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The Great Crash: Past and Present: Can There Be Another Crash?

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Can There Be Another Crash?

WALTER W. HELLER

Institutional improvements and advances in fiscal and monetary management make it unlikely that we'll have another crash. But supply-side problems, due to the oil situation and the rise of a new mercantilism, are a matter of concern for the future.

In the early 1930s, not just the stock market, but much of our national financial structure came tumbling down around our ears. The stock market slipped from its 1929 peak of 381 on the Dow Jones Industrial Average to a 1932 low of 36. In 1929-33, banks failed by the thousands, 9,765 in all. The money supply shrank by a third. The liquidity hinge of the twenties turned into the liquidity squeeze of the thirties.

Nothing illustrates more vividly "why government gets in the act" than the free-wheeling and freebooting stock market of the 1920s and the devastating string of bank failures in the 1930s. It was the age of the unfettered free (stock) market. No requirements to register stock, no disclosure rules, no limits on who could lend money to brokers, no margin requirements, no legal barriers to stock price manipulation, no limits on conflicts of interest between banks and their securities-firm affiliates.

For all practical purposes, these abuses were ended by legislation enacted in 1933-34 that set up the Securities and Exchange Commission to police the securities industry, separated commercial and investment banking, required registration and dis-

The late WALTER HELLER contributed this article to the March-April 1980 issue of *Challenge*. At that time he was Regents' Professor of Economics at the University of Minnesota and had been Chairman of President John F. Kennedy's Council of Economic Advisers.

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closure for stocks sold to the public, prohibited manipulation, and gave the Federal Reserve Board responsibility for setting margin requirements and regulating stock market credit. Few would deny that it is better to put up with the government presence—in the form of SEC and banking regulators, even if a bit overbearing or overzealous—than to let the buccaneers and bucket shops fleece the public, feed the speculative frenzy, and rock the economic boat as they did fifty years ago. To be sure, a secretary at Hardee's Food Systems can still turn a $46,000 profit on advance knowledge of a takeover offer, but that's a far cry from the hundreds of millions pocketed by the likes of Samuel Insull from his utility holding company pyramid, Albert Wiggin from short-selling the stock of his own Chase National Bank, and the President of the New York Stock Exchange, Richard Whitney, from embezzlement. (Like Whitney, by the way, the secretary was caught.)

Wall Street is a different world in a much deeper sense as well. It played a much more central role in the soul and psyche of the American economy in the "bad old days." Market performance was front-page news again and again in 1929-30, and when the market fell flat, it was a body-blow to public confidence. The central role of the market went far beyond psychological impacts. For example, 80 percent of all stock and bond financing in 1928-29 was derived from new stock issues. In 1978, the percentage was down to 12 percent. The direct impact on consumption was very much greater then than now: fifty years ago, it is estimated that the wealthiest 5 percent of American families—the main investors directly hit by the market crash—controlled over 30 percent of consumer purchasing power. Thanks mainly to economic growth and reduced inequality of opportunity and income, the proportion of total consumption related to the stock market is far less today. The ease of raising money in the stock market also led to some of the debilitating imbalance between investment and consumption in the 1920s. While output of mass consumer goods rose at less than a 3 percent annual rate in the 1920s, capital goods output increased at an annual average rate of over 6 percent. This disparity was related in part to the insatiable appetite for new stock issues but even more to the booming profits growing out of a 43 percent jump in worker productivity in the 1920s while wages rose only 20 percent. Support of consumer income through both more generous wage increases and over $200 billion annually of government transfer payments has made those disparities a thing of the past.

The stock market crash triggered a staggering liquidity squeeze—not just a liquidity crunch of the 1974 variety but a wrenching one-third shrinkage of the money supply from 1929 to 1933 interwoven with the dominoes effect of nearly 10,000 bank failures, the unwillingness of the Federal Reserve to be a lender of last resort to major financial institutions, and a worldwide financial crisis that brought its own downward spiral of liquidity and widespread defaults by overseas borrowers from American banks and bondholders. Today's built-in defenses against such contingencies are impressive. The Federal Reserve knows better than to let money shrink as it did in the thirties, and its willingness to serve as lender of last resort has forestalled any chain reaction from a Franklin National or Herstatt bank failure or a Penn Central bankruptcy. Insurance of bank deposits up to $40,000 per depositor by the Federal Deposit Insurance Corporation is a safeguard of critical importance. International cooperation through central bankers and the International Monetary Fund, Organization for Economic Cooperation and Development (OECD), and other international agencies reduces (though it does not remove) the dangers arising from our international financial system.

The great depression

Aside from financial factors, one must rate the progress in economic understanding and measurement, the advances in fiscal and monetary management, the increase in the size and the scope of government, and the structural changes in the U.S. economy as major forms of insurance against the kind of demand collapse that produced that dolorous decade of unemployment averaging over 18 percent and reaching a peak of 25 percent.

The perversity of government tax, budget, monetary, and trade policies in the early thirties has to be recalled in chapter-and-verse terms to be believed. Our fiscal policy levers, for example, were put in reverse. The Keynesian concept of demand management and fiscal activism had not been born. Witness

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the petition by 62 members of the Johns Hopkins University faculty inserted in the *Congressional Record* on June 1, 1932: "The two primary and essential measures called for by the present situation are evident. The first is the prompt adoption of a budget balanced both by vigorous retrenchment in the expenditures of all Federal departments and by adequate emergency taxation."

Responding to widespread calls for a balanced budget and the specific tax proposals of President Hoover, the Congress in 1932 reduced income tax exemptions, boosted personal tax rates from 1.125 percent to 4 percent in the bottom bracket and from 25 percent to 63 percent in the top bracket; boosted taxes on corporations; and introduced "temporary" excise taxes on electric energy, gas and oil, automobiles, selected durable goods, telephones, furs, jewelry, and so on (most of which were finally removed in 1965). True, after the initial budget retrenchment, both federal spending and federal deficits rose substantially during the Roosevelt administration. But a federal budget running at only 3 percent of GNP at the beginning of the decade and under 10 percent at the end was no match for the forces of depression.

One need not dwell at length on the fiscal revolution that has changed all this. Part of it is simply the greater leverage provided by a larger federal government, now constituting roughly 21.5 percent of GNP. And federal, state, and local governments now provide about 20 percent of all nonfarm jobs, against 10 percent fifty years ago (such jobs would tend to grow, not shrink, in a sustained slump). With the growth of government have also come changes in the structure of both taxes and spending that cushion downturns. Reliance on such automatic stabilizers as progressive income taxes plays a considerable role in this cushioning (though the impact of inflation in pushing up money incomes even when real incomes fall has blunted and occasionally reversed the effect). The growth of income maintenance programs, ranging from food stamps to unemployment compensation to public assistance to social security benefits—now running something like $225 billion a year against zero fifty years ago—provides landing nets under the incomes of a large fraction of the population. A one percent increase in unemployment triggers roughly $18 billion of increased transfer payments and reduced tax liabilities. Apart from these automatic effects, the positive use of tax cuts, jobs programs, and the like, represent an important defense against any collapse of aggregate demand, such as that which occurred in the 1930s.

Contrasts also abound in other areas of policies and economic structure. Against the drastic decline in money supply in the Great Depression, even a Volckerised monetary policy today has a rising, not a falling, money supply as its annual target. The objective is restraint, not self-destruction. The Smoot-Hawley Tariff Act of 1930 is another case in point. Precisely at the time when the United States should have been letting its debtors export more so that they could pay their debts, and precisely at the time when our leadership in keeping markets free was desperately needed, we erected high tariff walls and touched off a worldwide tariff war. We depreciated the dollar and torpedoed the World Economic Conference in London. International economic cooperation, not just in monetary affairs but in lowering tariff walls and maintaining consultation and some coordination through economic summits, has come a long way in the past fifty years. Today's job structure in the U.S. economy is also much less conducive to a steep slide in the economy. In 1929, two-thirds of the labor force worked in industries that produced or transported goods, while only one-third worked in service industries. Today, the recession-responsive goods industries provide only one-third of the total jobs, while the more stable service industries provide two-thirds.

Sources of unease

Is another slump of the magnitude and duration of the Great Depression—presumably from different sources and less amenable to the defenses and safeguards I have just reviewed—a realistic prospect in the foreseeable future? A possibility? Perhaps. A likelihood? No. And yet, it is appropriate to examine all contingencies, even the apocalyptic ones. Let me characterize my three areas of unease as follows:

• A demand debacle of the thirties is inconceivable. A supply debacle of the eighties is not.

• An unemployment disaster of the thirties is unthinkable. An inflation disaster of the eighties is

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unlikely but not unthinkable.

• An epidemic of economic nationalism—the blind protectionism, Schachtian exchange controls, autarchy, and beggar-thy-neighbor policies of the 1930s—is next to unthinkable. But a rising tide of what might be called modern economic mercantilism—the use, not of the tariff bludgeon, but of more subtle and devious devices like competitive interest rate escalation, currency devaluations, voluntary quotas, and non-tariff barriers—remains a disturbing possibility.

The potential supply debacle basically boils down to one word: oil. A major, sustained cut-off of Mideast oil could, for a time at least, plunge us into a supply-side depression. Any sizable and persistent disruption of supplies—whether from acts of sabotage or terrorism or from political turmoil in Iran, or unrest among the Shiite Moslems in Iraq, or the whims of Qaddafi in Libya, or Saudi-Arabian displeasure with our Palestinian policy—would cut deeply into our productive capabilities and even more deeply into those of our trading partners. It is difficult to quantify the threat, but if one is looking for the most readily identifiable source of deep trouble for the U.S. economy, there it is. If it were to occur, it would put the international cooperative mechanism and spirit of the free world to a severe test. The logical response would be to band together ever more closely in order to control and limit the damage. But the dangers of a falling out and a new burst of economic nationalism should not be discounted.

That brings us to the second source of latent danger, the tensions that are building up in international money and trade markets, tensions that are magnified by the large and growing OPEC surplus. Although the industrial world completed the Tokyo Round in the face of strong protectionist pressures, the temptations to impose new trade restrictions either directly or through currency devaluation remain strong. Even with rising exports, economic slowdown, and the prospect of a current-account deficit in the United States, the dollar remains vulnerable to the widespread desire to diversify into other currencies. No matter how much we respond to the demands of central bankers and other authorities abroad to exert "self-discipline," the urge to reduce dollar holdings will continue to threaten the exchange value of the dollar. In exercising that self-discipline by boosting interest rates and tightening credit, the Federal Reserve has reduced the odds on a flight from the dollar but increased the odds on a worldwide escalation of interest rates. Interest rate warfare would spell slower growth everywhere.

I see no early end to the stresses and strains and jockeying for position on the international economic front. It will get worse before it gets better. But I don't expect the industrial world to repeal fifty years of progress in international economic cooperation and ethics and return to the unseemly nationalism of the early thirties.

That brings us to the most vexing problem immediately before us, namely, our stubborn double-digit inflation. In spite of some of the lowest government deficits and highest interest rates in the industrial world, in spite of the sharp swing toward fiscal restraint we are now undergoing, and in spite of a good record in restraining average wage increases in the first year under the wage-price guidelines, this country has been making progress backwards on inflation. Under the drive of a 60 percent rise in world oil prices and sharp increases in the prices of food and home ownership—inflation sources that largely lie outside the scope of either voluntary restraints or mandatory controls—inflation has been solidly in the double digits in 1979. Under the impact of coming recession, hoped-for tapering of oil price increases, large grain crops, and eventual topping out of mortgage rates, inflation should drop out of the double digits by the end of winter and fall to 8 percent or less by the end of 1980.

What is neither widely realized by our overseas critics nor fully appreciated here at home, is that government finances of recent years are not the source of the trouble. Government has been shrinking as a percentage of GNP since 1975, when federal-state-local spending was 35 percent of GNP. It is 32.5 percent today. OECD comparisons show U.S. budget deficits (federal, state, and local combined) as the lowest of any major industrial country for the three years 1977-79: less than one percent of GNP against 3 percent in Germany, 6 percent in Japan, and 12 percent in Italy. More specifically, with double-digit inflation in view, the federal budget is programmed for sharp fiscal restraint. With an "inflation tax" of over $10 billion a year, with social security payroll taxes rising $18 billion in 1979-81, and with an expenditure squeeze of perhaps $20

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billion in these years (representing cutbacks in the trend increase in expenditures), we are undergoing a swing of over $60 billion toward fiscal restriction in 1979-81. The OPEC oil drag or tax (including domestic price decontrol) is siphoning an added $30 billion net out of the economy this year, a drag that may double by 1981.

I am not-so-subtly suggesting that, quite consistent with a continued assault on inflation, we will have to remove some of this tax overburden before 1980 is out.

Tax cuts or no tax cuts, one cannot be complacent about inflation. Since I first said ten years ago that "inflation has sunk its roots deep in the U.S. economy," it has in fact sunk its roots deeper and deeper. And every round in the battle against inflation finds it higher and higher. And yet I do not expect the U.S. economy to be brought to its knees by hyperinflation. I say this in part because I believe the conditions in the 1980s to be more favorable to holding inflation in check.

But as a fallback position, I believe that if all efforts of guided self-restraint should fail, and inflation continues to escalate, the country will choose mandatory controls before it jumps off the precipice to another Great Depression. As a steadfast opponent of such controls, I say this reluctantly. But at some point, still far down the road, the country may find that the costs of a rampant inflation—or the alternative costs of taking the fiscal-monetary cure via years of stagnation or even depression—are greater than even the heavy costs of a period of mandatory controls. At that point, well short of the precipice of runaway inflation or deep depression, one would call on the heavy hand of such controls to bring the self-propelling price-wage spiral or carousel back into a lower orbit. If fiscal-monetary moderation went hand-in-hand with the enforced de-escalation of the vitiating circle of pay-price or price-pay increases, the controls could be removed after a limited period without a self-defeating pop-up effect. I do not advocate the course I have just outlined. But if it came to the point that only such a course stood between us and runaway inflation or induced depression, I might join the infidels.

A brief look into the 1980s

As one looks into the eighties, one cannot readily dismiss the heavy shadows of stubborn inflation, possible oil cut-offs, and world instability. But those heavy clouds should not be permitted to blot out the considerable rays of economic sunshine that may brighten the U.S. scene in the coming decade.

First of all, demographics will be working for us. A maturing labor force will make for a better productivity performance. Workers in the 25-44 age group—the prime age group in terms of skills, ambition, and growing experience—will increase to more than 60 million against 47 million today. At the same time, the influx of inexperienced teenagers and women into the labor force will slacken. Against a 21 percent increase in the labor force in the 1970s, we will have only a 12 to 14 percent increase in the 1980s.

Productivity should be given another boost as capital investments step up in the 1980s. The substitution of labor for capital that took place in the seventies should be reversed in the eighties. The demographic thrust will be reinforced by government policies that are favorable toward investment. For example, more generous depreciation is almost a foregone conclusion as part of the next tax cut. Moreover, in the latter half of the eighties, the high-spending members of the post-war baby boom will be graduating into the higher-saving ages.

The genuine efforts to cut back economic regulations that stifle competition and cut the costs of social regulations to protect health, safety, and environment will be paying off in the 1980s. Stronger competition and lower compliance costs will provide at least some modest help in the battle against inflation.

Finally, it is to be constantly kept in mind that as we face the problems of the 1980s, we still draw on the strongest economy and the highest standard of living in the world. And as everyone knows who has traveled overseas recently, we are also a country of bargains—our consumer goods, most of our real estate, and our business enterprises offer outstanding buying and investment opportunities to the rest of the world. This should bring in considerable foreign capital to the United States of the eighties and, in the process, strengthen the dollar.

With reasonably good policy and reasonably good luck, the Great Crash and the Great Depression will return to their accustomed position as dim memories of a buried past.

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