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Supply-Side Investment Research
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| 10-yr T-Note: 3.35% | DJIA: 9,627.48 | NASDAQ: 2,084.02 | S&P 500: 1,044.14 | S&P 500 Undervalued: 119.9% |
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# LESSONS FROM THE GREAT DEPRESSION

*By Arthur B. Laffer*

**Summary**

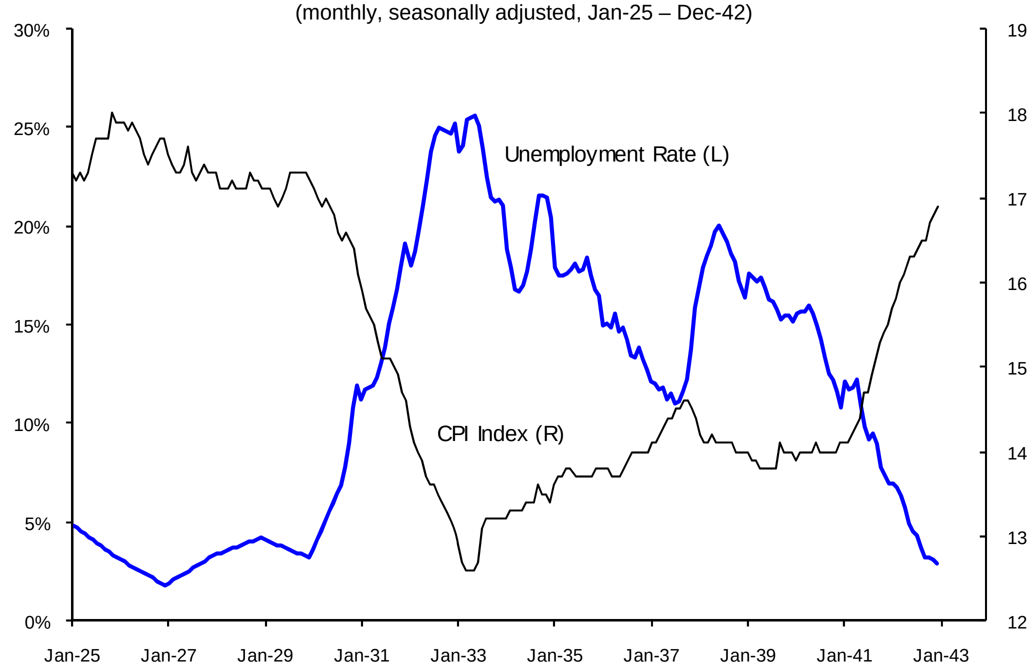
- Many economists conclude that the Fed's tight monetary policy led to the Great Depression and therefore, Bernanke must be careful not to tighten too soon.
- Unfortunately, this analysis is wrong. For one thing, the U.S. was on a gold standard which means that the Fed had little control over the money supply to begin with. This analysis also fails to consider the effect of the huge tax increases, including the Smoot Hawley tariff, which precipitated and greatly worsened the Great Depression.
- With this in mind, understand that many of the mistakes of the Great Depression are due to be repeated.
- Accordingly, we can have inflation even with declining output.

The 1930s has seemingly become the sole object lesson for today's monetary policy. Over the past twelve months, the Federal Reserve has increased the monetary base (bank reserves plus currency in circulation) by well over 100%, with an eighteen fold increase in bank reserves. The Federal Funds target rate now stands at an all-time low range of 0 to 25 basis points, with the 91 day T-bill yield equally low. And this was all done to avoid a liquidity crisis and a repeat of the mistakes that "led" to the Great Depression.

Even with this huge increase in the monetary base, Fed Chairman Ben Bernanke has reiterated his goal not to repeat the mistakes made back in the 1930s by tightening credit too soon, which he says would send the economy back into recession. Former Dallas Fed president Bob McTeer shares their views and attributes the sharp downturn in the economy in 1937 to the Fed's doubling of bank reserve requirements from August 1936 to May of 1937.

What many professionals take away from the U.S. experience of the 1930s is the inverse relationship between inflation and unemployment as shown below (Figure 1). The conclusion they reach is that tight money crashed the U.S. economy and caused deflation as well. Therefore we need really easy money now and there is no risk of inflation. They couldn't be more wrong if they tried.

Figure 1
**CPI Index vs. Unemployment Rate**
(monthly, seasonally adjusted, Jan-25 – Dec-42)

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While Fed policy was undoubtedly important in the 1930s, it was not the primary cause of the Great Depression or the economy's relapse in 1937. Instead, the Smoot Hawley tariff of 1929 / 1930 was the catalyst that got the whole process going. It was the largest single increase in taxes on trade during peacetime and precipitated massive retaliation by foreign governments on U.S. products. Huge federal and state tax increases soon followed thus doubling down on the initial decline in the economy caused by the Smoot Hawley tariff. Additional large tax increases in 1936 were the proximate cause of the economy's relapse in 1937.

In the years 1930 and 1931, there was a very slight increase in tax rates on personal income at both the lowest and highest brackets. The corporate tax rate was also increased from 11% to 12%. But beginning in 1932 the lowest personal income tax rate was raised from less than one half of one percent to 4% and the highest rate was raised from 25% to 63% (that's not a misprint!). The corporate rate was raised from 12% to 13.75%. All sorts of federal excise taxes too numerous to list were raised as well. The highest inheritance tax rate was also raised in 1932 from 20% to 45%, and the gift tax was reinstituted with the highest rate set at 33.5%.

In 1934 the highest estate tax rate was again raised from 45% to 60% and then to 70% in 1935. The highest gift tax rate went from 33.5% in 1933 to 45% in 1934 and 52.5% in 1935. The highest corporate tax rate was raised to 15% in 1936 and 1937 with a surtax on undistributed profits up to 27%. Finally, in 1936 the highest personal income tax rate was raised to 79%.

Because of the number of states and their diversity, I am going to aggregate all state and local taxes and express them as a percentage of GDP. This measure of state tax policy truly understates their contribution to the tragedy we call the Great Depression, but I'm sure you will get the picture. In 1929 state and local taxes were 7.2% of GDP and then rose to 8.5%, 9.7% and 12.3% for the years 1930, '31 and '32 respectively.

The damage caused by high taxation during the Great Depression is the real lesson we should learn. A government quite simply cannot tax a country into prosperity. If there were one warning I'd give to all who will listen, it is that U.S. federal and state tax policies are on an economic crash trajectory today, just as they were in the 1930s.

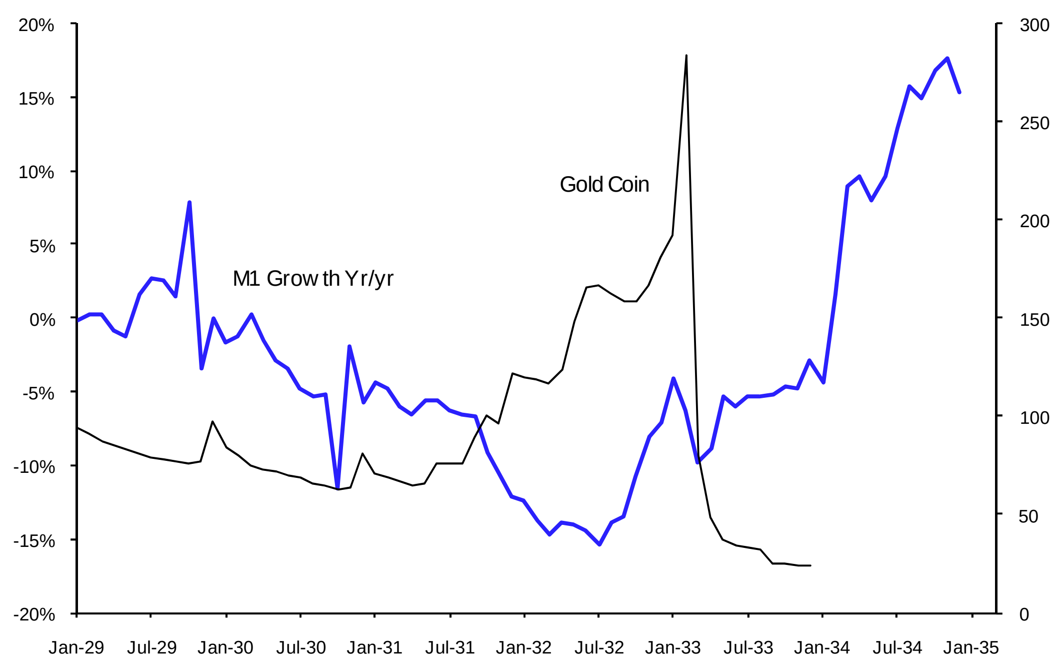
<u>Inflation</u>

Prior to 1933 the U.S. was on a true gold standard where gold coins, gold certificates and silver certificates actually circulated in the economy as money. A consequence of this monetary system was that the Federal Reserve had little power to control either bank reserves or interest rates, the primary tools by which the Fed executes monetary policy. Fed policy was reactive, not proactive, as so many experts argue today. As a result of the Smoot Hawley tariff and the 1932 tax increases, people literally panicked and increased their holdings of gold by converting fiat money and checking accounts into physical gold holdings.

Figure 2

**Gold Coin in Circulation Outside the Treasury and Federal Reserve Banks vs. M1 Money Growth Yr/yr**

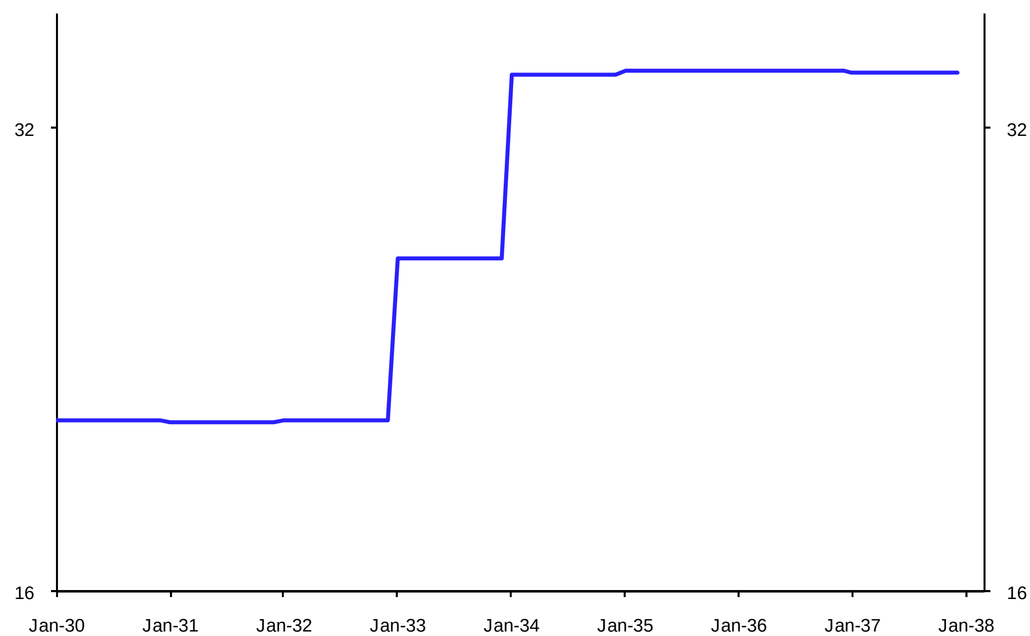
(monthly, seasonally adjusted, Jan-29 – Dec-34)



By mid 1932 there were public fears of a change in the gold-dollar relationship. Milton Friedman and Anna Schwartz wrote, "Fears of devaluation were widespread and the public's preference for gold was unmistakable."[1] Converting fiat money and checking accounts into gold caused the supply of money to contract, even though the monetary base continued to grow. Panic ensued (Figure 2 above).

Following this panic, in early 1933 the Federal government (not the Fed) declared a bank holiday, prohibiting banks from paying out gold or dealing in foreign exchange. An executive order made it illegal for anyone to "hoard" gold and forced everyone to turn in their gold and gold certificates to the government at an exchange value of $20.67 per ounce of gold in return for un-backed paper currency and bank deposits. All gold clauses in contracts private and public were declared null and void and by the end of January 1934 the price of gold, most of which had been confiscated by the government, was raised to $35 per ounce (Figure 3). In less than a year, the government confiscated as much gold as it could at $20.67 an ounce and then devalued the dollar in terms of gold by almost 60%. That's one helluva tax.

Figure 3
**Gold Spot Price $/Oz**
(monthly, semi-log, through Dec-37)




Friedman and Schwarz go on to write, "On February 23, 1933 Harrison told the directors of the New York Reserve Bank, 'There is little that foreigners can do to hurt our gold position,…the real danger comes from domestic sources…This movement represents something more than the hoarding of currency,…it represents in addition a distrust of the currency itself and it is inspired by talk of devaluation of the dollar and inflation of the currency.'"[2]

Following the devaluation of gold in early 1933, the monetary base proceeded to jump up substantially (Figure 4) as did stocks (Figure 5), which rallied nearly 100% in the subsequent three months.

[1] Milton Friedman and Anna Schwartz, "A Monetary History of the United States, 1867-1960," Princeton: *Princeton University Press,* 1963, pg. 350.
[2] *Ibid.*

Figure 4
**Monetary Base**
(monthly, semi-log, through Dec-37)

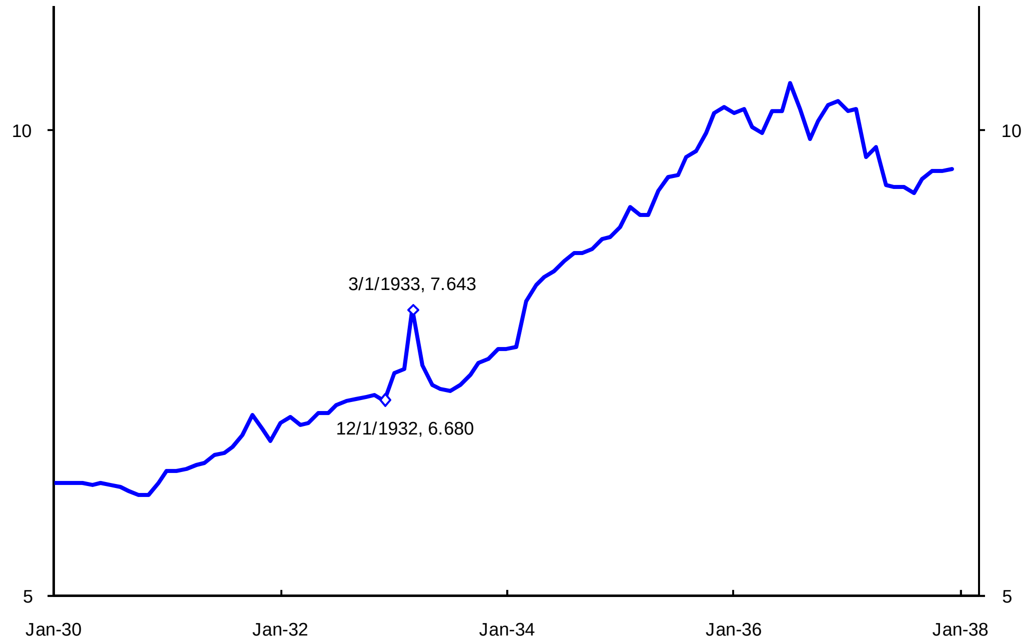
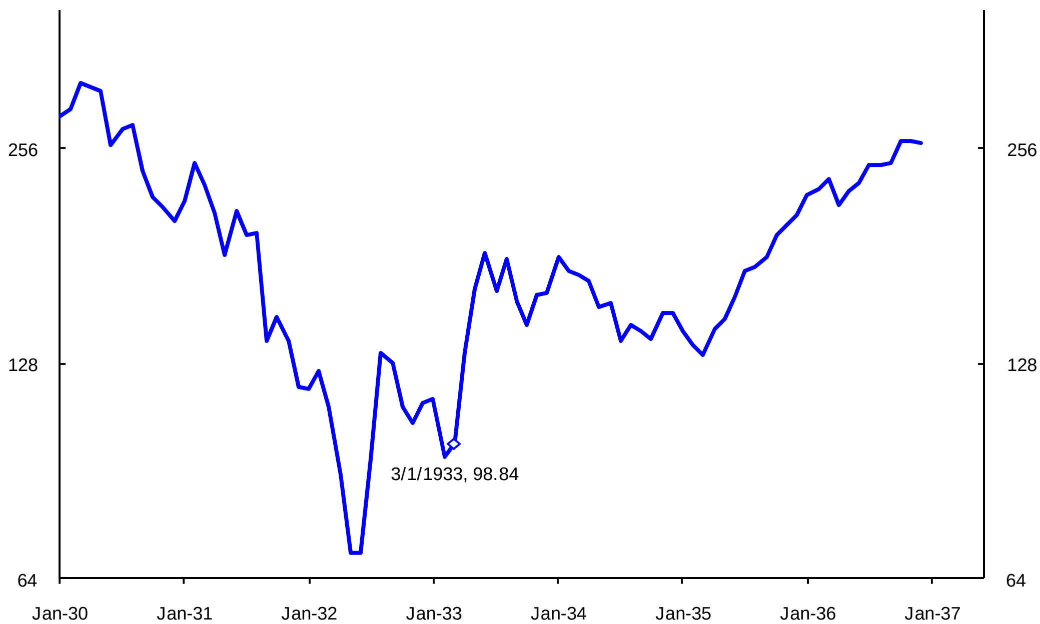



Figure 5
**Real S&P 500**
(monthly, semi-log, through Dec-37)




The increase in the demand for gold not only had the quantity effect mentioned above but it also put upward pressure on the price of gold. But since the price of gold was fixed at $20.67 an ounce, this meant that the prices of all goods and services had to fall for the relative price of gold to rise. Gold then as now is the first refuge of the cautious, only then the dollar price of gold couldn't rise as it can today.

If you look at the level of the Consumer Price Index there was a mild decline during the last half of the 1920s until early 1930. Thereafter, the price level tumbled until early 1933 just when the Administration declared a bank holiday, confiscated gold holdings and then devalued the dollar by almost 60%. From early 1933 until mid 1937 the CPI rose by about 15%. And that's the story.

Figure 5
**CPI Index Level**
(monthly, seasonally adjusted, Jan-25 – Dec-42)


The lessons here again are pretty straightforward. A country can experience inflation during a depression and that inflation is strictly a monetary phenomenon.

My hope is that those people who are running our economy look to the Great Depression as an object lesson. My fear is that they will mis-interpret the evidence and attribute high unemployment and the initial decline in prices to tight money, while increasing taxes to combat budget deficits.