JOINT ECONOMIC COMMITTEE

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RESEARCH REPORT #110-27
October 2008

HOOVER'S LETHAL ECONOMIC POLICY MIX

The popping of the housing bubble, the subsequent increases in residential mortgage loan delinquency and foreclosure rates, and the recent failures of commercial and investment banks have prompted some Americans to suggest that current economic policies are similar to Herbert Hoover's.

To assess the validity of this assertion, one must first understand what Hoover's economic policies actually were. There is a widespread misconception that under Hoover the federal government remained idle as the economy contracted. In reality, Hoover aggressively pursued bad economic policies that transformed what could have been at worst a short recession into the worst depression in U.S. history.

Although Hoover did not understand banking, finance, and monetary policy, his success as an engineer, entrepreneur, and government official prior to his inauguration convinced him that he did not require economic advice. Hoover thought that he already knew everything that there was to know about economics. Hoover's arrogance proved disastrous. Hoover repeatedly ignored sound advice from prominent economists to pursue relentlessly bad economic policies based on his wrong-headed notions, his quirky morality, and his anti-bank, anti-Wall Street prejudices.

Monetary Causes of the 1920s Stock Market Bubble and its Popping. Ignoring the shift of wealth that had occurred during World War I, Chancellor of the Exchequer Winston Churchill mistakenly returned the British pound to the gold standard at its pre-war mint price in 1925. At their pre-war mint prices, the U.S. dollar was undervalued, and the British pound was overvalued, producing persistent U.S. current account surpluses and persistent British current account deficits.

The first Governor of the Federal Reserve Bank of New York Benjamin Strong, who had assumed *de facto* control of U.S. monetary policy until his death in October 1928, pressed the Federal Reserve to lower U.S. interest rates, even though the Federal Reserve should have increased interest rates to temper a booming U.S. economy. Strong thought that lower U.S. interest rates would help the Bank of England maintain the gold standard at its pre-war mint price by encouraging financial flows from the United States to the United Kingdom that would partially offset Britain's current account deficit and would therefore reduce Britain's gold outflows. Economists now blame Strong's inappropriate monetary policy for the stock market bubble in 1928 and the first eight months of 1929 and the reversal of this policy after his death for the popping of the stock bubble in October 1929.

From a high of 381.17 on September 3, 1929, the Dow Jones Industrial Average dropped to 298.17 on October 24, 1929 and plunged to 230.17 on October 29, 1929. Seeking villains to demonize, Hoover instinctively blamed the crash in share prices on speculators and their short sales. Hoover urged Congress to launch investigations into the speculators and then proceeded to make an unprecedented series of economic policy blunders.

Acquiescence in Monetary Contraction and Three Rounds of Bank Failures. Noble laureate Milton Friedman assigned the blame for the unprecedented economic collapse between August 1929 and March 1933 to the Federal Reserve's misguided policy of monetary contraction.[1] Hoover could have forced the Federal Reserve to change its policy. Prior to 1935, two of the seven members of the Federal Reserve Board, the Secretary of the Treasury and the Comptroller of the Currency, served at the pleasure of the president, while the remaining five members were presidential appointees with staggered ten-year terms.[2]

Unfortunately, Hoover and a majority of his appointees still subscribed to the spurious "real bills" doctrine of monetary policy[3] that British economist Walter Bagehot had discredited nearly a half-century earlier in *Lombard Street*.[4] Hoover dismissed numerous warnings from prominent economists such as Irving Fisher that the Federal Reserve should stop contracting the money supply. Moreover, Hoover's appointees repeatedly rejected the pleas of George Harrison, the Governor of the Federal Reserve Bank of New York, to reverse the monetary contraction.

The collapse of outward U.S. foreign investment in 1929 caused a large inflow of gold into the United States during the next two years.[5] Normally, gold inflows would have increased reserves, causing commercial banks to expand the money supply by increasing loans to firms and households. However, the Federal Reserve counteracted this monetary expansion by selling government bonds. Economist Richard H. Timberlake lamented, "The commercial banking system would have had $1.05 billion more in reserve assets for its own production of loans and deposits if the Federal Reserve had not existed."[6]

Moreover, the Federal Reserve abdicated its roles as lender of last resort. Instead of extending loans to troubled commercial banks to check runs and prevent financial contagion, the Federal Reserve largely shut its discount window. Through three rounds of bank failures in October 1930, March 1931, and March 1933, the Federal Reserve's loans to commercial banks fell from $1.29 billion in 1928 to $0.12 billion in 1933.

Rather than press the Federal Reserve to act as lender of last resort, Hoover established a new federal agency to perform this function. On January 22, 1932, Hoover signed a law creating the Reconstruction Finance Corporation (RFC) to lend to commercial banks, non-financial corporations, and state and local governments.[7] Given the bureaucratic hurdles in establishing a new agency, the RFC was still not fully functioning when Hoover left office in March 1933.

Corporatism. As Secretary of Commerce under both Harding and Coolidge, Hoover had explicitly rejected free market economic policies in favor of a form of corporatism that he called "associationalism." Applying the principles of scientific management originated by Frederick Taylor, Hoover sought to eliminate "wasteful" competition in key industries through price fixing and the division of markets among competing firms. Following the popping of the stock bubble, Hoover attempted to implement associationalism throughout the U.S. economy.

Believing that high wages were the cause rather than the result of American prosperity, Hoover pressed major corporations to maintain their existing levels of production, employment, and compensation. While these corporations attempted to fulfill their pledges to Hoover, weakening demand eventually forced these corporations to reduce their output, lay-off employees, and slash wages.

Protectionism. During World War I, President Woodrow Wilson appointed Herbert Hoover as Food Administrator. To feed both Allied armies and civilians in Europe, Hoover pressed U.S. farmers to bring marginal lands into production. However, Hoover did not have a postwar plan to take these marginal lands out of production. The combination of (1) global overproduction (as European farmers resumed normal production after the Armistice), (2) an increase in the availability of grain production for human consumption (as farmers substituted motorized equipment for draft animals), and (3) a reduction in demand (because of 20 million war-related deaths) caused agricultural commodity prices to collapse.

By 1928, Hoover realized that his actions as Food Administrator had contributed to a depression in the U.S. agricultural sector. Seeking some way to help farmers, Hoover pressed for higher tariffs on agricultural imports when Congress convened in December 1929. Despite an open letter in the *New York Times* signed by more than one thousand economists (including Irving Fisher, Frank Taussig, Paul Douglas, J. Lawrence Laughlin, and Clair Wilcox) urging a veto,[8] Hoover defiantly signed the *Smoot-Hawley Tariff Act* on June 17, 1930. This act raised U.S. tariff rates on dutiable imports to their highest level in history.

As these economists had predicted, other countries retaliated by raising their tariffs on U.S. exports. Consequently, world trade flows collapsed. U.S. goods imports declined from $5.3 billion in 1929 to just $1.7 billion in 1933, while U.S. goods exports fell from $4.4 billion in 1929 to a mere $1.5 billion in 1933.

Collapse of the International Financial System due to the Pursuit of Incompatible Policy Objectives. Free trade was one of the Fourteen Points that President Woodrow Wilson had offered as the basis for a peace settlement of World War I.[9] At the Paris Peace Conference, however, Wilson (1) sacrificed free trade and (2) acquiesced to vindictive reparations on Germany that were set at $33.4 billion[10] to (1) win approval for his proposal to create a League of Nations and (2) block a Japanese proposal to guarantee racial equality in all signatory countries.[11]

France, the United Kingdom, and other allies expected to repay the $10.4 billion that they had borrowed from the United States during the war with German reparations. To pay these reparations, Germany needed to increase its export earnings substantially above their pre-war level. For German exports to increase sufficiently, the United States and the allies needed to reduce their tariffs. Instead of lowering trade barriers, however, the United States boosted its tariffs in 1922,[12] and other countries retaliated by hiking their tariffs. With insufficient export earnings, Germany became dangerously dependent on investment and loans from the United States to pay reparations.

Hoover did not understand that protectionism, allied repayment of U.S. loans, and German reparations were incompatible policy objectives. As both Secretary of Commerce and President, Hoover saw these issues in moral terms rather than economic terms. On one hand, Hoover was willing to reduce German reparations to the allies because reparations violated his sense of forgiveness and generosity toward the vanquished Germans. On the other, Hoover was unwilling to forgive U.S. loans to the victorious allies because he thought that the allies were financially able and thus had a moral obligation to repay their loans.

After Germany failed to pay a scheduled payment in January 1923, Belgium and France occupied the industrial area of the Ruhr valley. A crisis ensued. France refused to reduce German reparations, while U.S. banks refused to extend new loans to Germany until France agreed to a reduction. U.S. Representative on the Allied Reparations Commission Charles Dawes proposed a plan that was adopted in August 1924. Under the Dawes plan, (1) Belgium and France evacuated their troops from the Ruhr valley; (2) Germany resumed reparations payments, but the amount was temporarily reduced; and (3) U.S. banks resumed making loans to Germany.

By the time Hoover was inaugurated on March 4, 1929, Germany could not meet its escalating reparations payments under the Dawes plan. U.S. Representative on the Allied Reparations Commission Owen D. Young proposed reducing German reparations. Adopted at the Hague Conference in January 1930, the Young plan (1) limited annual reparations payments to $473 million, two-thirds of which could be postponed, and (2) reduced total reparations payments from $33.4 billion to $26.3 billion.

Deteriorating economic conditions forced Germany to default in early 1931. In response, Hoover arranged a one-year moratorium that began in July 1931. At the Lausanne Conference in July 1932, representatives of allies and Germany finally agreed to a plan that would forgive German reparations if the United States would forgive its loans to the allies. Outraged by the loan forgiveness, Hoover denounced this plan as “a combination” against the American people. He scuttled the plan and refused to extend the moratorium. With Germany unable to pay further reparations, France defaulted on its U.S. loans. Consequently, the international financial system collapsed.[13]

Record Peacetime Increase in Spending. Hoover sought to put the unemployed back to work through federal outlays on public works projects (e.g., Hoover Dam). As a result, federal outlays rose from $3.3 billion (equal to 3.4 percent of GDP) in fiscal year 1930 to $4.6 billion (equal to 8.0 percent of GDP) in fiscal year 1933. As a percent of GDP, Hoover’s 4.6 percentage point jump in federal outlays was the largest peacetime increase in federal spending under any president in U.S. history. Indeed, federal outlays were only 2.7 percentage points of GDP higher in their peak fiscal year before the outbreak of World War II under Franklin D. Roosevelt.[14]

The pump-priming spending programs (e.g., Public Works Administration and Works Progress Administration) that Americans associate with Franklin D. Roosevelt’s New Deal were actually a politically clever repackaging of Hoover’s initiatives. During a moment of unusual candor in a 1974 interview, FDR’s economic adviser Rexford Tugwell admitted “practically the whole New Deal was extrapolated from programs Hoover started.”[15]

Higher Tax Rates. Immediately after the stock bubble popped, Hoover won approval for a one-year reduction in individual and corporate income tax rates for 1929. Individual rates were reduced from a range of 1.125 percent to 25 percent to a range of 0.375 percent on taxable income over $4,000 ($40,000 in 2000 dollars) to 24 percent on taxable income above $100,000 ($1,005,000 in 2000 dollars), while the corporate rate fell from 12 percent to 11 percent.

Prior the institution of withholding and estimated tax payments under the *Current Tax Payment Act* in 1943, federal taxes owed on income earned in one year were paid by taxpayers in quarterly installments during the following year (i.e., taxpayers paid federal taxes owed on income earned in 1929 in quarterly installments during 1930). Thus, the economic effects of Hoover's one-year rate reduction for 1929 were similar to a one-off tax rebate under the current tax system.

While Hoover's one-year reduction in income tax rates for 1929 improved the cash flow of households and firms in 1930, Hoover's reduction did not provide any stimulus to increase production and investment because households and firms could not retroactively change the economic decisions that they had made during 1929. At most, Hoover's one-year rate reduction for 1929 provided a modest boost to consumption in 1930.[16]

Collapsing tax revenues and Hoover's spending initiatives produced large federal budget deficits. The federal government moved from a surplus of $734 million (equal to 0.8 percent of GDP) in fiscal year 1930 to a deficit of $2.6 billion (equal to 4.5 percent of GDP) in fiscal year 1933.

Opposed to budget deficits largely on moral grounds, Hoover pressed Congress to enact the largest tax increase in U.S. history up to that time in a vain attempt to balance the budget. Once again, Hoover blithely disregarded warnings from his friend, John Maynard Keynes, and other prominent economists not to increase taxes.

The *Revenue Act of 1932* hiked individual income tax rates to a range of 4 percent on taxable incomes over $4,000 ($50,430 in 2000 dollars) to 63 percent on taxable income over $1,000,000 ($12,610,000 in 2000 dollars). The corporate tax rate rose from 12 percent to 15 percent. Estate tax rates jumped from a range of 1 percent to 20 percent to a range of 1 percent to 40 percent on taxable estates above $10,000,000 ($126,100,000 in 2000 dollars). The gift tax was re-instated, and depositors paid a two-cent excise tax on every check written.

Prior to passage, the Treasury estimated that the 1932 act would produce additional revenue of $1.1 billion. This estimate proved wildly optimistic. Instead, tax revenues actually rose only by $43 million from fiscal year 1932 to fiscal year 1933.

Conclusion. Hoover did not understand the monetary causes for the stock market bubble, its popping, and the subsequent contraction in U.S. output and prices. Nor did Hoover appreciate how international imbalances spread the worsening economic contraction around the world. Repeatedly ignoring the sound advice of prominent economists, Hoover actively pursued bad economic policies based on his wrong-headed notions, his quirky morality, and his anti-bank, anti-Wall Street prejudices that deepened and lengthened the Great Depression.

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[1] Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1967-1960* (Princeton, NJ: Princeton University Press, 1963).

[2] Among the remaining five members, Hoover appointed Eugene Meyer as Chairman in 1930 and Wayland Magee in 1931 and reappointed George Jones in 1931.

[3] The real bills doctrine of monetary policy holds that central banks should increase or decrease the money supply in proportion to the extension of short-term loans by commercial banks to non-financial firms that (1) are used to finance the production of goods and services and (2) are repaid from the sale of such goods and services. In the 19th century, these loans were known as "real bills," hence the name of this doctrine. The real bills doctrine is pro-cyclical, directing a central bank to expand the monetary supply during economic upswings and to contract it during downswings.

[4] Walter Bagehot, *Lombard Street: A Description of the Money Market* (Homewood, IL: R. D. Irwin, 1963 [1873]).

[5] The United Kingdom abandoned the gold standard on September 20, 1931. Other countries soon followed. By 1932, the fear that the United States would also abandon the gold standard caused the gold flow to reverse from an inflow to an outflow.

[6] Richard H. Timberlake, *Monetary Policy in the United States: An Intellectual History* (Chicago: University of Chicago Press, 1993), 226.

[7] Ironically, Federal Reserve Chairman Eugene Meyer, who had presided over the Federal Reserve's failure to perform its lender of last resort function, urged Hoover to sign the bill establishing the RFC as an alternative lender of last resort. Had Meyer directed the Federal Reserve to perform the lender of last resort function for

which it had been established, the RFC would have been superfluous.

[8] "1,028 Economists Ask Hoover To Veto Pending Tariff Bill," *The New York Times* (May 4, 1930), 1. Found at: http://www.clubforgrowth.org/media/uploads/smooth%20hawley%20ny%20times%2005%2005%2030.pdf .

[9] "III. The removal, so far as possible, of all economic barriers and the establishment of an equality of trade conditions among all the nations consenting to the peace and associating themselves for its maintenance." Woodrow Wilson, *Address to a Joint Session of Congress*, 65th Cong., 2nd sess. (January 8, 1918). For text, see: http://www.yale.edu/lawweb/avalon/wilson14.htm.

[10] This amount was fixed by the Allied Reparations Commission in 1921.

[11] If Japan had prevailed, the *Treaty of Versailles* would have effectively outlawed the policy of racial segregation that Wilson had promoted in the United States.

[12] On September 21, 1922, Harding signed the *Fordney-McCumber Tariff Act*, which boosted the average tariff rate on dutiable imports from 27 percent to 38.5 percent.

[13] Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York: Grove Press, 2001), 350-351.

[14] Federal outlays were $6.5 billion (equal to 10.7 percent of GDP) in fiscal year 1934. Federal outlays remained at or below 10.7 percent of GDP through fiscal year 1940.

[15] See: http://www.pbs.org/wgbh/amex/goldengate/sfeature/sf_30s.html .

[16] Prior to 1943, an income tax rate reduction would have had to have been in effect for at least two years to have an incentive effect on production and investment.