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Learning from 1929

After yesterday's bailout fiasco and stock market drop, what can we expect going forward? And how can we prevent another Great Depression?

ROBERT KUTTNER | *September 30, 2008* | web only

Jeremy Conroy, 13, sells apples in front of the New York Stock Exchange Tuesday, Sept. 30, 2008 in New York. Conroy is reenacting a scene of boys selling apples during the Great Depression. Stocks are opening higher but financial markets remained troubled

One thing that people often forget is that the stock market crash of 1929 did not turn into the Great Depression overnight. The unemployment rate was still only 8.7 percent in 1930. GDP lost 6.4 percent in 1931, but the bottom fell out only in 1932, when GDP plunged by 13 percent. So it took three years for the damage to the stock market to ravage the banking sector, and eventually for the air to come out of the real economy. In the meantime, government did far too little.

The basic cause of the great crash of '29 was very similar to what we are experiencing today: too much speculation with too many exotic financial creations, using too much borrowed money.

Supposedly, 1929 could not happen again because of "what we learned." We learned that in a financial panic, the Federal Reserve needs to pour in heaps of "liquidity" -- money -- as the Fed failed to do after October 1929. One of the world's reigning experts on the Fed's failures of the early 1930s is one Ben Bernanke, and he certainly hasn't been stingy with the Fed's billions.

But the other lesson was the one "we" forgot -- not to let banks and other financial institutions turn themselves into casinos. It is helpful, in the spirit of Tonto's historic interrogatory to the Lone Ranger -- "What you mean, we?" -- to unpack that "we." The "we" who forgot the lessons included first and foremost Republican ideology -- deregulate everything and let markets run wild; secondly Bush administration regulatory officials who disdained even the regulations on the books; and third, the Wall Street Democrats who were de-regulation's willing enablers.

In some respects, the challenge today is more arduous than in 1929 because the financial products of this era are even more baroque; the economy is more internationalized, with the U.S. far more dependent on foreign capital; and there is also different sequencing of events. In 1929, the crash began in the stock market, but only in 1932 did banks begin collapsing (and the biggest banks never went down). This time, the crash began in the banking sector, and is only now triggering a stock market collapse.

That said, there is still time to prevent a crash from turning into a full-blown depression. Although the economy is on the edge of an abyss, there is one key political difference that bodes well for the timing. The crash of 1929 began in the first year of the Hoover Administration, and for three years Hoover dithered. The crash of 2008 occurred at the tail end of an exhausted Bush administration (and an exhausted free-market ideology. We only have to make it from October to January for a serious recovery strategy to commence. With some luck and leadership, we can telescope the process of reversing the damage from more than four years in the 1930s to just a few months in early 2009.

But we do need to prevent the economy from falling off a cliff in the next four months. And in the near term, there is a dire leadership vacuum compounded by an ideological panic on the part of the Republicans. Not surprisingly, Bush's influence is nil. Treasury

Secretary Hank Paulson, as the ultimate investment banker, proved the worst possible emissary for his own proposed deal. All he lacked was the top hat. Nancy Pelosi and Barney Frank were willing to provide troops for a Wall Street-oriented deal that they didn't much like, but not to bear sole responsibility.

And House Republicans at last experienced the accumulated contradictions of their worldview. The reigning ideology of the past three decades has been turned on its head. Disdain government and give Wall Street everything it wants. The right has tried to paper over how that ideology harms Main Street with the use of tax cuts as all-purpose balm. But this week, the ideology ran out of gas. House Republicans were left as the party of "no" -- in the apt words of conservative *New York Times* columnist David Brooks, as "nihilists." Nothing in their ideological kit bag could fix what was broken, but they responded viscerally to their constituents' disgust for the Paulson deal by voting it down.

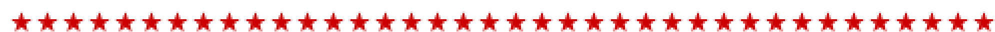
Democrats will shortly become stewards not just of a temporary bailout but of a long term recovery strategy. They might as well begin by pointing us on the right path. That includes direct refinancing for homeowners, direct government involvement in the management of failing financial institutions that are recapitalized by government money, through something like the Reconstruction Finance Corporations of the Roosevelt era; and a transfer tax on stock and bond transactions, both to raise needed revenue and to damp down the kind of speculation that led to the meltdown. Then Congress can begin the task of regulating the financial system properly. The basic concept is that any financial enterprise capable of taking down the system requires the tight government supervision that in the recent past has been limited to commercial banks.

This is Democratic ideology, if you drill down, just like financial regulation. But lately, that set of core convictions has gotten rusty. It needs to be reclaimed, and fast. Too many Democrats are still thinking small. Barack Obama has just put out a statement urging Congress to act on the bailout -- and his one new idea proposes that the FDIC insurance limit be increased to $250,000 per bank. But of all the things that are broken, this isn't one. Anybody with more than $100,000 in savings -- the present insurance limit per bank -- knows to put the money in more than one bank.

One other reversal of recent conventional wisdom will be required. Government will need to rely on substantial public spending to pull the wider economy out of the hole. Most of that can be raised by surtaxes on the wealthy and by transaction taxes on speculation, but it will also require a temporary increase in public deficits. Raise enough revenue to cover about $700 billion of financial recapitalization in year one, and in years two through eight use the proceeds for public works, infrastructure, good jobs, universal health coverage, expanded pre-kindergarten and child care.

In my book, Obama's Challenge, which went to press in late July, I put the necessary number for increased annual public spending at $600 billion. At the time, it felt like I might be over-reaching. If anything I was low.

So far, the financial collapse has been an ideological windfall for Democrats. Republicans appear to be flailing. Democrats seem steadier. But on January 20, their windfall will become their hurricane -- one that Democrats can use to soar or to crash. And they do not have much time to get this right.



Robert Kuttner is co-founder and co-editor of *The American Prospect* magazine, as well as a Distinguished Senior Fellow of the think tank Demos. He was a longtime columnist for *Business Week*, and continues to write columns in the *Boston Globe*. He is the author of ***Obama's Challenge*** and other books. For more read our "about the editors" **page**.