Crash Test

Is it 1929 all over again—or worse?

By Nicholas von Hoffman

Rock-a-bye, trader on the tip top
When the Board meets, the market
will rock.
When the rate rises, quotations
will fall.
And down will come trader,
margins and all.
—*The Wall Street Journal*
March 29, 1929

AS AMERICAN FINANCE is being twisted and reshaped almost hourly, many worry that we're in for an encore of the galvanic upheavals of 80 years ago. Is this a gruesome economic Groundhog Day?

There are important parallels but also major differences. The America of 1929 was energy self-sufficient. It was a muscular industrial society that imported few necessities. A businessman would have been hard pressed to get a foreign-manufactured safety pin into the country. We owed no foreign nation money; they owed us. We were at peace. The size of the military establishment was about right for a nation that did not believe in pre-emptive war and had no enemies.

We had a new president who, at least on paper, was ideally prepared for the economic holocaust. Herbert Hoover was the only president to distinguish himself as a businessman. In 1907, he started his own company, opening offices in New York, London, San Francisco, and Russia. By 1913, he had some 175,000 employees and was running mining operations around the world. Generations before the term "global economy" was coined, Hoover was practicing it.

By the standards of his time, Hoover was an interventionist, not inclined to remain inert while calamities rained down, although many in both parties thought differently 80 years ago. Secretary of the Treasury Andrew Mellon's recipe for dealing with the Depression was "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate." Ultimately, Hoover liquidated Mellon by making him ambassador to the United Kingdom.

Mellon was of the short, sharp retraction school, which believes an unhampered liquidation of the financially weak blows debt out of the economy fast and enables a quick recovery. The Mellon hypothesis still has adherents, but the politics are too awful for an administration to contemplate since this approach risks throwing 20 million people out of work in months if not weeks.

The 1929 crisis was a stock-market disaster. The 2008 crisis is a bond-market disaster. Yet they have important elements in common. Through much of the 1920s, the Federal Reserve made easy credit available to the nation's banks, which lent money to masses of people to buy stocks on margin. As long as the stock was worth more than the loan to buy it, all was well. The more people got into the market, the higher the prices of stocks went and the easier it was to use the stocks they had borrowed money to buy as collateral to borrow more money to buy more stocks that they did not pay for. Stock prices rose for so long that people came to believe that in the new, modern economy of the 1920s, prices could only go one way. Substitute the word "house" for the word "stock," and you see what the great grandchildren of 1929 did in the 2000s.

When the price of stocks purchased with borrowed money fell to a point where they were worth less than the loan, buyers had to come up with the money to make up the difference. If they couldn't, the stockbroker from whom they had gotten the loan took the stock and sold it. The same happened with mortgages and the bonds or collateralized debt obligations (CDO's) into which the mortgages were packed. Today, purchasers have to put down 50 percent of the price of a stock they buy on margin, but the investment banks that bought CDO's were putting up as little as 0.3 percent and borrowing the rest.

Thus the underlying mechanics of disaster in 2008 are similar to those of 1929. But there are differences. In 1929, there were no derivatives, those complex deals or arcane side bets that multiply potential losses of billions into trillions. We can thank computers for them. Without electronic computation and record keeping, trading and tracking at such speed and in such volume could not be done. Devilish tricks go back to the days of Daniel Drew (1797-1879), reputed inventor of stock watering, but without modern toys even Ole Dan'l, who went to jail and died bankrupt for the sheer gall of his business crimes, could not have pulled off the tricks we first saw with Enron.

What people in 1929 did with stock, Americans did in the last decade with real estate, but since Wall Street institutions financed the real estate bubble with bonds they were foolish enough to keep rather than fob off on suckers, the effect on the stock market has been about as dismal as 80 years ago.

With J.P. Morgan's heroics during the panic of 1907 as a model, the big financiers of 1929 attempted a similar act of "organized support" to gin up the market. In a moment that retains a place in Wall Street lore, New York Stock Exchange president Richard Whitney went to the trading floor to place an order for 25,000 shares of the United States Steel Corporation at $205, $10 higher than it had fallen. Whitney then did the same for shares in other major companies. The market rallied—but not for long.

The present secretary of the Treasury, Henry Paulson, also tried to put together "organized support" to drive up the swooning stock prices of financial companies choking on worthless CDO's. But would-be supporters were either broke or terrified of buying bonds everybody was calling "toxic waste."

From this point, 1929 and 2008 begin to diverge. After the organized support attempted by Whitney failed, there was nothing to do but ride out a hurricane of wealth destruction—unless the government attempted what the private sector had failed to do. Nothing of the sort had been done before, and although Hoover was a forward thinker, having the government prop up private business was a huge gulp for a man who in his weaker moments blamed the crash on John J. Raskob, a DuPont and General Motors finance executive. A bee got into Hoover's bonnet that Raskob, a Democrat, was the center of a short sellers' conspiracy. A similar bee has been buzzing into our heads, with the result being that short selling of the stock of more than 800 companies has been forbidden by the Securities and Exchange Commission.

Hoover, who had the optimism of a successful businessman, was waylaid with spasms of magical thinking. In the summer of 1930, he told a delegation of clergymen asking him to expand public works for the unemployed, "You have come 60 days too late. The Depression is over." But he eventually agreed to a shot at a bailout through the new Reconstruction Finance Corporation, which lent to banks, railroads, and insurance companies. It was not enough money and came too late, though had it been more and sooner, the results may not have been better.

Hoover's slowness may have resulted in part from his having assumed office in March, a few months before disaster struck in October. He had almost four years before he had to run again. The crisis of 2008 arrived in the middle of a campaign. It's impossible not to believe that someone in the White House or the Treasury said something like, "Either we save AIG or McCain loses."

Paulson and Fed chair Ben Bernanke were probably also hurried into action by their knowledge of the huge foreign investments in American financial companies and government bonds. A new drop in the value of the dollar or in their investments might cause the oil Arabs, the Chinese, and many others to stop lending the U.S. money. Moreover, foreign financial institutions, which are demanding that they be included in any rescue program, pose a grisly choice for the administration: accede to foreign demands and face furious reaction just before the election or decline and risk cracking America's economic position in the world, possibly turning it into the new Argentina. Hoover had no such nightmarish alternatives.

Bernanke, who has written a book called *Essays on the Great Depression*, ought to be prepared, if anyone is, to take on this crisis. Yet the America of 1929 and that of 2008 are so unlike as to be almost different countries. At this writing, Bernanke has not been successful in doing the first thing that the Federal Reserve Board is tasked with—keeping the financial system liquid. That is, making sure there is enough money available that commerce and industry do not starve for lack of affordable capital. Though Bernanke has tried, businesses and individuals are growing parched.

In the intellectual realm, the Hoover-Roosevelt administrations had organized opposition from Marxists and socialists. These small but clangorous political parties offered an ongoing, systematic critique of what the government was doing. Today, the disagreements aren't over basics and don't arise from a different premise and different analysis.

The last contrast between now and then concerns the American people themselves. One may wonder if the men and women whose images were recorded by Walker Evans's camera are to be found in 21st-century America. The greed and stupidity quotient is doubtless the same, but the Americans of 1929 were a grittier bunch. They were more self reliant, if only because they did not live in a service economy. They were closer to the land and made do with far less. They were thinner, bonier people who did not live as long and worked harder.

Phil Gramm, the former Texas senator, economist, and McCain adviser, got in trouble for saying of contemporary Americans, "We've sort of become a nation of whiners. You just hear this constant whining, complaining..." There is a grain of truth in that. If the hard times do come, they will be harder for us. ■

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The American Conservative

To: Gov. Sarah Palin
From: TAC Editors
Re: What Your Tutors Aren't Telling You

Congratulations on being chosen as John McCain's running mate. It's an honor, if a dubious one. As you know, conservatives have reservations about McCain. To your credit, they have few such concerns about you.

You've given new life to a party whose brand was bankrupt. You've energized a campaign that was embarrassing its own partisans. Across America, crowds flock to see you—not that old man who barely wheezed his way through the primaries. If John McCain wins, he will owe you, as the guy in the undisclosed location says, "Big time."

Wonder why Middle America finds you irresistible? Maybe they're big Tina Fey fans. More likely, you remind them of the conservative values they feared lost: faith, family, independence. This impression owes more to who you are than what you've done. But at least you keep Obama from cornering the market on hope. Conservatives have faith in you. Don't fail them as George W. Bush has.

You see what happened: the president's entire domestic agenda collapsed under the weight of his failed foreign policy. Social Security reform stalled. Pro-lifers became political orphans. And whatever gains Bush's tax cuts secured were wiped out by record spending. Everything was subordinated to the war on terror.

Conservatives grasping for something to commend give the president points for his judicial picks. But he would have much preferred justices like Alberto Gonzales and Harriet Miers—toadies whose top qualification was their willingness to give the executive more power.

The party that championed the things you prize—individual liberty, fiscal restraint, and a strong defense—has trampled civil rights, pushed us to the brink of insolvency, and broken our Armed Forces. After eight years of Bush, even diehard Republicans are glad to see him go. You might have noticed the elephant not in the room in St. Paul.

There's a better way. In fact, you figured it out in the 1996 presidential primary when you sported the flair of the leading pro-life candidate. (Your minders would prefer that we not mention his name. It triggers their Tourette's.) As you surely know, even beyond social issues, he represents a strain of conservatism that offers a consistent ethic of life and philosophy of limited government. It was not a coincidence that the most pro-life candidate in '96 was also passionately noninterventionist.

It's also no coincidence that those who want you to heed the siren call of global democratization care little for traditionalist causes. Recall that second night of the Republican Convention when you were told to blow off a reception in your honor hosted by Phyllis Schlafly so Joe Lieberman could chaperone your debut before the directors of AIPAC. Neoconservatives pay lip service to life, but, as their enthusiasm for Lieberman shows, they have higher priorities. Now they plan to make them yours.

You'll find the new friends conducting your foreign-policy crash course pleasant enough, if a little dogmatic and a lot condescending. They call you "Project Sarah." We saw that one staffer at AEI—that mystery monogram on all your briefing books—said you're "a blank slate." He added, "She's going places, and it's worth going there with her." That's how they operate. They don't implement their agenda themselves. Rather, they impose it on rising star. If things don't work out, it's because the Project wasn't sufficiently committed. (Just ask President Bush.)

Now you're the latest object of their attention, and you're probably finding the program a bit confusing. They tell you that the U.S. is fighting "World War IV," a struggle against "Islamofascism." We can win, they say, as long as we're prepared to bomb Iran and build up the national-security establishment at home, just like Reagan did.

Trouble is, your tutors also believe we're still engaged in "World War III," the Cold War with Russia. So maybe the Gipper didn't win that one after all. In fact, neoconservatives like Norman Podhoretz chided Reagan for appeasing Moscow. And when terrorists struck the Marine barracks in Lebanon in 1983, Reagan, instead of "staying the course," withdrew our troops. Your Beltway suitors prescribe the opposite of Reagan's strategy.

And as they would have it, we're not only waging World Wars III and IV, we're still fighting World War II. At least, that's the way it sounds when Robert Kagan opens a *Washington Post* op-ed by likening Russia's conflict with Georgia to Hitler's invasion of Czechoslovakia.

But Russia is not Germany, Georgia is no innocent Czechoslovakia, and Vladimir Putin is not Adolf Hitler—no matter what your guru Randy Scheunemann says. (He probably forgot to tell