Reliving the Crash of ’29: How Hoover’s Policies Blazed the Trail for FDR and Wrecked the US Economy

by Murray N. Rothbard

A half-century ago America – and then the world – was rocked by a mighty stock market crash that soon turned into the steepest and the longest-lasting depression of all time. Only the cataclysm of World War II was able to pull the Western world out of the Great Depression. It was not only the sharpness and depth of the depression that stunned the world and changed the face of modern history: It was the length, the chronic economic morass persisting throughout the 1930s, that caused intellectuals and the general public to despair of the market economy and the capitalist system. Previous depressions, no matter how sharp, generally lasted no more than a year or two. But now, for over a decade, poverty, unemployment, and hopelessness led millions to seek some new economic system that would cure the depression and avoid a repetition of it.

Political solutions and panaceas differed; for some it was Marxian socialism; for others, one or another form of fascism. In the United States the accepted solution was a Keynesian mixed economy or welfare-warfare state. Harvard was the focus of Keynesian economics in the United States, and Seymour Harris, a prominent Keynesian teaching there, titled one of his many books *Saving American Capitalism*; that title encapsulated the spirit of the New Deal reformers of the thirties and forties. By the massive use of state power and government spending, capitalism was going to be saved from the challenges of communism or fascism.

One common guiding assumption characterized the Keynesians, socialists, and fascists of the 1930s: that laissez-faire, free-market capitalism had been the touchstone of the U.S. economy during the 1920s, and that this old-fashioned form of capitalism had manifestly failed us by generating, or at least allowing, the most catastrophic depression in history to strike at the United States and the entire Western world. Well, weren’t the 1920s, with their burgeoning optimism, their speculation, their enshrinement of Big Business in politics, their Republican dominance, their individualism, their hedonistic cultural decadence, weren't these years indeed the heyday of laissez-faire? Certainly that decade *looked* that way to most observers, and hence it was natural that the free market should take the blame for the consequences of unbridled capitalism in 1929 and after.

Unfortunately for the course of history, the common interpretation was dead wrong: There was very little laissez-faire capitalism in the 1920s. Indeed the opposite was true: Significant parts of the economy were infused with proto-New Deal statism, a statism that plunged us into the Great Depression and prolonged this miasma for more than a decade.

In the first place, everyone forgot that the Republicans had never been the laissez-faire party: On the contrary, it was the Democrats who had always championed free markets and minimal government, while the Republicans had crusaded for a protective tariff that would shield domestic industry from efficient competition, for huge land grants and other subsidies to railroads, and for inflation and cheap credit to stimulate purchasing power and apparent prosperity. It was the Republicans who championed paternalistic Big Government and the partnership of business and government while the Democrats sought free trade and free competition, denounced the tariff as the "mother of trusts," and argued for the gold standard and the separation of government and banking as the only way to guard against inflation and the destruction of people's savings. At least that was the policy of the Democrats before Bryan and Wilson at the start of the twentieth century, when the party shifted to a position not very far from its ancient Republican rivals.

The Republicans never shifted, and their reign in the l920s brought the federal government to its greatest intensity of peacetime spending and hiked the tariff to new, stratospheric levels. A minority of old-fashioned "Cleveland" Democrats continued to hammer away at Republican extravagance and Big Government during the Coolidge and Hoover eras. Those included Governor Albert Ritchie of Maryland, Senator James Reed of Missouri, and former Solicitor General James M. Beck, who wrote two characteristic books in this era: *The Vanishing Rights of the States* and *Our Wonderland of Bureaucracy*.

But most important in terms of the Depression was the new statism that the Republicans, following on the Wilson administration, brought to the vital but arcane field of money and banking. How many Americans know or care anything about banking? Yet it was in this neglected but crucial area that the seeds of 1929 were sown and cultivated by the American government.

The United States was the last major country to enjoy, or be saddled with, a central bank. All the major European countries had adopted central banks during the eighteenth and nineteenth centuries, which enabled governments to control and dominate commercial banks, to bail out banking firms whenever they got into trouble, and to inflate money and credit in ways controlled and regulated by the government. Only the United States, as a result of Democratic agitation during the Jacksonian era, had had the courage to extend the doctrine of classical liberalism to the banking system, thereby separating government from money and banking. Having deposed the central bank in the 1830s, the United States enjoyed a freely competitive banking system – and hence a relatively "hard" and noninflated money until the Civil War. During that catastrophe, the Republicans used their one-party dominance to push through their interventionist economic program; it included a protective tariff and land grants to railroads, as well as inflationary paper money and a "national banking system" that in effect crippled state-chartered banks and paved the way for the later central bank.

The United States adopted its central bank, the Federal Reserve System, in 1913, backed by a consensus of Democrats and Republicans. This virtual nationalization of the banking system was unopposed by the big banks; in fact, Wall Street and the other large banks had actively sought such a central system for many years. The result was the cartelization of banking under federal control, with the government standing ready to bail out banks in trouble, and also ready to inflate money and credit to whatever extent the banks felt was necessary.

Without a functioning Federal Reserve System available to inflate the money supply, the United States could not have financed its participation in World War I; that war was fueled by heavy government deficits and by the creation of new money to pay for swollen federal expenditures.

One point is undisputed: The autocratic ruler of the Federal Reserve System, from its inception in 1914 to his death in 1928, was Benjamin Strong, a New York banker who had been named governor of the Federal Reserve Bank of New York. Strong consistently and repeatedly used his power to force an inflationary increase of money and bank credit in the American economy, thereby driving prices higher than they would have been and stimulating disastrous booms in the stock and real estate markets. In 1927, Strong gaily told a French central banker that he was going to give "a little *coup de whiskey* to the stock market." What was the point? Why did Strong pursue a policy that now can seem only heedless, dangerous, and recklessly extravagant?

Once the government has assumed absolute control of the money-creating machinery in society, it benefits – as would any other group – by using that power. Anyone would benefit, at least in the short run, by printing or creating new money for his own use or for the use of his economic or political allies. Strong had several motives for supporting an inflationary boom in the 1920s. One was to stimulate foreign loans and foreign exports. The Republican party was committed to a policy of partnership of government and industry, and to subsidizing domestic and export firms. A protective tariff aided inefficient domestic producers by keeping out foreign competition: But if foreigners were shut out of our markets, how in the world were they going to buy our exports? The Republican administration thought it had solved this dilemma by stimulating American loans to foreigners so that they could buy our products.

A fine solution in the short run, but how were these loans to be kept up, and, more important, how were they to be repaid? The banking community was also confronted with the curious and ultimately self-defeating policy of preventing foreigners from selling us their products, and then lending them the money to keep buying ours. Benjamin Strong’s inflationary policy meant repeated doses of cheap credit to stimulate this foreign lending. It should also be noted that this policy subsidized American investment banks in making foreign loans.

Among the exports stimulated by cheap credit and foreign loans were farm products. American agriculture, overstimulated by the swollen demands of warring European nations during World War I, was a chronically sick industry during the 1920s. It had awakened after the resumption of peace to find that farm prices had fallen and that European demand was down. Rather than adjusting to postwar realities, however, American farmers preferred to organize and agitate to force taxpayers and consumers to keep them in the style to which they had become accustomed during the palmy "parity" years of the war. One way for the federal government to bow to this political pressure was to stimulate foreign loans and hence to encourage foreign purchases of American farm products.

The "farm bloc," it should be noted, included not only farmers; more indirect and considerably less rustic interests were also busily at work. The postwar farm bloc gained strong support from George N. Peek and General Hugh S. Johnson; both, later prominent in the New Deal, were heads of the Moline Plow Company, a major manufacturer of farm machinery that stood to benefit handsomely from government subsidies to farmers. When Herbert Hoover, in one of his first acts as President – considerably before the crash – established the Federal Farm Board to raise farm prices, he installed as head of the FFB Alexander Legge, chairman of International Harvester, the nation’s leading producer of farm machinery. Such was the Republican devotion to "laissez faire."

But a more indirect and ultimately more important motivation for Benjamin Strong’s inflationary credit policies in the 1920s was his view that it was vitally important to "help England," even at American expense. Thus, in the spring of 1928, his assistant noted Strong’s displeasure at the American public’s outcry against the "speculative excesses" of the stock market. The public didn’t realize, Strong thought, that "we were now paying the penalty for the decision which was reached early in 1924 to help the rest of the world back to a sound financial and monetary basis." An unexceptionable statement, provided that we clear up some euphemisms. For the "decision" was taken by Strong *in camera,* without the knowledge or participation of the American people; the decision was to inflate money and credit, and it was done not to help the "rest of the world" but to help sustain Britain's unsound and inflationary policies.

Before the World War, all the major nations were on the gold standard, which meant that the various currencies – the dollar, pound, mark, franc, etc. – were redeemable in fixed weights of gold. This gold requirement ensured that governments were strictly limited in the amount of scrip they could print and pour into circulation, whether by spending to finance government deficits or by lending to favored economic or political groups. Consequently, inflation had been kept in check throughout the nineteenth century when this system was in force.

But world war ruptured all that, just as it destroyed so many other aspects of the classical liberal polity. The major warring powers spent heavily on the war effort, creating new money in bushel baskets to pay the expense. Inflation was consequently rampant during and after World War I and, since there were far more pounds, marks, and francs in circulation than could possibly be redeemed in gold, the warring countries were forced to go off the gold standard and to fall back on paper currencies – all, that is, except for the United States, which was embroiled in the war for a relatively short time and could therefore afford to remain on the gold standard. After the war the nations faced a world currency breakdown with rampant inflation and chaotically falling exchange rates. What was to be done? There was a general consensus on the need to go back to gold, and thereby to eliminate inflation and frantically fluctuating exchange rates. But how to go back? That is, what should be the relations between gold and the various currencies? Specifically, Britain had been the world's financial center for a century before the war, and the British pound and the dollar had been fixed all that time in terms of gold so that the pound would always be worth \$4.86. But during and after the war the pound had been inflated relatively far more than the dollar, and thus had fallen to about \$3.50 on the foreign exchange market. But Britain was adamant about returning the pound, not to the realistic level of \$3.50, but rather to the old prewar par of \$4.86.

Why the stubborn insistence on going back to gold at the obsolete prewar par? Part of the reason was a stubborn and mindless concentration on face-saving and British honor, on showing that the old lion was just as strong and tough as before the war. Partly, it was a shrewd realization by British bankers that if the pound were devalued from prewar levels England would lose its financial preeminence, perhaps to the United States, which had been able to retain its gold status.

So, under the spell of its bankers, England made the fateful decision to go back to gold at \$4.86. But this meant that British exports were now made artificially expensive and its imports cheaper, and since England lived by selling coal, textiles, and other products, while importing food, the resulting chronic depression in its export industries had serious consequences for the British economy. Unemployment remained high in Britain, especially in its export industries, throughout the boom of the l920s.

To make this leap backward to $4.86 viable, Britain would have had to deflate its economy so as to bring about lower prices and wages and make its exports once again inexpensive abroad. But it wasn't willing to deflate since that would have meant a bitter confrontation with Britain's now powerful unions. Ever since the imposition of an extensive unemployment insurance system, wages in Britain were no longer flexible downward as they had been before the war. In fact, rather than deflate, the British government wanted the freedom to keep inflating, in order to raise prices, do an end run around union wage rates, and ensure cheap credit for business.

The British authorities had boxed themselves in: They insisted on several axioms. One was to go back to gold at the old prewar par of $4.86. This would have made deflation necessary, except that a second axiom was that the British continue to pursue a cheap credit, inflationary policy rather than deflation. How to square the circle? What the British tried was political pressure and arm-twisting on other countries, to try to induce or force *them* to inflate too. If other countries would also inflate, the pound would remain stable in relation to other currencies; Britain would not keep losing gold to other nations, which endangered its own jerry-built monetary structure.

On the defeated and small new countries of Europe, Britain's pressure was notably successful. Using their dominance in the League of Nations and especially in its Financial Committee, the British forced country after country not only to return to gold, but to do so at overvalued rates, thereby endangering those nations' exports and stimulating imports from Britain. And the British also flummoxed these countries into adopting a new form of gold "exchange" standard, in which they kept their reserves not in gold, as before, but in sterling balances in London. In this way, the British could continue to inflate, and pounds, instead of being redeemed in gold, were used by other countries as reserves on which to pyramid their own paper inflation. The only stubborn resistance to the new order came from France, which had a hard-money policy into the late l920s. It was French resistance to the new British monetary order that was ultimately fatal to the house of cards the British attempted to construct in the 1920s.

The United States was a different situation altogether. Britain could not coerce the United States into inflating in order to save the misbegotten pound, but it could cajole and persuade. In particular, it had a staunch ally in Benjamin Strong, who could always be relied on to be a willing servitor of British interests. By repeatedly agreeing to inflate the dollar at British urging, Benjamin Strong won the plaudits of the British financial press as the best friend of Great Britain since Ambassador Walter Hines Page, who had played a key role in inducing the U.S. to enter the war on the British side.

Why did Strong do it? We know that he formed a close friendship with British financial autocrat Montagu Norman, longtime head of the Bank of England. Norman would make secret visits to the United

States, checking in at a Saratoga Springs resort under an assumed name, and Strong would join him there for the weekend, also incognito, there to agree on yet another inflationary *coup de whiskey* to the market. Surely this Strong-Norman tie was crucial, but what was its basic nature? Some writers have improbably speculated on a homosexual liaison to explain the otherwise mysterious subservience of Strong to Norman's wishes. But there was another, and more concrete and provable tie that bound these two financial autocrats together.

That tie involved the Morgan banking interests. Benjamin Strong had lived his life in the Morgan ambit. Before being named head of the Federal Reserve, Strong had risen to head of the Bankers Trust Company, a creature of the Morgan bank. When asked to be head of the Fed, he was persuaded to take the job by two of his best friends, Henry P. Davison and Dwight Morrow, both partners of J. P. Morgan & Co.

The Federal Reserve System arrived at a good time for the Morgans. It was needed to finance America's participation in World War I, a participation strongly supported by the Morgans, who played a major role in bringing the Wilson administration into the war. The Morgans, heavily invested in rail securities, had been caught short by the boom in industrial stocks that emerged at the turn of the century. Consequently, much of their position in investment-banking was being eroded by Kuhn, Loeb & Co., which had been faster off the mark on investment in industrial securities. World War I meant economic boom or collapse for the Morgans. The House of Morgan was the fiscal agent for the Bank of England; it had the underwriting concession for all sales of British and French bonds in the United States during the war, and it helped finance U.S. arms and munitions sales to Britain and France. The House of Morgan had a very heavy investment in an Anglo-French victory and in a German-Austrian defeat. Kuhn, Loeb, on the other hand, was pro-German, and therefore was tied more to the fate of the Central Powers.

The cement binding Strong and Norman was the Morgan connection. Not only was the House of Morgan intimately wrapped up in British finance, but Norman himself – as well as his grandfather – in earlier days had worked in New York for the powerful investment banking firm of Brown Brothers, and hence had developed close personal ties with the New York banking community. For Benjamin Strong, helping Britain meant helping the House of Morgan to shore up the internally contradictory monetary structure it had constructed for the postwar world.

The result was inflationary credit, a speculative boom that could not last, and the Great Crash whose fiftieth anniversary we observe this year. After Strong's death in late 1928, the new Federal Reserve authorities, while confused on many issues, were no longer consistent servitors of Britain and the Morgans. The deliberate and consistent policy of inflation came to an end, and a corrective depression soon arrived.

There are two mysteries about the Depression, mysteries having two separate and distinct solutions. One is, why the crash? Why the sudden crash and depression in the midst of boom and seemingly permanent prosperity? We have seen the answer: inflationary credit expansion propelled by the Federal Reserve System, in the service of various motives, including helping Britain and the House of Morgan. But there is another vital and very different problem. Given the crash, why did the recovery take so long? Usually when a crash or financial panic strikes, the economic and financial depression, be it slight or severe, is over in a few months, or a year or two at the most. After that, economic recovery will have arrived. The crucial difference between earlier depressions and that of 1929 was that the 1929 crash became chronic and seemed permanent.

What is seldom realized is that depressions, despite their evident hardship on so many, perform an important corrective function. They serve to eliminate the distortions introduced into the economy by an inflationary boom. When the boom is over, the many distortions that have entered the system become clear: Prices and wage rates have been driven too high, and much unsound investment has taken place, particularly in capital goods industries. The recession or depression serves to lower the swollen prices and to liquidate the unsound and uneconomic investments; it directs resources into those areas and industries that will most-effectively serve consumer demands – and were not allowed to do so during the artificial boom. Workers previously misdirected into uneconomic production, unstable at best, will, as the economy corrects itself, end up in more secure and productive employment.

The recession must be allowed to perform its work of liquidation and restoration as quickly as possible, so that the economy can be allowed to recover from boom and depression and get back to a healthy footing. Before 1929, this hands-off policy was precisely what all U.S. governments had followed, and hence depression, however sharp, would disappear after a year or so.

But when the Great Crash hit, America had recently elected a new kind of President. Until the past decade, historians had regarded Herbert Clark Hoover as the last of the laissez-faire Presidents. Instead, he was the first New Dealer. Hoover had his bipartisan aura, and was devoted to corporatist cartelization under the aegis of Big Government; indeed, he originated the New Deal farm price support program. His New Deal specifically centered on his program for fighting depressions. Before he assumed office, Hoover determined that should a depression strike during his term of office, he would use the massive powers of the federal government to combat it. No more would the government, as in the past, pursue a hands-off policy.

As Hoover himself recalled the crash and its aftermath:

> The primary question at once arose as to whether the President and the federal government should undertake to investigate and remedy the evils… No President before had ever believed that

> there was a governmental responsibility in such cases… Presidents steadfastly had maintained that the federal government was apart from such eruptions… therefore, we had to pioneer a new field.

In his acceptance speech for the Presidential renomination in 1932, Herbert Hoover summed it up:

> We might have done nothing… Instead, we met the situation with proposals to private business and to Congress of the most gigantic program of economic defense and counterattack ever evolved in the history of the Republic. We put it into action… No government in Washington has hitherto considered that it held so broad a responsibility for leadership in such times.

The massive Hoover program was, indeed, a characteristically New Deal one: vigorous action to keep up wage rates and prices, to expand public works and government deficits, to lend money to failing businesses to try to keep them afloat, and to inflate the supply of money and credit to try to stimulate purchasing power and recovery. Herbert Hoover during the 1920s had pioneered in the proto-Keynesian idea that high wages are necessary to assure sufficient purchasing power and a healthy economy. The notion led him to artificial wage-raising – and consequently to aggravating the unemployment problem – during the depression.

As soon as the stock market crashed, Hoover called in all the leading industrialists in the country for a series of White House conferences in which he successfully bludgeoned the industrialists, under the threat of coercive government action, into propping up wage rates – and hence causing massive unemployment – while prices were falling sharply. After Hoover's term, Franklin D. Roosevelt simply continued and expanded Hoover's policies across the board, adding considerably more coercion along the way. Between them, the two New Deal Presidents managed the unprecedented feat of making the depression last a decade, until we were lifted out of it by our entry into World War II.

If Benjamin Strong got us into a depression and Herbert Hoover and Franklin D. Roosevelt kept us in it, what was the role in all this of the nation's economists, watchdogs of our-economic health? Unsurprisingly, most economists, during the Depression and ever since, have been much more part of the problem than of the solution. During the l920s, establish-ment economists, led by Professor Irving Fisher of Yale, hailed the twenties as the start of a "New Era," one in which the new Federal Reserve System would ensure permanently stable prices, avoiding either booms or busts. Unfortunately, the Fisherines, in their quest for stability, failed to realize that the trend of the free and unhampered market is always toward lower prices, as productivity rises and mass markets develop for particular products. Keeping the price level stable in an era of rising productivity, as in the 1920s, requires a massive artificial expansion of money and credit. Focusing only on wholesale prices, Strong and the economists of the

1920s were willing to engender artificial booms in real estate and stocks, as well as malinvestments in capital goods, so long as the wholesale price level remained constant.

As a result, Irving Fisher and the leading economists of the 1920s failed to recognize that a dangerous inflationary boom was taking place. When the crash came, Fisher and his disciples of the Chicago school again pinned the blame on the wrong culprit. Instead of realizing that the depression process should be left alone to work itself out as rapidly as possible, Fisher and his colleagues laid the blame on the deflation after the crash and demanded a reinflation (or "reflation") back to 1929 levels. In this way, even before Keynes, the leading economists of the day managed to miss the problem of inflation and cheap credit and to demand policies that only prolonged the depression and made it worse. After all, Keynesianism did not spring forth full-blown with the publication of Keynes's *General Theory* in 1936.

We are still pursuing the policies of the 1920s that led to eventual disaster. The Federal Reserve is still inflating the money supply and inflates it even further with the merest hint that a recession is in the offing. The Fed is still trying to fuel a perpetual boom while avoiding a correction, on the one hand, or a great deal of inflation, on the other. In a sense, things have gotten worse. For while the hard-money economists of the 1920s and 1930s wished to retain and tighten up the gold standard, the "hard money" monetarists of today scorn gold, are happy to rely on paper currency, and feel that they are boldly courageous for proposing not to stop the inflation of money altogether, but to limit the expansion to a supposedly fixed amount.

Those who ignore the lessons of history are doomed to repeat it – except that now, with gold abandoned and each nation able to print currency *ad lib,* we are likely to wind up, not with a repeat of 1929, but with something far worse: the holocaust of runaway inflation that ravaged Germany in 1923 and many other countries during World War II. To avoid such a catastrophe we must have the resolve and the will to cease the inflationary expansion of credit, and to force the Federal Reserve System to stop purchasing assets and thereby to stop its continued generation of chronic, accelerating inflation.