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PERSPECTIVES THAT DRIVE ENTERPRISE SUCCESS

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Viewpoints

A Cure, Not a Cause

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On the eve of World War I (WWI) in December 1913, President Woodrow Wilson signed the Federal Reserve Act into law with a gold pen—symbolizing the dollar would remain as good as gold. In its original creation, the Federal Reserve (Fed) was not obligated to stabilize prices, promote full employment, smooth out the business cycle, buy Treasuries or push for economic growth. Despite the absence of these monetary policies now commonly associated with the Fed, the Federal Reserve Act was seen as an early Christmas gift to Wall St. banks (a gift for not just 1913, but for many decades to come).

First Federal Reserve Board Standing left to right: Paul M. Warburg, John Skelton Williams, W.P.G. Harding, Adolf C. Miller. Seated left to right: Charles S. Hamlin, W.G. McAdoo, F.A. Delano

The Federal Reserve Act replaced the National Bank Act of the Civil War era, and with its enactment, the reserve requirements were lowered from 25% to 18%, the prohibition against real estate lending was relaxed, banks were allowed to open foreign branches, and most importantly, the Fed was allowed to issue Federal Reserve notes (the same currency now in use). However, gold continued as the money standard and it was not uncommon for an individual to reach into their pocket, pull out a gold coin and plunk it down on the counter with a ringing sound (hence the term "sound money"). Now, the Fed would not be allowed to increase the money supply by simply issuing more notes (i.e., printing money), the law required 40% of the face amount of all outstanding Fed notes to be backed by gold. Thereby, an increase in money supply required at least a partial increase in gold reserves.

Federal Reserve Note in 1914

In 1914, WWI broke out in Europe. The U.S. remained neutral until 1917, and during those few years, European demand for U.S. exports boomed in everything from medical supplies to shoes and clothes. To fund their increased desire of U.S. goods, the Europeans delivered gold. All told during the 3-year period, the U.S. was the net recipient of $1.1 billion in new gold reserves and as a result, the monetary base expanded over 35%. In 1916, the U.S. government was running a fiscal surplus: $783 million in revenue, $734 million in expenditures. In 1917, the U.S. entered the war, and by 1919, the government was running a huge fiscal deficit, taking in $5.1 billion and spending $18.5 billion. To fund the war (and the growing fiscal deficit), President Wilson increased taxes, particularly on the higher income folks with a 77% tax on incomes above $1 million. However, tax receipts covered just 28% of the spending in 1919, the rest was borrowed. From 1916 to 1919, U.S. government debt increased from $1.2 billion to $21.5 billion (an increase of nearly 1800%).

It should come as no surprise that with the sudden inflow of gold, the growth in the monetary base and government borrowing to fund the war, the price of nearly everything rose... rapidly. While the economic statistics of the time are a bit dodgy, wholesale prices and GNP more than doubled from 1914 to 1920, and the Dow Jones Industrial average increased by more than 87%. The U.S. was enjoying a period of growth and prosperity never seen before.

After a brief economic slowdown following the end of the war in 1918, the U.S. economy continued to expand and prices continued to rise. Why not? The war was over and money was abundant and free-flowing thanks to the increased gold reserve and fiscal spending of the Wilson administration. The environment is well captured by the 1921 Queen's Quarterly publication as an "outbreak of speculation in business and stock market circles that for recklessness has had few parallels." For example, in 1919, Harry Truman (who would become the 33rd president of the United States) and his wartime buddy Eddie Jacobson opened Truman & Jacobson haberdashery (a modern day Men's Warehouse or JoS. A. Banks). As Eddie Jacobson would later be quoted, "Silk underwear for men, and silk shirts, were the rage. We sold shirts for $16." To provide some perspective, a $16 shirt in 1919 translates into $200 in current terms. If a $200 shirt sounds expensive, it was. Shortly after opening their store, the U.S. economy plunged into a depression. No, not the Great Depression, the depression of 1920-1921.

If you've never heard of the depression of 1920-1921, don't worry, you're not alone. If covered at all in the history books, it's usually relegated to a small footnote. Such an oversight is a mistake as the economic contraction and capital market declines were some of the most severe ever recorded (including the Great Depression):

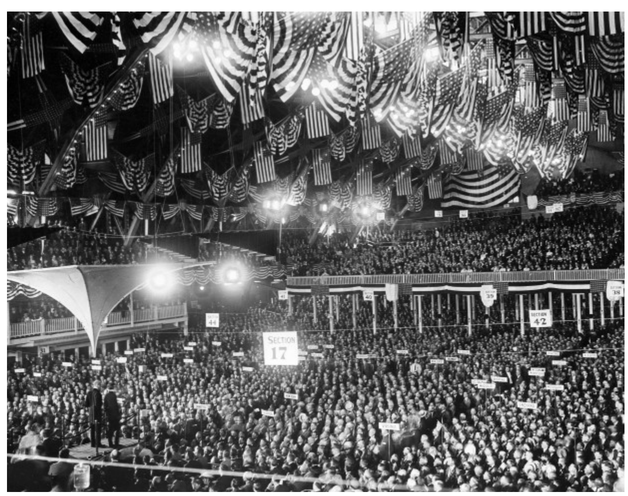
- National output declined nearly 24% (nominal) or nearly 9% (real)
- Producer prices fell nearly 41% (peak to trough)
- Industrial production fell 32%

- The unemployment rate is estimated to have increased from 5% to 19%
- Commodity prices went into a free fall
- Stock prices declined over 46%
- Corporate profits dropped 92%
- Widespread corporate bankruptcies (including poor Truman & Jacobson haberdashery)

Yet, as quickly as the depression started, it was over just 18 months later. How did the government and Fed produce such a spectacular turnaround, and can we do it again? Was it a public works program such as the Hoover Dam or Obama's "shovel ready" projects? Was it another form of Quantitative Easing (QE)? No, it was just the opposite. The Fed raised rates, the government cut taxes, reduced spending, paid down the public debt, and balanced the budget. I know, it is shocking– I'll give you a second to let it sink in.

The 1920-1921 depression is hallmarked not only by its severity and short time span, but also by the fact that the government and Fed did nothing to stop it. Furthermore, they implemented policies (raising rates and fiscal austerity) most 21st century economists would judge disastrous. With a single move in 1920, the Fed raised rates by 1.25% (one of the single, most violent, policy moves in Fed history). Benjamin Strong, the current day Ben Bernanke or Janet Yellen, stated, "After a year or two of discomfort, embarrassment, some losses, some disorders caused by unemployment, we will emerge with an almost invincible banking position, prices more nearly at competitive levels with other nations, and be able to exercise a wide and important influence in restoring the world to a normal and livable condition." Why was their approach so successful and what does it tell us about today's economy?

First we need to look at why the governmental fiscal policy changed so abruptly from stimulative to austere. In 1919, Woodrow Wilson suffered a debilitating stroke leaving him and the presidency virtually incapacitated, the details of which were kept from the general public. From the time of the stroke until the end of his term as President, Wilson's wife Edith determined what documents the President would see and what information he would be given (many have called her the first woman President), leaving the country without its strong leader. In the presidential election of 1921, the Republican candidate was Warren Harding. In his Republican nomination speech Harding stated: "We will attempt intelligent and courageous deflation, and strike at government borrowing which enlarges the evil, and we will attack the high cost of government with every energy and facility." Can you imagine one of the presidential candidates today calling for "intelligent and courageous deflation"? They would be placed in the penalty box with Ron Paul and derided as a lunatic (the world is still flat after all). Surely, the American populous would not elect Harding with such a platform? Wrong. Harding won in a landslide against Democratic candidate James Cox. True to his word, President Harding cut the federal budget nearly in half by 1922, the tax rates were slashed for all income groups, and the national debt was reduced by over 30%.



Republican National Convention, Chicago 1920 Warren Harding acceptance speech

Both President Harding and the Fed were committed to allowing prices to adjust lower despite constant calls from Herbert Hoover (Harding's commerce secretary) and John Skelton Williams (Comptroller of the Currency) to do something, anything, to help stop the decline. The decline did stop and a powerful and robust recovery ensued. (The history books remember the recovery well and labeled it "The Roaring 20s.") But, with no government or Fed support, why did prices stop declining? The age-old magnetic power of good investment value. Prices fell low enough to entice consumers into shopping, investors into committing capital and employers into hiring. Lower prices induced both consumption and investment, and with it, the U.S. economy recovered.

Contrary to the commonly held view today, particularly by the current Fed, lower prices are not a calamity, but a cure. The 1920-1921 depression was both severe and brief as a result of Fed and government policies allowing prices to naturally adjust to market clearing levels. According to economist Benjamin Anderson, "**In 1920-1921, we took our losses, we readjusted our financial structure, we endured our depression, and in August 1921 we started up again.** The rally in business production and employment that started in August 1921 was soundly based on a drastic cleaning up of credit weakness, a drastic reduction in the cost of production, and on the free play of private enterprise." It is instructive to compare the U.S. experience with the same period in Japan. In 1920, rather than letting prices naturally adjust, the Japanese government and businesses worked to keep prices artificially high. Anderson writes: "The great banks, the concentrated industries, and the government got together, destroyed the freedom of the markets, arrested the decline in commodity prices, and held the Japanese price level high above the receding world level for 7 years. During these years Japan endured chronic industrial stagnation and at the end, in 1927, she had a banking crisis of such severity that many great branch banking system went down, as well as many industries. It was a stupid policy. In the effort to avert losses on inventory representing one year's production, Japan lost seven."

Shortly after the economic rebound in 1921, the U.S. abandoned the laissez-faire policy in favor of a more active approach (known in economic circles as Keynesian). During an economic slowdown, Keynesian economics calls for increased fiscal stimulus and easier monetary policy (lower rates) with the objective of maintaining price stability: The exact opposite of the policies implemented in 1920-1921. Rather than let prices naturally adjust, the role of the government and Fed is to maintain price stability. On the surface, having no surging or plunging commodity prices, home prices, or consumer prices sounds good, but we all know from experience those type of objectives are not attainable. Furthermore, by not allowing prices to naturally adjust, important information is lost in the price. For example, as the U.S. equity tech bubble crashed, the Fed rushed in with ultra-low rates and easy credit standard to replace the equity tech bubble with a housing bubble. The U.S. consumers experienced home prices actually increasing during the 2001-2002 recession and incorrectly concluded that home prices never go

down. Consumer housing demand reached a fever pitch amid rampant speculation, and the resulting 2007-2009 credit and housing crisis left many wondering what went so wrong. By trying to stabilize prices, the Fed/government makes consumers/investors blind to them and unable to properly judge value.

Today, we have a federal government and Federal Reserve not only continuing to employ Keynesian economics, but on a scale and scope never before seen. In 2009, President Obama signed the $831 billion American Recovery and Reinvestment Act, aimed at providing fiscal stimulus for the struggling economy. **While the economy has at least partially recovered, it's likely in spite of fiscal stimulus and not a result of it. By its very design, fiscal stimulus will never work.** Fiscal stimulus is simply a reallocation of resources within an economy. Economists assume (as they usually do) the reallocation of resources will stimulate economic growth because they assume the resources were sitting idle (i.e. uninvested cash or excess business capacity). The government takes these resources and invests into projects virtually guaranteed to lose money. If the ventures were profitable, the private sector would already be doing them. Frederic Bastiat wrote about this idea in 1850, with the Broken Window fallacy in That Which is Seen, and That Which is Not Seen. If you never read it, it's worth considering (see here).

> *"A great industrial nation is controlled by its system of credit. Our system of credit is concentrated. The growth of the Nation, therefore, and all our activities are in the hands of a few men [Federal Reserve]. We have come to be one of the worst ruled, one of the most completely controlled and dominated Governments in the civilized world – no longer a Government by free opinion, no longer a Government by conviction and the vote of the majority, but a Government by the opinion and duress of small groups of dominant men."*
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> President Woodrow Wilson, 1916

For its part, the Fed has certainly been simulative, keeping rates at 0% since 2009, and expanding their balance sheet to over $4 trillion via QE. After nearly 6 years since the bottom and an unprecedented level of Keynesian stimulus, the lack of economic growth raises the question: have these policies only bought us time similar to Japan's experience in 1920-1927? Prices can be artificially maintained for a period of time, but there is a limit. Lower prices are not the cause of the problem, they can be the cure by providing a solid foundation for the next stage of growth. Personally, I would love to see a repeat of the Roaring 20s in 2020, but we may have to "take our losses" and "readjust our financial structure" first.

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