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Aftershock to Economy Has a Precedent That Holds Lessons

By JAMES B. STEWART

Like earthquakes, financial crises seem to be accompanied by aftershocks, like the one we've been living through this week. They can feel every bit as bad as the crisis itself. But economic history and academic research suggest they can set the stage for a sustainable recovery — and eventual sharp stock market gains.

The events of the last few weeks — gridlock in Washington, brinksmanship over raising the debt ceiling, Standard & Poor's downgrade of long-term Treasuries, renewed fears about European debt and a dizzying plunge in the stock market — bear an intriguing resemblance to some of the events of 1937-38, the so-called recession within the Depression, with a major caveat: it was a lot worse back then. The Dow Jones industrial average dropped 49 percent from its peak in 1937. Manufacturing output fell by 37 percent, a steeper decline than in 1929-33. Unemployment, which had been slowly declining, to 14 percent from 25 percent, surged to 19 percent. Price declines led to deflation.

"The parallels to what is happening now are very strong," Robert McElvaine, author of "The Great Depression: America, 1929-1941" and a professor of history at Millsaps College, said this week. Then as now, policy makers were struggling with how and when to turn off the fiscal stimulus and monetary easing that had been used to combat the initial crisis.

Are we at similar risk today? David Bianco, chief investment strategist for Merrill Lynch Bank of America, told me this week that "the market is collapsing faster than any fundamentals would warrant." The possibility that the United States faces a recession as bad as 1937's seems far-fetched. Nonetheless, the risk of another recession has soared, by Mr. Bianco's estimate, to an 80 percent probability, one that would be worse than the 1991 recession. He noted that there had been only three instances when such a steep market decline was not followed by recession: 1966, 1987 (after the October stock market crash) and 1998 (after the implosion of Long Term Capital Management.) "Confidence is shaken and rapidly falling," he said, a problem worsened by falling stock prices.

By 1937 an economic recovery seemed to be in full swing, giving policy makers every reason to believe the economy was strong enough to withdraw government stimulus. Growth from 1933 to 1936 averaged a booming 9 percent a year (rivaling modern-day China's), albeit from a very low base. The federal debt had swelled to 40 percent of gross domestic product in 1936 (from 16 percent in 1929.). Faced with strident calls from both Republicans and members of his own party to balance the federal budget, President Franklin D. Roosevelt and Congress raised income taxes, levied a Social Security tax (which preceded by several years any payments of benefits) and slashed federal spending in an effort to balance the federal budget. Income-tax revenue grew by 66 percent between 1936 and 1937 and the marginal tax rate on incomes over $4,000 nearly doubled, to 11.6 percent from an average marginal rate of 6.4 percent. (The marginal tax rate on the rich — those making over $1 million — went to 75 percent, from 59 percent.)

The Federal Reserve did its part to throw the economy back into recession by tightening credit. Wholesale prices were rising in 1936, setting off inflation fears. There was concern that the Fed's accommodative monetary policies of the 1920s had led to asset speculation that precipitated the 1929 crash and ensuing Depression. The Fed responded by increasing banks' reserve requirements in several stages, leading to a drop in the money supply.

The possible causes of the ensuing stock market plunge and steep contraction in the economy provide

fodder for just about everyone in the current political debate. Republicans can point to the Roosevelt tax increases. Democrats have the spending reductions, which coincides with Mr. McElvaine's view. "It appears clear to me that the cause was policies put into effect in 1936-37, mainly cutting spending when F.D.R. believed his re-election was secured," he said.

The Nobel-prize winning economist Milton Friedman blamed the Fed and the contraction in the money supply in his epic "Monetary History of the U.S." And the stock market itself may have been a culprit, falling so steeply that it wiped out the wealth effect of rising prices, undermined confidence and brought back painful memories of the crash. But taken together, they suggest that policy makers moved too quickly to withdraw government support for the economy.

In the current context, it's hard to blame the Fed for being too restrictive in its monetary policy, as the Fed was in 1937. If anything, critics fault it for being too accommodating, raising many of the same issues that led the Fed to tighten in 1937. Ben S. Bernanke, the Fed chairman, is a student of Depression history and is well aware of Mr. Friedman's monetary analysis. "He won't make the same mistake," Jeremy Siegel, professor of finance at the Wharton School of the University of Pennsylvania, said.

The Fed's pledge this week to keep interest rates near zero not just for a vague "extended period" but for a full two years rendered two-year Treasuries virtually risk-free and depressed their yields to a record low of 0.19 percent. This should lead investors to seek income from riskier assets, leading to lower interest rates across the spectrum, including mortgage rates.

Despite a brief stock market rally after the Fed's announcement, Mr. Bianco said he believed investors might be underestimating the significance of the Fed's move. "You will see household funding costs go down. That will be a benefit and should boost confidence." At the least, "The Fed has not abandoned us. They're doing what they can," he said.

But monetary policy can do only so much, especially if fiscal policy is moving in the opposite direction.

Christina Romer, a professor at the University of California, Berkeley, who has written extensively about the Great Depression, declared two years ago while chairman of President Obama's Council of Economic Advisors: "The urge to declare victory and get back to normal after an economic crisis is strong. That urge needs to be resisted."

Yet both political parties have strapped themselves to the mast of deficit reduction, one through spending cuts, the other tax increases. The recent market plunge may reflect not the largely symbolic S. & P. downgrade of United States Treasuries or worries about political gridlock, but widespread investor fears that both approaches risk a renewed recession by withdrawing stimulus from a fragile economy too soon. No one seriously disagrees that the budget deficit has to be addressed, either through spending cuts or tax increases or in some combination of the two. The question is when.

The good news about the 1937-38 recession, severe though it was, is that it lasted just a year, from May 1937 to June 1938 by most calculations. The precipitous 1937 stock market decline and surging unemployment jolted Washington into action. The Fed reversed its higher bank reserves policy and cut the discount rate to 1 percent. In April, President Roosevelt announced a $2 billion "spend-lend" program and embraced deficit spending. But the tax increases remained in effect. Economic growth resumed in June 1938 and was stronger than it had been in the 1933-37 period. Stock prices surged.

Of course, history never repeats itself exactly, and unfortunately for today's policy makers, the causes of the 1938 economic rebound seem less clear than the causes of the recession. While Keynesians have embraced the Roosevelt stimulus package to support their arguments for government intervention, others argue it came too late and was too small to account for the recovery. A Federal Reserve Bank of Chicago senior economist, François Velde, concluded that while traditional monetary and fiscal analyses tended to account for the severity of the 1937 downturn, other still-unidentified factors are needed to explain why the economy "rebounded so strongly."

Still, the sense that Washington was doing something to address the problems may have played a key role by bolstering confidence, which was reinforced by rising stock prices.

Historians can’t know if the 1938 recovery, strong as it was, would have been enough to finally end the Great Depression. World War II intervened. But nothing today seems nearly as dire as the problems facing the world in 1938. The 1937 aftershocks had the effect of galvanizing policy makers who had grown complacent about the recovery. The result was renewed economic growth, higher employment, higher wages and productivity — and higher stock prices. Investors who had the courage to buy stocks at their 1937 lows were looking at a 60 percent gain less than a year later.

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