EXPERIENCING DÉ JA VÛ ECONOMIC DEPRESSION: 1907 AND 2007

By Katherine Dang

PRESUPPOSITIONS

- The free market system is the ***voluntary exchanges*** of goods and services between individuals ***without*** the coercion and/or interference of a third party and ***with*** the protection of private property by law
    - the natural outgrowth of the spirit of individual liberty and self government inherent to, and inseparable from, the history of America
    - never precludes economic downturns nor failures, for "Everything human can fail," —Thomas Sowell, Hoover Institute
    - the opportunity for prosperity is always provided for, which fosters individual industry and productivity
    - When failures happen in the market place, markets readjust themselves. People pay a price for their misjudgments and mistakes. "Government interventions are usually based on trying to stop them from having to pay that price. —Thomas Sowell, Hoover Institute

- Congress acted unconstitutionally when, in 1913, it transferred its monetary powers to a ***private corporation***, a consortium of commercial banks: The Federal Reserve Bank

  Clause 1: The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;

  Clause 2: To borrow Money on the credit of the United States;

  Clause 3: To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;

  Clause 4: To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States;

  Clause 5: To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures;

  Clause 18: To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof. —**Article I, Section. 8.**

    - Congress created The Federal Reserve Bank with the intent of preventing economic failures in bank panics and national economic depressions by controlling the nation's money supply and nationalizing banking practices through the operations of the bank
    - government interference to control the uncontrollable: independent, individual actions and unpredictable, human behavior
    - ***fear*** of failure and loss in the general public; essentially ***no faith*** and trust in the liberty and self government of any people, ***only of a few***

- Government interventions, ***regulations,*** in the market place are *not* divine interventions, they make matters worse, either bringing on or prolonging an economic depression.

The Business Cycle

- A business cycle is identified as a sequence of four phases:
  - Contraction (A slowdown in the pace of economic activity)
  - Trough (The lower turning point of a business cycle, where a contraction turns into an expansion)
  - Expansion (A speedup in the pace of economic activity)
  - Peak (The upper turning of a business cycle)

- A business cycle is not a regular, predictable, or repeating phenomenon like the swing of the pendulum of a clock. Its timing is random and, to a large degree, unpredictable.

- A ***recession*** occurs if a contraction is severe enough
  - two consecutive quarters of decline in real GDP (Gross Domestic Product/Income) is commonly taken to be a recession.
  - determined by judgment rather than a formal rule
  - market economies are "self-adjusting" and that they cannot get stuck in a recession for very long.

- A deep trough is called a ***slump or a depression***.
  - There are six depressions in American history that are thought to be the worst since detailed records of economic data started to be kept (around 1867), **1873-79, 1893-97** (actually two contractions separated by an incomplete expansion), **1907-08, 1920-21, 1929-33, and 1937-38.**
  - A depression is ***a severe economic downturn that lasts several years***
  - "From the Great Depression, to the stagflation of the seventies, to the burst of the dotcom bubble last year, ***every economic downturn suffered by the country over the last 80 years can be traced to Federal Reserve policy***. The Fed has followed a consistent policy of flooding the economy with easy money, leading to a misallocation of resources and an artificial 'boom' followed by a recession or depression when the Fed-created bubble bursts." —Congressman Ron Paul, 2002

1907 Bankers' Panic

- The only proper function of banks is to supervise the investment of money entrusted to them by savers.
  - A ***banking panic*** may be defined as a class of financial shocks whose origin can be found in any sudden and unanticipated revision of expectations of deposit loss where there is usually an unsuccessful attempt to convert checking deposits into currency. . . . ***a rational depositor response*** to a information of deficit.

- The 1907 Panic was a ***financial crisis***: when money demand quickly rises relative to money supply
  - the stock market fell nearly 50% from its peak in 1906, the economy was in recession
  - when the public found out that currency was not available, they demanded it all the more, precipitating the fractional reserve collapse during the depression; there were numerous runs on banks and trust companies
  - The problems of pre-1914 banking in the U.S. involved too many government restrictions, not too few. Politicians may have believed that private banking was unstable; ***market forces*** can give us a successful banking and monetary system just as it provides us with food, clothing, and other necessities.

- You *quell* panics by organizing collective action to rescue institutions and generally convey confidence back into the market.
  - Morgan was called back from Richmond, Va. by his partners when the panic hit. He took the equivalent of a red-eye flight, attaching his private Pullman car to a steam engine and hurtling back to New York City overnight. He arrived on Sunday, October 20th and immediately convened a meeting of the leading financiers at his mansion on 34th Street. He chartered working groups to get the facts and then over the next several weeks deployed the information to organize successive rescues of the major institutions. He did allow some institutions to fail, because he judged that they were insolvent already. But of the institutions that he declared he would save, every one survived.
  - restriction payments while continuing to receive deposits quickly ended bank failures then. . .
  - Banks can respond to market forces if they are allowed to issue banknotes, which are an "inside money" just as are deposits,

The Federal Reserve Bank: Government Regulation of Banks

- The central banking system of the United States.
  - Created in 1913 by the enactment of the ***Federal Reserve Act,*** it is a quasi-public (government entity with private components) banking system composed of (1) ***the presidentially appointed Board of Governors*** of the Federal Reserve System in Washington, D.C.; (2) the Federal Open Market Committee; (3) twelve regional Federal Reserve Banks located in major cities throughout the nation acting as ***fiscal agents for the U.S. Treasury,*** each with its own nine-member board of directors; (4) numerous private U.S. member banks, which subscribe to required amounts of non-transferable stock in their regional Federal Reserve Banks; and (5) various advisory councils. As of February 1, 2006, Ben Bernanke serves as the Chairman of the Board of Governors of the Federal Reserve System.
  - The Federal Reserve was designed as an attempt to prevent or minimize the occurrence of bank runs, and to respond appropriately when they do happen. The business cycle is the natural and expected consequence of the unfettered operation of a market economy. Therefore ***if an unfettered market economy results in depressions, it is clearly undesirable.***
  - The Federal Reserve has the authority and financial resources to act as "lender of last resort" by extending credit to depository institutions or to other entities in unusual circumstances involving a national or regional emergency, where failure to obtain credit would have a severe adverse impact on the economy.Through its discount and credit operations, Reserve Banks provide liquidity to banks to meet short-term needs stemming from seasonal fluctuations in deposits or unexpected withdrawals. Longer term liquidity may also be provided in exceptional circumstances. The rate the Fed charges banks for these loans is the discount rate (officially the primary credit rate).

- In its role as the central bank of the United States, the Fed serves as a '***banker's bank***' and as the ***government's bank***. As the banker's bank, it helps to assure the safety and efficiency of the payments system.
  - As the government's bank, or fiscal agent, the Fed processes a variety of financial transactions involving trillions of dollars. Just as an individual might keep an account at a bank, the U.S. Treasury keeps a checking account with the Federal Reserve through which incoming federal tax deposits and outgoing government payments are handled. As part of this service relationship, the Fed sells and redeems U.S. government securities such as savings bonds and Treasury bills, notes and bonds. It also issues the nation's coin and paper currency.
  - The U.S. Treasury, through its Bureau of the Mint and Bureau of Engraving and Printing, ***actually produces the nation's cash supply; the Fed Banks then distribute it to financial institutions***
  - In the current system, private banks are for-profit businesses but government regulation places restrictions on what they can do. The Federal Reserve System is the part of government that regulates the private banks.the U.S. government, through the Federal Reserve System, oversees and regulates the activities of the private banks.

- The Fed sets monetary policy, making decisions about the total amount of money in the economy — also known as the money supply.it's ***tightening or loosening access***.
  - Monetary policy of the Federal Reserve System is based partially on the theory that it is best overall to expand or contract the money supply as economic conditions change. In practice, the Federal Reserve has never contracted the monetary supply since the Great Depression, on the fear that contracting the money supply may cause a deflationary recession, and because according to the operating theory of the Federal Reserve, monetary supply should expand as the economy expands to accommodate larger volumes of transaction.
  - "From the Great Depression, to the stagflation of the seventies, to the burst of the dotcom bubble last year, ***every economic downturn suffered by the country over the last 80 years can be traced to Federal Reserve policy.*** The Fed has followed a consistent policy of flooding the economy with easy money, leading to a misallocation of resources and an artificial 'boom' followed by a recession or depression when the Fed-created bubble bursts." — Congressman Ron Paul, 2002
  - ***Keynesian economics, the dominant economic paradigm from the 1940s to the 1970s.*** Keynesian economics got its start with the publication of John Maynard Keynes's ***General Theory of Employment***, Interest, and Money in 1936.
    - According to Keynes, what drives the economy is aggregate demand or aggregate expenditures. Aggregate demand can be broken down into three main components: personal consumption (C), private investment (I), and government expenditures (G). The relationship can be summed up with this formula: AD = C + I + G. If Aggregate Demand is strong, the economy will be strong. However, if Aggregate Demand falters, businesses will end up with large unsold inventories and will cut back on production to avoid surpluses in the future. As they cut back they will of course need fewer inputs—including labor—and high unemployment will result.

    - What is required to avoid a recession, then, is for the government to insure that the aggregate expenditures are enough to achieve full employment. The government can do that through either fiscal policy (taxation and government spending) or monetary policy (***control of the money supply)***. ***Keynes favored fiscal policy and recommended that the government engage in massive deficit spending.*** Deficit spending would allow for an increase in government spending without an offsetting increase in the tax burden on private individuals and businesses. Thus increased government spending could neutralize any decreased expenditures in the private sector, preserving employment and incomes and ultimately reversing the pessimistic expectations that led to the downturn in the first place. Keynesian "demand management" clearly prescribed an important role for the government.
  - "Yes, it's true consumer spending accounts for about 70 percent of nominal GDP [Gross Domestic Product or Gross Domestic Income]. But that doesn't cause anything. It's 2 percent or 3 percent or 5 percent of the population who are the risk-takers, the entrepreneurs, the innovators, who *cause* the growth." —Milton Friedman

The Great Depression, 1929–1941

- A complete abdication of the Fed's core responsibilities—responsibilities it had taken away from the commercial bank clearinghouses that had acted to mitigate panics before 1914—and was ***the primary cause of the Great Depression*** —the Fed's failure to carry out its assigned role as the lender of last resort.
  - **t**he most important cause of the bank runs that began in October 1930 was bad times in the farm belt, where the banks were especially weak and poorly diversified. The number of bank runs increased exponentially in December 1930—in that single month 352 banks failed. Most of the failing banks were in the Midwest , their failures caused by farmers who defaulted on their loans because they were hit hard by the economic downturn**.** No sooner did the first wave of bank runs subside than another got underway in the spring of 1931, creating what a "contagion of fear" among bank depositors. Bank crises continued to come in waves until the spring of 1933.
  - Rather than providing liquidity through loans, the Fed just watched as banks dropped like flies, seemingly oblivious to the effect this would have on the money supply. The Fed could have offset the decrease created by bank failures by engaging in bond purchases, but it did not. ***In the main, it stood idly by and let the crisis take its course—a pattern of behavior that was to be repeated again and again during the next two years.***

- Without the Fed "the same measures would have been taken [in 1930] as in 1907**—**a restriction of payments," economic recovery would very likely have begun in early 1931, just as it had in early 1908.
  - by preventing the draining of reserves from good banks, restriction would almost certainly have prevented the subsequent series of bank failures in 1931, 1932, and 1933, just as restriction in 1907 quickly ended bank failures then; the panic over and confidence restored.
  - would have prevented the crisis from spreading to "stronger banks," those not guilty of overextending themselves through over-risky loans.

- When we centralize great responsibility and power in one institution, its failure will have far-reaching and terrible consequences.
  - The institution failed because of the people within it. And given the immense power and influence it had over the economy, its failure was disastrous.

- the depression would not have been a Great Depression if there had been no Federal Reserve in the first place: "[I]f the pre-1914 banking system rather than the Federal Reserve System had been in existence in 1929, the money stock almost certainly would not have undergone a decline comparable to the one that occurred." (Milton Friedman)
- In 1929 there were a total of 25,000 banks in the United States. As the bank holiday ended, only 12,000 banks were operating (though another 3,000 were to reopen eventually).
- a drastic fall in the money supply: from 1929 to 1933 it fell by 27 percent—for every $3 in circulation in 1929 (whether in currency or deposits), only $2 was left in 1933.
  - Such inevitably led to a massive decrease in aggregate demand. People's savings were wiped out so their natural response was to save more to compensate, leading to plummeting consumption spending.
  - Naturally, total economic output also fell dramatically: GDP was 29 percent lower in 1933 than in 1929.
  - The unemployment rate hit its historic high of 25 percent in 1933.
- The GDP growth rates were of a magnitude not seen since:
  - 1930 -8.6%
  - 1931 -6.4%
  - 1932 -13%
  - 1933 -1.3%.

- ## FDR was inaugurated on March 4, 1933
  - two days later he declared a ***"bank holiday,"*** allowing banks legally to refuse withdrawals by depositors; it lasted ten days. With his famous phrase, ***"The only thing we have to fear is fear itself,"*** he intended to dissuade depositors from running on their banks, but by then it was far too late.

2007 Financial Crisis: The Mortgage Crisis, Failed Banks, Bailout, etc.

- Caused by the heavy hand of government and interference in the market place
  - ***the government-imposed conditions*** that caused the financial crisis, such as the Community Reinvestment Act of 1977 that made lenders offer credit to low-income people who couldn't pay the loans back.
  - these loans increased dramatically as a 9/30/99 New York Times article explained, "In a move that could help increase homeownership rates among minorities and low income consumers, the Fannie Mae Corp. is easing the credit requirements on loans that it will purchase from banks and other lenders." The answer is that ***the Clinton administration pressured the banks to help poor people become homeowners.*** Also the Clinton Justice Department ***threatened banks with lawsuits and fines*** ($10,000 per application) for redlining (discrimination) if they did not make these loans. Also ACORN (a community service organization) was instrumental in providing borrowers and pressuring the banks to make these loans.
  - in addition to federal laws that pressure lenders to lend to people they would not otherwise lend to**,** and in places where they would otherwise not invest, ***state and local governments have in various parts of the country so severely restricted building as to lead to skyrocketing housing prices,*** which in turn have led many people to resort to "creative financing" in order to buy these artificially more expensive homes.
  - ***the Federal Reserve System brought interest rates down*** to such low levels that "creative financing" with interest-only mortgage loans enabled people to buy houses that they could not otherwise afford, keeping interest rates artificially low, giving buyers and builders an incentive to buy and build; ***kept interest rates artificially low***, monthly mortgage payments were low and housing prices went up. Many home owners got home equity loans to pay their first mortgages and credit card debt.
  - the existence of the Reserve System prevented the drastic therapeutic measure: directly, by reducing the concern of the stronger banks, who, mistakenly as it turned out, were confident that borrowing from the System offered them a reliable escape mechanism in case of difficulty; indirectly, by lulling the community as a whole, and the banking system in particular, into the belief that such drastic measures were no longer necessary now that the System was there to take care of such matters.
  - Congress demanded that Fannie Mae & Freddie Mac (FM&FM) buy more of these risky loans to help the poor. Since the mortgages purchased and guaranteed by FM&FM are backed by the U.S. government, ***the loans were re-sold primarily to investment banks which in turn bundled most of them, taking a hefty fee, and sold the mortgages to investors all over the world as virtually risk free.***

- Approximately 6% of all mortgage loans in United States are in default.
  - Historically, defaults were less than one-third of that, i.e., from 0.25% to 2%.
  - A huge portion of the increased mortgage loan defaults are what are referred to as 'sub-prime' loans.

- Most of the sub-prime loans have been made to borrowers with poor credit ratings, no down payment on the home financed, and/or no verification of income or assets (Alt-A's). Close to 25% of sub-prime and Alt-A's loans are in default.

- The financial collapse of Fannie Mae and Freddie Mac is ***not*** a failure of the free market because lending institutions in a free market would not have taken on the high-risk loans.
  - The solution is not a taxpayer-financed bailout. ***The solution is to let them fail and allow the people who invested in them, as well as the people who purchased homes they couldn't afford, suffer the losses.***
  - Secondarily:
    - If Americans are going to be on the hook to bail out these government-sponsored enterprises, at the minimum congressional hearings ought to be held to find out who did what and when.
    - Accounting fraud and deception are the dominant features of government agencies; the accounting standards businesses have have to be applied to Washington

". . .they all keep talking about getting the bailout approved, so that the economy can get going, and we can all start borrowing money from banks again, whether businesses of individuals, and essentially, accumulate even more debt. They keep talking about credit and borrowing. ***Shouldn't they be instead preaching saving, or buying only what you can afford? They should, but they won't, because our banking system and the flow of currency relies on our need to borrow, so that we can consume, and consume, and consume, eventually leading to conspicuous consumption, and of course astounding debt.*** If we all suddenly stopped borrowing money (i.e., no credit cards, no car loans, no mortgages), and instead lived strictly within our means, there would be no new money created and we would have no economy. We live in an economy that encourages (and even requires) us to spend, instead of save. Does that make any sense? We are essentially slaves to the banks, even the government, and there's a good reason why. As Anselm Rothschild (one of our earliest most powerful bankers) once said, 'permit me to issue and control the money of a nation, and I care not who makes the laws.'" —Walter Williams, Economist, George Mason University

CONCLUSIONS

- J. P. Morgan and his fellow bankers used their own money, while the Federal Reserve System used their power to create money.
  - it was almost exactly 100 years ago — 1907, to be exact — that the original J. P. Morgan arranged a bailout of a troubled financial institution for the same purpose of preventing a panic that could end up with the whole economy declining.
  - there was no Federal Reserve System in 1907. That is why Wall Street bankers like J. P. Morgan had to do their own heavy lifting with their own money; nobody could demand that the original J. P. Morgan bail out more people with his own money.
  - the big difference between this year's rescue to stabilize the financial markets and that 101 years ago is that this year's government rescue leads to demands that still more rescues — including real bailouts — should be extended to homeowners and others; whatever the government does sets a precedent and causes more special interests to demand that they get the same treatment.
  - the value of money— all Federal Reserve Notes — goes down when more Federal Reserve Notes are issued to subsidize the purchase of Bear Stearns by J P Morgan Chase; "**we all paid to keep Bear Stearns out of bankruptcy,"** —Thomas Sowell, Hoover Institute

- Government intervention—beyond that of other depressions, *where the government did nothing*—caused the Great Depression and the financial crisis of 2008
  - Previous stock market crashes and previous downturns in the economy worked themselves out faster and less painfully than the Great Depression of the 1930s,
  - Before Presidents Herbert Hoover and Franklin D. Roosevelt came along, there was no expectation that the federal government would intervene when the stock market crashed or when there was a downturn in the economy.
  - The stock market crash of 1987 was at least as big as the stock market crash in 1929. But, instead of being followed by a Great Depression, the 1987 crash was followed by 20 years of economic growth, with low inflation and low unemployment.
    - The Reagan administration did nothing in 1987 so that markets could adjust. ***Ronald Reagan resisted loud calls for him to intervene.*** The result was not another Great Depression but the beginning of a decades-long period of prosperity.
  - "it's not wise for one person, or group of persons, to have so much power over our economy," —Milton Friedman, Economist
  - If ***Congress***. . . passes laws that will enable politicians to micro-manage businesses, that is a proven formula for big economic problems for a long time to come. —Thomas Sowell, Hoover Institute

- In 100 years we go from capitalism and free enterprise to nationalization and socialism, the most remarkable period of government intervention into the financial system since the Great Depression.
  - "Some people even believe that whenever there is 'market failure' the government ought to step in," —Thomas Sowell, Hoover Institute
  - The Bush bailout, as well as Federal Reserve Bank cuts in interest rates, is a wealth transfer from creditworthy people and taxpayers to those who made ill-advised credit decisions, and that includes banks as well as borrowers,"
    —Walter Williams, Economist, George Mason University
  - "The idea of a stimulus package is based on the general notion that there are things the government could do to make things better in the economy." —Thomas Sowell, Hoover Institute
  - The ***character*** of the American people in general seem ***disposed to invite nationalization, centralization and independency upon the all powerful government into the economy of their lives***: weak against the pressures of expediency, impatient in suffering, resistant to correction in consequences, selfish disregard for posterity
- Erroneous ideas and actions serve ***always*** to advance the right ideas and hurries it along to the fore, where before they were neither acknowledged nor welcomed
  - The pressures of adversity and pain of correction pauses headlong motion and stirs deep reflection for relief and resolution.