrictions. Now these thrift institutions could attract more funds by offering higher interest rates and make far riskier loans, especially in the booming commercial real estate market.

Before we get too far into the story, we need to meet another troublesome financial innovation: "moral hazard," a term borrowed from the insurance industry. If I have full insurance on my bicycle, I might not lock it up properly since it's not such a big deal (to me) if it's stolen—the insurance company will replace it. So, at least in theory, more insurance could lead to lazier bicycle riders—a moral hazard—who enable more bicycle thefts. In finance, the bicycle is risk. If I know I will be bailed out if I assume risk and fail, I'll assume more and more risk and let you bail me out if I fail.[12] Free-market conservatives use this to argue that we should let enterprises fail even if it causes short-term pain for society as a whole. They believe that after a relatively short period of time, the economy will right itself and be stronger than ever. And most importantly, the gamblers will not have been rewarded and the moral hazard is dampened as we move forward. (When we're talking about one or two banks at a time, that makes sense. When we're talking about the entire financial industry as a whole, it could take a decade and a world war to end a depression as it did in the 1930s.)

Here's the connection to the savings and loan banks (S&Ls). In addition to regulations on savings-bank practices, the New Deal also protected the millions of Americans who put their money in savings banks. The banks were required to follow prudent lending rules. At the same time, savings accounts of up to a certain amount were insured by the FDIC. For decades, savings and loans provided modest but secure returns for savers, and made secure housing loans that helped fuel the postwar housing boom.

The deregulations under Reagan allowed the S&Ls to offer higher interest rates and make more speculative loans and investments. However, even the free-market ideologues knew better than to eliminate the FDIC guarantees on savings. That could lead to depositor losses, bank runs, and financial panic. Instead the Reaganites got the FDIC to *increase* the level of deposit it would insure, further increasing the appeal of the S&Ls. Entrepreneurs immediately recognized that savings banks could become private money machines with very little downside. You could start or take over a bank, attract lots of customers with your higher interest rates, dramatically expand the balance sheet with risky investments, spend lavishly on yourself, and yet be able to tell customers that their money was safe and sound, FDIC insured. It was a whopper of a free-market moral hazard.

With the upside interest-rate regulations lifted, a host of casino players got into the business, opening up savings banks, enticing depositors with very attractive rates, and then placing bets on commercial development projects all over the country. Along the way they used the bank's money like a private piggy bank, buying planes, art, condos, and other personal booty. During the mid-1980s, U.S. savings banks were the best financial casino on the globe.

Then they went bust—in predictable ways. As savings and loan money flooded into commercial real estate, a construction boom led to overproduction of shopping centers and office complexes. Eventually the supply outstripped the demand. The bubble burst, leading to the collapse of more than one thousand savings and loan institutions. The government had a mess on its hands.

When the thousand or so banks failed, a few looters got nabbed, but most of the wily entrepreneurs walked away unharmed and vastly richer. The government took over the banks and their devalued assets, and protected the individual deposits as promised. Over the next decade the government sold off the assets. Taxpayers footed the $200 billion bill. Moral hazards always come at a price.

You'd think the S&L crisis would have given pause to the deregulatory orthodoxy. Not a chance. By the end of the Reagan era the casino was still wide open for business.

Looking back, you can see how the savings-and-loan moral hazard would lead eventually to bigger and bigger bailouts. The principle was now firmly established: We can't afford to let the system collapse even if it means bailing out thousands of venal, greedy entrepreneurs who have gambled their venture into the ground, grabbing riches along the way. We must bail out even the reckless, because it protects the innocent as well.

As the financial sector grew, the serious players knew that the government wouldn't let them fail—even if key investors and traders were not specifically covered by government insurance or regulations. Moral hazard was built into the system. Individual banks and financial companies might fail, but to protect all of us from a systemic meltdown, the feds would have to come to the rescue. The combination of deregulatory ideology and moral hazard was hypocritical: If you're a winner, it's a free market. If you lose big, we bail you out. Who wouldn't bet heavy in that kind of casino?

By the end of the Reagan years, vast pools of wealth were forming as astute investment managers generated enormous returns of 25, 30, 40 percent or more, year after year. Hedge funds, which had been minor players since they emerged in the 1950s, became much more popular with millionaire investors like George Soros and grew in influence. (Pension funds and college endowments would also become heavy investors in these unregulated funds.)

During the New Deal such outlandish returns would have been held suspect and investigated. But in the new deregulatory era there was a far greater acceptance, even admiration, for the fast-growing financial investments of the superrich. Wouldn't we all have liked to get a piece of that casino action?

Our government financial watchdogs argued that the government had no business regulating these funds because they were only for the rich and for large institutional investors—the general

public was not at risk. If the rich and institutional investors wanted to play in this high stakes casino that was their right. More than that, the idea was that government regulation would get in the way of the market-based regulation investors would impose on their own. Or as Alan Greenspan put it, "Indeed, institutional investors have accounted for a growing share of hedge fund investments, and they can and should protect their own interests rather than rely on the limited regulatory protections. . . ."[13]

With so much wealth sloshing around at the top, it was only a matter of time before clever financial traders developed new money-making-money products that promised ever higher returns. And with deregulation in full throttle there were few pesky government officials around with the time or inclination to question the soundness of those instruments, or the systemic risks they created.

Welcome to the brave new world of derivatives.